Response to the IASB Exposure Draft Financial Instruments: Expected Credit Losses

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INTRODUCTION

ICAS welcomes the opportunity to comment on the IASB's Exposure Draft: Financial Instruments: Expected Credit Losses.

The ICAS Charter requires its committees to act primarily in the public interest, and our responses to consultations are therefore intended to place the public interest first. Our Charter also requires us to represent our members' views and to protect their interests, but in the rare cases where these are at odds with the public interest, it is the public interest which must be paramount.

The ICAS Accounting Standards Committee has considered the Exposure Draft and I am pleased to forward their comments.

Any enquiries should be addressed to Ann Buttery, Assistant Director, Technical Policy and Secretary to the Accounting Standards Committee.

RESPONSE TO THE EXPOSURE DRAFT

KEY COMMENTS

We would firstly compliment the IASB on preparing an Exposure Draft which reflects a reasonable compromise between the faithful representation of the underlying economics and the cost of implementation, draws on previous comments and responses, and offers a pragmatic solution.

Recognition of twelve month expected credit loss at origination

We recognise that the approach in the Exposure Draft is not a conceptually pure solution; however, if a conceptually pure, plus operational, solution was in existence, it would have been found by now. There is no conceptual justification for a requirement to carry a provision of twelve months expected credit losses at origination or purchase of a financial instrument, however, we believe that the IASB has adopted a pragmatic approach and addressed the main concerns of the IAS 39 incurred loss approach which recognised loan losses too late.

We note that the proposed approach differs from that proposed by the FASB in the US and would encourage the IASB to continue to seek convergence with the FASB, if possible; however, we believe that the proposed US model, which recognises a lifetime expected credit loss allowance at origination, is inappropriate as it does not faithfully represent the underlying economics of financial instruments.

Practical implementation

We believe that, whilst the measurement of the twelve month expected loss allowance will be operational for banks, it may be more difficult for other organisations to implement, particularly non-financial organisations where the concept of twelve month expected credit losses is unfamiliar.

Operational guidance may need to be given to smaller financial institutions, or corporates, and therefore we would like to encourage the IASB, when carrying out their field testing, to ensure that their outreach program encompasses as broad a range of entities as possible.

Simplified approach for accounts receivables and lease receivables

We agree with the simplified approach for accounts receivables; however, we do not believe that a simplified approach for lease receivables is appropriate.

Disclosure of movements in balance sheet items

We are not convinced that a reconciliation of the gross carrying amount is needed and would encourage the IASB to develop better disclosure principles and, in particular, consider whether disclosures of movements in balance sheet items are relevant, necessary and operational.

RESPONSE TO EXPOSURE DRAFT QUESTIONS

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?

We believe that the recognition of a twelve month expected credit loss allowance when a financial instrument is originated or purchased is conceptually questionable; however, we recognise that there is no better alternative, and this earlier recognition of expected credit losses represents a pragmatic solution to the issues encountered with the IAS 39 incurred loss model which recognised losses too late.

We agree that recognising a loss allowance 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.

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?

We agree with (a) and (b) - the IASB's proposed approach in this Exposure Draft represents a reasonable compromise between the faithful representation of the underlying economics and the cost of implementation, and achieves a better balance than the previous 2009 Exposure Draft and Supplementary Document. As such, we do not believe that the approach taken in (c) achieves a better balance.

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?

Yes, we agree that the proposals in this Exposure Draft are reasonable.

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?

We believe that the Exposure Draft would be operational for banks, but may be more difficult for other organisations, particularly non-financial organisations where the concept of twelve month expected credit losses is unfamiliar. We therefore advise that operational guidance may need to be given to smaller financial institutions, or corporates, and would encourage the IASB to ensure that their outreach program covers as broad a range of entities affected as possible to ensure all perspectives are considered.

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 agree with (a) to (e), and specifically welcome the proposed operational simplifications. However, we are concerned that, as drafted, the Exposure Draft could require individual tracking of the probability of the default of loans at origination, and subsequently, and we do not believe that this is operational for all entities. We believe that the Exposure Draft should be more explicit that individual tracking of probability of default is not the only way in which entities can meet the significant deterioration principle and that significant deterioration can be assessed by other means aligned with internal credit risk practices.

Question 6

(a) Do you agree that there are circumstances when interest revenue calculated on a net carrying amount (amortised cost) rather than on a gross carrying amount can provide more useful information? If not, why not, and what would you prefer?

(b) Do you agree with the proposal to change how interest revenue is calculated for assets that have objective evidence of impairment subsequent to initial recognition? Why or why not? If not for what population of assets should the interest revenue calculation change?

(c) Do you agree with the proposal that the interest revenue approach shall be symmetrical (i.e. that the calculation can revert back to a calculation on the gross carrying amount)? Why or why not? If not, what approach would you prefer?

We agree with (a) to (c).

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?*

In response to (a) and (b), we believe that the detailed movement in balance sheet items, as required by Paragraph 35, reconciling the opening to closing balance of the gross carrying amount is irrelevant, unnecessary and would operationally be very difficult to achieve.

Specifically, we are concerned that general ledgers may not distinguish between the twelve month and lifetime loss categories. Further, the guidance is not clear as to whether a net or gross movement in balances would be disclosed if a loan moved between categories in a year, with gross movements showing large swings in balances.

We note in BC 111 and BC 112 that many users believe it is important to disclose this information; however, we do not believe that this provides relevant information about expected credit losses. We do however agree that a reconciliation of the allowance balance does meet the disclosure principle and believe that the IASB should explain how this disclosure meets the disclosure objective. We understand that the IASB are looking to simplify disclosures; however, simplification does not appear to apply to Paragraph 35, and further, we are not convinced that a reconciliation of the gross carrying amount is needed to meet the disclosure objectives of Paragraph 28.

We would encourage the IASB to develop better disclosure principles and consider whether disclosures of movements in balance sheet items are relevant, necessary and operational.

In response to (c), we do not believe any further disclosures are necessary.

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 agree that the proposals provide clarification; however, additional guidance may be required when a change is so significant that the loan is de-recognised.

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.*

Yes, we agree with the proposals and do not foresee any significant operational challenges.

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 agree that the simplified approach for accounts receivables is appropriate; however, we believe that lessors will be capable of dealing with the requirements of the Exposure Draft and therefore lease receivables should not be granted a simplified approach which would exclude them from those requirements.

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?

Yes, we agree with the proposals.

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?

As we indicated in our previous comment letter dated 1 June 2010, in response to the IASB Exposure Draft 2009/12: Financial Instruments: Amortised Cost and Impairment, we believe that a three year timeframe is necessary for entities to implement the requirements of IFRS 9. We also believe that, in practical terms, it is preferable if all proposals relating to financial instruments have the same mandatory effective date. The 2015 effective date should therefore be deferred again as it is no longer achievable.

In general, we welcome transitional provisions and simplifications, however we feel that the transitional arrangements currently proposed need clarification as they are difficult to understand. Nevertheless, we agree with the proposed relief from restating comparative information on transition particularly the inclusion of the proposed relief from reporting IAS 39 comparative information (as per Appendix C to the Exposure Draft).

Question 13

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

In general, we believe that this Exposure Draft is operational, and gives an appropriate answer. We would like to continue to encourage the IASB to achieve convergence with the FASB, if possible; however, we believe that the proposed US model, which recognises a lifetime expected credit loss allowance on origination or purchase of a financial instrument, is inappropriate as it does not faithfully represent the underlying economics of financial instruments.