CFA UK is
a member
society of

27 September 2012

IASB
30 Cannon Street
London, EC4M 6XH
United Kingdom

Dear Hilary,

The Chartered Financial Analyst Society of the UK (CFA UK) welcomes the opportunity to respond to the staff paper on the impairment of financial assets.

CFA UK represents more than 10,000 investment professionals working across the financial sector. For advocacy purposes on accounting and auditing issues, they are represented by the Financial Reporting and Analysis Committee (FRAC). Our members have not been surveyed for this response.

About CFA UK and CFA Institute

CFA UK serves society's best interests through the provision of education and training, the promotion of high professional and ethical standards and by informing policy-makers and the public about the investment profession.

Founded in 1955, CFA UK represents the interests of approximately 10,000 investment professionals. CFA UK is part of the worldwide network of member societies of CFA Institute and is the largest society outside North America.

CFA Institute is the global association of investment professionals that sets the standard for professional excellence and credentials. The organization is a champion for ethical behaviour in investment markets and a respected source of knowledge in the global financial community. The end goal: to create an environment where investors' interests come first, markets function at their best, and economies grow. CFA Institute has more than 110,000 members in 139 countries and territories, including 100,000 Chartered Financial Analyst® charterholders, and 136 member societies.

The aim of CFA UK's advocacy initiative is to work with policy-makers, regulators and standard-setters to promote fair and efficient-functioning markets, high standards in financial reporting and ethical standards across the investment profession. The society is committed to providing members with information regarding proposed regulatory and accounting standards changes and bases its responses on feedback direct from members or relevant committees.

Members of CFA UK abide by the CFA Institute Code of Ethics and Standards of Professional Conduct (enclosed). Since their creation in the 1960s, the Code and Standards have served as a model for measuring the ethics of investment professionals globally, regardless of job function, cultural differences, or local laws and regulations. The Code and Standards are fundamental to the values of CFA Institute and its societies.

Impairment of financial assets

Financial Reporting and Analysis Committee
Response to IASB staff paper
September 2012

Q1: Are you interested in the credit quality of loans from period to period? If so, which model provides you with a better understanding of changes in credit quality? If neither model provides adequate information for this purpose, what information do you need?

Yes, but the change needs to be material, especially if the reassessment is being done quarterly to provide an up-to-date picture in the results announcement. The examples, such as the one on page 13, make the reassessment of credit quality sound like an annual exercise unless there is some event that triggers an interim adjustment to the judgment, and therefore the allowance.

We felt that the questions were steering us towards favouring the deterioration model. The majority (see below) nevertheless agreed that the deterioration approach was preferable. In this model, because there are smaller upfront provisions, the impact of a change in credit quality will have a prompter, more direct impact through the booking of additional impairment charges.

The attraction of the lifetime expected loss model is that it appears simpler. It may also better capture the aim of prudential regulators because it creates a larger pool of provisions, leading to a smoother loss profile over the life of the loan. We noticed from the examples that there was less of a cliff-edge effect when credit quality deteriorates. However, the greater the pool of what are effectively general provisions, the more diluted the information about changes in credit quality, and it is those changes that give us crucial information.

There is also potential confusion over the causes of increases in provisions between loan growth and deteriorating credit quality. This is exacerbated by the fact that additional provisions for loan growth may be caused by a greater number of loans at the same maturity and/or by new or replacement loans at a longer maturity – as in the example on page 7. This raises a question about the impact on lenders' behaviour: will the prospect of larger day one losses act as inhibitor to loan growth either by volume or maturity? In the example on page 6, the bulletpoints suggest that a growing bank looks more prone to losses and "more expensive" than the steady state bank, as if this would be a false conclusion to draw. An alternative view is that the growing bank is more risky. But it is a drawback if earnings are suppressed for the wrong reason ie over-provisioning at origination.

In the deterioration model, the word "portion" is not clear. If the entity has worked out a figure for the full lifetime expected loss, it would be useful to know what that is, whether full provision is made on day one, or not. What does "portion" mean? Is it an annual share of the full EL? Or is it the potential EL over the next 12 months, taking that as a more realistic forecasting period and requiring less change from current practice? It appears to be the latter from the appendix on page 10, with an annual reassessment to cover the next 12 months.

However, the sentence on page 11 "When there is a sufficient deterioration in credit quality, the change from recognising a portion of lifetime losses to full lifetime losses will be reflected" sounds like a new version of the buckets that we found confusing in previous EL models. As the bulletpoints indicate, this raises the question of what might trigger the switch from annual to full lifetime EL. So

the cliff-edge effect could be aggravated not only by a change in credit quality over a 12-month horizon but by a switch from annual to full lifetime.

Q2: Do you agree that interest revenue recognition should change when losses are incurred? If so, do you agree that changing the interest revenue recognition in these cases to be calculated on a net rather than a gross basis provides useful information?

The deterioration model as illustrated on Page 2 of the paper looks sensible ie interest income recorded on the gross carrying amount until provisions are used up and the carrying amount is reduced.

Q3. Which approach do you believe would provide you with the most useful information overall? Why?

This is partly tackled in the answer to Q1. The short answer is that the majority of the committee favoured the deterioration approach because it was closer to economic reality, did not put prudential aims ahead of accounting and was more sensitive to changes in credit quality. One member commented that we are returning to the old provisioning model as a substitute for the management not doing a good job of pricing/assessing credit in the first place, which is not an accounting problem. It is also a matter for the board and the prudential regulators to ensure that the entity has sufficient equity to absorb both expected and unexpected losses.

Those who favoured the lifetime loss approach did so because it appeared to offer a simpler, single model that tackles the cliff-edge problem better. The flipside of the issue of favouring prudential concerns over accounting is that the lifetime model may respond more fully to what the G20/FSB had asked the accounting standard setters to do.

Neither model has overwhelming or enthusiastic support as each has negative aspects. Users are, however, keen to see the board reach a conclusion and implement the change.

Q4. If the IASB and the FASB were to reach different conclusions and require the different approaches as described, what information would you need to be able to compare the financial statements of companies applying IFRSs and US GAAP?

Whatever approach is chosen, the main thing we want to see is changes in credit quality and all other causes of changes in loan loss provisions. An example of this is that, if provisions are going up, there needs to be a clear distinction between those caused by the origination of new loans and those caused by deterioration in the quality of existing ones.

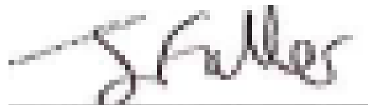
Both methods require subjective judgments by management, and that means we would like to see clear disclosures on the assumptions going into the calculations and on the key sensitivities. Some of these concerns are dealt with in the bulletpoints on page 14 but, in general, the more subjective the judgment, the more important the disclosures.

The danger is that the treatment of loans in the financial statements will be determined more by manipulation of expected loss provisions than by net interest from correctly priced loans, or the economic reality of deteriorating credit quality and incurred losses. So a considerable amount of high quality disclosure will be needed to bridge the gap between the movements in provisions and what is

actually happening to the loans.

We hope that the CFA UK's response is helpful to the IASB and would be open to further discussions with the IASB about any of the points we have raised.

Yours,



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