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3 July 2013

Re: EFRAG draft comment letter on Exposure Draft Financial Instruments: Impairment

Dear Françoise,

We are pleased to have the opportunity to provide our comments in order to contribute to the finalization of the EFRAG comment letter on Exposure Draft Financial Instruments: Impairment (the ED).

We appreciate the IASB's efforts to develop an approach for an expected loss impairment model in order to address the significant operational concerns widely raised by constituents (also OIC) during the consultation period on the IASB original 2009 Exposure Draft (original 2009 ED) and the 2011 Supplement Document (2011 SD).

In our comment letter on the IASB's original 2009 ED, we supported the transition to an expected loss model for impairment. This is because the current impairment model under IAS 39 allows entities to recognise only the credit losses related to events already occurred at the balance sheet date. We appreciated the IASB's effort in dealing with the issues related to the current model, developing an impairment model that considered the losses expected rather than those already incurred. In our opinion, the proposed expected loss approach was designed to result in earlier loss recognition compared to the incurred loss approach currently in IAS 39, by taking into account future credit losses expected over the life of the financial asset measured at amortised cost. Under that approach, the initial estimate of expected future losses was gradually recognised over the life of the instrument as it was incorporated into the effective interest rate. This is conceptually right. We noted that the proposed model had some merits in creating a link among performance measurement, risk, pricing and accounting. Thus, we agreed with the general fundamentals on which the IASB model was based.

However, even if conceptually the IASB model was right/ideal, its implementation appeared highly complex and it was too challenging to fit that model into the complex reality of the banks or other Legal Entities that are required to apply IFRS.

In our comment letter on the IASB 2011 SD, we noted that the common approach proposed in the SD relied on forward-looking information about credit losses and that it should allow an earlier recognition of credit losses compared to the current impairment model. Therefore, the proposals in the SD seemed to address the perceived weakness in IAS 39. However, we had some operational concerns also about that common approach.

So, due to our past concerns, in the absence of a better model, at this stage we accept the new model included in the ED as a good compromise between implementation costs and the need to provide an earlier recognition of credit losses. However, we have the following concerns on the model, as explained better in the Appendix:

- the so called “a significant increase in credit risk since initial recognition” trigger identified for the transfer from bucket 1 (ie 12-month) to bucket 2 (ie lifetime). In particular, we understand that risk management uses a wide range of indicators (not only PD) in order to highlight a significant deterioration. So, it is necessary that entities be allowed to use for accounting purposes all the instruments used to manage the risk of their financial instruments;
- the operational simplifications provided;
- the estimation of lifetime expected losses taking into consideration forward-looking adjustments;
- the selection in a range for the discount rate will result in diversity in practice, which will reduce comparability and, especially for long-term loans could imply significant impacts depending on the discount rate chosen;
- discounting expected losses for each single projected cash flow involves operational difficulties;
- regarding the implementation date of the proposed requirements it is important to consider the date of completion of the insurance project;
- some problems regarding transition requirements.

Our detailed responses to the ED questions are in the Appendix.

Should you need any further information, please do not hesitate to contact us.

Yours sincerely,

Angelo Casò

(Chairman)

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?

As we said in our past comment letters, we believe it is very important that the expected credit losses model is conceptually linked to the revenue recognition model. We note that the new approach does not reflect the economic link between the pricing of financial instruments and the credit quality at initial recognition. In particular, we believe that recognising a loss allowance (or provision) at an amount equal to 12-month expected credit losses at initial recognition is not strong in terms of logic because it does not take account of the link with the pricing. The loss provision at initial recognition should be zero because it is already considered in the pricing of loans.

However, in view of our past operational concerns on the original 2009 ED and the 2011 SD, on balance, we believe that the new approach should be considered as an adequate proxy.

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?

As said above, we considered the 2009 impairment model not applicable to open portfolios (i.e. the way in which banks manage their loans) and too onerous to implement, with regard to IT systems.

As the new model (2013 ED) clearly distinguishes loans deteriorated from those that are not, and it does not prescribe a loan loss allowance based on the lifetime estimates at initial recognition of each instrument, we should see that model as an improvement on the previous approach. With regard to the 12-month expected loss (12M EL), we consider the proposal operational, due to the synergies with the Basel 2 framework even if we expect that some adjustments to prudential input would be necessary.

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?

We agree with the scope of the proposed amendment.

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 above, we appreciate the IASB proposal to differentiate between loans characterized by a significant deterioration in their credit quality and loans that do not have a significant deterioration.

With regard to the 12-month expected credit losses, the requirements are clear enough and we consider the proposal operational, due to the synergies with the Basel 2 framework; however, we believe that it should be clearly stated that, in presence of listed bonds, an entity could consider both the internal information available and the internal risk monitoring process.

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?

We have the following concerns:

- We agree that the IASB "relative" approach is conceptually right. However, there are operational issues on the tracking of credit quality of the loans, and we would suggest that the IASB find a solution;
- We understand that risk management uses a wide range of indicators (not only PD) in order to highlight a significant deterioration. So, it is necessary that entities be allowed to use for accounting purposes all the instruments used to manage the risk of their financial assets;
- The "investment grade" notion should not be too rules-based. This is because the level above which a loan can be granted in one market for one entity is not necessarily the same for different entities in different markets, with a very limited possibility to have a common threshold valid for each market constituent;
- We believe that a 30-day rebuttable presumption might not be a clear indicator of a real deterioration in the credit quality of the loans. This also means that a "significant" deterioration is not the same for different markets/jurisdictions, and it is not evaluated in the same way by different risk management practices. For these reasons, this requirement should not necessarily reflect a significant increase in credit risk for all kind of loans. Moreover, we note the divergent approaches adopted by the IASB: in this case the IASB has decided to establish a quantitative threshold; vice versa, with regard to the "solely payment of principal and interest" (SPPI) test, it used a qualitative approach (i.e. the "more than insignificant" concept).

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 agree that interest revenue should be calculated on a net basis when there is objective evidence of impairment because this would provide more useful information for users analyzing the net interest margin.

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?

We agree with the proposed disclosure.

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?

Yes, we agree with the proposed treatment of financial assets on which contractual cash flows are modified.

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.

We do not have any specific comments regarding application of the model to loan commitments and financial guarantee contracts.

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?

We believe that the relative requirements are clear enough. For some entities this simplified approach could provide operational relief by eliminating the need to calculate 12-month expected credit losses and the assessing of when an entity shall recognize lifetime expected credit losses, even if we acknowledge that it would reduce comparability across entities.
We agree with the proposed amendments to IFRS 9 to measure trade receivables without a significant financing component at the invoice amount on initial recognition as this would align the requirements with those proposed in the revenue recognition project.

We also believe that some insurance-related issues should be included in the proposed amendments. We are referring to reinsurance receivables, considered as all amounts recoverable from reinsurers for paid and unpaid claims for which there is not statistical uncertainty, as well as receivables from policyholders and intermediaries. All these items are similar to trade receivables, considering they do not earn interest and they arise from a performance rather than financing activities.

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?

We believe that the requirements are clear enough.

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 believe that the entities should have at least three years to implement IFRS 9 after the completion of all phases. Moreover, it is important to consider the date of completion of the insurance project.

The practical expedient envisaged in the ED for the transition (the use of an absolute threshold of low credit quality), if interpreted assuming an investment grade or similar level for high credit quality, would result in greater burden for the preparers that operate in countries with sovereign rating close to investment grade (requiring to undertake efforts for collecting data about credit quality at origination). It is paramount that a statistical approach is allowed for the transition, based on the best available information.

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

We appreciate the distinction between loans that have deteriorated significantly and those that have not. This model is an improvement on the previous approach and the main benefit compared to IAS 39 is an early recognition of credit losses.