European Securities and Markets Authority

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EFRAG
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Belgium

The IASB's Exposure Draft *Financial Instruments: Expected Credit Losses*

Dear Ms Flores, Dear Françoise,

The European Securities and Markets Authority (ESMA) thanks you for the opportunity to contribute to the EFRAG's due process with regards to the Exposure Draft (ED) Financial Instruments: Expected Credit Losses. We are pleased to provide you with the following comments aimed at improving the decision-usefulness and transparency of financial statements and the enforceability of IFRSs.

Like EFRAG, ESMA strongly supported the integrated effective interest rate approach set in the 2009 ED as we believed it was conceptually sound and would best reflect the underlying economics of the lending business. However, it seemed that this model raised operational concerns among a majority of constituents.

ESMA also believes that the impairment model proposed in the ED lacks conceptual justification as reflected in the alternative view of Steven Cooper. Nevertheless, in the absence of a sound conceptual solution that could be put into practice, ESMA accepts the proposed model as a practical way to address the shortcomings of the IAS 39 incurred loss impairment model and the demands of the G-20 leaders.

In the Appendix to the letter, ESMA expresses its concerns that some proposed principles (e.g. significant increase in credit risk, definition of key terms, flexibility of the determination of the discount rate) lack clear articulation or sufficiently robust application guidance, provide too much discretion to the management of issuers in their application in a manner that would impede a sufficient degree of comparability across issuers and efficient enforcement. In particular, ESMA is concerned that the proposals related to the transfer of financial assets from stage 1 to stage 2 to reflect the deterioration in

credit risk are so vague that regulators might supplement the requirements in the ED with specific national guidance in this area leading to lack of comparability at global level.

Unlike EFRAG, ESMA does not support all proposed operational simplifications to make the transfer criteria easier to apply in practice. ESMA disagrees with the introduction of the investment grade exception as it believes that it would delay the recognition of lifetime expected credit losses and reduce the benefits of the introduction of an expected loss impairment model and potentially encourage earnings management. Furthermore, ESMA considers the 30 days past-due rebuttable presumption can be a relevant operational simplification to be used by some corporate entities but also finds that there is a risk that it might replace, in the eyes of many entities, the considerations foreseen for assessment of significant increase in credit risk.

The wide scope of interpretation of these requirements and lack of clarity in the wording of the proposal might cast doubt whether the proposals would address sufficiently the concerns about the timing of recognition of full lifetime expected losses compared with the aim of the IASB and the request of the G-20 leaders.

ESMA would suggest that IASB explicitly addresses forbearance practices as part of the final standard; we believe that when extending forbearance measures, issuers are granting concessions to borrowers due to their economic difficulties. When loans are forborn, in most cases, the recognition of impairment losses is appropriate. Without an explicit definition of forbearance, ESMA fears that diversity in practice and delay in recognition of credit losses will persist.

Furthermore, similar to EFRAG, ESMA is of the view that IFRS 9 should clearly define the criteria when a modification of a financial asset results in its derecognition. Even though ESMA accepts that the issue relates not only to the impairment guidance but also to the interaction of derecognition and impairment guidance, ESMA strongly encourages the Board to address this issue before finalising all phases of IFRS 9.

ESMA reiterates that it does not support the introduction of the proposed FVOCI category in IFRS 9. However, if IASB decides as part of the finalisation of the standard to introduce a third measurement category, ESMA would agree that a single set of impairment requirements apply to both financial assets measured at amortised cost and at FVOCI. ESMA would be against introducing a second impairment model as this would lead to increased complexity in financial reporting and re-introduce possibility for arbitrage. Therefore, ESMA agrees with the proposed scope in the ED and its application to all contracts with similar credit risk characteristics, including financial guarantee contracts and loan commitments.

ESMA believes that the new impairment model should be completed and implemented timely. While sufficient time should be allowed for proper implementation of these proposals, ESMA is concerned that it would be delayed beyond the period strictly necessary.

Our detailed comments on the ED are set out in the appendix to this letter. Please do not hesitate to contact us should you wish to discuss any of the issues we have raised.

Yours sincerely,

Steven Maijoor
Chair
European Securities and Markets Authority

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APPENDIX – ESMA's detailed answers to the questions in the IASB's Exposure Draft ED/2013/3 - *Financial Instruments: Expected Credit Losses*

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?

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?

1. In its comment letter[1] on the Exposure Draft *Financial Instruments: Amortised Cost and Impairment* ("2009 ED") ESMA (then CESR) supported the IASB's proposal to incorporate more

[1] Comment Letter: IASB's Exposure Draft Financial Instruments: Amortised Cost and Impairment, Committee of Securities Regulators, 25 June 2010

forward looking information about credit losses into the amortised cost model and to reflect initial expected credit losses as part of determining the effective interest rate. Even though, from the perspective of faithful representation of the underlying economics of the lending business, the model in the 2009 ED was conceptually sound, many operational concerns were raised by a majority of constituents.

2. ESMA accepts that any financial reporting standard needs to strike an appropriate balance between faithful representation of the underlying economics and the costs of its implementation. ESMA finds that recognising 12-month expected credit losses at initial recognition is difficult to accept from a conceptual point of view and might not reflect the economic link between the pricing of financial instruments and the credit quality at initial recognition. ESMA conceptually agrees with the Alternative View of Steven Cooper that recognition of this allowance at initial recognition would result in financial reporting that fails to reflect the economics of lending activities.

3. It is in this context that ESMA understands that the proposed model in the ED was considered as a pragmatic solution despite its lack of conceptual justification (as explained in paragraph BC61 of the proposal). ESMA understands the operational considerations underpinning the IASB's proposal of a model that would allow for upfront recognition of a 12-months expected credit losses and by incorporating a broader and more forward looking range of available credit information. This approach aims to address the perceived shortcomings of IAS 39 *Financial Instruments: Recognition and Measurement* of insufficient and/or late allowances being recognised ('too little too late problem') and the demands of G-20 and Financial Crisis Advisory Group for a model that would increase the level of loss allowances.

4. ESMA considers that recognising a loss allowance of an amount equal to the lifetime expected credit losses for all the financial assets at initial recognition would not achieve a balance between the faithful representation of the underlying economics and the cost of implementation and would not provide more relevant information on economic performance of financial assets in comparison with the proposed model. Whereas the same criticism could be made of the upfront recognition of 12 month expected credit losses at the reporting date, this can be seen as approximating to a certain degree the outcome of the 2009 ED whilst addressing the operational complexities that model raised.

5. Consequently, ESMA believes that, in the absence of a better operational solution, the approach proposed by the IASB in this ED is a pragmatic compromise and an improvement to the IAS 39 requirements. ESMA gives credit to the IASB for their effort to find a workable compromise solution over the past years that would fulfil the objectives of achieving more forward-looking provisioning, incorporating a broader range of credit information and greater transparency. Nonetheless, ESMA would urge the IASB to clarify the text and provide more specific guidance in specific areas of the ED

during final deliberations as ESMA is concerned that some proposed principles might not be applied consistently in practice and would be difficult to be enforced (please refer to our response to Q5). ESMA fears that these shortcomings might have consequences in terms of timing of recognition of the expected credit losses.

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?

6. ESMA agrees with the proposed scope in the ED and supports application of the same impairment model for loan commitments and financial guarantee contracts as this could help to improve consistency of application of the model to all contracts with similar credit risk characteristics.

7. As expressed in its comment letter to the IASB Exposure Draft – *Classification and Measurement: Limited Amendments to IFRS 9*[2], ESMA disagrees with the introduction of the third category of financial assets measured at FVOCI as it believes that its introduction is not necessary and would add significant complexity to IFRS 9. ESMA is concerned about the application of the proposed impairment model to the FVOCI category as the interaction between the recognition of expected losses in profit or loss and the movement of fair value changes in the other comprehensive income (OCI) makes it more difficult to understand the performance of the financial assets (e.g. when analysing the OCI, it might be more difficult to understand which movement relates to the movement in credit risk – i.e. the difference between recognised expected losses and market assessment of credit risk and which relates to other risks than credit risk).

8. However, if the IASB were to introduce a third measurement category, ESMA would agree that a single set of impairment requirements should apply to financial assets measured at amortised cost and at FVOCI. We believe that the use of a single set of requirements is important to ensure comparability of reported performance of various financial assets. In addition, ESMA believes that introducing a second impairment model would lead to increased complexity of financial reporting, as experienced in current requirements in IAS 39 (multiple impairment models) and could lead to arbitrage in the classification of financial assets. ESMA suggests adding specific disclosure requirements for FVOCI instruments asking for details of the impact on OCI between movements related to credit risk and other movements.

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[2] Comment Letter : The IASB Exposure Draft – *Classification and Measurement: Limited Amendments to IFRS 9*, European Securities and Markets Authority, 5 April 2013

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?

9. ESMA notes that this question should be answered by issuers rather than by securities regulators. However, ESMA notes that full lifetime expected credit losses need to be estimated and re-assessed for all financial assets at the end of each reporting period.

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?

10. In the context of the proposed model for recognition of expected credit losses, the decision **when** expected credit losses measured at the amount equal to lifetime expected credit losses should be recognised is critical for consistent application of the proposal requirements. In this respect, even though ESMA understands the need for operational simplifications of the model, ESMA is firmly of the view that any proposed operational simplification should not undermine the faithful representation of the underlying risk and performance of the lending business.

Significant increase in credit risk

11. ESMA agrees with the proposed requirement to recognise a loss allowance at an amount equal to lifetime expected credit losses on the basis of a significant increase in credit risk since initial recognition. However, even though the ED explains the methodology that should be used in assessing the significant increase in credit risk ("change in the probability of a default occurring on the financial instrument") it does not provide enough specific guidance on the criteria to be used by entities to do that assessment.

12. The proposals allow entities to use their own internal management process on how to determine the significant increase in the credit risk in order to align the financial reporting with it. ESMA understands the aim and agrees that, as the standard requires disclosures on the detailed methodology of assessment of significant increase in the credit risk, users might understand the difference between approaches followed by entities. Nevertheless, ESMA considers that lack of guidance in this area will:
    a. harm comparability as the transfer criteria will remain highly judgemental and sensitive to earnings management.
    b. give too much leeway to entities that might be tempted to wait too long before moving to lifetime expected losses and remain close to an incurred losses model.
    c. lead to difficulties in enforcement on when and how transfers of financial assets are done from stage 1 to stage 2.

13. ESMA notes that the risk of diversity in applying the requirements for transfers between stage 1 and stage 2 might endanger the objective of earlier recognition of credit losses. ESMA notes that there has been a wide diversity in application of the incurred loss concept in IAS 39 and lack of sufficiently robust and unambiguous transfer criteria might replicate this lack of consistency when applying the requirements proposed by the ED.

14. Even if we agree that transfers between stage 1 and stage 2 should be based on principles and not on rules, ESMA urges the Board to provide more specific guidance on the criteria to be used to determine when a significant increase in credit risk occurs.

15. Paragraph B20 lists elements that may assist the entity to determine whether life-time expected losses are required. Even if ESMA fully supports that this paragraph should not be a checklist and that judgment is required, we believe that the IASB should further develop on the basis of these elements and try to put greater weight on some of them. Indeed, as indicated above, in the absence of additional guidance, we fear that enforceability becomes very difficult with a negative impact on consistent application and comparability.

16. ESMA believes that the wording of paragraph B20 could be improved by requiring consideration of those elements rather than saying that they might assist in determination whether increase in credit risk was significant. Hence, ESMA suggests that at least the wording of the last sentence before the list is rephrased to: "*where relevant, the entity should at least consider the following when making that determination*".

Definition of key terms

17. ESMA also urges the Board to give definitions of all the key terms used in the ED as those terms might not be understood and applied consistently. These should include definition of "default" and "forbearance".

18. The ED does not define what is considered as a default. Paragraph BC97 explains that "*entities can use different definitions of default, including, where applicable, regulatory definitions (...) the IASB observed that they did not expect that expected credit losses would change as a result of the differences in the definition of a default because of the counterbalancing interaction between the way an entity defines default and the credit losses that arise given that definition*". ESMA does not agree with this reasoning and finds that such approach could harm the objective of consistent application and comparability of financial statements.

19. Another aspect that ESMA believes needs consideration relates to forbearance. Following some limited analysis of the financial institutions practices, in December 2012 ESMA issued a public statement Treatment of Forbearance Practices in IFRS Financial Statements of Financial Institutions[3]. In that statement ESMA refers to a common understanding on the notion of forbearance that should be used in the context of IAS 39 in order to ensure consistent application in that area. We would suggest that the Board considers including a definition of the "forbearance" within IFRS 9 and explain how it links to a concession provided by the lender due to the borrower's economic difficulties. ESMA fears that without the definition of forbearance in IFRS and specification of the interaction of forbearance practices with the new impairment model, diversity in practice might arise.

20. In particular, ESMA would suggest that the IASB specifies that in general, when loans are forborn, economic losses are realised – either in form of a loss on derecognition (when modification of the loan leads to derecognition) or in form of an impairment loss. ESMA believes that as the concession is granted due to the economic difficulties of the borrower, recognition of impairment losses on forbearance is appropriate. Forbearance practices should lead to classification of the forborn loans in Stage 2 or 3 depending on whether the issuer expected the objective evidence of impairment to have

[3] Public Statement: Treatment of Forbearance Practices in IFRS Financial Statements of Financial Institutions, European Securities and Markets Authority, 20 December 2012

an impact on future cash flows or not. ESMA would prefer that IASB would explicitly state that in the final standard.

21. Finally, ESMA agrees with the disclosure requirements related to collateral in paragraph B32. Nonetheless, ESMA would encourage the IASB to make explicit in the standard that in estimating the expected credit losses issuers should take into account the value of any pledged collateral. In addition, it should be made clear that any change in the value of collateral would lead everything being equal to a corresponding change of the amount of recognised allowance for credit losses.

Investment grade and low credit risk

22. ESMA disagrees with the introduction of the investment grade exception into the expected loss model. ESMA believes that the investment grade exemption would lead to failure to represent faithfully the deterioration of credit risk in that a range is established within which changes in credit risk are not deemed significant. This might prevent timely recognition of a sufficient amount of expected credit losses.

23. We acknowledge the IASB's efforts to make the transfer criteria easier to apply in practice. However, the '*investment grade*' category is not homogenous in being 'high credit quality'. For instance, a credit rating agency defines Baa as "*moderate credit risk*" and not "*low credit risk*" as defined in paragraph 6 of the ED. Furthermore, in many internal rating systems, the last notch of 'investment grade' is closer in its characteristics to the 'impaired' category than to the highest rating. According to the IASB staff paper, probabilities of default vary significantly for longer maturities as one moves towards the lower end of the investment grade range (BBB as compared to AAA)[4]. For example, the cumulative probabilities of default is said to vary between 0% and 1.06% for AAA instruments and 0.24% and 7.22% for BBB instruments over a 1-year to a 15-year time horizon.

24. We understand that, according to the proposal, a downgrade from AAA to BBB would not trigger the assessment of recognition of lifetime expected losses and thus what could be a large increase in credit risk would not be seen as being significant. This may influence management decisions regarding what is considered a significant increase in credit risk for non-investment grade instruments and thereby push the bar to move to Stage 2 higher, resulting in lifetime expected losses being recognised significantly later in the life of the instrument. Furthermore, it might impede comparability of financial statements and potentially encourage earnings management.

25. However, if the IASB decides to retain the investment grade exception in the final standard, ESMA believes that the ED should include further elements to address some of the practicalities of the use of

[4] see table with cumulative probabilities of default in IASB Staff Paper 5B November, 2012 p.26

the investment grade such as conflicting ratings for the same issuer published by credit rating agencies, delays in the timing of rating downgrades and different definitions of investment grade used by different rating agencies. Further, we would urge the IASB to limit the investment grade exception only to financial instruments with sufficiently low credit risk.

26. Furthermore, ESMA is wondering how to apply the requirement of paragraph 6 of the ED that internal credit risk rating should be *equivalent* to the external credit rating of 'investment grade'. For instance, ESMA would suggest to clarify that an internal rating system is not equivalent if it considers a financial asset as having a low credit risk if the internal rating remains investment grade but the external rating is downgraded under investment grade.

27. Moreover, ESMA urges the Board to re-consider the definition of 'low credit risk' defined in the ED with a reference to "*a default is not imminent and any adverse economic conditions or changing circumstances may lead to, at most, a weakened capacity of the borrower to meet its contractual cash flows obligations*". ESMA is concerned that the reference to imminent default would delay assessment and recognition of lifetime expected credit losses beyond the objective of the expected loss model. ESMA notes that according to IAS 39 paragraph 59 "*significant financial difficulty of the issuer or obligor*" is a sufficient criterion for recognition of lifetime credit losses – the loss is incurred even if there is no breach of contract. ESMA questions whether the current wording of the ED is sufficiently robust to ensure recognition of lifetime expected losses sufficiently early in comparison with the current incurred loss model.

28. ESMA questions whether the current wording in the ED should be read as concluding that it is highly probable that the issuer will not default even in case of adverse economic conditions. If it is the way it should be understood, we urge the Board to make sure that this criterion would not lead in practice to "too late and too close" to the current incurred loss model. In addition, we consider that 'a weakened capacity' concept is not sufficiently clear and would lead to diversity in practice, limiting the possibility of enforcement.

30-days rebuttable presumption

29. We consider that the 30 days past-due rebuttable presumption could be considered as operational simplification to be used in applying the model by some corporate entities. However, in ESMA's view, there is a risk that this rebuttable presumption may replace, in the eyes of many entities, the considerations foreseen in paragraph B20, according to which a transfer of the loans to stage 2 often should take place at a much earlier date. ESMA notes that objective evidence of impairment under the current incurred loss model is established at an earlier date because of the significant financial difficulty criterion, which comes before a breach of contract as referred in IAS 39 paragraph 59 and in the definition of objective evidence of impairment in Appendix A of the ED.

30. Further, past-due information is not forward looking information. Hence, we doubt if the IASB should retain this operational simplification in its current form. ESMA would encourage the Board to further detail in the Basis for Conclusions their reasoning why such indicator is incorporated in any forward-looking impairment model as the explanation in paragraph BC 75 might not be sufficient to ensure that the proposed model does not revert to an incurred loss notion.

Probability of default

31. ESMA agrees that the criterion of recognition of lifetime expected credit losses should be based on changes in the probability of default as it is aligned with the current risk management practices. ESMA notes that also the loss given default (LGD) that reflects the magnitude of expected losses would be reflected in the calculation of the lifetime expected credit losses.

Flexibility in the use of discount rate

32. As indicated in its comment letter to the SD[5], ESMA disagrees with the flexibility for the choice of the discount rate as this will impact comparability among issuers. Consequently, ESMA believes that this flexibility does not result in decision-useful information. IASB admitted in paragraph B29 that the requirements as currently drafted might lead to situations, in periods after initial recognition, where the risk-free rate (current rate selected) at the reporting date exceed the effective interest rate determined at initial recognition. ESMA questions whether the use of a risk-free rate as discount rate would be consistent with the definition of amortised cost measurement and would provide useful information to the users. Consequently, ESMA would urge the IASB that the final standard requires the use of effective interest rate as the discount rate.

Explanation of 12-month expected losses

33. Finally, ESMA would encourage the IASB to better explain and articulate the term 12-month expected losses as this term might suggest that issuers have to take into account only credit losses expected in the 12 months rather than the lifetime expected credit losses resulting from default events expected in the 12 month period as is intended by the IASB.

34. In general, ESMA is concerned that some aspects of the proposal (e.g. the articulation of significant increase in credit risk, lack of precise definition of key terms, flexibility of the determination of the discount rate) provide too much discretion to Management in applying these requirements in a manner that would impede a sufficient degree of comparability across the issuers and efficient enforcement.

[5] Comment Letter : The IASB's Supplementary Document on the Exposure Draft Financial Instruments: Amortised Cost and Impairment, European Securities and Markets Authority, 4 April 2011

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 (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?

35. ESMA agrees with the proposal in the ED that interest revenue should be calculated on a net carrying amount for assets that have objective evidence of impairment subsequent to initial recognition. This proposal is consistent with the current requirements in IAS 39 for impaired financial assets (the proposed definition of objective evidence of impairment in Appendix A corresponds with the definition of incurred loss in IAS 39 paragraph 59). ESMA agrees with the reasoning in the Basis for Conclusion that this treatment provides users more useful information when analysing performance of financial assets and net interest margin and that contractual return would in these circumstances no longer faithfully represent the economic return.

36. Using the criteria for impaired financial assets as defined in IAS 39 for changing the basis of calculation of interest is preferable to the non-accrual approach proposed by the FASB, as the non-accrual model does not properly reflect the time value of money of the expected shortfall(s) in cash inflows.

37. ESMA agrees with the proposal that the interest revenue approach should be symmetrical, as this would contribute to increase comparability and consistency of accounting for similar items.

38. Nevertheless, ESMA is concerned about the consistency of application of the net interest calculation. Given the diversity in the application of the current incurred loss model in IAS 39, ESMA questions whether there is sufficient clarity on when a financial asset deteriorates and is transferred to Stage 3 and consequently when interest revenue should be calculated on a net carrying amount. As a consequence ESMA urges the IASB to provide specific guidance on this point in the final standard.

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?

39. ESMA welcomes the proposed disclosure requirements included in the ED. As the proposed impairment model requires application of significantly more management judgement than current requirements of IAS 39, ESMA believes that a robust disclosure framework that would ask for a high level of transparency from issuers and enable users to compare credit risk practices across issuers should be required. Without transparent and comprehensive disclosures users would not be able to understand and assess the effects of developments in credit quality and its evolution and credit risk management on the issuer's financial statements.

40. ESMA considers very important that the standard requires detailed disclosures on the assessment of the increase in credit risk and the amount of increase of credit risk and impairment disaggregated by portfolios with a sufficient level of granularity (e.g. by credit quality). In particular, ESMA welcomes the reconciliation of opening balance to closing balance of both the gross carrying amount and the associated loss allowance.

Forbearance

41. In the Public Statement on Forbearance referred to in paragraph 19 of this comment letter, ESMA identified several disclosure items related to forbearance and modification of financial instruments that are revenant to be presented in view of the worsened economic outlook and perceived prevalence of forbearance practices. Whereas ESMA welcomes the disclosures proposed by the IASB in paragraph 35 and 38 of the ED, ESMA is concerned whether they would capture all types of forbearance practices applied by financial institutions at the relevant point of time. For instance, ESMA does not understand why the disclosure requirements in paragraph 38 about modification of cash flows is limited to situations in which the loss allowance was at an amount equal to lifetime expected credit losses. In some circumstances, modification of terms and conditions may take place just before lifetime expected credit losses have become necessary as modification can be the only way to avoid a breach of contractual terms. Therefore we believe these situations also require the disclosures foreseen by paragraph 38.

42. In particular ESMA would welcome a disclosure requirement that would include a reconciliation of the opening balance to the closing balances for forborn assets, if relevant, together with their respective allowances specifying assets to which forbearance measures have been extended during the reporting period and assets which are no longer considered to be forborn as well as effects of the

forbearance measures recognised in profit or loss during the reporting period (specifying impairment loss and loss arising on derecognition).

43. ESMA supports the disclosure of re-default rate on modified assets proposed in paragraph 38(b) of the ED. At the same time ESMA would find it useful to require a disclosure of a definition of "cure rate" applied (i.e. defining when an issuer no longer considers an asset to be forborn together with any consequences on the risk classification of the asset) as well as related quantitative disclosures providing sufficient transparency on the quantitative effect of such classification on the statement of financial position and statement of comprehensive income.

44. ESMA would also welcome that the IASB provides an example that would suggest that the appropriate level of disaggregation for classes of financial assets would include modified or forborn assets when such disclosure is relevant for users of financial statements (and forbearance activity is significant in the financial statements).

Credit ratings

45. ESMA suggests that final requirements explicitly require a mapping between external and internal ratings where internal ratings are used and a detailed definition of the internal ratings and the way they are determined.

Write-offs

46. ESMA supports the proposed disclosure requirements related to the policy on write-offs. ESMA notes that the write-off policy is influenced, among other factors, by the legal system (the speed of the legal proceedings will influence the length of the period until a write-off is realised) that could impair comparability across jurisdictions. Consequently detailed disclosure and clear understanding of requirements for write-offs is required to ensure comparability across jurisdictions.

47. In order to foster appropriate understanding of the requirement to write-off a portion of a financial asset, ESMA would encourage the IASB to provide additional application guidance that would make clear when a partial write-off is required. ESMA is concerned that the current wording of paragraph 22 of the ED is not clear on what are the criteria to distinguish when write off relates to a financial asset in its entirety or to a portion of it and at which point in time a partial write-off would be appropriate.

Location of disclosure requirements

48. From a drafting perspective, it is unclear to us why the IASB notes at the same time that IFRS 7 *Financial Instruments: Disclosures* may require disclosures that might satisfy the disclosure requirements in the ED (paragraph 31) and that in finalising the disclosure requirements the IASB might treat them as amendment to IFRS 7 (footnote 10). For the reasons of simplicity of application

and in order to avoid duplication or conflict in various disclosure requirements, ESMA would prefer that all disclosure requirements related to impairment of financial instruments are included as a single section in IFRS 7. In particular, ESMA founds the paragraph 30 of the proposed ED that requires an entity to provide additional information if the disclosures provided in accordance with the requirements of this standard are not sufficient to meet the objectives in paragraph 28 very useful and would suggest that that paragraph is included in IFRS 7 as well.

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?

49. ESMA agrees with the proposed treatment of financial assets on which contractual cash flows are modified, e.g., through forbearance. We agree that issuers compare the credit quality of the modified financial instrument at the reporting date with the credit quality of the unmodified financial instrument at initial recognition. ESMA would suggest that the IASB makes it explicit that the expectations of credit losses should reflect the increased riskiness of loans that were modified due to the actual or perceived financial difficulties of the debtor.

50. At the same time ESMA is of the view that IFRS 9 should clearly define the criteria when a modification of a financial asset results in its derecognition. In its letter[6] to the IASB and IFRS Interpretation Committee ESMA noted *"varying accounting practices for debt restructurings by lenders due to the lack of clear guidance which leads in turn to decreased comparability between financial statements"* and asked the IFRS IC and the IASB to provide *"guidance on how to account for debt restructurings from the holder's perspective"*. More specifically, ESMA noted that the lack of clear guidance combined with the possibility of application by analogy of the criteria used for financial liabilities (IAS 39 paragraph 40) may have consequential impacts that might weaken comparability of IFRS financial statements and enforceability of the standard, and encouraged the Board to consider these concerns as part of its on-going deliberations on IFRS 9.

51. Even though ESMA accepts that the issue does not relate only to the impairment guidance but relates to the interaction of the derecognition and impairment guidance, in light of the current economic climate, we would once again strongly encourage the Board to address this issue before finalising all phases of IFRS 9.

[6] Letter: The IFRS Interpretations Committee's tentative agenda decision on IAS 39 Financial Instruments: Recognition and Measurement – Accounting for different aspects of restructuring Greek government bonds. European Securities and Market Authority, 26 July 2012

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.

52. As noted in our response to Question 3, ESMA supports the application of the proposed model to loan commitments and financial guarantee contracts.

53. However, in relation to the financial guarantee contract ESMA questions whether the proposed impairment model would provide comparable results with those provided by the new accounting model for insurance contracts. In our comment letter on the ED Insurance Contracts[7] we suggested that financial guarantee contracts should be assessed on the basis of whether they include insurance risk or not. If so they should fall within the scope of IFRS 4 – *Insurance Contracts*. Therefore, for consistency and comparability purposes ESMA would urge the IASB to develop a model that would require all financial guarantee contracts with similar economic characteristics to be accounted for using a single accounting model and not allow free accounting policy choice.

54. The IASB proposes that the maximum period to consider when estimating expected credit losses is the maximum contractual period over which the entity is exposed to credit risk and not a longer period, even if that would be consistent with the business practice. ESMA questions whether such requirement would provide useful information in case of loan commitments that might have very short legal contractual period, but in practice are managed on a longer period basis as it would be impracticable to follow the contractual period (e.g. commitments from credit cards). In this context ESMA questions whether estimating expected credit losses only over the contractual period would lead to recognition of sufficient level of expected losses to reflect the underlying economics of the transaction.

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?

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[7] Comment Letter: IASB's Exposure Draft *Insurance Contracts*, Committee of Securities Regulators, 2 December 2010

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Trade receivables

55. ESMA agrees with the proposed simplified approach for trade receivables with no significant financing component. The BC 143 to BC 145 explain the reasoning for that and mention that not many trade receivables without a financing component would have a maturity longer than one year, so the lifetime expected credit losses and the 12-month expected credit losses would be the same, or very similar.

56. ESMA is generally not in favour of options in the accounting principles as options impair comparability. Therefore, with the aim to improve comparability, ESMA would suggest that a single model (i.e., the general model) is applied to all trade receivables with a significant financing component and to lease receivables.

Lease receivables

57. Regarding application of the expected losses model to lease receivables, ESMA urges the IASB to ensure consistency between the requirements of this ED and the ED on Leases[8]. In particular we would like to raise the following points:
    a. For Type A leases, lessors will recognise a lease receivable and a residual asset. We consider that the Board should include in this ED some explanations and examples on the allocation of the recoverable amount to the lease receivable and the residual asset.
    b. Paragraph B33 of this ED states that cash flows used for the measurement of a loss allowance should be "*consistent*" with the cash flows used in measuring the lease receivable in accordance with IAS 17. We understand that this wording should address e.g. variable lease payments that according to the ED on Leases are not included in the measurement of the lease receivable. ESMA fears that current wording of paragraph B33 is not sufficiently clear and might result in inconsistent application.
    c. This ED requires considering the contractual period whereas according to the ED on Leases the lease receivable might be recognised for a shorter period because of options to extend or terminate a lease. We consider these issues should be considered and addressed consistently between the two EDs.

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?

[8] Exposure Draft: *Leases*, International Accounting Standard Board, May 2013

58. ESMA agrees with the proposals for financial assets that are credit impaired on initial recognition. We noted that the conceptual basis of the proposal is similar to current requirements for financial assets acquired at a deep discount that reflect incurred credit losses in IAS 39 paragraph AG 5. At the same time ESMA would encourage the Board to add additional requirements in the standard asking for transparency on accounting for credit-impaired financial assets at initial recognition. In particular, based on the current proposals improvement of expectation of credit losses for these financial assets might lead to a presentation of a negative allowance. ESMA would prefer separate presentation of allowances for financial assets that are credit impaired at initial recognition but the expectation of credit losses have improved since initial recognition from those whose expectation of credit losses deteriorated since initial recognition.

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?

59. Given the effects of changes in the impairment model, in the broader context of economic developments and effects of the financial and economic crisis, ESMA reiterates the importance of timely completion of the proposed model and its implementation. While we believe that a sufficient time should be allowed for proper implementation of these proposals, ESMA is concerned that it would be delayed beyond the period strictly necessary.

60. Given the risk of using hindsight, ESMA agrees with the proposed transition requirements.

Question 13

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

61. ESMA welcomes that the IASB included the effect assessment as part of the ED. At the same time we would encourage the IASB to supplement the qualitative effect analysis with a more quantitative assessment that would allow the Board to consider whether the proposed model would lead to earlier recognition in all circumstances. In particular, that analysis could help the Board to assess whether the notion of significant deterioration is consistently understood and whether the transfer from Stage 1 to Stage 2 would happen at the point which the Board intended in the proposal. ESMA sees a risk

that the transfer from Stage 1 to Stage 2 might be delayed unless the wording of these requirements is clarified.

62. The proposed model should result in recognition of credit losses earlier than required in IAS 39. The current requirements included in IAS 39 require recognition of credit losses only once they are incurred. By proposing to recognise expected credit losses (or their portion) for all financial instruments this model aims to address the concerns of the G-20 and the Financial Stability Board that recommended earlier recognition of credit losses by considering a broader range of credit information.

63. However, ESMA is concerned that the current wording of the proposal, lack of clarity regarding the definition of significant increase in credit risk and existence of investment grade exception might lead to delayed recognition of expected credit losses or recognition of insufficient amounts. This might cast some doubts whether the proposals address sufficiently the concerns about timing and amount credit losses recognised.