Financial Reporting Council

DRAFT COMMENT LETTER

Comments should be submitted by 14 June 2013 to s.jamiloneill@frc.org.uk

Hans Hoogervorst
Chairman
International Accounting Standards Board
30 Cannon Street
London
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X July 2013

Dear Hans

ED/2013/3 "Financial Instruments: Expected Credit Losses"

The FRC is pleased to have the opportunity to comment on the IASB's Exposure Draft (ED) ED/2013/3 "Financial Instruments: Expected Credit Losses".

Our overall view on the proposals in the ED is set out below. Detailed responses to the questions asked in the ED are addressed in the Appendix to this letter.

1. Given the IASB's extensive research and work in this area over recent years, we believe that the ED's proposals strike a reasonable balance between cost of implementation and underlying economics and are likely to meet users' need to provide expected credit losses. We would therefore recommend that IASB address the additional clarifications requested by constituents (including those in this letter) and then aim to finalise the impairment phase of its project on financial instrument accounting as soon as possible.

2. The Accounting Standard Board (ASB[1]) letter dated 22 June 2010 supported the proposals for impairment of financial assets included in the IASB's 2009 ED. It did so on the basis that it was a conceptual model that would address the weaknesses highlighted in the incurred loss model by the credit crisis. However, at the time the ASB raised a number of operational concerns with those proposals. In arriving at the proposals in this current ED, we note the IASB's efforts at addressing those operational challenges whilst maintaining the link between pricing and credit quality of financial instruments.

3. Although we do not believe that recognising a portion of expected credit losses on initial recognition is conceptually sound, we believe that the proposal on this aspect in the ED is a pragmatic approximation of the underlying economics. We also believe that the approach in the ED has the potential to be responsive to credit

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[1] The responsibilities of the Accounting Standards Board were transferred to the FRC in July 2012. The Accounting Council advises the FRC on accounting standards and related issues.

impairments experienced in early years. However, we would not support recognising a credit allowance on initial recognition exceeding 12-month expected credit losses.

4. The appendix to this letter includes suggestions of specific aspects of the proposals that we feel can be clarified to ensure consistency of application. These include clarification of the concepts of "significant deterioration" and "Undue cost and effort" and the need to address the interest rates permitted to be used by the approach.

5. As stated in the ASB's response to both the 2009 ED and the SD, we continue to believe that the implications for IT system changes from this standard is likely to be extensive. As a result, we would suggest a lead time of three years to implement the proposed requirements. This should not prevent the IASB from permitting entities to apply the standard earlier if they have completed their transition before the mandatory date.

6. On a general note, we would recommend that close to the end of the project on financial instruments, there should be a review of all the new disclosures introduced by the different phases of this project as well as those in IFRS 7 to ensure that there is no overlap of disclosures which could be presented once and in a simpler way.

Should you have any queries about the comments in this letter please do not hesitate to contact either me or Seema Jamil-O'Neill at 020 7492 2422 or s.jamiloneill@frc.org.uk.

Yours sincerely

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Appendix A – Response to Detailed questions

Objective of an expected credit loss impairment model

Question 1
(a) **Do you agree that an approach that recognises a loss allowance (or provision) at an amount equal to a portion of expected credit losses initially, and lifetime expected credit losses only after significant deterioration in credit quality, will reflect:**
(i) **the economic link between the pricing of financial instruments and the credit quality at initial recognition; and**
(ii) **the effects of changes in the credit quality subsequent to initial recognition?**
If not, why not and how do you believe the proposed model should be revised?
(b) **Do you agree that recognising a loss allowance or provision from initial recognition at an amount equal to lifetime expected credit losses, discounted using the original effective interest rate, does not faithfully represent the underlying economics of financial instruments? If not, why not?**

Economic link between pricing and credit quality

1. We agree that the proposed approach in the ED is a pragmatic reflection of the economic link between pricing and credit quality of a financial instrument at initial recognition as well as when there are subsequent changes in credit quality.

2. In the ASB's previous responses it agreed with the IASB's view that expected credit losses are most faithfully represented by the proposals in the 2009 ED, enabling a timely recognition of expected credit losses.

3. It is clear that the tiered model in this ED[2] is not as conceptually pure as that in the 2009 ED. However, we support the proposed approach in the 2013 ED as it overcomes a number of operational challenges inherent in the 2009 ED, identified by IASB's constituents (including the ASB). We believe it does this by:

    i. distinguishing between instruments that have deteriorated in credit quality and those that have not;

    ii. eliminating the operational challenge of having to estimate the full expected cash flows for all financial instruments by limiting the measurement of lifetime expected credit losses to financial instruments that have significantly deteriorated in credit quality. This also ensures timely recognition of expected credit losses;

    iii. reducing the subjectivity in the calculation of expected losses in the "good book" by limiting it to a 12-month period. The 12-month expected losses also

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[2] The ED requires that an entity recognises a loss allowance equal to 12-month expected credit losses for all instruments *unless* credit quality deteriorates significantly after initial recognition when the loss allowance increases to lifetime expected credit losses.

have the effect of reducing the systematic overstatement of interest revenue in current IAS 39;

    iv. limiting the information that an entity would be required to maintain about the initial credit quality to that which is consistent with preparers' current risk management systems; and

    v. providing operational simplifications for certain financial instruments.

4. We agree with the IASB that these operational simplifications would result in an improvement in financial reporting as they would ensure earlier recognition of expected credit losses, lead to a reduction in systemic overstatement of interest revenue, and provide useful information on credit deterioration.

5. We also believe that these operational simplifications have ensured that the model for recognising expected credit losses will be easier to apply for all types of entities, those operating in the financial sector as well as those operating in sectors where financial assets are a by-product.

Recognising lifetime expected credit losses on initial recognition

6. We agree with the IASB that recognising a loss allowance or provision from initial recognition at an amount equal to lifetime expected credit losses, discounted using the original effective interest rate, (the FASB approach) does not faithfully represent the underlying economics of financial instruments.

7. We believe that in most cases this approach will lead to excessive front-loading of credit losses, at best, and double counting of credit losses on initial recognition where credit losses are priced into the financial asset.

8. We also believe that such an approach would not distinguish financial assets that have deteriorated in credit quality from those that have not.

The main proposals in this Exposure Draft

Question 2
(a)   **Do you agree that recognising a loss allowance (or provision) at an amount equal to 12-month expected credit losses and at an amount equal to lifetime expected credit losses after significant deterioration in credit quality achieves an appropriate balance between the faithful representation of the underlying economics and the costs of implementation? If not, why not? What alternative would you prefer and why?**
(b)   **Do you agree that the approach for accounting for expected credit losses proposed in this Exposure Draft achieves a better balance between the faithful representation of the underlying economics and the cost of implementation than the approaches in the 2009 ED and the SD (without the foreseeable future floor)?**
(c)   **Do you think that recognising a loss allowance at an amount equal to the lifetime expected credit losses from initial recognition, discounted using the original effective interest rate, achieves a better balance between the faithful representation of the underlying economics and the cost of implementation than this Exposure Draft?**

Balance between faithful representation and cost of implementation

9.   Yes, the FRC agrees that recognising a loss allowance equal to 12-months expected credit losses and at an amount equal to lifetime expected credit losses after significant deterioration in credit quality achieves an appropriate balance between the faithful representation of the underlying economics and the costs of implementation.

10.   Whilst we believe that the 2009 ED came closer to a conceptually pure approach for calculating expected credit losses, the ASB (as well as other constituents) raised concerns about the operationality and cost of implementation of that model. The IASB proposed a number of solutions to these issues in the SD. One such concept was the concept of the floor (the minimum allowance amount on the good book) from which we believe the concept of the 12-month expected credit losses has evolved.

11.   In the ASB's response to the SD (March 2011) it recognised that "the concept of the floor is a pragmatic solution which…provides an answer to the question of how to ensure sufficient impairment allowance is built up for financial instruments with early loss patterns". The ASB went on to support a 12-month floor on that basis. We believe that the current incarnation of that concept in the 2013 ED is similarly a pragmatic solution that aims to balance costs of implementation with faithful representation.

12.   As mentioned in the response to Q1 above, we believe the other operational simplifications achieved in the approach proposed in the 2013 ED will ensure that the model remains representative of the underlying economics as well as ensuring that its outputs produce relevant information for users of financial statements.

13.   We understand from our constituents that the model in this ED will be less costly to implement than the 2009 ED as well as the requirements under the FASB's proposals. Financial sector constituents also tell us that this model is also closer to the way they risk manage their portfolios.

Full Lifetime expected credit losses

14. We do not believe that recognising a loss allowance at an amount equal to the lifetime expected credit losses from initial recognition, discounted using the original effective interest rate, achieves a better balance between the faithful representation of the underlying economics and the cost of implementation than this Exposure Draft.

15. Although at first such a model appears to be simpler as it removes the need to track changes in credit quality to determine the point at which lifetime expected credit are to be recognised. However, recognising the lifetime expected credit loss allowance at the outset leads to a more subjective estimate with little objective information on several of the inputs. Neither will this model provide information to users on the credit deterioration of financial assets and the impact on the income statement.

Scope

Question 3
(a) **Do you agree with the proposed scope of this Exposure Draft? If not, why not?**
(b) **Do you agree that, for financial assets that are mandatorily measured at FVOCI in accordance with the Classification and Measurement ED, the accounting for expected credit losses should be as proposed in this Exposure Draft? Why or why not?**

16. We agree with the scope of this ED. However, we note that some of our constituents have raised concerns with the fact that the leasing standard has not been finalised yet as a result it is difficult to assess the real impact on including the leasing transactions within the scope of this ED.

17. In its responses to the 2009 ED and 2011 SD, the ASB recommended that IASB attempt to arrive at a singular impairment model for all financial instruments, regardless of how they are categorised for accounting purposes. As such, we agree that financial assets mandatorily measured at FVOCI should account for expected credit losses as proposed in the ED.

12-month expected credit losses

Question 4
Is measuring the loss allowance (or a provision) at an amount equal to 12-month expected credit losses operational? If not, why not and how do you believe the portion recognised from initial recognition should be determined?

18. As mentioned in our response to Q1 and Q2 we believe that measuring the loss allowance (or a provision) at an amount equal to 12-month expected credit losses is operational.

Assessing when an entity shall recognise lifetime expected credit losses

Question 5	
(a)	**Do you agree with the proposed requirement to recognise a loss allowance (or a provision) at an amount equal to lifetime expected credit losses on the basis of a significant increase in credit risk since initial recognition? If not, why not and what alternative would you prefer?**
(b)	**Do the proposals provide sufficient guidance on when to recognise lifetime expected credit losses? If not, what additional guidance would you suggest?**
(c)	**Do you agree that the assessment of when to recognise lifetime expected credit losses should consider only changes in the probability of a default occurring, rather than changes in expected credit losses (or credit loss given default ('LGD'))? If not, why not and what would you prefer?**
(d)	**Do you agree with the proposed operational simplifications, and do they contribute to an appropriate balance between faithful representation and the cost of implementation?**
(e)	**Do you agree with the proposal that the model shall allow the re-establishment of a loss allowance (or a provision) at an amount equal to 12-month expected credit losses if the criteria for the recognition of lifetime expected credit losses are no longer met? If not, why not, and what would you prefer?**

Significant increase in credit risk

In principle, we agree with the IASB that recognition of loss allowance (or a provision) at an amount equal to lifetime expected credit losses should be based on a significant increase in credit risk since initial recognition. We also note that the ED provides a substantial amount of guidance (paragraph B20-21) as well as a number of examples to illustrate the concept of "significant increase in credit risk since initial recognition".

19. However, we found some of the examples rather confusing. In particular, Example 6 "Public investment-grade bond" appears to arrive at a contrary conclusion to that suggested by the guidance on "significant deterioration" and presumption in the standard about investment grade financial assets. Similarly, the conclusion on Example 7 "Portfolio of credit cards" included in para IE41 of the ED seems counter-intuitive and provides little justification for why it has been applied to the whole portfolio.

20. We are also aware that a number of constituents continue to raise this as an area of concern. We note that this is a relative measure of deterioration and as such judgement will be applicable in making such an assessment. We believe this may be a reason for the unease in this area. We would suggest two interrelated actions:

  i. the scenario testing which we understand is being conducted addresses this issue as thoroughly as possible e.g. by addressing as many different types of real life deteriorations in credit quality as possible; and
  ii. the results of those scenario testing exercises are made available to all constituents to ensure that a consistent approach to applying this principle is developed without the need for extra rules and guidance being included in the standard itself.

21. In this context, we also note the concession in paragraph 17(b) of the ED stating that "information is reasonably available if obtaining it does not involve undue cost and effort." We are concerned that the term "undue cost and effort" is not a defined term

in the context of IFRS and may be interpreted in different ways by constituents depending on whether they are preparers, auditors or users of financial statements. However, a synonymous term "impracticable" is defined. We believe that rather than defining the new term the IASB should either refer to the term "impracticable". If this is not seen as a suitable solution then a cross-reference to the guidance on the application of "undue cost and effort" in the IFRS for SME Q&As may ensure consistency of application.

Financial assets at stage 3

22.   We note that one quirk of this model may be that, the measurement of lifetime expected credit losses on financial assets at stage 3 (where there is objective evidence of impairment at the reporting date) is likely to be lower than that calculated under the incurred loss model. For such assets, the incurred loss model would require impairment allowance of the most likely amount to be recognised. The model in the ED by contrast, would require the probability of default (PD) and the loan given default to be taken into account for such financial assets. As such, the ED model would be a probability weighted average amount that might be more or less than the incurred loss amount unless the PD is calculated at 100.

23.   It may be useful to consider this anomaly in detail to ensure that the impact of this is fully understood and explained in the final standard.

Time value of money

24.   We note that B29(a) states that

"when determining the discount rate used to reflect the time value of money for the calculation of expected credit losses …an entity shall, at initial recognition of a financial asset, determine as the discount rate for that asset any reasonable rate that is between (and including) the risk-free rate and the effective interest rate"

25.   This approach is inconsistent with the requirement in the same ED to calculate interest revenue by using the effective interest method and applying the effective interest rate.

26.   Given the impact of the interest rate used in such calculations, we believe this inconsistency should be removed from the ED and both interest revenue and the credit losses should be calculated using the same interest rate.

Symmetrical model

27.   We agree with the proposal that the model shall allow the re-establishment of a loss allowance (or a provision) at an amount equal to 12-month expected credit losses if the criteria for the recognition of lifetime expected credit losses are no longer met. We believe this approach is reflective of the real life economics of holding financial assets.

Interest revenue

Question 6	
(a)	Do you agree that there are circumstances when interest revenue calculated on a net carrying amount (amortised cost) rather than on a gross carrying amount can provide more useful information? If not, why not, and what would you prefer?
(b)	Do you agree with the proposal to change how interest revenue is calculated for assets that have objective evidence of impairment subsequent to initial recognition? Why or why not? If not, for what population of assets should the interest revenue calculation change?
(c)	Do you agree with the proposal that the interest revenue approach shall be symmetrical (i.e. that the calculation can revert back to a calculation on the gross carrying amount)? Why or why not? If not, what approach would you prefer?

28. We agree with the IASB that where the credit quality of a financial asset has deteriorated significantly then present interest revenue on a gross carrying amount basis does not reflect the economic return. This approach is consistent with the current requirements under IAS 39 and so should not lead to additional complexity for preparers.

29. In this context, our concerns with the applicable interest rate become more important. If different interest rates are applied for credit loss and interest revenue calculation purposes then the switch from gross to net basis may include the impact of the change in interest rates as well as reflecting the change in the economic return expectations. We therefore recommend that both interest revenue and the credit losses should be calculated using the same interest rate.

30. We believe a symmetrical interest revenue approach would enhance comparability of accounting treatment of similar financial assets across entities.

Disclosure

Question 7	
(a)	Do you agree with the proposed disclosure requirements? Why or why not? If not, what changes do you recommend and why?
(b)	Do you foresee any specific operational challenges when implementing the proposed disclosure requirements? If so, please explain.
(c)	What other disclosures do you believe would provide useful information (whether in addition to, or instead of, the proposed disclosures) and why?

31. We note that one impact of the ED approach is that where an entity is growing its portfolio of financial assets it is likely to give rise to a higher level of loan losses being recognised on initial recognition than would be the case under steady state. The opposite is true when a portfolio is in the state of run-off. We are uncertain how the presentation and disclosure requirements in the ED would ensure that these nuances are clarified to the user of the financial statements. We believe paragraph 41 should clearly stipulate that a qualitative analysis of impact on a portfolio of changes therein is important to explain such anomalies to users.

32. We also note that the paragraph 32 of the ED permits that "disclosure requirements in the IFRS shall either be given in the financial statements or incorporated by cross-reference …to some other statement, such as risk report and disclosures, that is available to users of financial statements on the same terms as the financial statements and at the same time."

33. We welcome this initiative to simplify and declutter the financial statements. We would however, recommend that the IASB consider this in the context of its project on disclosures to ensure that implications for the usability and auditability of such changes are fully considered.

Application of the model to assets that have been modified but not derecognised

Question 8
Do you agree with the proposed treatment of financial assets on which contractual cash flows are modified, and do you believe that it provides useful information? If not, why not and what alternative would you prefer?

34. FRC agrees with the proposed treatment of financial assets on which contractual cash flows are modified and result in a new asset being created.

35. We are however unclear about the implications of the model in the case of financial assets where a financial institution is applying forbearance and the modification does not result in a new asset. It would be helpful to clarify how the model applies in this situation.

Application of the model to loan commitments and financial guarantee contracts

Question 9
(a) **Do you agree with the proposals on the application of the general model to loan commitment and financial guarantee contracts? Why or why not? If not, what approach would you prefer?**
(b) **Do you foresee any significant operational challenges that may arise from the proposal to present expected credit losses on financial guarantee contracts or loan commitments as a provision in the statement of financial position? If yes, please explain.**

36. FRC agrees with the proposals on the application of the general model to loan commitment and financial guarantee contracts. As noted in our response to the SD, our financial sector constituents tend to manage loan commitments together with other items in open portfolios e.g. undrawn credit card commitments are managed together with credit cards with existing balances. Therefore it is appropriate to subject loan commitments to the same impairment requirements as those for other financial assets.

Exceptions to the general model
Simplified approach for trade receivables and lease receivables

Question 10
(a)   **Do you agree with the proposed simplified approach for trade receivables and lease receivables? Why or why not? If not, what changes do you recommend and why?**
(b)   **Do you agree with the proposed amendments to the measurement on initial recognition of trade receivables with no significant financing component? If not, why not and what would you propose instead?**

37.   FRC agrees with the proposed simplified approach for trade receivables and lease receivables. We welcome the fact the simplification would permit entities to apply the same impairment model to all different types of financial assets.

38.   However, we note concerns raised above in relation to the lack of a leases standard and therefore the lack of clarity on the application of the proposals to lease receivables.

Financial assets that are credit-impaired on initial recognition

Question 11
Do you agree with the proposals for financial assets that are credit-impaired on initial recognition? Why or why not? If not, what approach would you prefer?

39.   FRC agrees with the proposals for financial assets that are credit-impaired on initial recognition, which we note are a continuation of the requirements in AG5 of IAS 39.

Effective date and transition

Question 12
(a)   **What lead time would you require to implement the proposed requirements? Please explain the assumptions that you have used in making this assessment. As a consequence, what do you believe is an appropriate mandatory effective date for IFRS 9? Please explain.**
(b)   **Do you agree with the proposed transition requirements? Why or why not? If not, what changes do you recommend and why?**
(c)   **Do you agree with the proposed relief from restating comparative information on transition? If not, why?**

40.   As stated in the ASB's response to both the 2009 ED and the SD, we continue to believe that the implications for IT system changes from this standard are likely to be extensive. As a result, we would suggest a lead time of three years to implement the proposed requirements. This should not prevent the IASB from permitting entities to apply the standard earlier if they have completed their transition before the mandatory date.

Effects analysis

Question 13
Do you agree with the IASB's assessment of the effects of the proposals? Why or why not?

41.   The FRC agrees that the proposed model should generally result in earlier recognition of expected credit losses, although we think it important to address the anomaly we have highlighted above. We also agree that the proposals will lead to useful information for users on expected credit losses, on changes in those expectations and on the way entities manage their lending portfolios.