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14 April 2011

International Accounting Standards Board
30 Cannon Street
London
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United Kingdom

Our Ref: 2011/JE/TCSC1/IASB/60

RE: Supplementary Document on *Financial Instruments: Impairment*

Dear IASB Members:

The International Organization of Securities Commissions Standing Committee No. 1 on Multinational Disclosure and Accounting (Standing Committee No. 1) thanks you for the opportunity to provide our comments regarding the International Accounting Standards Board (IASB or the Board) Supplementary Document on *Financial Instruments: Impairment* (the Supplementary Document).

IOSCO is committed to promoting the integrity of international markets through promotion of high quality accounting standards, including rigorous application and enforcement. Members of Standing Committee No. 1 seek to further IOSCO's mission through thoughtful consideration of accounting and disclosure concerns and pursuit of improved transparency of global financial reporting. The comments we have provided herein reflect a general consensus among the members of Standing Committee No. 1 and are not intended to include all of the comments that might be provided by individual securities regulator members on behalf of their respective jurisdictions.

We have organized our letter in two sections. The first provides some general observations regarding the Board's proposal and the second answers selected questions from the Supplementary Document's Invitation to Comment.

General Observations

Project Objective

We continue to support the development of a financial asset impairment approach that incorporates more forward-looking information about credit losses into the amortized cost model than does the incurred loss model. We agree with the direction that the Board has taken to find a more operational approach. In assessing whether the impairment proposal described in the Supplementary Document will provide users with the most decision-useful information, we considered trade-offs between:

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- An approach based on how an entity manages credit risk, which could be difficult to verify and may not provide users with comparable information, and an approach with more objective criteria that may not result in financial reporting that reflects an entity's best estimate of future losses; and

- An approach that includes multiple steps to try to best capture the economics, but adds to the complexity of the model, and a simplified approach that is more understandable but may not accurately reflect the economics of lending.

Considering the trade-offs, we favor an impairment approach that has objective criteria that can provide users with decision-useful information regarding credit loss expectations. We think the model should:

- Reflect that the pricing of a loan (i.e., interest rate spread) captures loss expectations, but also reflect that expectations change over time based on events that have already happened and events expected to happen in the future. We view the time-proportionate calculation as a reasonable mechanism to allocate in an approximate manner originally expected credit losses over the expected life.

- Accelerate (relative to a straight-line time proportionate method) the timing of credit loss recognition for loans that have observable credit deterioration. We believe the "bad book" concept could be used to meet this objective.

- Include in the impairment model a mechanism for capturing the expected loss recognition pattern, so that losses are appropriately recognized for loans that have not yet but are expected in the near term to experience credit deterioration. We believe an approach based on the higher of the time-proportionate expected losses and losses expected in the near-term could accomplish this objective.

We understand that the Boards started their redeliberative process by first addressing recognition of credit impairment for open portfolios, given the operational complexities involved. We find it difficult to conclude on the merits of the Supplementary Document proposal without having a better understanding of how the proposed open portfolio approach will fit in with the Boards' anticipated overall impairment model. Further work on impairment recognition for closed portfolios, single instruments and purchased credit impaired financial assets, along with further development of interest revenue recognition more generally, are needed for Standing Committee No.1 to fully evaluate the Supplementary Document proposal.

We note that the Supplementary Document includes a description of further outreach planned by the Board and the Financial Accounting Standards Board (the Boards). We believe consideration of the information gathered from reporting entities about how concepts such as "good book" versus "bad book" and the "foreseeable future period" will be applied, as well as feedback gathered from users on the decision usefulness of the resulting financial reporting is essential before finalization of an impairment standard.

We understand that moving to a more forward-looking impairment model will increase the importance of subjective estimates, and believe that adequate disclosures that provide users with sufficient information about the assumptions and models that underlie those estimates are crucial.

Convergence

We are very supportive of the efforts taken by the Boards to develop a common approach to financial asset impairment recognition. We understand that during individual board deliberations each board has focused on separate primary objectives for improving impairment accounting. We are encouraged by the efforts to combine the objective of reflecting the economic relationship between interest revenue and expected credit losses with the goal of ensuring the allowance balance is sufficient to cover expected credit losses before they are evident. We believe that it is important that the combined efforts result in a high quality improved financial instrument standard.

Responses to the Board's Questions in its Invitation to Comment

Question 1
Do you believe the approach for recognition of impairment described in this supplementary document deals with this weakness (ie delayed recognition of expected credit losses)? If not, how do you believe the proposed model should be revised and why?

We agree that delayed recognition of expected credit losses is a weakness that is important to address, and that application of the proposed approach should result in earlier recognition of expected credit losses. While we are supportive of earlier recognition, we are apprehensive about an approach that could front end the recognition of a majority of expected losses such that the timing of loss recognition is not consistent with the economics of a lending transaction. We question whether the foreseeable future period as described in the Supplementary Document could be interpreted in such a way that the majority of expected losses would be recognized immediately when a loan is first originated, even when the pricing of the loan appropriately factored in those expected losses.

Question 2
Although the supplementary document seeks views on whether the proposed approach is suitable for open portfolios, the boards welcome any comments on its suitability for single assets and closed portfolios and also comments on how important it is to have a single impairment approach for all relevant financial assets.

Some members believe that the impairment proposal included in the exposure draft that the IASB published in November 2009 has conceptual advantages over the proposal in the Supplementary Document for both open and closed portfolios, because it more closely reflects the economics of lending. These members believe that if the IASB's original proposal can be operational for single instruments and closed portfolios, the approach should be applied at least for these instruments when practicable.

Other members believe that the principles underlying the timing and estimation of credit losses recognized in profit and loss should be consistent for all financial assets. These members are concerned that unless it can be demonstrated that the results of the approach included in the Supplementary Document approximate the original proposal, then having the two different approaches could result in significantly different reporting based on whether information is gathered on an open or closed portfolio basis. These members expect that the open portfolio approach will be the most commonly applied, and therefore having similar principles underlying the accounting for closed portfolios and single instruments as for open portfolios will yield significant comparability benefits.

Question 3
Do you agree that for financial assets in the 'good book' it is appropriate to recognise the impairment allowance using the approach described above? Why or why not?

Question 5
Would the proposed approach provide information that is useful for decision-making? If not, how would you modify the proposal?

We agree with the concept of allocating over time credit losses that had been appropriately factored into the pricing of a financial asset (i.e., loan). We understand the operational challenges for an open portfolio of distinguishing between originally expected credit losses and changes in credit loss expectations. We believe that using an allocation mechanism to recognise a portion of expected losses for a "good book" of loans is a reasonable approach to reflecting the economics of a lending relationship in a more practical manner.

Question 6
Is the requirement to differentiate between the two groups (ie 'good book' and 'bad book') for the purpose of determining the impairment allowance clearly described? If not, how could it be described more clearly?

Question 8
Do you agree with the proposed requirement to differentiate between the two groups (ie 'good book' and 'bad book') for the purpose of determining the impairment allowance? If not, what requirement would you propose and why?

We agree that it makes sense for certain instruments to recognize all future expected credit losses immediately in profit and loss, while for others an allocation approach better reflects the economics. We think it is important that the principle for distinguishing between a good book (partial recognition of expected losses via an allocation approach) and a bad book (full recognition of expected credit losses) should be based on an objective framework that can be consistently applied.

We support moving to a full expected credit loss recognition principle that is based on when an entity expects a collection deficiency or shortfall for an identified financial asset. Although we expect that an entity's credit risk management would change when credit problems develop, we believe that the principle for full expected loss recognition should be linked to the timing of identification of credit problems, instead of being linked to changes in an entity's credit risk management. Based on the Supplementary Document's description of the principle for determining whether a financial asset has become part of the bad book, we are concerned that an entity that is slow to change its credit risk management techniques will recognize less credit allowance for an economically similar loan than an entity that has more proactive credit risk management procedures.

Question 9
The boards are seeking comment with respect to the minimum allowance amount (floor) that would be required under this model. Specifically, on the following issues:
(a) Do you agree with the proposal to require a floor for the impairment allowance related to the 'good book'? Why or why not?
(b) Alternatively, do you believe that an entity should be required to invoke a floor for the impairment allowance related to the 'good book' only in circumstances in which there is evidence of an early loss pattern?
(c) If you agree with a proposed minimum allowance amount, do you further agree that it should be determined on the basis of losses expected to occur within the foreseeable future (and no less than twelve months)? Why or why not? If you disagree, how would you prefer the minimum allowance to be determined and why?
(d) For the foreseeable future, would the period considered in developing the expected loss estimate change on the basis of changes in economic conditions?
(e) Do you believe that the foreseeable future period (for purposes of a credit impairment model) is typically a period greater than twelve months? Why or why not? Please provide data to support your response, including details of particular portfolios for which you believe this will be the case.
(f) If you agree that the foreseeable future is typically a period greater than twelve months, in order to facilitate comparability, do you believe that a 'ceiling' should be established for determining the amount of credit impairment to be recognised under the 'floor' requirement (for example, no more than three years after an entity's reporting date)? If so, please provide data and/or reasons to support your response.

We agree with the concept of accelerating the timing of loss recognition when a higher proportion of credit losses are expected to be concentrated in the nearer term. We believe that for an open portfolio the determination of which is higher, the time-proportionate amount of remaining expected credit losses or credit losses for the foreseeable future period could change over time. We think adding tests for determining when there should be a computation of a floor could add to complexity, and likely not provide more decision-useful information.

Similar to our thoughts regarding the principle for determining full credit loss recognition, we believe that the principle underlying the amount of credit loss measured under the floor should be based on an objective framework that can be consistently applied. We are unsure whether clear enough principles can be articulated that explain how entities should distinguish between periods for which reasonably specific projections can and cannot be made. We are concerned that linking the floor to the ability to make specific projections will result in significant variances in the period of time covered by the floor based on the level of sophistication of the reporting entity. Additionally, we think that as economic conditions change, the foreseeable future period will change as a result of estimates becoming more or less difficult. We believe a floor would be most decision useful if it is comparable between entities and consistent over time. We think the Boards should consider a floor that is based on a 12-month period, which will also limit day-one loss recognition.

In addition to having a period of time covered by the floor that can be consistently applied, we also think there should be clarification on what it means for a loss to "occur" within that period of time. We are concerned that there could be diversity around what it means for a loss to "occur". For example, some may assume "occurred" losses are similar to losses that are "incurred" pursuant to IAS 39, while others may interpret "occur" in a different manner.

Question 11
The boards are seeking comment with respect to the flexibility related to using discounted amounts. Specifically, on the following issues:
(a) Do you agree with the flexibility permitted to use either a discounted or undiscounted estimate when applying the approach described in paragraph B8(a)? Why or why not?
(b) Do you agree with permitting flexibility in the selection of a discount rate when using a discounted expected loss amount? Why or why not?

We believe that providing flexibility about whether to discount or not discount, whether to use an annuity or straight-line approach, and what discount rate to use, is not appropriate. This level of accounting choice will reduce comparability. We agree with the concept of incorporating time value into the financial asset credit impairment model. We support the Boards' pursuit of time value principles that can be operational and result in a reasonable level of comparability. We think the effective interest rate used to recognize interest income could be an appropriate discount rate.

Question 14Z
Do you agree that the determination of the effective interest rate should be separate from the consideration of expected losses, as opposed to the original IASB proposal, which incorporated expected credit losses in the calculation of the effective interest rate? Why or why not?

We see the conceptual merit of the original IASB proposal, but understand the decision to decouple the effective interest rate calculation from consideration of expected losses.

Question 15Z
Should all loan commitments that are not accounted for at fair value through profit or loss (whether within the scope of IAS 39 and IFRS 9 or IAS 37) be subject to the impairment requirements proposed in the supplementary document? Why or why not?

We note that the Supplementary Document provides limited analysis of the implications of using the same loan impairment recognition model for loan commitments. On a high-level basis, we believe having one model that covers drawn and undrawn loans makes sense. We believe further work should be done by the Boards to consider the impact of using this impairment approach to recognize credit losses for loan commitments. For example, we note that for loans, recognition of expected credit losses on a time-proportionate basis is generally consistent with the recognition pattern of interest income, but for loan commitments not in the scope of IAS 39 and for which a lending arrangement is probable, in accordance with IAS 18 illustrative example 14 (a) (ii), recognition of commitment fees does not begin until the loan is funded.

Question 17Z
Do you agree with the proposed presentation requirements? If not, what presentation would you prefer instead and why?

We agree with separate presentation of interest income and impairment losses.

Question 18Z
(a) Do you agree with the proposed disclosure requirements? If not, which disclosure requirements do you disagree with and why?
(b) What other disclosures would you prefer (whether in addition to or instead of the proposed disclosures) for the proposed impairment model and why?

We believe the proposed impairment model introduces greater subjectivity into credit loss recognition. Given the level of judgment involved, we think it is important for the qualitative disclosure objectives to be supplemented by specific minimum quantitative disclosures. For example, if as proposed the foreseeable future period used for the floor is based on an entity's ability to make reasonable projections, we believe that, at a minimum, the entity should be required to disclose each period what time period (how many months) was included in its floor calculation. Inputs and assumptions used to determine expected credit losses is another area in which we believe more specific quantitative disclosures should be incorporated. For example, if an entity uses average loss rates over a specific period of time and then makes adjustments to those loss rates, the entity should disclose the quantitative historical loss rate used as a starting point and the specific data used to adjust the historical loss rates, such as forecasted changes in particular economic conditions.

Another area in which we are concerned that the level of disclosure will not provide adequate insight into the impact of the judgments used is the determination of the bad book. We note that paragraph Z15 of the Supplementary Document requires an entity to disclose a qualitative analysis that describes the criteria used to distinguish between the "good" and "bad" books. We believe disclosure of any specific quantitative criteria used, such as a certain number of days past due, should also be required. Additionally, we think it is important that entities be required to disclose the specifics of any changes made to the criteria used to distinguish between the "good" and "bad" books, why those changes were made, as well as the quantitative impact of those changes. Similarly we think these types of disclosures should be required for changes in methods used to determine time-proportionate amounts, the foreseeable future period or to estimate or measure expected credit losses.

Question 19Z
Do you agree with the proposal to transfer an amount of the related allowance reflecting the age of the financial asset when transferring financial assets between the two groups? Why or why not? If not, would you instead prefer to transfer all or none of the expected credit loss of the financial asset?

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We agree with the proposal to transfer out of the good book an amount of the related allowance reflecting the age of the financial asset that has become part of the bad book.

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We appreciate your thoughtful consideration of the comments raised in this letter. If you have any questions or need additional information on the recommendations and comments that we have provided, please do not hesitate to contact me at 202-551-5300.

Sincerely,

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