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Re: *EFRAG draft comment letter on IASB Supplementary Document Financial Instruments: Impairment*

Dear Françoise,

I am writing on behalf of the Italian Accounting Standards Setter (OIC) to respond to the EFRAG draft comment letter on IASB Supplementary Document Financial Instruments: Impairment ('the SD').

The OIC welcomes the IASB's efforts to develop a common approach with the FASB for an expected loss impairment model for open portfolios of financial assets measured at amortised cost in order to address the significant operational concerns widely raised by constituents (also OIC) during the consultation period on the IASB original Exposure Draft Financial Instruments: Amortised Cost and Impairment ('the original ED').

As a general concern, we agree that a 60-day comment period is inadequate to analyse in detail the new proposals. This is because the SD introduces new concepts (e.g. good/bad book and floor) and it is not merely a simplification of the expected loss model proposed in the original ED. Moreover, we suggest that the IASB carry out a field testing before any final decision is made.

In any case, we believe that the international convergence towards a high-quality standard for financial instruments should be the priority.

Bearing in mind this general concern, our detailed responses to the ED questions are as follows:

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?

In our comment letter on the IASB original ED, we supported the transition to an expected loss model for impairment. This is because the current impairment model under IAS 39 allows entities to recognise only the credit losses related to events already occurred at balance sheet date. We appreciated the IASB's effort in dealing with the issues related to the current model, developing an impairment model that considered the losses expected rather than those already incurred. In our opinion, the proposed expected loss approach was designed to result in earlier loss recognition compared to the incurred loss approach currently in IAS 39, by taking into account future credit losses expected over the life of the financial asset measured at amortised cost. Under this approach the initial estimate of expected future losses is gradually recognised over the life of the instrument as it is incorporated into the effective interest rate. This is conceptually right. We supported an impairment model based on expected losses rather than a model applicable only in circumstances in which trigger events occur. We noted that the proposed model had some merits in creating a link among performance measurement, risk, pricing and accounting. Thus, we agreed with the general fundamentals on which the IASB model is based.

We note that the common approach proposed in the SD relies on forward-looking information about credit losses and that it should allow an earlier recognition of credit losses compared to the current impairment model. Therefore, the proposals in the SD seem to address the mentioned perceived weakness in IAS 39. However, we have some concerns about the common approach as explained better below.

Question 2

Is the impairment model proposed in the supplementary document at least as operational for closed portfolios and other instruments as it is for open portfolios? Why or why not?

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.

We believe that a single impairment model should be applied to all financial assets measured at amortised cost. However, we note that a simplified approach is justified in cases in which the strict application of the impairment model cannot be feasible. In any case, this simplification should not introduce new concepts and should be a reasonable approximation of the original model.

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 4

Would the proposed approach to determining the impairment allowance on a time-proportional basis be operational? 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 appreciate that the common approach overcomes a number of operational complexities apparent in the original ED, allowing, at least, to distinguish the measurement of losses for financial assets recognised in the bad book from those belonging to the good book.

We agree with an approach whereby expected losses are not necessarily attributed to specific periods and, therefore, we support the recognition of expected credit losses based on a time-proportional approach for good books. However, we believe that allowing different alternatives to implement this approach would result in a reduction of comparability of financial statements. Therefore, we would be in favour of a single model such as the straight-line approach, allowing in some specific circumstances, and only if the entity can reliably estimate the timing of recognition of the future losses, a more precise model such as a discounting model.

Some concerns may arise on the concepts of floor and foreseeable future. Firstly the concept of floor does not seem to fit well with the principle of initial recognition of financial assets that implies initial recognition at fair value. Moreover, we note whilst the original expected model proposed by the IASB reflected the link between the pricing of the asset and the recognition of credit losses, the proposed model seems to depart from that relationship.

At the same time we understand that the IASB proposal (i.e. a time-proportional model without a floor) may result in actual losses occurring that exceed the allowance balance at the time of the loss. For example, it might occur if a portfolio has a concentration of loans that are expected to default early in their life. In specific situations, where this issue may exist, floor fixed at a period of 12 months could be applied.

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 7

Is the requirement to differentiate between the two groups (ie 'good book' and 'bad book') for the purpose of determining the impairment allowance operational and/or auditable? If not, how could it be made more operational and/or auditable?

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?

As already said above, we agree with the introduction of the distinction between good book and bad book because it is aligned with the way entities manage their loan portfolios.

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.*

Question 10

Do you believe that the floor will typically be equal to or higher than the amount calculated in accordance with paragraph 2(a)(i)? Please provide data and/or reasons to support your response, including details of particular portfolios for which you believe this will be the case.

In relation to the definition of 'foreseeable future', it seems that a number of different interpretations may arise on what could be meant by it. As it is not a fixed period, this could result in a lack of consistency in application across entities.

Therefore, we suggest that the IASB develop further guidance that ensures this concept is consistently applied in a transparent manner that users of financial statements are able to understand and compare.

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 do not support the proposal in the SD allowing alternative approaches for the recognition of the expected credit losses applying a time-proportional model.

With regard to flexibility in the selection of a discount rate when using a discounted expected loss amount, we note that this proposal will result in diversity in practice that would reduce comparability. Moreover, we note that this is a cross-cutting issue that interferes with a number of standards.

Question 12

Would you prefer the IASB approach for open portfolios of financial assets measured at amortised cost to the common proposal in this document? Why or why not? If you would not prefer this specific IASB approach, do you prefer the general concept of the IASB approach (ie to recognise expected credit losses over the life of the assets)? Why or why not?

We are supportive of the general concept underlying the original IASB approach (i.e. to recognise expected credit losses over the life of the assets). However, we note that the changes reported in this supplementary document represent an operational simplification to that model. We believe that by fixing some aspects on the definition of foreseeable future and the floor, explained above, the model proposed in this supplementary exposure could be a valuable improvement on the current IAS 39 impairment model.

Question 13

Would you prefer the FASB approach for assets in the scope of this document to the common proposal in this document? Why or why not? If you would not prefer this specific FASB approach, do you prefer the general concept of this FASB approach (ie to recognise currently credit losses expected to occur in the foreseeable future)? Why or why not?

As explained in our responses above, we do not support the FASB approach.

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 believe that the effective interest rate determined separately from the expected losses will ensure that the method is more operational. Therefore, we appreciate the effort of the IASB to resolve the concerns over the original proposals.

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?

Question 16Z

Would the proposed requirements be operational if applied to loan commitments and financial guarantee contracts? Why or why not?

We support the view that the same impairment model should apply for both loans and loan commitments since they are often managed within the same business strategy.

In our comment letter on the IASB Exposure Draft Insurance Contracts, we agreed with the IASB proposal that the contracts currently defined in IFRSs as financial guarantee contracts should be brought within the scope of the IFRS on insurance contracts.

Question 17Z

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

The new presentation proposals contain two line items (gross interest revenue and impairment losses). As the common approach does not differentiate between initial estimates of credit losses and changes in those estimates, it is no longer possible to present separately the effect of allocating the initial credit loss estimates and changes in those estimates. Therefore, we agree with the proposed presentation requirements.

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 agree with the proposed disclosure requirements except when the IASB proposes to require disclosure in tabular format for the past five years for the group for which expected credit losses are allocated using the time-proportional expected credit losses (i.e. the 'good book') - paragraph Z8 of the SD. That disclosure would comprise the estimate of lifetime expected credit losses (as updated for each reporting date), the balance of the outstanding

nominal amounts, the time-proportional allowance amount and any additional impairment loss recognised to reach the minimum allowance amount (if applicable). This is because the requirement to disclose a time series does not automatically increase the informational value of disclosures, and we believe that it could be too burdensome.

In any case, we suggest that the IASB consider the proposals in the SD in the context of the existing disclosure requirements in IFRS 7 and ensure that the level of guidance included in the disclosure standard remains consistent and balanced across topics.

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?

We suggest that the IASB amend the principle included in the SD to transfer financial assets from good book to bad book. This is because we believe that it would be more appropriate and operational, when an asset is transferred from good book to bad book, to transfer to the bad book all the expected credit loss of the financial asset and then re-estimate the amount of expected credit losses for both the good and bad books.

If you have any queries concerning our comments, please do not hesitate to contact us.

Yours sincerely,
Angelo Casò
(Chairman)