ASC
ACCOUNTING STANDARDS COUNCIL

1 September 2009

International Accounting Standards Board
1st Floor 30 Cannon Street
London EC4M 6XH
United Kingdom

(By email: CommentLetters@iasb.org)

Dear Sirs

RESPONSE TO REQUEST FOR INFORMATION ('EXPECTED LOSS MODEL') IMPAIRMENT OF FINANCIAL ASSETS: EXPECTED CASH FLOW APPROACH

The Singapore Accounting Standards Council (ASC) appreciates the opportunity to comment on the Request for Information on Impairment of Financial Assets: Expected Cash Flow Approach (Request for Information) issued by the International Accounting Standards Board (IASB) in June 2009.

General Comments

2. We note that the existing incurred loss impairment approach for financial assets has its criticisms and there is merit in the expected cash flow approach in addressing some of these concerns. Whilst we support the IASB's efforts to carry out this feasibility review of the expected cash flow approach in advance of developing its proposals for the exposure draft on impairment of financial assets, IASB has to address the possibility of earnings management by entities under the expected cash flow approach. It would be undesirable to return to the period before the introduction of the incurred loss impairment approach where entities made provisions when profits were higher than expected and releasing them when times were difficult.

3. Our comments are built on the following fundamentals:
   - the expected cash flow approach requires entities to assess impairment from the day the financial assets are recognised on the books and on an on-going basis till the day the instruments are derecognized. This differs from the existing incurred loss approach wherein impairment is assessed when there is a trigger event; and

- the expected cash flow approach promotes coherency with other regulatory requirements, such as Basel II, and allows a more consistent approach in assessing credit loss.

Our comments on the specific questions to the Request for Information are as follows:

Question 1

Is the approach defined clearly? If not, what additional guidance is needed, and why?

4. Whilst the incurred loss approach involves certain level of management judgment as to the "loss event trigger", the expected cash flow approach places an even greater reliance on management's assessment and foresight (future outlook, economic conditions etc) on the estimation of expected cash flows. For consistency and to facilitate comparison, we will like the Board to provide the following guidance:

    a) implementation guidance on moving from the incurred loss approach to the expected cash flow approach, in particular, provide practical guidance on the estimation of expected cash flows and probability of default, and specific guidance to ensure a smooth transition. Specific areas to consider:
        - how the expected cash flow approach should be applied on the existing portfolios?
        - should the change be effected prospectively or retrospectively?
        - how can the probability of default and expected cash flows be applied or estimated in a cost-effective manner for entities with wide or diverse portfolios and/or volatile results?
        - in the absence of historic data to derive the probability of default, what are the alternative data sources?

    b) Factors or parameters to be considered in assessing the expected cash flow; and,

    c) definition of "expected cash flow" and "probability of default", considering
        - whether expected cash flow is based on historical payment behavior?
        - what constitutes probability of default?

Question 2

Is the approach operational (ie capable of being applied without undue cost)? Why or why not? If not, how would you make it operational?

5. For those entities which are not within the scope of BASEL II reporting and have large portfolio of financial assets subjected to impairment test, it is likely that the expected cash flow approach can only be applied with significant costs for the following reasons:

   a) the scale of assessment of expected cash flow approach is expanded to include the entire portfolio of financial assets as opposed to the portfolio with "trigger" events under the incurred loss approach;
   b) expected cash flows would need to be continuously re-estimated as opposed to the "triggered" basis under the incurred loss approach; and
   c) the expected cash flow approach entails the collation of historic data for each of the cash flows.

6. In respect of entities which are within the scope of BASEL II, current processes or systems (effective interest rate computation, correlation and diversification effects, continuous reassessment etc) need to be changed. The grouping of loan classification may be affected and backtesting to prove the assumptions will also place a heavier burden on the entities.

Question 3

What magnitude of costs would you incur to apply this approach, both for initial implementation and on an ongoing basis? What is the likely extent of system and other procedural changes that would be required to implement the approach as specified? If proposals are made, what is the required lead time to implement such an approach?

7. Notwithstanding the fact that the information deficiency problem may be diminished (because incurred losses lagged probable losses) and the pro-cyclical nature of the incurred loss method can be displaced, the quality of the information under expected cash flow approach remains a question. Estimation of expected losses over a long horizon may not be credible and discretionary management of these provisions will potentially create a lot of comparability issues.

Address: The Secretariat, Accounting Standards Council,
c/o Ministry of Finance, 100 High Street, #10-01, The Treasury, Singapore 179434.
Website: www.asc.gov.sg Email: MOF_Feedback_ASC@mof.gov.sg Fax: (65) 6332 7435

8. The extent of costs to be incurred and lead time required is largely dependent on:
   a) the size of the portfolio;
   b) the profile of the financial assets (ie whether they are long tenure loans); and
   c) the ability of the existing systems to cope with the enlarged population of financial assets carried at amortised cost to determine the variables required by the new approach.

9. The costs which the entity is willing to incur has to be viewed in conjunction with the benefits of adopting the new approach and thorough assessment needs to be made with regards to the effort required to make the change.

Question 4

How would you apply the approach to variable rate instruments, and why? See the Appendix for a discussion of alternative ways in which an entity might apply the expected cash flow approach to variable rate instruments.

10. The key parameter under the expected cash flow approach is the probability of default to be applied to the future contractual cash flow. The stream of future contractual cash flows is not expected to differ between the incurred loss and expected loss approaches. As such, the incurred loss approach (under FRS 39.AG7 and 8) in estimating the future cash flows, a function of probability of default and future contractual cash flows, can similarly be applied under the "expected loss" model.

11. We agree with the two alternatives as set out in the Appendix to Request for Information which is also currently being applied in arriving at the expected cash flow for variable rate instruments.

12. Alternative A is a more theoretical approach with added precision, which requires strong support in terms of systems and process administration with the continuous resetting of the effective interest rate. In comparison, alternative B appears to be more practical in its application in terms of time and effort. Whilst alternative B is less precise, the results approximate alternative A. As such, alternative B is a more "balanced" approach.

Address: The Secretariat, Accounting Standards Council,
c/o Ministry of Finance, 100 High Street, #10-01, The Treasury, Singapore 179434.
Website: www.asc.gov.sg Email: MOF_Feedback_ASC@mof.gov.sg Fax: (65) 6332 7435

Question 5

How would you apply the approach if a portfolio of financial assets was previously assessed for impairment on a collective basis and subsequently a loss is identified on specific assets within that portfolio? In particular, do you believe:

- ***(a) changing from a collective to an individual assessment should be required? If so, why and how would you effect that change?***
- ***(b) a collective approach should continue to be used for those assets (for which losses have been identified)? Why or why not?***

13. The assessment should be based on a combination of (a) and (b) above that would result in the best estimate of losses for any asset or group of assets. The pre-requisite for collective assessment is to group the homogenous assets by, for example, similar credit risk characteristics which can be represented by the probability of default. Where there is a change in the probability of default for an identified asset, the identified asset may be re-grouped for collective impairment assessment or assessed for impairment on an individual basis.

Question 6

What simplifications to the approach should be considered to address implementation issues? What issues would your suggested simplifications address, and how would they be consistent with, or approximate to, the expected cash flow model as described?

14. The expected loss approach is a function of the contractual cash flows and the probability of default which is based on historical loss data. An alternative to the probability of default that could be considered may be a function of credit spread and recovery rate as follow:

    Probability of default = credit spread / (1 – recovery rate)

15. However, getting the above probability of default would be a challenge, especially in the Asian market, where credit spread and recovery rate are generally not trade-able. As such, the provision for specific guidance on deriving the probability of default will facilitate the implementation process.

16. Another consideration would be to incorporate the requirements of Basel II Expected Loss methodology into IFRS approach. The estimates of the expected losses should be calibrated using information on loss experience over a complete economic cycle and/or that credit loss estimates should be computed over the life of the loan or loan portfolio.

Address: The Secretariat, Accounting Standards Council,
c/o Ministry of Finance, 100 High Street, #10-01, The Treasury, Singapore 179434.
Website: www.asc.gov.sg Email: MOF_Feedback_ASC@mof.gov.sg Fax: (65) 6332 7435

17. We hope that our comments will contribute to the IASB's development of its exposure draft proposals for the impairment of financial assets. Should you require any further clarification, please contact me. Thank you.

Yours faithfully,

Dexter Tan
Secretary, Accounting Standards Council