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Dear M Flores

Response to Draft comment letter on IASB Exposure draft ED/2013/3 Financial Instruments: Expected Credit Losses

Thank you for the opportunity to respond to the EFRAG Draft comment letter on the Exposure Draft *ED/2013/3 Financial Instruments: Expected Credit Losses*). Our comments on your proposed responses are set out below.

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

EFRAG tentative response

> 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. However, EFRAG has no alternative at this stage to suggest in order to modify the model in a way that would both meet this concern and be operationally viable.
>
> EFRAG supports the proposed approach as it distinguishes between financial assets that have deteriorated in credit quality and those that have not, and thus provides useful information about the effects of changes in the credit quality of an entity's financial assets.
> EFRAG does not support an approach that requires lifetime expected credit losses to be recognised at initial recognition as in most circumstances 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.

We agree in general with the EFRAG comments, however we believe a comment on the need for convergence between IFRS and US GAAP should be included.

Such convergence is important to enable a level economic playing field and comparability for users of financial statements between IFRS and US GAAP entities and we urge the FASB and the IASB to continue to work together to develop a single set of globally accepted high-quality accounting standards to promote transparency in capital markets and to meet the needs of users and preparers.

This should be achieved in the measurement of impairment allowances, rather than by disclosure as this would cause entities to effectively adopt both models with the attendant increase in cost and complexity.

Whilst neither the FASB or the IASB impairment proposals allow companies to represent fully the economics of lending in their financial reporting, we support convergence towards the IASB model as a better approximation than the FASB model.

We agree with the IASB's approach, which is based on the concept of credit deterioration and differentiates between assets which have experienced significant credit deterioration and those that have not. We believe that the recognition of lifetime expected losses on assets that have experienced significant credit deterioration and only 12 month expected losses on assets that have not better represents the credit performance of a portfolio of instruments in comparison to the recognition of lifetime expected credit losses for all financial instruments, and so provides more reliable and decision useful information to users of financial information.

We would add that the IASB approach is more aligned with banks' credit risk management processes and therefore is likely to be more robust and reliable – and therefore give rise to more relevant information for investors – than the FASB proposals.

Foreseeable future proposals

We consider that EFRAG's comments should, in addition to disagreeing with the recognition of lifetime expected losses on initial recognition, reject the "foreseeable future" approach which is currently being put forward by some US GAAP preparers. We believe such a model is likely to result in diversity in practice, will lead to a lack of comparability across entities, and is an approach that is not founded in any current credit management practises and will lead to information that is therefore not inherently relevant or reliable.

The main proposals in the exposure draft (Question 2)

EFRAG tentative response

> EFRAG accepts the proposed approach because it will result in a more timely recognition of expected credit losses and hence addresses the weakness of an incurred loss model in a pragmatic way.
>
> Overall, we believe 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

We agree with the EFRAG draft comments that the IASB approach represents an appropriate balance between earlier recognition and achievability. We would also note that it is likely to be more responsive to changes in the economic environment, albeit at the expense of volatility in results.

Scope (Question 3)

EFRAG tentative response

EFRAG agrees with the scope of the Exposure Draft.

We agree with the EFRAG's comment and the scope of the IASB ED; however we consider that the FASB and the IASB, even if they fail to achieve convergence on the other issues, should at a minimum have the same scope and that both of the eventual standards should consistently include or exclude financial guarantees.

The pricing and initial fair value of guarantees is related to the expected credit losses at inception, and they are subject to the same risk management practices as lending and therefore it is conceptually reasonable to include them in the scope. However we note that a number of constituents have raised some concerns over applying the proposals to guarantees either due to operational complexities associated with intercompany financial guarantees or because they view financial guarantees as being more akin to insurance.

Questions to EFRAG's constituents

Are you comfortable having the same impairment model for both the amortised cost category and the FV-OCI category? Please explain.

If you prefer a different impairment model for the FV-OCI category than for the amortised cost category, please explain how this model would function and how it would reflect changes in credit quality.

We support the use of the same impairment model for amortised cost and FV-OCI assets although this lead to the inclusion of more assets in impairment calculations (and disclosures) and the development of new models for such assets.

A single impairment model addresses the concern of constituents in the financial crisis that impairment was unduly complex and led to inconsistency in the measurement of credit losses. In addition, it aids transparency in the presentation of credit risk.

12-month expected credit losses (Question 4)

EFRAG tentative response

EFRAG will respond to this question based on the information gathered from its field-test.

We are also in the process of assessing the operationality of the proposals through modelling, however, we expect that the calculation of the 12-month expected credit loss will be operational, if sufficient time is allowed to adjust regulatory models to comply with the requirements of IFRS 9.

The EFRAG comment letter should highlight that, while we will be able to leverage from the currently existing regulatory loss calculations, there are key differences between the current application of regulatory loss calculations and our understanding of the application of the accounting loss calculation that need to be reflected in the models. Furthermore not all the necessary data may be currently available to meet the accounting and auditing requirements. The IASB should take this into consideration when deciding on the effective date. (see below).

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

EFRAG tentative response

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.
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.
EFRAG agrees that the assessment for the recognition of lifetime expected credit losses should be based on changes in the probability of default.
We agree with the operational simplifications that the IASB has proposed as they are necessary to make the model workable for every entity.

We consider a model that is based on credit deterioration and is reflective of an entity's risk management practices is likely to be more robust and to give more relevant information than a model which is not. This approach also means that the income statement is reflective of economic events that have occurred during the period, and therefore agree with EFRAG's comments, especially around the assessment for the recognition of lifetime expected losses.

We support principles-based guidance on deterioration which provides indicators and factors that an entity actually uses to measure the deterioration instead of providing bright lines using data that it would only use for accounting purposes.

We are concerned that the guidance on investment / non-investment grade in paragraph 6 and B16 could be interpreted as just such a bright line. We have similar concerns about the 30 days past due presumption. We have observed that some constituents in the market believe that these two indicators need to be applied for all exposures even though delinquency is less relevant to wholesale portfolios and the investment grade assumption is not relevant to mortgages. We will ask the IASB to clarify in their final standard that both the delinquency assumption and the investment grade criteria are back stops and might not be relevant to all exposures i.e. that there are other indicators that may be used.

There should be further guidance on the application of paragraph B11 which suggests that the 12-month probability of a default occurring can be used to assess whether credit risk has increased significantly. While we believe this to be very useful, we are not sure whether such an approach would be applicable in light of the guidance in paragraph 8 that a simple comparison of absolute probabilities is not sufficient.

Furthermore we will ask for clarification on the requirement to track significant deterioration from the date of initial recognition (paragraph 5). We believe that most current credit risk management models are not measuring deterioration back to initial recognition instead track movements in credit quality on a period to period basis. We would like to get clarification whether this would be an acceptable practical expedient which will align with risk management practices.

Question to EFRAG's constituents

Do you believe that the '30 days past due' rebuttable presumption appropriately reflects when there is a significant increase in credit risk? If not, please explain why and what alternative period you would recommend.

We believe that 30 days past due presumption appropriately reflects a significant increase in credit risk. However as outlined above we have concerns about the presumption becoming a bright line to be applied for all exposures. We believe that additional guidance should therefore be provided as to what type of conditions would be necessary to rebut the presumption.

Examples

We are aware that there are concerns in the market that the IASB approach will not adequately reflect the credit risk inherent in specific loan facilities such as bullet loans. We believe an example in the application guidance would be helpful to demonstrate how losses will be captured before the bullet payment in the final year.

Furthermore, we think that the illustrative example of application to credit cards where the contractual cancellation period is 1 day needs further consideration. We agree with the proposed measurement period for expected losses over the contractual life (or shorter if evidenced behaviourally e.g. by prepayments) but we would welcome an illustrative example of how to apply it to credit cards in practice. Credit card arrangements are revolving lines of credit that provide incremental extensions of credit with no set contractual payment period and optional payments with discretion provided to the borrower regarding how much to pay in a given period (subject to an established minimum payment amount). The contractual cancellation period for such facilities could be, for example 1 day, however the constructive period over which credit is offered could be longer e.g. one year or more. The constructive period over which credit is offered might be established, for example, by a practice of the issuer conducting a periodic limit or facility review or the card renewal process 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 draw down on the undrawn facility is longer than the contractual cancellation period because the issuer has created a constructive expectation that credit will be extended over a longer period by its behaviour and expected losses should therefore be measured over a period that is longer than contractual cancellation period. For the drawn facility, including after additional draw downs are no longer permitted, the contractual life is further complicated by the period over which customers are permitted to make minimum payments. Credit card minimum payments are typically based on a percentage of outstanding (often plus unpaid fees and interest due), subject only to very small fixed minimum payment. This can mean the effective life could be many years even if customers are making no new charges and consistently adhering to the minimum payment requirements.

Interest revenue (Question 6)

EFRAG tentative response

> EFRAG agrees that interest revenue should be calculated on a net basis when there is objective evidence of impairment.

We agree with the EFRAG comment letter and would specifically highlight that we are not supportive of the concept of non-accrual loans included in the FASB proposals.

Nevertheless, we might ask for further clarification of the Stage 3 threshold as the guidance provided by the ED is insufficiently clear and can be read as being nearly indistinguishable from the criteria for significant credit deterioration. We therefore believe it would be helpful if the IASB provided indicators when an asset goes into default (e.g. when a bank ceases to manage the relationship and instead takes actions to collect as much as possible of the outstanding cash flows. Such indicator would provide a greater distinction between Stage 2 and Stage 3.

Time value of money

Time value of money should be addressed in the EFRAG comment letter, even though the field testing of the proposals is at an early stage.

The proposals in paragraph B29 regarding time value of money allow an entity a choice of discount rates between the EIR for the asset and the risk-free rate. While we are conceptually supportive of discounting at the EIR as it is likely the rate that is most consistent with the concept of this measurement model, we are aware that there are significant operational challenges in the use of EIR (which can be specific to each individual financial asset) and in practice it might be that for many assets the effect of different rates on the impairment allowance may be relatively insignificant.

Disclosure (Question 7)

EFRAG tentative response

EFRAG supports the proposed disclosures. In our view, they will increase transparency and comparability and provide relevant information about the credit quality of an entity's financial assets and its risk management activities.

We suggest the IASB should develop an alternative form of disclosure about experience adjustments, which would allow users to understand the quality of earlier accounting estimates.
However, as stated in the cover note, EFRAG is undertaking a field-test in order to better substantiate its final assessment on the proposals.

We agree that the financial statements should include information that enables users to understand the credit risk that a financial institution is exposed to, and how it manages and mitigates the risk. The more material the risk, the greater the level of disclosure should be. The current drafting in IFRS 7 Financial Instruments: Disclosures and the ED permit entities to achieve these objectives.

We believe that disclosure should be based as closely as possible on information provided to management to manage the risk; specifically tailored to the nature of the portfolios of debt instruments therefore providing flexibility to concentrate on areas with higher risk, which is certainly possible under IFRS 7.

The IASB's firm requirement for roll-forwards by class on all assets subject to the proposals and the associated impairment allowance is an excessive level of detail for most users other than analysts. Most users are interested in the nature of an entity's credit risk at the end of a period as an indication of future cash flows, rather than how the risk evolved in the period.

EFRAG will be aware that there are a number of initiatives which aim to expand disclosures in the financial services industry and make disclosures more consistent globally. In particular, the Enhanced Disclosure Task Force has issued a number of recommendations that are applicable to instruments within the scope of the ED. These recommendations have been implemented by many of the larger banks and are based on a consensus of views from investors, rating agencies, accounting firms, banks and trade associations. We would strongly recommend that the IASB aligns with these initiatives to ensure that there is no duplication of requirements and that the proposed disclosures meet the views of the stakeholders.

We additionally have some concerns on specific disclosure requirements in particular the requirements for modified assets and collateral as outlined below.

Questions to EFRAG's constituents

Do you believe that any of the proposed disclosures give rise to operational concerns or are unnecessarily burdensome? If so, please specify those disclosures and explain why the concern arises.

Do you believe that the proposed disclosures are appropriate for all types of entities?

We note that Paragraph 32 allows an entity to cross refer to another document provided to users on the same terms at the same time as the financial statements. While we welcome the IASB's attempt to leverage from other publicly available information, this will lead to significant issues in terms of auditability and the dissemination of such material. Most Banks Pillar 3 disclosures are not generally made available under the same terms as the financial statements and are not subject to audit.

This represents a considerable change to financial reporting whereby another document is used to meet financial statement requirements and the IASB should consider the practicalities of the proposal.

We believe that the requirement to track disclosures for modified assets in Paragraph 38 and written off assets in Paragraph 37 over the remaining life of the instruments is extremely burdensome, especially for loans which have been granted a modification and which have performed satisfactorily ever since. For revolving facilities, for example, credit cards the requirement in Paragraph 37 would therefore result in the facility included in the disclosure until the customer leaves. The same is also true for longer term retail products with long behavioural lives (e.g. mortgages in some jurisdictions) therefore resulting in an increasing number of assets in the disclosure and hence reducing the information that the disclosure provides.

Most banks are already making significant disclosures regarding modified loans where concessions have been granted as a result of the condition of the borrower ('forbearance') as these are assets which have a heightened level of credit risk.

We consider that entities will apply materiality to the disclosures and entities for which credit risk is less material will make a lower level of disclosure. This is expressly permitted in Paragraph 28. We also note that for many entities, the best guide to credit quality is age, in which case the current disclosures in IFRS 7 paragraph 37(a) would appear to be the most relevant and should be continue to be permitted by IFRS 9 as an indicator for credit quality by these entities.

Application of the model to assets that have been modified but not derecognised (Question 8)

EFRAG tentative response

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.

We agree with the EFRAG's comments, however believe that there is sufficient guidance in current IAS 39 (and the anticipated IFRS 9) regarding the derecognition of financial instruments.

The IASB should also consider the interaction of the impairment and modification accounting models. In many cases, there will be no modification gain or loss as the expected loss on the asset will be reflected in the impairment allowance for the asset.

Application of the model to loan commitments and financial guarantee contracts (Question 9)

EFRAG tentative response

EFRAG will respond to this question based on the information gathered from its field-test.

Question to EFRAG's constituents

Do you believe that a different impairment model should apply to loan commitments? If so, please explain how the model would function and reflect changes in credit quality.

We agree with the IASB proposal to include loan commitments in the scope of eventual standard. However, we believe that a comment should be made on the different measurement of expected losses on loan commitments and on financial assets at amortised cost.

We believe that the measurement of impairment on undrawn loan commitments and drawn facilities should be consistent to ensure that there is no disconnection in the measurement of the impairment allowance when the loan commitment is drawn.

Exceptions to the general model – simplified approach for trade receivables and lease receivables (Question 10)

EFRAG tentative response

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.

We agree with the EFRAG comments.

However we would encourage the IASB to consider the implication and interaction of the discounting proposals in this Exposure Draft with the measurement proposals in ED /2013/6 Leases.

Exceptions to the general model – financial assets that are credit impaired on initial recognition (Question 11)

EFRAG tentative response

EFRAG agrees with the proposals for financial assets that are credit impaired on initial recognition.

We agree with EFRAG's response.

Effective date and transition (Question 12)

EFRAG tentative response

EFRAG strongly believes that entities should have at least three years to implement IFRS 9 after the completion of all phases of IFRS 9.

However, as stated in the cover note, EFRAG is undertaking a field-test in order to better substantiate its final assessment on the proposals.

We agree that entities should have at least 3 years for implementation, which includes the time necessary for developing the required impairment models and a period of parallel running.

Given the apparent alignment of the IASB proposals with the Basel bank capital requirements there is a danger that it will be assumed that the proposals will be easy to adopt by credit institutions. This is not the case even for sophisticated institutions – for many portfolios and assets, models will need to be significantly modified in terms of probability of default, loss given default and discounting. For others, for example portfolios on a the standardised approach, entirely new impairment models will have to be developed. Above all else, methodologies for estimating lifetime expected loss for assets in stage 2 will need to be derived.

Additionally, we are concerned that certain of the transition requirements are unclear. In the absence of information about original credit quality, the ED proposes a short cut method with recognition of a 12 month expected loss for loans with low credit risk at transition ('investment grade') while all other assets would have a lifetime expected loss provision.

In the questions section, there is a reference that this short cut is not available when the past due status is used to assess changes in credit risk. We assume 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 approach.

However, a 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. 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. We would encourage the IASB to include a reference to 30 days past due explicitly in appendix C to clarify the requirements.

We agree with the IASB proposal that comparatives should not be required to be restated because, on this occasion, a robust transitional disclosure should provide users with enough relevant and decision useful information and appropriately balances the cost of full comparative restatement and the additional implementation time delay that this would necessitate. Furthermore we believe that comparatives could not be restated without the use of hindsight which would diminish their usefulness.

The proposals are likely to create more volatility in results which will be explained by disclosures in any case. Some institutions may voluntarily decide to give additional comparative information on transition.

Effects analysis (Question 13)

EFRAG tentative response

We agree that the proposed model should result in an earlier recognition of expected credit losses. In addition, we also agree with the conclusion in paragraph BC164 of the ED.

We agree with the EFRAG comment.

We trust that the EFRAG will find our comments useful. If you would like to discuss our response in more detail, then please contact David Bradbery (david.bradbery@barclays.com) or Ben Binnington (ben.binnington@barclays.com) at 1 Churchill Place London E14 5HP.

Yours faithfully

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