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ED237 Financial Instruments: Expected credit losses

Dear Sirs

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

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

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

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

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

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

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

Yours faithfully

Peter Wells