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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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International Accounting Standards Board
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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

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

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.)

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

		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.

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		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.