CRUF

The Corporate Reporting Users' Forum

To: Sue Lloyd
By email: **slloyd@ifrs.org**

22nd July 2010

Dear Ms Lloyd

The Corporate Reporting Users' Forum (CRUF) welcomes the opportunity to communicate our views on the Exposure Draft (ED) Financial Instruments: Amortised Cost and Impairment which was issued in November 2009.

The CRUF established a Financial Instruments sub-group at the time of the financial crisis as it became clear that a major overhaul of accounting standards would be required. This group responded to the Classification and Measurement ED in September 2009. There have been a number of meetings of this group with preparers, accounting standard setters, trade bodies and government representatives over recent months as part of our ongoing engagement in the financial instrument accounting project.

This letter does not seek to address each of the questions in the ED in detail nor do we seek to reopen the debate on "mixed measurement" vs. full "fair value" of financial instruments. Our comments focus on the ED from the perspective of users of bank financial statements rather than the normal general corporate user focus. We do, however, share the general concerns highlighted in a number of other comment letters (EFRAG, CBI, Business Europe etc.) that application to trade receivables and other operating financial assets will be problematic and largely unworkable.

The use of the "amortised cost model" within the mixed measurement approach is only justified on the basis that the financial assets in question are "operating" in nature and reporting reflects the business model. IFRS 9 provides a sensible framework when determining which assets meet this definition. The accounting should be designed to represent the dynamics of the transactions objectively and clearly so that users can understand them, track trends over time and assess the operational performance of management. Our comments are designed to reflect what we believe is required to meet this objective but it is worth making some general observations about user needs.

Users always focus on underlying operational performance as we believe that it is critical in predicting future performance. As a result it dominates value calculations and is the area that we spend 90% of our time considering. For any business:

- Future cash flow forecasts for businesses that are a going concern are derived from forecasts of operational profitability adjusted for capital absorbed for growth, not by extrapolation of the balance sheet.
- We must have enough information to enable us to model companies in such a way that they are comparable allowing us to contrast relative performance.
- Operational components of the balance sheet should reflect the capital invested in the business against which the profit generation performance is judged. These should not be distorted by fair value adjustments.

Financial assets are inherently complex from a user perspective, largely because they are not operating assets for the majority of companies but rather non-core assets which are available to meet financial obligations. We do have general agreement in the CRUF that simple loans, originated by a bank which intends to hold them to maturity and will manage any credit recovery internally are "operating assets". Whilst some CRUF members believe that fair value would still be the best measure, others feel that such assets may not lend themselves to a fair value methodology as the originating bank may have asymmetric access to information not available to an arms length third party which is the putative buyer in a fair value exercise. Furthermore fair value accounting, whilst it converts contractual flows into a spot value, does not reflect the contractual flows in the financial statements in the period to which they relate and therefore users lose critical information for modelling. With this context, we are keen to evaluate whether the proposed accounting model for provisioning meets our objectives.

Overall, we do welcome the expected loss model, although we are not fully convinced that the proposals in the ED meet our requirements of accounting for operational assets in a way that reflects our understanding of the underlying transactions.

In discussing the issue of Expected Loss, the CRUF agreed:

- Expected loss is preferable to incurred loss.

  Expected losses are priced, implicitly or explicitly, into loans and this should be reflected in the amount of income recognised over the life of the loan from inception. We believe that waiting for a loss event will result in too much profit being recognised up front and may stimulate banks to grow their loan books faster than desirable or economically defensible.

- Methodologies for calculating expected loss need to be made clear and operationally executable.

  The measurement and auditability of expected losses are clearly issues for management and the auditors and we note comments that have been made by these constituencies. We are concerned that if the issues are not solved that we will not get the information that is what it purports to be. One further worry is that management expectations for loss are normally at their lowest at the peak of the cycle when credit has been widely available. Many users would argue that this is the time when loss expectations should be at their highest.

- Most CRUF members felt that it was unclear how management will comply with the IASB's proposal for probability weighted average expected losses which are described in paragraph 8 of the ED.

    Most CRUF members feel that the expected loss which management are using for controlling the business will be adequate provided that there are sensitivity analyses provided for the major inputs. In particular we are concerned at the increasing use of such probability weighted calculations in accounting standards where probabilities are assigned to discrete potential outcomes where in reality these outcomes are often continuums which may mean point estimates are misleading. Management and auditors should consider the behaviour of the underlying results in different economic environments and make provision for their expected loss. The sensitivity analysis should describe the behaviour of the output (loan losses in this case) both as variables rise or fall (e.g. unemployment or house prices will cause losses on mortgage books to be much worse if the variable moves more negatively rather than positively and this skew and any discontinuity in outcomes should be made clear in disclosure)

Whilst we shared this general support for expected loss, a number of concerns were raised regarding how adjustments to expectations should flow through the profit and loss and the balance sheet.

On measurement, some took the view that a change in expectations should be adjusted for fully at the time the expectation changes as described in ED. This results in a one-off adjustment at that point which takes account of the effect of the change in expectations on the past and the future. It maintains the original effective interest rate (EIR) going forward, and means that the balance sheet number represents the new expected future cash flows discounted at the original EIR. The impairment loss (or the gain) when this adjustment is made represents the effect of how things are different from first expected, whether through management's misjudgment or market forces, in as much as they affect the credit quality of the assets.

Others took the view that a change in expectations should be accounted for as follows: the effect on past income already taken to the income statement should be recognised at the point expectations change, and the effect on future income should be recognised on a spread-forward basis. This view looks at the "Credit Adjusted Interest Rate" (i.e. contractual interest less expected losses) as being the most important information and views a change in expectations as an adjustment to the effective interest rate over the life of the loan with a catch-up provision or release to account for the past "error".

This "Credit Adjusted Interest Rate" approach was considered best by some as there was a belief that this reflects the new economic flows that we are anticipating from this operating asset. They have some doubts that the EIR at inception is "the correct" pricing that should have primacy within future reporting of profit and loss. As an example, if loans were originally priced with a loss expectation of 1% and subsequently it is determined that it should be 1.2%, then users would benefit from seeing the contractual interest less this larger loss on an ongoing basis, reducing management performance for the whole life of the loans. This is consistent with accounting for other non-financial operating assets where future returns often do not meet the original business case – if we always had to value PP&E based on a DCF using the original IRR that justified the investment, we would get results that were not particularly useful for investors.

Those who took this view felt that some sort of floor is necessary so that the loan or group of loans that has been subject to a change in expectations does not end up with negative income or income below a risk-free rate going forward. The assumption is that where this occurs, the loans will no longer be performing and will need to be looked at on a case by case basis. Certainly where loans are not expected to return the entire principal, a fuller impairment will be required, effectively rebasing the value to a level which reflects the net present value of any proceeds. This value will be based on the assessment of the credit department at the bank who will be responsible for collection. This differential treatment again has parallels with non-financial operating assets where carrying values are tested for impairment but not continually remeasured as trading forecasts change. Provisions that have been derived at the individual loan level should be separately disclosed in aggregate and by type of loan so users are able to differentiate specific provisions from a more general, portfolio based expected loss.

Some CRUF members believe that reflecting fully the impact of expectation changes in the balance sheet as they arise is necessary but that there need to be some constraints placed around the size of write-downs and write-backs to ensure consistency with the essence of amortised cost rather than fair value accounting. The boundaries would be such that the maximum impairment in a given period would be the aggregate of the actual incurred loss plus the originally expected (or revised) pro-rated loss for the remainder of the asset's life. The maximum uplift from a beneficial change in assumptions during a reporting period would be through recognition of the full contractual income for that period. This approach would be consistent with the Board's underlying philosophy that apportions all, none or some of interest received (or otherwise accrued) to building up provisions for expected losses, and would continue to apply this principle within each reporting period. It also has the benefit of making greater use of the objective evidence relating to actual incurred losses and of avoiding the risk of additional pro-cyclicality driven by overly-volatile changes in management expectations.

Looking at the issue through the eyes of a bank analyst can be instructive. During most of the economic cycle most bank analysts will look at the business mix of the bank and consider whether appropriate gross interest income is being earned when compared to the loan book profile. They want to see if pricing is adequate to compensate for credit risk and financing cost so that they can assess management performance relative to other banks. They continuously track NPLs and provision coverage ratios to monitor trends and look at the impact on earnings, capital and cash generation   In recessionary periods, bank analysts usually use disclosures of contractual positions and flows on the lending book and apply their own analysis to determine peak provisions based on how they think losses will develop using analogues of previous cycles with appropriate further adjustments to allow for changes in business mix. As soon as we lose the linkage between gross contractual flows, initially expected losses and revised expected losses the analysts lose the ability to perform much of this analysis.

Whilst we support the expected loss model in general terms, it is worth bearing in mind the comments we get from analysts who tell us that all provisioning models are open to some element of manipulation.

- The expected loss model is perhaps the most open to this manipulation as it explicitly relies on management forecasts for potentially long periods. The advantage is that credit losses are priced into spreads at origination and we are mainly interested when expected losses may exceed or undershoot base case assumptions. We would prefer to see provisioning based on the best estimate of ultimate cash flows rather than a marked to market derived view of probable credit loss – the bank management should have the best understanding of their loan book and recovery rates in a manner which should be more granular and based on specific strategies to maximise recoveries. There was some consensus though that if management buys credit protection against any counterparty, then the expected losses on the associated loans should correlate with the implied credit loss in the market, as implicitly they believe that losses could be worse than the derivative market is indicating otherwise they would not buy the protection.

- The incurred loss model is again subject to management interpretation of when losses are considered to have been incurred. It has generated provisions far too late to be useful and application is far from consistent. We have seen banks reschedule loans on inappropriate terms and claim that they are "performing" when clearly a provision would be necessary. This may also be a problem with the expected loss model where we have proposed a portfolio approach for "performing" loans.

CRUF believes the disclosure requirements in the exposure draft are a marked improvement to enhance investment decision usefulness. Some members even feel the incurred loss model could be acceptable with the required disclosure. On the other hand, most members think further improvement can be achieved in following points.

- Classification according to internal rating.

  We understand IFRS7 requires general disclosure, but the amortization method financial instruments need their own disclosure

- Covenants information

  We would like to see a table of outstanding amounts according to types of covenants and the amounts that already infringe covenants.

- Stress test

  CRUF thinks all the financial institutions should conduct the stress tests. The ED already requires disclosure of stress tests but it should also require the entities which do not conduct the stress tests to clearly show the reasons for not doing so in the note. This will motivate the entities to introduce the tests. Some members want to see information whether the tests are conducted internally or outsourced to vendors.

- Industry, Geography & Size analysis

  Banks should disclose loan amounts analysed by the industry and geography of their customer and by size of individual loan exposure, where an entity uses this information for internal management. Provisioning information based on this granularity would be very helpful.

- Original expectations disclosed if any expected losses are "spread-forward"

  We recommend disclosure on the face or in the notes what the originally expected losses are separately from changes to expectations.

We recognise that we have not achieved consensus in our own discussions as this is one area where there really does not seem to be a "right answer". We note there are many other suggestions being made by other parties including FASB's proposal, the Expert Advisory Group and EFRAG. We would therefore encourage an ongoing dialog as CRUF may have further thoughts as the Board continues to deliberate.

It is also worth re-emphasising our desire to see financial reporting kept separate from the information needs of regulators and related discussions about regulatory capital. We do not believe that the needs of investors will be well served by determining financial reporting outputs based upon a perceived need to prevent pro-cyclical feedback loops developing in the banking system. Rather, it is our view that the twin aims of capital market stability and economic growth are best served by clear disclosure, honest reporting by preparers, and an independent, pragmatic, evidence-based approach by accounting standard setters. Specifically, we commend the Board that it did not adopt the concept of "through the cycle provisioning" which certain regulatory authorities apparently asked the Board to consider as a measure to cope with pro-cyclicality of accounting. "Through the cycle provisioning" which asks the banks to increase or decrease the bank reserves according to changes of macro economic environments is solely an issue for bank regulatory authorities. On the look-forward period it was noted that Basel might provide a useful starting point and that the CRUF would prefer banks to be able to use their existing information and systems, but that looking forward only one year and not over the life of the loan was unlikely to be acceptable in an expected loss model.

These comments reflect the views of CRUF participants from Japan, Australia, Germany, the UK and the US. We have signed in our individual capacities rather than as representatives of our employer organisations.

Yours faithfully,

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About the Company Reporting Users' Forum

The CRUF was formed in 2005 as a discussion forum with the aim of helping its participants in their approach to the debate on current and future corporate reporting requirements. In particular, participants are keen to have a fuller input into the deliberations of the International Accounting Standards Board and Financial Accounting Standards Board.

The CRUF is a discussion forum. Its participants take part in CRUF discussions and joint representations as individuals, not as representatives of their employer organisations. It does not seek to achieve consensus views, though at times some or all of its participants will agree to make joint representations to standard setters or to the media.

CRUF participants include individuals from both buy and sell-side institutions, and from both equity and fixed income markets. The forum includes individuals with global or regional responsibilities and from around the world. The CRUF meets on a regular basis in UK, Germany, France, Australia, USA and Japan with facilities for remote participation.