Rådet för finansiell rapportering

The Swedish Financial Reporting Board

RFR-rs 2010:07

International Accounting Standards Board
30 Cannon Street
London EC4M 6 XH
United Kingdom

Dear Sirs,

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

The Swedish Financial Reporting Board is responding to your invitation to comment on the International Accounting Standard Board's Exposure Draft ED/2009/12 Financial Instruments: Amortised Cost and Impairment.

Our main concerns are the summarised below.

We consider that the model proposed by the IASB is unnecessary complex and that changes in the current amortised cost model are not warranted. Instead we recommend an adjusted impairment model which is based on an expected loss approach given that the benefits of an adjusted model exceed the cost of change, both initially and subsequently, and consider that this model should be carried out at portfolio level. We consider that the IASB model fails to fully capture that the business model for a single contract may be different than the business model at the level of a portfolio.

We consider that current estimates of expected losses should update the effective net return over the financial instrument's remaining term. Only the adjustment of the historically recognised return should affect profit and loss immediately.

Our detailed comments are as follows:

Objective and measurement of amortised cost

The model for the recognition of expected credit losses, as proposed by the IASB, is overly complex and fails to capture the business model in the generating of return on ordinary loan portfolios. We also do not agree with the description of the objective of amortised cost measurement in the exposure draft.

We consider that the IASB model fails to fully capture that the business model for a single contract may be different than the business model at the level of a portfolio. The business model is for individual financial assets to collect the contractual cash flows. However, at the portfolio level the business model might be to collect the expected cash flows after reduction for expected losses. We consider that the expected loss model proposed by the IASB fails to recognise this difference. For an individual financial asset (of normal credit quality) there is no expected loss, instead the loss is

The Swedish Financial Reporting Board
Box 7680 SE-103 95 STOCKHOLM Sweden
Tel: +46-8-50 88 22 79 Fax: +46-8-32 12 50
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unexpected. Therefore, we believe that the most relevant presentation of the cash flows for individual financial assets is to recognise the cash flows using the contractual effective interest rate. However, based on experience it is reasonable to assume that there will be losses on the portfolio level, i.e. there are expected losses at the level of the portfolio. Therefore, we propose, as further described below, that expected losses should be measured and recognised using a portfolio model. Since this model focuses on the aggregation of unexpected losses that have not been individually identified, we consider that the financial assets that have been individually identified to be impaired should be removed from the portfolio and measured individually with the impairments recognised in profit and loss.

Impairment model based on a portfolio approach

We consider that the methodology for the calculation of amortised cost should be made separately from the measurement of impairment charges. Therefore we consider that the last part of the sentence in paragraph 5 should be deleted: "as well as the initial estimate of expected credit losses on a financial asset". Our proposed methodology would align the measurement objective of amortised cost for both assets and liabilities. We are also convinced that such choice of methodology will make it easier for the users of the financial statements to predict future cash flows, thereby better fulfilling the objective described in paragraph 1 "useful information to users of financial statements for their assessment of the amounts, timing and uncertainty of future cash flows".

In addition, the costs of implementing and applying the principles and approaches proposed in the exposure draft may be higher than the expected benefits. We are uncertain as to whether the precision requested in the exposure draft is possible to apply in order to receive the best and most accurate estimate. We believe it is difficult (and sometimes impracticable) to assess and set a timing for probability weighted expected losses on individual loan engagements. We envisage that it would only be in rare circumstances entities would be able to have a reliable estimate on the timing of expected future losses, especially at inception of the loan engagement. In most cases we consider that entities are predicting estimated losses on a portfolio level, and that the expectation is not materialized in cash flows at given times, but more as an estimate of the size of future credit losses. We believe that this is especially true for low risk portfolios.

We agree that an expected loss model for impairment could improve the present impairment rules. However, the proposed model is overly complex and the focus on the initial estimate instead of the current estimate of expected losses will reduce the usefulness.

We consider that provisions for expected losses are different in nature than incurred losses. Expected losses are contingent on a future event. As such they are not related directly to single assets and liabilities. The nature of expected losses is instead similar to liabilities or insurance contracts. It is clearly expressed in IAS 8.36 that a change in accounting estimate "shall be recognised prospectively by including it in profit and loss in (a) the period of the change, if the change affects that period only, or (b) the period of the change and future periods if the change affects both." Furthermore, since the change in estimate does not directly relate to changes in assets or liabilities, but instead relates to changes in estimates of future adverse events that will change future interest income of the portfolio as such, not the single asset or liability, the exception in paragraph 37 does not apply.

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There are several arguments for that:

1. The uncertainty of the credit risk is higher at inception. Therefore the initial estimate is normally exaggerated
2. The initial estimate does not reflect the current estimate of expected losses. Especially, if the objective of an amortised cost estimate is to allocate estimated future cash flows, the estimate should be based on the currently estimated cash flows, not historical estimates.
3. Several types of loan agreements gives the lender the possibility to adjust the contractual interest rate if the credit quality has deteriorated, i.e. using the current estimates of expected losses will better reflect the contractual possibilities to adjust the interest rate.

Recognition of current estimates of expected losses:

The IASB proposes a presentation of currently estimated expected losses by:

1. Reducing the interest income with initial expected losses, and
2. Adjusting the total present value effect due to changes in future expected losses immediately as an adjustment of the present interest income.

We consider that using the "initial estimate of credit losses" as a reduction of recognised contractual interest income, instead using the current estimate of expected losses badly reflects the presently expected future cash flows of the entity. We consider that using the current estimates gives better decision-useful information for users and that an approach where the initial estimate is updated with the most current information is preferable; i.e. a model that recognises the current estimate of expected losses as if the entity always had recognised the present estimate. The superior model for doing that is to adjust the contractual interest income with the expected losses that would had been recognised if the entity, from the inception of the contract had had the present expectations of expected losses, and thereafter recognise the current expectations expected credit losses as a reduction of the contractual effective return of the assets measured at amortised cost for the remainder of a financial instrument's term. Only changes in estimates that affect the historically recognised return should immediately be recognised in profit and loss.

Effective date and transition

We believe a mandatory effective date of three years after the requirements are issued would be insufficient if the present proposals are kept. There are two basic requirements that make an implementation overly burdensome and expensive:

1. The requirement to calculate and recognise an effective interest rate after reduction for probability weighted expected losses related to contractual cash flows.
2. The requirement to calculate the effective interest rate for floating rate financial assets and liabilities by extracting the expected future floating interest rate levels using a zero coupon curve (AG B12).

The complexity in the methodology proposed by the IASB and the need to adjust IT-systems are much higher than the burden imposed by regulated entities when they implemented the Basel II requirements for capital adequacy calculations (by some

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estimated to be five times as high). Those implementation projects lasted for much more than the proposed implementation period of three years.

Instead, if a portfolio approach was implemented for the calculation of expected credit losses and the present methodologies for the calculation of the effective return on fixed and floating interest rate financial assets and liabilities were maintained, then a three year implementation period could be reasonable.

Furthermore, we do not agree with the proposed transition requirements since we consider that retrospective application would increase the burden on preparers on initial application and could in some instances make the required lead-time to implement the proposal to short.

We favour a simplified approach in order to make the implementation period as short as possible and also in order to make as many preparers as possible able to implement the new requirements earlier than they otherwise would be able to do. As such we propose a solution without restatement of comparative information. Instead the accumulated current expected losses of the portfolios measured at amortised cost should be recognised at the date of transition with a contra entry against retained earnings. I.e. the expected losses that should be recognised at an allowance account for expected losses should be the ones that would have been recognised if the entity had always applied the standard without any changes in estimates of the expected loss.

We do not agree with the proposed disclosure requirements related to transition. We believe the requirements proposed in paragraph 28 are burdensome and we do not see that this information provides decision useful information to users.

Practical expedients

We support the inclusion of practical expedients in the proposal and we believe the proposed guidance on practical expedients is appropriate.

Other presentation and disclosure concerns

We acknowledge that practical expedients already included in the current proposal can justify a simplified approach for those entities where the effect of discounting is immaterial. Therefore we believe that it is rational to have the same presentation requirements regardless if the business model is to earn interest income or if interest income is just a minor part of the income for the entity.

However, we fail to understand why the extra burden imposed on the calculation of the effective interest rate by introducing a requirement to calculate the effective interest rate both for contractual and expected cash flows is motivated.

We believe that it is questionable as to whether disclosing stress testing information would give users decision-useful information. The disclosure requirements could in some instances incentivise entities to not perform severe stress testing, but instead use internal stress testing that produces a desired outcome since the disclosure requirement is linked to internal risk management procedures. Furthermore, stress testing is normally made of an estimated future performance. There might be severe legal risks in certain jurisdictions to display such information. It is normally also part of the heart of the business which may be damaging for the entities' competitive advantage to display such information to competitors.

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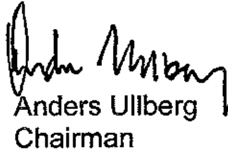
Rådet för **finansiell rapportering**

If you have any questions concerning our comments please address our Executive member Carl-Eric Bohlin by e-mail to: carl-eric.bohlin@radetforfinansiellrapportering.se

Stockholm, 5 July 2010

Yours sincerely



Anders Ullberg
Chairman

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