EFRAG

European Financial Reporting Advisory Group

9 July 2013

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

Dear Sir/Madam,

Re: Exposure Draft *Financial Instruments: Expected Credit Losses*

On behalf of the European Financial Reporting Advisory Group (EFRAG), I am writing to comment on the Exposure Draft *Financial Instruments: Expected Credit Losses* issued by the IASB on 7 March 2013 (the 'ED').

This letter is intended to contribute to the IASB's due process and does not necessarily indicate the conclusions that would be reached by EFRAG in its capacity as advisor to the European Commission on endorsement of definitive IFRS in the European Union and European Economic Area.

We conceptually supported the integrated effective interest rate approach in the 2009 ED and we supported the time proportionate approach in the Supplementary Document; however, we acknowledge the significant operational concerns expressed by constituents regarding the implementation of those approaches.

EFRAG believes that the recognition of a portion of expected credit losses at initial recognition is not conceptually sound. Nevertheless, in our view the proposed approach represents a reasonable proxy for reflecting the performance of an entity by adjusting the interest income earned in a period that is more operational and less costly compared to the 2009 ED. Therefore, in the absence of a better model, EFRAG believes it is time that the IASB should finalise its impairment requirements having this approach as a basis and taking into account our recommendations in the appendix to this letter.

EFRAG accepts the proposed approach because we expect it will result in an earlier recognition of expected credit losses and hence addresses the weakness of an incurred loss model. However, we note that the proposals would require significant implementation and ongoing costs. In particular, our constituents identified a number of operational difficulties and uncertainties as to how the proposals should be applied, which are described in the Appendix to this letter. We are more particularly concerned that our field test has clearly highlighted that the current proposals do not allow entities to leverage existing risk management and regulatory practices and that not all necessary data are available. Therefore, we suggest the IASB to reconsider how the model could be implemented in such a way that entities are able to leverage their existing practices and hence limit the costs and increase the reliability of their estimates. We also note that many constituents indicated that the operational difficulty to comply with the proposed disclosure requirements would be high. Consequently, we encourage the IASB to review the level of proposed disclosures in order to balance appropriately the cost for preparers and benefits for users. More generally, we believe that the results of our field-test (which has already been shared in draft with your staff) provide valuable information about the operability and the clarity of the proposals, therefore we encourage the IASB to consider that work in finalising its proposals.

EFRAG's assessment is that the proposed approach could strike an acceptable balance between the cost of implementation (provided the IASB addresses the operational difficulties referred to above) and the underlying economics, while meeting the need to provide earlier for expected credit losses as expressed by financial regulators and other constituents.

EFRAG understands that any impairment model that uses a single measurement approach under which lifetime expected credit losses are recognised at initial recognition – such as the model proposed by the FASB – will remove the need to reclassify financial assets from one stage to another. Nevertheless, in our view, such a model would not be less subjective and not necessarily operationally simpler compared to the proposed approach in the ED. EFRAG believes that such an approach would provide less relevant information about the effects of changes in the credit quality subsequent to initial recognition, and would not result in an appropriate balance between the representation of the underlying economics and the cost of implementation as the double counting effect of expected loss recognition at inception is aggravated by the consideration at once of life time expected losses and the resulting distortion of interest income.

We note – and share - the concerns of many constituents in Europe on the lack of convergence and the implications for preparers and users. Therefore, we urge the Boards to try where possible to align their proposals. We offer a few suggestions in the remainder of the letter where we see potential for better alignment. That being said, we strongly believe that the two fundamental objectives of depicting credit deterioration over the life of an instrument (or a portfolio of instruments) and presenting an interest income amount that reflects faithfully the performance of the debtor should not be compromised, not even for the sake of convergence.

EFRAG believes that in setting the standard's effective date, the IASB should carefully assess the time entities need to implement the new requirements with the required degree of reliability, so that improvements materialise in practice. To implement the proposed requirements, entities would need a full three years after publication. This period could be reduced only if substantial changes are made along the lines of our recommendations to make the standard more operational and less costly to implement. This assessment should be made taking into consideration the capabilities of entities in general and not focus exclusively on large banks with sophisticated systems and practices.

If you would like to discuss our comments further, please do not hesitate to contact Panagiotis Papadopoulos, Didier Andries or me.

Yours faithfully,

Françoise Flores
EFRAG Chairman

APPENDIX

EFRAG's responses to the questions raised in the exposure draft

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 full 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 at an amount equal to all expected credit losses from initial recognition, discounted using the original effective interest rate, does not faithfully represent the underlying economics of financial instruments? If not, why not?

EFRAG's response

EFRAG does not agree that recognising a portion of expected credit losses at initial recognition reflects the economic link between the pricing of a financial instrument and the credit quality at initial recognition when the financial instrument is priced at market terms because it ignores the revenue aspect of the transaction. However, although we do not suggest an alternative model, we believe that our recommendations would make the model operationally more viable.

Notwithstanding our conceptual concerns, EFRAG supports the proposed approach as it distinguishes between financial assets that have deteriorated in credit quality and those that have not, and thus provides useful information about the effects of changes in the credit quality of an entity's financial assets.

EFRAG does not support an approach that requires lifetime expected credit losses to be recognised at initial recognition since such an approach would result in excessive front-loading of credit losses given initial expectations of credit losses are priced into a financial asset, and would provide less relevant information on credit deterioration and the presentation of the lender's performance.

We note the concerns of many constituents in Europe on the lack of convergence and the implications for preparers and users. Therefore, we urge the Boards to try where possible to come closer. We offer a few suggestions in the remainder of the letter where we see potential for further alignment.

Question 1(a)(i)

12-month expected credit losses

1 EFRAG agrees that the requirement to recognise at initial recognition a portion of the lifetime expected credit losses will result in an earlier recognition of expected

credit losses. However, we also agree with the analysis in paragraph BC66 of the ED:

> *'…the 12-month expected credit losses proposal in this Exposure Draft would result in an overstatement of expected credit losses for financial instruments, and a resulting understatement of the value of any related financial asset, both at and immediately after initial recognition of those financial instruments. In particular, the initial carrying amount of financial assets would be below their fair value'.*

2 Nevertheless, while we have considerable sympathy for the alternative view expressed by Stephen Cooper on the 12-month expected credit loss measurement, we also believe that the proposed approach represents a reasonable proxy for recognising the initial credit loss expectations that is more operational and less costly compared to the 2009 ED.

<u>Economic link between pricing and credit quality at initial recognition</u>

3 Paragraph BC19(a) of the ED explains that in developing the proposed expected credit loss model, the IASB observed that typically initial credit loss expectations are reflected in the initial pricing. However, paragraph BC46 of the ED notes that it may be impractical (if not impossible) to reliably isolate and measure the portion of the credit spread that is intended to compensate the lender for undertaking the credit risk.

4 While there may not always be a clear economic link for each and every financial instrument between the pricing and its credit quality at initial recognition (e.g. when a lender wishes to gain market share or in the case of a credit bubble), EFRAG believes that such a link normally does exist. Therefore, we favour a model that takes as its initial objective to reflect the effective return by allocating interest revenue, but that changes its primary objective to recognising impairment allowances when credit losses exceed those initially expected.

5 In our view, recognising an economic loss at initial recognition does not result in a faithful presentation of the transaction, since it ignores the revenue aspect of the transaction. Consequently, recognising a portion of the initial expected credit losses at initial recognition normally does not reflect appropriately the economic link between the pricing and the initial credit quality when the financial instrument has been priced at market terms.

6 However, although we do not suggest an alternative model for the reasons explained in our response to Question 2(a) below, we believe that our recommendations would help the IASB address the concerns raised by participants in our field-test and thus make the model operationally more viable.

Question 1(a)(ii) – Effects of changes in credit quality

7 EFRAG agrees with the reasoning in paragraph BC16 of the ED that for financial instruments that are measured at amortised cost, information about changes in credit quality is more relevant to users in understanding the likelihood of the collection of future contractual cash flows than the effect of other changes such as changes in market interest rates.

8 Therefore, we support the proposed approach as it distinguishes between financial assets that have deteriorated in credit quality and those that have not, and thus provides useful information about the credit quality of an entity's financial assets, its credit risk management activities and the effect of those activities on the entity's financial statements (see also our response to Question 5(c)).

9 EFRAG believes that any impairment approach should take as its initial objective to reflect the effective return by allocating interest revenue and initial credit loss expectations over the life of the financial asset. However, we believe that once a significant deterioration in credit quality has occurred, an entity will be focussed on recovering principal and the primary objective of the model should be to recognise an impairment allowance based on expected lifetime losses.

Question 1(b)–Recognition of lifetime expected credit losses from initial recognition

10 EFRAG has taken note of the arguments in paragraphs BC14-BC17 of the FASB Proposal. However, as explained in paragraph 4 we agree with the IASB's observation that typically the initial pricing includes a compensation for initial credit loss expectations. Therefore, we agree with the IASB's analysis that requiring the entity to further deduct an amount from the transaction price that represents the same amount that it has already discounted from the contractual cash flows results in the entity double-counting its initial estimate of expected credit losses.

11 While we acknowledge that this element in the IASB's approach is similarly not conceptually sound, in our view, the effect would be less pronounced. Consequently, EFRAG does not support a model that requires lifetime expected credit losses to be recognised at initial recognition as it would result in most circumstances in excessive front-loading of credit losses given that initial expectations of credit losses are priced into a financial asset. Furthermore, we believe that such a model would provide less relevant information about the effects of changes in the credit quality subsequent to initial recognition. Nevertheless, while agreeing with the analysis above, we believe that it would be helpful if the IASB articulated more clearly in the final standard what the 12-month expected credit loss allowance aims to portray.

Convergence

12 Despite our stated preference for the IASB model over the FASB's approach, we note the concerns of many constituents in Europe who fear that a converged solution is out of sight given the fundamentally different approaches pursued by both Boards. We acknowledge that the Boards came from different starting points and had different objectives. Nonetheless, given the calls for convergence from the G20 as well as from users and preparers, we urge the Boards to try where possible to align their proposals. We offer a few suggestions in the remainder of the letter of areas where we see potential for better alignment (e.g. the scope in relation to financial guarantee contracts and the treatment of purchased and originated credit-impaired financial assets).

13 That being said, we strongly believe that the two fundamental objectives of depicting credit deterioration over the life of an instrument (or a portfolio of instruments) and presenting an interest income amount that reflects faithfully the performance of the debtor should not be compromised, not even for the sake of convergence. We acknowledge that the Boards are currently far apart as regards the accounting for financial assets in the 'good book'. Even when taking into account that the business models of US and European banks differs (in respect of instruments contracted, the life of the instruments and their holding period), reconciling the FASB's approach to the IASB model would, in substance, mean imposing a 36 to 48 months expected loss amount on the assets in the 'good book', which we do not find convincing other than for the sake of setting aside higher buffer amounts. We are especially worried about the consequences this would have for the presentation of interest income in the statement of profit or loss, as annual interest income would appear to being distorted significantly by such an approach.

14 Moreover, we do not agree that any portion of initial expected credit losses should be determined on the basis of losses expected to occur within the foreseeable future. As noted in our letter in response to the Supplementary Document in 2011, we have concerns about the notion of 'foreseeable future', since that term was not clearly defined nor well understood. It would therefore be difficult to ensure consistent application. Further, the approach would penalise more sophisticated preparers who are capable of longer range forecasts. The more an entity would make an effort to look further in the future, the higher the possibility it would need to recognise a higher allowance. This would discourage entities to develop their expected loss models properly.

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 Supplementary Document (without the foreseeable future floor)?

(c) Do you think that recognising a loss allowance at an amount equal to the full 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?

EFRAG's response

EFRAG accepts the proposed approach because we expect it will result in an earlier recognition of expected credit losses and hence addresses the weakness of an incurred loss model. However we note that the proposals would require significant implementation and ongoing costs. Furthermore, our constituents identified a number of operational difficulties and uncertainties as to how the proposals should be applied. Therefore, we suggest the IASB to carefully revise how the model should be implemented to significantly increase the ability of entities to rely on the existing risk management practices or regulatory requirements, and hence limit the costs and increase reliability of their estimates.

Overall, we believe that the approach in the ED achieves a better balance between the faithful representation of underlying economics and the cost of implementation of the approaches in the 2009 ED and the Supplementary Document (without the foreseeable future floor).

EFRAG believes that recognising the full lifetime expected credit losses from initial recognition does not result in an appropriate balance between the representation of the underlying economics and the cost of implementation.

15 EFRAG accepts the proposed approach because we expect it will result in an earlier recognition of expected credit losses and hence addresses the weakness of an incurred loss model. However we note that the proposals would require significant implementation and ongoing costs. Furthermore, our constituents identified a number of operational difficulties and uncertainties as to how the proposals should be applied, which are described in the remainder of this letter. We are more particularly concerned that our field-test has clearly highlighted that the current proposals do not allow entities to leverage existing risk management and regulatory practices and that not all the necessary data necessary are available. Therefore, we suggest the IASB to reconsider how the model should be implemented in such a way that entities are able to leverage their existing practices and hence limit the costs and increase reliability of their estimates. More generally, we believe that the results of our field-test provide valuable information about the operability and the clarity of the proposals, therefore we encourage the IASB to consider that work carefully in finalising its proposals.

Question 2(a)

16 We conceptually supported the integrated effective interest rate approach in the 2009 ED and we supported the time proportionate approach in the Supplementary Document; however, we acknowledge the significant operational concerns expressed by constituents regarding the implementation of these approaches.

17 EFRAG believes that the recognition of a portion of expected credit losses at initial recognition is not conceptually sound when credit risk is priced appropriately. Therefore, as noted in our response to Question 1, we would concur with the alternative view of Stephen Cooper that ‘a 12 month period is without conceptual foundation and that the recognition of this loss allowance would result in financial reporting that fails to reflect the economics of lending activities, which could mislead users of financial statements’.

18 In addition, as we explain in our response to Question 2(c) below, we do not believe that recognising the full lifetime expected credit losses from initial recognition results in an appropriate balance between the representation of the underlying economics and the cost of implementation.

19 However, we note also the repeated request from the G20, the Financial Crisis Advisory Group and other constituents for the IASB to develop a forward-looking model that reflects expected credit losses and results in a higher level of provisioning in general.

20 Notwithstanding our conceptual concerns about the initial recognition of the 12-month expected credit losses, the proposed approach is a step in the right direction because:

(a) it uses a dual measurement objective for the recognition of credit loss expectations resulting from a credit deterioration, when those expectations are not sufficiently priced into the financial instrument;

(b) it addresses the delayed recognition of expected credit losses in the existing IAS 39;

(c) it deals with the occurrence of early loss patterns;

(d) it can also be more responsive to ‘incurred but not yet reported/recognised’ (IBNR) losses than IAS 39;

(e) compared to previous proposals, it is more operational and capable of being implemented in practice at a more reasonable cost.

21 In summary, EFRAG accepts the proposed approach because we expect it will result in an earlier recognition of expected credit losses and hence address the weakness of the current incurred loss model. Based on our assessment, the proposed approach would achieve an acceptable balance between the cost of implementation and the underlying economics, while meeting the need to provide earlier for expected credit losses as expressed by financial regulators and other constituents.

22 Finally, in the absence of a better model, the IASB should finalise its impairment requirements having this approach as a basis and taking into account our recommendations and address the operational difficulties identified in our field-test in order to reduce the implementation cost for preparers.

Question 2(b)

23 EFRAG agrees that the approach in the 2009 ED provided the most relevant information about the amortised cost measurement by allocating initial expected credit losses and interest income over the remaining life of a financial asset. However, we acknowledge the operational challenges of such an approach.

24 In its comment letter on the IASB's Supplementary Document in 2011, EFRAG supported the time-proportionate approach for the allocation of expected credit losses, and the decoupling of interest income and expected credit losses. In that letter, EFRAG disagreed with the proposal regarding the foreseeable future to deal with early loss patterns.

25 In conducting outreach on the Supplementary Document, EFRAG learned that constituents were concerned about additional costs resulting from the requirement to perform two separate calculations on a regular basis, and the subjectivity of inputs in relation to early loss patterns and the foreseeable future. Based on that outreach, we concluded that, even without the floor, the Supplementary Document would still be operationally challenging by requiring lifetime expected credit losses to be calculated from initial recognition for all loans, and would not deal sufficiently with early loss patterns. In contrast, the ED would require lifetime expected losses to be calculated only when there is a significant increase in credit risk after initial recognition.

26 Although, we acknowledge that the 12-month expected credit loss is not conceptually sound, nevertheless, in our view, it is a clear measure that will allow entities to use where possible existing credit risk management tools and systems and deal with early losses in a pragmatic way. While we accept the 12-month expected credit loss measurement for financial assets that have not deteriorated significantly in credit quality since initial recognition, we believe that this is the maximum acceptable length and the final requirements should not be based on a larger portion of lifetime expected credit losses. Moreover, as we have explained in our response to Question 1(b) above, we do not support the notion of 'foreseeable future' since it was neither clearly defined nor well understood. It would therefore be difficult to ensure consistent application. Further, the approach would penalise more sophisticated preparers who are capable of longer range forecasts.

27 EFRAG understands that the requirement in the ED to track changes in the credit quality will increase the level of complexity in the model; however, we note that the ED provides a number of operational simplifications that in our view will mitigate the level complexity.

28 Overall, we believe that the approach in the ED achieves a better balance between the faithful representation of underlying economics and the cost of implementation than the approaches proposed in the 2009 ED and the Supplementary Document (without the foreseeable future floor).

Question 2(c)

29 EFRAG understands that any impairment model that uses a single measurement approach that recognises lifetime expected credit losses from initial recognition will remove the need to reclassify financial assets from one stage to another. Nevertheless, by having to estimate the full amount of expected credit losses over a longer period such a model would be more subjective – particularly in those situations where there are no indications of a significant credit deterioration – and not necessarily operationally simpler compared to the proposed approach in the ED.

30 Furthermore, in our view the above approach would not be less costly as it will entail all the other operational challenges of an expected credit loss model. We also note that such a model would provide users with less relevant information about credit deterioration of financial assets.

31 As noted in paragraph 1 above, such an approach would result in the initial carrying amount of the financial asset being reported below its fair value. In our view, recognising a 'day-one loss' on any financial asset that is priced at market terms defeats the initial measurement requirements in IAS 39 and IFRS 9 *Financial Instruments* by ignoring the fact that any initial credit loss expectations have been considered in the pricing of that instrument.

32 In addition, we observe that using the original effective interest rate instead of the credit adjusted effective interest rate to discount credit losses that have been originally priced will result in significant frontloading by overstating expected credit losses on initial recognition, and overstating the performance in the following years.

33 Consequently, EFRAG believes that recognising the full lifetime expected credit losses from initial recognition does not result in an appropriate balance between the representation of the underlying economics and the cost of implementation.

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?

EFRAG's response

EFRAG agrees with the scope of the Exposure Draft.

Question 3(a)

34 EFRAG agrees with the proposed scope in the Exposure Draft.

35 EFRAG supports the view that the same impairment approach should apply for both loans and loan commitments, since they are often managed within the same business strategy.

Question 3(b)

36 To the extent that IFRSs will be amended to allow a FV-OCI category for particular debt securities, EFRAG agrees that the proposed impairment requirements should also apply to that FV-OCI category. We recognise that the presentation at the balance sheet level of applying the impairment model to the amortised cost and the FV-OCI category will be different. We believe it is important that both the amortised cost category and the FV-OCI category are subject to the same impairment requirements as this ensures comparability of amounts that are recognised in profit or loss for assets with similar economic characteristics. Furthermore, we agree with the IASB that having different impairment requirements would be a source of complexity.

37 EFRAG notes that while the application of the model results in the same profit or loss pattern when applied to the amortised cost category or the FV-OCI category, there is a difference in the impact on equity. When applied to the FV-OCI category, on initial recognition the model results in a debit in profit or loss that is offset by a credit in other comprehensive income. The IASB should explain in the Basis for Conclusions how this difference should be interpreted.

12-month expected credit losses

Question 4

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

EFRAG's response

Based on the findings of its field-test, EFRAG found that the reliance on probabilities of default in credit risk management is currently limited and hence the ability to use where possible current credit risk management to implement the ED. While financial institutions which follow the Internal Ratings Based Approach for credit risk management may have detailed statistical data on credit risk behaviour (e.g. probabilities of default, loss given defaults, maturities, exposures at default) of their clients, this may not be the case for financial institutions following the Standardised Approach for credit risk management, corporates and insurers.

EFRAG believes that the final standard should provide further clarification how constituents that do not apply an Internal Ratings Based Approach for credit risk management could implement the standard without undue cost. We suggest that the IASB should explore to what degree information other than the data currently available could be used as a reasonable proxy in order to reduce the costs of implementation.

38 EFRAG acknowledges that several regulated industries make use of estimates of expected losses. However, these calculations differ from the requirements put forward by the proposed model which should be applied by entities in all industries.

39 Based on its field-test EFRAG concluded that the reliance on probabilities of default in credit risk management is currently limited and hence the ability to use where possible current credit risk management to implement the ED. While financial institutions which follow the Internal Ratings Based Approach for credit risk management may have detailed statistical data on credit risk behaviour (e.g. probabilities of default, loss given defaults, maturities, exposures at default) of their clients, this may not be the case for financial institutions following the Standardised Approach for credit risk management, corporates and insurers. It should be noted that even financial institutions following an Internal Ratings Based Approach may not necessarily do so for all their portfolios or financial instruments, but may also partly rely on the Standardised Approach for certain portfolios or geographic areas.

40 Additionally, the data on credit deterioration available to financial institutions which follow the Internal Ratings Based Approach need to be adapted in order to be used in implementing the ED, e.g. the probabilities of default collected for risk management purposes are based upon a through-the-cycle approach while the ED requires a point-in-time approach. These differences may require a lot of work to be overcome for those financial institutions which follow an Internal Ratings Based Approach for credit risk management purposes.

41 Building the expected losses model of the ED may be even more challenging for all other constituents. While EFRAG agrees that the final standard should not list acceptable techniques or methods for measuring the loss allowance, we are of the opinion that the final standard should provide sufficient guidance for other constituents to be able to apply the model. EFRAG believes that the final standard should provide further clarification how constituents that do not apply an Internal Ratings Based Approach for credit risk management could implement the standard without undue cost. We suggest that the IASB should explore to what degree information other than the data currently available could be used as a reasonable proxy in order to reduce the costs of implementation.

Assessing when an entity shall recognise lifetime expected credit losses

Question 5

(a) Do you agree with the proposed requirement to recognise a loss allowance (or a provision) at an amount equal to lifetime expected credit losses on the basis of a significant increase in credit risk since initial recognition? If not, why not and what alternative would you prefer?

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

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

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

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

EFRAG's response

EFRAG supports the proposed approach to recognise lifetime expected credit losses when there is a significant deterioration in the borrower's ability to meet its contractual terms since initial recognition.

EFRAG supports the IASB's decision to include application guidance on the assessment of a significant increase in credit risk that is also suitable to non-lending businesses. However, we believe that further guidance and clarifications are still necessary to ensure a common understanding and consistent application.

EFRAG in principle agrees that the assessment for the recognition of lifetime expected credit losses should be based on changes in the probability of default. However, we suggest the IASB amend the wording in paragraph 8 to make clear that the assessment of changes in the probability of default should be the objective and that other approaches could also be used to make the assessment. In addition, we suggest the IASB emphasise that the objective of discounting is to reflect the time value of money.

Based on the findings of our field-test, we support the proposed operational simplifications as they are necessary to make the model workable for every entity. However, we suggest the IASB ensure that the relevant guidance in the final standard is clear in order to avoid that the proposed simplifications are being interpreted as a bright line.

Question 5(a)

42 EFRAG believes that there are two distinct objectives in accounting for credit losses; (1) to reflect the effective return by allocating interest revenue and (2) to recognise an impairment allowance for credit losses in excess of those initially expected. The first objective is only appropriate to the extent that the interest revenue is expected to cover any credit losses, while the second objective is appropriate when credit losses significantly exceed the original expectations.

43 EFRAG agrees with the proposal to recognise lifetime expected credit losses on the basis of a significant deterioration in the borrower's ability to meet its contractual terms, because that credit deterioration would not have been reflected in the original pricing (i.e. interest rate) of the financial asset.

44 As explained in paragraph 49 below, while we agree that it is appropriate to base the approach on a relative deterioration of the credit quality, practical expedients are required to make the model more operational in practice.

Question 5(b)

45 EFRAG supports the IASB's decision to include application guidance on the assessment of a significant increase in credit risk that is also suitable to non-lending businesses. However, we believe that further guidance and clarifications are necessary to ensure a common understanding and consistent application.

46 EFRAG believes that it would helpful if the standard included further guidance on how to calculate expected credit losses on instruments that require payments only at maturity, e.g. a 10-year bullet loan. In addition, we note that paragraphs IE34-IE41 of the ED include an example that illustrates how the proposals would apply to a portfolio of credit cards that are cancellable after a one-day notice period. We suggest including in this example how to deal with the contractual cancellation period. More specifically, while the contractual cancellation period for such

facilities could be, for example one day, the constructive period however, over which credit is offered could be longer due to current practice of the issuer.

47 Furthermore, we note that many constituents found the guidance in paragraphs IE29-IE33 of the ED to be inconsistent with the principle described in paragraph 5 of the ED which requires lifetime expected credit losses to be recognised only after a significant increase in credit risk after initial recognition. In particular, constituents were concerned that the guidance in the particular example could be interpreted as a bright line.

48 We also note that paragraph B11 of the ED, suggests that the 12-month probability of default occurring could also be used to assess whether the credit risk has increased significantly since initial recognition. While we agree that this might be helpful in practice, it is not clear whether such an approach would meet the requirements in paragraph 8 in the ED, which mentions that a simple comparison of absolute probabilities is not sufficient.

49 EFRAG agrees with the reasoning in paragraph BC67 of the ED that a single absolute credit quality threshold would not be appropriate for all different types of financial instruments.

50 However, we note that paragraph BC202 in the ED implies that an entity can segregate its portfolios and apply the credit quality assessment to portfolios with similar credit risk characteristics in an absolute manner. We agree with that approach and believe that it would be helpful if the IASB could state this explicitly in the body of the final standard. This would reduce the cost of the requirement to assess the relative credit deterioration, by allowing entities to use an absolute threshold to individual portfolios.

51 We note that in order to assess whether the credit risk on a financial instrument has increased significantly since initial recognition, paragraph 8 of the ED requires an entity to use the probability of a default. We understand that some constituents believe that the wording in paragraph 8 suggests that in order to make that assessment, entities should apply a statistical approach that relies on probabilities of default as explicit inputs. We suggest the IASB amend the wording in that paragraph to make clear that the assessment of changes in the probability of default is the objective of the assessment and that there are other approaches that could be used to make the assessment.

52 EFRAG agrees that, generally, an estimate of expected credit losses should reflect the time value of money. We also support the flexibility in choosing the discount rate for the reasons explained in paragraph BC94 of the ED. Nevertheless, in our view the unrestricted range of permitted discount rates appears to be overly broad. In particular, the wording in paragraph B29(a) of the ED suggests that an entity can choose any rate between and including the risk-free rate and the effective interest rate.

53 We are concerned that the above flexibility could potentially lead to double-counting particularly when the credit risk would be reflected in both the cash flows and the discounted rate, which would result in a lower impairment allowance. Therefore, we suggest the Board to emphasise that the objective of discounting is to reflect the time value of money. In our view, this would ensure that an entity avoids picking an inappropriate rate discount rate. If an entity usually calculates the present value by discounting nominal cash flows with a risk-adjusted rate, but does no longer have the original effective interest rate available (e.g. in an open portfolio context), then it should still be required to estimate an appropriate discount rate that reflects the credit risk in the portfolio. Consequently, in our view,

discounting at the risk-free rate would only be appropriate in rare cases (i.e. if substantially all of the assets in the portfolio are risk-free).

Question 5(c)

54 EFRAG agrees that the assessment for the recognition of lifetime expected credit losses should be based on changes in the probability of default, as it does not require the full estimation of expected credit losses. In addition, we note that grounding the assessment to changes in the probability of default will provide users with additional information about credit quality and explain whether the entity is mainly focussed on collecting interest revenue or focussed on recovering principal.

55 Although we agree with the proposed requirement, we note that recognising lifetime expected credit losses based only on changes in the probability of default, might not deal appropriately with certain loan agreements where the interest rate is automatically adjusted for changes in credit risk (e.g. in certain syndicated loans and certain consumer loans in markets such as Sweden). While some of those loans might not meet the cash flow characteristics test in IFRS 9, we believe that the IASB should explicitly consider the impact of the proposed impairment model on those loans that would qualify for measurement at amortised cost.

56 On a related note we request the IASB to clarify the time horizon to be taken into account for the purpose of a lifetime expected loss calculation in circumstances where the parties to the instrument have to re-agree on the conditions (including any credit spread) for a specified period. Take, for instance, a mortgage loan with a 40-year term whose interest rate is only fixed for the first ten years. After ten years the interest rate applying to the next interval is reset to the then current conditions (including credit). It does not seem clear from the proposals on what term the lender would have to base its calculations. If the loan deteriorated at some point within the first interval: Would the impairment calculation be based on the remaining term until the next re-pricing date (as any losses expected thereafter could effectively be priced into the rate for subsequent intervals), or would the calculation take the entire remaining life of the instrument into account? The latter would effectively mean discounting cash flows at a rate that would not be a measure of the time value of money since the rate for these later cash flows will only be fixed upon future reset dates. Further, it does not seem clear to us whether re-pricing could result in moving a loan back into stage one.

Question 5(d)

57 EFRAG supports the use of principle-based guidance on credit deterioration which provides indicators and factors rather than bright lines, but we acknowledge that the requirement to track changes in the credit quality will be operationally challenging. Therefore, we agree that operational simplifications are necessary to make the model workable for every entity.

58 EFRAG understands that the proposed ’30 days past due’ rebuttable presumption would not necessarily be aligned with the existing credit risk management practices. We note that the aforementioned presumption would not drive the accounting but would mainly affect the amount of work required in order to assess whether there is a significant increase in credit risk. However, we suggest the IASB clarify that the’30 days past due’ rebuttable presumption is not to be interpreted as a bright line.

59 Furthermore, we agree that there is no conceptual basis for a 30 -day period; however, given that this provides some degree of relief to preparers without significantly affecting the level of the impairment allowance, we believe it is

appropriate. We also believe that – given that '30 days past due' is already a lagging indicator – it would generally not be appropriate to use a longer period for the purposes of this relief.

60 Some constituents believe that the rebuttable presumption that a significant deterioration in the borrower's ability to meet its contractual terms has occurred when payments are more than 30 days past due if no other borrower-specific information is available would not provide relief in practice, because the condition would be triggered in many cases when payments are late but no concern exists about the underlying credit risk. They believe that when the condition is triggered, an entity would need to rebut the presumption, which in itself could be burdensome. EFRAG does not agree with this reasoning because, in our view, an entity could rebut the presumption based on historical statistical information on portfolios with similar credit risk characteristics. Nevertheless, we would appreciate if the IASB stated this explicitly in the standard.

61 EFRAG also supports the proposed simplification for financial instruments with low credit risk and agrees that the primary focus of the model should be when there is a significant increase in credit risk. In our view, the proposed definition of low credit risk is meaningful and consistent with our understanding that the probability of default increases at an exponential rate as a financial asset deteriorates in credit quality (i.e. where significant changes in credit risk rating grades do not result in significant changes in the absolute probability of default). Therefore, we believe it strikes the right balance between the benefits of making the distinction between financial assets that have deteriorated significantly in credit quality and the costs of making that distinction.

62 However, we observe that many financial instruments that are purchased or originated today will have a credit quality that will likely be below the 'investment grade' level. Consequently, the proposed simplification might only apply in a relatively limited range of circumstances. Furthermore, we note that the use of the phrase 'investment grade' leads many constituents (e.g. financial institutions that apply the Standardised Approach for measuring credit risk and non-financial institutions) to understand that they would be required to use ratings provided by external ratings agencies. We believe that the IASB should make clear in the standard that there is no requirement to obtain external credit ratings for the purposes of applying the impairment model.

63 The FASB ED proposes a practical expedient for debt securities classified at FV-OCI that will allow an entity to not recognise expected credit losses when both (1) the fair value of the debt security is greater than (or equal to) the amortised cost and (2) expected credit losses are insignificant. However, as noted in paragraph 36 above, EFRAG believes that such a practical expedient would be inconsistent with the conceptual approach underlying the proposed FV-OCI category, since this approach intends to reflect in profit or loss the effects of carrying those instruments at amortised cost. Furthermore, in our view, recognising expected credit losses based on the fair value of a debt security would not be appropriate because a fair value also reflects changes in factors other than credit risk.

64 EFRAG notes that many participants in our field test indicated that the 30-days past due rebuttable presumption has an important impact on making the ED operational. The same is valid for the low credit risk practical expedient. Without both these practical expedients the ED would be far more difficult to implement.

Question 5(e)

65 EFRAG believes that both unfavourable and favourable changes in credit quality should be recognised in a consistent manner using the same principles and criteria, as this would provide comparability in the way entities account for like items. Consequently, we agree that an entity should be allowed to re-measure the loss allowance back to the 12-month expected credit loss when the criteria for the recognition of the lifetime expected credit losses are no longer met.

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 and presented 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 and presentation 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?

EFRAG's response

EFRAG agrees that interest revenue should be calculated on a net basis when there is objective evidence of impairment.

Question 6(a)

66 EFRAG notes that the decoupled approach in the Exposure Draft considers the recognition of interest revenue and the recognition of expected credit losses separately, which means that an entity recognises interest on the gross carrying amount without taking expected credit losses into consideration. However, we agree with the IASB's conclusion in paragraph BC98 of the ED that 'there are some financial assets that have deteriorated in credit quality to such an extent that presenting interest revenue on the basis of the gross carrying amount that reflects the contractual return would no longer faithfully represent the economic return'. We believe that this would provide more useful information for users analysing the net interest margin.

Question 6(b)

67 The requirement to calculate interest revenue based on a net carrying amount when there is objective evidence of impairment increases the complexity of the impairment model. However, EFRAG agrees with the IASB that, as preparers have been determining interest on the net amortised cost in a similar way under IAS 39, no new complexity is added.

68 Interest is seen as compensation for the initial expected credit losses and compensation for time value of money. When credit losses become so important that they cannot longer be compensated by the interest revenue, different approaches can be used to measure the interest revenue. Conceptually EFRAG

believes that the IASB approach to calculate the interest revenue based on a net carrying amount when there is objective evidence of impairment is better than the non-accrual approach used by the FASB in its model. The use of a non-accrual principle requires a difficult distinction to be made as to whether cash flows represent interest or principal which can result in the time value of money not being fully recognised in impairment provisions, particularly if debt terms are modified.

69 EFRAG agrees with the IASB's analysis that there are concerns about using 'incurred loss' criteria in an expected credit loss model, but accepts that it is necessary to retain the faithful representation of interest revenue.

Question 6(c)

70 We agree with the proposal that the interest revenue approach shall be symmetrical, as this would provide comparability in the way entities account for like items.

Disclosures

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?

EFRAG's response

While EFRAG supports the proposed disclosure objectives, we are concerned that the proposed disclosures are likely to be excessive, more particularly for non-financial institutions. Therefore, we urge the IASB to ensure that the level of disclosures in the final standard is proportionate for non-financial institutions.

We believe that the proposed disclosures will increase transparency and comparability and provide relevant information about the credit quality of an entity's financial assets and its risk management activities.

We note that many constituents indicated that the operational difficulty to comply with the proposed disclosure requirements would be high. Therefore, we encourage the IASB to consider carefully the findings of our field-test – which have already been shared in draft with your staff – and review the level of proposed disclosures in order to balance appropriately the cost for preparer's and benefits for users.

In addition, the IASB should develop an alternative form of disclosure about experience adjustments, which would allow users to understand the quality of earlier accounting estimates. We also suggest that the information for modified financial assets be limited to the year of modification.

Finally, we recommend that all relevant disclosures be placed in IFRS 7 *Financial Instruments*.

71 EFRAG agrees with the proposed disclosure objectives as they are aligned with the recognition and measurement principles of the ED. However, while we believe that the proposed disclosures are appropriate for the majority of financial institutions, we are concerned that they are likely to be excessive for non-financial institutions. Therefore, we urge the IASB to ensure that the level of disclosures in the final standard is proportionate for non-financial institutions and consistent with the objectives described in paragraph 28 of the ED.

72 EFRAG believes that disclosures play a fundamental role in complementing financial information derived from applying the proposed impairment model, as this model requires the application of more judgement than IAS 39. To increase transparency and comparability, we believe that the disclosures should help users to understand the effects of credit risk of financial instruments on an entity's financial position and performance.

73 EFRAG agrees with the IASB's assessment in paragraph BC184 of the ED that *'any approach that attempts to reflect expected credit losses will be subject to measurement uncertainty and will place greater emphasis on management's judgement and the quality of the information used'*. We believe that the disclosures will increase transparency and comparability, and provide relevant information about 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. In our view, the disclosures on reconciliations, and the inputs and assumptions used to estimate expected credit losses are necessary to achieve the disclosure objective. Having said that, in practice, disclosures will reach the appropriate level of relevance only if the IASB ensures – with short-term amendments to IAS 1 as currently envisaged and/or otherwise – that the final requirements lead to sound practice.

74 Nevertheless, we note that many constituents indicated during our field-test, that overall the operational difficulty to comply with the proposed disclosure requirements would be high. Therefore, we encourage the IASB to consider the findings of our field-test – which have already been shared in draft with your staff – and review the level of proposed disclosures in order to balance appropriately the cost for preparer's and benefits for users.

Back-testing

75 EFRAG acknowledges the concerns about providing 'back-testing' disclosures in the context of open portfolios as described in paragraph BC109 of the ED. Nevertheless, consistent with the recommendation in our comment letter on the IASB's Supplementary Document, we suggest the IASB should develop an alternative form of disclosure about experience adjustments. This would allow users to understand the quality of earlier accounting estimates.

Write-off policy and modifications

76 EFRAG notes that the timing of a write-off of a financial asset in accordance with paragraph 21 of the ED would depend on an entity's 'reasonable expectations of recovery', which would in part depend on the legal system in the relevant jurisdiction (e.g. legal systems may move at different speeds and an entity's legal options may be exhausted sooner in some jurisdictions). Similarly, we note that the details underlying modifications are often specific to jurisdictions. Therefore, we support the disclosures regarding the write-off policies and modifications as they will provide relevant information and increase comparability between jurisdictions.

77 Paragraph 22 in the ED states that write-offs can relate to a portion of a financial asset, but does not explain when such write-offs would be appropriate or required. In order to mitigate the effects of inconsistent application of the notion of partial write-offs, which would be based on an entity's individual assessment of the facts and circumstances, we believe the IASB should provide application guidance that explains when partial write-off would be appropriate.

78 We note that some of our constituents noted that the requirement to track disclosures for written-off financial assets in paragraph 37, and modified financial assets in paragraph 38 over the remaining life of the instruments would be burdensome, especially for revolving facilities and long-term products that have been performing well after their modification. In our view, the proposed requirement would result in disclosures that would not necessarily provide useful information in the accounting periods following the initial period where the write-off took place. Therefore, we suggest the IASB, to limit the information for modified financial assets to the year of modification.

79 Finally, we believe that the drafting in paragraph 38 could be made clearer to indicate that the disclosure requirements in that paragraph should apply only to modifications of financial assets on which lifetime expected credit losses are recognised as a result of a significant increase in credit risk and assets held under the simplified approach that are modified when more than 30 days past due - or the equivalent number of days under the rebuttable approach.

Other disclosures

80 Paragraph 31 in the ED requires preparers to decide which disclosures in IFRS 7 and in the ED result in duplication. EFRAG believes that it is the task of the IASB, as a standard setter, to avoid duplicating disclosure requirements between standards as this would reduce costs for preparers and avoid divergence in practice. Therefore, we recommend that all relevant disclosures be placed in IFRS 7 *Financial Instruments.*

81 Paragraph 32 in the ED allows an entity to provide disclosures by cross-reference to other statements or risk reports, noting that without that information incorporated by cross-reference, the financial statements are incomplete. EFRAG agrees with the proposal and supports such cross-referencing as it allows entities to cope with a possible overlap between mandatory requirements emanating from IFRS applied to financial statements and national law to other parts of the financial report.

82 EFRAG also believes the IASB should develop a proper disclosure framework which would specify not only what information needs to be disclosed, but also what leeway might be appropriate in terms of where the information is disclosed.

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?

EFRAG's response

EFRAG agrees with the proposed treatment of financial assets whose contractual cash flows are modified but is of the opinion that the standard needs to clarify when a modification results in derecognition, as well as how to differentiate between modifications resulting from deteriorations in credit risk on the one hand and those resulting from commercial reasons on the other hand.

83 The ED requires an entity 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. EFRAG agrees with this approach when the modification does not result in derecognition as it will more appropriately reflect the deterioration in credit risk that has occurred. At the same time it should be made clear that the expectation of credit losses should also take into account any experience of how such modified assets behave.

84 The impairment proposals would affect modified financial assets where the modification does not result in derecognition. EFRAG notes that it is not always clear when a modification as a result of a debt restructuring results in derecognition and when not. In our letter of 26 July 2012 to the IFRS Interpretations Committee, we noted that 'it would be helpful if the standards explicitly dealt with debt restructurings more generally, which would be particularly relevant in the light of the current financial crisis. In this respect we note the absence of certain definitions that are critical for the derecognition assessment process, and the lack of an explicit discussion in IAS 39 of when a modification of a financial asset (or exchange of debt instruments) results in derecognition. Therefore, we suggest that the Interpretations Committee recommend to the IASB that accounting for debt restructurings and modifications be addressed as part of the finalisation of IFRS 9 *Financial Instruments*.'[1]

85 EFRAG recognises that modifications of financial assets do not solely result from increases in credit risk of the debtor but can also take place for business or commercial reasons. EFRAG believes, even when the ED does not describe modification losses as impairment losses, that when the ED has the intention to address the latter type of modifications unrelated to credit risk losses, this should be more clearly specified in the final standard.

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 provisions arising from expected credit losses on financial guarantee contracts or loan commitments as a separate line item in the statement of financial position? If yes, please explain.

[1] Letter to IFRS Interpretations Committee, 26 July 2012, *IAS 39 Financial Instruments: Recognition and Measurement – Accounting for different aspects of restructuring Greek government bonds.*

EFRAG's response

EFRAG supports the inclusion of loan commitments and financial guarantee contracts into the scope of the standard.

86 EFRAG supports that financial guarantee contracts remain within the scope of the proposed impairment model as in many cases these are subject to the same risk management practices as lending. In addition, we believe that the IASB and FASB should align the scope of their projects with regard to financial guarantee contracts, either to include or exclude financial guarantee contracts. EFRAG is of the opinion that this is one of the areas where the projects should converge.

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?

(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?

EFRAG's response

EFRAG supports the proposed simplified approach for trade receivables and lease receivables. However, we believe that further application guidance is necessary regarding the application of the proposals to lease receivables.

Simplified approach

87 As a matter of principle, EFRAG would be in favour of requiring the same impairment model to all financial assets, as this would ensure comparability and provide more useful information about the effect of changes in credit quality.

88 However, from a pragmatic point of view, we accept that applying the full impairment model to lease receivables and trade receivables would not result in an appropriate trade-off between costs and benefits. In particular, we understand that application of an expected credit loss model and particularly the requirement to track changes in credit quality would be challenging for certain lessors and most corporates as they do not maintain the same level of granular information as banks or other financial institutions. In addition, we agree that the benefits of applying the general model to trade receivables that do not have a significant financing component would not outweigh the cost of implementation given the short-term nature of these receivables. Therefore, EFRAG supports the proposed simplified approach for trade receivables and lease receivables.

89 We acknowledge that the simplified approach would reduce comparability across entities. However, in our view, also allowing entities to apply the general model would increase comparability within entities, especially for group entities with different activities that wish to apply the same impairment model within the group.

Proposed amendment to IFRS 9

90 EFRAG agrees with the proposed amendment to IFRS 9 to measure trade receivables that do not have a significant financing component at the transaction price as this would align the requirements of IFRS 9 with those proposed in the revenue recognition project.

Application to lease receivables

91 Under the revised Exposure Draft Leases, lessors would recognise separately in their statement of financial position a lease receivable (measured at the present value of the lease payments) and a residual asset (measured as an allocation of the carrying amount of the underlying asset). EFRAG understands that the recoverable amount of the underlying asset should be allocated in part to test the lease receivable for impairment, and in part to test the residual.

92 EFRAG agrees that the entity should not test the lease receivable and the residual as a single unit of account. An increase in the fair value of the residual asset is not a transfer of economic resources from the debtor to the lessor and therefore should not offset the effects of deterioration in the lessee's creditworthiness.

93 In addition, we note that the revised exposure draft on leases includes an illustrative example in paragraph 84 on how to allocate the recoverable amount of the underlying asset. We recommend that all relevant guidance should be included in a single standard, and therefore suggest that the illustrative example be placed in the final standard on impairment.

94 EFRAG notes however that there are some specific application issues in the context of lease receivables, and we recommend that the IASB provides clarification:

(a) The ED refers to 'cash shortfalls', defined as the difference between the principal and interest due under the contract, and the cash flows that the entity expects to receive. EFRAG notes that lease arrangements may include variable lease payments which, under the upcoming Leases exposure draft, are normally not included in the measurement of the lease receivable. Paragraph B33 of the ED tries to address the issue by requiring that 'when measuring a loss allowance for a lease receivable, the cash flows used for the measurement *should be consistent with* the cash flows used in measuring the lease receivable in accordance with IAS 17'. However, we are not convinced that this drafting is clear enough to result in a consistent application in practice.

(b) The revised Exposure Draft Leases contains specific requirements regarding options to extend (or terminate early) a lease. Consequently, the lease receivable recognised relates to a period that is often significantly shorter than the maximum contractual period and usually different from the expected duration of the lease. EFRAG believes that these issues should be addressed more clearly in the application guidance to the ED.

(c) In a lease, the lessor retains legal ownership of the underlying asset. EFRAG believes that the application guidance should clarify how a lessor should treat the value (and possible changes in its value) of a right-of-use asset that serves as collateral in measuring the loss allowance.

(d) The ED refers to the application of the proposed impairment model to undrawn loan commitments. Under a Type-B lease, a lessor is contractually bound to provide access to the underlying asset. We recommend that the

IASB specifies if the lessor's obligation under a lease could constitute an undrawn loan commitment.

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?

EFRAG's response

EFRAG agrees with the proposals for financial assets that are credit impaired on initial recognition.

95 EFRAG agrees with the proposal in the ED to carry forward the scope and requirements in paragraph AG5 of IAS 39, which require an entity to include the initial expected credit losses in the estimated cash flows when calculating the effective interest rate for financial assets that have objective evidence of impairment on initial recognition. EFRAG agrees with the IASB that such an approach, even when it does not achieve full comparability with the impairment treatment of other financial assets, the impairment model does faithfully represent the underlying economics for this type of financial assets.

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?

EFRAG's response

EFRAG strongly believes that to implement the proposed requirements, entities would need a full three years after publication . This period could be reduced only if substantial changes are made along the lines of our recommendations to make the standard more operational and less costly to implement. This assessment should be made taking into consideration the capabilities of entities in general and not focus exclusively on large banks with sophisticated systems and practices.

96 EFRAG believes that in setting the standard's effective date, the IASB should carefully assess the time entities need to implement the new requirements with the required degree of reliability, so that improvements materialise in practice. To implement the proposed requirements, entities would need a full three years after

publication. This period could be reduced only if substantial changes are made along the lines of our recommendations to make the standard more operational and less costly to implement. This assessment should be made taking into consideration the capabilities of entities in general and not focus exclusively on large banks with sophisticated systems and practices. The IASB should reconsider the transitional requirements of IFRS 9 to ensure that the restated comparative information is meaningful. If the IASB were to conclude that it is not possible to revise the transitional requirements such that the comparative information is meaningful, we would recommend that relief from restating comparative information be granted.

97 While EFRAG agrees that it might not be possible to apply the requirements of the ED without the use of hindsight, we believe that the IASB should consider that not requiring restatement of comparative information would force users to make certain adjustments for which they have far less information than preparers.

98 Finally, we suggest that the IASB provides, as soon as feasible, a realistic timetable for implementation of the standard in order to allow constituents to anticipate and manage the proposed changes in a cost-effective manner.

99 EFRAG believes that paragraph C2 of the transition requirements needs further clarification. The paragraph states that, if at the date of initial recognition of a financial instrument, determining the credit risk would require undue cost or effort, the loss allowance or provision shall be determined only on the basis of whether the credit risk is low. This relief is not available for financial instruments whose past-due status is used to assess changes in credit risk, because it is assumed that the information will be available to make the assessment. We believe that it should be clarified that, the possibility to rebut the 30 days past due presumption should remain valid in these cases.

Effects analysis

Question 13

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

EFRAG's response

We agree that the proposed model would be more responsive to changes in credit quality compared to IAS 39, and therefore would result in an earlier recognition of expected credit losses.

In addition, we believe that the results of our field-test provide valuable information about the operability and the clarity of the proposals, therefore we encourage the IASB to consider that work carefully in finalising its proposals.

100 EFRAG appreciates the step forward that the IASB has taken integrating the effect analysis into the standard setting process. In our view, paragraphs BC164-BC216 include useful information that will enable users, preparers and other interested parties to understand and evaluate the potential effect of the requirements.

101 During the comment period, EFRAG conducted a field-test with the National Standard Setters of France, Germany, Italy and the UK in order to assess whether the proposals in the ED would address the weaknesses of the incurred loss model

in IAS 39, whether the proposals were operational, and the likely costs of implementation.

102 EFRAG agrees with the analysis in paragraph BC170 of the ED, that the proposed model would be more responsive to changes in credit quality compared to IAS 39, and therefore would result in an earlier recognition of expected credit losses.

103 We note that users have indicated that the distinction, between financial instruments that have deteriorated significantly and those that have not, provides useful information about expected credit losses and changes in expectations, and the way entities manage their lending portfolios.

104 We also note that many constituents have indicated that they are likely to incur significant costs, both for the implementation and ongoing application of the proposals. Nevertheless, we agree with the conclusion in paragraph BC164 of the ED.

105 Finally, we believe that the results of our field-test provide valuable information about the operability and the clarity of the proposals, therefore we encourage the IASB to consider that work carefully in finalising its proposals.