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Dear Martin

Request for Information *Impairment of Financial Assets: Expected Cash Flow Approach*

This letter sets out the comments of the UK Accounting Standards Board (ASB) on the above Request for Information (RfI).

The ASB welcomes the IASB's decision to consider and investigate alternatives to the incurred loss approach to impairment of financial assets. We believe that this decision will ensure that a debate can take place on the relative merits of the various models before the most suitable model is adopted.

Although the RfI focuses on the feasibility of the expected cash flow approach and states that views on the relative merits of alternative impairment approaches are not requested, we do not believe that one can be discussed without reference to the other. In fact, paragraph 5 of the RfI does exactly that by listing the criticisms levelled at the incurred loss approach which leads the IASB to explore the expected cash flow approach. As such, the ASB would like to take this opportunity to summarise some concerns it has with the proposed approach in the RfI which we believe need to be taken into account before any proposals on impairment losses are made by the IASB. These include:

The model requires credit losses to be estimated and included in the effective interest rate (EIR) at initial recognition as well as being updated on an ongoing basis. This will require reporting entities to assess the probability of credit losses for the duration of the loan. On assets where no relevant market data is available, entities would be required to estimate the probable losses. If entities do not have historical records on the probability of credit losses for a particular asset the resulting data is likely to be subjective and open to manipulation. This issue is particularly important for one-off large loans. It may also be an issue for receivables held by corporate entities within the scope of these requirements if a portfolio level assessment is not permitted.

Our constituents will be reporting to you directly on this matter however, we understand they believe that the complexity inherent in this model and the impact on reporting is significant. If that is the case we are not convinced that the benefit achieved, in terms of the exact accuracy of the number on the balance sheet date, justify the level of complexity involved in the calculation.

If you would like to discuss these comments, please contact Seema Jamil-O'Neill on 020 7492 2422 or myself on 020 7492 2434.

Yours sincerely

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Appendix: Responses specific questions

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

1. The information on the expected loss model in the IASB's RfI and the accompanying staff papers are fairly high level so that some crucial details are missing. These include:

Lack of historical data and subjectivity of information on impairments

2. The model requires credit losses to be estimated and included in the effective interest rate (EIR) at initial recognition as well as being updated on an ongoing basis. This will require reporting entities to assess the probability of credit losses for the duration of the loan. On assets where no relevant market data is available, entities would be required to estimate the probable losses. We are unclear as to how the model will deal with financial assets where historical data on credit losses, often used to estimate future data, is unavailable. If the aim is for entities to use models to simulate a proxy then in our view the information generated on impairments will be highly subjective and subject to misrepresentation. Our understanding is that amongst others this is likely to be a problem for: insurance companies that manage portfolios of assets and therefore tend not to have information on individual basis; and receivables held by corporate entities where loans are not managed on an expected loss basis.

3. Furthermore, it is unclear how the difference between EIR based on credit history obtained from the market and that based on internally generated information will be highlighted to the investor. We can only infer that this implies further disclosures in the financial statements along the lines of the current disclosures on fair value hierarchy and the assumptions used in models will be required in relation to financial assets at amortised cost.

Impact on Portfolios

4. It is unclear from the material provided how impairment calculations will differ on revolving credit portfolios. These portfolios tend to contain short-term financial assets that may be replaced on a regular basis. If expected losses are calculated on the basis of the average age or some similar number it would entail including estimates for financial assets that may not be included in the portfolio at the outset or at the date of reporting.

5. Similarly, it is unclear how the effects of correlation will be reported in the EIR. The levels of correlation between individual credits within a portfolio can have a direct impact on the actual levels of credit losses. A portfolio of loans where all the loans are to customers in a town dominated by a steel mill is highly internally correlated. This is because most customers' ability to

repay the loan is particularly sensitive to the closure of the steel mill. Although, this information may be being collated and considered by other risk functions within the bank it is not that straightforward to convert this into information that would be relevant for accounting purposes. Furthermore, any uncertainties in these calculations will be imported into the expected loss calculations.

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

6. Our understanding is that the cost of initial implementation is likely to be substantial for certain types of entities, e.g. banks and insurance companies. This would become a particular problem where entities do not have historical data on credit losses at the level the IASB appears to be stipulating in the RfI i.e. at the individual loan/ receivable level where entities manage them on a portfolio basis.

7. Additionally, subsequent monitoring and reporting of the financial assets at amortised cost would require more review time to perform the regular updates to the EIR required to reflect the differences between the expected and actual impairments.

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?

8. We do not have any direct information on the level of costs for our constituents in applying these requirements. However, our understanding is that for multi-national financial institutions, both banks and insurance companies, the costs of initial implementation as well as ongoing costs are likely to be significant and comparable to the initial implementation of IAS 39.

9. Similarly, the systems changes are also likely to be significant requiring extensive costs as well as lead times to implement consistently. We have been informed by some constituents that the estimates provided to the IASB by BNP Paribas in their June presentation are fairly close to the actual likely costs and lead times.

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.

10. We are unable to see any technical superiority between the two approaches to amortisation of upfront costs for variable rate instruments. However, as

Approach A (use the initially determined amortisation pattern over the life of the transaction) would be easier to implement and is likely to be closer to the profile of the upfront fees, which are fixed at the outset.

11. In terms of the approach to impairment of variable interest rate instruments we would not support Approach A as it is highly complex in nature, and so will be difficult to explain to users of the financial statements, as well as likely to be costly to implement for preparers.

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?

12. We believe that a collective (portfolio) approach should be permitted for assets which are managed on a portfolio basis and have similar credit characteristics. An expected loss approach is essentially a portfolio basis of assessment as it is easier to identify for a large portfolio of receivable or other financial assets, with similar credit characteristics, what percentage would incur losses than it is to assess whether an individual financial asset would incur losses.

13. We understand that impaired assets are removed from a portfolio of performing assets in practice. We do not believe an eventual standard on this should prescribe when entities remove impaired financial assets from portfolios.

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?

14. This question implies minor tweaks in the approach as currently set out in the RfI. As noted in the cover letter and our responses to the questions above there are significant concerns with this approach which render it highly complex to implement and explain to the users of the account. We believe that the complexity is inherent in the way the EIR will be calculated, monitored and reported on an ongoing basis.

15. Aside from complexity, we do not believe that the impairment information generated by this method is superior to that currently reported under the incurred loss method. In fact it has the potential to obscure information on key ratios currently used by investors and analysts.

16. Other considerations would include: phased implementation to ensure entities have sufficient historical data amassed to be able to based the assumptions on credit losses; and categorisation of assets by degrees of inherent risk (e.g. as in the Bank of Spain impairment model presentation to the IASB during June 2009).