Issues Paper
ED 237 *Financial Instruments: Expected Credit Losses*

(This paper was prepared on 21 May 2013)

Introduction and background

1 The purpose of this issues paper is to outline potential issues in ED 237 and decide whether these issues, or any other issues, should be included in the AASB's submission on IASB ED/2013/3. This paper is structured to correspond to the questions asked by the IASB in ED/2013/3.

2 Comments are to be received by the IASB by 5 July 2013 and were due to the AASB on 10 May 2013. One submission has been received by the AASB as at the date of this Issues Paper (agenda paper 9.4). The paper incorporates feedback from that submission and feedback received as a result of staff's initial targeted outreach. Staff are aware of additional submissions that are expected to be received after the requested due date. Further feedback is also being obtained at roundtables in Melbourne on 21 May 2013 and Sydney on 24 May 2013. This issues paper does not incorporate feedback from the roundtables.

3 Due to the timing of the comment period, staff recommend that the AASB's submission to the IASB is finalised through the AASB's financial instruments impairment sub-committee, (which at the date of this issues paper comprises Victor Clarke, John O'Grady, Roger Sexton and Kevin Stevenson).

4 The following key issues are discussed in this paper:

- Approach of the proposed model for recognising a loss allowance
- Operability of the proposed model – 12 month expected credit losses
- When to recognise full lifetime expected credit losses
- Interest revenue
- Disclosure
- Assets that are modified but not derecognised
- Loan commitments and financial guarantee contracts
- Exceptions to the general model – trade and lease receivables
- Financial assets that are credit-impaired on initial recognition
- Effective date and transition
- Effects analysis

Approach of the proposed model for recognising a loss allowance

Question 1 of ED/2013/3

(a) Do you agree that an approach that recognises a loss allowance (or provision) at an amount equal to a portion of expected credit losses initially, and lifetime expected credit losses only after significant deterioration in credit quality, will reflect:

(i) the economic link between the pricing of financial instruments and the credit quality at initial recognition; and

(ii) the effects of changes in the credit quality subsequent to initial recognition?

If not, why not and how do you believe the proposed model should be revised?

(b) Do you agree that recognising a loss allowance or provision from initial recognition at an amount equal to lifetime expected credit losses, discounted using the original effective interest rate, does not faithfully represent the underlying economics of financial instruments? If not, why not?

Question 2 of ED/2013/3

(a) Do you agree that recognising a loss allowance (or provision) at an amount equal to 12-month expected credit losses and at an amount equal to lifetime expected credit losses after significant deterioration in credit quality achieves an appropriate balance between the faithful representation of the underlying economics and the costs of implementation? If not, why not? What alternative would you prefer and why?

(b) Do you agree that the approach for accounting for expected credit losses proposed in this Exposure Draft achieves a better balance between the faithful representation of the underlying economics and the cost of implementation than the approaches in the 2009 ED and the SD (without the foreseeable future floor)?

(c) Do you think that recognising a loss allowance at an amount equal to the lifetime expected credit losses from initial recognition, discounted using the original effective interest rate, achieves a better balance between the faithful representation of the underlying economics and the cost of implementation than this Exposure Draft?

Preliminary staff views

5 Staff are concerned that both the FASB and IASB models are complex, conceptually flawed and inconsistent with amortised cost measurement. Furthermore staff are concerned that recognition of financial assets at below fair value with recognition of day one losses in profit or loss, which is a feature of both the IASB and FASB models, does not reflect the economics and pricing of the underlying transaction.

6 It is unfortunate that the IASB and FASB have exposed different models. Staff support the IASB and FASB's intention to redeliberate the models together and support their efforts to reach a converged model if possible.

7 The AASB raised with the IASB (in the comment letter dated 30 June 2009 on ED/2009/12 *Financial Instruments: Amortised Cost and Impairment*, and the comment

letter dated 1 April 2011 on ED/2009/12), the notion of incurred but not reported ('IBNR') as a model which could build on the current 'incurred loss' model of IAS 39 *Financial Instruments: Recognition and Measurement.* Staff consider that an IBNR approach has merit conceptually and could be applied to reach a reliable estimate of impairment losses on a timely basis. Staff therefore would prefer an IBNR approach to the model proposed in the ED.

8 However, staff appreciate that both models attempt to provide an approach that can be made operational and build on existing systems and processes that are likely to be in place for credit management purposes and seek to respond to constituent feedback on the previously exposed models.

9 Feedback received to date from Australian constituents indicates that most have resigned themselves to there being a change to an expected loss model. Among those constituents there are mixed views, with some preferring the IASB model and some preferring the FASB model.

10 In the context of there being an expected loss model, staff preliminary recommendation is to support the progress that the IASB and FASB have made in the project. However staff recommend raising concerns to the IASB about the following:

(a) the lack of a conceptual basis (for both models);

(b) the disconnect from the economics of the underlying transactions at initial and subsequent recognition, and from the notion of 'amortised cost';

(c) the complexity of the IASB model (against an objective of reducing complexity) and the likely outcome that the model is used for accounting purposes only and not derived from an entity's existing credit systems;

(d) the degree of judgement involved in determining what is a 'default event' and when 'significant deterioration' has occurred (and when it has reversed) since these terms are not defined;

(e) whether the models appropriately depict the change in position in the case of changing economic environments (such as improving credit risk environments as well as deteriorating credit risk environments);

(f) the possibility of earnings management through the ability to shift assets between stage 1 and stages 2 and 3, and move from partial to full expected losses and vice versa (and on transition);

(g) possible double counting arising from discounting future cash flows of an asset and discounting of the associated loss allowance.

11 Staff consider that recognition of a loss allowance at an amount equal to '12-month'[1] expected loss for assets that have not significantly deteriorated in credit quality is arbitrary. Staff understand that this has been proposed by the IASB as a means to

1 '12-month' expected losses are the expected credit losses that result from default events that are possible within 12 months after the reporting date.

reduce the potential operational challenges and hence the cost of implementing an expected loss model, and results in an expected loss model that may more closely reflect the underlying economics than a model that recognises full expected loss on day one (that the FASB is proposing).

12 Despite this, staff consider that it would be more consistent with the model overall to permit entities to apply their judgement in determining the amount of expected loss to be recognised, based on a supportable loss emergence period, with 12-months as a minimum expected loss period. For example, for a portfolio where loss events typically emerge after 18 months, an expected credit loss based on an 18-month timeframe should be required to be recognised and would provide a better depiction of the expected value of the portfolio than using only a 12-month timeframe for expected loss (which could result in an underprovision in the context of an expected loss model).

13 Staff suggest commending the IASB for conducting field work on the models and to defer reaching a conclusion on the optimal model before the outcome of the field work has been considered.

Question 1 to the Board:

Do you agree with the staff recommendations? Are there any other issues in relation to ED/2013/3 questions 1 and 2 that should be addressed in the AASB's submission?

Scope

Question 3 of ED/2013/3

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

(b) Do you agree that, for financial assets that are mandatorily measured at FVOCI in accordance with the Classification and Measurement ED, the accounting for expected credit losses should be as proposed in this Exposure Draft? Why or why not?

Preliminary staff views

14 Staff agree with the scope of the ED, except for concerns about including financial assets that are mandatorily at fair value through other comprehensive income (FVOCI)[2]. Applying an expected loss to FVOCI financial assets would lead to undue complexity in accounting for these instruments, with the movement in OCI representing nothing more than a balancing figure. The initial accounting for such FVOCI assets would be different from an identical asset 'at fair value through profit or loss' (FVPL), only as a result of the 'business model' assessment. FVPL assets would not incur recognition of day one losses, whereas mandatory FVOCI assets would incur day one losses. Staff are concerned about this inconsistency and possible impacts on behaviour, as a result.

2 FVOCI is proposed as a mandatory measurement category for certain financial assets in the IASB's ED/2012/4 *Classification and Measurement: Limited Amendments to IFRS 9*. The ED was open for comment to the IASB until 28 March 2013) and at the date of this issues paper no decision has been made by the IASB whether to introduce this category to IFRS 9 *Financial Instruments*.

Question 2 to the Board:

Do you agree with the staff views? Are there any other issues in relation to ED/2013/3 question 3 that should be addressed in the AASB's submission?

Operability of the proposed model – 12-month expected credit losses

Question 4 of ED/2013/3

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?

Preliminary staff views

15 Feedback from some constituents is that the model would be complex and expensive to apply. Feedback also indicates that entities do not monitor credit risk at an instrument by instrument level, nor on the change in credit risk from initial recognition. Instead credit risk might be assessed at a customer exposure level, across a range of instruments and products. Assessment would be at a point in time, rather than relative to initial recognition. Some constituents therefore expect that they would need to run at least two information systems: one for credit risk management purposes, one for accounting (and possibly a third information system for regulatory reporting, if required).

Question 3 to the Board:

Do you agree with the staff views? Does the Board have other issues to raise?

When to recognise full lifetime expected credit losses

Question 5 of ED/2013/3

(a) Do you agree with the proposed requirement to recognise a loss allowance (or a provision) at an amount equal to lifetime expected credit losses on the basis of a significant increase in credit risk since initial recognition? If not, why not and what alternative would you prefer?

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

(c) Do you agree that the assessment of when to recognise lifetime expected credit losses should consider only changes in the probability of a default occurring, rather than changes in expected credit losses (or credit loss given default ('LGD'))? If not, why not and what would you prefer?

(d) Do you agree with the proposed operational simplifications, and do they contribute to an appropriate balance between faithful representation and the cost of implementation?

(e) Do you agree with the proposal that the model shall allow the re-establishment of a loss allowance (or a provision) at an amount equal to 12-month expected credit losses if the criteria for the recognition of lifetime expected credit losses are no longer met. If not, why not, and what would you prefer?

Preliminary staff views

16 Staff do not support the IASB's proposed requirement to recognise lifetime expected credit losses on the basis of a significant increase in credit risk since initial recognition as it does not appear to reflect the underlying economics of transaction credit risk.

17 It is our understanding that for credit management purposes entities do not currently track the change in credit risk at an instrument level from initial recognition, as outlined in the response to question 4 above and this would require system changes to implement.

18 Notwithstanding the comment immediately above, if the IASB were to proceed with this approach, staff consider that probability of default (PD) and loss given default (LGD) should both be considered to determine whether lifetime expected loss should be recognised ie. a determination of whether there has been significant increase in credit risk since initial recognition should be made relative to both change in PD (a percentage) and change in LGD (an absolute amount). For example if there is a significant increase in LGD but not PD, it is not clear why recognition of lifetime losses should be prohibited in the context of the model.

19 Staff do not think that inclusion of a rebuttable presumption of 30 days past due as an indicator of significant deterioration of credit risk is helpful, other than in a very limited range of simple transactions. Staff consider that it would be more useful to provide a range of indicators that would be evidence of 'significant deterioration' in a similar manner to the indicators provided in paragraph 59 of IAS 39 (and the draft defined terms in Appendix A of ED2013/3) for objective evidence of impairment. However, if the rebuttable presumption is retained, feedback from constituents suggests that a 60 or 90 day past due trigger may be more appropriate.

20 In any case, staff agree with the simplification for 'investment grade' assets but would go further and suggest an 'IBNR' approach for 'investment grade' assets.

Question 4 to the Board:

Do you agree with the staff views? Does the Board have other issues to raise?

Interest revenue

<u>Question 6 of ED/2013/3</u>

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

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

(c) Do you agree with the proposal that the interest revenue approach shall be symmetrical (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?

Preliminary staff views

21 Staff agree with the proposals in the ED for calculating interest revenue on a net basis as this should reflect interest at the effective yield of the instrument. Staff also agree that the approach should be symmetrical.

Question 5 to the Board:
Do you agree with the staff views? Does the Board have other issues to raise?

Disclosure

Question 7 of ED/2013/3

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

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

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

Preliminary staff views

22 Broadly staff agree with the proposed disclosures, however staff expect that some entities may need to introduce new systems and processes to capture data in the form required[3].

Question 6 to the Board:
Do you agree with the staff views? Does the Board have other issues to raise?

Assets that are modified but not derecognised

Question 8 of ED/2013/3

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?

Preliminary staff views

23 Staff agree with the approach in the ED for assets that are modified but not derecognised. That is, staff consider that loss provisioning for a financial asset that is

3 Staff expect that some relief should be provided for Tier 2 entities reporting under the Reduced Disclosure Regime, for example relieving them of the requirements in paragraph 35 of the ED for a reconciliation of the gross carrying amount and associated loss allowance for different categories of financial asset.

modified but not derecognised should be determined as if the same financial asset continues to exist.

24 The ED proposes that if a financial asset is renegotiated/modified and that results in its derecognition, the date of the renegotiation/modification is treated as the date of initial recognition. It would seem that on recognition as a new financial asset there could be no 'significant deterioration' of credit risk therefore only '12-month expected credit losses' could be recognised. This contrasts with a financial asset that was modified and not derecognised, where lifetime expected losses might need to be recognised at the point of modification. It also contrasts with financial assets that are credit impaired at initial recognition which would have no provisioning at initial recognition. The entity may have additional information about the borrower such that it might be more appropriate to recognised lifetime expected losses than 12 months of expected losses. It appears that this would be prohibited under the proposals.

Question 7 to the Board:

Do you agree with the staff views? Does the Board have other issues to raise?

Loan Commitments and Financial Guarantee Contracts

<u>Question 9 of ED/2013/3</u>

(a) Do you agree with the proposals on the application of the general model to loan commitment and financial guarantee contracts? Why or why not? If not, what approach would you prefer?

(b) Do you foresee any significant operational challenges that may arise from the proposal to present expected credit losses on financial guarantee contracts or loan commitments as a provision in the statement of financial position? If yes, please explain.

Preliminary staff views

25 Staff agree in principal that the same model should apply to loan commitments and financial guarantee contracts. However we have the same concerns about the application of the model to these items as were raised above in the comments on questions 1 and 2 about complexity, lack of conceptual basis and inconsistency with amortised cost measurement. Staff expect that some entities would have significant operational challenges in applying the model to these items.

Question 8 to the Board:

Do you agree with the staff views? Does the Board have other issues to raise?

Exceptions to the general model – trade and lease receivables

<u>Question 10 of ED/2013/3</u>

(a) Do you agree with the proposed simplified approach for trade receivables and lease receivables? Why or why not? If not, what changes do you recommend and why?

(b) Do you agree with the proposed amendments to the measurement on initial recognition of trade receivables with no significant financing component? If not, why not and what would you propose instead?

Preliminary staff views

26 On the basis of cost versus benefit staff agree with the proposed simplification of the general model for trade receivables that do not constitute a financing transaction (ie to measure a lifetime expected loss allowance).

27 Staff do not agree with permitting an accounting policy election to be made for lease receivables and trade receivable that do constitute a financing transaction (between the dual measurement model and lifetime expected losses), on the basis that staff consider that the model should be applied consistently with other types of financial asset.

Question 9 to the Board:

Do you agree with the staff views? Does the Board have an alternative view?

Financial assets that are credit-impaired on initial recognition

<u>Question 11 of ED/2013/3</u>

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?

Preliminary staff views

28 The IASB has not justified why financial assets that are credit impaired at initial recognition would not have day-one loss recognition, whereas originated financial assets which are not credit impaired do have day-one loss recognition. This appears to highlight a weakness in the model. The treatment of financial assets that are credit impaired at initial recognition would potentially be inconsistent with originated financial assets that are renegotiated/modified and recognised as new financial asset, as noted in the response to question 8 above.

Question 10 to the Board:

Do you agree with the staff views? Does the Board have an alternative view?

Effective date and transition

<u>Question 12 of ED/2013/3</u>

(a) What lead time would you require to implement the proposed requirements? Please explain the assumptions that you have used in making this assessment. As a consequence, what do you believe is an appropriate mandatory effective date for IFRS 9? Please explain.

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

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

Preliminary staff views

29 Staff recommend that the IASB is encouraged to consider aligning the application date of IFRS 9 with the application date of the insurance contracts standard. This is because insurers will have many of these financial assets backing their insurance liabilities and aligning the effective date would enable them to make the changes in a coordinated way

30 At the earliest staff suggest that this could be for annual reporting periods beginning on or after 1 January 2017.

31 Staff are concerned about the transition arrangements which permit lifetime expected losses to be recognised on transition as a practical expedient. This could be abused if excessive provisions are recognised on transition which are later released to profit or loss in subsequent periods as an unwarranted gain.

32 Staff agree with providing relief from restating comparative information on transition to facilitate earlier adoption than might otherwise be the case.

Question 11 to the Board:
Do you agree with the staff views? Does the Board have an alternative view?

Effects analysis

Question 13 of ED/2013/3

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

Preliminary staff views

33 Staff have not yet determined whether they agree with the IASB's assessment of the effects of the proposals. Further information is expected to be gathered at the roundtables to be held in the week commencing 20 May 2013.

Question 12 to the Board:
What is the Board's view?

Other matters

Question 13 to the Board:
Are there any other matters which should be included in the AASB's submission to the Board?