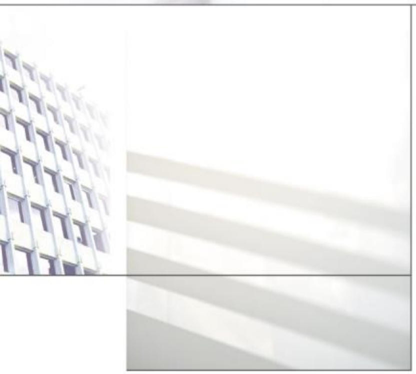

European Financial Reporting Advisory Group

EFRAG's final position on the IASB's ED/2013/3 *Financial Instruments: Expected Credit Losses*

Final comment letter 9 July 2013

EFRAG's overall assessment

	EFRAG position
EFRAG agrees with	EFRAG's assessment is that the proposed credit deterioration approach could strike an acceptable balance between the cost of implementation (provided the IASB addresses the operational difficulties identified in the field-test organised by EFRAG and the National Standard Setters of France, Germany, Italy and UK) and the underlying economics, while meeting the need to provide earlier for expected credit losses as expressed by financial regulators and other constituents. We accept the proposed approach that requires recognition of a 12-month expected credit loss at initial recognition and lifetime expected credit losses when there is a significant increase in credit risk, because it will result in a more timely recognition of expected credit losses, and hence address the weakness of an incurred loss model. However, we note that the proposals would require significant implementation and ongoing costs. EFRAG believes that the recognition of a portion of expected credit losses at initial recognition is not conceptually sound when credit risk is priced appropriately.

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EFRAG's overall assessment (Continued)

	EFRAG position
EFRAG does not agree with	EFRAG does not support the element in the FASB's model that requires the recognition of lifetime expected credit losses at initial recognition since it would result in excessive front-loading of credit losses given initial expectations of credit losses are priced into a financial asset, and would provide less relevant information on credit deterioration and the presentation of the lender's performance. EFRAG believes that recognising the full lifetime expected credit losses from initial recognition does not result in an appropriate balance between the representation of the underlying economics and the cost of implementation as the double counting effect of expected loss recognition at inception is aggravated by the consideration at once of life time expected losses. EFRAG shares the concerns of many constituents in Europe on the lack of convergence and the implications for preparers and users. We urge the Boards to try where possible to align their proposals and make suggestions for this in our letter. However, we strongly believe that the two fundamental objectives of depicting credit deterioration over the life of the instrument (or a portfolio of instruments) and presenting an interest income amount that reflects faithfully the performance of the debtor should not be compromised, not even for the sake of convergence.

EFRAG's overall assessment (Continued)

	EFRAG position
EFRAG recommends	Our field test has clearly highlighted that the current proposals do not allow entities to sufficiently leverage existing risk management and regulatory practices and that not all necessary data are available. Therefore, we suggest the IASB to reconsider how the model could be implemented in such a way that entities are able to leverage their existing practices and hence limit the costs and increase reliability of their estimates. We also note that many constituents indicated that the operational difficulty to comply with the proposed disclosure requirements would be high. Consequently, we encourage the IASB to review the level of proposed disclosures in order to balance appropriately the cost for preparers and benefits for users. To implement the proposed requirements, entities would need a full three years after publication. This period could be reduced only if substantial changes are made along the lines of our recommendations to make the standard more operational and less costly to implement. This assessment should be made taking into consideration the capabilities of entities in general and not focus exclusively on large banks with sophisticated systems and practices.

Objective of an expected credit loss impairment model (Question 1)

	EFRAG position
Economic link between pricing and credit quality at initial recognition	EFRAG does not agree that recognising a portion of expected credit losses at initial recognition reflects the economic link between the pricing of a financial instrument and the credit quality at initial recognition when the financial instrument is priced at market terms because it ignores the revenue aspect of the transaction. We do not suggest an alternative model but believe that our recommendations would make the model operationally more viable.
Effect of changes in credit risk after initial recognition	Notwithstanding our conceptual concerns, EFRAG supports the proposed approach as it distinguishes between financial assets that have deteriorated in credit quality and those that have not, and hence provides relevant and useful information about the effects of changes in the credit quality on an entity's financial assets.
FASB approach	EFRAG does not support an approach that requires lifetime expected credit losses to be recognised at initial recognition since such an approach would result in excessive front-loading of credit losses given initial expectations of credit losses are priced into a financial asset, and would provide less relevant information on credit deterioration and the presentation of the lender's performance. We urge the IASB and FASB to converge their models where possible. We offer a few suggestions in the comment letter for this purpose.

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The main proposals in this exposure draft (Question 2)

	EFRAG position
IASB approach	EFRAG accepts the proposed approach because we expect it will result in an earlier recognition of expected credit losses and hence address the weakness of an incurred loss model. However, the proposals would require significant implementation and ongoing costs. Also operational difficulties and uncertainties are to be overcome to apply the proposals. Therefore we suggest the IASB to revise how the model should be implemented to significantly increase the ability of entities to rely on the existing risk management practices or regulatory requirements and hence limit the costs and increase reliability of the estimates.
Comparison with the 2009 ED and the 2011 SD	EFRAG believes that the approach in the ED achieves a better balance between the faithful representation of underlying economics and the cost of implementation of the approaches in the 2009 ED and the Supplementary Document (without the foreseeable future floor) for the reasons below: ○ The Supplementary Document would still be operationally challenging by requiring lifetime expected credit losses to be calculated for all loans from initial recognition, and would not deal sufficiently with early loss patterns; ○ The 12-month expected credit loss will allow entities to use where possible existing credit risk management practices and deal with early loss patterns.

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The main proposals in this exposure draft (Question 2) (Continued)

	EFRAG position
FASB approach	EFRAG believes that the approach proposed in the FASB ED does not result in an appropriate balance between the representation of the underlying economics and the cost of implementation.

Scope (Question 3)

	EFRAG position
Scope	EFRAG agrees with the proposed scope of the Exposure Draft. ○ We support the view that the same impairment approach should apply for both loans and loan commitments, since they are often managed within the same business strategy. ○ We believe it is important that both the amortised cost category and the FV-OCI category are subject to the same impairment requirements as this ensures comparability of amounts that are recognised in profit or loss for assets with similar economic characteristics.

12-month expected credit losses (Question 4)

	EFRAG position
12-month expected credit losses	Based on the findings of its field-test, EFRAG found that the reliance on probabilities of default in credit risk management is currently limited and hence the ability to use where possible current credit risk management to implement the ED. While financial institutions which follow the Internal Ratings Based Approach for credit risk management may have detailed statistical data on credit risk behaviour of their clients, this may not be the case for financial institutions following the Standardised Approach for credit risk management, corporates and insurers. EFRAG believes that the final standard should provide further clarification how constituents that do not apply an Internal Ratings Based Approach for credit risk management could implement the standard without undue cost. We suggest that the IASB should explore to what degree information other than the data currently available could be used as a reasonable proxy in order to reduce the costs of implementation.

Assessing when an entity shall recognise lifetime expected credit losses (Question 5)

	EFRAG position
Recognition of lifetime expected credit losses	EFRAG supports the proposed approach to recognise lifetime expected credit losses when there is a significant deterioration in the borrower's ability to meet its contractual terms since initial recognition because that credit deterioration would not have been reflected in the original pricing (i.e. interest rate) of the financial asset. EFRAG in principle agrees that the assessment for the recognition of lifetime expected credit losses should be based on changes in the probability of default. However, we suggest the IASB amend the wording in paragraph 8 of the ED to make clear that the assessment of changes in probability of default should be the objective and that other approaches could also be used to make the assessment.
Application guidance	We agree with the approach in paragraph BC202 of the ED that an entity can apply the credit quality assessment to portfolios with similar credit risk characteristics in an absolute manner, and believe that it would be helpful if the IASB could state this explicitly in the body of the final standard.

Assessing when an entity shall recognise lifetime expected credit losses (Question 5) (Continued)

	EFRAG position
Operational simplifications	EFRAG supports the use of principle-based guidance on credit deterioration which provides indicators and factors rather than bright lines, but we acknowledge that the requirement to track changes in the credit quality will be operationally challenging. Therefore, we agree that operational simplifications are necessary to make the model workable for every entity. The proposed ’30 days past due’ rebuttable presumption would not necessarily be aligned with the existing credit risk management practices. We note that the aforementioned presumption would not drive the accounting but would mainly affect the amount of work required in order to assess whether there is a significant increase in credit risk. However, we suggest the IASB clarify that the ’30 days past due’ rebuttable presumption is not to be interpreted as a bright line. EFRAG also supports the proposed simplification for financial instruments with low credit risk and agrees that the primary focus of the model should be when there is a significant increase in credit risk. In our view, the proposed definition of low credit risk is meaningful and consistent with our understanding that the probability of default increases at an exponential rate as a financial asset deteriorates in credit quality.

Interest revenue (Question 6)

	EFRAG position
Interest revenue	EFRAG agrees that interest revenue should be calculated on a net basis when there is objective evidence of impairment. We agree with the IASB's conclusion in paragraph BC98 of the ED that 'there are some financial assets that have deteriorated in credit quality to such an extent that presenting interest revenue on the basis of the gross carrying amount that reflects the contractual return would no longer faithfully represent the economic return'. EFRAG believes that presenting interest revenue on a net basis is better than using a non-accrual approach as the latter requires a difficult distinction whether cash flows represent interest or principal which can result in in the time value of money not being fully recognised in impairment provisions.

Disclosures (Question 7)

	EFRAG position
Disclosures	While EFRAG supports the proposed disclosure objectives, we are concerned that the proposed disclosures are likely to be excessive, more particularly for non-financial institutions. We ask the IASB to consider carefully the findings of our field-test and review the level of proposed disclosures in order to balance appropriately the cost for preparer's and benefits for users. We believe that the proposed disclosures will increase transparency and comparability and provide relevant information about the credit quality of an entity's financial assets and its risk management activities. The IASB should develop an alternative form of disclosure about experience adjustments, which would allow users to understand the quality of earlier accounting estimates. We also suggest that the information for modified financial assets be limited to the year of modification. Finally, we recommend that all relevant disclosures be placed in IFRS 7 *Financial Instruments*.

Modified but not derecognised (Question 8) Loan commitments - Financial guarantee contracts (Question 9)

	EFRAG position
Modifications	EFRAG agrees with the proposed treatment of financial assets whose contractual cash flows are modified but is of the opinion that the standard needs to clarify when a modification results in derecognition, as well as how to differentiate between modifications resulting from deteriorations in credit risk on the one hand and those resulting from commercial reasons on the other hand.
Loan commitments *Financial guarantee contracts*	EFRAG supports the inclusion of loan commitments and financial guarantee contracts into the scope of the standard as in many cases these are subject to the same risk management practices as lending. In addition, we believe that the IASB and FASB should align the scope of their projects with regard to financial guarantee contracts, either to include or exclude guarantee contracts. EFRAG is of the opinion that this is one of the areas where the projects should converge.

Simplified approach (Question 10)
Credit impaired on initial recognition (Question 11)

	EFRAG position
Simplified approach	EFRAG supports the proposed simplified approach for trade receivables and lease receivables. However, we believe that further application guidance is necessary regarding the application of the proposals to lease receivables. As a matter of principle, EFRAG would be in favour of requiring the same impairment model to all financial assets, however, from a pragmatic point of view, we accept that applying the full impairment model to lease receivables and trade receivables would not result in an appropriate trade-off between costs and benefits. In particular, we understand that the requirement to track changes in credit quality would be challenging for certain lessors and most corporates as they do not maintain the same level of granular information as banks or other financial institutions. EFRAG notes there are specific application issues in the context of lease receivables for which we ask the IASB further clarification.
Credit-impaired assets at initial recognition	EFRAG agrees with the proposal in the ED to carry forward the scope and requirements in paragraph AG5 of IAS 39, which require an entity to include the initial expected credit losses in the estimated cash flows when calculating the effective interest rate for financial assets that have objective evidence of impairment on initial recognition.

Effective date and transition (Question 12)
Effects analysis (Question 13)

	EFRAG position
Effective date and transition	EFRAG strongly believes that to implement the proposed requirements, entities would need a full three years after publication. This period could be reduced only if substantial changes are made along the lines of our recommendations to make the standard more operational and less costly to implement. This assessment should be made taking into consideration the capabilities of entities in general and not focus exclusively on large banks with sophisticated systems and practices.
Effects analysis	We agree that the proposed model would be more responsive to changes in credit quality compared to IAS 39, and therefore would result in an earlier recognition of expected credit losses. In addition, we believe that the results of our field-test provide valuable information about the operability and the clarity of the proposals, therefore we encourage the IASB to consider that work carefully in finalising its proposals.