17 June 2013

Our ref: ICAEW Rep 85/13

Your ref: ED/2013/3

Hans Hoogervorst
Chairman
International Accounting Standards Board
30 Cannon Street
London
EC4M 6XH

Dear Hans

ED/2013/3 *Financial Instruments: Expected Credit Losses*

ICAEW is pleased to respond to your request for comments on ED/2013/3 *Financial Instruments: Expected Credit Losses.*

Please contact me should you wish to discuss any of the points raised in the attached response.

Yours sincerely

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ICAEW REPRESENTATION

ED/2013/3 FINANCIAL INSTRUMENTS: EXPECTED CREDIT LOSSES

Memorandum of comment submitted in June 2013 by ICAEW, in response to IASB's exposure draft ED/2013/3 *Financial Instruments: Expected Credit Losses* published in March 2013.

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INTRODUCTION

1. ICAEW welcomes the opportunity to comment on the exposure draft ED/2013/3 *Financial Instruments: Expected Credit Losses* published by the IASB on 6 March 2013, a copy of which is available from this link.

WHO WE ARE

2. ICAEW is a world-leading professional accountancy body. We operate under a Royal Charter which obliges us to work in the public interest. ICAEW's regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the UK Financial Reporting Council. We provide leadership and practical support to over 140,000 member chartered accountants in more than 160 countries, working with governments, regulators and industry in order to ensure that the highest standards are maintained.

3. ICAEW members operate across a wide range of areas in business, practice and the public sector. They provide financial expertise and guidance based on the highest professional, technical and ethical standards. They are trained to provide clarity and apply rigour, and so help create long-term sustainable economic value.

4. The Financial Reporting Faculty is recognised internationally as a leading authority on financial reporting. The Faculty's Financial Reporting Committee is responsible for formulating ICAEW policy on financial reporting issues, and makes submissions to standard setters and other external bodies. The faculty also provides an extensive range of services to its members, providing practical assistance in dealing with common financial reporting problems.

MAJOR POINTS

While no impairment model is without conceptual flaws, the IASB's current proposal offers a workable solution

5. We were unconvinced by the conceptual basis of the proposals set out in ED/2009/12. While we agree that there is a link between the credit risk of the borrower and the interest rate, we had doubts about the relevance and understandability of the information that would result from including initial expectations of credit losses in the determination of interest and immediately recognising all changes in these expectations as impairment allowance. We were concerned that actual losses could occur before sufficient allowance was created by the deferral of interest and that it would be impossible to determine whether these actual losses were those that were initially expected or should result in a change in expectations. In addition, we were concerned that the application of the proposals was likely to be so complex and the resulting output so difficult to understand and explain that the proposal could not meet any reasonable cost/benefit analysis.

6. The solution must therefore find the right balance between having a supportable conceptual basis and being capable of practical application. In addition, as set out in our response to the board's earlier consultations we consider that an acceptable impairment model should:

- Incorporate a broader range of credit information, including forward-looking information, in order to allow an earlier identification of credit losses and not preclude the recognition of expected losses on loans that are currently performing.
- Be consistent with the initial recognition of financial assets at fair value and with the notion of matching in interest receivable and credit losses.
- Treat performing loans differently from non-performing loans so that all losses which have occurred are immediately recognised, facilitating links to risk management practices, thereby providing useful information about credit deterioration.
- Be suitable for all types of entity, not just those in the financial sector.

7. We believe that, overall, the board's current proposals achieve these objectives. While the requirement to recognise all losses expected to result from default events within the 12 months after the reporting date has no conceptual basis, and results in some counterintuitive outcomes (eg, for growing businesses and acquisitions) it can be accepted as part of the overall package to support earlier loss recognition in a simple manner. Moreover, by recognising lifetime expected credit losses when there is a significant deterioration in credit quality, the proposals better match interest income and credit losses and provide a closer link to risk management than previous proposals. This is likely to result in more relevant and understandable information.

8. For pragmatic reasons, we therefore support the board's proposals. They offer a solution that is operationally viable and represents an improvement to existing practice. Impairment is of critical importance and, after four years of examining different options, including attempting converged solutions, the board should move as quickly as possible to finalise a standard based on its latest proposals, including clarifications as determined through its due process. Returning to the drawing board in search of a better solution is no longer an option.

Convergence with US GAAP

9. In an ideal world, we would like to see a converged impairment standard. However, in our view, it is more important for the IASB to focus on finalising a quality solution rather than continuing to attempt to agree a compromise and accept the FASB's proposals, which we believe have serious flaws.

10. We have serious concerns about the FASB's latest model. The conceptual basis of recognising all expected credit losses upfront does not reflect the economic substance of lending. It could also have serious unintended commercial and broader economic consequences. These concerns are discussed further in our response to question 1(b) below.

Costs and benefits

11. While the board's latest proposals in many cases should be less costly to implement than their predecessors, the costs involved should not be underestimated. It may be that larger banks and other financial sector institutions will be able to leverage regulatory models to help develop systems for implementing the requirements. However, it should not be assumed that this will significantly ease the burdens, not least because there are many differences between the regulatory and accounting requirements and not all the necessary data may be available to meet the latter. Moreover, it is important to note that relatively few banks currently use the 12-month expected loss information for the purposes of prudential regulation and that many smaller banks are therefore likely to incur significant costs in order to implement the proposals as they may have to build systems to estimate 12-month expected losses from scratch. These concerns are discussed further in our response to question 2(b) below.

Disclosures

12. On the whole we are supportive in principle of the proposed disclosure requirements which we believe could potentially increase transparency and comparability provided the requirements are clear. However, we are concerned that the long list of disclosures will encourage a checklist approach to compliance, which should be discouraged. We also have some specific concerns about some of the detailed requirements, most notably those of paragraphs 31 and 32. These concerns are discussed further in our response to questions 7(a) and 7(b) below.

The effective date of IFRS 9 should be further deferred

13. As noted in our recent response to ED/2012/4, we recommend that the board act promptly to start the due process necessary to formally delay the effective date of the 2010 version of IFRS 9 in order to allow companies sufficient time to prepare for the significant changes that lie ahead. We also reiterate our belief that the mandatory adoption date for both IFRS 9 and the new insurance standard should be three years after their finalisation.

RESPONSES TO SPECIFIC 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?

14. We support the approach in this exposure draft which recognises a limited portion of expected credit losses initially and lifetime expected credit losses only after significant deterioration. We agree that recognition of lifetime expected losses appropriately reflects the effects of changes in credit quality subsequent to initial recognition.

15. We were unconvinced by the conceptual basis of ED/2009/12. While we agree that there is a link between the credit risk of the borrower and the interest rate, we believe this link is best reflected by initially recognising the loan at fair value, which assumes that it has been fairly priced. In fact, since the timing of losses cannot be predicted with any certainty, it is not clear why adjusting yield rateably over the life of the loan provides relevant information. Therefore, we are not convinced by the conceptual argument that a portion of expected credit losses should be initially recognised which relates to an economic link with pricing and credit quality.

16. We note that the staff paper 6A for the December 2011 board meeting rejected the notion that recognising 12-month expected credit losses upfront would approximate the yield adjustment included in ED/2009/12. Movements in the allowance for performing loans cannot approximate a yield adjustment reflecting the economic link between pricing and initial credit quality

17. We have sympathy with some aspects of Stephen Cooper's alternative view regarding the necessity for the recognition of 12-month expected credit losses and agree with the assessment in paragraph BC61 that there is no conceptual justification for the 12-month time horizon. We are troubled that the recognition of initial allowance at an amount equal to 12-month expected credit losses results in an immediate loss even though the asset is recognised at fair value and no economic loss exists. This is a particular concern for growing businesses and the acquisition of portfolios of performing loans, for example in business combinations, when significant losses will be immediately recognised in profit or loss even though the portfolio has been recognised at fair value. Such losses may be viewed by market participants as accounting entries which can be ignored rather than a reflection of the economic reality and may result in the development of additional non-GAAP measures.

18. Nevertheless, while the requirement to recognise all losses expected to occur as a result of loss events in the 12 months after the reporting date has no conceptual basis, the recognition of some upfront losses is clearly necessary for any approach to be widely accepted. For pragmatic reasons, we therefore support the board's proposals. They offer a solution that is operationally viable and represents an improvement to existing practice.

19. We believe that the field testing being carried out by preparers and other stakeholders at the request of the IASB and EFRAG may provide valuable insights into the operability of the proposed model and we therefore encourage the IASB to consider this carefully when finalising its proposals.

Question 1 (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?

20. Yes. We agree that the recognition of lifetime expected credit losses upfront does not faithfully represent the underlying economics of financial instruments.

21. We have serious concerns about the FASB's latest model, which was published in December 2012. The conceptual basis of recognising all expected credit losses upfront is highly questionable, calling into doubt whether such an approach meets the objectives of financial reporting. Such an approach does not reflect the economic substance of lending and would distort profit or loss as well as the initial recognition at fair value. The difficulties in measuring lifetime expected credit losses, particularly for long-lived performing financial assets, where the measurement differences to other approaches are greatest, are significant, including their sensitivity to judgements about the future, which is inherently uncertain. As a result, we are concerned about both the relevance and verifiability of such measurements and therefore whether they result in faithful representation that is able to meet the needs of users of financial statements.

22. These concerns raise questions about whether the FASB model could also have serious unintended commercial and broader economic consequences. For example, excessive initial recognition of losses could change incentives for new lending in some economic circumstances and in some jurisdictions. The approach could also encourage shorter-term loans and commitments which could have adverse consequences for some economies. We believe these questions about broader economic consequences are relevant since they are the result of accounting that may not be an accurate reflection of commercial lending practice.

23. Moreover, for longer-lived financial assets, determining lifetime credit expected losses in the absence of any deterioration will necessarily be highly subjective. Basing loss expectations on historical data does not reduce the subjectivity, since past experience does not necessarily reflect current or expected future performance and there are difficulties in linking macro-economic factors directly to credit losses. The main drivers of impairment charges in these circumstances may be factors unrelated to credit risk, such as changes to the expected lives and the effects of discounting. Minor changes to assumptions and expectations of the future could have a major impact on earnings and it may be difficult to assert one assumption as being more reasonable and supportable than another. This would not be conducive to consistent application. We note that the Financial Crisis Advisory Group concluded in its final report in June 2009 that, although an expected loss model seems more prudent than the incurred loss model, the IASB and the FASB would have to take care to avoid facilitating earnings management, which would decrease transparency.

24. Some may suggest recognising lifetime losses relating to loss events which are expected to occur over a 'foreseeable future' or some period which is reliably estimable and predictable as a possible compromise to achieve convergence. We do not support such views. As we noted in our response to the supplementary document published by the two boards in 2009, we do not think the future is foreseeable or that it would be possible to define such a period in an operational manner. While we agree that 12 months is arbitrary, an indefinable future horizon for loss events cannot result in an operational standard that would be consistently applied. We have concerns about initial loss recognition, but can accept an arbitrary 12-month period as part of the wider IASB model because it is clearly defined, appropriately limited and relatively simple to apply.

25. We also note that there are other important differences between the IASB and FASB approaches which would need to be resolved before even the measurement of lifetime expected loss could be said to be converged. For example, discounting is explicitly required by the IASB, albeit with a wide range of rates being acceptable. The FASB approach considers that discounting may be either explicit or implicit in the methodology adopted. We do not believe that discounting is implicitly included in some of the methods which the FASB's draft update would permit and we believe the non-accruals approach is also inconsistent with recognising the time value of money. We are therefore doubtful that a converged approach can be agreed on a timely basis, although we recognise the importance of convergence in this area.

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?

26. Yes. We agree that the proposals offer a compromise solution that achieves a reasonable balance between more timely recognition of expected losses, consistency with risk management practices and the costs of implementation.

27. However, we believe that the application of the proposals to facilities such as overdrafts and credit cards where the contractual life of both the drawn and undrawn amounts can be called or withdrawn with little or no notice needs further consideration. 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 longer period is consistent with business practice. While we understand the conceptual accounting basis for this, we have difficulty reconciling the resulting outcome with the notion of expected loss. The contractual term of some portfolios, such as credit cards and overdrafts in some jurisdictions, could be as little as one day for both undrawn commitments and existing balances. Not only would basing impairment allowances on such terms be contrary to users' reasonable expectations of expected loss, it would result in outcomes for which no actual loss experience exists on which to base estimates. We note that the constructive period over which credit is offered in these situations might be established by a practice of the issuer conducting an annual limit or facility review and informing the customer, unless there is a credit event which may accelerate action. In this case the period over which the issuer is exposed to credit risk on the undrawn facility may be considered to be longer than the contractual cancellation period because the issuer has created a constructive expectation that credit will be extended at least annually. It could be argued that expected losses should therefore be measured over a period that is longer than contractual cancellation period. In some jurisdictions, the contractual life of the drawn balance may be the period over which the minimum payments can be expected to repay the drawn amount, which adds further complexity.

Question 2 (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)?

28. Yes. We agree that the proposals should reduce the cost of implementation compared with ED/2009/12 and the supplementary document issued in 2011.

29. Not only did we have doubts about the conceptual basis of ED/2009/12, we also felt that its application was likely to be complex and the resulting output difficult to understand and explain. In addition, we felt that the cost of implementation would be substantial and that it would take significant time for preparers. Similarly, the proposals set out in the supplementary document would have imposed a significant burden on banks and other financial sector institutions, particularly where current systems and processes do not generate the information required to comply with the proposals. In both cases, we questioned whether the benefits fully justify the potential costs involved.

30. While the board's latest proposals in many cases should be less costly to implement than their predecessors, the costs involved should not be underestimated. It may be that larger banks and other financial sector institutions will be able to leverage regulatory models to help develop systems for implementing the requirements. However, it should not be assumed that this will significantly ease the burdens, not least because there are many differences between the regulatory and accounting requirements and not all the necessary data may be available to meet the latter. Moreover, it is important to note that relatively few banks currently use the 12-month expected loss information for the purposes of prudential regulation and that many smaller banks are therefore likely to incur significant costs in order to implement the proposals as they may have to build systems to estimate 12-month expected losses from scratch.

31. The proposals already contain some practical expedients and alternative methodologies. We think it is important that the basic requirements are clearly articulated and that it is clear how and why the practical expedients and alternative methodologies meet the basic requirements. This will help consistent application and allow preparers to develop their own methodologies with some comfort that they will be compliant. Field testing would provide an indication of the complexities and costs of gathering this data in practice and additional operational simplifications that could be supported in the final standard.

32. However, in some areas it may also be necessary to reduce options and better articulate the underlying concepts. For example, permitting a wide choice of discount rates without explaining what factors should be taken into account in determining the 'ideal' rate, makes it difficult to choose effectively. The board should be open to reducing some optionality where it would help drive consistent application to the benefit of users.

Question 2 (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?

33. No. Since we do not support immediate recognition of full lifetime expected credit losses on the grounds that it does not faithfully represent the underlying economics, we do not believe that such a method can meet any reasonable cost/benefit test.

Question 3 (a)

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

34. We agree that loan commitments and lease receivables within the scope of IAS 17 should be subject to the same impairment methodology as loans. We would, however, like to give further consideration to the interaction between the impairment of the lease receivable and that of the residual asset. This needs to be considered in the context of the proposed leasing standard and our comments will therefore be included in our response to that consultation. As noted in our response to question 9(a) below, we believe further consideration may need to be given to the interaction between 12-month expected loss and the amount initially recognised less cumulative amortisation with respect to financial guarantee contracts within the scope of IFRS 9.

Question 3 (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?

35. The measurement and presentation of amortised cost impairment is one of the reasons such a FVOCI category results in increased complexity and makes the financial statements more difficult to understand. However, if a mandatory FVOCI category is introduced, the same approach to accounting for expected credit losses should be applied as to financial assets measured at amortised cost. This would avoid some of the criticisms levelled at IAS 39 during the financial crisis by ensuring that comparable amounts are recognised in profit or loss for all financial assets and avoiding the complexity that arose from IAS 39's multiple impairment models. We would not want to return to a situation where different financial assets are subject to different impairment methodologies.

36. We note, however, that many of the financial assets that qualify to be measured at FVOCI will be high quality debt securities. Therefore, expected credit losses will usually be relatively small in the absence of any credit deterioration. This may mean that in some cases – for example where such assets are owned by entities other than those in the financial sector – there would be an additional cost in determining the 12-month expected credit loss.

37. The FASB has addressed this issue by not requiring any impairment to be recognised for financial assets which are measured at FVOCI if their fair value is greater than or equal to their amortised cost and the expected credit loss is considered insignificant. This exception is probably necessary given that the FASB model recognises lifetime expected credit losses regardless of whether or not there has been any deterioration in credit quality.

38. While we do not believe that such a practical expedient is necessary in IFRS, we note that individual preparers may come to the conclusion that there is no need to recognise 12-month expected credit losses in their financial statements for high quality 'investment grade' debt securities as the amounts involved are likely to be immaterial. It may be helpful for the basis for conclusions to acknowledge this possibility to support the practical application of the standard.

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?

39. Yes. We believe that it is possible to either use suitably amended Basel models where available or other methods to determine the 12-month expected credit losses. This would, however, be more complex and costly than may be initially assumed, since there can be significant differences between accounting concepts and Basel requirements. As noted above, field testing would provide an indication of the complexities and costs of gathering suitable data in practice and additional operational simplifications that could be supported in the final standard, perhaps through application guidance.

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?

40. Yes. We agree that there should be a point at which it is appropriate to recognise lifetime expected credit losses and that this point equates to where there is a significant increase in credit risk since initial recognition.

Question 5 (b)

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

41. The proposals do not specify what is meant by the credit risk on a financial instrument increasing significantly since initial recognition, other than the list of indicators in paragraph B20. We believe that this is appropriate since the transfer point will vary for different types of financial asset in different jurisdictions which makes it impossible for the standard to establish a single absolute credit quality threshold. Entities will need to exercise appropriate judgement within the guidance provided which we think appropriately includes reference to the life of the financial instrument and its original credit quality.

42. We note that paragraph B11 suggests that the 12-month probability of a default occurring can be used to assess whether credit risk has increased significantly. We agree that this may be very helpful in practical application. It would therefore be helpful if the rationale for why this can meet the objectives could be expanded to address how this approach would meet the requirements in paragraph 8 that a simple comparison of absolute probabilities of default is not sufficient. Reference to the circumstances when this is likely to be a reasonable assumption and circumstances, such as changes in the contractual terms of the loan after 12 months, which could call the assumption into doubt, may be relevant to this analysis. It is also not clear what ‘the information considered’ could be; if the entity uses the 12-month probability of a default occurring as a proxy, this may be the (only) information available.

43. Permitting a wide choice of discount rates without explaining what factors should be taken into account in determining the ‘ideal’ rate, makes it difficult to choose effectively. The board should be open to reducing some optionality where it would help drive consistent application to the benefit of users. It may be that the original effective interest rate (or a suitable proxy) is the most suitable rate and one which will result in more consistency between stages 2 and 3.

Question 5 (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?

44. Yes. We agree that the assessment of when to recognise lifetime expected credit losses should consider changes in probability of default occurring rather than changes in expected credit losses or credit loss given default. We also agree that the consideration should be given to the remaining term of the loan so that deterioration is not identified merely the result of the passage of time. However, paragraph 8 should be re-drafted to avoid the conclusion that – as a result of the use of the word ’shall’ – the only acceptable methodology to determine lifetime PD curves at inception is to compare them to lifetime PD curves at the reporting date. While the underlying principles should be clearly stated, there are likely to be a variety of methodologies that can be developed to implement the requirements and the standard should not appear to require a specific methodology.

45. We note that some are concerned that the transfer notion may not address the timely recognition of expected credit losses on loans which have terms resulting in later loss patterns, for example interest only periods or interest step ups. These concerns may be alleviated if guidance were provided, perhaps in the clarification suggested in paragraph 42 above, that made it clear that contractual terms affecting a period after the next 12 months should be included in the assessment where they could influence the judgement as to whether there is significant deterioration.

Question 5 (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?

46. Yes. We agree with the proposed operational simplifications that instruments which remain 'investment grade' need not be assessed for significant deterioration and the rebuttable presumption that there is significant deterioration if payments are more than 30 days past due.

47. However, it would be helpful to clarify in what circumstances deterioration from 'investment grade' to 'non-investment grade' is likely to be significant. Also, the relationship between the use of internal and external credit grades should be clarified and circumstances when external credit grades provide more or less persuasive evidence than internal assessments should be explored. For example, would corporates be expected to be able to rely on up to date and directly applicable external credit ratings or would they be expected to make their own estimations and potentially rebut external credit ratings?

48. In addition, the use of the word 'shall' in paragraph 9 could indicate that more forward-looking information must be used, in isolation – if it is available – perhaps regardless of the cost or effort in obtaining it. We suggest that the text should be clarified so that the rebuttable presumption that there is significant deterioration if payments are more than 30 days past due applies, even if the entity has available other information. This would assist entities that wish to use 30 days past due as a back stop, even if they will supplement this with additional information that is more forward-looking. It would also not discourage those who may develop such information in the future. While it should be made clear that relevant information, perhaps about renegotiated loans, should not be ignored, it should equally be possible that all entities can use the 30 days past due rebuttable presumption. We believe this is necessary to ensure practical and more consistent application.

Question 5 (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?

49. Yes. We agree that the proposal should allow for transfers from lifetime expected credit loss measurement to 12-month expected credit loss measurement if the reasons for the transfer no longer apply. This is generally consistent with other impairment requirements in IFRS.

50. We note that this introduces additional complexity and tracking, but will provide better information than keeping loans that were once considered to have significantly deteriorated but which have improved in the lifetime allowance category.

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?

Question 6(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?

51. We agree that there are circumstances when interest revenue should be calculated on the net carrying amount. However, we query whether the exposure draft describes these circumstances in the most appropriate way and whether disclosures reflecting the resulting definition of stage 3 will provide the most useful information. One of the main criticisms of IAS 39 impairment provisions was that the impairment triggers were applied inconsistently in practice. While the removal of the notion of 'incurred but not reported' may allay some of these concerns, it nonetheless seems inappropriate to just bring forward the IAS 39 criteria without further consideration. In addition, where new systems are required, there are likely to be additional costs in incorporating the identification of loans in stage 3. Therefore, it may not be the case that there are no additional costs in maintaining the IAS 39 indicators.

52. In practice, there is a continuum as loans deteriorate and are written off and the difference between stages 2 and 3 is intended to represent two points on this continuum, stage 2 when there is significant deterioration and stage 3 when there is objective evidence of impairment. The distinction between these points may not be clear or easy to identify on a consistent basis. This seems evident in the overlap between the indicators of significant deterioration in B20 and the indicators of objective evidence of impairment in appendix A. For example, delinquency in interest or principal repayments may relate to a single missing payment which would be akin to 30 days past due. Similarly, while a 'significant change in the operating results of the borrower' would trigger a move to stage 2, it will not always be easy to distinguish this from the 'significant financial difficulty of the borrower' that would provide the objective evidence of an impairment that would trigger a move to stage 3. It may also become hard to understand the meaning of this sub-population of loans, once systems are in place to identify loans for which lifetime expected credit loss allowance are appropriate, and the old IAS 39 indicators become less understood by the constituency as a whole as they are no longer used to determine allowances.

53. Therefore we believe that the IASB should reconsider how this point is described. It may be that users would prefer stage 3 to represent loans where there is no uncertainty of whether or not they will default because they have defaulted eg, where the probability of default is 1 or, in other words, based on the entity's own disclosed definition of default. This could facilitate a comparison of loans with expected losses and loans where there is certainty of loss. It may also be better aligned with risk management.

Question 6 (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?

54. In principle, we agree with the introduction of a symmetrical approach. However, this is a further complication to amending the measurement of interest which we believe should be critically reviewed during the field testing and outreach. If stage 3 is retained and defined as loans which are individually assessed as being in default, it seems less likely that they would revert back to stage 1 or 2, which would help reduce the complexity of producing and understanding the disclosures.

Question 7 (a)

Do you agree with the proposed disclosure requirements? Why or why not? If not, what changes do you recommend and why?

55. On the whole we are supportive in principle of the proposed disclosure requirements which we believe could potentially increase transparency and comparability provided the requirements are clear.

56. The proposed model requires the application of significantly more judgement than is required by IAS 39. We therefore regard appropriate disclosures as being essential if users are to understand the effects of credit risk on an entity's financial position and performance. In particular we believe that such disclosures should provide sufficient information to enable users of the financial statements to assess the judgements made by management and to enable them to draw meaningful comparisons across entities. In practice, we have concerns about whether this can be achieved, given the volume of financial assets of different types in different jurisdictions. Resolving the issue of how this volume of data can be aggregated into meaningful and understandable information is critical. Since the populations are so much larger and therefore more significant to entities such as banks, these disclosures will be more important but possibly more complex than those for financial instruments with level 3 fair values.

57. Individually many of the proposed disclosures have some merit, though some are perhaps things that are 'nice to have' rather than essential. The danger is that the long list of disclosures included in the exposure draft will encourage a checklist approach to compliance, which should be discouraged. In the absence of a disclosure framework, critically reviewing the overall credit risk disclosure package to eliminate duplication and clearly articulating the principles underlying the specific disclosures could go some way to easing concerns about the requirements encouraging a checklist approach.

58. Additional disclosures should not be introduced unless they are clearly decision useful. We question whether all of the proposed disclosures – for example the requirements to track modified and written off assets for long periods – meet this threshold.

59. We have similar concerns with the requirements for movement over time analysis of loan balances and allowances by loss measurement category which could require more individual loan tracking for disclosure than is required to meet the measurement requirements. The need for management to understanding the drivers of loan loss allowance will become even more important given the potential volatility of the expected losses. This is likely to lead to the development of additional management information and disclosures based on such information could be more useful than the disclosures currently set out in the exposure draft. It may be that the disclosure requirements can be better targeted as a result of the field testing.

60. We note that paragraph 29 allows entities to judge for themselves what level of detail should be disclosed, what the emphasis on each disclosure should be and the amount of aggregation that is appropriate. An additional consideration should be whether the disclosure is relevant to the entity's circumstances and legal environment.

61. We have some specific concerns about some of the detailed requirements, as discussed in our response to question 7(b) below. Moreover, as noted in our reply to question 6 above, we query whether the benefit of including the proposed disclosures relating to stage 3 will justify the cost if that category remains defined based on IAS 39 indicators of impairment.

62. We believe that all relevant disclosures should ultimately be incorporated into IFRS 7 *Financial Instruments: Disclosures* and that the IASB should ensure that there is no duplication in requirements, rather than relying on entities to avoid duplication as implied by paragraph 31. We recommend that paragraph 31 should be deleted from the final standard.

Question 7 (b)

Do you foresee any specific operational challenges when implementing the proposed disclosure requirements? If so, please explain.

63. Yes. Specific concerns are discussed in the paragraphs which follow.

64. Paragraphs 32 of the exposure draft states that the proposed disclosure requirements may be satisfied by cross referring from the financial statements to other statements, such as a risk report, that contain the relevant information. IFRS disclosure requirements, unlike other legal and listing rule requirements, must be in the scope of the audited financial statements. While it is possible to include disclosures outside the audited financial statements within the scope of the audit report, to date such disclosures are within the same document ie, the annual report and accounts. If this is the intention of paragraph 32, it seems unnecessary since this is already accepted practice. If the intention of paragraph 32 is to suggest that disclosures can be made in other documents, such as banks' pillar 3 reports provided they are available on the same terms and at the same time as the financial statements, this is likely to cause practical difficulties. It is not clear how other documents can be included in the scope of the audit report and it is possible that pillar 3 disclosures will be based on regulatory balances that cannot easily be reconciled to the financial statements. We suggest that paragraph 32 is deleted from the final standard.

65. Paragraph 35(d) refers to 'the total amount of undiscounted expected credit losses at initial recognition'. It is unclear whether this is intended to be a one-off disclosure in the period of initial recognition – perhaps in aggregate for all such purchases or originations in the period – or the cumulative roll forward of such losses related to financial assets which have been recognised at any point in the past and not yet derecognised. If it is intended to be the latter, there are likely to be difficulties in tracking components of the total losses at initial recognition which relate to financial assets which have been derecognised, particularly where amounts have been determined on a portfolio basis. We suggest that the board clarifies its intentions. We also note that some users would prefer presentation of the gross acquired loans together with the credit loss at acquisition, this has operational benefits for preparers and would be consistent with FASB proposals so the IASB may like to reconsider this requirement.

66. Paragraph 37 refers to 'the nominal amount of financial assets written off that are still subject to enforcement activity'. It is unclear whether 'nominal amount' is intended to be the net carrying amount at write off, the original principal amount of the financial asset (which may no longer be relevant where there have been repayments of principal), the amount that is legally recoverable under the enforcement activity or some other amount. It is also unclear whether the intention is for the 'nominal amount' to relate to the financial assets written off in the period or for it to be a cumulative roll forward of the total potential recoveries, the latter of which would presumably include deductions for those which are no longer subject to enforcement activity. If it is intended to be the latter, there may be difficulties in tracking potential recoveries that are still subject to enforcement activity, particularly if the enforcement is more passive in nature. Again, we suggest that the board clarifies its intentions.

67. The relationship between paragraph 38(a) and 38(b) is not clear. Paragraph 38(a) discloses the carrying amount of loan in stages 2 and 3 which have been transferred to stage 1. Paragraph 38(b) discloses loans which have 're-defaulted'. Presumably this refers to loans which were modified while they were either in stage 2 or 3 and met the entity's own disclosed definition of default, were then transferred to stage 1 and, subsequently, were further transferred to either stage 2 or 3 and met the entity's own definition of default. If stage 3 equated with 'default' as described in the answer to question 6 above, then it would be clear which component of lifetime expected loss measurement 'such financial assets' made reference.

68. There are likely to be issues in providing quantitative information about the extent to which collateral and other credit enhancements reduce the severity of expected credit losses as set out in paragraph 40(c). It may be difficult to quantify the effect of collateral on expected losses and the disclosure would involve performing calculations with and without such quantification which seems an additional complication which may not be justified by the usefulness of the resulting information.

69. The purpose of the disclosure in paragraph 45 is not clear. If there is information value in understanding individually assessed allowances, the requirement may be more relevant and consistently applied if the aim is to differentiate allowances relating to individually identifiable loans from other loans. For example, the individual loans in a portfolio of loans which are 30 days past due are individually identifiable, even though the allowance may be determined on a portfolio basis.

Question 7 (c)

What other disclosures do you believe would provide useful information (whether in addition to, or instead of, the proposed disclosures) and why?

70. We have no suggestions for additional disclosures at this stage.

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?

71. Yes. We agree with the proposed treatment.

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?

72. We agree that the general model should be applied to loan commitments. Many entities in the financial sector manage loan commitments together with other items in open portfolios eg, undrawn credit card commitments are often managed together with credit cards with existing balances. Therefore it is appropriate for such commitments to be subject to the same impairment requirements as other financial assets.

73. We are, however, concerned about the proposals to apply the general model to financial guarantee contracts. Further consideration should be given to the interaction between the deferred income liability, which is amortised over the period of the commitment and the requirement to recognise 12-month expected loss. Both the initial fair value, which is the deferred income liability before amortisation, and the 12-month expected loss contain elements related to loss expectation. We are uncertain whether recognising a liability for the higher of the deferred income liability and 12-month expected loss will result in an appropriate recognition of income over time with respect to guarantees which have not suffered a significant increase in credit risk.

74. We note that paragraph B29 requires entities to use a discount rate that reflects the current market assessment of the time value of money when calculating expected credit losses for undrawn loan commitments, which is different from the discount rate that will be used when calculating expected credit losses for drawn amounts. In practice, however, undrawn loan commitments are typically assessed along with any drawn amounts for risk management purposes. Using different discount rates for drawn and undrawn amounts therefore seems an unnecessary complication. Moreover, it seems odd that allowance for expected credit losses will change when the loan is drawn simply due to the use of a different discount rate. We therefore question whether this requirement is operational and will provide the most useful information.

Question 9 (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.

75. For loan commitments, no. For financial guarantee contracts, see our answer to question 9(a) above.

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?

76. While in principle it would be desirable to have a single impairment model for all financial assets, we agree that benefits of applying the proposed model to certain financial assets would be outweighed by the costs involved. While this is particularly true for short-term trade receivables, it is also a concern for long-term receivables and lease receivables. We therefore support the proposed simplified approach.

77. However, we have yet to consider the board's new exposure draft on leases in detail. We must therefore reserve final judgement on the proposed simplification relating to lease receivables until such time that we have been able to consider it in the context of the proposed new leasing model.

Question 10 (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?

78. Yes. We agree with the proposal to measure trade receivables that do not have a significant financing component at the transaction price as this would not only provide relief for many entities outside of the financial sector but also align the requirements of IFRS 9 with those proposed by the revenue recognition standard.

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?

79. We agree that the requirements of paragraph AG 5 of IAS 39 relating to assets that are credit-impaired on initial recognition should be carried forwards.

80. While it is fairly easy to identify purchased credit-impaired assets – for example, where they are purchased at a deep discount – this is not always the case for originated credit-impaired assets. It would therefore be useful if the board could better explain in what circumstances originated loans could be credit impaired, perhaps by including some illustrative examples.

81. Example 9 shows a modification that does not result in the derecognition of the original loan. It may be helpful to include a further example of where the original loan is derecognised to illustrate whether or not the new loan that is recognised in its place is considered to be credit-impaired on initial recognition. Similarly, additional examples looking at other scenarios where an entity may be compelled to originate credit-impaired assets would be helpful.

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.

82. As stated in our responses to previous consultations, we believe that IFRS 9 and the new insurance standard are so intrinsically linked that they should have concurrent mandatory adoption dates. Moreover, we reiterate our belief that the mandatory effective date for both standards should be three years after their finalisation.

83. We once again recommend that the board act promptly to start the due process necessary to establish a more realistic effective date of the 2010 version of IFRS 9. Doing so would allow companies sufficient time to prepare for the significant changes that lie ahead. This is particularly important for US foreign private issuers who, in the absence of a change to the existing standard, will need to start preparing to adopt this version of IFRS 9 for 2015.

Question 12 (b)

Do you agree with the proposed transition requirements? Why or why not? If not, what changes do you recommend and why?

84. We believe the transition requirements could be clarified. In the absence of information about original credit quality, it appears that 12-month expected loss will be recognised for loans with low credit risk at transition (‘investment grade’). Based on the statement in the questions, ‘This relief is not available for financial instruments whose past-due status is used to assess changes in credit risk, because it is assumed that the information will be available to make the assessment’, it is also assumed that the intention is that 12-month expected loss will also be recognised for loans which are not 30 days past due at transition, but that lifetime expected loss would be recognised for all other loans. We agree that this would represent a sensible transition. However, reference to 30 days past due is not explicitly included in appendix C. A literal reading of paragraph C2 is that lifetime expected loss is recognised for all loans, other than those with low credit risk at transition. In addition, as noted paragraph 48 above, we are concerned about the clarity of the general application of the 30 days past due practical expedient. Therefore, we consider that paragraph C2 should explicitly state that, regardless of whether or not original credit quality information is available, information about past due status and other relevant information available at transition can be used to assess whether lifetime expected loss should be recognised on transition.

85. Transition could also be facilitated by suggesting that reasonable and supportable assumptions can be made about original credit information in the absence of complete information about original credit quality. We understand that approaches that use such assumptions are being considered for transition for the insurance proposals and the approach for impairment should be on a similar basis.

Question 12 (c)

Do you agree with the proposed relief from restating comparative information on transition? If not, why?

86. Yes, as in many instances it will be impossible to provide comparative information without using hindsight.

Question 13

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

87. We appreciate the board's attempts to integrate its effects analysis into the standard-setting process. We agree that the proposals will result in a more timely recognition of losses that better reflects economic reality and provides more comparable and useful financial information.

88. However, while paragraphs BC164-BC216 contain some useful information that will enable users, preparers and other interested parties to understand the potential effects of the proposed requirements, we are not convinced that the board's analysis of likely costs of both implementing the proposals and complying with them on an on-going basis is complete.

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