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Dear Martin

IASB ED *Financial Instruments: Amortised Cost and Impairment*

This letter sets out the comments of the UK Accounting Standards Board (ASB) on the IASB Exposure Draft (ED) *Financial Instruments: Amortised Cost and Impairment*.

In arriving at its response to the ED the ASB has conducted extensive outreach with its constituents as well as holding a meeting for all our constituents during May 2010.

Our overall view on the proposals in the IASB's ED is set out below. Detailed responses to the questions asked in the ED are addressed in the Appendix to this letter.

1. The ASB agrees with the IASB that the recent credit crisis demonstrated the weaknesses in the current incurred loss impairment model for financial assets. As such the ASB would support the inclusion of forward looking credit loss information in the amortised cost measurement of financial assets. In this respect, we would also support the review of expected credit loss information at each remeasurement date. .

2. The ASB also concurs with the IASB that other alternative impairment models (e.g. a through-the-cycle or dynamic provisioning approach) are not consistent with the objectives of financial reporting, which aims to provide decision useful information to investors and creditors. We firmly believe that a through-the-cycle approach is directly aligned to a financial stability objective and is more appropriate for the purposes of the regulatory capital calculations.

3. On the basis of the views set out in paragraphs 1 and 2 the ASB conceptually agrees with the proposals for impairment of financial assets included in the IASB's ED.

4. However, the ASB has some concerns about the proposals in the ED. These include concerns that:

   - there is complexity inherent in the IASB's proposals which results in application challenges. The IASB itself has acknowledged this and has set up the Expert Advisory Panel (EAP) to address these issues;

   - the increased role played by management judgement in determining the assumptions to be included in the model as well as the estimates of future cash flows. Under the proposals in the ED, these need not be based on observable data leading to concerns about reliability of the information and the potential for earnings management;

   - the implementation of EIR inclusive of expected credit loss. We believe that a number of the operational complexities in IASB's proposals arise from this aspect of the proposals. In this regard, we support the EAP's work on decoupling of EIR from the expected loss calculation. However, we are concerned that due to the timing of the EAP's work IASB's constituents have not had the opportunity to fully explore and ascertain the consequences of decoupling; and

   - the EAP's work is yet to resolve the issues in relation to the application of IASB's proposals to open portfolios, practical expedients for smaller entities and application of IASB's proposals to short term receivables. We believe these are significant issues which need resolution.

5. As noted above, the ASB and its staff conducted significant outreach activities, including a roundtable of its constituents that was attended by IASB Board member Stephen Cooper as well as Sue Lloyd from its staff. A significant number of our constituents are concerned that the operational challenges and costs of implementing the proposals in IASB's ED significantly outweigh the benefits of that approach. We are encouraged that the EAP is dealing with a number of the more significant concerns raised by our constituents e.g. estimating the amount and timing of future credit losses. However, as noted above, we are concerned that issues in relation to open portfolios and application of the IASB's proposals to smaller entities are still unresolved.

6. We, therefore, recommend that IASB continue to work on resolving the operational issues with the proposals in its ED. In doing so, we would encourage the IASB to investigate other methodologies that are capable of including expected losses on financial assets held at amortised cost but have fewer operational challenges.

7. Given the far ranging impact of adopting the IASB's proposals for financial instruments, we would recommend that the IASB publish an ED outlining its full proposals for accounting for financial instruments before the end of 2010. Such an ED should include the proposals on classification and measurement included in IFRS 9, the treatment of assets held at amortised cost and relevant credit losses, proposals on hedge accounting and the final presentation and disclosure requirements for financial instruments. We believe this will enable constituents to consider the proposals and their adequacy in the round.

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 to questions set out in the ED

Objective of amortised cost measurement (paragraphs 3–5)

Question 1
Is the description of the objective of amortised cost measurement in the exposure draft clear? If not, how would you describe the objective and why?

1. We agree with the approach taken by the IASB in this area. The ASB supports principles based standards and as such agrees that it is appropriate to set out the objective of amortised cost measurement before producing the detailed requirements in this area. However, we believe the objective can be clarified and made more applicable to instruments such as short-term receivables, where interest revenue or expense are not applicable and the only relevant item may be the expected credit losses.

2. Paragraph 3 of the ED proposes an objective of amortised cost measurement as follows:

   'to provide information about the effective return on a financial asset or financial liability by allocating interest revenue or interest expense over the expected life of the *financial instrument*.'

3. No actual definition of what might constitute "effective return" is included in the ED. The objective infers that this is the allocation of interest revenue or interest expense over the expected life of the financial instrument. However, paragraphs 4 and 5 of the ED set out additional items that may be incorporated in the effective return and appear to contradict the information in the objective in Paragraph 3. This contradiction can be removed by establishing a broader objective of amortised cost measurement as follows:

   "The objective of amortised cost measurement is to provide information about the cashflows arising from and the effective return on a financial instrument over its expected life."

4. A definition of what might constitute effective return could then incorporate all the items the IASB includes in paragraphs 4 and 5 of the ED, differentiated depending on the financial instrument i.e. interest-bearing financial asset, non-interest bearing financial assets e.g. short-term receivables or financial liabilities.

Question 2
Do you believe that the objective of amortised cost set out in the exposure draft is appropriate for that measurement category? If not, why? What objective would you propose and why?

5. No. Refer to our answer to Question 1 above.

Measurement principles (paragraphs 6–10)

Question 3
Do you agree with the way that the exposure draft is drafted, which emphasises measurement principles accompanied by application guidance but which does not include implementation guidance or illustrative examples? If not, why? How would you prefer the standard to be drafted instead, and why?

6. The ASB supports the emphasis on measurement principles, but we believe that the IASB should be providing more non-mandatory application guidance or illustrative examples. In arriving at this view, we have considered the fact that adoption of the proposals is likely to lead to a significant change in the accounting for financial assets held at amortised cost and the entities within the scope are likely to face significant implementation and operational challenges. We have also considered the mechanical nature of the ongoing measurement requirements (as demonstrated by the illustrative examples currently on the IASB's website); the diversity in the type of financial instruments within the scope; and the percentage of financial instruments on an entity's balance sheet within the scope.

7. The lack of adequate application guidance is likely to lead to divergence in practice, especially given that the there are many different definition of expected loss and the IASB's version is just one of many. For example, some UK constituents believe that the likely outcome of applying this model to current portfolios of financial assets held by banks at amortised cost will not be significantly different to the current incurred loss approach due to the elements of the incurred but not reported approach used by these entities.

8. Furthermore, there is little understanding of how to apply the model to large individual loans, restructured financial assets or open portfolios. We understand that these are areas currently being addressed by the IASB's Expert Advisory Panel (EAP). We would encourage the IASB to publish the EAP's work in these areas. We believe such additional guidance will enable entities to conserve time and resources in attempting to understand application of the IASB's requirements to these commonly held loans and portfolios.

Question 4

(a) Do you agree with the measurement principles set out in the exposure draft? If not, which of the measurement principles do you disagree with and why?

(b) Are there any other measurement principles that should be added? If so, what are they and why should they be added?

9. Our answer to this question is split into consideration of the conceptual and operational aspects of the expected loss model proposed in the IASB's ED. Following extensive discussion with UK constituents, we agree conceptually that an expected loss model to account for financial assets at amortised cost is superior to the incurred loss model. However, implementation and operational problems abound with the IASB's proposed model.

Conceptual aspects

10. ASB and most of our constituents, especially investors, are in favour of switching recognition of losses from incurred to expected losses. Most constituents are unhappy with the level of provisioning under the incurred loss model. Preparers and auditors dislike the triggers used to evaluate whether there is indication of losses under the current IAS 39 model. Investors do not like artificially high profits being booked upfront or delays in reporting losses. They are clear that the credit crisis has shown that the incurred loss model in IAS 39 has both these shortcomings and so needs to be improved.

11. If actual losses occur before sufficient expected loss provisions have been built up, the IASB model will lead to re-measurement adjustment for 'good loans' (ie those performing better than expected). We believe this volatility in the financial statements would be difficult to explain to investors.

Operational aspects

12. The expected loss model, as proposed by the IASB, has significant operational challenges for precisely those entities e.g. banks, for whom a high percentage of the balance sheets consists of financial assets at amortised cost. We understand that some of these issues are being considered by the EAP. However, we list them here to provide the IASB with a full analysis of the concerns raised and since, at the time of writing, the actual issues and solutions being discussed by the EAP are uncertain. Most of these are likely to result in significant implementation costs as well as increasing costs on an ongoing basis.

    a. Pricing for products is driven by competition in the market, of which credit risk is only one element. However, it is not a stable or explicit element. A number of constituents feel that a methodology needs to be developed to enable them to ascertain how this credit risk element will be separated from the other elements in the price at initial recognition.

b. The credit loss information, required for inclusion in the cash flow calculations, is retained by the credit system in most banks. Currently the accounting and credit systems in the vast majority of banks are not interlinked. For most banks the implementation of this requirement will incur significant systems costs. Most banks when asked quote costs that are comparable to the Basel implementation projects as a minimum. Any workarounds on this issue will need to take into account the fact that reconciliations between systems on a wholesale basis often increase the likelihood of lack of comparability of data and errors, increase preparer costs for performing reconciliations and having them audited.

c. Currently banks only use expected cash flows in exceptional cases i.e. for loans already identified as being impaired, to ascertain the extent of the impairment. The proposal will require this methodology to be applied to all financial assets held at amortised cost (which will include investment securities classified as such under IFRS 9). This will considerably increase the systems requirements on an ongoing basis.

d. Availability of historical data, in particular on implementation, is an issue. The IASB's model requires data for the expected life of the financial asset. Given the long-dated nature of a number of amortised cost financial assets this can be hard to collate. A possible source may be the data used for Basel II calculations. However, a number of bank consumer lending portfolios for Basel II calculations follow the standardised approach. This entails simple estimations rather than the detailed information required under the advanced approach.

e. No current methodology on how to determine expected losses over the life of instruments/ portfolios exits, although we understand that the EAP is working on this aspect and considering parallels with the requirements under Basel II. But a read across to Basel II is difficult as it defines a period of default, resulting in a prudent estimate. Estimates for financial reporting purposes need to be neutral, so that Basel II numbers can not be imported without requiring extra work to address this issue. Further, Basel numbers include expectations for only twelve months after the balance sheet date whereas the IASB proposals would include expectations over the expected life of the loan, which for a long-dated instrument like a mortgage may be 7-10 years.

f. Unit of account issues have not been resolved. So although it is feasible to calculate a loss expectation for a closed portfolio of a large number of similar loans, straightforward parallels cannot be made for expected losses for large individual loans.

g. Treatment of open portfolios, portfolios with revolving credits or pre-payable instruments is not certain under this model. We understand that this is another area the EAP is currently considering.

13. We have also heard from user constituents who are concerned that a large number of bank assets are held at amortised cost and given the levels of management judgement introduced by the proposals in the ED increases the scope for earnings manipulation. Frequent, and sometimes debatable, value changes that may not convey any information about the changing operational performance or risk are seen as unhelpful in a stable amortised cost approach. As a minimum, some disclosure of the management's assumptions in key areas would be required for users to ascertain comparability across the market.

14. It is important to consider the preparers' concerns against the benefits for the users. From a user's point of view, the key benefit of the IASB model is that entities will not be booking high upfront interest charges or delaying reporting of losses.

15. Given the large number of concerns with the costs, complexity and operational difficulties inherent in this model we would encourage the IASB to investigate other simpler ways of implementing an expected loss methodology that deliver the same benefits to users. We understand that there are other models including ones put forward by the European Banking Federation (EBF), the Basel committee and the one included in the FASB's ED published in May 2010. We believe that the IASB should perform a thorough analysis of the results from these model and whether they are able to provide the benefits to user without the implementation difficulties identified with IASB's model.

Objective of presentation and disclosure (paragraphs 11 and 12)

Question 5

(a) Is the description of the objective of presentation and disclosure in relation to financial instruments measured at amortised cost in the exposure draft clear? If not, how would you describe the objective and why?

(b) Do you believe that the objective of presentation and disclosure in relation to financial instruments measured at amortised cost set out in the exposure draft is appropriate? If not, why? What objective would you propose and why?

16. The ASB would recommend that the objective of presentation and disclosure is more directly linked to the overall objective of amortised cost measurement. We believe the following amended objective has a clearer link to the objective of amortised cost measurement and is broad enough to be applicable to the different types of financial instruments.

"An entity shall present and disclose relevant information that enables users of the financial statements to evaluate the effective return on a financial instrument carried at amortised cost. ~~financial effect of interest revenue and expense, and the quality of financial assets including credit risk."~~

17. The requirements can then elaborate on the kind of information required for different types of financial instruments to enable an entity to meet this overall objective.

Presentation (paragraph 13)

Question 6

Do you agree with the proposed presentation requirements? If not, why? What presentation would you prefer instead and why?

18. Yes, we agree with most of the presentation requirements. However, although the presentation requirements in paragraph 13 of the ED currently include information on the effective interest, the expected credit losses and changes in these estimates, it does not provide any information on losses incurred due to a default. We believe such incurred losses have informational value for investors and should be given equal prominence.

19. Additionally, the presentation requirements in paragraph 13 of the ED are not decision useful for non-financial entities whose only financial instruments are short-term receivables. As effective interest is not a relevant concept for these financial instruments, presentation requirements largely based around interest revenue and expense do not provide adequate information for users. We would recommend that the IASB include comparable but relevant presentation requirements for such entities upfront in the ED itself.

Disclosure (paragraphs 14–22)

Question 7

(a) Do you agree with the proposed disclosure requirements? If not, what disclosure requirement do you disagree with and why?

(b) What other disclosures would you prefer (whether in addition to or instead of the proposed disclosures) and why?

20. No. We believe that the amount of disclosures at a meaningful level (e.g. by product, geography and/or vintage) will be extensive. One regional building society in the UK identified at least 300 portfolios in its vintage mortgage

book. Larger banks that operate in many geographical markets across a number of different products will have significantly more. A large UK bank stated that they would need almost one hundred extra pages in their Annual Report to provide the loan triangles at a meaningful level of analysis. We believe that the IASB need to carefully consider the trade-off between meaningful disclosures and volume of disclosures in this instance.

21. We are also concerned that some disclosures (e.g. loss triangle) appear to assume closed portfolios of limited duration. As a result, they are likely to be difficult to implement for long dated and open ended portfolios.

22. We are not convinced of the relevance of the stress testing disclosure requirements in paragraph 20 of the ED. Users have often complained to us about stress testing (and sensitivity) information provided in financial statements. They are concerned that such information is unrealistic and that portfolios are only tested for a single variable change with all other relevant/ interdependent factors being ignored. We believe that the same difficulties as noted above (in paragraph 22), with the level at which an entity makes its disclosures, will render any stress testing disclosures at a group level irrelevant.

23. In principle, the ASB supports the objective of providing disclosures about entities loss experience and sensitivity to changes in markets, including through the use of loan triangles and stress testing. However, it acknowledges that this might create operational challenges for certain entities. Therefore, the ASB recommends that the IASB put forwards an objective of disclosures that sets out the key rational for proposing certain disclosures (like loan triangles and stress testing) and then enable entities to use the methodology that suits their circumstances to provide the relevant information to users. The ASB is aware that the EAP is currently focusing on open portfolios and application of the ED's requirements to the different types of financial instruments carried at amortised cost. We believe that the EAP should additionally consider the operationality of the disclosure requirements in the ED.

24. We believe that the disclosures on estimates and changes in estimates in paragraphs 16-19 of the ED provides sufficient information about the estimation techniques, inputs and assumptions used by an entity.

25. We are not convinced that the definition of non-performing loans should include bright lines such as due past 90 days. We believe it is more decision useful to require an entity to disclose how it defines balances that are past due, together with the quantum of its expectation of incurred losses at that period past due.

Effective date and transition (paragraphs 23–29)

Question 8
Would a mandatory effective date of about three years after the date of issue of the IFRS allow sufficient lead-time for implementing the proposed requirements? If not, what would be an appropriate lead-time and why?

26. A number of ASB constituents, in particular large international banks, have significant concerns about the implementation date given the extent of assets and liabilities on their statements of financial position impacted by the requirements in the ED, the implications for IT system changes and the concerns in relation to unresolved application issues e.g. for open portfolios, long-dated instruments, large individual loans, etc. All these issues are before any transition requirements on provision of comparative information are considered.

27. The ASB understands that the EAP is currently looking at exploring some practical expedients to be applied to these and other issues. As a result, the ASB is unable to conclude on the sufficiency of the lead-time of three years as we believe it will depend on the final resolution of those issues.

Question 9
(a) Do you agree with the proposed transition requirements? If not, why? What transition approach would you propose instead and why?
(b) Would you prefer the alternative transition approach (described above in the summary of the transition requirements)? If so, why?
(c) Do you agree that comparative information should be restated to reflect the proposed requirements? If not, what would you prefer instead and why? If you believe that the requirement to restate comparative information would affect the lead-time (see Question 8) please describe why and to what extent.

28. We do not agree with the transition requirements as presented in the ED. The ASB believes that the transition requirements proposed in the ED need to be enhanced to ensure they limit the use of hindsight in accounting for financial instruments held by the entity on transition date. Currently paragraphs 25 and 26 of the ED state that the effective interest rate adjustment should be based on "all available historical data". We believe that this approach will inevitably mean that hindsight plays a part in the calculation of this adjustment leading to some degree of bias.

29. We, therefore, believe that to reduce this bias in the transition adjustment a better approach may be to require entities to collect data from a set date, e.g. exactly three years prior to the implementation date of the final standard. If

entities collected data from that date they will have some historical information on which to base the effective interest rate adjustment.

30. We agree that the comparative information should be restated to reflect the proposed requirements. Given the fact that the IASB model will require entities to collate extensive data for all financial instruments carried at amortised cost, we believe that the additional requirements for comparatives will only make a marginal difference to these requirements. We, therefore agree with the IASB that the benefits of restated comparatives outweigh the costs for preparers.

Question 10

Do you agree with the proposed disclosure requirements in relation to transition? If not, what would you propose instead and why?

31. The ASB agrees with the disclosure requirements in relation to transition.

Practical expedients (paragraphs B15–B17)

Question 11

Do you agree that the proposed guidance on practical expedients is appropriate? If not, why? What would you propose instead and why?

32. The ASB agrees with the inclusion of practical expedients in the requirements. However, we would recommend that the objectives of amortised cost measurement as well as those for presentation and disclosure requirements need amending to ensure they are equally applicable to the practical expedients as well as to other financial assets (see our answers to Questions 1 and 5).

33. The ASB does, however, have concerns about the materiality test in the ED. We believe that limiting the use of practical expedients only to the situations where the effect is immaterial creates a "Catch-22" situation for entities. Essentially, this requirement would force entities to perform the calculations as required by the ED and then compare it to the practical expedients to ascertain materiality of the overall effect. This appears to defeat the actual purpose of including the practical expedient.

34. We would recommend that the IASB clarifies the role of materiality in this context and how entities might take advantage of the practical expedients without incurring the necessary costs..

Question 12

Do you believe additional guidance on practical expedients should be provided? If so, what guidance would you propose and why? How closely do you think any additional practical expedients would approximate the outcome that would result from the proposed requirements, and what is the basis for your assessment?

35. Please see answer to Question 11 above.