

6 April 2011

Sir David Tweedie
Chairman
International Accounting Standards Board
30 Cannon Street
London ED 4M 6 XH
United Kingdom

Dear Sir David

IASB Supplement to the Exposure Draft *Financial Instruments: Amortised Cost and Impairment*

The Malaysian Accounting Standards Board welcomes the opportunity to provide comments on the IASB Supplement to the Exposure Draft *Financial Instruments: Amortised Cost and Impairment*.

We appreciate the efforts of the IASB and FASB to arrive at a converged solution for the impairment of financial assets managed on an open portfolio. We note that the IASB and FASB have different objectives when their respective impairment models were developed. The IASB's objective emphasizes on the need to reflect the relationship between the pricing of financial assets and expected losses whilst the FASB's objective is to ensure that impairment allowance are adequate to cover foreseeable expected credit losses.

As noted in our 30 June 2010 letter regarding "IASB Exposure Draft on Financial Instruments: Amortised Cost and Impairment", we expressed support for a more forward looking provisioning methodology. However we had reservations with the proposed impairment methodology which prescribed the use of expected cash flows and the inclusion of expected credit losses into the effective interest rate ("EIR") calculation. We are pleased to note that this supplemental document acknowledged some of the operational concerns of the original ED.

We agree with the Boards that the proposed impairment approach would provide for more timely recognition of credit losses. However having considered the revised proposals set out in the supplemental document, we have concerns particularly on the following:

1) Concept of good book and bad book

The supplemental document proposed to differentiate the portfolio into good book and bad book for the purpose of recognizing impairment allowance. The Boards have deliberately refrained from establishing bright line criteria for the classification between the good book and bad book but rather choosing to rely on the entities' internal credit risk management policies. Though the Boards have outlined a general transfer principle which is when the entity switches from a collectability mode to recovery, we believe the application of such a principle in practice will be diverse amongst entities and hence affecting comparability. There is also a potential for earnings management as the entities would have the flexibility to classify and transfer assets between the two books. We would therefore like to suggest that the Board considers leveraging the Basel II's definition of default as the criteria for the assessment of the good book/bad book and also to enhance these criteria to develop a set of more robust and well defined principles.

2) The two impairment recognition approaches for the good book

The supplemental document proposed two approaches to the recognition of impairment loss for the good book whereby the impairment loss would be the higher of (i) the time proportional amount and (ii) the amount of credit losses expected to occur within the foreseeable future which would not be less than 12 months i.e. the floor amount. We note that recognition of expected loss on a time proportional method is consistent with IASB's objective whilst the recognition of full expected loss for the foreseeable future is consistent with FASB's objectives. Entities would be required to carry out **two** expected loss calculations in order to determine what would be the higher amount. It remains a question whether the results from the 2 approaches would be so significant to warrant the additional effort. We believe the proposed approaches set out in the document is unduly complex and will impose considerable burden to the entities, particularly from the perspective of data availability as well as systems capability. We would therefore urge the Boards to consider a single approach. As noted in our 30 June 2010 letter, we would again recommend to the Boards to leverage the Basel II model. The proposed impairment model can be aligned to the estimated loss calculation using the Basel II approach (with a time horizon of a minimum 12-month period based on the derived probability of default (PD), loss given default (LGD) and exposure at default (EAD)). As for entities where Basel II data is not available, we propose adopting the IASB's time proportional approach as the basis to recognise impairment losses. For prudential purpose, we have an alternative view among our constituents that the 'floor' should be retained if the time proportional approach is selected and applied.

Our detailed responses are enclosed in the Appendix of this letter. If you need further clarification or have any queries regarding this letter, please contact Ms Christine Lau at +603 2240 9200 or by email at christine@masb.org.my

Yours sincerely



Mohammad Faiz Azmi
Chairman

Appendix

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?

We support a more forward looking provisioning methodology and we commend IASB for acknowledging the operational challenges associated with the original ED. This proposed model does address some of those operational concerns we have expressed in the past, and at the same time provides for the early recognition of impairment loss as intended under an expected loss model.

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 a single impairment model should be applied for all financial assets which are measured at amortised cost, be it assets managed under an open or closed portfolio or a single instrument. The impairment model proposed in the supplementary document should be operational for assets managed in a closed portfolio as well.

However the supplementary document currently scopes out "short-term receivables without a stated interest rate that are so short term that the effect of discounting for time value of money is immaterial." Whilst we generally agree with the exemption, we are of the view that the intended exemption is not sufficiently explained and thus the application of the scope exclusion is not totally clear. We would suggest that the Board issue further clarification to address this.

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?

The ED proposed 2 approaches to the recognition of impairment loss for a good book whereby the impairment loss would be the higher of (i) the time proportional amount and (ii) the amount of credit losses expected to occur within the foreseeable future which would not be less than 12 months ie the floor amount. We note that recognition of expected loss on a time proportional method is consistent with IASB's objective whilst the recognition of full expected loss for the foreseeable future is consistent with FASB's objectives.

The Boards have clarified that the lifetime expected credit loss estimate should consider all available internal and external information. This would include historical and current economic conditions as well as supportable forecasts of future events and future economic

Appendix

indicators. Availability of data would be a challenge and significant judgment would be required to arrive at the expected credit loss estimates.

In addition to the above concern on data availability, we also do not agree with the proposal of having two approaches for the recognition of impairment losses. Entities would be required to carry out two expected loss calculations in order to determine what would be the higher amount. It remains a question whether the results from the 2 approaches would be so significantly different to warrant the additional effort.

Given the operational complexity and the demands on systems infrastructure, we would strongly urge the Board to consider a single approach for the good book which is aligning the proposed impairment model to the estimated loss calculation using the Basel II approach (with a time horizon of a minimum 12-month period based on the derived probability of default (PD), loss given default (LGD) and exposure at default (EAD)). For entities adopting the Basel II Internal Rating-Based approach for credit risk capital calculation purposes, these entities are already determining their own estimation for the components mentioned above and hence can leverage the same set of data. In addition, aligning the proposed impairment model to Basel II would allow consistency between risk measure and financial reporting measure in the assessment and measurement of credit losses. We think the possibility of under-provision using the Basel II credit loss parameters could be mitigated with a set of well defined criteria for differentiating assets in the good and bad books. Thus, if our proposal of adopting one method i.e. leveraging Basel II, for the good book is accepted, we would request for the Board to consider enhancing the existing criteria for good and bad books.

However we also acknowledge that different entities have different levels of sophistication and are at different stages in their Basel II implementation (Standardised versus Internal Rating-Based Approach). To cater for such differences, we would like to propose that entities be given the flexibility to choose between the Basel II or time proportional approach. Once selected, the entity has to apply the approach consistently unless it can be demonstrated that a change is justified by better quality impairment level.

For prudential purpose there is an alternative view among our constituents that the 'floor' be retained if the time proportional approach is selected and applied.

Question 4

Would the proposed approach to determining the impairment allowance on a time-proportional basis be operational? Why or why not?

As noted in our response to Q3, we would strongly urge the Board to consider aligning the proposed impairment model to the Basel II approach.

If the Boards decide to proceed with the time-proportional approach, we believe the operational complexity will lead to higher implementation costs and longer implementation lead time. Under the time proportional approach the entity is required to determine the weighted average life and weighted average age of the portfolio. In doing so the entity would have to maintain record of origination as well as data to estimate the expected maturity of the assets. The entity would also have to consider prepayments, extension of credit period, rescheduling and defaults. Additional complexity will arise where assets do not have contractual maturity periods, for example overdraft or credit card receivables. The proposal

Appendix

currently does not provide any specific examples, for instance on how to calculate the weighted average age or weighted average life. We believe application guidance and illustrative examples need to be provided.

Question 5

Would the proposed approach provide information that is useful for decision-making? If not, how would you modify the proposal?

As noted in our response to Q3, significant amount of judgment and assumptions are used in the assessment and classification of assets into good and bad books, estimation of expected credit losses and the calculation of the amount of losses to be recognised using the two methods in the proposal. The information produced is a mixed basket – it does not represent the lending practice (time proportionate amount) nor the entire loss allowance (“the floor amount”), hence its usefulness for decision making is questionable. In addition issues on lack of comparability across different entities will be more pronounced due to the different assumptions used by one entity compared to the other.

We would reiterate our recommendation to leverage the Basel II methodology and data set in measuring credit losses for financial reporting.

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?

As noted in our responses to Q3, Q4 and Q5, we would like to propose for the Board to consider leveraging the Basel II’s definition of default as criteria for the assessment of the good book/bad book. We would suggest for the Board to enhance these criteria to be much more robust to cover all possible scenarios (such as the restructured and rescheduled cases) and to be more specific with clear definition (e.g. the use of quantitative thresholds and widely used qualitative triggers) for consistent application among different reporting entities.

Whilst we support the segregation into two books, we would like to propose that entities be given the discretion to label the two categories in a manner that best fits their internal policies with relevant disclosures provided to link the two ‘named categories’ to the good /bad book concept.

Appendix

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?

Entities which do not manage credit risk using an approach that differentiates the management of financial assets depending on the uncertainty about their collectability are still required to differentiate their financial assets into the two groups. The supplementary document gives examples of criteria such as days past due or when management identifies the loans as doubtful. As the Board has deliberately refrained from establishing bright line criteria for the classification, there is a potential for earnings management as the entities have the flexibility to classify and transfer assets between the two books. We would like to suggest for a set of more robust and well defined criteria to be developed with sufficient guidance provided (please refer to our response to Q6 above), particularly if our proposal in our response to Q3 above for a single method to be used for good book is accepted.

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?

We agree with the proposed requirement to differentiate between the good book/ bad book for the purpose of determining the impairment allowance.

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?**

The ED proposed 2 approaches to the recognition of impairment loss for a good book whereby the impairment loss would be the **higher** of (i) the time proportional amount and (ii) the amount of credit losses expected to occur within the foreseeable future which would not be less than 12 months ie the floor amount. We note that recognition of expected loss on a time proportional method is consistent with IASB's objective whilst the recognition of full expected loss for the foreseeable future is consistent with FASB's objective.

We acknowledge that for financial assets for which expected credit losses are recognised over time in an early loss pattern scenario, the time proportional approach may not create an impairment balance sufficient to cover the expected losses before they occur. However we do not support the proposal to set a floor for in the manner as proposed in the document. As noted in BC 86, "the lack of any clear articulation of what the foreseeable future means is likely to result in a significant divergence in practice". The flexibility in choosing and changing the foreseeable future may also result in earnings management.

Appendix

Please refer to our proposal in the response to Q3 above for having a single method which is to align the impairment model to Basel II approach. We would also like to propose to enhance the existing criteria for differentiating good and bad books as stated in our responses to Q3 and Q6 above. We believe a set of more robust and well defined criteria for differentiating or identifying assets to be included in the bad book could mitigate the risk of insufficient impairment provision made.

- (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?**

Please refer to our response to (a) above.

- (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?**

Please refer to our response to (a) above. It may also be more appropriate to use a shorter period (than the minimum period of 12 months) for short term assets e.g. consumer loans such as credit card receivables as credit losses are often determined and written off within a year.

- (d) **For the foreseeable future, would the period considered in developing the expected loss estimate change on the basis of changes in economic conditions?**

Yes, we would consider changing the foreseeable future period in light of changes in the 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.**

We do not believe that the foreseeable future period is typically a period greater than 12 months. The 12-month period coincides with the annual financial reporting cycle, which is the same period used in assessing the going concern presumption underlying the financial statements.

- (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.**

Whilst we do not believe that the foreseeable future period is typically a period greater than 12 months, we acknowledge that it remains a possibility. For example a reporting entity with more robust credit data and appropriate modelling capabilities could

Appendix

arguably be able to 'foresee' further. It is unclear in the ED now if an entity has the ability to forecast longer, whether or not this knowledge must be used in extending the minimum 12-month floor. If this knowledge is required to be used to determine the floor, then there may be counter-intuitive outcomes where those entities with more robust credit data (and most likely better credit risk management) would have to maintain higher impairment balances compared to those entities without similar forecasting abilities.

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.

Please refer to our response to Q9 for our proposal of a single method for the good book, and our response to Q7 on the criteria for differentiating good and bad books in mitigating risk of under provision of credit losses.

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 agree with the proposal to permit flexibility to use either a discounted or undiscounted estimate to allow for the different levels of sophistication amongst the preparers. As noted in our response to Q3 where we would like to propose to align the impairment model to Basel II credit loss calculation, we would also like the Board to permit flexibility in the choice of a suitable discount rate, including the weighted average cost of capital (WACC) that is used in Basel II model.

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 support the use of a single method for the good book and would urge the Board to consider aligning the proposed approach to the Basel II credit loss model.

However as noted in our response in Q3, we would like to propose that entities be given the

Appendix

flexibility to adopt the IASB proposed time proportional approach. Despite our concerns expressed in response to Q4, we support the IASB approach as it maintains the link between the pricing of the financial asset and expected credit losses. Recognising expected credit losses over the life of the asset reflect the economics of the lending transaction.

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?

We are not supportive of the FASB approach as it does not reflect the economics of the lending transaction. However we do acknowledge that the FASB model is operationally less complex to implement.

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 agree that the determination of the effective interest rate should be separate from the consideration of expected losses as it would be practically difficult to integrate the expected credit losses into the effective interest rate computation.

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?

We support the proposal that loan commitments be subject to the same impairment requirements as these are managed in the same manner as loan assets in most circumstances. Applying the same impairment rules would result in more decision useful information.

Question 16Z

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

Yes, since loan commitments and financial guarantee contracts are managed in the same manner as loan assets in most circumstances.

Appendix

Question 17Z

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

We are agreeable 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 generally agree with the proposed disclosure requirements except for the "disclosure of information about the impairment allowance that depends on the age of the portfolio compared to its expected life for 5 years, including the nominal amount of the financial assets, the total expected credit losses, the amount of the credit loss allowances and effects of the minimum allowance amount." In our opinion the disclosure of 5 year comparative figures is too onerous and data availability will be a big challenge.

In addition we are also not agreeable to the disclosure on the comparison of previous estimates of expected credit losses with actual outcomes (i.e. backtesting) especially in the initial stages of implementation where credit loss models are still subject to refinement and where data availability may be a challenge. We recognize that the comparison of previous estimates with actual outcomes is important to allow users to assess the reliability of estimates used by the entities. Hence we would like to suggest that a reprieve from such disclosures be given during the initial implementation period so as to allow entities sufficient time to collect the required data. Such a reprieve period is not expected to be longer than 5 years.

In addition, if our proposal to the use of a single method for the good book i.e. the Basel II credit loss model is accepted, there should be sufficient disclosures on the methodology applied, the data used and the parameters derived (PDs, LGDs and EADs etc. for each class of assets) in measuring the credit losses. The Basel II Pillar 3 disclosures should be leveraged for this purpose.

Appendix

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?

The supplemental document proposed that the transfer of financial assets between the two books be based on the entity's internal risk management. It also proposed that when an entity transfers a financial asset between the two books, it would also transfer the related portion of the loss allowance and that allowance amount should reflect the age of the asset. In determining the time proportional amount of loss allowance for the transferred asset, the entity has to consider the age and life of the individual asset.

As the loss allowance of the two books have to be re-estimated at each reporting date, we believe the information on the amount of allowance transferred is of little use. Given the operational complexity in determining the loss allowance transferred and the relevance of the information, we would like to propose that the Board to consider allowing also another method, i.e. assessment of sufficiency of impairment balances for both the good and the bad books separately without the transfers of allowances between the two books. Each of the books would be reassessed after the transfer of assets between them, and any shortfall/excess in the level of their respective impairment balances would be provided for or reversed.