



Floor 18 | Tower 42 | 25 Old Broad Street  
London EC2N 1HQ | United Kingdom

t +44 (0)20 7382 1770  
f +44 (0)20 7382 1771

[www.eba.europa.eu](http://www.eba.europa.eu)

t +44 (0)20 7382 1765 direct  
[andrea.enria@eba.europa.eu](mailto:andrea.enria@eba.europa.eu)

## THE CHAIRPERSON

Hans Hoogervorst  
Chairman  
International Accounting Standard Board  
30 Cannon Street  
London  
EC4M 6XH

04 July 2013

### **Exposure Draft (ED/2013/3) Financial Instruments: Expected Credit Losses**

Dear Mr Hoogervorst

The European Banking Authority (EBA) welcomes the opportunity to comment on the IASB's Exposure Draft ED/2013/3 Financial Instruments: Expected Credit Losses.

The EBA has a strong interest in promoting sound and high quality accounting and disclosure standards for the banking and financial industry, as well as transparent and comparable financial statements that would strengthen market discipline.

The EBA welcomes the efforts of the IASB to improve financial reporting in the area of financial instruments as requested by the G20 and in this regard supports the introduction of an expected loss model. The current incurred loss model has resulted in the well-known "too little too late" recognition of credit losses. The move to an expected loss model will improve the decision usefulness and relevance of financial reporting for users, including prudential regulators.

We support a model that differentiates between the different stages of credit deterioration during the life of the financial instrument. This model also incorporates a broader range of credit risk information and it reflects banks' credit risk management.

We acknowledge the efforts of the IASB during the past years to develop a model which takes into account the evolution of the credit quality of financial assets and we recognise the difficulties to strike the right balance between faithfully representing the underlying economics of financial instruments and having a model that is operationally workable. In this context, we recognise the merits of this model and see that it achieves a good compromise.

As prudential supervisors we would be concerned if provisions are not built appropriately to withstand the expected losses that will materialise in future periods and therefore it is necessary that there is an adequate level of provisions for loans and other financial instruments at each stage of the model depending on their credit quality.

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In relation to stage 1, we believe that the IASB should provide additional guidance on the meaning of “default” (or another suitable term) as this will help achieving consistent application among entities. The definition could be broadened to encompass a wide range of loss events and not only “technical defaults”.

The definition of and provisioning for stage 1 is particularly relevant for financial assets that have early loss patterns and it is important that the model proposed provides an appropriate level of provisioning in these situations. The EBA understands that there are various possible options for addressing this, including the use of a broader definition of default, or through amendments in stage 1 / stage 2 transfer criteria that would result in such loans being classified in stage 2 either at original recognition or earlier than would be the case under the Exposure Draft’s proposals. We ask the IASB to consider these options further.

In addition, we believe that financial assets should be transferred on a timely basis from stage 1 to stage 2 to reflect their deterioration in credit risk. At this stage, it is difficult to say whether the transfer will occur too late in the process although as pointed out in our answer to question 5, we are concerned about some of the wording used in the Exposure Draft. We are also concerned that there might not be sufficient guidance provided about “significant increase in credit risk” to ensure that it is capable of consistent application.

The EBA has also some concerns about the low credit risk exception as it departs from the principle-based approach of the model and could eventually result in a delayed transfer to stage 2.

Regarding convergence, we note that many stakeholders have highlighted the importance of having one single impairment model. We concur with this view and our preference would be to have a converged model. However, we support a model that reflects the different stages of deterioration of financial instruments, such as is the intention in the IASB model. We believe that some of our comments could help reduce the differences between the IASB and FASB models. In any case, we think that the IASB should finalise the impairment project swiftly as entities will need some time for its implementation and we would not consider it appropriate for this Standard to be further delayed.

Our detailed comments on the Exposure Draft (ED) have been provided in the appendix of this letter.

If you have any questions regarding our comments, please feel free to contact Mr Michel Colinet (+32.2.220.5247) in his capacity as Chairman of the technical group that coordinated this comment letter.

Yours sincerely

*(signed)*

Andrea Enria

CC: Mr Michel Colinet, Chairman of the Technical Group

Appendix: detailed comments on the Exposure Draft

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## Appendix

### Objective of an expected credit loss impairment model

#### Question 1

(a) Do you agree that an approach that recognises a loss allowance (or provision) at an amount equal to a portion of expected credit losses initially and lifetime expected credit losses only after significant deterioration in credit quality will reflect:

(i) the economic link between the pricing of financial instruments and the credit quality at initial recognition; and

(ii) the effects of changes in the credit quality subsequent to initial recognition?

If not, why not and how do you believe the proposed model should be revised?

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

#### *Response*

We acknowledge the efforts of the IASB during the past years to move from an incurred to an expected loss model in order to develop an impairment model that addresses the “too little too late” problem and more faithfully reflects the credit risk of banks’ financial assets. The IASB has developed during these years different alternatives and asked constituents for their views. We recognise the difficulty of finding one single model that addresses the diversity of management activities for loans and other financial instruments and that covers the complexities of the economics underpinning loan pricing and loan loss provisioning. We understand that it is also difficult to strike a balance between faithfully representing those economic complexities and having a model that is operationally workable.

We welcome the IASB efforts to align the model with banks’ credit risk management practices and to distinguish between loans that have not deteriorated (stage 1) and loans that have deteriorated in credit quality (stages 2 and 3). We support a model that distinguishes the different stages of deterioration in credit quality of loans.

We also welcome that the IASB model broadens the spectrum of information used to measure credit losses. Taking into account more forward-looking information (i.e. reasonable and supportable forecasts of future events and economic conditions at the reporting date) will allow an earlier reflection of changes in credit risk estimations. However, this should not lead to an overly optimistic estimation of credit risk but should be reasonable in light of both forward-looking information and historical experience. This highlights the importance of having credit risk models which include adequate inputs and information to be sufficiently responsive to changes in the credit risk of the obligor. We also support the application of this model to both on and off-balance sheet exposures as this will better align with banks’ credit risk management practices.

In relation to the approach followed in the ED, we take note of the discussions on the conceptual basis for a day one loss, as the fair value of financial instruments should reflect the expected losses in their

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price. However, as set out in the following paragraphs we think that an allowance for financial instruments included in stage 1 is justifiable.

Reflecting a loss allowance for those financial instruments will help ensure that losses that are expected (which might exist either on the individual item or might be required in order to reflect portfolio experience more widely) can in some way be captured. This is more prudent than the current provisioning approach which arguably leads to an overstatement of interest income in periods preceding those when losses are actually incurred. While the 2009 ED might have captured those concerns better from a conceptual standpoint we understand this is no longer an available option in light of operational considerations.

In addition, the link of the pricing of financial instruments to credit quality is not perfect in real life, especially for originated loans, and although we encourage supervised credit institutions to price their loans as accurately as possible we observe that in practice it is not so easy to precisely set or identify the premium included in the price of the loan (which will also reflect other factors relevant to pricing decisions) that corresponds to the actual credit risk of the individual customer. The dislocation between expected credit losses and the pricing of loans is particularly observable during economic booms where credit monitoring is more lax (or credit assumptions more optimistic) due to the economic circumstances, and in markets that are very competitive. Including an initial credit loss allowance could, at least in part, and in such circumstances, compensate for such an imperfection in terms of fair presentation in the financial statements.

For these reasons, we concur with the view that this model achieves a good balance between reflecting the credit deterioration of loans during their life and the operational concerns that alternative models would entail. However, we think that the model needs to be improved as regards the definition of the stage 1 loss provision and to ensure a timely transfer to stage 2 and a more harmonised practise among entities (see our responses to Q4 and Q5).

Having said that, we do have concerns about some important aspects of the detail in the ED, as explained more fully in our responses to subsequent questions.

## **The main proposals in this Exposure Draft**

### **Question 2**

(a) Do you agree that recognising a loss allowance (or provision) at an amount equal to 12-month expected credit losses and at an amount equal to lifetime expected credit losses after significant deterioration in credit quality achieves an appropriate balance between the faithful representation of the underlying economics and the costs of implementation? If not, why not? What alternative would you prefer and why?

(b) Do you agree that the approach for accounting for expected credit losses proposed in this Exposure Draft achieves a better balance between the faithful representation of the underlying economics and the cost of implementation than the approaches in the 2009 ED and the SD (without the foreseeable future floor)?

(c) Do you think that recognising a loss allowance at an amount equal to the lifetime expected credit losses from initial recognition, discounted using the original effective interest rate, achieves a better

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balance between the faithful representation of the underlying economics and the cost of implementation than this Exposure Draft?

### *Response*

We think that the IASB has prepared a model that reflects the different stages of the deterioration in credit quality of financial assets and we welcome that differentiation being made. In this regard, we recognise the efforts of the IASB during the past years to find a model that achieves an appropriate balance between the faithful representation of the underlying economics and the implementation impediments.

As prudential supervisors we are concerned if provisions are not built appropriately to withstand the expected losses that will materialise in future periods and therefore, we consider it crucial that there is an adequate recognition of provisions for loans at each different stage of the model depending on their credit quality. In addition, there must be a timely transfer of loans from stage 1 to stage 2 and 3. In this regard, we would be concerned if the transfer to a lifetime expected loss took place at a late stage (thereby not adequately reflecting deterioration in credit quality) and we also think that sufficient guidance needs to be provided in the ED to achieve a common understanding among entities about the timing of the transfer to each of the stages, so as to achieve consistent application (see our response to Q5).

It is important that the 12 month expected loss criteria are sufficiently robust, which may not be the case presently given uncertainties around the definition of default (hence our proposals to consider suitably broadening the scope of the term 'default'). Similarly, uncertainties around the transfer criteria are such that we are concerned that large changes in the credit quality of assets in stage 1 may not be considered sufficient to justify their transfer to stage 2, which might consequently lead to under-provisioning of expected losses recognised under the model. Of course, the expected loss in stage 1 and the criteria to transfer assets to stages 2 are interlinked, as the deterioration of the credit quality could lead to either an update of the 12 month PD expectation or to raise questions as to whether a lifetime expected loss estimate would be more appropriate. Given such interdependence, it is important that these individual parts are clearly defined and described and are capable of being applied consistently both within firms and between them. In this sense, the clarity of the key requirements will also enhance its enforceability and its auditability.

## **Scope**

### **Question 3**

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

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*Response*

- (a) The EBA welcomes the proposed scope of the ED as it allows having a single impairment model for both on and off balance sheet items; for purchased debt instruments and for originated loans; and this irrespective of whether the instrument is measured at amortised cost or at FVOCI. Although having a single approach implies some challenges in specific situations, it has the great advantage of reducing the complexity in financial reporting for both preparers and users; and thereby facilitates the understanding and comparability of financial statements.

One of the ways the Board can address those specific situations where the proposed model causes operational difficulties is by providing simplifications (as is the case for lease receivables), guidance or specific examples.

- (b) On this basis we are supportive of the Boards proposal to apply the same impairment model to assets measured at FVOCI (should the Board retain this third measurement category<sup>1</sup>). As it may be difficult to identify and understand the impact of the related journal entries, we recommend the Board to introduce additional disclosure requirements identifying, in a single integrated note, the changes in OCI due to stage 1 and/or stages 2/3 provisioning and due to fair value changes. We would also recommend the final Standard requires separate disclosures for financial instruments measured at amortised cost and financial instruments measured at FVOCI.

## **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 recognized from initial recognition should be determined?

*Response*

The proposed stage 1 loss allowance corresponds to the expected shortfalls in contractual cash flows over the life of a financial instrument that will result if a default occurs in the 12 months after the reporting date, weighted by the probability of that default occurring.

Whilst the 12 month limit could be seen as an arbitrary cut-off, the EBA shares the IASB's view that for the reasons explained under Q1 this is an acceptable approximation to address the operational complexity of the methods proposed in the 2009 ED and the 2011 SD.

We have a general concern that the explanations used in the Standard and Basis for Conclusions are not always clear. As an example of this, the explanation given in BC63 stating that "12-month expected credit losses are not the lifetime expected credit losses that an entity will incur on financial instruments that it predicts will default in the next 12 months" is confusing, particularly as it follows on from a very similar sentence. It should also be clarified that this paragraph only intends to explain the meaning of the 12 month expected credit losses and it does not mean that for the transfer to stages 2

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<sup>1</sup> Please refer in this regard to our comment letter on the ED on Classification and Measurement: Limited amendments to IFRS 9.

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or 3 only a 12 month term needs to be assessed (which would be contrary to paragraph 8 of the ED). Such statements may be read and understood differently, which we believe is a result of the confusing nature of the text. The EBA believes it is important that explanations of the model are clear and capable of consistent understanding and application. Otherwise, the model might still be operational but inconsistently applied and could give rise to uncertainties over how provisioning levels compare across firms.

In this regard, we would find it useful if the Standard includes further guidance on the concept of default used for determining the 12 month expected credit losses and in doing so, the IASB could explore requiring the use of a wide range of indicators of loss events.

We would also welcome further guidance on the articulation of the 12 month expected credit losses for stage 1 and the transfer to stage 2. This should result in the Standard providing guidance on the meaning of significant increase in credit risk (see our response to Q5) and clarifying that when such increase does not result in the transfer to stage 2 it should lead to an update of the 12 month PD (for instance for assets subject to the low credit risk exception). As the ED currently stands it is not clear that this is the case (for instance, see BC202 and BC208). In principle, an increase in credit risk should be factored into the allowance considering the lifetime of the asset and this implies the transfer to stage 2 should not be delayed (we understand that the provision for stage 1 could cover increases in credit risk if they are not significant).

As currently presented, the 12 month limit may be perceived as a cap to the build-up of adequate levels of loss allowances, and will have a particular effect depending on the definition of default used. It is important that the new impairment model allows banks to consider known loss patterns related to their respective risk profiles (based on long-term observations of probabilities of default or objective loss experience). If the definition of default is restrictive (i.e. technical default) then the implications are especially relevant for financial assets with early loss patterns (but just beyond the 12 month limit). This reasoning only emphasises the importance of having a suitable and broad definition of default so that either: a) the 12 month PD captures these items appropriately (which is not yet clearly the case); b) there is a clear expectation that loans with such loss patterns are likely to be recorded in stage 2 already; or c) there is a sufficiently early trigger under which they would move to lifetime expected losses.

Even though the accounting requirements for the calculation of the 12 month expected losses are different from the prudential requirements, there are existing capabilities (such as systems / models / data) that banks might be able to build on in order to comply with the proposed Standard, thus reducing the implementation costs.

## **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?

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



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(c) Do you agree that the assessment of when to recognise lifetime expected credit losses should consider only changes in the probability of a default occurring, rather than changes in expected credit losses (or credit loss given default ('LGD'))? If not, why not and what would you prefer?

(d) Do you agree with the proposed operational simplifications, and do they contribute to an appropriate balance between faithful representation and the cost of implementation?

(e) Do you agree with the proposal that the model shall allow the re-establishment of a loss allowance (or a provision) at an amount equal to 12-month expected credit losses if the criteria for the recognition of lifetime expected credit losses are no longer met? If not, why not, and what would you prefer?

### *Response*

(a) The EBA agrees with the proposed requirements to recognise a loss allowance (or a provision) at an amount equal to lifetime expected credit losses when the credit quality deteriorates after initial recognition. We welcome that the IASB has considered how credit risk is managed by banks when developing its proposed model. Therefore, we support conceptually a model which is based on the concept of credit deterioration.

The EBA is however concerned that the proposals may not provide sufficient clarity as to when lifetime expected losses should be recognised. As the transfer criteria play an important role in the overall model, it is important that the final Standard defines further what a significant increase in credit risk is and that it provides guidance and examples on how this concept is expected to work in practice. This would greatly facilitate comparability of financial statements due to the inherent judgmental nature of such concepts.

Moreover, we have reservations regarding whether there will be timely and appropriate recognition of loan loss provisioning due to the lack of clarity of the term "significant" and also due to the wording used in the ED for the transfer criteria as explained in letter (d).

(b) In line with our previous comment, we recommend that the Board develops more detailed guidance in order to bring more clarity to the meaning of "significant increase" and thus limit the subjective assessments as to when a significant increase in credit risk has occurred. Whilst the EBA acknowledges that the Standard should still be principles-based there is a need for more guidance on what is actually meant by "a significant increase".

(c) The EBA agrees that the assessment of when to recognise lifetime expected credit losses should consider only changes in the probability of default occurring taken into account our comments previously made regarding a suitable broad definition of default.

We note that this issue does not seem to be explicitly addressed in the current ED for transfers from stage 2 to stage 3 although we would understand that only the probability of default should be taken into account. Despite being an indicator of the credit quality of an exposure, we consider that collateral should not be taken into account for assessing the transfer between the different stages as the emphasis should be placed on the credit quality of the borrower. The transfer between stages considering collateral may pose different challenges. For instance, there could be uncertainties



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regarding the value of collateral or an entity may have originated loans with high credit risk reliant on the value of the collateral. Besides those issues, which are directly related to the ED, we take note of the fact that under current IAS 39 there is also lack of clarity on whether collateral needs to be considered for classification purposes (impaired vs. not impaired). We would welcome appropriate clarification from the Board on the consideration of collateral in order to ensure consistent application, as well as useful information is included in the financial statements.

(d) The EBA has some reservations regarding the proposed operational simplifications.

*The exception for low credit risk assets*

The EBA acknowledges the IASB's efforts to provide simplifications, but we are not convinced that the exception for assets with low credit risk is appropriate in itself.

Firstly, exceptions should by nature be avoided or very limited in principles-based standards, and should be duly motivated (not only by cost considerations). We suggest that the rationale behind the exception for low credit risk should be made more obvious.

Secondly, we observe that this exception introduces an additional layer of concepts and criteria (for defining "low credit risk") whose interaction with the general principle of "significant deterioration" is not clear and might result in contradictory conclusions. The ED determines that a financial instrument has low credit risk "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" (paragraph 6 of the ED). The EBA is of the view that waiting for a default that is imminent (before getting to stage 2) introduces a rather high threshold which is quite close to an incurred loss model. We expect that the credit quality of the concerned asset would need to experience significant deterioration before default becomes imminent.

We also wonder whether it is realistic to be able to differentiate a credit deterioration that increases the risk of default from a credit deterioration that may "lead to, at most, a weakened capacity of the borrower to meet its contractual cash flow obligations".

The EBA is therefore of the view that the model would gain in consistency and clarity if the exception in this area is based on well-articulated principles. Therefore, if the concept of "low credit risk" is to be maintained we would prefer to define it in a way that is fully consistent with the concept of significant credit deterioration.

*The reference to investment grade*

We have additional, more specific concerns about the reference to the concept of 'investment grade'.

It can be observed that the 'investment grade' category is not homogenous and cannot be qualified throughout as being of 'high credit quality'. It can also be suggested that 'low credit risk' as referred to in the ED is not clearly defined, which in turn makes assessment of 'investment grades' an even more subjective topic, especially where internal ratings are used or where ratings by external agencies for specific items vary.

We are concerned that the investment grade exception is too arbitrary and presents perhaps too much of a deviation from the general principles of having a model based on significant deterioration. It has been observed that probabilities of default vary significantly for longer maturities and towards the

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lower end of the investment grade range (BBB as compared to AAA)<sup>2</sup>. We understand that under the ED a downgrade from AAA to BBB would not trigger the transfer of a financial instrument from stage 1 to stage 2 and the recognition of lifetime expected losses, as the financial instrument would still be considered 'investment grade'. As the cumulative probabilities of default vary between 0% and 1.06% for AAA and between 0.24% and 7.22% for BBB, from a 1-year to a 15-years time horizon, this means that a downgrade from AAA to BBB could show a significant increase in credit risk without a sufficient reflection of this in provisioning levels. In contrast, single grade deterioration from BBB to BB would not be eligible for the exception which, in light of the above, appears as a rather arbitrary bright-line.

There is also a concern that this may influence management decisions regarding internal ratings, tracking of changes in credit quality, and interpreting what is considered a significant change in credit risk for non-investment grade instruments.

On this basis, the EBA invites the Board to revisit its proposals regarding the reference to investment grades. The Board could consider removing it or, introducing it as an additional test (instead of an exception) or indicator of credit quality deterioration, while also providing additional language on its rationale and the way it could be used consistently with the overall objective of assessing credit quality deterioration.

#### *The 30 days past due presumption*

Finally, the EBA acknowledges the rebuttable presumption that the transfer criterion is met when contractual payments are more than 30 days past due, but notes that this is rather backward looking and does not lead in itself to more forward looking (expected) allowances for credit losses. We are concerned that the effect of this simplification might be to delay the recognition of expected credit losses. We believe that, where information is available indicating that significant credit deterioration has occurred, it should not be ignored. For example, a lender may be able to see from a customer's accounts and credit information that there is increased reliance on borrowings (such as credit cards, overdrafts, etc) well before a payment is actually missed.

In this sense, possibly the 30 days past due test could be better considered as another indicator and / or additional test to be used in the credit risk assessment: this would help to ensure that firms use it to support their assessment of expected credit losses on portfolios, rather than being seen as the sole measure for those losses (as the rebuttable presumption approach appears to permit).

(e) We agree with the proposal that the model allows 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. This proposal is consistent with the overall approach retained in the ED where the recognition of expected credit losses is based on the changes in credit quality.

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<sup>2</sup> See table with cumulative probabilities of default in IASB Staff Paper 5B, November 2012, page 26

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## Interest Revenue

### Question 6

(a) Do you agree that there are circumstances when interest revenue calculated on a net carrying amount (amortised cost) rather than on a gross carrying amount can provide more useful information? If not, why not, and what would you prefer?

(b) Do you agree with the proposal to change how interest revenue is calculated for assets that have objective evidence of impairment subsequent to initial recognition? Why or why not? If not, for what population of assets should the interest revenue calculation change?

(c) Do you agree with the proposal that the interest revenue approach shall be symmetrical (ie that the calculation can revert back to a calculation on the gross carrying amount)? Why or why not? If not, what approach would you prefer?

### *Response*

(a) The EBA agrees with the IASB that interest revenue should be calculated on a net carrying amount for assets that have objective evidence of impairment subsequent to initial recognition. This accounting treatment provides users with more useful information when analysing the performance and the net interest margin of the financial assets. We are of the view that the need for information shifts from interest revenue to credit losses when there is an objective evidence of impairment. Recognising and presenting interest revenue on the gross amount that reflects the impaired contractual returns would not faithfully represent the true economic return in these cases.

Regarding purchased or originated credit-impaired financial assets on which interest revenue is determined on the amortised cost amount, we also agree with the IASB that this model more faithfully represents the underlying economics for these financial assets.

(b) The EBA agrees with the IASB to change how interest revenue is calculated for assets that have objective evidence of impairment subsequent to initial recognition. There is an increase in the complexity of the model having a requirement to calculate interest revenue based on a net carrying amount when there is objective evidence of impairment. However, given that preparers under IAS 39 currently determine interest on the basis of net amortised cost this proposal will most likely not increase complexity.

(c) The EBA agrees with the IASB's proposal that the interest revenue approach should be symmetrical i.e. that the calculation can revert from the net to gross carrying amount when there is no longer objective evidence of impairment. The approach could contribute to the consistency and the comparability of accounting for similar items.

### *Other EBA comments:*

The EBA proposes the IASB to provide more practical guidance for the calculation of the effective interest rate (EIR) regarding floating rate instruments. According to the current practice under IAS 39

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the calculation of EIR is either based on an actual benchmark rate that was set for the relevant period or on expectations of future interest rates, and changes in these expectations. In our opinion there is a need for more practical guidance for preparers in this matter to avoid confusion regarding the practical treatment in recognising interest revenue on floating rate instruments.

We also take note of the fact that the ED allows preparers to choose the appropriate discount rate to use in order to discount expected losses. This rate is any reasonable rate that is between (and including) the risk-free rate and the effective interest rate. However, such choice might limit the comparability of financial information and reduce understanding for the users of financial statements. The IASB could require the use of the effective interest rate and, if not possible, allow the use of a reasonable rate such as the contractual interest rate as a practical expedient.

## **Disclosure**

### **Question 7**

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

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

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

### *Response*

(a) The EBA welcomes the proposed disclosure requirements as we believe they will help increase transparency and comparability and provide useful information to users of financial statements about the credit quality of an entity's financial assets and the impact on its financial position and performance including:

- The amounts in the financial statements arising from expected credit losses; and
- The effect of deterioration and improvement in the credit quality of financial instruments

The proposals in the ED relating to expected loss require the application of management judgement to a much greater extent than under the incurred loss model in IAS 39. We therefore find it important that management choices and the outcome of these are reflected in the disclosures in order to help readers identify and understand the level of expected credit losses recognised at every stage.

We agree with the requirements for entities to disclose a reconciliation of the gross carrying amount and the loss allowance (or provision) and the inputs and assumptions used in measuring the 12-month and lifetime expected credit losses.

In addition, the EBA agrees with the requirement in the ED for an entity to disclose information on the effect of deterioration and improvement in the credit risk of financial assets. In order to facilitate this, the entity is required to disclose the inputs and assumptions used in determining whether a significant increase in credit risk has occurred and analysis of the gross carrying amount of financial assets by credit grade and provisions recognised for loan commitments and financial guarantees contracts.

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Such disclosures will be necessary for users of financial statements to understand and assess the financial information included in the financial statements.

Additional disclosures relating to purchased or originated credit-impaired financial assets, the write off policy, modifications, credit enhancements and credit concentrations will also in the EBA's view provide relevant information and increase comparability between entities given the broad room for management judgement.

It may be considered that these proposed disclosures are excessive for non-financial institutions. However, we are of the view that transparency is very necessary for financial institutions in order to provide relevant information to the users of financial statements regarding the credit quality of an entity's financial assets, its risk management activities and the effect of those activities on the entity's financial position and performance.

(b) Paragraph 31 in the ED requires preparers to decide which disclosures in IFRS 7 and in the ED result in duplication. We are of the view that there is likely to be an element of duplication and as such we agree with the proposals contained in this paragraph to minimise duplication as this will reduce the costs for preparers. The EBA would support, once IFRS 9 is finalised, the inclusion of all disclosures requirements related to financial instruments within IFRS 7, as it is currently the case for IAS 39 disclosure requirements.

(c) We are of the view that the IASB should develop an alternative form of disclosure about experience adjustments which would enable the users of financial statements to understand the quality of earlier accounting estimates as a result of back-testing exercises.

We have noted that not in all circumstances the level of allowances should be disclosed. The ED requires the disclosures of the gross carrying amounts in paragraph 44 (see also example 13) by credit risk rating grade and in paragraph 45 for financial instruments assessed on an individual basis. However, there is no requirement to disclose the level of allowances. We find it relevant to know the amount of allowances for assets of different credit quality, as this will allow comparisons on the level of allowances.

We believe that specific disclosures are required for movements between stages. It is important to understand how provisioning levels on portfolios are affected by transfers, as opposed to movements in allowances within each stage (i.e. to what extent is an impairment charge the result of increases in expected losses already measured using a 1 year PD and lifetime PD, as opposed to movements resulting from write-offs and impairment charges that reflect movement of assets among the stages).

We also welcome further guidance suggesting the appropriate level of disaggregation for types of financial assets. We take note of the reference in paragraph 34 to classes of financial instruments, but we would suggest additional guidance on how to separate between different exposure classes, while it would be useful to obtain for each type of asset or exposure class the gross carrying amount and the associated amount of the allowance.

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

### Question 8

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

#### *Response*

The EBA believes that it is very important to achieve an adequate treatment of assets that have been modified. We would be concerned if the modification of assets results in delaying loss recognition and masking asset quality deterioration. To this end, clarifications are needed on the rules applicable for modified assets.

We would welcome if the final Standard provided further guidance on the notion of modification. For instance, the IASB could clarify whether refinancing operations (operations where a financial institution grants a new loan to a debtor that is then used to repay a former loan) are to be considered modifications not resulting in derecognition. It could also clarify whether commercial modifications are included in the scope or the scope includes only modifications due to financial difficulties of the borrower.

The EBA agrees with the proposed treatment of financial assets for which contractual cash flows are modified without resulting in derecognition. However, we would suggest clarifying the principles set out in B24 and possibly their introduction within the main body of the Standard. In general, we find that there is not enough guidance in the ED and in order to understand the application of the model to assets that have been modified we need to resort to example 9.

We have some concerns that the last sentence of paragraph B24, which states that “a loan is not automatically considered to have improved in credit quality merely because the contractual cash flows have been modified” could lead to a general interpretation that any modification of an asset may lead to an improvement of the credit quality, since we consider borrower payment capacity should be the most relevant factor to consider. Moreover, we note that paragraph B24 seems not to apply to all modified exposures, but only to those that were past due when modified. This might suggest that modifications only apply to past due exposures while we believe that all modified exposures should be covered. In general, we would be concerned if loan modifications are used with the sole objective to reclassify assets to stage 1. Moreover, if an asset is modified due to credit deterioration of the borrower, we would view such asset subject to lifetime losses calculation.

If the modification of a financial asset results in derecognition and recognition of the modified asset, the entity should consider whether the modification indicates that the newly recognised asset is credit impaired at initial recognition. In this case, since a high level of judgment is required, the EBA would welcome more guidance on the assessment of the newly recognised asset.

More generally, the EBA notes it is not always clear when a modification in contractual terms results in derecognition. The lack of a clear principle could result in inconsistent application across preparers, so we suggest that the Board tackles this issue. Current wording of paragraph B23 may imply that when new assets are recognised they would be classified in stage 1 and we question the classification of

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these assets as there could be concerns on the borrower's ability to pay. We would also be concerned if depending on whether there is a modification or derecognition the assets are classified differently.

The EBA agrees, as explained in Example 9 paragraph IE60 to IE62 that improvements in the borrower's creditworthiness could lead over time to the reclassification of a modified asset to stage 1. In order for users to be able to assess over time the effect of modifications on an institution's credit risk profile, we therefore support comprehensive disclosures on modified exposures.

## **Application of the model to loan commitments and financial guarantee contracts**

### **Question 9**

(a) Do you agree with the proposals on the application of the general model to loan commitment and financial guarantee contracts? Why or why not? If not, what approach would you prefer?

(b) Do you foresee any significant operational challenges that may arise from the proposal to present expected credit losses on financial guarantee contracts or loan commitments as a provision in the statement of financial position? If yes, please explain.

### *Response*

The EBA agrees with the application of the general model to loan commitments and financial guarantee contracts, since similar credit risk management practices are applied to all these types of financial instruments by banks. Also, we agree with the proposal for the presentation of provisions for such financial instruments in a separate line item in the statement of financial position as a liability.

We see that for the estimation of the expected credit losses for loan commitments, an entity is required to consider the expected portion of the commitment that will be drawn down within 12 months of the reporting date and the respective portion for the remaining life of the loan commitment. However, we will welcome some guidance in the model with regards to the qualitative and / or quantitative input factors that need to be considered for such estimation. This might leave room for significant subjectivity in the estimations used to calculate the exposure at default and limit the comparability of the financial information prepared.

The proposed model focuses on the duration of the period when a contractual obligation to extend credit exists. We think that like in other areas where the model has aligned with credit risk management practices, the IASB could assess further whether the model should consider the period over which an entity expects to extend credit and whether considering the contractual period would result in sufficient provisions in all circumstances.

## **Exceptions to the general model**

### *Simplified approach for trade receivables and lease receivables*

### **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?



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(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?

*Response*

No comment

### **Exceptions to the general model**

*Financial assets that are credit-impaired on initial recognition*

#### **Question 11**

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

*Response*

Similar to existing guidance in IAS 39, for financial assets that are impaired upon origination or purchase the ED proposes requiring an entity to include initial expected credit losses in the estimated cash flows when computing effective interest rate. Such credit-adjusted EIR would then be used to calculate the amortised cost and interest revenue from such assets, with a loss allowance being recognized pursuant only to a change in lifetime expected credit losses since initial recognition. According to the ED, this approach more faithfully represents the underlying economics for these assets.

In our view, this clearly reflects upon the IASB's underlying assumption that initial credit loss expectations are priced into financial assets, which is perhaps more likely to be appropriate for purchased debt instruments than for originated impaired loans.

Paragraph 15 of the ED states that "an entity shall recognise favourable changes in lifetime expected credit losses as an impairment gain even if the cumulative changes 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". As currently drafted, the ED proposes to include the initial lifetime expected credit losses in the impaired asset's estimated cash flows. The amortised cost of the asset would therefore reflect the estimated cash flows and we question the reasons to recognise an impairment gain (negative allowance) after initial recognition if the asset is not measured at fair value. As stated in paragraph 65 of IAS 39 "the reversal shall not result in a carrying amount of the financial asset that exceeds what the amortised cost would have been had the impairment not been recognised at the date the impairment is reversed".

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## Effective date and transition

### Question 12

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

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

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

### *Response*

We would welcome the finalisation of this project as soon as possible and that the effective date is timed so as to give entities enough time for appropriate and proper implementation. While it is important that we have an expected loss model in place, it is also important that information produced by firms is of a sufficiently high quality.

## Effects analysis

### Question 13

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

### *Response*

Conscious of the difficulties involved in translating the proposal into numbers, the EBA welcomes engagement of the IASB with a number of credit institutions worldwide in an attempt to quantify the magnitude of the proposal's impact. We have concerns with some of the assumptions in paragraphs BC169 to BC216 in the ED, especially to the extent that they could drive the conclusions of such fieldwork.

We believe that the IASB should reconsider this section once it has received feedback on the proposal and the IASB should also analyse the results of its field testing.

Paragraph, BC208 states that the operational burden of tracking the PD for all financial assets since initial recognition would be eased by not requiring an entity to recognize lifetime expected credit losses on low credit risk assets (irrespective of their change in credit risk). The paragraph also says that "an entity will not need to assess the changes in credit quality from initial recognition for financial instruments that have a low credit risk on a reporting date (also in BC202). We wonder whether these two sentences mean that there is no need to track the credit risk of low risk assets and therefore the 12 month expected loss does not need to be updated even when there is deterioration on the credit quality of the assets.

As opposed to this is the reasoning behind only requiring recognition of 12 month expected credit losses for poor credit quality assets: BC213 states that "the IASB did not want to create a disincentive for entities to lend to customers with poor credit quality". Accounting should not drive management

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behaviour, but it should appropriately depict the financial impact of credit risk that builds into a portfolio whenever available information exists that allows a reliable estimation of the related losses.

Based on the above mentioned arguments, we are particularly opposed to the reasoning in BC197 that “some users of financial statements would prefer a representation of credit losses with a conservative or prudential bias, arguing that such a representation would better meet the needs of regulators”. Our duty to protect the safety and soundness of banking institutions gives us valuable insight on the ways in which risks are taken on by banks and build up into their portfolios, and therefore when requiring earlier recognition of a higher amount of credit losses we are not envisaging the creation of an additional buffer, but rather trying to tackle the “too little too late” concern and a faithful recognition of the credit quality of the financial assets.