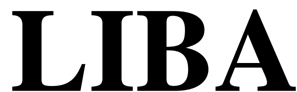

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1 September 2009

International Accounting Standards Board
30 Cannon Street
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Submitted via the "Open to Comment" page at www.iasb.org

Dear Sirs

Request for Information ('Expected Loss Model') Impairment of Financial Assets: Expected Cash Flow Approach

Following our meeting with IASB staff on 25 August, I am writing on behalf of LIBA (the London Investment Banking Association) to comment on the Request for Information ('Expected Loss Model') Impairment of Financial Assets: Expected Cash Flow Approach (the "RfI"). LIBA is, as you know, the principal UK trade association for firms active in investment banking and securities trading; a list of our members is attached.

Measurement of financial assets held on an amortised cost basis is a key issue for many of our members, particularly those who hold significant portfolios of purchased and/or originated loans or other assets. Any changes to the present model are therefore highly significant to these members.

The current approach has been subject to much discussion and debate as a result of the current crisis, with particular focus from regulators. While welcoming the IASB's involvement and leadership in the issue, some of our members believe it is important to clarify that this involvement is only for the purposes of improving financial reporting, and that any regulatory concerns should be tackled by the regulators; they believe the IASB should, in particular, make it clear that their objective is not driven by the intention to introduce counter-measures to any pro-cyclicality.

Our members hold a number of different views on the most appropriate impairment model for financial assets. Some believe that a model based on expected losses is conceptually the right approach, as it ensures that losses are recognised in a timely manner and reflects the way that loans and other financial assets are managed. Others, however, do not accept that such a model would meet the objectives of financial reporting, believing that the subjectivity and

complexity inherent in this approach will inevitably cause the results to lack reliability and transparency; these members also have concerns that, even with extensive disclosure of assumptions, the results would not be readily understandable, or comparable between entities.

Not withstanding the varied opinions on the conceptual merits of an expected loss model, the majority of our members see material practical difficulties in the model put forward by the IASB staff. Specifically, there is significant concern over the quantity of data required to implement such a model, which is far in excess of the data required for calculating expected losses under the Basel regime. Members are also concerned that such a model would require multiple data sets to be run in parallel for the same loan. For example, reported interest income would bear no resemblance to actual cash payments and receipts, and the accounting data would therefore need to be maintained separately from the operational data required for cash processing. Such a model would also require estimates of the timing and amount of all future cash flows for financial assets, as opposed to expected future losses of principal, which is what many institutions use to manage assets today.

Some members are also concerned that the proposed approach would result in the initially expected credit losses being reported as a reduction of interest income; they believe this would result in interest income and impairment charges that users would not understand, and that there would also be a knock-on impact to commonly used credit statistics.

Our responses to the specific questions in paragraph 11 of the RfI are set out below.

Question 1 - Is the approach defined clearly? If not, what additional guidance is needed, and why?

We believe the principles behind the suggested approach need more clarification and depth of explanation before it could be successfully implemented. However, we would not support the inclusion of prescriptive rules dictating specifically how the principles in any impairment model should be applied.

Specifically, we believe further clarification is needed on the following points before the suggested model can be properly evaluated:

? It appears that transition is intended to be prospective; we hope this interpretation is correct as we believe retrospective application would be unduly complex and of no value.

? Given the inherent subjectivity of the proposed model, we believe that disclosures around how a reporting entity has calculated its impairment charge, including the key assumptions, are key to ensuring transparency and comparability. However, we would not support a disclosure regime that would lead to firms being required to run both an expected loss model and an incurred loss model: this would represent a significant operational burden and we doubt whether it would provide sufficient decision-useful information to be of significant benefit to users.

? Whilst we welcome the issuance of examples on the application of the principles to variable rate instruments, we would like clarification that such examples are intended to be indicative of different acceptable approaches rather than being prescriptive as to the single required approach.

A number of our members are concerned with the result of the model that credit losses that are initially expected are reported as a reduction of interest over the life of the facility.

Question 2 - Is the approach operational (i.e. capable of being applied without undue cost)? Why or why not? If not, how would you make it operational?

We believe application of the suggested approach will require many of our members to incur substantial additional costs and resources. The model is a significant move from the current incurred loss models and has materially different data requirements. For example, when future losses are considered for regulatory purposes it is generally only with a one-year time horizon; the new approach will require forecasting losses for the entire life of the loan.

The RfI appears to use the terms "expected losses" and "expected cash flows" interchangeably to explain the proposed approach, but these terms have different meanings in practice and so some clarification is needed: an expected loss approach is one that estimates principal losses over the time horizon based on the visibility of inputs, while an expected cash flow approach is based on the estimation of the timing and amount of all cash flows over the life of an instrument. We understand the proposal is to use an expected <u>cash flow</u> approach as described above, but this point needs to be clarified.

Most members are very concerned about the operationality of a true expected cash flow approach. Specifically, they are concerned that systems and processes will need to be significantly amended to estimate the timing and amount of all cash flows for loans as opposed to just principle losses. Such changes would be likely to take years to implement (see also our response to Question 3 below).

Concerns have also been raised over the need to pool loans for the purposes of calculating the impairment charge. It seems likely that a large number of pools would be required and members are concerned about their ability to set up, monitor and track this population of asset pools as well as reconcile them back to the loan level data maintained for business purposes. Our members also believe it will not be practical to calculate impairment charges on consumer facilities at the loan level given the large number of loans that exist.

Other members are also concerned about the reliability of the estimates required to estimate all cash flows over the life of longer term financial assets such as mortgages, as the visibility of the relevant inputs is significantly shorter than the maturity of such instruments. The development of suitable controls and review procedures to manage the exercise of such judgement will also be a significant challenge.

Question 3 - What magnitude of costs would you incur to apply this approach, both for initial implementation and on an ongoing basis? What is the likely extent of system and other procedural changes that would be required to implement the approach as specified? If proposals are made, what is the required lead time to implement such an approach?

The magnitude of costs and need for system and procedural changes varies between firms but is likely to be considerable for most of our members: some have suggested that developing the processes and systems required to implement an expected cash flow approach would take at least two years from the point where the detailed specifications are available.

Question 4 - How would you apply the approach to variable rate instruments, and why? See the Appendix for a discussion of alternative ways in which an entity might apply the expected cash flow approach to variable rate instruments.

Our members currently apply a variety of approaches to the measurement of variable rate interests. However the majority apply the "catch-up" approach as described in Approach B. Currently the catch-up relates mainly to changes in effective rate and is rarely significant, so this method is viewed as a practical expedient.

If the expected cash flow approach was introduced the impact is likely to be more significant, but we do not yet have a consensus view on how best to approach this.

Question 5 - How would you apply the approach if a portfolio of financial assets was previously assessed for impairment on a collective basis and subsequently a loss is identified on specific assets within that portfolio? In particular, do you believe:

(a) changing from a collective to an individual assessment should be required? If so, why and how would you effect that change?

(b) a collective approach should continue to be used for those assets (for which losses have been identified)? Why or why not?

Our members believe that either approach could be used and would depend upon the systems and data available. Given the need for constant reassessment the results of either approach should be consistent.

Question 6 - What simplifications to the approach should be considered to address implementation issues? What issues would your suggested simplifications address, and how would they be consistent with, or approximate to, the expected cash flow model as described?

One of the more complicated features of the proposed model is the need for constant reassessment of the expected losses. Some members have suggested that the operational burden would be reduced if this requirement were relaxed so that expected losses would be included on initial recognition, but incurred losses included only on an ongoing basis. (Those who reject the incurred loss model would obviously not support this approach).

The model suffers from difficulties in estimating both the magnitude and timing of the expected cash flows. Some members have suggested the following simplification might help to overcome these challenges, using a loan carried at amortised costs as an example:

i) At inception the loan is recorded at its nominal value or transaction price;
ii) An effective interest rate (EIR) is then calculated on the basis of expected credit losses; expected losses are determined through comparing contractual and expected cash flows.
iii) Over the life of the loan, the excess of interest received over interest accrued in the P&L through the EIR is accumulated in a portfolio provision.
iv) When a credit loss is incurred on the loan, the related impairment is recorded against the portfolio provision.

v) The adequacy of the expected credit loss included in the EIR is periodically reviewed through re-assessment of expected credit losses. Any adjustment gives rise to a portfolio provision addition or reduction through the P&L.

vi) A breakdown of movements in the portfolio provision is disclosed to the users of the financial statements.

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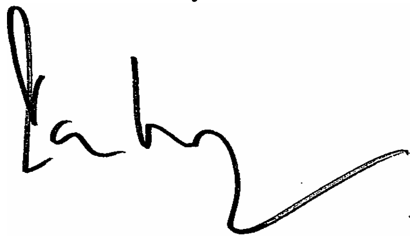
I hope these comments are helpful. We would of course be pleased to expand on any points which you may find unclear, or where you would like further details of our views. We would also, as indicated at our recent meeting with IASB staff, be pleased to discuss the practicalities of implementation of any variants of the present proposals that might be put forward in a forthcoming Exposure Draft.

Yours sincerely



Ian Harrison
Director

LONDON INVESTMENT BANKING ASSOCIATION

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