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	
6	National Australia Bank	√
7	ANZ	√
8	Ernst & Young	√
9	PricewaterhouseCoopers	√

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800 Bourke Street
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5 July 2013

Mr Hans Hoogervorst
Chairman
International Accounting Standards Board
1st Floor 30 Cannon Street
London EC4M 6XH
UNITED KINGDOM

cc: Mr Kevin Stevenson, Chairman, Australian Accounting Standards Board (AASB)

Dear Sir

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

Thank you for the opportunity to comment on Exposure Draft 2013/3 Financial Instruments: *Expected Credit Losses* (the ED). Our comments on the specific questions raised by the IASB are addressed in the Appendix.

National Australia Bank Limited (NAB) is one of the four major Australian banks. Our operations are predominantly based in Australia, New Zealand, the United Kingdom, the United States and Asia. In our September 2012 full year results we reported net profit after tax of A$4.1 billion and total assets of A$763 billion.

The NAB is generally supportive of the IASB proposals and prefers this approach to the FASB model. While neither model properly represents the economic link of the pricing of financial assets and credit quality, the IASB model provides a better reflection of the underlying economics of financial assets while addressing the operational complexities of previous proposals.

We have the following general comments on the ED:

12-month expected credit losses
We note that the ED does not provide sufficient explanation for the use of the 12-month period to measure expected credit losses for those financial assets that have not experienced a significant increase in credit risk since initial recognition (in Stage 1). We believe the use of the IBNR (incurred but not reported) concept will enhance the measurement of expected credit losses for Stage 1 financial assets, using a minimum period of 12 months.

Monitoring significant increase in credit risk
The ED requires credit risk to be monitored at the account/facility level which is not aligned to banking practice where credit risk is assessed at the customer level. Alignment of the ED requirements with current credit risk management practices would remove operational complexities.

Low credit risk – investment grade
We recommend the inclusion of a rebuttable presumption when applying the low credit risk simplification criteria to investment grade to reflect that, in practice, financial institutions could consider certain investment grade financial assets as having low credit quality.

Interest revenue recognition
We would support the use of the non-accruals approach to account for interest revenue for financial assets with objective evidence of impairment. We believe this more appropriately reflects that such assets are managed with a focus to recover outstanding amounts rather than to earn a yield. The non-accruals principle is also used by regulators and has been included in the FASB proposals.

Assets measured at fair value to other comprehensive income (FVOCI)
We welcome the inclusion of a practical expedient similar to that proposed in the FASB model which permits an entity to elect not to recognise expected credit losses on individual financial assets measured at FVOCI where the fair value of the individual financial asset is greater or equal to the amortised cost and the expected losses are insignificant.

Early adoption
New accounting standards normally permit early adoption. Our preference is for permission to early adopt at the beginning of the financial period in which the standard is released, or effective from the standard release date.

Disclosure requirements
The proposed disclosures are extensive and these should be revised to remove those disclosures that are onerous, or where useful information is already provided under the IFRS 7 requirements. Our specific concerns are outlined in Question 7.

The Appendix to this letter outlines our responses to the specific questions in the ED which should be read in the context of the general comments raised above.

Should you have any queries regarding our comments, please do not hesitate to contact Vanessa Fong at Vanessa.Fong@nab.com.au.

Yours sincerely

Marc Smit
Head of Group Accounting Policy

APPENDIX – Response to Specific Questions

Objective of an expected credit loss impairment model

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) We are generally supportive of the proposed approach in the ED to recognise a loss allowance (or provision) at an amount equal to a portion of expected credit losses initially, and lifetime expected losses only after significant deterioration in credit quality.

However, we do not agree that the proposed model faithfully reflects the economic link between the pricing of financial instruments and credit quality at initial recognition. The proposed approach results in the recognition of day one losses which does not reflect that credit risk is initially priced into a financial instrument to compensate for credit losses that are expected to arise over the life of the financial asset. We believe the proposed model in the 2009 Exposure Draft *Financial Instruments: Amortised Cost and Impairment* provided a better reflection of this economic link; however we acknowledge the 2009 ED presented significant implementation challenges.

More specifically, the proposed model in the ED requires 12-months expected credit losses to be recognised for financial assets initially, or where these have not suffered a significant increase in credit risk since initial recognition, but does not provide sufficient explanation for this concept. We expand in our commentary on this area in our responses to Q2(a) and Q4.

While we support the proposed approach, we encourage the IASB to take into account the responses and recommendations in our comment letter when finalising the standard.

b) We 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.

Immediate recognition of lifetime expected credit losses is overly conservative resulting in significant front-loading of credit losses, and ignores the pricing of credit risk into the terms of the financial instruments to compensate for such losses, that in reality occur over time.

The main proposals in the Exposure Draft

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) Consistent with our response to Q1(a), while we are generally supportive of the proposed model, we highlight our concerns with the use of the 12-month expected credit loss criteria.

   While we understand that this approach links in the recognition of lifetime expected credit losses only when there is a significantly increase in credit risk since initial recognition, we note that the ED does not explain the principle for the use of the 12-month period in measuring credit losses in Stage 1. We discuss our preference to use the "IBNR" (incurred but not recognised) concept in Q4 to enhance the measurement of expected credit losses in Stage 1.

b) While the proposed models in the 2009 ED and 2010 SD (without the foreseeable floor) achieved better faithful representation of the underlying economics than the approach in this ED, the proposals in the previous models contained operational complexities and would have been more costly and challenging to implement. We agree this ED is a more practical approach than the previous proposals.

c) Consistent with our response to Q1(b) we do not agree that the recognition of lifetime losses from initial recognition as required by the FASB model. While this would be less costly to implement, we believe this will not achieve the appropriate balance in the faithful representation of the underlying economics. Recognition of lifetime credit losses from initial recognition ignores banking practice where initial expected credit losses are priced into the instrument. In addition, such credit losses at initial recognition do not occur immediately but are compensated by interest margins over time. We support the IASB model over the FASB proposal.

Scope

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) We agree with the proposed scope of the ED, with the exception of financial assets measured at fair value to other comprehensive income (FVOCI) as explained in Q3(b).

b) While we agree that having a single impairment model for expected credit losses improves comparability and reduces complexity, our preference is that financial assets measured at FVOCI be excluded from the general model in the ED.

Banks invariably hold investments in liquidity portfolios in order to comply with regulatory requirements and these investments are held for the purpose of selling rather than for the collection of cashflows from principle and interest. These assets comprise of high quality assets (e.g. government trading bonds). Many of these assets are presently classified as *Available for Sale* investments under IAS 39 and measured at fair value.

We support the inclusion of a practical expedient similar to that proposed in the FASB model which permits an entity to elect not to recognise expected credit losses on individual financial assets measured at FVOCI where the fair value of the individual financial asset is greater or equal to the amortised cost and the expected losses are insignificant. We expect financial assets that are short term and of high quality would meet the criteria. The inclusion of a practical expedient will reduce the operational burden on preparers of financial statements without reducing the quality of information provided for such assets, as these assets will be reflected at fair value in the statement of financial position.

12-month 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?

Measurement of an amount equal to 12-months expected credit losses is operational; however we do not believe this accurately reflects the credit risk for Stage 1 financial assets, nor the credit risk differential between long and short dated exposures.

We would recommend an IBNR approach to be allowed for Stage 1 exposures, albeit with a 12-month minimal expected credit loss. The IBNR approach, being similar to the current approach used under IAS 39, is performed by estimating (using historical data) product and regional level loss horizon periods to acknowledge that even though Stage 1 exposures have not yet displayed evidence of deterioration, that there will have been deterioration as a result of events that have occurred but not yet recognised in the Bank's credit risk data.

We believe that entities should be permitted to use measurement criteria reflective of how credit risk is managed and monitored. The IBNR approach currently used by banks to measure credit losses is also compliant with local regulatory requirements.

We also acknowledge that the IASB aims to achieve global consistency in provisioning levels, and therefore would require parameters that ensure banks in different regions do no use periods that are significant lower than 12 months and hence result in untimely measurement of expected credit losses. Alignment of the ED requirements with an entity's credit risk management practice could be achieved by way of the 12-month floor.

Assessing when an entity shall recognise lifetime expected credit losses

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 ED proposes that lifetime expected credit losses be recognised when there is a significant increase in credit risk since initial recognition. As the term "*significant increase in credit risk*" is not defined in the ED, entities are required to apply judgement and this should reflect the credit risk management practices relevant to their financial instruments. On this basis, we agree with the concept of recognising lifetime expected credit losses when credit risk significantly increases.

While we agree with the premise of using a change in credit risk as the trigger for recognition of lifetime expected credit losses (the Stage 2 criteria), we do not believe it is appropriate or operational to assess this change in credit risk at the account/facility level.

We recommend that the assessment of a significant increase in credit risk be based (for non-retail products) using the customer level. For non-retail lending we manage credit profiles at the customer level, and this is particularly relevant for cross collateralised facilities. Monitoring credit risk for Stage 2 triggers at the account/facility level is not only operationally difficult to implement but could result in a customer's facilities being split between each Stage, which does not align with credit risk management principles.

We request that the IASB develop further guidance in this area incorporating our recommendations which also reflects current risk management practice across banks and other lending organisations.

b) We find the examples in the ED are limited in illustrating the practical application of the proposed model as the fact patterns used are brief and do not reflect all relevant information that entities have access to and will use in assessing credit risk and impairment.

   The illustrative examples could be enhanced or replaced with practical examples, particularly using any insights gained from the results of the IASB outreach/fieldtest. The fact pattern in the examples could include:

   i) a customer with multiple loan facilities with varying draw downs.
   ii) how reasonable and supportable forecasts are used in measuring expected losses and how such losses are allocated to each Stage.

c) We agree that the assessment of when to recognise lifetime expected credit losses should consider changes in probability of default occurring rather than changes in expected credit losses or credit loss given default.

d) We do not agree that the application of the low credit risk simplification to investment grade financial assets provides a faithful representation of credit risk for these financial assets, particularly for large banks. In practice, investment grade financial assets could be considered by financial institutions as having low credit quality; an example would be if a AAA-rated financial asset deteriorates to a BBB credit rating.

   We recommend flexibility in applying the low credit risk simplification by either:

   - including a rebuttable assumption for investment grade assets; or
   - keeping the criteria "principles-based" and removing the strict rules on investment grade.

   We support the 30-day past due rebuttable presumption and expect to use days past due to assess credit risk, where appropriate. We note this simplification is more likely to benefit corporates that do not have sophisticated credit risk systems.

e) We agree with the proposal to allow transfers from a lifetime expected credit loss measurement to the 12-month expected loss, where the criteria for lifetime expected credit losses no longer applies.

   We have however expressed concerns over the use of a 12-month expected credit losses measurement (refer Q4), and have identified operational complexities in the tracking of credit risk in our response to Q5(a).

Interest revenue

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) We agree that there are circumstances when interest revenue calculated on a net carrying amount is appropriate and provides more useful information such as for purchased credit impaired financial assets. An entity makes an investment decision when it acquires credit-impaired financial assets with the expectation of achieving a credit-adjusted yield, and therefore interest revenue using the credit-adjusted effective yield represents the economic return on such financial assets.

   However, we do not believe this should be applied for financial assets that have objective evidence of impairment as explained in Q6(b).

b) We do not agree with interest revenue recognition on a net carrying amount basis (also referred to as the 'discount unwind') for financial assets that are in Stage 3. While this approach does not differ from current requirements of IAS 39, this does not provide useful information. In practice, banks manage impaired loans on a non-accrual basis and change the credit risk management focus from earning a yield to the recovery of contractual principle and interest accrued up to the time of impairment. In addition, regulators already use the concept of non-accrual accounting for impaired assets for regulatory reporting, which reflects that revenue should not be recognised unless it is deemed to be realisable.

   We also note that the FASB proposal uses a non-accruals principle which would require entities to stop accruing interest when it is not probable that they will collect substantially all of the principal and interest, which is based on rules established by US banking regulators.

   Most credit servicing systems currently face difficulties in including credit losses in the estimate of effective interest rate and there is an opportunity under IFRS 9 to revisit the requirements and align the accounting to credit risk management and regulatory reporting practices.

   We would support the use of the non-accruals approach to account for interest revenue for financial assets with objective evidence of impairment (i.e. in Stage 3), and would welcome a replacement of the proposal in the ED.

c) We agree with the proposal that the interest revenue approach shall be symmetrical. Where objective evidence no longer exists, interest revenue should be recognized in a consistent manner as for those assets that do not have objective evidence of impairment.

Disclosure

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) Adequate disclosures are required to provide transparency and comparability between financial reports in understanding the judgement used in implementing the proposed ED.

We believe that some of the proposed disclosures are onerous and excessive and question the usefulness of these disclosures to users of financial reports, and whether this is consistent with the IASB's initiative to improve and simplify disclosures to achieve an appropriate balance between the cost of implementation and the benefits of such requirements.

i) *Reconciliation of opening to closing balance of gross carrying amounts for each financial asset (ED paragraphs 35-36).*

We question the usefulness of the requirement to provide a reconciliation of gross carrying amounts for each class of financial asset as this is not reflective of how financial institutions manage amortised cost financial assets. Banks manage the performance and assess the asset quality of these financial assets on the basis of net interest income, bad and doubtful debts expense, arrears data and loan impairment coverage. The proposed requirement is therefore excessive, imposing additional cost to report information that is unlikely to be meaningful to users of financial reports.

It would be more appropriate to disclose the gross closing balances for each financial asset category at each reporting period, together with a reconciliation of movements in the respective loss allowance (or provision) balances.

ii) Gross carrying amounts by credit risk (ED paragraph 44)

We do not agree with the requirement to disclose the gross carrying amounts for each asset profile by credit risk rating which is further split between the 12-month and lifetime expected credit losses categories.

As each entity (across global regions) apply their own judgement on the lifetime expected loss triggers this data is subjective and therefore would not provide comparable information between entities preparing financial reports. This extensive information is also likely to be commercially sensitive.

We recommend removing this requirement as preparers of financial reports already provide sufficient credit risk information under IFRS 7, including past due and impairment information and concentration of risk for financial assets.

b) Our concerns on operational challenges are outlined in Q7(a) above.

We support the proposal to permit cross referencing to other information that is available to users of financial reports (for e.g. Risk and Capital Report) which will avoid duplication in preparing disclosures. While this would not create operational challenges, it may have implications for auditors and potentially impose additional audit costs.

c) We do not have examples of other disclosures that would provide useful information.

Application of the model to assets that have been modified but not derecognised

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?

We do not agree with all the proposals for the treatment of the modified financial assets and provide the following recommendations:

i) We believe these proposals should apply to modifications of credit-impaired financial assets rather than all modifications of financial assets.

ii) We note the ED lacks guidance in relation to the separate line item in the statement of profit or loss in which modification gains/losses should be presented. If the scope is limited to credit-impaired financial assets, the modification gain or loss should not be separately presented in the statement of profit or loss, but be included in the loss allowance expense. A modification loss arising from the deterioration in credit quality and should be presented as an increase in the loss allowance expense. Consequently a modification gain would reflect a recoupment of previously assessed expected losses and should be a decrease in the loss allowance expense.

Application of the model to loan commitments and financial guarantee contracts

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) We agree with the proposals on the application of the general model to loan commitments and financial guarantee contracts. This is not dissimilar to current practice.

b) We do not foresee any significant operational challenges in presenting expected credit losses on financial guarantee contracts or loan commitments as a provision in the statement of financial position.

Exceptions to the general model

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) We support the proposals under the simplified approach for trade receivables and lease receivables. The proposed simplifications will mainly be beneficial for small to medium-sized entities and is unlikely to have a major impact for large financial institutions.

b) Refer to our comments in 10(a).

Financial assets that are credit-impaired on initial recognition

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?

We agree with the proposals for financial assets that are credit-impaired on initial recognition.

Effective date and transition

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) The IASB has worked on the development of a standard to account for expected credit losses for financial instruments over several years and have issued draft proposals since 2009. We encourage the IASB to issue a final standard at its earliest, so that we can commence with implementing the requirements and preparing our financial reports reflecting the expected credit loss model.

   The *Classification & measurement* component of IFRS 9 (subject to the proposed limited amendments) is already available for entities to adopt. Adoption of the *Classification & measurement* and *Expected credit losses* components of IFRS 9 would be more cost effective and allow better allocation of resources if implemented concurrently.

Therefore, our preference is that the standard will permit early adoption, either commencing at the beginning of the financial period in which the standard is released, or immediately from the standard release date.

While we would prefer a standard that permits early adoption, we would support the deferral of the mandatory effective date for IFRS 9 beyond annual financial periods beginning on or after 1 January 2015, acknowledging that other entities may have varying levels of operational challenges to implement the proposed approach. The proposed approach will require substantial time and resources to develop and implement systems and process changes, governance processes and to gather relevant data. We note that a significant challenge for financial institutions is the lack of available initial credit risk data of existing portfolios, which impacts implementation lead time. As our credit systems already capture origination data, we are not faced with similar implementation issues as our peers.

We envisage a reduction in our expected implementation lead time, if the IASB finalises the standard incorporating our recommendations in relation to the measurement criteria and disclosure requirements, modifying the standard accordingly.

b) We agree with the proposed transition requirements to permit retrospective application only if this does not involve undue cost and effort, and without the use of hindsight. The approach is practical and provides a balance between providing useful information on the initial adoption of the proposals and the associated cost.

c) We welcome the relief from restatements and providing comparative information as this would be onerous to implement on initial adoption of the final standard.

Effects analysis

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

We largely agree with IASB's assessment of the effects of the proposals and have outlined our concerns in our earlier responses specific to the questions.

We support the IASB model over the FASB model, however we would like to see enhancements in the final standard based on the responses and recommendations outlined above, to achieve the appropriate balance of providing timely and useful information on expected credit losses, and the cost of implementation and ongoing operations.

5 July 2013

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

Dear Mr Hoogervorst,

Re: ED/2013/3 'Financial Instruments: Expected Credit Losses'

Australia and New Zealand Banking Group Limited (ANZ) is listed on the Australian Securities Exchange. Our operations are predominately based in Australia, New Zealand and the Asia Pacific region. Our most recent annual results reported profits before tax of US$5.9 billion and total assets of US$672 billion.

We acknowledge the significant progress the International Accounting Standards Board (IASB) has made in relation to the ongoing development of a final standard in relation to credit losses, specifically we welcome the Board's positive action in simplifying the proposed standard since the initial exposure draft (ED) and the subsequent supplementary document (SD). We further acknowledge the progress the Board made with the Financial Accounting Standards Board (FASB) in producing a converged standard up to the point the FASB decided to pursue their own option.

However, ANZ does not support the ED on expected credit losses in its current form due to the significant complexity created by the requirement to track credit quality of individual exposures (even across one obligor) throughout the life of a financial instrument. We have estimated the cost associated with the development and implementation of a system to track such information to be approximately USD50 million with a lead-time of 24-30 months to complete. Furthermore, the sole purpose of such a system would be to ensure compliance with the financial reporting requirements under IFRS and would not be used for credit risk management purposes.

We believe this and our other concerns raised in this letter can be addressed without fundamental changes to the proposed standard. Our recommendations not only significantly reduce the cost and timeframe of implementation but, in our view, will lead to better alignment of the standard with current credit risk management practices.

Tracking credit quality over loan life

The changes in credit quality of an individual financial instrument from inception and over its life is currently not recorded within credit systems, and the performance relative to origination quality is not seen as an important tool in the management of credit risk. Credit risk management is more focussed on the current credit risk rating of the obligor, rather than the current state compared to its origination credit rating.

To overcome these significant operational issues, we believe that the proposed standard should be amended to align the migration point between bucket 1 and buckets 2 and 3 to an entity's existing portfolio risk appetites and credit writing policies approved by the

entity's Key Management Personnel. Under this proposal, the threshold for migration to lifetime expected losses (i.e. the tipping point from measurement of expected losses from a 12 month to lifetime basis) would be where an obligor's current rating fell below the poorest rating that an entity would originate a new instrument to an entity with a similar credit characteristics based on internal standard risk tolerances.

Therefore, once an obligor's credit rating decreases below the origination cut-off point, the deterioration is considered 'significant' even though the relative level of decline to this point since inception will be different for different obligors. We believe entities internal credit origination thresholds represent an appropriate point at which to base the change in measurement period for expected credit losses. Sufficient rigour is applied to the determination of the levels and they form an important pillar of internal credit risk management policy. In addition, they are set at a granular level so as to enable application across loan classes (for example, limits are set for each relevant Basel asset class).

Such an approach would significantly reduce the operational complexity and judgemental interpretation of 'significant deterioration'.

Minimum 12 month expected loss

We agree with the IASB that the 12-month time horizon for the calculation of expected losses[1] lacks conceptual merit. To develop a conceptual basis for a time period, we believe the notion of an emergence period could be introduced. That is, the average time between the date when a loss event occurs (e.g. the obligor is retrenched) and the significant deterioration takes places. We believe the notion of an emergence period introduces a conceptual basis for the time period used to determine the measurement period used to determine the level of credit losses on instruments that have not experienced significant deterioration in credit quality.

Emergence periods vary across portfolios and can be determined with a degree of confidence by analysis of the defaults experienced on the underlying portfolio. Ranges of 12 to 24 months are common, and in extreme circumstances may extend to 30 months. For a practical expedient, we believe the IASB could propose that the emergence period is 12 months be a rebuttable presumption - rebuttable where an entity has sufficient data to support an alternative *longer* duration.

We believe the above would provide a conceptual basis for the duration used to calculate expected loss prior to a significant deterioration in credit rating without placing a significant burden on preparers in through the rebuttable presumption.

Application to debt instruments held at fair value through other comprehensive income

We strongly disagree with the proposed requirement to apply the general impairment model to debt instruments held at fair value through other comprehensive income (FVOCI). A debt instrument purchased at fair value already incorporates the markets view of credit risk inherent in that instrument. Therefore, the requirement for an entity to make a further adjustment for credit risk is counter intuitive and contrary to the fair value requirements of IFRS 13 Fair Value Measurement.

We believe the IASB could look to the practical expedients contained within the FASB model on expected credit losses to overcome these conceptual issues.

Convergence

[1] IASB Exposure Draft paragraph BC 61 "…The IASB acknowledges that this is an operational simplification, and that there is no conceptual justification for the 12-month time horizon."

Finally, we would ask the IASB to continue to work with the FASB in attempting to reach common ground in relation to the credit impairment model as divergence on this issue would create a significant impediment to the goal of developing a single set of high quality global financial reporting standards.

We stress that it would be counterproductive to require reconciliation between the IFRS and FASB models within IFRS financial statements if convergence were not achieved. Currently we perform reconciliations between IFRS and regulatory credit loss provision balances, and the introduction of a third reconciliation would only confuse users and place undue burden on preparers to calculate credit losses under different models.

We are supportive of the other proposals contained with the proposed standard and encourage the Board to consider our proposed simplifications which we believe will result in a high quality standard that achieves the Boards stated objectives in relation to this topic, and can be implemented at a reasonable cost and timeframe.

Should you have any queries on our comments, please do not hesitate to contact me at shane.buggle@anz.com.

Yours sincerely

Shane Buggle
Deputy Chief Financial Officer

Copy: Chairman, Australian Accounting Standards Board (AASB)

APPENDIX 1

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) We believe the proposed approach outlined in the ED does not reflect the economic link between the pricing of financial instruments and their credit quality at initial recognition. The pricing of financial instruments includes a risk premium that reflects the expectation of lifetime credit losses on that instrument. Economically, credit risk premiums incorporated in the yield compensate banks for the credit losses they expect to suffer over the life of financial assets. As such, the proposed approach does not reflect this economic relationship between pricing and credit quality and leads to a mismatch between the recognition of income and credit losses on the instrument. However, we acknowledge that this mismatch is necessary in order to simplify the credit-provisioning model to enable it to be practically implemented.

The ED explains how credit losses are calculated prior to and on significant increase in credit risk of financial assets. We acknowledge that the IASB recognises there is no conceptual basis why a loss allowance equal to 12-month expected losses is an appropriate duration for recording initial credit impairment for all financial assets that have not suffered a significant increase in credit risk. In our response to Question 4, we outline how a principal based approach could be adopted when establishing the time period adopted for the measurement of credit losses on financial assets that have not experienced a significant deterioration in credit quality.

In respect of the effects of changes in credit quality, we believe that the migration of a financial instrument from a 12 month expected loss to a lifetime expected loss following a significant deterioration in credit quality does adequately reflect the underlying performance of that instrument.

Although we do note there are theoretical shortcomings of the proposed standard, we do feel the current proposal (subject to our recommendations) does achieve a reasonable balance between the costs to implement versus the quality of information provided compared to alternative methods.

b) We agree that recognising a lifetime expected loss on initial recognition discounted using the original effective useful life does not faithfully represent the underlying economics of financial instruments. As outlined above, the compensation for credit risk is realised over the life of a financial instrument via the credit-adjusted yield and this proposal would require all the expected losses arising on that instrument to be realised upfront.

While we see such a model as simplistic in both its design and execution, it lacks any theoretical justification and is likely to have unintended consequences on the growth of new business and the issuance of long dated financial instruments.

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 in our response to Question 1 above, we agree the proposed approach (subject to our recommendation on tracking credit quality and the period over which expected losses are determined) achieves an appropriate balance between the faithful representation of the underlying economics and the cost of implementation.

b) We agree that the proposed approach 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. However, we note that some of the proposals in the SD could result in a better alignment of accounting for credit losses and risk management practices of reporting entities than the proposals in the ED. Specifically we feel that the proposals from the SD to align the migration from the 'good' to the 'bad' book to internal credit management practices is superior to the current proposals. We have further elaborated on this in our response to question 5.

c) No. As highlighted in our response to Question 1 above, although such approach may be operationally simplistic it will result in a significantly less faithful representation of the underlying economics of financial assets compared to the approach proposed in the ED.

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) We agree with the proposed scope of the ED.

b) We strongly disagree with the proposed requirement to apply the general impairment model to debt instruments held at fair value through other comprehensive income (FVOCI). A debt instrument purchased at fair value already incorporates the markets pricing of credit risk inherent in that instrument. Therefore, the requirement for an entity to make a further adjustment for credit risk is counter intuitive and contrary to the fair value principles established in IFRS 13 Fair Value Measurement.

We encourage the IASB to consider alternative impairment requirements for this category of financial assets that will be capable of addressing the issues discussed above.

We note that FASB's expected loss model partially addresses the issues raised above by allowing a practical expedient for financial assets at FVOCI when expected credit losses are insignificant. We believe the following approach would be operationally viable and would result in meaningful information about financial assets at FVOCI:

- no credit losses should be recognised on financial assets with fair values above the amortised cost; and
- when the fair values fall below the amortised cost and the expected credit losses are significant, an amount equal to expected credit losses should be reclassified from OCI and recognised as an impairment loss in profit or loss.

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?

Subject to our recommendations, we agree that the measurement of a provision equal to 12 month expected credit loss is operational. However, we do not believe the 12-month time horizon for the calculation of expected losses has conceptual merit. To develop a conceptual basis for a time period for the purposes of an initial expected loss calculation, we believe the notion of an emergence period could be introduced. The emergence period should reflect the time between the date when a loss event occurs (e.g. obligor is retrenched) and the significant deterioration takes places. We believe this introduces a conceptual basis for the period of time expected losses are calculated on for instruments that are not subject to significant deterioration since origination.

Emergence periods vary across portfolios and can be determined with a degree of confidence by analysis of the defaults experienced on the underlying portfolio. Ranges of 12 to 24 months are common, and in extreme circumstances may extend to 30 months. For a practical expedient, we believe the IASB could propose that the emergence period is 12 months be a rebuttable presumption - rebuttable where an entity has sufficient data to support an alternative *longer* duration.

We believe the above would provide a conceptual basis for the calculation without placing a significant burden on preparers in relation to data requirements.

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) No, we do not agree that the proposed requirements to recognise a loss allowance at an amount equal to the lifetime expected credit losses on the basis of a significant increase in credit risk **since initial recognition**. We have two primary areas of concern:

- The current proposal is not operationally implementable without a significant system cost and prolonged lead-time. We have estimated a cost of approximately USD50 million, and a lead time of 24-30 months to develop, build and implement a system for the primary purpose of compliance with the *current* version of the accounting standard; and

- Financial institutions do not manage credit risk based on migration of credit quality, but rather on the absolute level of credit quality at a point in time. Our current credit risk systems do not retain origination credit quality, as it is not considered critical to the management of credit risk as origination credit quality is just one set of point in time data (albeit an important one). Following origination, important information (updated financial and behavioural information) is available to assess the credit standing / rating of an obligor.

We believe the IASB could resolve the two most significant issues with the proposed standard by aligning the requirements in the ED with existing credit risk management practices. We believe that the proposed standard should be amended to align the migration point between bucket 1 and buckets 2 and 3 to an entity's existing portfolio risk appetites and credit writing policies approved by the entity's Key Management Personnel. Under this proposal the threshold for migration to lifetime expected losses would be the where an obligor current rating fall below the poorest rating an entity would originate with a similar borrowing based on internal standard risk tolerances (i.e. falling below the level at which we would continue to originate new instruments would be the tipping point from the measurement of expected losses from a 12 month to lifetime timeframe).

This eliminates the requirement to track the credit quality of an individual facility from origination and establishes an absolute level of credit quality that aligns with existing credit management practices thus reducing the requirement to make costly and complex system changes.

b) Please refer to our comment under a) above.

c) Yes, we agree that changes in probability of default (PD) should be considered when assessing when lifetime expected losses are recognised.

d) The operational improvements we have recommended at in response to part a) above would result in lifetime expected losses being recognised when the credit quality declines to a point below the regular origination credit quality for that asset type. In some instances, this approach may lead to assets rated above investment grade being subject to lifetime expected loss.

For consistent application of our recommended operational improvement, we do not believe the investment grade operational simplification is necessary, as it does not align with actual credit risk management practices.

e) We support the re-establishment of 12 month expected losses if the criteria for the recognition of lifetime expected credit losses are no longer met. However to remain consistent with our recommended operational improvement we would expect the re-establishment of a 12 month expected loss when the credit standing / rating of that obligor improves to the internal credit rating at which that asset would be originated.

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 that interest revenue calculated on either a gross or a net carrying amount of impaired loans provides useful information to users. Financial instruments subject to individual indicators of impairment are managed in a completely different manner to 'unimpaired assets' with actual cash collections being the key measurement criteria. Currently under IAS 39, the exercise of assigning interest income to impaired instruments is performed as a separate exercise from our core systems and is done purely for the purpose of compliance.

As a consequence, we believe the non-accrual approach as suggested by the FASB for credit-impaired assets is consistent with the management of credit impaired assets and improves the balance between a faithful representation of the underlying economics and the cost of implementation / ongoing costs.

b) Refer to comments under (a) above.

c) We agree that interest revenue approach should be symmetrical however we encourage IASB to take into account our specific comments under (a) above.

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) We are supportive of many of the proposed disclosure and we welcome the proposal in the ED to allow incorporating impairment disclosures by cross-reference from the financial statements to other information available to users (noting potential scope implications for entities' auditors). We believe this will help to avoid duplication of information, improve the quality of financial statements and other information available to users and reduce costs associated with their preparation.

However, we believe some of the disclosure requirements in the ED are generally not consistent with how financial institutions manage credit risk and hence will not provide useful information to the users of financial statements. In addition, some disclosure requirements are operationally difficult to implement and will contribute to a longer lead-time requirement to implement.

Following are our concerns in relation to specific disclosure requirements in the ED:
Reconciliation of the gross carrying amounts of financial assets (ED paragraphs 35-36)

- A cash flow based reconciliation including disclosure of reclassifications of financial assets from 12-month to lifetime expected losses measurement on the basis of their gross carrying amounts do not reflect how financial institutions manage performance of amortised cost financial assets. Specifically, performance of these assets is managed on the basis of net interest income, loan impairment expense, coverage and arrears data. Hence, we believe the proposed disclosures will not provide value and will be confusing to the users of financial statements.

- We believe, the IASB should revise the ED to require a disclosure of gross carrying amounts for each of the types of financial assets mentioned in paragraph 35 (a) – (d) at each reporting date but not a reconciliation between opening and closing balances of their gross carrying amounts.

Nominal amount of financial assets written off that are still subject to enforcement (ED paragraph 37)

- We do not agree with this disclosure as enforcement activities may continue after a write off and disclosure of nominal amounts and anticipated losses on identifiable facilities may mislead users as to potential recoveries and be prejudicial in the recovery process.

- We also note that this disclosure requirement contradicts IAS 37 guidance for contingent assets, which are not disclosed if the inflow of economic benefits is less than probable.

b) We expect the following specific operational challenges in relation to proposed disclosure requirement:

- Reconciliation of the gross carrying amounts of financial assets (ED paragraphs 35-36. Illustrative Example 12)

- Disclosures of reconciliation of the gross carrying amounts of financial assets will require financial institutions to keep track of all changes in gross carrying amounts. As mentioned above financial institutions manage performance of amortised cost financial assets on net interest income and loan impairment expense basis and do not normally keep track of all changes in gross carrying amounts for either financial reporting or management accounting purposes. We see little value in disclosing such information and believe the costs of preparation including the costs of implementation of changes to existing systems will outweigh the benefits of disclosing this information.

c) We do not believe there are any additional disclosures required. In addition, we believe that if convergence were not achieved by IASB and FASB, it would be counterproductive to require reconciliation between the IFRS and US GAAP models within IFRS financial statements. Currently we perform reconciliations between IFRS and regulatory credit loss provision balances, and the introduction of a third reconciliation would only confuse users and place undue burden on preparers to calculate credit losses under different models.

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?

We support the proposed treatment for modified financial assets and request that it is linked to guidance on derecognition of financial assets. However, we believe any difference between the gross carrying amount of modified financial assets and the present value of modified cash flows discounted at the original effective interest rate should be recognised within impairment losses in the income statement. Modifications follow a change in credit risk and therefore such presentation will result in useful information for users of financial statements.

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) Except as discussed below we agree with the proposal on the application of the general model to loan commitments and financial guarantee contracts.

   Financial institutions manage loan commitments as part of credit exposures together with outstanding loan balances on a total commitment basis. We believe impairment on all loan exposures including commitments should be measured on the same basis. Specifically, expected losses on undrawn portions of credit commitments should be reported as part of loan loss allowances and not presented in a separate line item in the statement of financial position as a liability. This will ensure alignment of information reported in the financial statements with credit risk management purposes.

   The ED (BC 129) proposes that loan commitments (or financial guarantee contracts) that can be withdrawn before credit is extended are excluded from impairment measurement on the basis that no present contractual obligations to extend credit exist for such loan commitments. Contractually many credit commitments can be withdrawn before credit is extended but financial institutions do not manage credit commitments on a contractual basis but on a behavioural experience basis. For example, lending commitments under credit card products can be contractually cancelled on a very short notice and so may not be provided for at all under the existing ED. However, such credit commitments are normally included as part of total commitments for credit risk and liquidity management as well as regulatory capital purposes. Hence, the impairment requirements should be modified to allow such credit commitments to be included in calculation of credit loss allowances.

b) As noted above financial institutions consider loan commitments and financial guarantees to be a part of overall credit exposures with PD and LGD factors applied to total exposures at default to calculate credit risk charges for regulatory reporting purposes. In addition, undrawn portions of loan commitments are normally not separated from the drawn portions for credit risk or management reporting purposes. Hence, the separation of amounts relating to the loan commitments portion of total credit exposures is operationally challenging and of limited value to users.

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) We support the proposed simplification approach.

b) Refer to comments under (a) above.

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?

We agree with the proposals in the ED for financial assets that are credit-impaired on initial recognition.

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. Therefore, 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) We are unable to implement the proposed ED in its current form without significant system build / modifications. As outlined above, to plan, develop, test and implement a new system to capture the information required by the proposed ED would take approximately 24-30 months to complete (based on system builds of similar complexity) at a cost of approximately USD50 million.

   Because of the above costs and timeframe involved, we would require a lead-time of 4 or 5 years to implement the proposed requirements. However, should the IASB chose to adopt the operational improvements as outlined in our letter, including removing the requirement to track credit quality of a loan over its life, we feel the implementation costs would reduce to approximately USD5million and the timeframe for implementation would reduce to 12-18 months.

b) We agree with the proposed retrospective application of the proposals in the ED.

c) We agree with the proposed relief from restating comparative information on transition.

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

We agree with IASB's assessment that BC 201 that implementation of the expected credit loss approach will require substantial system changes, time and resources even for financial institutions that are already calculating expected credit losses for regulatory purposes.

We broadly agree with IASB's assessment of the effects of the proposals, except in respect of Financial assets at FVOCI. As discussed under Question 3 (b) above the proposals in the ED in relation to impairment of financial assets at FVOCI will not result in useful information for user of financial statements. We disagree with IASB's assessment that the proposed approach will faithfully reflect the economic reality of expected credit losses that are associated with these financial assets.

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09 July 2013

Ernst & Young's global submission to the IASB on the Exposure Draft ED/2013/3 – Financial Instruments: Expected Credit Losses

Dear Mr Stevenson

Please find enclosed Ernst & Young's global submission to the IASB on the above Exposure Draft.

Yours sincerely

Ernst & Young

Encl:

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Submitted electronically through the IASB website (www.ifrs.org)

5 July 2013

Dear IASB members

Invitation to comment – Exposure Draft ED/2013/3 – *Financial Instruments: Expected Credit Losses*

Ernst & Young Global Limited, the central coordinating entity of the global EY organisation, welcomes the opportunity to offer its views on the above Exposure Draft (ED).

The IASB's proposals

We support the Board's efforts to introduce a new impairment model based on expected credit losses, that would help address the generally perceived weaknesses of the currently applied incurred loss model, by ensuring timely recognition of credit losses and providing more useful and relevant, forward-looking information.

We appreciated the conceptual merit of the 'expected cash flow approach' proposed in the original 2009 ED *Financial Instruments: Amortised Cost and Impairment* but believed that the cost of implementation and very considerable operational difficulties outweighed the benefits. Also, we were supportive of the converged approach proposed in the 2011 Supplementary Document (SD) *Financial Instruments: Impairment* for the impairment of financial instruments under IFRS and US GAAP but were concerned about the operational difficulties in defining 'foreseeable future' and determining when an asset should be moved from the 'good book' to the 'bad book' and vice versa.

We acknowledge that it is difficult to support, on conceptual grounds, the recognition of a loss allowance on the initial recognition of a financial instrument if it has not yet exhibited any credit deterioration; however, we believe that the current proposal offers a pragmatic solution, which provides a better balance between conceptual theory and operational practicability than the 2009 ED and the 2011 SD. Moreover, recognising lifetime expected credit losses only after there has been a significant increase in credit risk, does help reflect the economic linkage between pricing and credit quality at initial recognition. The three stage approach also provides useful information to differentiate financial instruments that have deteriorated in credit quality from those that have not.

More application, implementation and audit guidance will be needed

We believe that the new proposal is more operable than that set out in the 2009 ED and the 2011 SD. Nevertheless, if the Board decides to proceed with the expected credit loss model proposed in this ED,

preparers, including less sophisticated banks and non-financial entities such as leasing companies, will face major implementation challenges.

For instance, although the investment grade exception and the more than 30 days past due presumption may provide some operational relief, we believe that, without further guidance, what is meant by 'a significant increase in credit risk' will be a significant challenge to interpret. Similarly, there are no established industry practices or methods for adjusting historical loss experience to reflect forecast future events and economic conditions. Because the proposal will require the application of judgment, there will inevitably be differences in the estimates made by different preparers. However, these interpretation issues will result in considerable diversity of application that is best avoided by the issue of further guidance.

It is important that this guidance is coordinated by a single body, so as to avoid the emergence of local guidance and hence diversity of practice. We believe that the Board should lead this, but make use of an expert advisory panel involving regulators such as the Basel Committee. This guidance will need to be prepared relatively quickly, in parallel with the completion of the Standard, in order not to delay its implementation or to create additional burden on preparers in having to amend their implementation once the guidance is prepared. Moreover, auditors will face similar challenges and appropriate international audit guidance will need to be developed to support them before the Standard is implemented.

Areas of concerns and recommended clarifications on the IASB's proposals

We believe that the ED needs to be improved before it is finalised. We have highlighted a number of areas where we believe the ED should be reworded or where the Board should provide clarification of its intention, in order to ease the application of the proposed model and address some of the operational challenges. These include:

- The ED does not define the term 'default events'. In estimating 12-month expected credit losses, it is not clear whether 'default events' would include potential causes of future default or just defaults. In addition, how 'default events' is defined may result in significantly different amounts recognised in the 12-month expected credit loss allowance. Please see further comments made in our response to Question 4 in Appendix A.

- In assessing whether an allowance or provision for lifetime expected credit losses is required, it would be helpful to state in the application guidance, and illustrate in an example, that tracking of credit deterioration or improvement may not be necessary, if an entity is able to:

  (i) Segment its portfolio based on shared risk characteristics;

  (ii) Determine the initial credit quality of each segment; and

  (iii) Then set 'absolute' thresholds to determine when the recognition of lifetime expected credit losses would be appropriate.

  In addition, it would be useful to clarify that entities are not expected to rely on sophisticated quantitative comparisons of the probability of a default curves across the life of the financial instruments to make this assessment and that entities are able to rely on their current credit risk

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management processes. Please see further comments made in our response to Question 5 in Appendix A.

Convergence with US GAAP

We continue to believe that the impairment of financial instruments is an important area for convergence of IFRSs and US GAAP. The two accounting models should be sufficiently aligned (both in principle and in application) that it would be meaningful to compare the financial performance of entities reporting under the two different regimes. We appreciate that over the last few years, both the Boards have tried to develop a converged approach and we encourage them to continue to work to try to find a common solution. Nevertheless, we recognise that differing regulatory environments may make this impracticable and it is important that there should be no undue delay in finalising the Standard.

Expected implementation lead time

As the preparation of guidance, method and standard practice, along with the development of new systems and processes will take time, the Board will need to give constituents sufficient lead time to implement and apply the expected credit loss model. Also, we recommend that the Board conduct further outreach with preparers (including those in emerging economies) to seek to develop further simplifications and practical expedients to help preparers implement the proposals in the ED on transition, as well as on an ongoing basis.

Consequently, the mandatory effective date for the complete version of IFRS 9 *Financial Instruments*, including the limited amendments to classification and measurement, impairment and hedge accounting requirements, should be deferred at least to 2016, with early application permitted.

Appendices

We have attached the following appendices to this letter:

- In Appendix A, we respond to the specific questions in the invitation to comment.
- In Appendix B, we comment on additional matters that have not been asked about in the invitation to comment.
- In Appendix C, we include our editorial comments for the Board to consider in its drafting of the final Standard.

Should you wish to discuss the contents of this letter with us, please contact Tony Clifford on +44 20 7951 2250.

Yours faithfully

Ernst + Young Global Limited

Ernst & Young Global Limited

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Appendix A – Responses to the specific questions in the invitation to comment

Question 1: Objective of an expected credit loss impairment model

(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?

We are of the view that it is difficult to support, on conceptual grounds, the recognition of an allowance or provision on the initial recognition of a financial instrument if it has not yet exhibited any credit deterioration. In theory at least, credit risk is priced into the transaction on the origination or acquisition of a financial instrument and therefore the fair value of the financial instrument recorded on initial recognition should already incorporate the expected credit risk.

We also believe that an allowance or provision should, ideally, be built up over the life of a debt financial instrument as any credit spread is recognised, and that this should be adjusted if there is a significant change in credit loss expectations, such that the initial linkage between pricing and credit quality is broken.

In our response to the original 2009 ED, we agreed with the conceptual merit of the original 2009 ED, however, we were concerned with its operability. As a consequence, we accept that the recognition of an initial allowance or provision for financial instruments, increased to the lifetime expected credit losses (ECL) once there has been a significant deterioration in credit quality, provides a reasonably pragmatic way of building up an allowance or provision for credit losses.

Question 2: The main proposals in this Exposure Draft

(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) Consistent with our response to Question 1, we accept that the current proposal, to recognise 12-month ECL on initial recognition and lifetime ECL when there has been significant deterioration in credit quality, is a pragmatic solution.

We acknowledge that the Board's decision to require an allowance equivalent to a portion of the lifetime ECL over the next 12-month time horizon has no conceptual justification but is an operational simplification, as stated in paragraph BC61. In addition, we agree with the Board, as indicated in paragraph BC64, that the 12-month term may be easier to implement for some sophisticated financial institutions as they are already measuring 12-month ECL for prudential regulatory capital requirements calculated under Basel II, although adjustments would be required to comply with the proposals in the ED (e.g., financial institutions would need to use a point-in-time probability of a default (PD) for IFRS reporting rather than a through-the-cycle PD in accordance with the Basel II regulatory requirement. Please also note our comments in response to Question 4). Moreover, the 12-month period is probably the easiest term to communicate to users of financial statements, as it links to what is expected in the next annual reporting cycle.

However, there are interpretations and drafting issues in relation to the measurement of 12-month and lifetime ECL that we have raised in our responses to Questions 4 and 5.

(b) While we acknowledge that the current proposal has advantages and disadvantages compared to the previous ED and SD, on balance, we accept that the current proposal achieves a better balance between faithful representation and the costs of implementation. We did not regard the original 2009 ED as operable and we had significant concerns as to how to apply the concept of 'foreseeable future' in the 2011 SD.

We have also considered the alternative view presented in paragraphs AV1 to AV11, i.e., the 'gross up' method that aims to simplify and replicate the outcome of the original 2009 ED. We believe that this alternative method would still present operational challenges for entities to estimate lifetime ECL unless further operational simplifications or practical expedients can be provided.

(c) See our comments in response to Question 1.

Question 3: Scope

(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) We support the proposed scope of this ED, to apply the same expected credit loss model to financial assets, loan commitments and financial guarantee contracts that are not measured at fair value through profit or loss under IFRS 9, together with lease receivables under the IAS 17 *Leases* and current leases proposals. The scope reflects that credit risk is a common denominator of these instruments and those in the scope of the financial instruments standard.

However, we do have concerns as to the implementation and operational challenges that non-financial institutions will face when estimating ECL, even if there is a choice to opt for the simplified approach (please see further comments in response to Question 10 (a)).

(b) We do not have a strong view on whether the expected credit loss model should apply to financial assets that are mandatorily measured at fair value through other comprehensive income (FVOCI) as proposed in the Classification and Measurement ED.

- The current IFRS impairment model for available for sale debt financial assets has been heavily criticised and needs to be replaced (unlike under US GAAP where there are not the same concerns).

- It is sensible to apply the same model for assets measured at amortised cost and at FVOCI, consistent with the Board's objective to align the profit or loss treatment for both categories.

- However, the recognition of credit losses in OCI gives rise to information in OCI that will be difficult to explain (given the offsetting entries to profit or loss and OCI, both on initial recognition and for changes in the ECL) and is arguably unnecessary, if changes in credit risk are already reflected in fair values. The other possible treatment would be to accept a difference in the profit or loss recognition of debt financial assets recorded at fair value though OCI compared to those recorded at amortised cost. Under this approach there would be no recognition of a loss allowance on the initial recognition of a low credit risk (i.e., investment grade) debt financial asset recorded at FVOCI and to recognise lifetime ECL only when there has been significant deterioration in credit risk. (However, please see our comments in response to Question 5 in relation to assessing when an entity shall recognise lifetime ECL.)

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Question 4: 12-month expected credit losses

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?

Although there is no conceptual justification for an allowance based on 12-month ECL, it is a pragmatic solution as long as it can be applied consistently by different entities. We believe that the Board should provide further clarification and application guidance on the definition of 12-month ECL, in particular, the term 'default events'.

- Appendix A in the ED defines 12-month ECL as *'The expected credit losses that result from those default events on the financial instruments that are possible within the 12 months after the reporting date.'*
- Paragraph BC97 states that *'This Exposure Draft does not define default. Instead, entities can use different definitions of default including, where applicable, regulatory definitions of default In making this decision, the IASB observed that they did not expect that expected credit losses would change as a result of differences in the definition of default because of the counterbalancing interaction between the way an entity defines default and the credit losses that arise given that definition of default.'*

If the term 'default events' is not clearly defined and insufficient guidance is provided, there will be diversity in interpretation and application of the model. The reasons for our concerns are set out below.

First, the word 'events' makes it ambiguous and it is not clear whether the Board intended to introduce a wider category that includes potential *causes* of future defaults (e.g., an increase in unemployment rates that is expected to increase default rates) or just defaults. This concern arises because 'loss events' as used in IAS 39 *Financial Instruments: Recognition and Measurement* is a wider concept than just failure to pay, and includes other events that have an estimable effect on future cash flows. We are concerned that it is therefore unclear whether the notion of 'default events' is intended to align more closely with the indicators for moving financial instruments into the lifetime ECL measurement category (i.e., 'bucket 2'), or with objective evidence of impairment (i.e., 'bucket 3'). We assume that the Board did not intend 'default events' to be interpreted as widely as 'loss events' and that it was intended that 'default events' were meant to be consistent with the definitions of default as applied by banking regulators. However, we believe that the Board should clarify what is intended. We also note that for certain types of loans with unusual timing of cash flows (such as zero coupon bonds or interest free periods), the definition of default should be defined appropriately to reflect circumstances indicating that they will not be paid back in full, even if no cash flows are contractually due in the next 12 months.

Second, how 'default events' is interpreted can affect the measurement of 12-month ECL for loans where failure to pay is only considered a default event once the loan is past due by a significant period, such as 60, 90 or 180 days past due (DPD). This is especially likely to be the case if the entity uses delinquency as its primary method of determining whether there has been a significant increase in credit risk and does not rebut the 30 DPD presumption. While, as set out in BC 97, an earlier definition of default (say, 30 DPD rather than 90 DPD) would normally be associated with a lower loss given default (LGD) (given that a greater proportion of defaults will cure) and hence the effect of a higher expected number of defaults will be counterbalanced by their reduced severity, the effect of the interplay between the definition of default and the movement to lifetime ECL measurement category is not completely

eliminated by this offsetting effect. . This is because, applying the rebuttable presumption, instruments which have not yet experienced a significant deterioration must all be less than 30 DPD.

For example, assuming that the rebuttable presumption of more than 30 DPD is used as the criterion for moving loans from the 12-month to the lifetime measurement category, if for assets with similar risk characteristics, default is defined:

- Between 1 and 30 DPD, then a 12-month calculation will identify ECL that will arise in the next year.

- At 60 DPD, a default cannot arise until month 2 because no loans that are already 30 DPD will be present in the 12-month measurement category. Hence, the calculated ECL will be approximately 11/12 of that using a 30 DPD definition.

- At 180 DPD, a default cannot arise until month 6, hence the calculated ECL will be approximately 7/12 of that using a 30 DPD definition.

It should also be noted that, because there will be no loans in the 12-month measurement category that are yet 30 DPD, the 12-month ECL estimate required under this ED will differ from the Basel II 12-month ECL (unless the Basel II 12-month ECL are already calculated separately for different risk categories amongst performing loans).

This discussion points to the need for the Board to be more prescriptive as to what it intends to be provided for in the 12-month ECL allowance (either through a more specific definition of default or through a clearer rational behind the amount of ECL meant to be reflected in ‘bucket 1’).

Third, there is varied use of terms in the ED and it would be helpful if the Board clarifies the relative meanings of ‘expected credit losses’, ‘impairment’, ‘default’ and ‘objective evidence of impairment’, reducing the number of similar terms or aligning their definition unless they are ascribed different meanings.

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

(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) We support the Board's proposal to recognise a loss allowance or a provision equal to lifetime ECL when there has been significant increase in credit risk since initial recognition.

(b) Although the investment grade exception and the more than 30 DPD presumption may provide some operational relief, we believe that, without further guidance, what is meant by 'a significant increase in credit risk' will be a significant challenge to interpret and will lead to diversity in application.

It is important that this guidance is coordinated by a single body, so as to avoid the emergence of local guidance and hence diversity of practice. We believe that the Board should lead this, but make use of an expert advisory panel involving regulators such as the Basel Committee. This guidance will need to be prepared relatively quickly, in parallel with the completion of the Standard, in order not to delay its implementation or to create additional burden on preparers in having to amend their implementation once the guidance is prepared.

Nonetheless, we note below some recommendations for the drafting of the Standard which would help address some of the operational challenges.

First, it would help alleviate one of the major concerns in having to track credit deterioration, if the Board were to set out in the Application Guidance what is currently expressed only in the Basis for Conclusions (paragraph BC 202), that an entity would be permitted to set 'absolute' thresholds to determine when recognition of lifetime ECL would be appropriate, if the entity is able to segment its portfolios appropriately based on shared risk characteristics and if the entity is able to determine the initial credit quality of each segment. The absolute threshold would therefore differ depending on the initial credit quality. It would be helpful to accompany this clarification in the application guidance with an illustrative example.

- Paragraph BC 202 states that *'Participants in recent outreach activities noted that the cost of implementing the proposed expected credit loss approach would depend on how entities*

segment their portfolios. An entity may, for example, segment its portfolios by credit quality at origination and assess deterioration by comparing the credit quality at the reporting date with the initial credit quality for only that segment of the portfolio that did not have low credit risk. Thus, the costs of applying the deterioration criteria would vary depending on the diversity of initial credit quality and the sophistication of credit risk management systems.'

Second, it would be useful to clarify that entities are not expected to rely on sophisticated quantitative comparisons of the PD curves across the life of the financial instruments to assess significant increase in credit risk. We note that paragraphs 8, B14 and B15 as currently worded, could be interpreted as requiring that significant deterioration be only measured by comparing specific points in the PD curves throughout the life of the financial instrument, taking into account the age of the financial instrument. Such PD curves may not be available in certain banks or for certain portfolios and when available, they may not be stored throughout the life of the financial instrument. It would be useful to clarify that entities are able to rely on their current credit risk management processes and note that significant deterioration can be assessed qualitatively, without the need to track precise probabilities of default.

- Paragraph 8 states that *'... To make that assessment, an entity shall compare the probability of a default occurring over the remaining life of the financial instrument as at the reporting date with the probability of a default occurring on the financial instrument over its remaining life as at initial recognition...'*

- Paragraph B14 adds that *'Because of the relationship between the remaining life and the probability of a default occurring, the change in credit risk cannot be assessed simply by comparing the change in the absolute probability of a default occurring over time. For example, if the probability of a default occurring for a financial instrument with a remaining life of 10 years at initial recognition is identical to the probability of a default occurring on that financial instrument when its remaining life in a subsequent period is only 5 years, that may indicate an increase in credit risk...'*

- Paragraph B15 further states that *'The significance of a change in the credit risk depends on the probability of a default occurring at initial recognition...'*

Nevertheless, we recognise that these are valid observations and that they may be useful to clarify how PD measures should be interpreted to assess a significant deterioration.

Third, paragraph B11 of the ED would permit an entity to use the 12-month (rather than the lifetime) PD occurring to assess whether the loss allowance or provision should be based on lifetime ECL, if it does not result in a different outcome. It is unclear how an entity would be able to determine that the use of the 12-month PD would be appropriate without calculating the lifetime PD. Indeed, for all financial instruments for which PD depends on the term to maturity, the 12-month PD for a residual maturity of X years would need to be compared with the 12-month PD estimated at origination for the same residual term, Therefore, it is unclear how this 'proxy' will really ease implementation.

- Paragraph B11 states that *'An entity shall use the lifetime probability of a default occurring when deciding whether the credit risk has increased significantly since initial recognition. However, an entity may use the 12-month probability of a default occurring to determine whether credit risk has increased significantly since initial recognition if the information considered does not suggest that the outcome would differ.'*

Fourth, the ED requires an analysis of credit deterioration on an instrument by instrument basis. Although we are not challenging the need to link deterioration to pricing, we note that credit risk is

generally assessed at the level of the counterparty (and not at the level of a given product). In corporate lending, credit risk analysis is based on the financial analysis of the borrower and does not depend on the age of the products. If the counterparty is considered to have weakened significantly, then all outstanding loans will be considered to be of higher credit risk. In retail lending, when a delinquency is observed on a given product, it will generally result in the reclassification of all outstanding transactions as 'non-performing'. We believe that in most situations, analysis at the level of the counterparty will result in the same outcome as analysis on an instrument by instrument basis. The main exception to this would be if new loans have been recently extended at the market rate after there has been a deterioration in the borrower's credit risk. Some guidance stressing that an analysis at the level of the counterparty may be a good proxy if all outstanding loans have been originated at similar credit qualities, could be useful to alleviate the concern that the assessment of deterioration can only be implemented at the level of the individual instrument.

Fifth, we believe that embedding forward looking information is a key aspect of the new model that needs to be supported by sufficient guidance. Examples 7 and 8 as currently drafted do not seem entirely consistent and may raise some confusion.

- In Example 7, a mere anticipation of a significant increase in unemployment results in the movement of the entire credit card portfolio to the lifetime ECL measurement category (although the behavioural scoring process has not yet reflected the expected increases in default). This example raises the question of the expected link between the economic factors (e.g., unemployment) and the heightened credit risk. We believe such movement should only be triggered when the impact of such a relationship is reliably demonstrated by historical observations.

- In Example 8, economic conditions are said to have deteriorated significantly in all regions, unemployment levels have increased and the value of residential property has decreased causing the loan-to-value (LTV) ratios to increase, however, the impact of economic indicators vary:

  (i) In Region One, the bank considers that there has been a significant deterioration if there has been a significant decrease in the behavioural score or if the mortgages are more than 30 DPD. Therefore, the deterioration in economic conditions mentioned above does not move these loans into the lifetime ECL measurement category (except to the extent that the economic conditions are already reflected in the behavioural score or the DPD). This conclusion does not seem consistent with that reached in Example7.

  (ii) In contrast, in Region Three, the increase in interest rates (which probably also applies to the other regions) results in the movement of the entire portfolio to the lifetime ECL measurement category because "historically, an increase in interest rates has been a lead indicator of future defaults on mortgages in Region Three." It is not clear why this would not also be applicable for Region One, unless historically there has been no similar relationship between interest rates and future defaults.

We do not believe that a current or anticipated deterioration in economic conditions should automatically lead to significant movement of an entire portfolio into the lifetime expected credit losses measurement category. However, it is currently unclear how this effect can be avoided if the PDs are adjusted upwards (even in the form of an overlay), given the fact that a significant deterioration is measured through PDs. We could envisage an approach whereby:

- As long as the link between economic conditions and credit risk is only global (i.e., cannot be linked to specific sub-portfolios), it should only be reflected through a point-in-time adjustment or “stress factor” added to the ECL estimate; and

- Only when the heightened risk situation can be linked to expected defaults at the level of specific sub-portfolios, then the deteriorated economic conditions may result in movement to the lifetime ECL measurement category.

Sixth, the 30 days past due rebuttable presumption is a useful simplification for lenders who primarily use delinquency data to assess significant deterioration. However it would be helpful to amend the text to make it clear that the presumption is designed for entities who primarily use delinquency data and that it would not be necessary to rebut this presumption if the lender primarily uses other methods to assess the probability of default and hence whether the credit risk has significantly increased.

(c) We agree with the proposal that the assessment of when the recognition of lifetime ECL would be appropriate should be based on the PD occurring, rather than changes in credit loss given default.

(d) We support the proposed operational simplifications set out in the ED as they will ease the operational challenges for preparers and reduce diversity in the application of the proposals in the ED. However, we note that the investment grade exception would prohibit entities from recognising lifetime ECL if there has been significant credit risk deterioration (e.g., deterioration from AAA to BBB+), but the financial asset is still deemed to be of investment grade quality.

We recommend that the Board seek further feedback from users on whether they would prefer greater consistency and comparability across entities (as currently proposed in the ED) or closer alignment between an entity’s credit risk management and its provisioning process (i.e., the Board to consider making the investment grade simplifcation a rebuttable presumption).

(e) We agree with the proposal that the model should be symmetrical, so that entities are required to revert to 12-month ECL if the lifetime ECL criterion is no longer met. One of the application difficulties for the impairment of available-for-sale investments in equity instruments under IAS 39 is that entities are more reluctant to recognise an allowance if there is no subsequent way of releasing that amount when the quality of the asset improves.

Question 6: Interest revenue

(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 support the proposal for interest revenue to be calculated on a net rather than a gross carrying amount under certain circumstances, in particular for financial assets deemed to be 'non-performing' (i.e., 'bucket 3'), as this would more appropriately reflect the underlying economics and not result in overstatement of interest revenue in the financial statements.

(b) We are mixed in our views on whether the change in the calculation of interest revenue from the gross to the net carrying amount under the IFRS 9 impairment requirements should be based on objective evidence of impairment, a term that refers back to IAS 39 incurred loss events . Although the IAS 39 incurred loss events are well established, it may be better for entities, in particular financial institutions, to realign their systems to the current proposals, such as, when default events have occurred (this may, for instance, include payments that are not expected to be repaid in full or when payments are more than 90 DPD).

(c) We agree that the interest revenue approach should be symmetrical, i.e., to allow the calculation of the interest revenue to revert back to a calculation based on the gross carrying amount. This is also consistent with our support for the model to be symmetrical between the 12-month and lifetime measurement categories, as indicated under Question 5(e).

Question 7: Disclosure

(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) We support the Board's intention to enhance the transparency of an entity's credit risk and provisioning process, provide users with more useful and relevant information and improve comparability across entities through the proposed disclosure requirements. This is particularly important because of the level of judgment inherent in measuring ECL and the disclosures will help users understand the basis for the measurement of ECL and how the assessment of significant credit deterioration has been made.

However, we are concerned about the overall quantity of disclosures required in the financial statements and that this may overburden users with too much detail. We recommend that the Board seek further feedback from constituents on the proposals, assess whether the disclosures would be relevant and would provide decision-useful information for users commensurate with the costs for preparers.

(b) We expect that it may be operationally difficult for entities to provide some of the proposed disclosures. In particular, the movement between the 12-month and lifetime ECL allowance as required by the quantitative reconciliation disclosures in paragraph 35, would require entities to continuously track and retain historical information for financial assets in the various stages of credit deterioration.

Moreover, entities may have to develop unique and separate systems for all three stages of credit deterioration to meet these disclosure requirements, in addition to existing systems used for management reporting and solvency reporting.

(c) We believe that the disclosure requirement in paragraph 39(c) should be extended to require entities to explain how forecast assumptions translate into loss estimates. This is essential to help users understand how the inputs and assumptions are used in an entity's estimation technique when calculating the expected credit loss allowance. For example, entities using the same inputs and assumptions, such as unemployment rates and macroeconomic indicators, are likely to have different expected credit loss allowances depending on how these inputs and assumptions are used in their estimation technique. Therefore, additional disclosures to those in paragraph 39(b) would be helpful, such as the effect of using forward looking estimates compared to historical loss rates.

In addition, given that the proposed impairment model is meant to be anchored in risk management practices and data, we believe its understandability would be enhanced through disclosures explaining the main differences between the parameters used for risk management and capital requirements compared to those used for accounting purposes. This disclosure might only be a qualitative description.

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

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?

We agree with the proposed treatment of financial assets that have been modified but not derecognised, i.e., to recognise a modification gain or loss in profit or loss based on the gross carrying amount after modification and to assess credit risk deterioration or improvement based on a comparison between the modified and the original unmodified contractual terms.

However, we note that there is a transition issue related to trailing disclosures that are required under paragraphs 38(a) and 38(b), whereby an entity would need to track and disclose information related to modified financial assets that have improved and moved back to the 12-month expected credit losses measurement category or those that have deteriorated further and have defaulted again. An entity would not be able to comply with this disclosure requirement if information is not available on transition and we suggest that transition relief is provided for financial assets that have been modified prior to the date of initial application. Such an explicit transition relief is preferable to relying on the 'impracticable' notion in IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* because of the expected prevalence of this issue.

In addition, there is currently no specific guidance in IFRS 9 to determine when the renegotiation or modification of the contractual cash flows of a financial asset would result in a derecognition of that financial asset. In September 2012, the IFRS Interpretations Committee's decided that the old Greek Government Bonds that are exchanged should be derecognised, by analogising to the notion of a substantial change of the terms of a financial liability as per paragraph 40 of IAS 39 to a financial asset (or on the basis of the extinguishment of the contractual rights to the cash flows from the assets as per paragraph 17(a) of IAS 39). To ensure consistency in the assessment of whether a substantial change of

terms (i.e., modification) would result in the derecognition of a financial asset, we recommend that the Board provide further guidance in IFRS 9 to clarify this application.

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

(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) We support the proposal to apply the same impairment model to loan commitments and financial guarantee contracts as this will improve consistency in accounting for credit losses for financial assets with similar credit risk (e.g., loans when the commitments are drawn down).

(b) We expect financial institutions to face similar operational challenges in implementing the proposal for financial guarantee contracts and loan commitments, i.e., the operational challenges are similar whether the proposal is applied to loans or loan commitments. However, it should be easier for financial institutions to use the same impairment model for their loan commitments and financial guarantee contracts, as they would only need to create one system for all financial instruments that are in scope of the ED.

Question 10: Exceptions to the general model - *Simplified approach for trade receivables and lease receivables*

(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) We welcome the proposed simplified approach for trade receivables, as this is consistent with recording trade receivables (on which no interest is charged) at fair value on initial recognition and will help reduce the implementation and operational challenges of not having to track credit deterioration for many non-financial entities with less sophisticated systems.

However, we are concerned that the effect of applying the simplified approach for the large lease receivables that will be recorded under the new leases accounting model will give rise to similar concerns to those discussed in response to Question 1. It may be appropriate to allow the simplification to used for particular classes of leases, rather than applied on an 'all-or-none' basis. Also, non-financial entities, particularly leasing companies, will face greater challenges in estimating lifetime ECL on initial recognition and through the entire life of the receivables. This is inherently more judgmental and may be more difficult for non-financial entities which give extended credit, due

to limited availability of data and less sophisticated systems and processes. For such preparers, implementation of the new Standard will be a challenge and more guidance is likely to be needed.

(b) We agree with the proposed amendments for an entity to measure trade receivables that do not have a significant financing component in accordance with IFRS [X] *Revenue from Contracts with Customers* at their transaction price on initial recognition less lifetime ECL. This treatment will result in these 'short-term' trade receivables being measured at 'fair value' on initial recognition as the asset would be measured based on the invoice amount and the loss allowance would be measured based on lifetime ECL (assuming that the discounting effect is immaterial).

Question 11: Exceptions to the general model - *Financial assets that are credit-impaired on initial recognition*

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?

We support the proposed exception to the general model for financial assets that are credit-impaired on initial recognition. We share the Board's view that the proposed treatment more faithfully represents the underlying economics for these financial assets than the general model and that it will not create additional operational complexity for preparers as the scope and requirements for these financial assets have not changed from IAS 39.

Question 12: Effective date and transition

(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) Based on discussions with our clients and as noted by the Board in its effects analysis in the ED, it is expected that there will be substantial changes to current processes, systems and governance structure and time will be needed to gather the necessary data.

We believe that the Board will need to give sufficient time for guidance and industry standards to be developed and for preparers to implement the proposals in the ED. However, the guidance will need to be prepared relatively quickly, in parallel with the completion of the Standard, in order not to delay its implementation or to create additional burden on preparers in having to amend their implementation once the guidance is prepared.

Also, we recommend that the Board conduct further outreach with preparers (including those in emerging economies) to seek to develop further simplifications and practical expedients to make it possible for preparers to proceed with the proposed expected credit loss model.

Accordingly, we propose that the Board should defer the mandatory effective date of IFRS 9 to at least 2016 and to allow early application of the completed version of IFRS 9 that will include the limited amendments to classification and measurement, impairment and general hedge accounting requirements.

(b) Although the proposed transition requirements are helpful for preparers, in addition to our comments in response to Question 8 in relation to trailing disclosures for modifications, we are concerned that the transition requirements in paragraph C2(a) may result in significant diversity in application, as financial instruments that do not have low credit risk will automatically have an allowance measured at lifetime ECL if an entity considers that it is unable, without 'undue costs and effort', to determine their initial credit risk on initial recognition. Also, the transition requirements in paragraph 2(a) should, ideally not be necessary: consistent with our comments set out in (a) above, we recommend that the Board develop further simplifications and practical expedients that will help preparers implement the proposals in the ED on transition, as well as on an ongoing basis.

In addition, we believe that users would find it helpful if entities were required to:

- Disclose the gross carrying amount when they have applied paragraph C2(a) and explain the reasons why and how they have applied the transition relief of measuring the loss allowance based on the 12-month term if the credit risk is low at the date of initial application.
- Provide some narrative to accompany the transition requirement in paragraph C4 to provide a reconciliation of the ending impairment allowances under IAS 39 or the provisions under IAS 37 to the opening loss allowances or provisions under the current proposals, to assist users understand better the accounting impact on transition.

(c) Although it will result in non-comparable numbers in the financial statements in the year of adoption, we believe that the proposal not to restate comparative information on transition will provide significant operational relief for preparers, and allow an earlier mandatory implementation date.

Question 13: Effects analysis

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

We agree with the Board's analysis of the effects of this ED and support its plan to gather further feedback from constituents on the likely effect of the proposals in this ED in different jurisdictions as part of the Board's fieldwork and outreach activities (as indicated in paragraph BC168).

Appendix B – Additional matters that have not been asked about in the invitation to comment

Basis for an estimate of expected credit losses: best available information

Paragraph 17(b) states that '*In estimating expected credit losses, an entity shall incorporate the best available information. For the purpose of this [draft] IFRS, the best available information is that which is reasonably available, including information about past events, current conditions and reasonable and supportable forecasts of future events and economic conditions at the reporting date. Information is reasonably available if obtaining it does not involve undue cost or effort. Information that is available for financial reporting purposes is available without undue cost or effort.*'

Incorporating reasonable and supportable forecasts of future events and economic conditions

As the proposed expected credit loss model represents a significant change from the current incurred loss model, preparers, including non-financial entities such as leasing companies, will be faced with major new challenges, including, estimating 12-month and lifetime ECL.

The challenges in estimating 12-month and lifetime ECL fall into three categories:

(a) Determining historical loss experience when entities have insufficient data;

(b) Forecasting future events and economic conditions; and

(c) Adjusting historical loss experience to reflect forecast future events and economic conditions.

There are no established industry practices or methods to address the third of these challenges. Without further guidance, there will be diversity in application. It is important that this guidance is coordinated by a single body, so as to avoid the emergence of local guidance and hence diversity of practice. We believe that the Board should lead this, but make use of an expert advisory panel involving regulators such as the Basel Committee. Moreover, auditors will face similar challenges and appropriate international audit guidance will need to be developed to support them before the Standard is implemented.

It would be helpful for the Board to emphasise the importance of an entity's historical credit loss experience. For example, the application guidance could be expanded to incorporate wording similar to that used by the FASB in its response to its thirteenth *Frequently Asked Question* issued on 25 March 2013 in relation to *Proposed Accounting Standards Update, Financial Instruments—Credit Losses (Subtopic 825-15)*, to emphasise that:

- *'An entity's ability or inability to obtain or develop reasonable and supportable forecasts of future event and economic conditions would only affect the entity's analysis of whether (and how) the historical credit loss experience is adjusted for what is currently expected. This does not override the*

need to consider credit loss experience for similar assets of similar credit risk as the foundation of the estimate of expected credit losses.

- *An entity may use several different approaches for adjusting historical credit loss experience for current conditions and reasonable and supportable forecasts about the future, including:*

  (i) *Reverting to unadjusted historical averages for future periods beyond which an entity is able to make or obtain reasonable and supportable forecasts, or*

  (ii) *Assuming that economic conditions will remain stable for future periods beyond which an entity is able to make or obtain reasonable and supportable forecasts (that is, freezing the furthest reasonable and supportable forecast and utilising that forecast for the remaining future periods).'*

Undue cost or effort

Also, we are concerned that the ED is not clear on the effort that is expected to make use of data that already exists within the organisation when estimating ECL. Information may be held by the institution in risk or other systems that is not currently used for financial reporting. Is the 'undue cost and effort' guidance applicable (so that entity would assess if it would take undue cost and effort to use this information for financial reporting) or would the entity be considered to possess the data, so that the undue cost and effort guidance does not apply?

Appendix C – Editorial comments for the Board to consider in its drafting of the final Standard

Comment number	Paragraph reference in the draft	Comment	Suggested solution
1	Para 6	The description for the low credit risk operational simplification should be revised as the current wording 'is not imminent' suggests a later lifetime expected credit losses recognition threshold than was probably intended. Paragraph 6 states *that 'For the purposes of this [draft] IFRS the credit risk is low if a default is not imminent ...'*	Specifically, we propose that the reference to 'default is not imminent' be deleted.
2	Para 9	The last sentence could be better expressed. Also, the words 'causal link' may suggest that there is a causal relationship between a significant increase in the probability of a default occurring on a financial assets and financial assets on which payments are more than 30 days past due.	Rephrase to: *'For example, historical evidence may demonstrate~~s~~ that there is no ~~causal~~ link between a significant increase in the probability of a default occurring on financial assets and financial assets on which payments are more than 30 days past due, but it may ~~does~~ identify such a link for financial assets on which payments are more than 60 days past due.'*
3	Para 23	Presentation of interest revenue as a separate line item is inconsistent with IAS 1.82(a) and would require consequential amendment to IAS 1.	Re -consider the presentation of interest revenue as a separate line item or require consequential amendment to IAS 1. Also, consider whether there are any unintended consequences for non financial entities.
4	Para 35(d)	It is not clear whether the requirement to disclose 'the total amount of undiscounted expected	Clarify whether the disclosure is required for all assets on balance sheet or those that are acquired or

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		credit losses at initial recognition' is required for all assets on balance sheet or those that are acquired or originated during the reporting period.	originated during the reporting period.
5	Para B15	Although the example in paragraph B15 may not have been intended to imply that there has been a significant increase in risk, the choice of numbers may give that impression. Paragraph B15 states that *'For example, an absolute change of 2 per cent in the probability of a default occurring will be more significant for an asset with an initial probability of a default occurring of 5 per cent, than for an asset with an initial probability of a default occurring of 20 per cent.'* Although we suspect that it was not the Board's intention, we are concerned that this wording implies that a 2% increase in the probability of a default (PD) for an asset with an initial PD of 5% would be regarded as 'significant'. If we refer to the S&P's *Global Corporate Average Cumulative Default Rates By Rating Modifier (1981 – 2011)*, a 5 year term asset rated BB+ with an expected PD of 5% would require a 3.3% increase in PD before the asset is downgraded to BB (with a PD of 8.3%). Therefore, a 2% increase in PD would be less than a single credit rating notch downgrade. We had understood the Board to regard a 'significant' decline in credit quality to be a somewhat larger change, e.g. BBB to BB.	If our understanding is correct, we recommend that the Board to revise or remove the example. Amending it to a 5% change for an asset with an initial probability of a default occurring of 2% would help, as such a change would most likely be regarded as significant.

		Moreover, the requirement as per paragraph 44 to disclose the gross carrying amount by credit risk rating grades of at least three grades implies that a decline in a single internal grading would be equivalent to a decline in multiple notches in external ratings (since external ratings have many more grading levels).	
6	Para B19(c)	It is unclear why 'collateral type' is considered a risk characteristic when collateral would influence the loss given default and not the probability of default.	Collateral should feature as a risk characteristic for this purpose only as in B19(h).
7	Para BC74	The reference to 'undue cost or effort' is referred to as 'undue cost and effort'.	Replace with 'undue cost or effort'.
8	Para BC132	Reference to 'legal obligation' should be to 'contractual obligation'.	Replace with 'contractual obligation'.
9	Para IE59	The formula for interest revenue has a circular reference and does not work when there is a modification.	Revise the formula to: D = Gross: 5% x (A – C)
10	Example 10, Para IE63	It would be helpful if the example on FVOCI assets could illustrate how the ECL would be calculated when the FVOCI assets are not purchased at par and the 12-month ECL are expressed in terms of a percentage. For example, an entity purchases a bond at CU 900 with a par amount of CU 1000 and the 12-month ECL is estimated to be 2% based on the bond's credit rating. The ECL booked on initial recognition would presumably be CU 20 (i.e., CU 1000 x 2%) and not CU 900 x 2%.	Extend the fact pattern and assumptions in Example 10 to illustrate the articulation between the 12-month ECL and the par amount (compared to the fair value) when the FVOCI assets are bought at a discount.

Kevin Stevenson
Chairman
Australian Accounting Standards Board
PO Box 204
Collins Street West VIC 8007

via email: standard@aasb.gov.au

15 July 2013

Dear Kevin

Re: Exposure draft 237 *Financial Instruments: Expected Credit Losses*

I am enclosing a copy of PricewaterhouseCooopers' response to the International Accounting Standards Board's exposure draft ED/2013/3 *Financial Instruments: Expected Credit Losses.*

The letter reflects the views of the PricewaterhouseCoopers (PwC) network of firms and as such include our own comments on the matters raised in the request for comment. PwC refers to the network of member firms of PricewaterhouseCoopers International Limited, each of which is a separate and independent legal entity.

AASB specific matters for comment
We are not aware of any regulatory or other issues that could affect the implementation of either of the proposals for not-for-profit and public sector entities.

Subject to our concerns about specific matters as expressed in our submissions to the IASB, the proposals would result in financial statements that would be useful to users. Should the proposed amendments be approved by the IASB, we are not aware of anything that would indicate that the proposals are not in the best interests of the Australian economy.

I would welcome the opportunity to discuss our firm's views at your convenience. Please contact me on (02) 8266 4664 if you would like to discuss our comments further.

Yours sincerely,

Paul Brunner
Partner, PricewaterhouseCoopers

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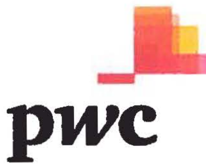

International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

3 July 2013

Dear Sir/Madam,

Exposure Draft – Financial Instruments: Expected Credit Losses

We are pleased to respond to the invitation by the IASB (the 'Board') to comment on behalf of PricewaterhouseCoopers on the Exposure Draft ('ED'), *Financial Instruments: Expected Credit Losses*. Following consultation with members of the PricewaterhouseCoopers network of firms, this response summarises the views of those member firms who commented on the exposure draft. 'PricewaterhouseCoopers' refers to the network of member firms of PricewaterhouseCoopers International Limited, each of which is a separate and independent legal entity.

We recognise the significant efforts made by both the IASB and FASB (the "boards") over the past several years to respond to the accounting concerns raised by constituents following the financial crisis. We understand the fundamental difficulties associated with establishing a credit impairment model that balances conceptual theory, operational feasibility and economic reality. Furthermore, we are cognizant of the difficulties associated with creating a model that responds to the needs of constituents that operate in a wide variety of economic and political environments.

Notwithstanding these difficulties, credit impairment is consistently identified by constituents as a critical element of the accounting framework and thus an area where a converged model is needed. Therefore, we continue to support the development of a single converged model for credit impairment under both IFRS and US GAAP and urge the boards to resume collaboration during the re-deliberation process to achieve this goal.

We believe an expected loss approach that requires constituents to consider a broader information set, including future expectations, represents a significant improvement as compared to the incurred loss model used today. Consistent with our comment letters on the original IASB exposure draft, *Financial Instruments: Amortised Cost and Impairment*, the FASB proposed accounting standards update, *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities*, the joint supplementary document, *Financial Instruments: Impairment*, and the FASB's proposed accounting standards update, *Financial Instruments – Credit losses*, we continue to support an expected loss approach to accounting for the credit impairment of financial assets.

Our responses to the Board's questions are included in Appendix 1 to this letter. The key comments that we would like to raise with the Board are summarised below.

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The FASB model

We acknowledge the difficulties associated with an expected loss model, both conceptual and operational. Previous proposed expected loss approaches that attempted to match the recognition of credit losses with interest income were cited by many constituents as being conceptually sound, but too operationally complex to apply in practice. As we noted in our comment letter submitted to the FASB on 31 May 2013 (please see the letter in Appendix 2) the FASB's proposed standard would eliminate some of this complexity by requiring the recognition of all expected losses upon origination or purchase of a financial asset and the use of the effective interest rate for interest income recognition.

While we acknowledge the operational benefits of the FASB's proposed standard, we believe that requiring full recognition of expected losses upon origination would not reflect the economics of lending transactions. Financial assets subject to credit risk that are originated or purchased at market terms will be initially reflected on the balance sheet, after considering the allowance, at an amount below fair value, both individually and in the context of a portfolio. This is inconsistent with the economics of market based transactions. We do not believe the mere presence of credit risk that was inherently included in the transaction price for a financial instrument should give rise to a day 1 loss.

We believe the requirement to recognise all "lifetime" expected losses through the income statement upon origination or purchase is overly punitive, particularly to entities that operate in environments with high levels of growth or acquisitions of portfolios. Based on the factors summarised above, we do not support the FASB's proposed credit impairment standard.

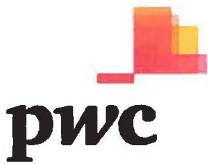
The Alternative Model

We considered an alternative model that would require the initial estimate of "lifetime" credit losses to be deferred and amortised over the expected life of the asset. Subsequently, any changes in this initial estimate would be recorded through the provision expense each period, and the unamortised portion of the initial estimated credit loss would be written off upon reclassification of the loan to 'credit impaired'. We believed that this alternative model represented a potential for compromise, as it required the balance sheet to reflect the full expectation of credit losses, but also provided some degree of matching between the initial amount of credit risk and the interest income that compensates the lender for such risk.

The alternative model is consistent with the guidance for purchased credit impaired (PCI) assets within the FASB's proposed standard, and is also consistent with the IASB member's dissent on the IASB's proposed credit impairment model. Despite the alternative model having a number of perceived benefits, our significant outreach efforts suggested minimal support for this model due to its perceived operational complexity, as well as concerns raised about the nature of the 'debit' that is initially recognised as an offset to the allowance for credit losses. As a result of this feedback, we do not recommend the alternative model.

The IASB Model

The IASB's proposed model establishes a threshold prior to recognising full lifetime expected credit losses. We believe the presence of a threshold, based on an increase in credit risk, represents a conceptual improvement as compared to the FASB's proposed standard and is a good platform upon which the boards can develop a converged approach.



While we do not believe the mere presence of credit risk that was inherently included in the transaction price for a financial instrument should give rise to a day 1 loss, we appreciate the need for a loss allowance for assets recorded in Stage 1. We note the operational challenges raised by constituents in respect of the more conceptual previous proposals which sought to recognise the initial expected credit losses in the income statement over the life of the financial instrument. In this context, we believe that in moving away from conceptual purity to meet practical considerations, any impairment measure developed should be easy to understand and relatively straight forward to determine. The 12-month expected loss meets both of these criteria. In addition, the 12-month expected loss can be reconciled to the Basel expected loss measure so entities can leverage their Basel systems when calculating these amounts. We therefore support the Board's attempt to develop a practical solution for this issue.

While we support establishing a threshold prior to recognising full lifetime expected credit losses in the IASB model, we believe that the model, as written, may not adequately capture the concept that, for certain assets, a significant increase in credit risk that has taken place from that which was included in the pricing of the loan, will not be identifiable at an individual asset level until some point in the future. We believe these assets meet the criteria for recognition in the lifetime expected credit loss component of the model, especially given that the exposure draft states entities should use forward-looking information in determining whether there has been a significant increase in credit risk. However, the model provides an exception to the recognition of lifetime expected credit losses for those assets that have low credit risk, such as those with a credit rating equivalent to investment grade. The guidance also implies that assets that are less than 30 days past due may be exempt from the lifetime expected credit losses component of the model. Whilst we appreciate the benefit of having practical expedients, they appear to result in credit losses on these assets that are not identifiable at an individual asset level being excluded from the lifetime expected credit loss component of the model. We believe that further clarification should be made to ensure that credit losses on assets that have met the significant deterioration threshold, albeit not on an individually identifiable basis, are fully captured by the model.

As the IASB was finalising the proposed model, the terminology related to the credit deterioration threshold was changed from 'more than insignificant' to 'significant'. In practice, some constituents view the term 'significant' as conveying a higher threshold than the term 'more than insignificant' and therefore concluded that the Board changed the recognition criterion. Other constituents do not see a difference in those terms and concluded that the recognition criteria were unchanged. Regardless of which terminology is used, this highlights a potential lack of understanding as to the degree of deterioration that is necessary to trigger a move to the full lifetime expected credit loss category. We recommend the IASB clarify within the proposed standard or supplemental implementation guidance its intent regarding the threshold. That clarification would help to limit diverse interpretations of what constitutes a change in credit risk that requires the recognition of all expected losses.

Conclusion

We believe the model described in the IASB's Exposure Draft, together with our suggested modifications as set out above and in Appendix 1 to this letter, would achieve an appropriate balance between the faithful representation of the underlying economics and the cost of implementation. We also believe that these enhancements result in a credit impairment model that successfully achieves the principles established by the G20 subsequent to the financial crisis, primarily the need to establish

a model that is based on expected losses, allows entities to look forward into future periods and results in more timely recognition of credit losses.

If you have any questions, please contact John Hitchins, PwC Global Chief Accountant (+44 207 804 2497) or Gail Tucker (+44 117 923 4230).

Yours faithfully

PricewaterhouseCoopers

Appendix 1

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)

We believe an expected loss approach that requires constituents to consider a broader information set, including future expectations, represents a significant improvement as compared to the incurred loss model used today. Consistent with our comment letters on the original IASB exposure draft, *Financial Instruments: Amortised Cost and Impairment*, the FASB proposed accounting standards update, *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities*, the joint supplementary document, *Financial Instruments: Impairment*, and the FASB's proposed accounting standards update, *Financial Instruments – Credit losses*, we continue to support an expected loss approach to accounting for the credit impairment of financial assets.

We believe an impairment model should: (i) measure credit losses consistent with current expectations regarding collectability, and (ii) recognise the initial expected losses over the life of the instrument in a manner consistent with its pricing. We believe this better reflects the economics of lending transactions than recognising a portion of expected losses or full lifetime expected credit losses at initial recognition. For this reason we do not think that an approach that recognises a loss allowance (or a provision) at initial recognition at an amount equal to a portion of expected credit losses or full lifetime expected credit losses will reflect the economic link between the pricing of financial instruments and the credit quality. Financial assets originated or purchased at market terms will be initially reflected on the balance sheet at an amount below fair value, both individually and in the context of a portfolio, which is inconsistent with the economics of market based transactions.

However, we appreciate the need for a loss allowance for assets recorded in Stage 1 and we note the operational challenges raised by constituents in respect of the more conceptual previous proposals which sought to recognise the initial expected credit losses in the income statement over the life of the financial instrument. In this context, we believe that in moving away from conceptual purity to meet practical considerations, any impairment measure developed should be easy to understand and relatively straight forward to determine. The 12 month expected loss meets both of these criteria. In addition, the 12-month expected loss can be reconciled to the Basel expected loss measure so entities can leverage their Basel systems when calculating these amounts. We therefore support the Board's attempt to develop a practical solution for this issue.

We agree that recognising a loss allowance (or provision) at an amount equal to lifetime expected credit losses after significant deterioration in credit quality will reflect the effects of changes in the credit quality subsequent to initial recognition.

We also acknowledge that recognition of a portion of full lifetime expected credit loss allowance upon initial recognition and full lifetime expected credit loss allowance after a significant increase in credit risk addresses some of the criticisms of 'too little, too late' that arose during the financial crisis. However, as noted in our cover letter, we believe that further clarification should be made to ensure that credit losses on assets that have met the significant deterioration threshold, albeit not on an individually identifiable basis, are fully captured by the model.

(b)

We agree that recognising a loss allowance (or provision) in the profit or loss account 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. We believe the requirement to recognize all "lifetime" expected losses through the income statement upon origination or purchase is overly punitive, particularly to entities that operate in environments with high levels of growth or acquisitions of portfolios.

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?

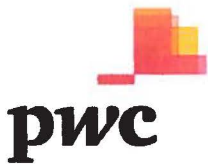
(b) Do you agree that the approach for accounting for expected credit losses proposed in this Exposure Draft achieves a better balance between the faithful representation of the underlying economics and the cost of implementation than the approaches in the 2009 ED and the SD (without the foreseeable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

As noted above, we 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.

Consistent with our comment letters on the original IASB exposure draft, *Financial Instruments: Amortised Cost and Impairment*, the FASB proposed accounting standards update, *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities*, the joint supplementary document, *Financial Instruments: Impairment*, and the FASB's



proposed accounting standards update, *Financial Instruments – Credit losses,* we continue to support an expected loss approach to accounting for the credit impairment of financial assets. An expected loss model would address the regulatory concerns around the recognition of incurred losses and some of the criticisms of 'too little, too late'.

We acknowledge the difficulties associated with an expected loss model, both conceptual and operational. Previous proposed expected loss approaches that attempted to match the recognition of credit losses with interest income were cited by many constituents as being conceptually sound, but too operationally complex to apply in practice. As noted in our response to question 1 for this reason, we agree that the current proposal achieves an appropriate balance between the faithful representation of the underlying economics and the cost of implementation subject to the changes suggested in the paragraphs below.

While we support establishing a threshold prior to recognising full lifetime expected credit losses in the IASB model, we believe that the model, as written, may not adequately capture the concept that, for certain assets, a significant increase in credit risk that has taken place from that which was included in the pricing of the loan will not be identifiable at an individual asset level until some point in the future. We believe these assets meet the criteria for recognition in the lifetime expected credit loss component of the model, especially given that the exposure draft states entities should use forward-looking information in determining whether there has been a significant increase in credit risk. However, the model provides an exception to the recognition of lifetime expected credit losses for those assets that have low credit risk, such as those with a credit rating equivalent to investment grade. The guidance also implies that assets that are less than 30 days past due may be exempt from the lifetime expected credit losses component of the model. Whilst we appreciate the benefit of having practical expedients, they appear to result in some credit losses that are not identifiable at an individual asset level being excluded from the lifetime expected credit loss component of the model. We believe that further clarification should be made to ensure that credit losses on assets that have met the significant deterioration threshold, albeit not on an individually identifiable basis, are fully captured by the model.

Whilst we understand the IASB's rationale for allowing entities to have a choice of discount rate when determining the impairment loss, we believe that such a wide choice (e.g. historic versus current and from risk free rate to EIR) will undermine comparability. We believe it would be preferable to calculate the impairment loss by using the EIR as the discount rate. This has the benefit of using the same discount rate for interest revenue and impairment and would avoid the need for a catch up adjustment when assets become credit impaired.

(c)

We do not think that recognising a loss allowance (or provision) in the profit or loss account at an amount equal to the lifetime expected credit losses from initial recognition, discounted using the original effective interest rate, would achieve a better balance between the faithful representation of the underlying economics and the cost of implementation as it does not accurately reflect the economics of lending transactions and is overly punitive particularly to entities that operate in environments with high levels of growth or acquisitions of portfolios.

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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)

We agree with the proposed scope of the Exposure Draft. We support a single credit impairment model for portfolios of financial assets carried at amortised cost, financial guarantees in the scope of the financial instruments standard and loan commitments that are not accounted for at fair value through profit or loss (whether within the scope of IAS 39 and IFRS 9 or IAS 37). Many of these commitments will eventually become loans carried at amortised cost and financial institutions generally consider loans, loan commitments and financial guarantees together when making their credit assessments. Our outreach efforts suggested strong support for the application of the same impairment model for loans, loan commitments and financial guarantees as this is consistent with how financial institutions manage credit risk across their various portfolios. Hence we believe that the application of the same credit impairment model to loans, loan commitments and financial guarantees would be appropriate.

(b)

We agree that financial assets mandatorily measured at FVOCI in accordance with the Classification and Measurement ED should be included in the scope of the Exposure Draft. Consistent with our comment letter on the Exposure Draft *Classification and measurement: Limited amendments to IFRS 9* for financial assets that meet the criteria for FVOCI, we agree to having a profit or loss profile that is the same as financial assets measured at amortised cost with all other changes recognised in other comprehensive income. In most cases this provides users with relevant information that is consistent with the business model for those financial assets (since holding to collect and to sell includes both amortised cost and fair value information), although we recognise that when an entity plans to sell fair value information may be of greater importance.

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?

Based on our outreach, we believe that measuring the loss allowance (or a provision) at an amount equal to 12-month expected credit losses will be operational. However, we encourage the IASB to discuss with preparers whether they foresee any operational difficulties with the 12-month expected credit loss measurement.

As this model seeks to sacrifice some conceptual purity for operational considerations, it is very important that the measurement basis is well understood and relatively straight forward to implement. We believe 12 month expected losses meets both of these criteria. In addition, 12-month expected loss

can be reconciled to the Basel expected loss measure so entities can leverage their Basel systems when calculating these amounts.

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)

We 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 from that which was included in the pricing of the loan upon initial recognition. We believe that this is an appropriate threshold which is consistent with current expectations regarding collectability.

(b)

Please refer to our answer to question 2(b) above. We believe that further clarification should be made to ensure that credit losses on assets that have met the significant deterioration threshold, albeit not on an individually identifiable basis, are fully captured in the lifetime expected credit losses component of the model.

As the IASB was finalising the proposed model, the terminology related to the credit deterioration threshold was changed from 'more than insignificant' to 'significant'. In practice, some constituents view the term 'significant' as conveying a higher threshold than the term 'more than insignificant' and therefore concluded that the Board changed the recognition criterion. Other constituents do not see a difference in those terms, and concluded that the recognition criteria were unchanged. Regardless of which terminology is used, this highlights a potential lack of understanding as to the degree of deterioration that is necessary to trigger a move to the full lifetime expected credit loss category. We

recommend the IASB clarify within the proposed standard or supplemental implementation guidance its intent regarding the threshold. That clarification would help to limit diverse interpretations of what constitutes a change in credit risk that requires the recognition of all expected losses.

Our outreach noted that a trigger based upon a significant increase in credit risk may present operational challenges for some preparers since credit risk is managed based on the current credit risk of an instrument, as opposed to the original credit risk of the instrument. While we support the proposed model, we encourage the IASB to discuss with preparers the extent to which they foresee any operational challenges in implementing the proposals.

In addition, during our outreach, a large number of constituents raised concerns about the lack of a definition of default in the standard. These constituents note that at present there are different definitions of default applied by regulators, applied by entities and even, sometimes, applied by different parts of the same entity and that different definitions could give rise to a different recognition or measurement of expected losses. We believe that clarifying its definition in the standard or alternatively the Board's understanding of 'default' in the basis for conclusion would reduce potential diversity in practice.

(c)

We agree that the assessment of when to recognise lifetime expected credit losses should consider only changes in the probability of a default occurring. We think that the change in the probability of a default properly reflects the change in credit risk as opposed to the changes in the amount of loss given default that reflects the changes in the absolute amount of expected credit loss.

(d)

Please refer to our answer to question 2(a-b) above.

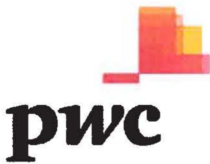
(e)

We agree with the proposal to 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 (assets can move back to Stage 1). We believe it is essential that the model be symmetrical to properly address all significant movements in credit risk.

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-c)

We note that there are circumstances when calculating interest revenue on the basis of a gross carrying amount would overstate the overall economic return on a financial asset. Therefore, we support the change in the calculation of interest revenue when there is objective evidence of impairment, since we think that the risk of overstatement increases significantly at this point. We also agree that the interest revenue approach should be symmetrical (interest calculation can be switched back to gross basis if the assets are no longer credit impaired) as it is very important from an operational perspective to have only one approach to the calculation of interest for each individual stage of the model.

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-c)

We agree with the disclosure objective in the Exposure Draft, and in particular the proposed disclosures of the amounts that arise from expected credit losses and the effect of deterioration and improvement in credit risk of financial instruments. However, we believe that the required disclosures taken as a whole will be onerous for many preparers and may cause operational difficulties. In particular, we consider the disclosure for modified assets and collateral to be too detailed and that the disclosure of the reconciliation from the opening to the closing of the gross carrying amount (required by paragraphs 35 and 36) puts significant burden on the preparers and has limited benefit for the users as it does not reflect how entities manage credit risk. We would suggest that this latter disclosure should be replaced by requiring the disclosure of the opening and the closing balance for each of the categories listed in paragraphs 35 (a)-(d) and in paragraph 36 with narrative description of the reasons for changes within the year.

Consistent with our comment letter on the original IASB exposure draft, we encourage the IASB to apply a "through the eyes of management" approach to disclosure. This should help users to understand how management determines the credit quality of their financial assets, how they track this quality over time (i.e. credit migration), how they determine their credit losses and how they assess the accuracy of their estimation process.

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?

We agree with the proposed treatment of financial assets on which contractual cash flows are modified. However, we believe that the Board should undertake a separate project to provide guidance on when a modification results in derecognition of the financial asset and when the asset should continue to be recognised. One of the issues encountered with during the sovereign debt crisis was determining when a troubled debt restructuring was so significant that it constituted an extinguishment.

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-b)

As noted in our response to question 3 we agree with the application of the general model to loan commitments and financial guarantee contracts and we do not foresee any significant operational challenges as most entities manage credit risk for these contracts in the same way as they manage credit risk for financial assets.

However, certain entities currently assess impairment for credit risk management purposes based on the behavioural expectations of the entity. We agree that a provision should not be necessary for contractually revocable, on demand, loan commitments from a conceptual stand point as entities should, in theory, be able to contractually avoid a cash outflow. However, we note that in practice entities have incurred losses on contractually revocable commitments as they may not be able, from a practical perspective, to review all such contracts prior to funding the commitment. Therefore, we support allowing entities to continue to provide for these commitments on a behavioural basis.

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-b)

We agree with the simplified approach for trade receivables and lease receivables since it provides operational relief by removing the requirement to track credit quality. Given their short-term nature, we expect that the loss allowance determined under the simplified approach should generally equate to the loss allowance determined under the general model.

We also agree with allowing an accounting policy choice for trade receivables with significant financing component and for lease receivables as this will allow entities to decide which model they wish to adopt from a cost/benefit perspective.

We also support the proposed amendment on initial recognition of trade receivables with no significant financing component.

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?

We agree with the proposal for financial assets that are credit impaired on initial recognition. We believe recognising interest revenue based on the credit-adjusted effective interest rate more faithfully represents the underlying economics for these assets.

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?

pwc

(a)

We recommend that sufficient time be given for companies to address the complexities of the new model and ensure the necessary processes and internal controls are in place. We also acknowledge that the new model might have regulatory capital implications that some financial institutions may also need time to address. As such, we encourage the IASB to seek feedback from preparers (in particular financial institutions) on what they believe is the appropriate time needed to implement the proposals. This feedback should be obtained from both large and small entities across the various industries and territories affected, as the lead times necessary to implement the proposals may be different depending on the size of the entity, its industry and market. It is important that all entities have enough time to properly implement the proposals.

(b)

A number of financial institutions issue loans at sub investment grade and for a large number of these it will be very difficult on transition to the new standard to obtain the probability of a default at initial recognition for existing portfolios without undue cost or effort. We believe that the requirement to recognise full life time expected losses for all of these assets (i.e. assets which do not have a low credit risk at transition) is overly punitive as certain of these assets will not have experienced a significant increase in credit risk, but entities will not have the probability of a default at initial recognition to prove this fact. We would urge the Board to develop an additional practical expedient for these assets on transition. We recognise the difficulties in developing such a practical expedient but would suggest the Board conduct additional outreach for the purpose of developing such an expedient.

(c)

We agree with the proposed relief from restating comparative information on transition as it would be difficult to do so without the use of hindsight. This also helps to meet the objective of setting the mandatory effective date for IFRS 9 as early as possible.

Question 13:

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

With the exceptions of the matters above we agree with the IASB's assessment of the effects of the proposal.

However, in addition to our previous comments, we do not agree with the last sentence of paragraph BC215 on the comparison of the FASB and IASB model. Under the IASB model the loss allowance on assets with low credit risk would be recognised at 12-month expected credit loss whereas under the FASB model it would be recognised at full lifetime expected credit loss (when measured at amortised cost) or at most likely at nil (when measured at FV-OCI and meeting the practical expedient). Given that the impairment losses are calculated at different amounts under both proposals, we do not agree with the statement that there would not be a significant difference in the loss allowance on financial assets with low credit risk under both proposals.

Appendix 2

Comment letter on the FASB's Proposed Accounting Standards Update, *Financial Instruments - Credit Losses (Subtopic 825-15)* submitted to the FASB on 31 May 2013.

May 31, 2013

Ms. Susan Cosper
Technical Director
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

PricewaterhouseCoopers LLP appreciates the opportunity to comment on the FASB's Proposed Accounting Standards Update, *Financial Instruments - Credit Losses (Subtopic 825-15)* (the "proposed standard").

We recognize the significant efforts made by both the FASB and IASB (the "boards") over the past several years to respond to the accounting concerns raised by constituents following the financial crisis. We understand the fundamental difficulties associated with establishing a credit impairment model that balances conceptual theory, operational feasibility, and economic reality. Furthermore, we are cognizant of the difficulties associated with creating a model that responds to the needs of constituents that operate in a wide variety of economic and political environments.

Notwithstanding these difficulties, credit impairment is consistently identified by constituents as a critical element of the accounting framework and thus an area where a converged model is needed. Therefore, we continue to support the development of a single converged model for credit impairment under both IFRS and US GAAP and urge the boards to resume collaboration during the re-deliberation process to achieve this goal.

We believe an expected loss approach that requires consideration of a broader information set, including future expectations, represents a significant improvement as compared to today's incurred loss model. Consistent with our comment letters on the original IASB exposure draft, *Financial Instruments: Amortised Cost and Impairment*, the FASB proposed accounting standards update, *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities,* and the joint supplementary document, *Financial Instruments: Impairment*, we continue to support an expected loss approach to accounting for the credit impairment of financial assets. We do not, however, support the proposed standard.

The proposed standard

We acknowledge the difficulties associated with an expected loss model, both conceptual and operational. Previous proposed expected loss approaches that attempted to match the recognition of credit losses with interest income were cited by many as being conceptually sound, but too operationally complex to apply in practice. The proposed standard would eliminate some of this complexity by requiring the recognition of all expected losses upon origination or purchase of a financial asset and the use of the effective interest rate for interest income recognition.

While we acknowledge the operational benefits of the approach set out in the proposed standard, we believe that requiring full recognition of expected losses upon origination would not reflect the economics of lending transactions. Financial assets subject to credit risk that are originated or purchased at market terms will be initially reflected on the balance sheet, after considering the allowance, at an amount below fair value, both individually and in the context of a portfolio. This is inconsistent with the economics of market based transactions. We do not believe the mere presence of credit risk that was inherently included in the transaction price for a financial instrument should give rise to a day 1 loss.

We also believe the requirement to recognize all "lifetime" expected losses through the income statement upon origination or purchase is overly punitive, particularly to entities that operate in environments with high levels of growth or acquisitions of portfolios. For these reasons, we do not support the proposed standard.

The alternative model

We considered an alternative model under which the initial estimate of "lifetime" credit losses would be deferred and amortized over the expected life of the asset. Subsequently, any changes in this initial estimate would be recorded through the provision expense each period, and the unamortized portion of the initial estimated credit loss would be written off upon reclassification of the loan to non-accrual status. We believed that this alternative model represented a good potential for compromise, as it required the balance sheet to reflect the full expectation of credit losses, but also provided some degree of matching between the initial amount of credit risk and the interest income that compensates the lender for such risk.

The alternative model is consistent with the guidance for purchased credit impaired (PCI) assets within the proposed standard, and is also consistent with the IASB member's dissent on the IASB's proposed credit impairment model. Despite the alternative model having a number of benefits, our significant outreach efforts suggested minimal support for this model due to its perceived operational complexity, as well as concerns about the nature of the "debit" that is initially recognized as an offset to the allowance for credit losses. As a result of this feedback, we do not recommend the alternative model.

The IASB's proposed model as written

We considered the credit impairment model as proposed in the IASB's credit impairment exposure draft, *Financial Instruments: Expected Credit Losses,* which establishes a threshold prior to recognizing full lifetime expected credit losses. We believe the threshold, which is based on an increase in credit risk, represents a conceptual improvement as compared to the proposed standard and is a good platform upon which the boards can develop a converged approach.

While we support this aspect of the IASB's proposed model, we believe that the model, as written, may not adequately capture the concept that, for certain assets, a significant increase in credit risk that has taken place will not be identifiable at an individual asset level until some point in the future. These assets would seem to meet the criteria for recognition in the lifetime expected credit loss component of the model, especially given that under the model, entities should use forward-looking information in determining whether there has been a significant increase in credit risk. However, the model provides an exception to the recognition of lifetime expected credit losses for assets that have low credit risk, such as those with a credit rating equivalent to investment grade. The guidance also implies that assets that are less than 30 days past due may be exempt from the lifetime expected credit losses component of the model. Thus, credit losses on these assets do not appear to be captured in the lifetime expected credit loss component of the model.

We considered whether the "12 month expected loss" component of the proposed model would instead capture the credit losses on these assets. However, we believe only a portion of the credit losses that are present in a portfolio, but are not yet identifiable on an individual asset basis, will be captured in the "12 month expected loss" component of the model. The remaining portion will not be captured because of the amount of time that lapses between the point a significant increase in credit risk has taken place and when the loss ultimately manifests itself into an identifiable event (such as default). This time period often varies based on the nature of the asset; and for some assets it can extend well beyond a twelve-month period. This has led some constituents to express concern that in certain cases, the IASB's proposed model, as written, could result in lower levels of credit allowances as compared to current practice in the United States.

Proposed changes to the IASB model

We recommend the boards pursue an enhanced version of the IASB's proposed model and offer the following suggestions.

We believe that the IASB model should more explicitly address assets that have experienced a significant increase in credit risk, but such increase is not yet identifiable at an individual asset level. Some may interpret the model as capturing a portion of this amount through the "12 month expected loss" component of the provision for individual assets that have not yet experienced an identifiable significant increase in credit risk. However, as discussed above, it is not clear that this will adequately capture the expected credit losses for all of these assets. Accordingly, we recommend that further clarification should be made to ensure that credit losses on assets that have met the significant deterioration threshold, albeit not on an individually identifiable basis, are fully captured by the model.

As the IASB was finalizing the proposed model, the terminology related to the credit deterioration threshold was changed from "more than insignificant" to "significant". In practice, some constituents view the term "significant" as conveying a higher threshold than the term "more than insignificant" and therefore concluded that the board changed the recognition criterion. Other constituents do not see a difference in those terms, and concluded that the recognition criterion was unchanged. We recommend the IASB clarify within the proposed standard or supplemental implementation guidance its intent regarding the meaning of "significant" as compared to "more than insignificant." That clarification would help to limit diverse interpretations of what constitutes a change in credit risk that requires the recognition of a credit loss.

Additional comments on IASB proposal

The IASB issued its exposure draft in March of 2013. In addition to the different impairment models proposed by each board, the timetables to provide comments are also different, with comments on the IASB's exposure draft not due until July 5, 2013. We will provide additional feedback on the details of the IASB's proposal in our response to its exposure draft.

Conclusion

We believe our proposed changes to the IASB's model would result in a model that more closely reflects the economics of lending transactions and the credit deterioration cycle than the model in the proposed standard. We also believe they would result in a credit impairment model that successfully achieves the principles established by the G20 subsequent to the financial crisis, primarily the need to establish a model that is based on expected losses, allows entities to look forward into future periods, and results in more timely recognition of credit losses.

Attachment 1 to this letter contains our responses to the questions accompanying the proposed standard.

If you have any questions regarding our comments, please contact Paul Kepple at (973) 236 5293, John Althoff at (973) 236 7021, or Christopher Gerdau at (973) 236 5010.

Sincerely,

PricewaterhouseCoopers LLP

PricewaterhouseCoopers LLP

Appendix 1:

As communicated in our cover letter, we recommend the boards resume collaboration with the goal of developing a converged impairment model. We believe the IASB's impairment model represents the best starting point for this collaboration. Our responses to the questions below address the FASB model specifically, and are provided in the event the FASB elects not to pursue convergence with the IASB.

Question for All Respondents

Question 1: *Do you agree with the scope of financial assets that are included in this proposed Update? If not, which other financial assets do you believe should be included or excluded? Why?*

We are supportive of the FASB's efforts to establish one impairment model for all financial assets subject to losses related to credit risk that are not classified at fair value through net income. We generally agree with the scope of financial assets that are included in the proposed update, with two exceptions.

The proposed update includes reinsurance receivables that result from insurance transactions within the scope of Topic 944. Non-performance risk on reinsurance receivables is comprised of both credit risk and dispute risk. We believe recognizing each risk component under different measurement models will be complex. Accordingly, we recommend that reinsurance receivables be covered in the insurance contracts project. Both the insurance contracts project and the impairment project reflect expected loss models. Including reinsurance receivables in the insurance contracts project should not result in a fundamentally different measurement principle. But it would allow insurers to account for their insurance liabilities, as well as their reinsurance assets, under the same accounting model.

The scope of the proposed update does not include financial guarantees. We disagree with the FASB's decision to address financial guarantees in the insurance contracts project. We believe that financial guarantees should be subject to the same credit impairment model as funded financial assets, which also involve the transfer of credit risk. Additionally, we believe many financial institutions may find it operationally easier to evaluate and measure the credit risk associated with a financial guarantee in conjunction with that same customer's loans and loan commitments.

As noted in our cover letter, we do not support the FASB's proposal and believe the boards should continue working together to achieve convergence based upon enhancements to the IASB's proposed impairment model. In the event the FASB is unable to support this approach, we recommend that the FASB pursue targeted amendments to areas of current US GAAP most in need of revision rather than its current proposal. Certain areas that would be impacted by the proposed standard, including the accounting for impaired loans under ASC 310-10-35-12 (formerly FAS 114) and the accounting for other-than-temporary impairment of securities under ASC 320-10-35-18 (formerly FSP FAS 115-2), are well understood by preparers and users and are generally not viewed as requiring significant revisions. However, removing credit loss measurement from ASC 450 (formerly FAS 5) and establishing a separate impairment model that eliminates the probability threshold in favor of an expected credit loss model would be an improvement.

Recognition and Measurement
Questions for Preparers and Auditors

Question 9: *The proposed amendments would require that an estimate of expected credit losses be based on relevant information about past events, including historical loss experience with similar assets, current conditions, and reasonable and supportable forecasts that affect the expected collectability of the financial assets' remaining contractual cash flows. Do you foresee any significant operability or auditing concerns or constraints in basing the estimate of expected credit losses on such information?*

We support the consideration of relevant information such as those sources identified above. We note that the use of estimation techniques of reverting to a mean or assuming a "terminal" rate are not addressed in the proposed standard, but were subsequently addressed in the FAQ document published on March 25, 2013. We recommend the final standard explicitly address these techniques, given that we expect them to be common practices. Providing more explicit acceptance of these techniques will also potentially eliminate some of the operational concerns associated with long-term credit assumptions and estimates.

Question 10: *The Board expects that many entities initially will base their estimates on historical loss data for particular types of assets and then will update that historical data to reflect current conditions and reasonable and supportable forecasts of the future. Do entities currently have access to historical loss data and to data to update that historical information to reflect current conditions and reasonable and supportable forecasts of the future? If so, how would this data be utilized in implementing the proposed amendments? If not, is another form of data currently available that may allow the entity to achieve the objective of the proposed amendments until it has access to historical loss data or to specific data that reflects current conditions and reasonable and supportable forecasts?*

We believe that preparers are best suited to answer questions related to the availability of data needed to implement the proposed standard. We expect that many different sources of data will be available for preparers, including historical data, industry data, economic forecasts, and regulatory guidance, and they will be used to varying degrees. However, we believe it is important for the FASB to acknowledge the use of these different data sources, as well as the fact that preparers will have latitude in determining the best methods to use to develop credit loss estimates in their individual circumstances. This latitude will likely result in a range of reasonably acceptable credit loss estimates that might be determined by individual preparers faced with similar fact patterns.

Question 11: *The proposed amendments would require that an estimate of expected credit losses always reflect both the possibility that a credit loss results and the possibility that no credit loss results. This proposal would prohibit an entity from estimating expected credit losses based solely on the most likely outcome (that is, the statistical model). As described in the Implementation Guidance and Illustrations Section of Subtopic 825-15, the Board believes that many commonly used methods already implicitly satisfy this requirement. Do you foresee any significant operability or auditing concerns or constraints in having the estimate of expected credit losses always reflect both the possibility that a credit loss results and the possibility that no credit loss results?*

We agree that allowances for expected credit losses should not be based solely on the "most likely" scenario. However, we disagree with the requirement to always reflect both the possibility that a credit loss results and the possibility that no credit loss results. We recommend that the requirement be revised to call for determination of a mean that considers sufficient relevant information and is representative of the expected credit losses. We agree with the proposed standard that many methods currently used in practice would satisfy the objective of a mean estimate.

The proposal to require consideration of a scenario in which a credit loss exists would create complexity in many areas that would not otherwise be complex, such as consideration of collateral. The FAQ document states that "collateral serves to reduce a lender's exposure to credit losses on a given loan and would be taken into consideration when estimating expected credit losses." While we understand and support the concept that collateral should be taken into consideration when estimating expected credit losses, it is unclear how the FASB wants this to be done. If the FASB intends for preparers to consider a scenario where a credit loss occurs on the instrument and the value of the collateral is insufficient, this should be more explicitly stated and additional guidance should be provided to aid in performing the analysis.

Requiring the consideration of a credit loss for certain instruments for which the risk of loss is expected to be insignificant creates an unnecessary burden to preparers for very little benefit to users. Examples include, but are not limited to, US treasury bonds, US government guaranteed loans, and other instruments of the highest credit

quality. In these situations, we do not believe there is a sufficient benefit to requiring preparers to specifically consider a scenario where a credit loss exists and compute a theoretical credit loss that has a remote chance of occurring.

Question 12: *The proposed amendments would require that an estimate of expected credit losses reflect the time value of money either explicitly or implicitly. Methods implicitly reflect the time value of money by developing loss statistics on the basis of the ratio of the amortized cost amount written off because of credit loss and the amortized cost basis of the asset and by applying the loss statistic to the amortized cost balance as of the reporting date to estimate the portion of the recorded amortized cost basis that is not expected to be recovered because of credit loss. Such methods may include loss-rate methods, roll-rate methods, probability-of-default methods, and a provision matrix method using loss factors. Do you foresee any significant operability or auditing concerns or constraints with the proposal that an estimate of expected credit losses reflect the time value of money either explicitly or implicitly? If time value of money should not be contemplated, how would such an approach reconcile with the objective of the amortized cost framework?*

We support the concept that a credit loss estimate should consider the time value of money. While a discounted cash flow calculation explicitly considers the time value of money, we recognize that there are significant operational challenges associated with requiring such calculations to be used and believe the costs would exceed the benefit. Therefore, we support accepting many methods that are currently used in practice and believe that users accept such practical expedients as well.

While we support the continuation of many current practices, we believe that the language in the proposed standard related to "implicitly" considering the time value of money creates confusion with respect to which methods may be acceptable. Therefore, we recommend the FASB consider eliminating the "implicit" references and instead state that many methods commonly used today, such as loss rates or probabilities of default/loss given defaults, are practical expedients that would be acceptable methods to measure the expected credit loss.

Question 13: *For purchased credit-impaired financial assets, the proposed amendments would require that the discount embedded in the purchase price that is attributable to expected credit losses at the date of acquisition not be recognized as interest income. Apart from this proposal, purchased credit-impaired assets would follow the same approach as non-purchased-credit-impaired assets. That is, the allowance for expected credit losses would always be based on management's current estimate of the contractual cash flows that the entity does not expect to collect. Changes in the allowance for expected credit losses (favorable or unfavorable) would be recognized immediately for both purchased credit-impaired assets and non-purchased-credit-impaired assets as bad-debt expense rather than yield. Do you foresee any significant operability or auditing concerns or constraints in determining the discount embedded in the purchase price that is attributable to credit at the date of acquisition?*

We support the FASB's efforts to simplify the accounting for purchased credit impaired (PCI) assets. Subsequent to acquisition, PCI assets are generally credit risk managed in the same way as originated assets that have experienced significant deterioration and therefore should be subject to the same subsequent measurement of expected losses. We believe that the PCI guidance included in the proposed standard represents an improvement to current practice under US GAAP, as it would reduce the complexity of today's accounting model for these types of assets. We also believe that recognizing interest income at a rate that is lower than the effective yield calculated from contractual payments is appropriate to reflect the contractual cash flows expected to be collected.

Currently, entities are required to estimate cash flows on PCI assets and continually update those estimates when calculating yield under ASC 310-30, *Loans and Debt Securities Acquired with Deteriorated Credit Quality*. Therefore, we do not see significant auditing or operational concerns with determining the discount embedded in the purchase price that is attributable to credit at the date of acquisition.

The fair value of purchased loans, both PCI and non-PCI, include many factors in addition to estimated credit losses (interest rates, credit spreads, expected maturity, etc). The FASB should provide additional clarity on the application of the proposed standard to loans purchased at premiums and discounts, particularly where such premiums and discounts are driven by factors other than estimated credit losses. Such complexity was introduced into the accounting model when "carrying over" allowance amounts were prohibited under FAS 141R (now codified in ASC 805).

Question 14: *As a practical expedient, the proposed amendments would allow an entity to not recognize expected credit losses for financial assets measured at fair value with qualifying changes in fair value recognized in other comprehensive income when both (a) the fair value of the individual financial asset is greater than (or equal to) the amortized cost basis of the financial asset and (b) the expected credit losses on the individual financial asset are insignificant. Do you foresee any significant operability or auditing concerns or constraints in determining whether an entity has met the criteria to apply the practical expedient or in applying it?*

As stated in our response to Question #11, we do not believe that there is sufficient benefit to requiring preparers to specifically consider a scenario where a credit loss exists and compute a theoretical credit loss for situations in which a credit loss has a remote chance of occurring. Therefore, we do not believe that a practical expedient is necessary. However, if the FASB retains the language currently in the proposed standard and therefore requires each credit loss estimate to consider a scenario where a credit loss exists, we support the practical expedient. We do not believe there are significant operability or auditing concerns associated with the practical expedient currently proposed.

Question 15: *The proposed amendments would require that an entity place a financial asset on nonaccrual status when it is not probable that the entity will receive substantially all of the principal or substantially all of the interest. In such circumstances, the entity would be required to apply either the cost-recovery method or the cash-basis method, as described in paragraph 825-15-25-10. Do you believe that this proposal will change current practice? Do you foresee any significant operability or auditing concerns with this proposed amendment?*

We generally support the concept of no longer recognizing interest income when it is not probable that substantially all of the contractual cash flows will be collected. While the concept of non-accrual exists today in the banking industry and is generally well understood for loans, the concept will cause changes in the accounting for securities and will result in changes to current practice.

We support the FASB's efforts to move the non-accrual concept into US GAAP. However, this will present a number of challenges, particularly with the accounting subsequent to placing an asset on non-accrual status. For example, complexity can ensue with respect to subsequent charge-offs and recoveries of the asset. While these complexities exist currently with respect to loans, we expect the questions on these concepts to be even more pronounced with the decision to subject securities to non-accrual accounting. The FASB should consider providing additional implementation guidance and examples to more clearly illustrate the subsequent accounting for various asset types placed on non-accrual status.

Question 16: *Under existing U.S. GAAP, the accounting by a creditor for a modification to an existing debt instrument depends on whether the modification qualifies as a troubled debt restructuring. As described in paragraphs BC45–BC47 of the basis for conclusions, the Board continues to believe that the economic concession granted by a creditor in a troubled debt restructuring reflects the creditor's effort to maximize its recovery of the original contractual cash flows in a debt instrument. As a result, unlike certain other modifications that do not qualify as troubled debt restructurings, the Board views the modified debt instrument that follows a troubled debt restructuring as a continuation of the original debt instrument. Do you believe that the distinction between troubled debt restructurings and non-troubled debt restructurings continues to be relevant? Why or why not?*

We believe that the distinction between TDR and non-TDR is relevant for certain purposes. We agree with the FASB that a TDR represents a creditor's effort to recover as much of the original cash flows of the instrument as possible and therefore should not be considered a new loan. We believe that the TDR distinction, whereby a TDR cannot be a new loan, eliminates the complexity of having to subject these types of modifications to ASC 310-20-35-11 (formerly EITF 01-7) to determine whether a modification is a new loan or a continuation of an old loan. Therefore, we support retaining the concept of a TDR for this purpose.

We also recognize that information about a lender's troubled debt modification programs and the success of those modification programs is valuable to users of the financial statements. Therefore, we believe the distinction between TDR and non-TDR is relevant for disclosure purposes. We encourage continued dialogue about what the appropriate content and level of disclosure should be.

From a recognition and measurement perspective, we do not believe that the TDR distinction is necessary. We believe that subsequent to a TDR modification, the proposed standard should be applied consistently with other modifications not accounted for as new loans. Therefore, we believe it is not necessary to require an adjustment to the amortized cost basis of the asset to reflect the economic concession granted to the borrower, and that the measurement technique used to determine credit losses should be consistently applied.

The current TDR guidance is complex and rules driven. Because we believe that the TDR distinction is only relevant for certain purposes, we encourage the FASB to consider simplifying the current guidance by establishing principles upon which to determine whether a modification constitutes a TDR and is therefore subject to additional disclosure requirements.

If the FASB elects to proceed with the proposed guidance on TDRs, we recommend revising the guidance on the adjustment required to the amortized cost basis of the asset. That guidance requires creditors to calculate the effective interest rate (post troubled debt restructuring) based on the *contractual* terms of the modified asset. Consideration of the *contractual* term of the instrument, rather than its *expected* term, would result in the adjustment representing an economic concession granted over the entire contractual life of the instrument. In reality, the concession would only be given during the term the instrument is expected to remain outstanding. Therefore, we recommend the guidance allow lenders to consider prepayments when establishing the effective interest rate for purposes of calculating the adjustment to the amortized cost basis of the asset.

Question 17: *Do you believe the disclosure proposals in this proposed Update would provide decision-useful information? If not, what disclosures do you believe should (or should not) be required and why?*

We are generally supportive of the disclosure proposals in the proposed update.

Question 18: *Do you foresee any significant operability or auditing concerns or constraints in complying with the disclosure proposals in the proposed Update?*

We do not foresee significant operability or auditing concerns with the disclosure proposals.

Question 19: *Do you believe that the implementation guidance and illustrative examples included in this proposed Update are sufficient? If not, what additional guidance or examples are needed?*

We are supportive of the FASB's inclusion of implementation guidance and illustrative examples to aid in understanding how to apply the principles of the proposed standard. However, we believe the current examples require enhancements to ensure constituents understand how certain commonly used methods, including loss rates, are acceptable practical expedients to comply with the model. We recommend that further information be provided, including how the data used in the examples was derived, to help highlight why these methodologies are

acceptable practical expedients. We also would recommend including an example of an approach that would not work, along with the rationale as to why, to help constituents draw comparisons between the potential methodologies.

Given the subjectivity of the methodologies and estimates required to calculate expected credit losses, constituents will benefit from the additional clarity provided by the FAQ document to effectively implement the proposed standard. We believe many of the concepts embedded in the FAQ document, including, but not limited to, interest income recognition, consideration of collateral, and methods to calculate expected loss should be incorporated into the final standard. We recommend the FASB give this consideration.

Question 20: *Do you agree with the transition provision in this proposed Update? If not, why?*

We generally support the transition provisions in the proposed update. However, we believe there are several areas where there could be operational complexity associated with transition and therefore additional guidance, including a practical expedient, should be provided.

The proposed definition of purchased credit impaired (PCI) financial assets in the proposed standard represents a change from current practice under ASC 310-30. Thus, hindsight would be necessary to determine whether assets would have met the proposed definition of PCI at initial purchase. In addition, even if assets accounted for as PCI under today's guidance are also determined to meet the proposed definition, hindsight would be required to determine the appropriate transition adjustment, as consideration would need to be given to cash flow estimates that were made at the time of purchase and any subsequent yield adjustments/impairments that were recorded on the asset. Furthermore, constituents often apply ASC 310-30 to assets that technically do not meet the definition of PCI as established in ASC 310-30. This was an accommodation made several years ago based on discussions with the SEC and banking regulators and is commonly referred to in practice as "applying SOP 03-3 by analogy." The accommodation was based on this model being deemed "superior" to the current model, which involves complexities with purchased non-impaired loans. These assets would not technically meet the definition of PCI as outlined in the proposed standard; therefore, preparers would face additional complexity in transitioning these assets out of the current PCI guidance and into the proposed non-PCI guidance.

We believe there could also be complexity with regard to other classes of assets. For example, securities that are currently accounted for under ASC 320-10-35-18 (formerly FSP FAS 115-2) have previously been subject to other-than-temporary impairment (OTTI) analyses. If an asset was determined to be OTTI, a loss would have been recorded and the cost basis of the asset adjusted. Under current guidance, the cost basis cannot be adjusted up if subsequent cash flow expectations improve. The proposed standard would establish an allowance for credit losses on securities that would be revisited each period, with subsequent improvements in cash flow expectations being recorded as gains. This represents a change to current practice that could present additional transition challenges.

We believe the types of analyses described above will be very difficult for preparers and, in some cases, the information required may not be available. We encourage the FASB to perform outreach to determine an acceptable practical expedient to alleviate the complexity of transitioning to the new standard.

Question 21: *Do you agree that early adoption should not be permitted? If not, why?*

We previously communicated, in our response letter to the classification and measurement exposure draft, that we do not support early adoption for the majority of the classification and measurement standard due to the fact that such early adoption would undermine comparability for financial statement users. We believe that the adoption date for classification and measurement and impairment should be the same given the clear inter-relationship between the two models. Therefore, we would also support not permitting early adoption of the impairment standard.

Question 22: *Do you believe that the effective date should be the same for a public entity as it is for a nonpublic entity? If not, why?*

We generally support giving private companies additional time to implement the guidance and learn from the experiences of public companies. Moreover, we believe it is important that the effective date for the classification and measurement standard and the credit impairment standard be the same.

Questions for Preparers and Auditors
Question 23: *Do you believe that the transition provision in this proposed Update is operable? If not, why?*

Subject to the clarifications and practical expedients requested in our response to Question #20, we believe that the transition provision in the proposed update is operable.

Question 24: *How much time would be needed to implement the proposed guidance? What type of system and process changes would be necessary to implement the proposed guidance?*

The amount of time necessary to implement the proposed standard will depend on the final standard and on the types and complexity of financial instruments originated by, invested in, and issued by companies. We recommend that ample time be given for companies to address the complexities of the new model and ensure the necessary processes and internal controls are in place. We encourage the FASB to seek feedback from preparers on what they believe is the appropriate time needed to implement the proposed standard. In addition, since the final standard will impact the accounting for financial instruments that are widely held in the US market, additional time may be needed to educate investors and allow market participants to react and make changes to accommodate the new developments. Finally, we note that the FASB will be issuing additional standards that impact the accounting for financial instruments as well as other major elements of the financial statements. We encourage the FASB to consider the impact of the adoption of all of these standards when determining an effective date.