Hong Kong Institute of
Certified Public Accountants
香港會計師公會

Our Ref.: C/FRSC

Sent electronically through the IASB Website (www.ifrs.org)

15 July 2013

International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

Dear Sirs,

IASB Exposure Draft of Financial Instruments: Expected Credit Losses

The Hong Kong Institute of Certified Public Accountants is the only body authorised by law to promulgate financial reporting, auditing and ethical standards for professional accountants in Hong Kong. We welcome the opportunity to provide you with our comments on this Exposure Draft. Our responses to the questions raised in your Invitation to Comment are set out in the Appendix for your consideration.

We generally support the objective of recognising earlier provisioning of credit losses to address the problem of recognising such losses too late or too little that was evident during the financial crisis. While we have not previously supported the expected credit loss models in the IASB's earlier exposure draft due to practical and operational concerns over implementation, we recognise that an expected credit loss methodology is a theoretically appropriate approach to impairment and the proposed model is seeking to make that theoretically appropriate approach operational.

We, however, are concerned that the approaches to meet the abovementioned objective taken by the IASB and by the US Financial Accounting Standards Board (FASB) are quite different. We consider the convergence in guidance on expected credit losses by the boards is critical to supporting well-functioning global capital markets.

As mentioned in our comment letter on the IASB Exposure Draft on Acquisition of an Interest in a Joint Operation (Proposed Amendment to IFRS 11), we are concerned on the recent frequency and number of limited-scope "quick fixes" from the IASB particularly in relation to standards which have not so long been finalised by the IASB. This places extra burden on national standard setters and preparers, especially if the quick fixes affect processes and necessitate computer system changes. This concern is particularly relevant to the impairment standard as, for preparers, the implementation cost and effort involved in changing processes and computer systems are expected to be significant. We therefore urge the IASB to ensure the standard is appropriately considered and field tested to ensure it is robust enough on finalisation to avoid later quick fixes.

37th Floor, Wu Chung House,
213 Queen's Road East, Wanchai, Hong Kong
香港灣仔皇后大道東213號胡忠大廈37樓

Tel電話: (852) 2287 7228
Fax傳真: (852) 2865 6776
(852) 2865 6603

Website網址: www.hkicpa.org.hk
Email電郵: hkicpa@hkicpa.org.hk

We also would recommend the IASB to raise our concerns on "quick fixes" to the IFRS Due Process Oversight Committee. We would suggest review of due process to assess whether there are additional activities that should be part of the due process (for example, in conducting a wide circulation of a near-final draft of the standard for fatal flaw review prior to finalisation) to help to reduce the subsequent need for quick fixes. In addition to consider parts of the due process currently in place which may not be working so well and could be improved in order to reduce the need for subsequent amendments to recently issued and effective standards.

If you have any questions regarding the matters raised in our submission, please contact Ambrose Wong, our Associate Director of Standard Setting at ambrose@hkicpa.org.hk.

Yours faithfully,

Simon Riley
Director, Standard Setting

Encl.

Hong Kong Institute of CPAs

Comment on IASB Exposure Draft of Financial Instruments: Expected Credit Losses

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 generally support the objective of seeking to recognise a portion of expected credit losses initially as a loss allowance (or provision) and lifetime expected credit losses when there is a significant deterioration in credit quality. We also believe that the model adopted in the final Standards should reflect the effects of changes in credit quality subsequent to initial recognition.

We note that the proposed model may not faithfully reflect the economic link between financial instrument pricing and the credit quality at initial recognition. However, we believe that the current proposals are a compromise between reflecting the underlying economics of a lending transaction and easing operational complexities, as compared with the 2009 IASB Exposure Draft.

We have the following concerns and improvement recommendations:

- Three-stage model

  The Exposure Draft proposes three stages to reflect the general pattern of deterioration in credit quality of a financial instrument. We are concerned that the coverage in the summary of the Exposure Draft may be internally inconsistent and may not be clearly discernible from the text of the Exposure Draft itself. 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 those financial instruments with objective evidence of impairment. It is unclear whether there is a difference between a credit loss event and objective evidence of impairment. It would be preferable if the Exposure Draft referred to the 3 stages specifically and more importantly, there needs to be clarification as to what Stage 2 and 3 represent.

  The IASB has substantially retained the same definition of objective evidence of impairment as currently set out in IAS 39. However, what has changed between IAS 39 and the Exposure Draft is that "incurred but not reported loss" ("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 and 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 a 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 IASB should consider to explaining in the final standard why IBNR is excluded from Stage 3 even though it is objective evidence of impairment.

- Discount Rate

  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 rate for each financial instrument. While some entities may make operational simplifications in calculating an effective interest rate (e.g. amortising discounts and fees on a straight line basis), the effect of such simplifications should be assumed to be immaterial. In addition, it is unclear why a choice of discount rates would result in useful information to financial statement users; this may lead to diversity in practice and, consequently, reduce comparability. We consider 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

  Assessment of whether there has been a significant increase in credit risk may be performed on a portfolio basis as stated in Paragraph B17. However, such portfolio 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.

  Financial instruments are often aggregated into a portfolio on the basis of shared characteristics. However, where entity-specific credit information is not available, it is not possible to conclude that the shared risk characteristics actually relate to the ability of each specific underlying borrower to service the loan and/or repay the principal. 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. Under the criteria of paragraph B17, it is unclear that a portfolio assessment could be performed using typical portfolio risk drivers.

  Accordingly, we would recommend the IASB to consider revising the criteria in paragraph B17 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 Exposure Draft is often confusing and inconsistent. For example, there are inconsistent references to financial instruments versus financial assets. The Exposure Draft refers a number of times to a credit loss event and default, which are not defined in the Exposure Draft.

  Paragraph 27 of the Exposure Draft 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 recommend the IASB to 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.

- Collateralised financial instruments

  Paragraph B32 states that the estimate of expected cash flows on a collateralised 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 generally consider that recognising a loss allowance or provision at initial recognition at an amount equal to lifetime expected credit losses, discounted using the original effective interest rate, may not faithfully represent the underlying economics of a financial instrument, as it ignores the fact that expected credit losses are normally priced into a financial instrument at initial recognition. Pricing is affected by the rates competitors are offering and also, in some countries and under certain circumstances, the maximum pricing permitted on loans may be controlled. The expected credit losses hence may not always be priced into a financial instrument at initial recognition. Also, in economic reality the credit losses do not generally occur immediately and are normally compensated by the interest margin recognised over time.

Moreover, by having to estimate the full amount of expected credit losses over a longer period, such a model would be more subjective and not necessarily operationally simpler compared to the proposed approach in the Exposure Draft. Such a model may also provide users with less relevant information about credit deterioration of financial assets.

Having said that, certain commentators in our jurisdiction support recording the lifetime expected losses immediately rather than as proposed in the Exposure Draft. They see the Exposure draft's approach will effectively defer their recognition until there has been a significant change in credit quality and therefore this is effectively when the loss is "incurred". Those commentators are also of the view that, even if the expected credit losses are already priced into a financial instrument, losses should be recognised immediately on loan origination as they are already expected to occur. Deferrals of losses may not meet the objective of recognising expected losses as soon as possible which is the main criticism of the "incurred loss model" and is the issue the revised standard is trying to address. The commentators who take the above view are in favour of a model similar to that proposed by the US Financial Accounting Standards Board as the objective is clearer and should be easier to apply in practice

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?

We generally consider that the current proposal of 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 is a compromise between reflecting the underlying economics of a lending transaction and easing operational complexities, as compared with the 2009 IASB Exposure Draft. Our concerns and comments are set out above. The costs of implementation will depend on the systems changes needed by each reporting entity and can be determined if adequate time is allowed for thorough field-testing.

(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 Exposure Draft and the Supplement Document (without the foreseeable future floor)?

The principal weakness of the 2009 Exposure Draft model was its significant operational complexity.

We generally believe that the approach in the current Exposure Draft represents a compromise between the faithful representation of underlying economics and the cost of implementation than the approach proposed in the 2009 IASB Exposure Draft and the Supplement Document (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?

We consider recognising a loss allowance at an amount equal to the lifetime expected credit losses from initial recognition, discounted using the original effective interest rate may not achieve a better balance between the faithful representation of the underlying economics and the cost of implementation than this Exposure Draft. Please refer to our response to Question 1(b).

Question 3

(a) Do you agree with the proposed scope of this Exposure Draft? If not, why not?

We consider the proposed scope of this Exposure Draft to be appropriate. In particular, we believe that the same impairment approach should apply for both loans and loan commitments as the objective for both exposures is the timely recognition of expected losses.

(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?

We consider that the expected credit losses of the financial assets should be recognised consistently across the board regardless of whether they are mandatorily measured at FVOCI or amortised cost in accordance with the Classification and Measurement Exposure Draft (whichever model is finalised by the IASB). We believe such accounting would enhance comparability among financial assets and also reduce complexity.

However, there will be an apparent contradiction for financial instruments classified as FVOCI when the fair value of the instrument is above its amortised cost (after consideration of credit losses). In such situations, the Exposure Draft would require 12-month credit losses to be recognised 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 utilised. 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 recognised when the observable fair value of an asset is above its amortised cost. However, we recognise that there are situations when market prices lag credit loss expectations of some market participants. The exception should not prevent an entity from recognising 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.

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?

We consider there may be operational challenges in reliably estimating lifetime expected credit losses given the differences between the Basel approach and the proposals in the Exposure Draft. There are concerns on the practicalities for banks that are using standardised or basic models under Basel in terms of obtaining reliable information beyond entity-specific delinquency rates. Preparers may not have existing infrastructure to leverage for purposes of calculating expected credit losses for financial reporting purposes.

Moreover, when there is a difference of approach proposed in the Exposure Draft, we would recommend IASB to consider using terminology which is not so similar and thus subject to ambiguity with the Basel terminology (e.g. Basel "expected loss" disclosed in Pillar 3 documents would not be the same as "expected credit loss" for accounting purposes under IFRS).

We note that 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, but that is a practical expedient which is not reflected in the Exposure Draft. We recommend IASB to consider including such an approach in the Standard particularly where the financial asset has a variable interest rate whereby fair value changes can be more clearly attributed to changes in credit risk.

We also note that the Exposure Draft does not contain a definition of "default event", which we believe is critical for determining which type of events would trigger 12-month expected credit losses. Without such a definition entities might apply a narrow approach such as a cash shortfall as opposed to the loss event that resulted in the cash shortfall. The cash shortfall may not occur within the same 12 month period that the loss event occurs. Since the intention of the IASB is to capture events that are likely to 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 Exposure Draft. A "default event" may effectively be a forecasted impairment event.

Moreover, the Exposure Draft 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 can clarify the following matters 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.

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 consider 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 to be appropriate. We believe that a significant increase in credit risk is a good indicator that expected credit losses may in fact be realised and such losses will be more accurately determined than they would have been at origination. In addition, the contractual interest payment would also be insufficient to absorb expected credit losses when there has been a significant increase in credit risk.

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

We recommend the IASB to consider including additional guidance in determining "significant deterioration". The lack of definition on "significant deterioration" may lead to diversity in practice as some entities may consider a significant deterioration to have occurred only just prior to an impairment event while other entities may choose a more conservative approach by recording lifetime expected credit losses significantly in advance of an impairment event. Such lack of a consistent definition may also create challenges for auditors.

We note that Paragraph 6 of the Exposure Draft states that an investment grade rating would be considered to be low credit risk and paragraph IE32 provides an example of a financial instrument that is not low credit risk because, in part, it has been placed on a 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 consider clarifying whether or not it is providing a bright line test in paragraph 6.

We also understand that the Exposure Draft would require 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. We recommend the IASB to 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 recommend that the facility commitment date may be used to avoid complicating the situation when there are multiple draw downs or in the case of current accounts with overdraft facilities that may frequently switch between asset and liability balances.

(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?

In addition to the changes in the probability of default occurrence, we recommend the IASB to consider whether the deterioration in quality of underlying collateral should also be considered in the assessment of when to recognise lifetime expected credit losses.

Also, 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 in reality will be nil because the collateral is sufficient to cover contractual payments due. The IASB should consider linking the disclosures with existing collateral disclosures.

We would also welcome the IASB to consider producing additional implementation guidance on deriving the "probability of default" to facilitate more consistent application and comparability of financial results across different entities.

Certain commentators in our jurisdiction have an alternative view that assessment of probability of default in substance represents an "incurred loss model" as the factors or evidence affecting the probability of default will be the same or similar to events that give objective evidence of impairment. Moreover, one of the events of objective evidence of impairment mentioned in paragraph 59 of the current IAS 39 is *"a breach of contract, such as a default or delinquency in interest or principal payments"* and this is in fact less stringent than the 30 days past due rebuttable presumption proposed in the Exposure Draft.

(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?

We generally agree with the proposed simplification for financial instruments with low credit risk and consider that the primary focus of the model should be on a significant increase in credit risk. Having said that, we have the following improvement recommendations:

- Rebuttable presumption

  The Exposure Draft 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. However, the actual text of the Exposure Draft does not state this. Paragraph 9 of the Exposure Draft 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 the 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 Exposure Draft, 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 changes 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 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. Paragraph BC 75 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, 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 Exposure Draft 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. 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 were 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 are typically readily available, at least on a portfolio basis, in most markets. On the other hand, the standard needs sufficient quality from preparers to avoid a "dive to the bottom", where entities simply ignores 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.

- 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 Exposure Draft 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 categorised 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 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, as this would enable both upside and downside changes in credit quality be recognised in a consistent manner using the same principles and criteria.

However, we believe that there may 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 may 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 recommend 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.

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 generally 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. We believe there are some financial assets that have deteriorated in credit quality to such an extent that presenting interest revenue on the basis of a gross carrying amount that reflects the contractual return would no longer faithfully represent the economic return.

Having said that, certain commentators in our jurisdiction commented that continued accrual of interest even on a net basis would appear imprudent and counter-intuitive. What the interest amount represents is unclear as the accrued interest would not represent contractual interest due. Those commentators consider the principles on interest recognition should be consistent as far as possible with those being developed under the revenue recognition project.

(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 with the proposal to change how interest revenue is calculated for assets that have objective evidence of impairment subsequent to initial recognition although such requirement may increase the complexity of the impairment model. As it would no longer be probable to collect the contractual cash flows in full when there is objective evidence of impairment, we consider continuing to recognise full interest in accordance with the contractual terms in such circumstances would not reflect the economic substance.

(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?

We agree with the proposal that the interest revenue approach should be symmetrical, as this would provide comparability in the ways entities account for similar items.

Question 7

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

We consider that the proposed disclosure requirements increase transparency and comparability. We consider that any approach that attempts to reflect expected credit losses will be subject to measurement uncertainty and will place greater emphasis on management's judgment and the quality of the information used. As such we acknowledge that there is a required need for increased understanding and transparency of the methodologies and assumptions made in those judgments.

We note that the proposed 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 judgment, but it is inevitable that some of the proposed disclosures will be onerous and will require new systems solutions to be developed. We are concerned that the proposed disclosure requirements may create practical difficulties for smaller-sized financial institutions and non-financial institutions.

We recommend the IASB to consider adopting a "through the eyes of management" approach to disclosure. This would cover how management determines the credit quality of their financial assets, how they track this quality over time (i.e. credit migration), how they determine their credit losses and how they assess the accuracy of their estimation process. We consider this approach may enable a cut back on the overly prescriptive and voluminous disclosures that are currently proposed.

We have also the following improvement recommendations:

- We note that paragraph 31 of the Exposure Draft states that other standards may require disclosures that may satisfy the disclosure requirements in accordance with the Exposure Draft. Entities should not duplicate the information and should be permitted to cross-reference to these disclosures. We believe that the IASB should avoid creating duplicate requirements within the standards.

- We are concerned that the proposed requirement to disclose reconciliation of the gross carrying amount of those assets with the loss allowance measured at an amount equal to lifetime expected credit loss (Example 12 in the illustrative examples) and the disclosures of loan portfolio analysed by credit rating (Example 13 in the illustrative examples) would be operationally challenging.

- We understand that, in current practice, many financial instruments are not individually credit-scored throughout their life, particularly in a consumer portfolio. The disclosure requirement might result in the need for smaller financial institutions, which may not use any specific credit grade system, to create a credit grade system. This would be a situation where accounting requirements are creating information, but not reporting it.

- A commentator in our jurisdiction is of a view that the IFRS 7 aging disclosure is considered beneficial and that it may be useful to consider retaining these.

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

Please refer to our response to Question 7(a).

(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 and have some concerns that the bigger picture in terms of what are the drivers of credit quality and expectations at the reporting date could be overlooked. We consider our proposal on adopting a "through the eyes of management" approach to disclosure, as mentioned in our response to Question 7(a) would help to ease these concerns.

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 generally agree with the proposed requirement to compare the credit quality of the modified financial instrument at the reporting date with the credit quality of the unmodified financial instrument at initial recognition. We consider this approach will more appropriately reflect the deterioration in credit risk that has occurred when the modification does not result in derecognition.

The Exposure Draft also proposes to treat modified financial instruments that do not result in derecognition differently from financial instruments that do result in derecognition due to a modification. We generally agree that a modified financial asset should retain the original effective interest rate 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 derecognition requirements under IFRS 9 do not provide guidance on when, if ever, a modified financial asset should be derecognised and a new financial asset recognised reflecting the modified terms. The current derecognition criteria under IFRS 9 states that an asset should be derecognised when either the contractual rights to the cash flows from the financial asset expire or the asset is transferred and meets the derecognition criteria. The IASB should consider to clarifying what was contemplated when making reference to derecognising a financial asset as a result of modification.

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 Exposure Draft are limited to situations where there is a present contractual obligation to extend credit. This may imply that commitments that are unconditionally cancellable without notice (for example: credit card facilities) are not included in the expected loss model. It may be questionable whether this will represent economic realty because, in practice, borrowers will often utilise the limits on their cards before the banks actually cancel or reduce the limit. By that point, the on-balance sheet loan is recognised and is subject to expected loss measurement, but it may be credit impaired at initial recognition. We recommend the IASB to consider allowing 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.

We consider there may be operational challenges in estimating the amounts and timing of draw downs, especially when there is limited past experience with specific types of lending or borrowers.

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 generally agree with the proposed 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. We consider the proposed approach achieves a better balance between cost and benefit, especially for lessors and non-financial institutions that generally do not maintain the detailed information, and this poses them with challenges in tracking credit quality changes. Given that many trade receivables have a tenor of less than one year, the simplified approach should result in impairment allowances that are comparable to the full approach proposed in the Exposure Draft.

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 not to track changes in credit risk.

Having said that, one of the regulatory authorities in our jurisdiction expressed concerns on the rebuttable presumption that a significant increase in credit risk will be deemed to have occurred necessitating the provision of lifetime expected credit loss when payments are more than 30 days past due. In such circumstances many entities may have to provide for an exceptionally large amount of impairment losses on adoption of the proposed model and that authority is concerned that the financial statements as a result may not be able to reflect the true performance of the business.

(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 invoiced amount on initial recognition. However, IASB should consider providing additional guidance on what constitutes a significant financing component.

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 generally agree with the proposals for financial assets that are credit-impaired on initial recognition, which require an entity to include the initial expected credit losses in the estimated cash flows when calculating the effective interest rate.

However, certain commentators in our jurisdiction have an alternative view. They are of the view that incorporating expected losses in the determination of amortised cost would substantially change the meaning of "amortised cost" and creates a new hybrid meaning of amortised cost that is inclusive of credit loss impairment allowances. Adopting this approach changes the current meaning of amortised cost and therefore the asset balances and the interest revenue to be recognised under the "effective interest method". IAS 39 currently requires the effective interest rate to be determined without taking into account future credit losses (unless financial assets are acquired at a deep discount that reflects incurred credit losses). It would be difficult to determine as well as audit the "credit-adjusted effective interest rate" and the related amortised cost balances as to calculate it properly requires precision in projecting the exact timing and the quantum of the expected cash shortfalls over the life of the loan. A difference in timing may be material to the computed amounts.

We also agree that the loss allowance for such financial instruments should be reversed even if the cumulative changes are positive, as 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 in respect of the all other financial instruments.

Question 12

(a) What lead time would you require to implement the proposed requirements? Please explain the assumptions that you have used in making this assessment. As a consequence, what do you believe is an appropriate mandatory effective date for IFRS 9? Please explain.

We believe that, given the complexity of the subject matter, entities would need considerable time and effort in education and system modification. We consider that the time required for entities to prepare would be no less than three years. We also believe that IFRS 9 should have an effective date that is consistent with the impairment standard because the financial instruments that will be subject to the impairment standard will be dependent on the criteria in IFRS 9.

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

Please refer to our response to Question 12(c).

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

We agree with the proposed transition requirements, which provide exemption from restating prior period financials. We believe that the proposals achieve a reasonable balance between providing useful information for users and lowering the cost of implementation.

Question 13

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

We consider paragraphs BC164–BC216 contain useful information that will enable users, preparers and other interested parties to understand and evaluate the potential effect of the requirements. We generally agree with IASB's assessment that the implementation and ongoing application of the proposed impairment model will be complex and costly.

We note that the IASB plans to undertake fieldwork during the comment period to obtain the likely effect of the proposed requirements. We would be grateful if the IASB would keep stakeholders informed of the findings and results of this fieldwork exercise.

~ End ~