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By post and email: commentletters@hkicpa.org.hk

Mr. Simon Riley
Director, Standard Setting
Hong Kong Institute of Certified Public Accountants
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HKICPA

Dear Mr. Riley

IASB's Exposure Draft of Financial Instruments: Expected Credit Losses

We refer to your letter dated 8 March 2013 inviting our comments on the International Accounting Standards Board's Exposure Draft of Financial Instruments: Expected Credit Losses.

Our comments on the specific questions raised in the exposure draft are attached. Should you have any questions, please do not hesitate to contact our Assistant Manager, Mr. Timothy Tam, at 2526 6080.

Yours sincerely

Boey Wong
Secretary

Enc.

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Vice Chairmen Bank of China (Hong Kong) Ltd
The Hongkong and Shanghai Banking Corporation Ltd
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Responses of the Hong Kong Association of Banks ("HKAB") to Specific Questions in the International Accounting Standards Board's Exposure Draft on Financial Instruments: Expected Credit Losses

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?

We have consistently supported the earlier provisioning of credit losses to address the "too late/too little" problem that was evident during the financial crisis. While we have not previously supported the expected credit loss models in the IASB's earlier exposure drafts due to practical and operational concerns over implementation, we recognize that an expected credit loss methodology has strong theoretical support. While we continue to believe that the proposals in the IASB's Exposure Draft *Financial Instruments: Expected Credit Losses* (the "ED") will require significant time and effort to implement and will likely result in significant diversity in practice, we are prepared to accept the general direction the ED takes.

We believe that recognizing *lifetime expected credit losses* only after a significant deterioration in credit quality is a reasonable approximation of the economic link between the pricing of financial instruments and the credit quality at initial recognition. The pricing on a financial instrument that has experienced a significant deterioration in credit quality is no longer adequate to absorb expected losses. Therefore, it is appropriate for *lifetime expected credit losses* to be recognized in profit and loss at such time. While credit deterioration and the associated inadequacy in pricing may happen gradually, we believe the proposed model is adequate to reflect in a pragmatic way the economic linkage between pricing and credit deterioration.

As acknowledged by the IASB, the requirement for *12-month expected credit losses* has no conceptual basis as it will result in a "day one" loss for newly originated financial instruments even when those instruments are fairly priced. We recognize, however, that this will serve to provide a minimum level of loss allowance and reduce the "cliff effect" that would otherwise result from moving to *lifetime expected credit losses* without the initial recognition of *12-month expected credit losses*. It would be helpful if the IASB expanded on the reasons for this requirement in the basis for conclusions to the final standard.

We have the following technical comments on the ED:

Three-Stage Model

The summary to the ED states that there are three stages in the main proposals to reflect the general pattern of the deterioration in credit quality of a financial instrument. Stage 1 includes financial instruments that have not deteriorated significantly in credit quality since initial recognition or that have low credit risk at the reporting date. Stage 2 includes financial instruments that have deteriorated significantly in credit quality since initial recognition (unless they have low credit risk at the reporting date) but that do not have objective evidence of a credit loss event. Stage 3 includes financial assets that have objective evidence of impairment at the reporting date.

This summary is inconsistent in itself and is not clearly discernible from the actual text of the ED. Stages 1 and 2 refer to financial instruments while Stage 3 refers to financial assets. Stage 2 excludes financial instruments that do not have objective evidence of a credit loss event but Stage 3 includes only financial instruments with objective evidence of impairment. It is not clear that there is a difference between a credit loss event and objective evidence of impairment. It would be helpful if the ED specifically referred to the 3 stages. More importantly, there needs to be clarification as to what Stage 3 represents.

The IASB has substantially retained the same definition of objective evidence of impairment as is currently in IAS 39. However, what has changed between IAS 39 and the ED is that "incurred but not reported losses ("IBNR") has been eliminated from the list of examples of events that provide objective evidence of impairment. Eliminating an example does not change the definition. IBNR was always logically included in the definition of objective evidence of impairment based on the fact that historical experience will indicate that loss events will have occurred that are not yet known at the reporting date. It is the occurrence of the loss event that defines objective evidence of impairment not whether it has emerged or not. An IBNR is inherent in the definition of "objective evidence of impairment." The final standard should specifically state that IBNR is excluded from the definition of objective evidence of impairment and thus not included in Stage 3 losses.

Discount Rate

The ED allows a choice of discount rates (i.e., any reasonable rate that is between (and including) the risk-free rate and the effective interest rate) to be used when discounting expected credit losses. The appropriate discount rate should be considered in the context of the definition of credit losses in the ED. A credit loss is defined in the ED as the present value of the difference between all contractual principal and interest cash flows and all the cash flows the entity expects to collect. Contractual cash flows include all future interest payments, while accounting accrues for interest overtime. Therefore, the carrying value of a financial asset at any point in time does not reflect future interest. If a discount rate lower than the effective interest rate (e.g., credit adjusted interest rate) is used for discounting then the discounted value of expected credit losses could exceed the carrying value because the present value of lost contractual interest payments would be greater than zero. The use of a credit adjusted interest rate makes sense only in the context of an expected cash flow model where there are multiple outcomes including both loss and no loss scenarios. The expected loss methodology under the ED is not an expected cash flow model.

The IASB is proposing to permit a choice of discount rates as an operational expedient given that many entities do not currently calculate a theoretically pure effective interest rate for each financial instrument. However, while some entities do make operational simplifications in calculating effective interest rate (e.g., amortizing discounts and fees on a straight line basis), the effect of such simplifications should be assumed to be immaterial. In addition, we do not understand why a choice of discount rates would result in useful information to users of financial statements. This would lead to diversity in practice that would reduce comparability. The rate used to discount expected losses should be aligned with the rate the entity uses to accrue interest (which should approximate the effective interest rate of the instrument).

Assessment on a Portfolio Basis

Paragraph B17 states that an entity may perform the assessment of whether there has been a significant increase in credit risk on a collective basis. However, the collective assessment is only permitted if the financial instruments have shared risk characteristics that are indicative of the borrowers' ability to pay all of the amounts due in accordance with the contract terms. We believe that this criterion is too restrictive and is inconsistent with how loans are managed on a portfolio basis. Financial instruments can be aggregated into a portfolio on the basis of shared characteristics that drive losses in a portfolio. However, where entity specific credit information is not available, it is not possible to conclude that the shared risk characteristic actually relates to the ability of each specific underlying borrower to pay. For example, losses in a mortgage portfolio may be driven by unemployment rates and collateral values. In any mortgage portfolio, there will be borrowers whose ability to pay is completely independent of unemployment rates or collateral values (e.g., where the borrower has other sources of wealth). Under the restrictive criteria of paragraph B17, it is not clear that a portfolio assessment could be performed using typical portfolio risk drivers. We suggest that the criteria in paragraph B17 be revised such that a collective assessment is permitted where the financial instruments have shared characteristics that are indicative of the credit quality of the portfolio as a whole (i.e. characteristics that drive portfolio credit losses but not necessarily pertain to changes in the credit risk of specific instruments).

Terminology

We find that the terminology used in the ED is often confusing and inconsistent. For example, there are inconsistent references to financial instruments versus financial assets. The ED refers a number of times to a credit loss event and default, which are not defined in the ED.

Paragraph 27 of the ED requires an entity to present impairment losses (including reversals of impairment losses or impairment gains) as a separate line item in the statement of profit or loss and other comprehensive income. It is not clear whether "impairment losses" are limited to losses resulting from "objective evidence of impairment" or relate to all credit losses (including *12-month expected credit losses* and *lifetime expected credit losses*). We suggest that the IASB separately define the profit and loss category that results from all credit losses and use that terminology separately from "impairment losses". The face of the statement of profit or loss should have one amount only that pertains to all credit losses. The proposed roll-forward disclosures of credit loss allowances by category will provide the break-down of the credit loss amount arising from the 3 Stages.

The definition of *credit loss* and *cash shortfall* is duplicative and confusing. Appendix A defines *credit loss* as "the present value of the difference between all principal and interest cash flows that are due to an entity in accordance with the contract and all the cash flows that the entity expects to receive." Paragraph B27 states "expected credit losses are an estimate of the present value of all cash shortfalls over the remaining life of the financial instrument" and then separately defines *cash shortfall.* Appendix A and Paragraph B27 should be aligned.

Collateralized financial instruments

Paragraph B32 states that the estimate of expected cash flows on a collateralized financial instrument considers the probability of a foreclosure and the cash flows that would result from it. It is not clear whether the cash flows from the collateral should be based on the fair value of the collateral at the reporting date or whether entities are expected to forecast the variability in future cash flows arising from collateral, which would create even greater complexity in implementing the standard.

(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 agree that recognizing *lifetime expected credit losses* at initial recognition does not faithfully represent the underlying economics of financial instruments. Such an approach ignores the fact that expected credit losses are priced into a financial instrument. The approach in the FASB exposure draft is based on such a methodology and will result in the recognition of excessive loss allowances based on lifetime losses for all assets regardless of their credit quality (resulting in the financial asset's carrying amount being below its fair value on origination). Forecasting *lifetime expected credit losses* for newly originated financial instruments will be highly speculative. While the ED also requires the recognition of *lifetime expected credit losses*, that requirement only applies to financial instruments which exhibit a significant decrease in credit quality since origination, a point at which the forecast of expected credit losses should be more accurate. In addition, the FASB model would tend to mask the deterioration (or improvement) in the credit quality of assets.

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?***

See response to Question 1(a).

(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)***

The 2009 ED utilized an expected cash flow methodology for all financial instruments measured at amortized cost, which would have required modelling all outcomes including outcomes without cash shortfalls. This ED models only *12-month expected credit losses* for all financial instruments within scope or *lifetime expected credit losses* when there has been a significant decrease in credit quality. So there has been some reduction in the extent of modelling required. However, the proposed standard still requires making significant judgments about the nature, severity and timing of future default events and requires tracking credit quality throughout the life of a financial instrument.

The SD added additional complexity with the use of floors and the calculation of weighted average lives. This ED does not include these and therefore represents a less complex approach to recognizing initial expected losses.

(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?***

See response to Question 1(b).

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 instruments 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?***

We generally agree with the scope of the proposed ED. In principle, financial instruments for which periodic income recognition is based on an amortized cost model should follow the same model for recognition of credit losses. However, there will be an apparent contradiction for financial instruments classified as FVOCI when the fair value of the instrument is above its amortized cost (after consideration of credit losses). In such situations, the ED would require *12-month expected credit losses* to be recognized in profit and loss and reversed in OCI. The reported credit loss expense would not be consistent with market expectations of future credit losses. This will be particularly true for highly rated debt securities for which most loss allowances will never ultimately be utilized. We would support the inclusion in the final standard of an exception (similar to the expediency exception in the FASB exposure draft) that would not require credit loss expense to be recognized when the observable fair value of an asset is above its amortized cost. However, we recognize that there are situations when market prices lag credit loss expectations of some market participants. The exception should not prevent an entity from recognizing expected credit losses when its view of credit losses in a financial instrument differs from the level of credit losses reflected in market prices for that instrument.

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?

Operational Concerns

We believe that given the differences between the Basel approach and the proposals in the ED, there will be significant challenges in reliably estimating lifetime expected credit losses. We have particular concerns, however, regarding the practicalities for banks that are using standardised or basic models under Basel in terms of obtaining reliable information beyond entity-specific delinquency rates. They do not have any existing infrastructure to leverage for purposes of calculating expected credit losses for financial reporting purposes. In addition, we believe that it would be helpful if the IASB could use terminology which is not so easily confused with the Basel terminology. This could help to avoid confusion for users (e.g. Basel "expected loss" disclosed in Pillar 3 documents would not be the same as "expected credit loss" for accounting purposes).

The building blocks for estimating expected credit losses under the proposals in the ED may appear superficially similar to those used for Basel II expected loss calculations (i.e. EL = PD x EAD x LGD). There are, however, substantial differences between the two models. These differences start with the regulatory approach having a built-in bias towards prudence. The proposals in the ED, on the other hand, are intended to represent economic events and circumstances in an unbiased and neutral manner that is suitable for general purpose financial reporting. There are numerous areas of detail in which the proposals in the ED differ from the regulatory approach. Examples include regulatory rules requiring:

- LGD to be based on a through-the-cycle, downturn scenario;
- Collateral to be calculated using prescriptive rules;
- Floors on PD and EAD;
- Definition of default to be in accordance with a regulatory definition (which may or may not be suitable for use in applying the proposals in the ED);
- Expected Loss to cover a one-year horizon.

While it is believed that in cases where an IRB(A) approach is used, some leverage off the Basel data and models may be possible; however, it is also clear that significant systems work will be required to modify the Basel process for use in applying the proposals set out in the ED. Other operational issues include forecasting the period in which a future credit loss might occur, which is necessary for reflecting the time value of money.

Paragraph AG84 in IAS 39 provides a practical expedient to measure impairment based on the fair value of an asset when there are observable market prices. This practical expedient is not reflected in the ED. We suggest that such an approach be included in the ED particularly where the financial asset has a variable interest rate whereby fair value changes can be more clearly attributed to changes in credit risk.

Definition of Default Event

The ED does not define *default event*, which is critical for determining which type of events would trigger 12-*month expected credit losses*. Absent a specific definition, entities might apply a narrow definition such as a cash shortfall as opposed to the loss event that resulted in the cash shortfall (such as a job loss). The cash shortfall may not occur within the 12 month period that the loss event occurs. Since the intention of the IASB is to capture events that result in future cash shortfalls, the definition of *default event* should be aligned with the types of events that provide objective evidence of impairment, which is already defined in the ED. Effectively, a *default event* should be a forecasted impairment event.

Definition of 12-month expected credit losses

The ED defines *12-month expected credit losses* as the expected credit losses that result from those default events on the financial instrument that are possible within the 12 months after the reporting date. It would be helpful if the IASB made the following matters much clearer in the implementation guidance:

- The 12 month period refers only to default events that are possible within 12 months. The expected credit losses are calculated by multiplying the probability of default occurring in the next 12 months by the lifetime expected losses that would arise from that default.
- The 12 month expected credit losses are not the expected cash shortfalls over the next twelve months. They are the effects of the entire credit loss on an asset weighted by the probability of default occurring in the next 12 months.

Assessing when an entity shall recognize 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?

We agree that a significant increase in credit risk since initial recognition is an appropriate trigger for recognition of *lifetime expected credit losses*. Given that the objective of the impairments project is to accelerate the recognition of credit losses, a significant increase in credit risk is a good indicator that expected credit losses may in fact be realized and such losses will be more accurately determined than they would have been at origination. In addition, at the point in time where there has been a significant increase in credit risk, the contractual interest payments would be insufficient to absorb expected credit losses.

(b) Do the proposals provide sufficient guidance on when to recognise lifetime expected credit losses? If not, what additional guidance would you suggest?

Significant Deterioration

The ED does not define significant deterioration, which may be difficult to do in any way that would not be overly restrictive. This may result in diversity in practice as some entities may consider a significant deterioration to have occurred only just prior to an impairment event. Other entities may choose a more prudent approach by recording *lifetime expected credit losses* significantly in advance of impairment events. The lack of a consistent definition may create challenges for auditors. The Basis for Conclusions justifies the approach based in part on how the fixed pricing of a financial instrument becomes inadequate as credit risk increases. However, as pricing contains many elements it is neither practicable to identify the credit spread in an instrument nor when the credit spread becomes inadequate because of a significant increase in credit risk. The IASB should emphasize that a significant deterioration in credit risk does not mean that a default is imminent.

Paragraph 6 states that an investment grade rating would be considered to be low credit risk. Paragraph IE32 provides an example of a financial instrument that is not low credit risk because, in part, it has been placed on negative watch list. An investment grade security could be on a negative watch list at the reporting date. Conversely, most would consider a rating downgrade from AAA to BBB to be "significant", even though BBB is still investment grade. In addition, the use of this example may cause some diversity in practice, as different countries have different definitions of "investment grade". The IASB should clarify whether or not it is providing a bright line test in paragraph 6.

Initial Credit Quality

The ED requires the recognition of *lifetime expected credit losses* if the credit risk on a financial instrument has increased significantly since initial recognition and the credit risk is not low. The IASB should clarify the point-in-time at which the initial credit quality of a loan should be used for determining whether credit risk has increased. In the case of lending under a facility, it is unclear as to whether the facility commitment date should be used or the individual draw down dates. We suggest that the facility commitment date should be used (which would also be the date on which the credit assessment was made to price the lending) otherwise the situation would become too complex when there are multiple draw downs. This complexity will also be present in the case of current accounts with overdraft facilities that may switch between asset and liability balances frequently.

(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?

We agree that the trigger for recognition of *lifetime expected credit losses* should be based on a change in probability of default rather than changes in the amount of expected credit losses. Given that the objective is to recognize losses earlier, the trigger should not be tied to the size of the losses being measured. Individual losses may not be significant but on a portfolio basis could be material.

It is likely that there will be financial instruments classified as having a loss allowance measured at *lifetime expected credit losses* when the actual loss allowance is nil because collateral is sufficient to cover contractual payments due. The IASB should consider linking the disclosures with existing collateral disclosures.

(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?***

Rebuttable Presumption

The ED includes a rebuttable presumption that the credit risk on a financial instrument has increased significantly when contractual payments are more than 30 days past due. Our understanding (based on the introduction to Question #5 and paragraph BC75) is that the intent of this provision is to require the calculation of *lifetime expected credit losses* only at the point where a financial instrument is more than 30 days past due in situations where there is no other borrower-specific information available, without undue cost or effort, to determine that there has been a significant increase in credit risk since initial recognition. (In other words, where there is an inability to otherwise assess a change in credit risk, *lifetime expected credit losses* are not recorded for an instrument that is current but only when the instrument becomes 30 days past due.) However, the actual text of the ED does not state this. Paragraph 9 of the ED states: "... However, there is a rebuttable presumption that the criterion in paragraph 5 is met when contractual payments are more than 30 days past due. This presumption is rebutted if other persuasive information is available that indicates that the credit risk has not increased significantly even though the contractual payments are more than 30 days past due." We have the following observations regarding this inconsistency:

- Paragraph 9 addresses only past due financial instruments; it does not address when the entity is unable to make a borrower-specific assessment for financial instruments that are current.
- Paragraph 9 makes no reference to "undue cost or effort". The reference to "undue cost or effort" is in paragraph 17(b) of the ED, which applies to the calculation of expected credit losses not the determination of whether there has been a significant increase in credit risk since initial recognition. (Paragraph 7 makes an ambiguous cross-reference to paragraph 9; however, this is not clear enough to conclude that paragraph 17(b) applies to the assessment of the change in credit risk.)
- The use of the term "rebuttable presumption" is not defined and does not have a clear meaning within an accounting context. Use of this term should be avoided, particularly as it may be interpreted differently in different markets and under different translations of IFRS.
- We suggest that paragraph 17(b) be made clearly applicable (with appropriate changes) to both the assessment of the change in credit risk and the calculation of expected credit losses.
- Paragraph 9 refers to persuasive information regarding credit risk. BC75 refers to entity specific information. The IASB should clarify whether credit risk assessed on a portfolio basis is entity specific information and/or persuasive information.
- The final sentence of paragraph 9, as drafted, requires there to be "no causal link" between "more than 30 days past due" and a "significant increase in the probability of default". This could lead to somewhat fruitless discussions in the sense that all assets which default (and on which losses are suffered) become 30 days past due at some point.

- We suggest that paragraph 9 be re-drafted in its entirety to state that when an entity is unable to determine whether there has been a significant deterioration in credit risk for a financial instrument (in accordance with the criteria in paragraph 17(b)), then the entity does not calculate lifetime expected losses for that instrument until, and if, that instrument becomes more than 30 days past due, at which point it should calculate *lifetime expected credit losses.*

The introduction to Question 5 in the ED presents this rebuttable presumption as an operational simplification. However, paragraph BC75 appears inconsistent as to whether the rebuttable presumption is an operational simplification or intended "to ensure that the criterion does not revert to an incurred loss notion", which would be the case if lifetime expected losses were only taken when assets were significantly past due (e.g., 150 days past due). To the extent that the rebuttable presumption is intended to represent an operational simplification, we question to what extent entities will actually be able to avail themselves of this simplification. In other standards, IFRS allows for exceptions and expedients where historical information is not available to meet the criteria of a particular standard. The existence or non-existence of historical information is generally a fact that an auditor can conclude on. However, in the context of a forward looking assessment such as credit risk, we believe it may be difficult to support that the assessment cannot be made given that data points for a credit risk assessment (e.g., unemployment rates, GDP, collateral values, etc.) are typically readily available, at least on a portfolio basis, in most markets. On the other hand, the standard needs demand sufficient quality from preparers to avoid a "dive to the bottom", where entities simply ignore the potential for losses on financial instruments that are current. We suggest that the IASB take these concerns into consideration when redrafting paragraph 17(b) which should provide clear criteria by which it can be concluded that an entity is unable to determine a significant deterioration in the credit risk of a financial instrument. (Please refer to our response to Question 10(a) suggesting the use of a provision matrix as an operational expediency.)

Low Credit Risk

We agree that financial instruments that have low credit risk should not carry a loss allowance equal to *lifetime expected credit losses*. We see this as consistent with the overall approach of the ED as a decrease in credit quality of a financial instrument that otherwise remains as a low credit risk should not be considered to have had a significant increase in credit risk.

Additional clarification could be provided around the definition of low credit risk. The existing definition states: "the credit risk is low if a default is not imminent and any adverse economic conditions or changing circumstances may lead to, at most, a weakened capacity of the borrower to meet its contractual cash flow obligations on the financial instrument." The imminent time period is undefined and may be interpreted differently by different entities. It is not clear whether the reference to adverse circumstances relates only to the imminent time period or beyond. In addition, it is not clear where the line is between those financial instruments that have low credit risk and those that do not have low credit risk. On the one hand, the criteria for low credit risk may be too easily met if expectations of default beyond the "imminent" period would still result in a financial instrument being categorized as having low credit risk. On the other hand, even the best quality borrower may fail its obligations so requiring that there be no expectation of default could result in all financial instruments being classified as other than low credit risk.

(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?***

We support the proposal to reverse as this reflects the underlying economics of a lending business. However, we believe that there will be situations where comparing the original probability of default to the current probability of default after the financial instrument has moved to Stage 2 or Stage 3 will be difficult. For instance, if a financial instrument was initially evaluated for changes in credit risk based on a portfolio approach, it would be difficult to compare the original credit risk characteristics from a portfolio to the specific credit characteristics of an individual instrument that has reached Stage 2 or Stage 3. In order to mitigate the significant data tracking that would be required, we suggest that the final standard permit an expediency whereby financial instruments that have migrated to Stage 2 or Stage 3 may be assessed for changes in credit risk (i.e., changes that would result in the financial instrument moving back into Stage 1) by reference to currently originated instruments of the same nature.

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?***

We agree that interest income should cease being accrued on a gross basis when an asset is considered impaired. This is consistent with the existing requirement to discount any remaining expected cash flows based on the original EIR, which results in lower reported interest income.

(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?***

We agree that impairment should be the trigger for a change in interest income recognition. The proposed requirement to recognize *lifetime expected credit losses* in certain circumstances should not trigger a change in interest income recognition as the losses at such a point remain speculative. To cease interest recognition at such a point would be distortive.

(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?***

Yes. We believe that this is consistent with the current approach that calculates interest based on the remaining expected cash flows.

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?***

The disclosures include both quantitative requirements and qualitative descriptions of key assumptions and judgments. In the case of banks, the level of granularity of such disclosures will itself be a significant judgement, but it is inevitable that some of the proposed disclosures will be onerous and will require new systems solutions to be developed.

Paragraph 31 states that other standards may require disclosures that may satisfy the disclosure requirements in accordance with the ED. Entities need not duplicate the information and are permitted to cross-reference to these disclosures. We believe that the IASB should avoid creating duplicative requirements within its standards rather than leaving the matter to preparers to resolve.

(b) ***Do you foresee any specific operational challenges when implementing the proposed disclosure requirements? If so, please explain.***

Paragraph 44 requires disclosures of gross carrying amounts of financial assets by *credit risk rating grade* and requires that a minimum of three grades be used even if the entity uses fewer grades. However, the ED specifically permits the assessment of an increase in credit risk on a collective basis. Financial instruments assessed for a significant increase in credit risk on a portfolio basis would not be credit scored. Indeed, in current practice many financial instruments are not individually credit scored throughout their life, particularly in consumer portfolios.

This disclosure requirement might result in the need for smaller financial institutions, which may not use any specific credit grade system (but rather set minimum thresholds for external credit rating, income levels, collateral levels, etc.), to create a credit grade system. This would be a situation where accounting requirements are creating information, not reporting it.

The proposed disclosure requirement is inconsistent with both existing practice and the requirements in the ED. The specific disclosure requirement should be eliminated in favour of a more qualitative disclosure on how credit changes have arisen and been recognized.

(c) ***What other disclosures do you believe would provide useful information (whether in addition to, or instead of, the proposed disclosures) and why?***

We believe that the proposed disclosures are already very comprehensive, perhaps overly so. We have some concern that the bigger picture in terms of what are the drivers of credit quality and expectations at the reporting date could be overlooked.

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

Question 8

Do you agree with the proposed treatment of financial instruments 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?

The ED proposes to treat modified financial instruments that do not result in de-recognition differently than financial instruments that do result in de-recognition due to a modification. We agree that a modified financial asset should retain the original EIR and, when assessing whether there has been a significant increase in credit risk, that the credit risk at the reporting date should be compared to the credit risk at initial recognition under the original unmodified terms. However, the de-recognition rules under IFRS 9 do not provide guidance on when, if ever, a modified financial asset should be de-recognized and a new financial asset recognized reflecting the modified terms. The current de-recognition criteria under IFRS 9 states that an asset should be derecognized when either the contractual rights to the cash flows from the financial asset expire or the asset is transferred and meets the de-recognition criteria. The IASB should clarify what it is contemplating when making reference to derecognizing a financial asset as a result of a modification. We do not believe that the impairment standard should be delayed as a result of this, however.

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?***

In relation to commitments, there is an application issue in that the scope of the proposals in the ED is limited to situations where there is a present contractual obligation to extend credit. This implies that commitments that are unconditionally cancellable without notice (as is common for credit card facilities, for example) are not included in the expected loss model. It is questionable whether this will represent economic reality, because in practice, borrowers will often utilise the limits on their cards before the bank actually cancels or reduces the limit. By that point, the on-balance sheet loan is recognized and is subject to expected loss measurement, but it may be credit impaired at initial recognition. We suggest that the final standard allow for the recognition of expected credit losses on lending facilities when it is probable that the facility will be drawn down, even when there is not a present contractual obligation to extend credit.

(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.***

There may be practical difficulties in estimating the amounts and timing of draw downs, particularly where there is limited past experience with specific types of lending or borrowers.

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?***

We agree with the simplified approach for trade receivables and lease receivables which requires measuring the loss allowance at an amount equal to the lifetime expected losses for trade receivables and permits the option to do so for lease receivables. Given that many trade receivables have tenors less than one year, the simplified approach should result in impairment allowances that are comparable to the full approach proposed in the ED.

We believe that a provision matrix (similar to the simplified approach for trade receivables) that calculates *lifetime expected credit losses* should be optional for all financial instruments. The credit loss provision would be based on historical loss rates adjusted for forward looking information and time value applied against both the current and past due categories of financial instruments. This would eliminate the need to track changes in credit quality but would avoid a "dive to the bottom" because it would require the recognition of *lifetime expected credit losses* for any financial instrument for which an entity elected to not track changes in credit risk.

(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?***

We agree with the proposal to amend IFRS 9 to measure trade receivables that have no significant financing component at the invoice amount on initial recognition. However, clear guidance should be provided on what constitutes a significant financing component.

Question 11

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

IFRS 9 requires that financial instruments be recorded at fair value upon initial recognition. The IASB should clarify that the initial estimate of lifetime expected credit losses is implicit in the fair value of the financial asset at initial recognition.

The ED proposes that the cumulative change in *lifetime expected credit losses* since initial recognition be reflected as a loss allowance for purchased or originated credit-impaired financial instruments. The amount of change is recognized in profit and loss even if the cumulative change in lifetime expected credit losses are positive and exceed the amount of expected credit losses that were included in the estimated cash flows on initial recognition.

We agree that the loss allowance for such financial instruments should be reversed even if the cumulative changes are positive. This will reflect the latest estimates of the collection of contractual cash flows. However, where the cumulative changes exceed the initial amount of expected credit losses, the loss allowance should be eliminated and the gross carrying amount increased as appropriate. Otherwise, a debit balance will result in the loss allowance as it pertains to the financial instrument in question, which would understate aggregate credit loss allowances on all other financial instruments.

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.***

Given the significant system and process changes that would be required to implement the proposals in the ED, we believe that an effective date no earlier than 1 January 2017 would be appropriate. This assumes that a standard is finalized by the end of 2013. We believe that IFRS 9 should have an effective date that is consistent with the impairments standards because the financial instruments that will be subject to the impairments standard will be dependent on the criteria in IFRS 9.

In determining an implementation date, the IASB should give consideration to the ability of both large and small entities to meet the significant operational challenges that will arise from adopting a new standard. Time should also be allowed to determine the regulatory capital impact of the proposed model and for any potential realignment of regulatory capital rules with the final standard.

(b) ***Do you agree with the proposed transition requirements? Why or why not? If not, what changes do you recommend and why?***

We support the exception from restating prior periods. Given the proposed requirements in the ED to consider the deterioration in credit risk over the life of a financial asset, restating prior periods would require an historical assessment that would be impractical for many entities.

The ED provides that if, at the date of initial application, determining the credit risk at the initial recognition of a financial instrument would require undue cost or effort, then the credit loss allowance would be determined only on the basis of whether the credit risk is low. The "undue cost or effort" criterion is something that many entities would feel uncomfortable using, and in practical terms, may not be acceptable to users. However, we are concerned that if the implementation timetable is relatively short, then entities will not have time to assess the PD's of instruments at initial recognition and will therefore have no option but to measure all financial instruments at *lifetime expected credit losses*. The credit loss allowance required could be significant and may have implications for capital adequacy. The Board should take this into consideration when setting the mandatory adoption date.

(c) ***Do you agree with the proposed relief from restating comparative information on transition? If not, why?***

Please see our comments on Question 12(b) above.

Effects analysis

Question 13

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

While the IASB has acknowledged the costs of implementation, we do not think that such costs can be understated. Accounting systems are designed to provide historical information; moving towards forward looking analyses will require significant process and system changes. The transition period must reflect this.