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5 July 2013

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

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

Dear Sir

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

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

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

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

We have the following general comments on the ED:

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

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

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

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

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

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

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

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

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

Yours sincerely

Marc Smit

Head of Group Accounting Policy

APPENDIX – Response to Specific Questions

Objective of an expected credit loss impairment model

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

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

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

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

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

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

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

The main proposals in the Exposure Draft

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

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

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

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

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

Scope

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

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

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

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

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

12-month expected credit losses

Question 4
Is measuring the loss allowance (or a provision) at an amount equal to 12-month expected credit losses operational? If not, why not and how do you believe the portion recognised from initial recognition should be determined?

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

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

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

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

Assessing when an entity shall recognise lifetime expected credit losses

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Interest revenue

Question 6
(a) Do you agree that there are circumstances when interest revenue calculated on a net carrying amount (amortised cost) rather than on a gross carrying amount can provide more useful information? If not, why not, and what would you prefer? (b) Do you agree with the proposal to change how interest revenue is calculated for assets that have objective evidence of impairment subsequent to initial recognition? Why or why not? If not, for what population of assets should the interest revenue calculation change? (c) Do you agree with the proposal that the interest revenue approach shall be symmetrical (i.e. that the calculation can revert back to a calculation on the gross carrying amount)? Why or why not? If not, what approach would you prefer?

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

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

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

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

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

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

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

Disclosure

Question 7
(a) Do you agree with the proposed disclosure requirements? Why or why not? If not, what changes do you recommend and why? (b) Do you foresee any specific operational challenges when implementing the proposed disclosure requirements? If so, please explain (c) What other disclosures do you believe would provide useful information (whether in addition to, or instead of, the proposed disclosures) and why?

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

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

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

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

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

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

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

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

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

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

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

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

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

Question 8
Do you agree with the proposed treatment of financial assets on which contractual cash flows are modified, and do you believe that it provides useful information? If not, why not and what alternative would you prefer?

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

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

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

Application of the model to loan commitments and financial guarantee contracts

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

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

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

Exceptions to the general model

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

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

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

Financial assets that are credit-impaired on initial recognition

Question 11
Do you agree with the proposals for financial assets that are credit-impaired on initial recognition? Why or why not? If not, what approach would you prefer?

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

Effective date and transition

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

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

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

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

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

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

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

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

Effects analysis

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

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

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