List of Submissions to ED 237 *Financial Instruments: Expected Credit Losses*

1 Hayes Knight
2 Representatives of the Australian Accounting Profession
(CPA Australia and The Institute of Chartered Accountants in Australia)
3 QBE
4 University of Technology Sydney
5 HoTARAC

QBE INSURANCE GROUP LIMITED
ABN 28 008 485 014

Head Office
82 Pitt Street
Sydney NSW 2000
AUSTRALIA

Postal Address
GPO Box 82
Sydney NSW 2001
AUSTRALIA

Telephone: +61 (2) 9375 4444
Facsimile: +61 (2) 9235 3166
DX 10171 Sydney Stock Exchange

30 May 2013

Hans Hoogervorst
Chairman
International Accounting Standards Board
30 Cannon Street
LONDON EC4M 6XH
UNITED KINGDOM

Dear Sir,

Re: Exposure Draft ED/2013/3 Financial Instruments: Expected Credit Losses

QBE Insurance Group Limited (QBE) is an Australian-based public company listed on the Australian Securities Exchange. QBE is Australia's largest international insurance and reinsurance company with operations in 48 countries. We are also one of the top 20 global insurers and reinsurers as measured by net earned premium. Our investment portfolio is over US$30 billion, comprising assets backing policyholders' liabilities and shareholders' funds, primarily managed in-house by our global investment team.

QBE fully supports the IASB in its aim to clarify, simplify and improve the consistency of accounting for financial instruments and we have a particular interest in the interaction between the proposals for accounting for financial instruments and the development of the insurance contracts standard. We welcome the opportunity to comment on the exposure draft issued.

We consider that the pricing of financial instruments takes into account credit risk along with many other risks such as interest rate, inflation, liquidity and economic risks. Applying the exposure draft proposals to credit and loan portfolios reflects the commercial practice applied in managing these portfolios. Applying the exposure draft to investment assets, requiring identification and isolation of one component of risk from the pricing of a financial instrument, is inherently a judgemental process and does not reflect the commercial reality of managing investment grade financial instruments.

For those entities whose business model results in the mandatory application of the FVOCI approach the measurement at fair value already takes into account the impact of credit risk along with other risks. Isolating the credit risk component of all financial instruments is a significant burden for no added value given this does not reflect the risk management approach and focuses on only one of many risks that need to be managed. Given this burden, we consider fair value through profit or loss should remain as an option for instruments which would otherwise be reported as FVOCI.

From our perspective of managing financial assets, we have a number of particular concerns regarding the recommendations set out in this exposure draft, in particular:

- The proposals do not reflect the commercial reality of managing investment grade financial instruments. This is likely to result in differences between management and statutory financial reporting, increasing complexity for both preparers and users of financial statements contrary to the IASB commitment to simplifying requirements and reducing complexity.
- We consider the proposals for measuring expected future losses to be overly complex and note there will be considerable cost in applying the methodology, both in terms of developing new systems and monitoring the proposed credit provisions.
- The identification of a 12 month window appears to be an arbitrary timeframe which adds more complexity and does not reflect commercial practice whereby credit risk associated with financial investments should be monitored for all future time periods in order to identify when appropriate provisioning or sale is necessary.

- Identifying and separating credit risk components is highly judgemental and likely to increase inconsistency between financial reports.
- The proposals appear one-sided with no contemplation of credit gains being reported in the P&L other than as a reversal of previous losses.

The introduction of the FVOCI category as an expedient to matching the proposals in the insurance standard, whereby movements in discount rate are reported in the OCI, is misguided. Inflation risk is a significant driver of the value of general insurance liabilities with movements in inflation risk reported in the P&L. Under the FVOCI classification, the inflation risk included in the fair value of financial instruments held to support insurance liabilities will remain in OCI.

The incurred loss impairment model required under the current standard has been applied in Australia effectively through recent turbulent financial periods. Consideration should be given to further enhancing this existing impairment model to ensure more consistent application globally, for example providing more guidance on the identification of objective evidence of impairment. In addition, the current approach is a principles based approach whereas the proposals in the exposure draft introduce a far more rules based approach which we consider unnecessary and a move away from the core philosophy of other standards.

Our comments on the specific questions raised in the Exposure Draft are included in Attachment A.

Yours sincerely,

Neil Drabsch
Chief Financial Officer

cc Kevin Stevenson, Chairman and CEO, AASB

Attachment A - ED/2013/3: Financial instruments: expected credit losses

Question 1
(a) Do you agree that an approach that recognises a loss allowance (or provision) at an amount equal to a portion of expected credit losses initially, and lifetime expected credit losses only after significant deterioration in credit quality, will reflect:
(i) the economic link between the pricing of financial instruments and the credit quality at initial recognition; and
(ii) the effects of changes in the credit quality subsequent to initial recognition?
If not, why not and how do you believe the proposed model should be revised?

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

(a) (i) We do not believe that an approach which recognises a loss provision at an amount equal to a portion of expected credit losses initially and lifetime expected losses only after significant deterioration in credit quality faithfully represents the underlying economics of a financial instrument.

Below is an S&P table which outlines the global default rates by credit rating in the past 10 years. This table illustrates that default on 'investment grade' (i.e. AAA – BBB) debt is a very rare occurrence; therefore, a default occurring on the same securities within the next 12-month period would have an even lower probability. The ED requires a provision for 12-month expected credit losses even for low risk ("investment grade") financial instruments. Recognition of a loss provision for such assets will not add any further relevance or credibility to financial statements; however, it will be an added cost burden to preparers of financial statements. We do not believe that the cost/benefits of implementing this change are reasonable.

S&P TABLE

Gobal Corporate Annual Default Rates By Rating Category

(%)	AAA	AA	A	BBB	BB	B	CCC/C
2003	0.00	0.00	0.00	0.23	0.57	4.02	32.93
2004	0.00	0.00	0.08	0.00	0.43	1.56	15.56
2005	0.00	0.00	0.00	0.07	0.31	1.72	9.09
2006	0.00	0.00	0.00	0.00	0.30	0.81	12.38
2007	0.00	0.00	0.00	0.00	0.20	0.25	14.95
2008	0.00	0.38	0.38	0.48	0.79	4.01	26.47
2009	0.00	0.00	0.22	0.54	0.73	10.56	48.94
2010	0.00	0.00	0.00	0.00	0.56	0.82	22.52
2011	0.00	0.00	0.00	0.07	0.00	1.53	15.83
2012	0.00	0.00	0.00	0.00	0.29	1.50	26.62

Setting up an initial provision where no losses are expected to occur is also likely to result in a divergence between management and financial reporting, adding to the complexity of financial statements for both preparers and users.

(a) (ii) Where objective evidence exists of a deterioration in credit quality, it is appropriate to provision for the increased credit risk and recognise the deterioration in credit quality in the reported result. The incurred loss requirements in IAS 39 have been applied successfully, in our experience, throughout turbulent periods in financial markets. We understand there is a lack of consistency in the application of this standard across different markets and consider an appropriate solution would be to provide more detailed guidance on the application of the existing standard in response to the G20 requirements rather than introduce an overly complex expected loss basis which does not reflect the underlying economics of the transactions.

(b) No comment provided.

Question 2
(a) Do you agree that recognising a loss allowance (or provision) at an amount equal to 12-month expected credit losses and at an amount equal to lifetime expected credit losses after significant deterioration in credit quality achieves an appropriate balance between the faithful representation of the underlying economics and the costs of implementation? If not, why not? What alternative would you prefer and why?
(b) Do you agree that the approach for accounting for expected credit losses proposed in this Exposure Draft achieves a better balance between the faithful representation of the underlying economics and the cost of implementation than the approaches in the 2009 ED and the SD (without the foreseeable future floor)?
(c) Do you think that recognising a loss allowance at an amount equal to the lifetime expected credit losses from initial recognition, discounted using the original effective interest rate, achieves a better balance between the faithful representation of the underlying economics and the cost of implementation than this Exposure Draft?

(a) As noted above, we are concerned that recognising any provision equal to 12-month credit losses on financial instruments which are investment grade does not fairly represent the economics of these financial instruments.

In theory, all financial instruments have an element of risk therefore a loss allowance will also be required for low risk assets. Failure to recognise a provision for credit loss will imply that the financial instruments are 'risk-free', which in theory they are not.

In practice, incurring credit losses on low risk financial instruments is an extremely rare event (as per S&P default table and borne out by our experience over many years and including during the GFC). The cost to implement systems to comply with the requirements of this ED requiring provisioning for all instruments, could be substantial, and are likely to outweigh perceived benefits.

We consider an appropriate alternative would be to enhance the requirements of the existing IAS 39 to ensure more consistent application of the determination of objective evidence of deterioration in credit quality and requiring provisioning for expected losses from that point.

We consider that financial instruments with objective evidence of significant credit deterioration which are purchased or held by an entity should not be considered as held for expected cash flows or held for expected cash flows and to sell and therefore should be more appropriately categorised as FV through P&L.

(b) No comment provided.
(c) No comment provided.

Question 3
(a) Do you agree with the proposed scope of this Exposure Draft? If not, why not?
(b) Do you agree that, for financial assets that are mandatorily measured at FVOCI in accordance with the Classification and Measurement ED, the accounting for expected credit losses should be as proposed in this Exposure Draft? Why or why not?

(a) No comment provided.
(b) We consider the FVOCI approach has been developed to achieve matching of financial instruments with the treatment of insurance liabilities. The aim appears to be to match the movements in interest rates on debt instruments with the discount rates on insurance liabilities. This approach fails to recognise the natural offset of inflation and interest rates (via discount rates) on the valuation of insurance liabilities which are significant for general insurance. We therefore disagree with the mandatory measuring of investments at FVOCI.

The proposed approach to measuring expected credit losses attempts to remove movements in value due to credit risk from OCI and report it in the profit or loss. Where there is a provision on

> *initial recognition and this provision subsequently reduces, the initial movement would be a gain – paragraph 27 states "An entity shall present impairment losses (including reversals of impairment losses or impairment gains) determined in accordance with this [draft] IFRS as a separate line item in the statement of profit or loss and other comprehensive income."*
>
> *This sentence does not contemplate an initial gain which is possible and ought to be recognised under the proposed model.*

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?

Recognition of a loss allowance equal to 12-month expected credit losses will have operational issues for many organisations. The approach may work well in some instances (i.e. recognising provisional losses for credit cards, short term trade receivables, loans etc); however, it's much more difficult to apply the same concept to financial instruments. Many organisations will not have this kind of data readily available, and implementing systems to do so could be very costly. The ED emphasises that information should be readily available without undue cost or effort; however, many organisations have different risk, front office and accounting systems which will need to be integrated to comply with the ED. Large financial institutions may hold hundreds or thousands of financial instruments, therefore, an automated system solution for measuring the 12-month loss allowance and subsequent disclosure is a necessity.

Our view is that no loss allowance should be applied at initial recognition for financial instruments which are considered low risk (i.e. investment grade). Recognition of a provisional loss for low risk financial instruments is unlikely to increase the relevance of financial reports, provisional losses will be estimates at best, and would be likely to be vastly different to actual incurred credit losses. We also consider the 12 month window and arbitrary timeframe which does not reflect the commercial reality of managing financial instruments whereby managers would be very unlikely to restrict their risk horizon to a 12 month timeframe.

Question 5
(a) Do you agree with the proposed requirement to recognise a loss allowance (or a provision) at an amount equal to lifetime expected credit losses on the basis of a significant increase in credit risk since initial recognition? If not, why not and what alternative would you prefer?
(b) Do the proposals provide sufficient guidance on when to recognise lifetime expected credit losses? If not, what additional guidance would you suggest?
(c) Do you agree that the assessment of when to recognise lifetime expected credit losses should consider only changes in the probability of a default occurring, rather than changes in expected credit losses (or credit loss given default ('LGD'))? If not, why not and what would you prefer?
(d) Do you agree with the proposed operational simplifications, and do they contribute to an appropriate balance between faithful representation and the cost of implementation?
(e) Do you agree with the proposal that the model shall allow the re-establishment of a loss allowance (or a provision) at an amount equal to 12-month expected credit losses if the criteria for the recognition of lifetime expected credit losses are no longer met? If not, why not, and what would you prefer?

(a) The Fair value through P&L (FVP&L) classification basis captures all investment risks, including credit risk. Where there is objective evidence of impairment and it is probable that a default will occur, FVP&L measurement should be mandatory. This will remove the complexity of trying to recognise life time expected losses and complying with the disclosure requirements in this ED which will require significant judgement and inconsistent and possibly unreliable outcomes.

The market price reflects any significant increase or decrease in credit risk, and this observable evidence of price may contradict the subjective impairment assessments made by companies on these securities. FVP&L will be a more objective and observable measurement in most cases, and will result in much more relevant information to users of financial statements.

(b) The stages on page 6 of the ED are clear – no further information required.

(c) No comment provided.

(d) The operational aspect is unlikely to be as simple as set out in the ED. Large financial institutions which hold significant volumes of debt financial instruments will need to invest large amounts of time and money to implement systems which will provide the information necessary to comply with ED requirements.

(e) As noted above, we do not agree with the recognition of 12-month expected credit losses for financial instruments which are considered low risk. This information will not be meaningful in most circumstances and will further reduce comparability of financial statements.

Question 6

(a) Do you agree that there are circumstances when interest revenue calculated on a net carrying amount (amortised cost) rather than on a gross carrying amount can provide more useful information? If not, why not, and what would you prefer?
(b) Do you agree with the proposal to change how interest revenue is calculated for assets that have objective evidence of impairment subsequent to initial recognition? Why or why not? If not, for what population of assets should the interest revenue calculation change?
(c) Do you agree with the proposal that the interest revenue approach shall be symmetrical (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?

(a) We do not believe there is merit in changing the accrual process for financial instruments. Interest accruals for financial instruments are system generated based on the appropriate market conventions. Most systems will not have an option to modify the interest accrual calculation between the net and gross carrying amount. This process would also be contrary to the economics of market practices, i.e. securities which have a higher degree of credit risk must offer higher interest rates to entice investors. Investors would have a reasonable expectation that they will be appropriately compensated for the additional risk they are taking, hence, reducing the interest revenue on higher risk financial instruments goes against fundamental economic principles.

(b) If there are instances whereby there is objective evidence that interest income is impaired due to the deterioration of credit risk, a better process of accounting for this is to "write off" interest income, rather than modifying the basis of the accrual.

(c) No comment provided.

Question 7

(a) Do you agree with the proposed disclosure requirements? Why or why not? If not, what changes do you recommend and why?
(b) Do you foresee any specific operational challenges when implementing the proposed disclosure requirements? If so, please explain.
(c) What other disclosures do you believe would provide useful information (whether in addition to, or instead of, the proposed disclosures) and why?

Refer comments above – no additional comments on disclosure provided.

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?

Any financial instruments which have modified contractual cash flows due to increased credit risk should be mandatorily measured at fair value through profit and loss.

Question 9
(a) Do you agree with the proposals on the application of the general model to loan commitment and financial guarantee contracts? Why or why not? If not, what approach would you prefer?
(b) Do you foresee any significant operational challenges that may arise from the proposal to present expected credit losses on financial guarantee contracts or loan commitments as a provision in the statement of financial position? If yes, please explain.

No comment provided.

Question 10
(a) Do you agree with the proposed simplified approach for trade receivables and lease receivables? Why or why not? If not, what changes do you recommend and why?
(b) Do you agree with the proposed amendments to the measurement on initial recognition of trade receivables with no significant financing component? If not, why not and what would you propose instead?

No comment provided.

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?

Financial instruments which have objective evidence of being credit impaired should be mandatorily measured at fair value through profit and loss. Amortised cost and FVOCI measurement should be strictly limited to financial instruments which have no objective evidence of impairment and are expected to fulfil their obligations in respect to contractual cash flows.

Question 12
(a) What lead time would you require to implement the proposed requirements? Please explain the assumptions that you have used in making this assessment. As a consequence, what do you believe is an appropriate mandatory effective date for IFRS 9? Please explain.
(b) Do you agree with the proposed transition requirements? Why or why not? If not, what changes do you recommend and why?
(c) Do you agree with the proposed relief from restating comparative information on transition? If not, why?

A 3 year effective date from issue of the final standard would appear sensible given the scale of systems changes needed in many organisations.

Question 13
Do you agree with the IASB's assessment of the effects of the proposals? Why or why not?

We do not believe that the proposals as outlined in the ED will achieve the desired outcome of the IASB. The proposed model of the IASB to recognise credit losses earlier may work effectively for organisations dealing with lease contracts, loan commitments, credit card debt and trade receivables; however, applying the same concept to financial instruments is too simplistic in its approach and results in overly complex requirements which do not reflect the underlying economics of the financial instruments or the commercial practice of managing financial instruments.

The overall aim is for early recognition of credit losses and this can be achieved by improving the guidance in IAS 39 as to the circumstances that give rise to credit losses and therefore require provisioning and the circumstances which would trigger a move to FVP&L as a more appropriate classification.

School of Accounting
City Campus
1-59 Quay Street
Haymarket NSW 2000
PO Box 123 Broadway
NSW 2007 Australia
T +61 2 9514 3560
F +61 2 9514 3669
www.uts.edu.au
UTS CRICOS PROVIDER CODE 00099F

13 June 2013

The Chairman
Australian Accounting Standards Board
P O Box 204
Collins Street West VIC 8007
Australia

standard@aasb.gov.au

The Chairman
International Accounting Standards Board
30 Canon Street
London EC4M6XH
United Kingdom

ED237 Financial Instruments: Expected credit losses

Dear Sirs

In relation to the above exposure draft I would like to comment as follows.

1. It Lacks theoretical underpinning: In reading this exposure draft it is difficult to see how this is building on the foundations of the IASB's Framework, or how it is consistent or cohesive with other accounting standards. There is no consideration of asset measurement models and the issues that they suggest. Rather, this exposure draft is being driven entirely by bank regulators. It is modeling accounting around the requirements of one type of user of financial reports – regulators – and it is modeling accounting so it is participatory in the bank supervisory process. One way of viewing this exposure draft is that it is mandating variable asset measurement to reflect expected changes in economic conditions so that we can maintain constant regulatory capital ratios. This is akin to redefining the way speed is calculated in city areas so we can maintain constant speed limits. A fundamental question is whether what is proposed by this exposure draft is appropriate for general purpose financial reports.

2. It is incomplete as regards impairment: The exposure draft purports to be concerned with impairment for financial assets recorded using the amortised cost method. It then focusses on credit losses and this is addressing only half the issue. Impairment of financial assets can arise from changes in interest rates and this will be a significant issue when interest rates increase from current record low levels. A manifestation of this will be financial assets recorded at values significantly in excess

UNIVERSITY OF
TECHNOLOGY SYDNEY

School of Accounting
City Campus
1-59 Quay Street
Haymarket NSW 2000
PO Box 123 Broadway
NSW 2007 Australia
T +61 2 9514 3560
F +61 2 9514 3669
www.uts.edu.au
UTS CRICOS PROVIDER CODE 00099F

of what would typically be labeled 'recoverable amount'. A related consequence of implementing this exposure draft is that accounting will be increasingly 'pro-cyclical'. Deteriorating economic conditions will result in increases in expected credit losses, reduced equity and reduced bank lending. Conversely, improving economic conditions will lead to decreases in expected credit losses, increased equity and increased bank lending. This may be useful in protecting bank regulators from criticism but is it appropriate from an economic management perspective or for general purpose financial reports. Inclusion of interest rate effects would ameliorate these pro-cyclical impacts of the exposure draft. This concern with pro-cyclical impacts is an issue as much of the criticism of fair value accounting for financial instruments has centered on it being 'pro-cyclical' and there is an extensive literature considering this, including Plantin, Sapra and Shin, 2008, Journal of Accounting Research).

3. Double counting: The proposed recognition of expected credit losses mandates the 'double counting' of expected credit losses. Expected credit losses are factored into the interest rate on issue. Hence the accounting choices on issue are to either:
    a. Recognize the financial asset at the future cash flows discounted at the implicit interest rate (i.e., the value received); or
    b. Recognize the financial asset at the future cash flows discounted at the risk adjusted discount rate, and recognize a loss for expected credit losses and a gain for compensation for credit risks (i.e., these offsetting gains and losses are the difference in cash flows discounted at the implicit interest rate and the risk adjusted interest rate).

    These choices cannot be mixed without there being either double counting as occurs here or non-recognition of expected credit losses. Subsequent to initial recognition, irrespective of the choice made, only changes in expected credit losses would be recognized. A further unintended consequence of this is that if banks are growing or lending was being expanded this would overstate expected credit losses recognized and potentially confound economic policy.

In summary, I have concerns about this exposure draft at the theoretical level, in its implementation and its economic consequences. My final comment is that bank regulators should be careful what they wish for, as this exposure draft may not deliver what was intended.

Yours faithfully

Peter Wells

ED237 sub 5

Department of Treasury and Finance

1 Treasury Place
GPO Box 4379
Melbourne Vic 3001
Australia
Telephone: (+61 3) 9651 5111
Facsimile: (+61 3) 9651 5298
DX 210759

Contact: Peter Gibson
Phone: 02 6215 3551

Mr Kevin Stevenson
Chairman
Australian Accounting Standards Board
PO Box 204
COLLINS ST WEST VIC 8007

Dear Mr Stevenson Kevin

AASB ED 237 *Financial Instruments: Expected Credit Losses*

The Heads of Treasuries Accounting and Reporting Advisory Committee (HoTARAC) welcomes the opportunity to provide comments to the Australian Accounting Standards Board (AASB) on Exposure Draft 237 *Financial Instruments: Expected Credit Losses.*

HoTARAC commends the International Accounting Standards Board (IASB) on their endeavours to address the issue of timely recognition of credit losses and the introduction of a single approach for all debt instruments. HoTARAC considers the current proposals an improvement on the two previous exposure documents on this topic and acknowledges IASB's attempt to simplify its approach for non financial institutions.

While HoTARAC's preference is for earlier recognition of credit losses through modifying the current incurred loss model to remove the loss trigger, if the IASB's proposals are to proceed HoTARAC recommends addressing:

- the degree of management discretion in their application;
- the double-counting on initial recognition;
- their operational complexity and the accompanying extensive disclosure requirements; and
- the lack of clarity in determining what is a significant deterioration in credit risk.

HoTARAC believes that these issues, at least partially, stem from the decision to retain the dual measurement model for expected credit losses. The majority of HoTARAC suggests that the IASB give serious consideration to the single measurement model proposed by the United States' Financial Accounting Standards Board.

State Government Victoria

HoTARAC's detailed comments and responses to questions from the exposure draft are attached.

If you have any queries regarding HoTARAC's comments, please contact Peter Gibson from the Australian Department of Finance and Deregulation on 02 6215 3551.

Yours sincerely

Grant Hehir
CHAIR
HEADS OF TREASURIES ACCOUNTING AND REPORTING ADVISORY COMMITTEE

18 June 2013

General Comments:

HoTARAC agrees that a single impairment model for financial assets is desirable. HoTARAC also agrees that there is a need to review the current model to ensure the timely recognition of credit losses. HoTARAC considers the current proposals to be an improvement on the 2009 Exposure Draft. HoTARAC particularly welcomes the removal of the requirement to perform dual calculations required under the 'good book'/'bad book' approach, the removal of the ambiguous term 'foreseeable future', the simplification for trade and lease receivables and the use of the '30 day rule' rebuttable assumption to establish a clearer demarcation between recognition points for 12 month and lifetime expected credit losses. However, HoTARAC notes that the application of the '30 day rule' will potentially mean frequent reallocation of financial assets between the two measurement bases.

However, HoTARAC reiterates its concerns that the proposals introduce expectations of future events into the measurement of financial assets, a departure from the measurement of other assets and liabilities. Accordingly, HoTARAC does not support the proposal of the incorporation of expected credit losses into measurement, preferring the current incurred loss model, modified to eliminate the need for a loss trigger.

In terms of practical application, HoTARAC observes that a considerable degree of management judgement is required in assessing future events and economic conditions, deterioration in credit risk and determining the 'reasonable' interest rate used in discounting for the time value of money. In HoTARAC's view, this opens the door to potential manipulation of results, for example through the cherry-picking of economic forecasts and favourable interest rates.

The information that is 'reasonably available' under paragraphs B5-B8 is also likely to vary considerably between entities. In addition to adding to the costs of preparation, this may also result in the undesirable outcome of identical or similar instruments being measured differently depending on which entity is measuring them. This will be a particular concern with the dual measurement bases, where entities could use fundamentally different measurement bases for identical financial instruments depending on their assessment as to whether there has been a significant deterioration in credit risk.

In HoTARAC's view, some of the practical difficulties in application could be addressed through the use of a single measurement model along the lines proposed by the Financial Accounting Standards Board (FASB) in their exposure document *Financial Instruments – Credit Losses* ("the FASB model"). HoTARAC considers the FASB model to remove the subjectivity inherent in assessing where there is a 'significant deterioration' in credit risk and to be operationally simpler to apply. HoTARAC also observes that the use of a lifetime model is proposed as a simplification for trade and lease receivables and a majority of HoTARAC jurisdictions believe that serious consideration should be given to whether this approach can be extended to simplify the complexity of the overall proposals. HoTARAC further recommends that the time value of money always be discounted using the effective interest rate, again removing a subjective judgement associated with the proposals.

HoTARAC notes the IASB's concerns over the potential double count of credit losses on initial recognition, but believes this could be addressed by the 'gross up' method discussed in BC25 and supported in the alternative view of Mr Cooper. In line with HoTARAC's

recommendation for the discount for the time value of money above, the increase in the gross carrying amount should be amortised using the effective interest rate.

Question 1

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

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

(ii) the effects of changes in the credit quality subsequent to initial recognition?
If not, why not and how do you believe the proposed model should be revised?

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

(a)

(i) HoTARAC does not agree that limiting credit losses to those arising from default events possible within 12 months reflects the economic link between the pricing of financial instruments and their credit quality at initial recognition. HoTARAC believes that the initial pricing of an instrument will reflect the expectations of credit loss and agrees with the alternative view of Mr Cooper that including a loss allowance on initial recognition will understate value (and overstate provisions for loan commitments and financial guarantees) and not faithfully represent the transaction.

(ii) HoTARAC agrees, but would prefer a single measurement base.

(b) HoTARAC agrees. However, as noted in the general comments, HoTARAC believes this could be addressed through the use of the 'gross up' method.

Question 2

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

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

(c) Do you think that recognising a loss allowance at an amount equal to the lifetime expected credit losses from initial recognition, discounted using the original effective interest rate,

achieves a better balance between the faithful representation of the underlying economics and the cost of implementation than this Exposure Draft?

(a) HoTARAC does not agree. HoTARAC's majority preference is for the single impairment model along the lines of that proposed by the FASB. HoTARAC believes the dual measurement approach adds unnecessary operational costs to measuring expected credit losses.
HoTARAC also observes that the proposals require a relative assessment of whether there has been a significant change in credit risk against credit quality at initial recognition (paragraph B12). This may result in circumstances where instruments with similar credit risks are allocated to different measurement bases.

(b) HoTARAC agrees that the current model is preferable to the approaches taken in the 2009 ED and the SD.

(c) The majority of HoTARAC jurisdictions agree.

Question 3
(a) Do you agree with the proposed scope of this Exposure Draft? If not, why not?

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

(a) The majority of HoTARAC does not agree that the scope is adequate, as it should also cover all other financial liabilities, except those at fair value through profit or loss. In addition, as entities do not recognise their own performance risk in their financial liabilities held at amortised cost, the holder and issuer of a financial instrument will apply different valuation bases.

(b) HoTARAC agrees, subject to the other comments made regarding accounting for expected credit losses.

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?

HoTARAC considers the 12-month expected credit loss operational; however this will involve considerable implementation costs, particularly for entities that are not financial institutions. The HoTARAC majority reiterates its preferences for the lifetime expected model, applied from recognition. HoTARAC considers the lifetime expected credit losses operationally simpler to apply.

Question 5
(a) Do you agree with the proposed requirement to recognise a loss allowance (or a provision) at an amount equal to lifetime expected credit losses on the basis of a significant increase in credit risk since initial recognition? If not, why not and what alternative would you prefer?

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

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

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

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

(a) As outlined in the General Comments above, the majority of HoTARAC believes a single measurement model, along the lines of that proposed by the FASB, should apply.

(b) HoTARAC considers the proposals to provide clearer guidance than the previous exposure draft. However, HoTARAC notes the term 'significant' is not defined in the exposure draft and would be a matter for individual judgement. In HoTARAC's view, the scope of the exposure draft and its application to a wide range of financial instruments and entities could cause considerable difficulties in practical application.

(c) HoTARAC agrees, subject to the other comments articulated in this response.

(d) HoTARAC agrees with the proposed simplification. However, HoTARAC's strong preference is that if the expected credit loss model is to proceed, implementation costs be reduced through the use of a single measurement model.

(e) HoTARAC agrees, subject to our other comments.

Question 6

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

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

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

(a) HoTARAC considers this method to be the most appropriate under HoTARAC's favoured incurred loss model in line with the current requirements of IAS 39.

(b) HoTARAC agrees and notes that this is the same as the current requirements under IAS 39.

(c) HoTARAC agrees. While HoTARAC has concerns on the proposals, instruments with similar risks should be consistently measured.

Question 7

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

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

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

(a) HoTARAC appreciates the removal of back-testing disclosure (BC109), but considers the proposed disclosure requirements excessive as the requirements of the ED are likely to lead to several pages of disclosures. In part, this reflects the complexity of having the dual measurement approach of 12 month and lifetime expected credit losses and the requirements to justify appropriate classification of financial instruments. HoTARAC observes that the disclosure requirements seem to be a mechanism to explain the subjective judgements used by management and that this may indicate fundamental flaws with the proposals. While this may make the proposals more auditable, it will also increase the time and effort required for preparers and auditors. In HoTARAC's view, disclosures could be simplified by adopting a single measurement base (obviating the need for explaining movements in financial assets between the three buckets) and taking the effective interest rate for the time value of money (i.e. reducing subjectivity). In HoTARAC's view, this will alleviate much of the burden for preparers and avoid information overload for users.

(b) HoTARAC notes that the compilation and disclosure of the information required may be particularly onerous for entities that are not financial institutions and do not currently have the necessary systems in place. HoTARAC considers this particularly pertinent given the scope of the application of the proposals.

(c) HoTARAC believes the proposed disclosures are extensive.

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?

HoTARAC agrees, subject to our other concerns with the proposals.

Question 9

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

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

(a) HoTARAC agrees that it is preferable to have a single model for financial instruments, but has concerns over the proposed extension of the model, particularly to financial guarantee contracts for the operational reason outlined in response to 9(b).

(b) HoTARAC does not view the proposals for loan commitments as posing a more significant operational challenge than their application to financial assets. However, HoTARAC observes that a number of entities that are not financial institutions provide financial guarantees and will be required to devote considerable resources to meeting the proposed requirements.

Question 10

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

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

(a) HoTARAC agrees with a simplified approach for trade receivables.

(b) HoTARAC agrees.

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?

HoTARAC's preference is for a single measurement model as outlined in response to Question 1. HoTARAC favours the application of the 'gross up' method, similar to the FASB's approach for purchased credit-impaired assets to maintain the general principle of the proposals that credit losses should be separated from interest.

Question 12

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

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

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

(a) As the mandatory effective date of IFRS 9 is presently 1 January, 2015, HoTARAC suggests that should the proposed requirements be implemented, they should be deferred for at least another two years following IFRS 9's effective date. For many

users, the initial work that will be required to implement the proposal will be so onerous that earlier application will not be possible.

(b) HoTARAC agrees, subject to the comments on timing, above.

(c) HoTARAC agrees.

Question 13

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

HoTARAC agrees that:

- the proposal will overcome the weakness in the current model of delaying recognition of credit losses (BC170).
- changes in the fair value of a financial instrument results in a combination of risks. However, HoTARAC recommends that the current expedient under paragraph AG84 of IAS 39 of using the fair value to measure impairment for financial assets held at amortised cost be explored for entities that are not financial institutions for which the recognition of credit losses is a less critical measure of performance.

HoTARAC disagrees that the IASB's proposal:

- will improve comparability (BC182). As outlined in the general comments, this may be impaired by the different information available to entities applying the model.
- best balances the costs and benefits (BC190 and BC203) for the reasons outlined in this submission. The single measurement model proposed by the FASB would mitigate implementation costs by sidestepping the need for the two measurement models, particularly for non financial institutions.

The majority of HoTARAC disagrees that the IASB's proposal is more appropriate than the US FASB approach of a lifetime expected credit loss (BC172). As outlined in response to Question 1, in HoTARAC's majority view, the US approach, although not ideal, is operationally simpler.

Response to AASB Questions:

General Comments

HoTARAC is concerned over the restricted timeframe allowed for consideration of the proposals given their complexity, the divergence from FASB and the fundamental conceptual changes they introduce. HoTARAC notes that respondents to the FASB are almost unanimous in requesting additional time to consider the proposals after a comment period of over four months. HoTARAC considers the comment period allowed by the AASB to be short and not conducive to the preparation of high quality responses, but appreciate the relief granted to HoTARAC by the AASB staff.

1. whether, overall, the proposals would result in financial statements that would be useful to users;

HoTARAC does not agree that the proposals would result in financial statements that are useful to users. HoTARAC's reasons and preferred model are outlined in response to the ED. While HoTARAC agrees with the need for the timely recognition of credit losses, the majority of HoTARAC believes that there are simpler alternative such as the FASB's approach.

HoTARAC is also concerned over the degree of discretion entities have in the application of the proposals, in particular in relation to the assumptions about future economic conditions, identifying a significant deterioration in credit risk and discount rates used in calculating the time value of money. HoTARAC believes that this compromises the objectivity of financial statements, reduces comparability and results in voluminous disclosure requirements.

2. whether there are any regulatory issues or other issues arising in the Australian environment that may affect the implementation of the proposals, particularly any issues relating to:
(a) not-for-profit entities; and
(b) public sector entities, including GAAP/GFS implications;

(a) No comment.
(b) Non-marketable loans under GFS are carried at their nominal amount with no allowance account. As the proposals only change the timing of the recognition of credit losses, rather than the nature of the allowance account, this will not result in new harmonisation differences but may impact on the quantum of existing differences. The proposal to include 12 month expected credit losses on initial recognition will result in financial assets being recognised at below market value creating a GAAP/GFS divergence for financial instruments within the scope of the proposals GFS measures at market value. The proposal to recognise expected credit losses on loan commitments and financial guarantees may result in an additional or larger harmonisation differences as these are either not recognised under GFS or recognised at market value.

3. whether the proposals are in the best interests of the Australian economy; and

HoTARAC does not offer any comments on whether the proposals are in the best interests of the Australian economy.

4. unless already provided in response to specific matters for comment 1 – 3 above, the costs and benefits of the proposals relative to the current requirements, whether

quantitative (financial or non-financial) or qualitative.

The major benefit of the proposal is the potential for more timely recognition of credit losses. The costs to preparers will be the resources used in assessing credit losses in line with the proposals and the extensive disclosure requirements. The costs to users will be the additional complexity, the lack of comparability between different financial instruments, information overload and difficulty in understanding the extensive disclosures.