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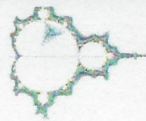

European Financial Reporting Advisory Group
Françoise Flores, EFRAG Chairman
35, Square de Meeûs
1000 Brussels

June 6, 2013

Dear Sir/Madam,
Dear Françoise, Didier, Panagiotis,

We appreciate the opportunity to comment on *EFRAG's Draft Comment Letter Financial Instruments: Expected Credit Losses*.

Aguilonius is a Brussels-based consulting and software partnership, headed by top experts with decades of experience in the wide area of International Financial Reporting Standards, prudential regulation and regulatory reporting, related to the financial services industry.

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Aguilonius is also preferred supplier to both small and large financial institutions and supervisors, supplying highly specialised software solutions and consulting services in the area of regulatory reporting, focusing on IFRS, XBRL, COREP, FINREP, Solvency II, …

Similar to EFRAG's position, we accept IASB's proposed approach for recognizing credit losses because it will result in a more timely recognition of expected credit losses compared to the current incurred loss model as described in IAS 39 and it provides an answer to some of the operational concerns raised as a comment on IASB's impairment model as described in its Supplementary Document.

In general, we suggest EFRAG to make a number of clarifications (such as the basis on which it reached conclusions on key issues, elaborate on a number of themes, …) as well as to include a number of topics on which EFRAG is currently silent. We refer to the unit of account, the impact of a discount rate between risk free and the effective interest rate. Finally, we are wondering whether EFRAG could look more in detail to the FASB's proposed impairment principles and assess whether (some of) FASB's proposal are from a conceptual perspective preferable compared to IASB's impairment principles. If that would be the case, EFRAG could list these principles in its comment letter to the IASB.

If you would like to discuss our comments further, please do not hesitate to contact me at nico.deprez@aguilonius.com or +32 478 97 97 75.

Yours faithfully,

Nico Deprez

EFRAG's Cover Letter

In its cover letter, EFRAG mentions that it supports the effective interest rate approach but recognizes the significant operational concerns. Therefore, in absence of a better model and although not conceptually sound, EFRAG supports the portion of expected credit losses at initial recognition in order to overcome the operational concerns. It would be interesting and useful for stakeholders if EFRAG explains how these two criteria (operational concerns versus conceptually sound) relate to each other and why the argument of operational concerns is given more weight than 'conceptually sound' element in making its decision.

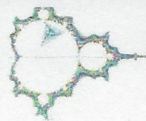
An important impact of this current impairment model as proposed by the IASB in its latest exposure draft is that it can lead to day one losses. Consequently, the value at which the asset is reported can significantly differ from its initial fair value. It would be helpful if EFRAG explores this issue and lists the arguments why it believes that this measurement basis (credit risk adjusted fair value) is preferable above the other one (fair value).

In the last paragraph of its cover letter, EFRAG refers to FASB's impairment model. We agree that in case of long term financial assets FASB's model would lead to higher credit losses at first reporting date compared to IASB's model. However, the comments made in the cover letter are written mainly in one direction and consequently the introduction is silent about (potential) advantageous FASB's impairment model could have compared to IASB's impairment model. For the sake of completeness and neutrality, it is probably worth to mention these advantageous as well. For instance, contrary to IASB's impairment model FASB's model avoids a cliff effect in the impairment allowance due to significant increase in credit risk attached to the financial instrument. A reduced cliff effect was one of the concerns raised by Basel Committee in its letter of December 2012 to both IASB and FASB.

Finally, EFRAG could include somewhere in its comment letter an in depth analysis and comparison of both IASB's and FASB's impairment model. Differences could then be assessed against conceptual and operational grounds. If elements of the FASB proposal are preferable above the ones stated in the IASB's exposure draft, EFRAG could mention these elements in its comment letter to the IASB together with the arguments and clarification on the criteria used to reach its conclusion.

Key areas which could be highlighted are:

1) financial guarantee contracts in scope of the standard
2) definition of loan commitments
3) accounting treatment of purchased credit impaired financial instruments
4) practical expedient for assets classified in FV OCI under FASB model
5) discount rate under FASB & IASB
6) probability weighted versus possible outcome
7) rebuttable assumption of 30 days overdue under IFRS
8) exceptions for low credit risk, short term receivables, leasing receivables,
9) collateral dependent financial assets under FASB model
10) non-accrual versus accrual on net basis



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 full 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 at an amount equal to all expected credit losses from initial recognition, discounted using the original effective interest rate, does not faithfully represent the underlying economics of financial instruments? If not, why not?

In paragraph 13 it is stated that EFRAG agrees with the recognition of a portion of the lifetime expected credit losses. It's worth to either change wording or to clarify this because it's confusing with what is mentioned in the cover letter and paragraph 23 referring to time-proportionated credit losses as proposed by the IASB's supplementary document.

In explaining the link between credit risk and pricing, EFRAG mentions in the draft comment letter that there is not always a clear economic link. We fully agree but we believe EFRAG could further explore the situations where this is not the case. One of the main reasons why the link between pricing and credit risk is missing has to do with a different definition of 'unit of account' in financial reporting on the one hand and in commercial approach on the other hand. Two illustrative examples: 1) mortgage loans are sometimes sold at cost (even if there is a high credit risk) because the customer has concluded a death and/or house insurance. Financial institutions realize a gain on the package but not on each individual instrument, 2) car manufacturers sometimes provide a financing at 0% instead of granting a higher discount on the purchase price of the car. Again, the total package is profitable but not each individual underlying transaction.

As the unit of account clearly plays an important role in pricing a financial asset and because none of the current IASB standards nor exposure drafts dealing with financial instruments provide clear principles/guidance on how to determine the 'unit of account', we suggest EFRAG to have a word on this subject in its final comment letter to the IASB.

The unit of account not only impacts the pricing of a financial instrument, it also plays a role in determining the discount rate to be used in calculating the impairment loss. The exposure draft lays down that the discount rate should be a rate between risk free and effective interest rate. If the unit of account is different than the individual underlying financial asset one could end up in a situation where the effective interest rate is lower than the risk free rate. In such a situation, the exposure draft states that a risk free interest rate cannot be used.

It would be helpful to explain in more detail the double-counting of initial estimated expected credit losses EFRAG is referring to in paragraph 22.

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 Supplementary Document (without the foreseeable future floor)?

(c) Do you think that recognising a loss allowance at an amount equal to the full 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?

Once there is objective evidence of impairment for a financial instrument, it moves from stage 2 to stage 3. By comparing the examples of objective evidences of impairment mentioned in IFRS 9 Appendix A *Defined Terms* with paragraph 59 of IAS 39, we noted that the IASB did no longer include the following objective evidence : … *the observable data indicating that there is a measureable decrease in the estimated future cash flows from a group of financial assets since the initial recognition of those assets, although the decrease cannot yet be identified with the individual financial assets in the group*. It would be helpful to highlight this difference, explaining the reason why this has been left as well as the consequences.

For the sake of clarity, it would be helpful if EFRAG explains what is meant by and why it disagreed with the 'foreseeable future to deal with early loss patterns' as not everybody will understand that this. We assume that EFRAG is referring to the floor –impairment allowance may not be lower than the credit losses expected within the next twelve months- applicable to the time proportionated credit losses as described in IASB's Supplementary Document.

Regarding the leverage of the existing credit risk management practices, we can only advise EFRAG to either moderate the leverage or to put it more in perspective. In first place, leverage will mainly be applicable for the financial industry more specifically those applying the internal ratings-based method for credit risk. We are not convinced that other industries could leverage of existing practices neither financial institutions using the standardized approach under Basel. Having a look at the internal ratings-based method, leverage will be rather limited and according to us, limited to the recycling the internal credit classification only. All other elements (EAD, PD and LGD) will differ under IFRS 9.

In its comment letter, EFRAG discusses the discount rate to be used. However, we would go further in the reasoning and explaining the impact of using a discount rate between risk free and the effective interest rate as there are a number of disadvantages connected to this principle:

1) a decrease of comparability between financial statements as estimates will use different discount rates;
2) an increased impact of judgment and estimate as the way entities will define 'risk free' will differ;
3) a decrease in consistency in calculating the amount of impairment allowances for financial assets as a risk-adjusted effective interest rate or effective interest rate should be used for purchased/originated credit-impaired financial assets and impaired financial assets respectively instead of a risk free rate;
4) it makes the principle complex as exposure draft forbids the usage of a risk free rate when it exceeds the effective interest rate. This could be the case either during lifetime of the financial asset (resulting in a switch of risk free to effective interest rate as discount rate) but also at initial recognition for instance or due to the unit of account issue;
5) it leads to volatility in credit allowances due to changes in risk free interest rate and thus movements in credit allowance is not only due to change in credit risk or time value;
6) a decrease in convergence with FASB's exposure draft as it requires the use of the effective interest rate as discount rate.

Question 3

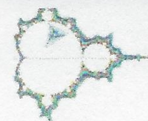
(a) Do you agree with the proposed scope of this Exposure Draft? If not, why not?

(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?

Relating to question 3 (b), EFRAG supports IASB's accounting principal for recognizing an impairment loss on financial assets classified in FV OCI as it ensures comparability of amounts that are reported in profit and loss. We refer to paragraph 43 of the comment letter as well as IE63 of IASB's exposure draft. We do not agree with EFRAG's arguing for the following reasons :

1) there is no comparability on balance sheet level between a credit loss allowance for financial assets measured at amortised cost and the one for financial assets measured at fair value through other comprehensive income;
2) there is no comparability on equity level as recognition of credit loss allowance is reflected in profit and loss for assets measured at amortised cost while the impact is neutralized by a credit in Other Comprehensive Income for those measured at fair value through other comprehensive income;
3) it's true that at the level of profit and loss statement both categories lead to the same result however in the Statement of Comprehensive Income that is no longer the case;
4) there is a credit in other comprehensive income which does not make any sense – also from a prudential reporting perspective the accounting treatment is not neutral;
5) it will be very difficult to reconcile your movements in profit and loss with the changes in credit loss allowance.

We believe that the following accounting entry would lead to more comparable results. It would be useful if different accounting treatments are discussed in the comment letter.



Dt	Bond	1000
Dt	Cost of Risk/P&L	20
Ct	@ cash	-1000
Ct	@ Credit Allowance	-20

EFRAG could refer in its comment letter to FASB's practical expedient for assets classified at fair value through other comprehensive income.

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?

As said earlier in this document, the leverage of existing credit risk procedures is rather limited as these are mainly for financial institutions applying the internal rating-based method for assessing the credit risk in a banking book.

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?

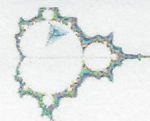
(b) Do the proposals provide sufficient guidance on when to recognise lifetime expected credit losses? If not, what additional guidance would you suggest?

(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?

As comparability is one of EFRAG's criteria against which IASB's accounting principles are assessed, we suggest to provide more guidance on how to define & determine 'investment grade'. Based on current



guidance (or lack of it) in IASB's exposure draft each entity will define its own policy and consequently will decrease comparability between financial statements. This is important because the lower an investment grade is defined the more assets are subject to a 12-month probability of default. Consequently the credit allowance will be much lower than the one required to cover the lifetime expected losses.

Secondly, the standard should be clear on how the probability of default is determined: either on a 12-month (similar to Basel framework) or on a lifetime expected credit loss (cumulative probability of default). This is again not neutral. As an example (based on Moody's information[1]): the probability of default for an AA-rated corporate bond with 10 year maturity equals to 0,501 while the probability of default for a Baa-rated corporate bond with a one-year maturity equals to 0,202. Although the former has a higher credit rating, the latter has the lowest probability of default.

In paragraph 59 EFRAG states *...it believes that there are two distinct objectives in accounting for credit losses (1) to reflect the effective return by allocating interest revenue and (2) to recognize an impairment allowance for credit losses in excess of those initially expected.* Although we agree with this statement, we believe that the ED does not always respect that objective. EFRAG could make that point in this paragraph.

Paragraph 61 *... use the change in the probability of a default occurring on the financial asset rather than the change in the expected credit losses.* we would elaborate on this in order to avoid any misunderstanding. In fact, the shorter the remaining maturity is, the lower the probability of default will be (even if the credit rating remains unchanged) Reading this paragraph without additional support could be misleading.

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 and presented 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 and presentation change?

(c) Do you agree with the proposal that the interest revenue approach shall be symmetrical (ie 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?

We disagree with EFRAG's statement made in paragraph 80 : *Interest is seen as a compensation for expected credit losses.* I refer to IFRS 9 paragraph 4.1.3 : *Interest is consideration for the time value of money and for the credit risk associated with the principal amount outstanding during a particular period of time.* Either EFRAG adds 'compensation for time value' to this sentence or it replaces 'interest' by 'credit spread'. In addition, the interest will only include the initially assessed credit risk. Subsequent increases in

[1] Moody's Investors Services : Corporate Default and Recovery Rates 1920-2010 – February 28, 2011.

expected credit losses are not recognized via the effective interest rate but via the constitution of a credit loss allowance.

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?

No specific comments.

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?

We have a number of comments to EFRAG's response in paragraph 103:

(1) modifications to existing contract can be made for other reasons that increased credit risk (eg commercial reason);
(2) standard does not clarify whether modification losses should be reported as an impairment loss;
(3) EFRAG is silent about the 'unit of account' when you have to compare an existing financial instrument with the credit quality of an unmodified financial instrument.

An illustrative example: assume that an existing retail customer is renegotiating the conditions of its mortgage loan. Contrary to the situation where the customer initially agreed with the terms and conditions of the mortgage loan, he will now underwrite a home insurance contract and will transfer all his saving accounts and investments to this financial institution. For the financial institution, the credit risk is lower because the customer transferred saving accounts and investments. On top of that, the total profitability on that customer is much higher. Consequently, the institution is willing to drop the interest rate on the mortgage loan significantly. Key question is whether the drop in interest rate in modified contract should be regarded as an impairment loss especially because that loss is compensated by a higher return on fees & commissions earned on insurance contract and investment transactions.

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 provisions arising from expected credit losses on financial guarantee contracts or loan commitments as a separate line item in the statement of financial position? If yes, please explain.

Additional guidance is needed to clearly understand which credit commitments are included in the scope of IFRS 9. The standard refers to 'present contractual obligations' which will often be translated by financial institutions as those credit commitments that are irrevocable. More clarifying guidance would help not only preparers but would also increase comparability. For instance what if the present contractual obligation disappears, or credit commitments for which there is no present contractual obligation but there will probably one in the future or with those commitments for which there is currently no legal commitment but from a commercial perspective the financial institution cannot refuse ?

It's worth to touch a word on FASB's exposure draft regarding scope-in of credit commitments. The standard refers to a legally binding commitment (thus no reference to 'present obligation').

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?

No specific comments except that such a simplified approach is not foreseen in FASB's exposure draft.

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?

EFRAG could compare FASB's and IASB's accounting treatment of credit impaired financial assets and assess which accounting principles are conceptually sound. In case it would be FASB's proposal, then it would be worth to include these in IASB's final accounting principles dealing with credit-impaired financial assets.

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?

We do agree with a three-year implementation time starting to count once all phases of IAS 39 replacement project are published.

However, it could be useful to have a same application date for IFRS 9, IFRS 4 Phase 2, Leasing and Revenue Recognition.

Question 13

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

No specific comments.