AUSTRALIAN BANKERS' ASSOCIATION INC.

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International Accounting Standards Board
Comment letters
30 Cannon Street
LONDON, EC4M 6XH
UNITED KINGDOM

Dear Sir/Ms,

Exposure Draft ED/2009/12 - Financial Instruments: Amortised Cost and Impairment

Please find attached comments from the Australian Bankers' Association (ABA) on Exposure Draft ED/2009/12 – Financial Instruments: Amortised Cost and Impairment.

Yours sincerely

Tony Burke

Objective of amortised cost measurement

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?

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?

The description of the objective of amortised cost measurement in the exposure draft is clear. However, the objectives do not clearly make a link between amortised cost measurement and impairment.

Financial institutions do not manage nor measure credit risk or losses with reference to effective return or interest income/expense. Therefore, should the exposure draft remain as currently drafted, we believe the objective should be expanded to explain why this link should be made when the concepts of yield and impairment are decoupled by the banking and finance industry.

Measurement Principals

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?

Whilst we disagree with the measurement principals, we agree with the way the exposure draft is drafted. We believe an emphasis on measurement principals accompanied by appropriate guidance leads to a user friendly standard.

The current application guidance and basis of conclusion are extremely useful. However, due to the complexity of the measurement methodology, together with the practical challenges of implementation, further guidance is required, including illustrative examples (including examples of how the approach would work with an open portfolio of loans) and implementation guidance. These have historically proven to be beneficial in interpreting the requirements of a standard, especially where significant assumptions and judgement are required.

Measurement Principals

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?

We support the IASB's objective of introducing an expected loss methodology to loan impairment. However, while we agree in principal with the approach, we do not agree with the detailed measurement principals set out in the exposure draft. Our key concerns follow.

We concur with the views of the Expert Advisory Panel, that financial institutions manage credit risk and losses separately from NIM and not on an effective interest rate (EIR) basis. Measurement on an EIR basis would not mirror how we manage our business and, therefore we do not consider it appropriate.

The proposed methodology is logical from a single instrument and closed portfolio perspective, but is extremely complex when applied to open portfolios. In a large financial institution, with many complex open portfolios across many divisions, with various credit ratings and multiple interest rates, the method becomes almost impossible to apply.

Additionally, applying the methodology to credit cards presents particular difficulties as cash flows are notoriously hard to predict. We would ask the Board to provide guidance on topics such as this.

The measurement principals require gains and losses resulting from changes in credit loss expectations to be expensed when estimated. This would lead to the full impact of the change being recognised in the income statement at the time of the change in expectation and therefore would not achieve the Board's objective of creating a distribution of income/expense that reflects the returns on an instrument over its life.

We recommend that such changes be recognised over the remaining expected life of the impacted portfolio/asset. As part of this approach the timing of the loss could be considered. If the loss is expected to occur on an individual asset within next 6 to 12 months, it may be appropriate to recognise the loss now. If it is change in expectations over the remaining life of the portfolio, it is more appropriate to spread these losses over time.

In addition we request guidance on what is defined as a change due to estimates of credit losses in order to achieve consistency of application of the loan impairment methodology by all.

These principals can also bring about counter intuitive results. For example, following changes (from initial expectations) in interest rates, an impairment gain or loss would be recognised on a variable rate loan.

It should also be noted that financial institutions do not currently have systems set up to perform the required calculations. Therefore, in order to apply the proposed methodology, new systems would be required leading to a costly and time consuming implementation.

Measurement Principals

Question 4

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

We understand that there are a number of alternative approaches (including those of the US Financial Accounting Standards Board, the European Banking Federation, and the Basel Committee) being considered and developed in the UK and US, which are being proposed to the IASB. We would like to express our support for the review of alternative models and continued dialogue. In particular, there may be alternatives that come to light after the comment period that should be considered. Given the complexities, cost and time involved, we would welcome a comprehensive analysis of all alternatives prior to settling on a method to be applied.

We would appreciate re-exposure of the standard prior to an alternative approach being finalised and are eager to provide feedback on alternative approaches being consider by the Board and staff.

Objective of presentation and disclosure

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?

The presentation and disclosure objective is clearly articulated and is appropriate for the topic at hand.

Presentation

Question 6

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

We do not support the proposal for expected credit loss expense to be presented within interest revenue.

Net Interest Margin (NIM) is a key metric for retail banks and is well understood by users of the accounts. Inclusion of a credit loss adjustment within NIM will lead to confusion amongst users and further non-GAAP measures.

Credit losses should be presented as a single number (encompassing expected credit loss and gain/loss due to changes in expectations) on the face of the income statement, so that they and other key line items can continue to be clearly identified and understood by users.

Disclosure

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?

As articulated in paragraph 11 of the exposure draft, disclosures should enable users of the accounts to fully understand the credit quality of financial instruments and the effect of these on the result of an entity.

The disclosures detailed in the exposure draft are extensive and cover many areas of credit quality, but the volume of disclosures proposed will reduce the useability and comparability of financial statements. In addition many of the disclosures may confuse users and draw attention away from the value of the information provided.

We understand certain investors may consider some types of additional information beneficial, however we request that the reasons for this information be examined in joint sessions with the providers so any perceived benefits can be validated, with agreement on the level of additional transparency such requests would provide.

Stress Testing

Under the current broad proposals, if an entity performs any stress testing for internal risk management or any other purpose, it must disclose this fact, together with the implications on the financial position and performance of the entity. Australian financial institutions are required by regulators to perform "catastrophic" stress testing. Disclosure of the results of such testing could mislead users of the accounts.

Additionally, a user could easily make an incorrect decision upon comparing disclosures of an organisation that does perform such testing with one that does not.

We recommend the requirement to disclose stress testing to be removed from the standard.

Year of origination disclosures

We question how disclosures made by year of origination are relevant to amortised cost and impairment. Financial institutions do not manage credit loss risks by year of origination. Assets are managed in open portfolio by similar credit rating. Hence, year of origination disclosures do not enable users of financial statements to evaluate the quality of financial assets including credit risk.

Disaggregation of gains & losses into amounts attributable to changes in estimates of credit losses and those attributable to other factors (Paragraph 18)

The disaggregation disclosure proposed will be operationally complex to produce and is therefore impractical to include. However, we do note that this disclosure would be beneficial to the understanding of users should the exposure draft be implemented in its current form. As noted above, we believe credit losses should not be impacted by the amounts attributable to other factors eg changes in estimates of prepayment rates and hence, the fact that it is necessary draws attention to the flaws in the methodology.

Should this disclosure be included in the finalised standard, guidance will be required on what is defined as a change due to estimates of credit losses and that defined as attributable to other factors.

Effective date and transition

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?

Under the current proposal, retrospective application of the standard is required. To comply with IAS 1, entities will need to produce comparative information for the two years preceding adoption. Given the extent of effort required analysing and collating the necessary information, we question whether a three year period will be sufficient. This would be impacted by the system limitations to produce historical information in the manner required by the current proposal.

We therefore believe that a four year period between issue and mandatory adoption would be more appropriate.

Effective date and transition

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.

Question 10

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

Exemption from providing comparative disclosures would ease the transition process, reduce the overall cost of adopting the standard and assist in making a three year transition period more practical and achievable.

Theoretically any comparative information disclosed should be calculated using the measurement principals in the standard. However, the principals would make it extremely difficult to calculate comparative balances, due to the lack of data available, the unreliability of historic assumptions by portfolio required to be made on origination, and the changes in circumstances required for calculation of provisioning balances.

Practical expedients

Question 11

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

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?

As detailed above, we believe illustrative guidance and application of the practical expedients is essential, particularly around the more complex issues such as accounting for open portfolios, credit cards and variable rate loans. Hence further guidance including examples should be provided.