Australian Government

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Hans Hoogervorst
Chairman
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Dear Hans

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

The Australian Accounting Standards Board (AASB) welcomes the opportunity to provide comments on ED/2013/3 *Financial Instruments: Expected Credit Losses*. In formulating its comments, the AASB sought and considered the views of Australian constituents through comment letters, roundtable discussions and other consultation. The comment letters received are published on the AASB's website.

The AASB broadly supports the general direction of the proposed model in ED/2013/3 but also has concerns about the model, in particular, relating to:

- the lack of a conceptual basis for requiring a loss allowance at an amount equal to 12-month expected credit losses at initial recognition. This loss allowance would result in amortised cost (or the net carrying amount of the financial instrument) that is less than the instrument's fair value immediately on recognition, which would not adequately reflect the economic link between the pricing of financial instruments and the credit quality at initial recognition. The AASB considers that such a loss allowance is arbitrary and would not convey information that is useful.
- operability, as the model in ED/2013/3 requires credit information on financial assets to be tracked from initial recognition. The AASB was informed that Australian entities with existing credit systems generally do not track credit information in that manner. The current practice of most entities is to assess their borrower/debtor's credit risk at a point in time. In addition, although some larger financial institutions currently employ credit systems that could be modified to enable application of the proposals in ED/2013/3, the vast majority of Australian entities, including smaller financial institutions and non-financial institutions, would require new systems to be developed to implement the model in ED/2013/3.

- the operational simplification for trade and lease receivables that permits the recognition of a lifetime expected credit loss upon initial recognition does not faithfully represent the underlying economics of such transactions. In addition, the AASB does not agree with permitting an entity to make an accounting policy election for trade and lease receivables that contain a financing component as it believes that the model should be applied consistently with other types of financial asset.
- application of the model in ED/2013/3 to financial assets measured at fair value through other comprehensive income (FVOCI) (as proposed in ED/2012/4 *Classification and Measurement: Limited Amendments to IFRS 9*) as, for a number of Australian insurers, these financial assets are currently measured at fair value through profit or loss, and accordingly, are not subject to impairment testing. These entities do not have credit systems in place which could be readily adapted to calculate the loss provisions proposed in ED/2013/3 and the cost burden of implementing credit systems that meet the requirements of ED/2013/3 might outweigh any benefit of calculating and presenting expected credit losses in the way in which is proposed in ED/2013/3. The AASB considers that, as a matter of principle, entities should be permitted not to recognise expected credit losses on financial assets measured at FVOCI when there is reasonable and supportable history and current information about the high credit quality of these financial assets, such that both (1) the fair value of the financial asset is greater than (or equal to) the amortised cost and (2) expected credit losses on such financial assets are insignificant (this is similar to the expedient proposed by the FASB).
- the proposed presentation of interest revenue based on a net carrying amount. The AASB is not convinced that there are circumstances when interest revenue calculated on a net carrying amount (amortised cost) can provide more useful information. Furthermore, the AASB does not consider the IASB has provided paragraph BC99 sufficient rationale for such an interest rate calculation.

The AASB is suggesting some important possible modifications that could address its concerns about the model in ED/2013/3. Our rationale and description of these recommended modifications are explained in more detail in Appendix A. Our views in relation to the proposals in ED/2013/3 are explained in more detail in Appendix B.

If you have any queries regarding any matters in this submission, please contact me or Christina Ng (cng@aasb.gov.au).

Yours sincerely,

K.M. Stevenson

Kevin M. Stevenson
Chairman and CEO

Appendix A

Recommended modifications to ED/2013/3 *Financial Instruments: Expected Credit Losses*

The AASB believes the proposals in ED/2013/3 are an important step in the right direction as the AASB supports the development of an impairment model that takes a forward-looking approach to recognising losses based on currently available information. The AASB has a number of significant concerns with the model in ED/2013/3. This Appendix sets out possible modifications to address the AASB's concerns while also achieving the IASB's objectives. The AASB's detailed comments on ED/2013/3 are set out in Appendix B.

Overall, the AASB encourages the IASB to develop a forward-looking impairment model that is more principles-based, rather than a model with rules that unnecessarily cut across an entity's credit risk management practices. This is to facilitate application of the model by entities of all jurisdictions, economies, nature and size. The AASB's suggested modifications to the proposed model in ED/2013/3 utilise a concept of 'expected but not reported losses', which the AASB considers to be in line with the underlying economics of a wide range of businesses and the general credit risk management of entities involved in holding financial debt assets that are not carried at fair value through profit or loss (FVPL).

Overview of the AASB's rationale

If a financial instrument forming part of a portfolio is initially recognised at fair value, the effective interest rate will incorporate expectations of loss. There should be no need for any day one loss to be recognised. If credit risk does not change, nor will any provision for impairment be needed for the portfolio over its life as the performance of the portfolio will be as expected at initial recognition. Though individual instruments may need to be written down, on average the portfolio, as the unit of account, will return the discounted carrying amounts of the total of the instruments in the portfolio. Under and over recoveries will offset when, overall, initial expectations of losses are met.

Allowance for losses will be needed when expectations about losses are not incorporated into the effective interest rate. This could occur because of a lack of information when setting the original credit assessment or when there is a change of circumstance that is unexpected. All such 'corrections' should be made to the carrying amount of the financial assets if the original effective interest rate is to continue to be used.

Many banks currently grade their customers for credit risk and apply loss provisioning to the sub-portfolios for each grade. These internal gradings are mapped to external gradings for regulatory purposes.

This is currently carried out on an incurred but not reported (IBNR) basis for those sub-portfolios and would need to be changed to an expected but not reported (EBNR) basis to achieve the objectives of the IASB ED. The change from IBNR to EBNR can be managed by changing the overlays calculated for each sub-portfolio to estimate the losses within each of them.

A weakness of the IBNR approach applied by banks is that all loans in a sub-portfolio are subjected to the loss factor for the sub-portfolio, irrespective of whether the loans are 'day one' or 'day two' as the sub-portfolios are managed on an open portfolio basis. This 'simplification' could be conceptually incorrect but practically does mitigate or dilute misclassification on day one and removes the need to track credit ratings by instrument over time. All that is needed at each provisioning point is to know the balance of the sub-portfolio and any changes to the loss factor.

If the economic overlays are designed to cope with the profile of the loans in each sub-portfolio, that is, whether the loans are day one or any other age, the risk of incorrectly provisioning day one loans is offset. The overlay would provide a weighted average loss factor that copes with the mix in loan lives. At the sub-portfolio level, if there were no mispricing at origination, in theory, there would be no day one losses.

Whenever loans are reclassified from their current gradings, a change in provisioning should take place, as each sub-portfolio in each grading has a loss factor. This should reflect the fact that the loans, if written today, would have different terms and conditions because credit risks are different for each grade.

If it is accepted that changes in credit ratings of loans should lead to adjustments to the provision for losses on the portfolio (subject to a cap of not having the portfolio revalued above its historical carrying amount), no distinction is needed between 12-month and life-time losses. (This approach is different from that of the FASB's, which would provide for day one foreseeable life-time losses without any change in credit risk).

A practical problem in following this suggested approach is that the overlays need to be able to cope not only with loans of varying lengths but also re-gradings from other sub-portfolios. A day one loan should not generate a change in a provision. A re-graded loan should cause a change.

The weighting of the loans in the sub-portfolio overlays of itself may not be responsive to disproportionate re-gradings and would need to be revised when re-gradings happens.

As credit risk is a function of the customer's ability to pay, and a customer may have multiple contracts with an entity, it is inappropriate to require credit risk to be tracked for individual instruments. The approach recommended avoids this issue and also removes the need for tracking of individual instruments. Moreover, it is used in practice, albeit on an IBNR basis.

AASB's recommended possible modifications to ED/2013/3 based on forward-looking information

Overview of proposed modifications

The AASB proposes that the principle for recognising expected but not reported losses is to reflect an entity's financial asset credit risk assessment based on whether the same or similar pricing (credit terms) of the financial asset would continue to be accepted if the instrument were issued at the time of assessment.

The AASB considers that this proposed principle would not require any day-one loss recognition and because an entity would allocate a credit risk grade for each of its borrowers/debtors, every financial instrument subject to impairment would have a loss allowance subsequent to initial recognition reflecting changes in the borrowers'/debtors' credit risk gradings since initial recognition or last re-assessment A model that is based on this principle would be applicable to all types of financial assets that are not at FVPL with little need for operational simplifications or practical expedients to be included in the accounting standard. This proposed modification is in contrast to the FASB model that requires lifetime expected credit losses to be recognised at initial recognition; an approach the AASB believes cannot be reflective of the underlying economics and does not support.

At initial recognition

Consistent with IFRS 9 *Financial Instruments* and IAS 39 *Financial Instruments: Recognition and Measurement*, at initial recognition, a financial asset should be measured at fair value, and in the case of a financial asset not at FVPL, plus or minus transaction costs that are directly attributable to acquisition or issue of the instrument.

For example, a financial asset would be measured at initial recognition at fair value. Fair value would be determined in accordance with IFRS 13 *Fair Value Measurement*[1]. Generally fair value would be determined as the transaction price agreed between the issuer of the financial instrument and the borrower/debtor.

In many cases the amount recognised would be consistent with the recognition of revenue which, in accordance with the IASB's revised ED/2011/6 *Revenue from Contracts with Customers* and as tentatively agreed by the IASB in its re-deliberations, would be measured at the transaction price, which for contracts with variable consideration would be based on expected value or most likely amount, and adjusted for the time value of money if financing is significant. (Transaction costs are ignored here for simplicity.)

Subsequent measurement

In principle, an entity would assess whether credit risk has changed and recognise those changes in loss allowance based on changes in the borrowers'/debtors' risk gradings. If the entity were to purchase or reissue an asset, or portfolio of assets, and would continue to accept the same or similar pricing (credit terms) with the knowledge of its borrower's/debtor's change in credit risk at that point in time, it is probable that there has been an insignificant change in credit quality. Conversely, if the entity would not continue to accept the existing pricing (credit terms) in a way that the entity modifies the pricing or credit terms of the asset to reflect the change in credit risk (and in some circumstance, the entity would no longer continue its business relationship with the borrower/debtor), it is probable that there has been a change in credit risk that should be recognised. This approach does not require the entity to track the credit risk of a financial asset, or portfolio, over time. Rather, it bases the assessment of changes in credit risk of a customer on relevant factors (discussed in section 'Assessment of Change of Credit Risk' below) at the time of assessment.

[1] IFRS 13 paragraph 9 defines fair value as 'the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date'.

Appendix A

Recommended modifications to ED/2013/3 *Financial Instruments: Expected Credit Losses*

Based on the principle of credit risk assessment above, an entity should recognise a loss allowance as follows:

(1) If there has been a credit change such that if the financial asset were issued or purchased at that point in time the entity would continue to accept the same or similar credit terms for that financial asset, the entity should recognise a loss allowance, or an adjustment to an existing loss allowance that reflects the change in the borrower's/debtor's credit risk grading.

(2) If there has been a credit deterioration such that if the financial asset were issued or purchased at that point in time the entity would no longer accept the same or similar credit terms, and accordingly, would modify the pricing (or credit terms) of the financial asset (and in some circumstance, the entity would no longer continue its business relationship with the borrower/debtor), the entity should recognise lifetime expected losses whether reported or not (EBNR).

(3) If there has been a credit improvement, such that if the financial asset were issued or purchased at the reporting date the entity would no longer continue to accept the same or similar credit terms, and accordingly, would modify the pricing (or credit terms) of the financial asset to be more favourable to its borrower/debtor, the entity should no longer recognise lifetime expected but not reported losses, and adjust the loss allowance to reflect the change in the borrower's/debtor's credit risk grading, to the extent that the adjusted carrying amount does not exceed the financial instrument's historical carrying amount.

Assessment of change of credit risk

The principle in the assessment of whether a change in credit risk has occurred should be whether an entity would continue to accept the same or similar credit terms, and not modify the pricing if the financial asset were issued or purchased at that point in time. This assessment should be based on information from the entity's internal credit risk management practices corroborated by reliable and supportable external information and forecasts of future events and economic conditions. An entity's credit risk management practices need to be able to facilitate credit risk assessments. Some entities' credit risk models may include a debt provisioning matrix/debt ageing analysis and those models that are used for regulatory reporting purpose.

If an entity's credit risk management practice is to apply probabilities of default to assess changes in credit risks, those probabilities of default should be based on internal historical information adjusted for reliable and supportable external information. The assessment should include consideration of the following factors, where relevant to the entity[2]:

[2] These factors were proposed in paragraph B20 of IASB ED/2013/3 and have been altered in this Appendix A to reflect that credit risk assessments should be performed at a borrower/debtor level, and not at the instrument level. This is to ensure that all financial assets associated with the one borrower/debtor are

(a) changes in external market indicators of credit risk for a particular borrower/debtor or similar borrower/debtor with the same credit characteristics. Changes in market indicators of credit risk can include, but are not limited to:
  (i) the credit spread;
  (ii) the credit default swap prices for the borrower or borrowers of similar credit characteristics;
  (iii) the length of time and extent to which the fair value of a financial asset has been less than its amortised cost; and
  (iv) other market information related to the borrower, such as changes in the price of a borrower's debt and equity instruments;
(b) an actual or expected changes in the borrowers'/debtors' external credit rating;
(c) changes in internal price indicators of credit risk as a result of a change in credit quality, including, but not limited to, the credit spread that would result if a particular financial instrument or similar financial instrument with the same terms and the same counterparty were newly originated or issued at the reporting date;
(d) other changes in the rates or terms of an existing financial instrument that would be significantly different if the instrument was newly originated or issued at the reporting date (such as more stringent covenants, increased amounts of collateral or guarantees, or higher income coverage) because of changes in the credit risk of the borrower/debtor;
(e) an actual or expected internal credit rating downgrade for the borrower/debtor or decrease in behavioural scoring used to assess credit risk internally. Internal credit ratings and internal behavioural scoring are more reliable when they are mapped to external ratings or supported by default studies;
(f) existing or forecast adverse changes in business, financial or economic conditions that are expected to cause a change in a borrower/debtor's ability to meet its debt obligations, such as an actual or expected increase in interest rates or an actual or expected increase in unemployment rates;
(g) changes in operating results of the borrower/debtor. Examples include actual or expected declining revenues or margins, increasing operating risks, working capital deficiencies, decreasing asset quality, increased balance sheet leverage, liquidity, management problems or changes in the scope of business or organisational structure (such as the discontinuance of a segment of the business) that results in a significant change in a borrower's/debtor's ability to meet its debt obligations;
(h) [this point has been removed—the AASB considers this factor is not relevant in the context of the AASB's proposed modifications as credit risk is a function of the borrowers'/debtors' ability to pay, and accordingly, a change in a borrowers'/debtors' credit risk, and not the financial instrument];
(i) an actual or expected adverse change in the regulatory, economic, or technological environment of the borrower/debtor that results in a change in the borrower's/debtor's ability to meet its debt obligations, such as a decline in the demand for the borrower's/debtor's sales product because of a shift in technology;

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assessed for credit impairment (improvement) in the same manner. The AASB notes there may be some repetition in these factors.

(j) changes in the value of the collateral supporting the obligation and the quality of third-party guarantees or credit enhancements, which are expected to reduce the borrower's/debtor's economic incentive to make scheduled contractual payments or to otherwise have an effect on the probability of a default occurring. For example, if the value of collateral declines because house prices decline, borrowers in some jurisdictions have a greater incentive to default on their mortgages;
(k) a change in the quality of the guarantee provided by a 100 per cent shareholder (or an individual's parents) if the shareholder (or parents) have an incentive and financial ability to prevent default by capital or cash infusion;
(l) changes, such as reductions in financial support from a parent entity or other affiliate or an actual or expected change in the quality of credit enhancement, which are expected to reduce the borrower's/debtor's economic incentive to make scheduled contractual payments. Credit quality enhancements or support include the consideration of the financial condition of the guarantor and/or, for interests issued in securitisations, whether subordinated interests are expected to be capable of absorbing expected credit losses (for example, on the loans underlying the security);
(m) expected changes in the loan documentation including an expected breach of contract that may lead to covenant waivers or amendments, interest payment holidays, interest rate step-ups, requiring additional collateral or guarantees, or other changes to the contractual framework of the instrument;
(n) changes in the expected performance and behaviour of the borrower/debtor, including changes in the payment status of borrowers/debtors in the group (for example, an increase in the expected number or extent of delayed contractual payments or an increase in the expected number of credit card borrowers who are expected to approach or exceed their credit limit or who are expected to be paying the minimum monthly amount);
(o) changes in the entity's credit management approach in relation to the financial instrument, ie based on emerging indicators of changes in credit quality of the financial instrument, the entity's credit risk management practice is expected to become more active or focused on managing the instrument, including an instrument becoming more closely monitored or controlled, or the entity specifically intervening with the borrower/debtor; and
(p) borrower's/debtor's past-due information.

Policy for determining whether a change in credit risk needs to be recognised

An entity should determine and disclose the policy it applies to assess whether credit risk has changed. For example, an entity would recognise lifetime expected but not reported losses when the borrowers' credit risk rating falls below the entity's 'acceptable credit grade' at that point in time. An entity would continue to adjust its loss allowance based on the changes in a borrower's credit risk rating that has not fallen below the entity's acceptable credit terms.

Appendix B

Detailed comments on ED/2013/3 *Financial Instruments: Expected Credit Losses*

The AASB proposes a model that utilises an 'expected but not reported model'. This is a development of the IASB's proposed model in ED/2013/3 which could be applied to reliably estimate impairment losses on a timely basis and would have merit conceptually. They would also not require significant systems changes. The AASB's suggested possible modifications to the IASB's model are set out in Appendix A of the AASB submission.

The following responses are also provided to assist the IASB with its deliberations should it continue to pursue its proposed model in ED/2013/3.

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 credits 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) The AASB does not agree that an approach that recognises a loss allowance (or provision) both at an amount equal to a portion of expected credit losses initially, and lifetime expected credits losses only after significant deterioration in credit quality, would adequately 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.

In originating and purchasing financial assets, an entity would typically consider the expectation for losses and factor that expectation into the pricing of the instrument. Therefore, the instrument price should reflect the expectation for credit losses of the instrument. However, the IASB's proposed model would require initial recognition of '12-month expected credit losses' resulting in amortised cost (or the net carrying amount of the financial instrument) that is less than the instrument's fair value immediately on recognition. Such a loss allowance is arbitrary and would not convey information that is useful.

The recognition of losses at initial recognition appears to result in double counting of expected credit losses that are already factored into the pricing of the instruments. Therefore it is the AASB's view that recognition of losses at initial recognition does not faithfully represent the economics of the underlying transaction.

It is also not clear how the IASB's proposed model would function in the case of financial assets acquired in a business combination. If the financial assets are recognised at fair value on acquisition and subsequently at amortised cost or FVOCI, there would be a 'day 2' credit loss recognised. Alternatively, if the proposed model is applied at the acquisition date goodwill would be increased or an immediate loss recognised. Neither of these accounting outcomes would appear to faithfully represent the transaction.

Possible modifications to the proposed model in ED/2013/3 that might better achieve the IASB's desired objectives, and avoid any initial recognition and double counting of losses, are, as indicated earlier, set out in Appendix A of the AASB submission.

(b) Consistent with the IASB's view, the AASB agrees 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, also does not faithfully represent the underlying economics of 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) The AASB does not agree that recognising a loss allowance (or provision) both at an amount equal to 12-month expected credit losses ('stage 1') and at an amount equal to lifetime expected credit losses after significant deterioration in credit quality ('stages 2 and 3') achieves an appropriate balance between the faithful representation of the underlying economics and the costs of implementation.

While the AASB appreciates the IASB's intention to 'simplify' expected credit loss recognition (compared with earlier exposure drafts) by requiring the recognition of 12-month expected credit losses upon initial recognition and on a rolling basis if credit risk has not increased significantly, the AASB is of the view that this employs an arbitrary time-horizon and lacks a conceptual basis. Without such a basis, the approach cannot convey information that is useful.

The AASB has concerns about the operational complexity of the proposed model in ED/2013/3 in its current form and that it may only be capable of being implemented in larger financial institutions.

In particular, the IASB's model would require an entity to 'track' the change in credit risk for each financial instrument from initial recognition. In Australia entities do not typically track credit risk (i) from initial recognition; and (ii) on an instrument-by-instrument basis, but rather on an overall customer exposure at a point in time. The AASB was informed that the changes in credit quality of financial instrument from inception and over its life is currently not recorded within credit systems, and the performance of the instrument relative to its credit quality at inception is not an essential factor in the management of credit risk. Furthermore, as mentioned in Appendix A of the AASB submission, credit risk is a function of a customer's ability to pay, and a customer may have multiple contracts with an entity. An estimated cost of implementation is detailed in our response to Question 12(a).

In addition, the AASB considers the general model in ED/2013/3 is tailored more towards larger financial institutions with existing credit systems that could be modified (albeit not without incurring a significant cost), which has resulted in the need for practical expedients, operational simplifications and other exceptions to the general model. As explained in Question 4, a vast majority of entities in Australia do not currently have the same (or any) credit systems and information that would be required by ED/2013/3, and accordingly, these other entities would have to build new credit systems for the purpose of calculating the credit losses to be recognised. Consistent with its comments on the 2009 ED and the Supplementary Document ED, the AASB is concerned that the proposed model in ED/2013/3 in its current form would not achieve a better balance between faithful representation of the underlying economics and the cost of implementation, particularly for smaller financial institutions.

The AASB expects that to implement the proposed model in ED/2013/3 without modifications would impose a cost burden that is likely to exceed any benefits to users.

(b) The AASB considers that the approach for accounting for expected credit losses proposed in ED/2013/3, with modifications as set out in Appendix A of the AASB submission, would achieve a better balance between the faithful representation of the underlying economics and the cost of implementation than the approaches in the 2009 Exposure Draft and the Supplementary Document (without the foreseeable future floor).

(c) The AASB does not 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.

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

(a) The AASB agrees with the proposed scope of the Exposure Draft.

(b) The AASB is of the view that if the measurement objective for a financial asset that is mandatorily measured at FVOCI in accordance with the Classification and Measurement Exposure Draft is to present in profit or loss amounts equivalent to those which would be presented in profit or loss for the same financial asset if it were measured at amortised cost, the same impairment model should be applied to both measurement categories.

However, the AASB has concerns that applying the IASB's proposed model to financial assets that are mandatorily measured at FVOCI would result in an amount being presented in other comprehensive income (OCI) that is not meaningful. The OCI amount would comprise fair value changes of the financial assets, excluding amounts presented in profit or loss for credit loss provisioning. The resulting OCI amount may not be readily understood by users.

The AASB also observes that the IASB's proposed model would require the recognition of a day-one loss for financial instruments that are mandatorily measured at FVOCI and at amortised cost but would not require the recognition of a day-one loss for financial assets that are measured at FVPL. The AASB has concerns about this inconsistency of measurement and the potential impacts on behaviour.

A number of Australian insurers have concerns with the effects of the proposals in the Classification and Measurement Exposure Draft and ED/2013/3. They are concerned that they would be required to measure high credit quality financial assets at FVOCI which are currently at FVPL. These financial assets are not currently subject to impairment testing and the entities do not have credit systems in place which could be readily adapted to calculate the loss provisions proposed in ED/2013/3. In addition, the cost burden of implementing credit systems that meet the requirements of ED/2013/3 for high credit quality financial assets (with reasonable and supportable evidence of a low probability of defaulting) might outweigh the benefit of calculating and presenting expected credit losses in the way in which is proposed in ED/2013/3. The AASB considers that, as a matter of principle, entities should be permitted not to recognise expected credit losses on financial assets measured at FVOCI when there is reasonable and supportable history and current information about the high credit quality of these financial assets, such that both (1) the fair value of the financial asset is greater than (or equal to) the amortised cost and (2) expected credit losses on such financial assets are insignificant. (This is similar to the expedient proposed by the FASB.)

Question 4
Is measuring the loss allowance (or 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?

The AASB has concerns with the operability of the IASB's proposed model. As discussed in the response to Question 2, many entities, including some banks, would not have existing credit systems in the manner that is described in ED/2013/3. The AASB was informed that even though banks, subject to Basel regulatory reporting, currently calculate and have information relating to 12-month expected loss for the purposes of prudential regulation, considerable adjustments on that 12-month loss information would be required to produce the 12-month expected credit loss calculation and information required by ED/2013/3. Accordingly, some adjustments to existing credit systems, or a new credit system for accounting compliance purpose would be necessary. In addition, most entities in Australia would not currently have credit systems and information to calculate a 12-month expected credit loss. Overall, the AASB considers that the proposed loss allowance measure at an amount equal to 12-month expected credit losses could be implemented but not without incurring significant costs. Modifications to the proposals in ED/2013/3 that might better achieve the IASB's desired objectives are set out in Appendix A of the AASB submission.

In addition, the AASB has concerns with the current wording of the definition of '12-month expected credit losses' in ED/2013/3. The proposed definition of '12-month expected credit losses' in ED/2013/3 is 'the expected credit losses that result from those default events on the financial instrument that are possible within the 12 months after the reporting date'. Paragraph B27 of ED/2013/3 clarifies that 'expected credit losses' are an estimate of the present value of all cash shortfalls *over the remaining life of the financial instrument*. It is not clear from the proposed definition in ED/2013/3 that 12-month expected credit losses are the expected shortfalls in contractual cash flows *over the life of the financial instrument* that will result if a *default event is expected to occur* in the 12 months after the reporting date. It would be useful if the IASB clarifies the definition in ED/2013/3 along the lines that the 12-month expected credit losses are the *expected cash shortfalls over the life* of the financial instrument *associated with the default event that is expected to occur in the next 12 months*. Furthermore, to avoid the risk of misinterpreting a 'default event that is expected to occur', it would be useful if the IASB clarifies that an expected default event is not when a cash shortfall occurs, rather it is the expected event (for example, a rise in unemployment and information of job loss) that could result in a future cash shortfall.

The AASB notes ED/2013/3 does not provide examples of default events. The AASB supports not providing such examples unless it is made clear that they may only apply in some circumstances. Otherwise, they can be interpreted as requirements, which may be inconsistent with an entity's credit risk management practice. The AASB considers that any concern about comparability could be addressed by requiring disclosures that explain the entity's policy of what constitutes a default event and why such definition is selected (as currently proposed in paragraph 39(a) of ED/2013/3).

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 the 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 the expected credit losses (or 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?

Appendix B

Detailed comments on ED/2013/3 *Financial Instruments: Expected Credit Losses*

(a) The AASB agrees that an entity should recognise a loss allowance (or a provision) at an amount equal to lifetime expected credit losses on the basis of an increase in the credit risk, but on a principle that credit risk has increased to an extent that the entity would no longer continue to accept the same or similar pricing or credit terms if it were to issue or purchase the financial asset at that point in time (as proposed in Appendix A of the AASB submission).

The AASB is not supportive of proposals that would require tracking the change in credit risk since initial recognition. As mentioned earlier, Australian entities do not typically track credit risk (i) from initial recognition; and (ii) on an instrument-by-instrument basis, but rather on an overall customer exposure at a point in time. The AASB has concerns that to track credit information since initial recognition would impose a cost burden that is likely to exceed any benefits to users. The AASB was informed that the changes in credit quality of a financial instrument from inception are currently not recorded within credit systems, and the performance of the instrument relative to its credit quality at inception is not an essential factor in the management of credit risk. Furthermore, as mentioned in Appendix A of the AASB submission, credit risk is a function of a borrowers'/debtors' ability to pay, and a borrower/debtor may have multiple contracts with an entity. An estimated cost of implementation is detailed in our response to Question 12(a).

(b) The AASB expects that some diversity would arise as a result of the degree of judgement involved in determining when to recognise lifetime expected credit losses and additional guidance would be unlikely to significantly reduce this diversity. The AASB considers that its proposed principle referred in its response to Question 5(a) above would provide some clarity when exercising judgement as to whether an entity should recognise lifetime expected credit losses. However, as mentioned in our response to Question 4, as the definition of lifetime expected credit losses includes the notion of a 'default event', the IASB should clarify that an expected default event is not when a cash shortfall occurs, rather it is the expected event (for example, a rise in unemployment and information of job loss) that would result in a future cash shortfall.

(c) The AASB agrees 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 the expected credit losses (or loss given default ('LGD')).

(d) The AASB does not fully support the proposed operational simplifications.

Investment Grade assets

The AASB considers this proposed simplification of 'investment grade assets' or instruments with 'low credit risk' may delay the recognition of lifetime loss depending on how the guidance is interpreted. The proposed definition of 'low credit risk' is if a default is not imminent and any adverse economic conditions or changing circumstances may lead to, at most, a weakened capacity of the borrower to meet its contractual cash flow obligations on the financial instrument. The AASB considers this proposed simplification could be applied inconsistently because it depends on how an entity interprets when a default is *imminent*. An instrument can be of high credit risk, yet a default may not be imminent. Conversely, an instrument can be of low credit risk, but a default may be imminent. In addition, some entities may regard a credit-rating adjustment of AAA to BBB to be a significant credit deterioration if it no longer meets the entity's 'low credit risk' definition. However, other entities may take a different view.

'30 days past due' rebuttable presumption

The AASB is of the view that the proposed rebuttable presumption that a significant increase in credit risk has occurred when payments are more than 30 days past due, if no other borrower specific information is available, is likely to be rebutted in many cases and therefore would have little use or meaning. Instead there could be more dependence placed on disclosure of the entity's policy for determining changes in credit risk.

Suggested alternative simplifications

An alternative simplification, as mentioned in our earlier responses, would be to introduce a principle that entities should be permitted not to recognise expected credit losses on financial assets measured at FVOCI when there is reasonable and supportable history and current information about the high credit quality of these financial assets, such that both (1) the fair value of the financial asset is greater than (or equal to) the amortised cost and (2) expected credit losses on such financial assets are insignificant. (This is similar to the expedient proposed by the FASB.) This principle would be particularly beneficial for entities that invest primarily in very low credit risk financial assets, such as some Australian insurers, (assuming that such financial assets are not measured at FVPL).

(e) The AASB agrees that the model should be symmetrical such that it requires 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. However, the AASB has concerns that, in practice, entities may more readily move into recognising lifetime expected credit losses compared with a move back to 12-month expected credit losses.

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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) The AASB would prefer a gross approach as it is not convinced that there are circumstances when interest revenue calculated on a net carrying amount (amortised cost) can provide more useful information. The AASB does not consider the IASB has provided paragraph BC99 sufficient rationale for such an interest rate calculation. Furthermore, the AASB was informed about the system challenges in performing such a calculation. Instead of the proposed net carrying amount calculation, the AASB was informed that the non-accrual approach, similar to the FASB's proposal, is consistent with current practice[3] and regulatory reporting. The AASB considers that the IASB should be consistent with its current thinking in their revenue joint-project with the FASB when considering the presentation method.

(b) Consistent with our response to Question 6(a), the AASB does not believe the IASB provided sufficient rationale to justify its proposal to require presentation of interest revenue on a net basis for financial instruments that have objective evidence of impairment. The AASB recommends that the IASB consider a presentation requirement that is consistent with its joint-project on revenue with the FASB.

(c) The AASB agrees if both gross and net approaches are adopted the approach should be symmetrical such that the calculation can revert back to a calculation on the gross carrying amount.

[3] In general, banks manage impaired loans on a non-accrual basis, that is, they cease recognising interest revenue, and change their credit risk management focus from earning a yield to recovering outstanding contractual cash flows.

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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) The AASB broadly agrees with the proposed disclosures. However, the AASB is of the view that the disclosure requirements could be burdensome and costly for smaller financial institutions and non-financial entities to prepare.

In particular, the following disclosures raised concern that the cost to preparers may outweigh any benefit to users:

- the reconciliation from opening to closing balances of the gross carrying amount and loss allowance (or provision) of financial assets with 12-month expected credit loss recognised; lifetime expected credit loss recognised, objectively impaired financial assets and purchased or originated credit-impaired financial assets (paragraphs 35). As an alternative, the AASB suggests that the gross carrying amounts and associated loss allowance (or provision) of those financial assets should be disclosed as at the opening and closing reporting dates;

- the nominal amount of financial assets written off that are still subject to enforcement activity (paragraph 37);

- the quantitative and qualitative analyses of significant positive or negative effects on the loss allowance caused by a particular portfolio or geographical area (paragraph 41); and

- the gross carrying amount of financial assets and provisions for loan commitments and financial guarantee contracts by credit risk rating grades (by at least three grades even if the entity uses fewer credit grades internally) (paragraph 44).

The AASB also has concerns about paragraph 32 of the Exposure Draft which proposes to allow entities to incorporate disclosures by cross-reference from the financial statements to some other statement such as a risk report that is available to users of financial statements on the same terms and at the same time as the financial statements. The AASB considers that disclosures deemed sufficiently important as to be required by an accounting standard should be included within the financial statements themselves. Incorporation of disclosures by cross-reference could also lead to operational issues concerning the audit of such information, if the cross-referenced statement is not already subject to audit in a particular jurisdiction.

(b) Many entities would not have the requisite systems in place to provide the proposed disclosures.

(c) The AASB does not believe there is any other disclosure that should be required that would provide more useful information and justify the additional cost.

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?

In principle, the AASB agrees with the logic that, for credit loss provisioning purposes, the model should be applied to financial assets that are modified but not derecognised, as if the same financial asset continued to exist.

However, the AASB is concerned the implication is that for a financial asset that is derecognised as a result of a modification, the proposals appear to require the modified financial instrument to then be treated as a new instrument. Accordingly there could be no 'significant deterioration' from initial recognition, hence only '12-month expected credit losses' could be recognised.

This gives rise to a potential inconsistency with the initial recognition of purchased credit impaired financial instruments, for which no credit loss would be initially be recognised. This could be avoided if the possible modifications proposed in Appendix A of the AASB submission are adopted instead.

The AASB also has concerns with the operability of the proposed requirements for non-financial entities that routinely modify numerous financial instruments, such as telecommunications entities. It is likely that the proposals, if adopted, could be burdensome for those entities to monitor modifications and shift loss recognition between 12-month and lifetime expected losses.

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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) The AASB agrees that the model should also apply to loan commitments and financial guarantee contracts.

(b) Consistent with our earlier responses, the AASB expects that smaller financial and non-financial institutions could face significant operational challenges in implementing this model due to its complex nature.

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) Consistent with our earlier responses, the AASB considers the proposed simplification for trade and lease receivables that permits the recognition of a lifetime expected credit loss upon initial recognition does not faithfully represent the underlying economics of such transactions. Possible modifications to this proposal that might better achieve the IASB's desired objectives are set out in Appendix A of the AASB submission.

In addition, the AASB does not expect that the proposed simplifications for trade receivables and lease receivables would alleviate the operational burden since a calculation of expected loss on a lifetime basis would still be required. For many entities this would require new systems to be developed in order to capture the relevant information and perform the calculations.

The AASB also does not agree with permitting an entity to make an accounting policy election for trade and lease receivables that contain a financing component. The Board believes that the model should be applied consistently with other types of financial asset. The AASB also considers comparability of information would be reduced by some entities applying the dual-measurement model and some applying the single-measurement model within the same industry due to allowing an accounting policy choice that does not faithfully represent the underlying economics of transactions.

(b) Consistent with earlier responses, the AASB considers that recognition of a lifetime expected loss on initial recognition for trade and lease receivables with no significant financing component does not reflect the underlying economics of the transaction. The AASB considers the model should be applied consistently with other types of financial asset.

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?

Consistent with the response to Question 8 above, the AASB notes the potential inconsistency in initial recognition of financial assets that are credit-impaired on initial recognition and the apparent requirement to recognise 12-month expected credit losses on financial instruments that were modified and subsequently derecognised. The Exposure Draft does not provide an explanation for this.

The AASB considers that the same model should be applied consistently to financial instruments whether originated or purchased. Notwithstanding this view, the AASB considers that the proposals in the Exposure Draft to not recognise credit losses at initial recognition on the purchase of a credit impaired financial asset is more representative of the underlying economics because the purchase price of the financial asset would have taken expected credit risk into consideration . The AASB therefore questions why this is the case for purchased credit impaired financial instruments and not for originated financial instruments.

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?

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(a) The lead time for the proposed requirements would depend on the final form of the model. If the model were to require tracking of credit risk at an instrument level from initial recognition, the lead time would be longer than if a model is introduced which does not require such tracking.

The AASB was informed by one Australian bank that participated in the field-testing of ED/2013/3 that implementing the proposed model in its current form would require significant system build/modifications. The establishment of systems according to the requirements of ED/2013/3 (including plan, develop, test and implementation of the new system) would cost approximately USD 50 million and would require 24-30 months to complete.

Insurers are likely to hold a significant quantity of financial assets that will be accounted for under IFRS 9 when mandatory; therefore it could be cost effective for insurers to implement any change to insurance contract accounting and financial instruments simultaneously. However, the AASB does not recommend delaying the effective date of IFRS 9 if the insurance standard were to be deferred. Instead, the AASB considers the IASB should attempt to complete its project on insurance contracts sooner to align with IFRS 9.

(b) The AASB is concerned about the transition requirements to allow a loss allowance equal to lifetime expected losses to be recognised for financial assets for which it is not possible to determine (without undue cost and effort) whether the credit risk has increased significantly since initial recognition. This could result in excessive provisioning which would be released to profit or loss in a subsequent reporting period, artificially inflating profit. The AASB considers that this could be avoided by the IASB considering a possible modification, which does not require credit risk at initial recognition to be known, suggested by the AASB in Appendix A of our submission.

(c) The AASB expects that determining comparatives for restatement without the use of hindsight would be challenging in practice. Therefore, the AASB agrees with the proposed relief from restating comparatives on transition, however, if an entity does restate comparatives this fact should be disclosed.

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

The AASB is aware that the IASB is undertaking field testing of the proposed model, in which one Australian bank has participated. The AASB was informed of the findings of the participating Australian bank, and our response to Question 12(a) has been framed with these in mind. Without the results of such testing it is not possible to fully determine what the effects of the proposals would be.

In Australia, it may be the case that application of the proposed model would not significantly increase the total amount of loss provisioning recognised by entities as the provisioning for financial assets to which '12-months expected loss' is recognised may be lower than at present, and the provisioning for financial assets to which lifetime losses is recognised may be greater. The overall impact may vary by entity.

The AASB agrees with the comment in paragraph BC201 that the implementation of the expected credit loss approach will require substantial system changes, time and resources resulting in significant costs for most entities including financial institutions that are already calculating expected credit losses for regulatory purposes. In particular, significant costs would be expected to be incurred in developing systems to track change in credit risk by instrument from initial recognition.

It is not clear that the benefit to users of the information that would be provided as a result of ED/2013/3, without modification, would outweigh those significant costs. However, the AASB does believe that the modifications it has recommended in Appendix A will overcome this.