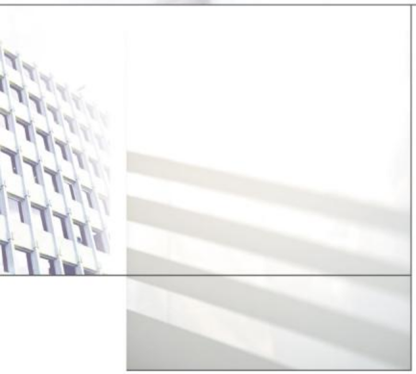

EFRAG

European Financial Reporting Advisory Group

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

Draft comment letter 16 April 2013

EFRAG's overall assessment

	EFRAG preliminary position
EFRAG agrees with	• We accept the proposed approach that requires recognition of a 12-month expected credit loss at initial recognition and lifetime expected credit losses when there is a significant increase in credit risk, because it will result in a more timely recognition of expected credit losses, and hence address the weakness of an incurred loss model in a pragmatic way. • EFRAG's preliminary assessment is that the proposed approach strikes an acceptable balance between the cost of implementation and the underlying economics, while meeting the need to provide earlier for expected credit losses as expressed by financial regulators and other constituents. • EFRAG supports the proposed credit deterioration approach as it distinguishes between financial assets that have deteriorated in credit quality and those that have not because it provides relevant and useful information about the likelihood of the collection of future contractual cash flows and the effect of changes in the credit quality of an entity's financial assets.

EFRAG's overall assessment (Cont'd)

	EFRAG preliminary position
EFRAG does not agree with	• EFRAG believes that the recognition of a portion of expected credit losses at initial recognition is not conceptually sound when credit risk is priced appropriately. • EFRAG tentatively does not support the element in the FASB's model that requires the recognition of lifetime expected credit losses at initial recognition as in most cases it will 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. • EFRAG believes that recognising the full lifetime expected credit losses from initial recognition does not result in an appropriate balance between the representation of the underlying economics and the cost of implementation.
EFRAG recommends	• EFRAG preliminary assessment is that the recognition of a portion of expected credit losses at initial recognition is not conceptually sound. However, in the absence of a better model, the IASB should finalise its impairment requirements having this approach as a basis and taking into account our recommendations below: ○ We believe that it would be helpful if the IASB could state explicitly in the body of the final standard that an entity can apply the credit quality assessment to portfolios with similar credit risk characteristics in an absolute manner.

EFRAG's overall assessment (Cont'd)

	EFRAG preliminary position
EFRAG recommends	○ We suggest the IASB to develop an alternative form of disclosure about experience adjustments, which would allow users to understand the quality of earlier accounting estimates. ○ We believe the IASB should provide application guidance that explains when a partial write-off would be appropriate. ○ EFRAG is of the opinion that the standard needs to clarify when a modification results in derecognition. ○ We believe that further application guidance is necessary regarding the application of the proposals to lease receivables. ○ EFRAG believes that entities should have at least three years to implement IFRS 9 after the completion of all phases of IFRS 9.

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

	EFRAG preliminary position
Economic link between pricing and credit quality at initial recognition	As mentioned earlier EFRAG believes that recognising a portion of expected credit losses at initial recognition is not conceptually sound.
Effect of changes in credit risk after initial recognition	EFRAG supports the proposed approach as it distinguishes between financial assets that have deteriorated in credit quality and those that have not, and hence provides relevant and useful information in understanding the likelihood of the collection of future contractual cash flows and the effects of changes in the credit quality of an entity's financial assets.
FASB approach	For the reasons explained earlier EFRAG does not support the FASB approach.

The main proposals in this exposure draft (Question 2)

	EFRAG preliminary position
IASB approach	For the reasons explained earlier EFRAG accepts the proposed approach in the ED.
Comparison with the 2009 ED and the 2011 SD	Overall, EFRAG's preliminary assessment is that the approach in the ED achieves a better balance between the faithful representation of underlying economics and the cost of implementation of the approaches in the 2009 ED and the Supplementary Document (without the foreseeable future floor) for the reasons below: ○ The Supplementary Document would still be operationally challenging by requiring lifetime expected credit losses to be calculated for all loans from initial recognition, and would not deal sufficiently with early loss patterns ○ The 12-month expected credit loss will allow entities to leverage existing credit risk management practices and deal with early loss patterns in a pragmatic way.
FASB approach	As explained earlier EFRAG believes that the approach proposed in the FASB ED does not result in an appropriate balance between the representation of the underlying economics and the cost of implementation.

Scope - (Question 3)
12-month expected credit losses - (Question 4)

	EFRAG preliminary position
Scope	EFRAG agrees with the proposed scope of the Exposure Draft. ○ We support the view that the same impairment approach should apply for both loans and loan commitments, since they are often managed within the same business strategy ○ We believe it is important that both the amortised cost category and the FV-OCI category are subject to the same impairment requirements as this ensures comparability of amounts that are recognised in profit or loss for assets with similar economic characteristics.
12-month expected credit losses	EFRAG will respond to this question based on the information gathered from its field-test.

Questions to EFRAG's constituents

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

(b) 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.

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

	EFRAG preliminary position
Recognition of lifetime expected credit losses	EFRAG supports the proposed approach to recognise lifetime expected credit losses when there is a significant deterioration in the borrower's ability to meet its contractual terms since initial recognition because that credit deterioration would not have been reflected in the original pricing (i.e. interest rate) of the financial asset. EFRAG agrees that the assessment for the recognition of lifetime expected credit losses should be based on changes in the probability of default as it does not require the full estimation of expected credit losses and is aligned with existing credit risk management processes.
Application guidance	We agree with the approach in paragraph BC202 of the ED that an entity can apply the credit quality assessment to portfolios with similar credit risk characteristics in an absolute manner, and believe that it would be helpful if the IASB could state this explicitly in the body of the final standard.

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

	EFRAG preliminary position
Operational simplifications	We tentatively agree with the operational simplifications when evaluating whether lifetime expected credit losses should be recognised that the IASB has proposed (i.e. 'investment grade' and the 30 days past due rebuttable presumption) as they are necessary to make the model workable for every entity.

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.

Interest revenue (Question 6)
Disclosures (Question 7)

	EFRAG preliminary position
Interest revenue	EFRAG preliminary assessment is that interest revenue should be calculated on a net basis when there is objective evidence of impairment. We agree with the IASB's conclusion in paragraph BC98 of the ED that 'there are some financial assets that have deteriorated in credit quality to such an extent that presenting interest revenue on the basis of the gross carrying amount that reflects the contractual return would no longer faithfully represent the economic return'
Disclosures	EFRAG tentatively supports the proposed disclosures. While the proposed disclosures are likely to be excessive for non-financial institutions, they are clearly appropriate for financial institutions. 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 to develop an alternative form of disclosure about experience adjustments, which would allow users to understand the quality of earlier accounting estimates.

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Disclosures (Question 7) (Cont'd)

Questions to EFRAG's constituents

(a) 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.

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

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

	EFRAG preliminary position
Modifications	EFRAG agrees with the proposed treatment of financial assets whose contractual cash flows are modified but is of the opinion that the standard needs to clarify when a modification results in derecognition.
Loan commitments *Financial guarantee contracts*	EFRAG will respond to this question based on the information gathered from its field-test. Please refer to our response in Question 3 (Scope)

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.

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

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

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

	EFRAG preliminary position
Effective date and transition	EFRAG strongly believes that entities should have at least three years to implement IFRS 9 after the completion of all phases of IFRS 9.
Effects analysis	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.