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

Feedback to constituents

July 2013

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Introduction

Objective of this feedback statement

EFRAG published its final comment letter on the IASB ED/2013/3 *Financial Instruments: Expected Credit Losses* on 9 July 2013. This feedback statement summarises the main comments received by EFRAG on its draft comment letter and explains how those comments were considered by the EFRAG Technical Expert Group (EFRAG TEG) during its technical discussions.

Background to the Exposure Draft

On 7 March 2013, the IASB published the ED *Financial Instruments: Expected Credit Losses*. The ED proposed to eliminate the existing requirement to recognise an impairment loss only after a credit loss event has occurred. Instead the ED would require expected credit losses to be always recognised and updated for any changes, even if there is not a specific credit loss event. Furthermore, the ED proposed a dual-measurement approach that would require an entity to distinguish between financial assets that have deteriorated and those that have not, and recognise an allowance for 12-month or lifetime expected credit losses depending on the extent of deterioration in the borrower's ability to meet its contractual terms.

Further details are available on the EFRAG website.

EFRAG draft comment letter

EFRAG published a draft comment letter on the proposed ED in April 2013. In that letter, EFRAG noted that conceptually it supported the integrated effective interest rate approach in the 2009 ED and the time proportionate approach in the Supplementary Document, however, EFRAG acknowledged the significant operational concerns expressed by constituents regarding the implementation of those approaches.

In addition, EFRAG noted that the recognition of a portion of expected credit losses at initial recognition was not conceptually sound. However, in the absence of a better model, EFRAG suggested the IASB should finalise its requirements having the approach in the ED as a basis and taking into account EFRAG's recommendations. EFRAG accepted the proposed approach because it would result in a more timely recognition of expected credit losses, and hence address that weakness of an incurred loss model. EFRAG's preliminary assessment was that the proposed approach provided an acceptable balance between the cost of implementation and the underlying economics, while meeting the need to provide earlier for expected credit losses. Nevertheless, EFRAG emphasised that it was undertaking a field-test with the National Standard Setters of France, Germany, Italy and the UK to substantiate its final assessment on the proposals.

EFRAG observed that the impairment model proposed by the FASB that recognised lifetime expected credit losses from initial recognition would not be less subjective and not necessarily operationally simpler compared to the IASB's approach. EFRAG concluded that such an approach did not result in an appropriate balance between the representation of the underlying economics and the cost of implementation, and would provide less relevant information about the effects of changes in the credit quality subsequent to initial recognition.

EFRAG requested its constituents' views on whether: (a) the same impairment model should apply for both the amortised cost and the FV-OCI category, (b) the '30 days past due' rebuttable presumption appropriately reflected when there was a significant increase in credit risk, (c) the proposed disclosures gave rise to operational concerns and were appropriate for all entities and (d) a different impairment model should apply to loan commitments.

Comments received from constituents

Twenty comment letters were received from constituents in time to be considered in the July EFRAG TEG meeting and are available on the EFRAG website.

The comment letters received came from national standard-setters, business associations, professional organisations, listed companies and EU authorities. The following table provides an overview of the respondents by type and country.

Respondent by type	
National Standard Setters	8
Associations-Organisations	8
Preparers	2
Regulators	1
Consultants	1
	20

Respondent by country	
UK	5
Germany	4
European respondents	2
Belgium	1
Denmark	1
France	1
International respondents	1
Netherlands	1
Italy	1
Norway	1
Portugal	1
Spain	1
	20

Appendix A lists the respondents to EFRAG's draft comment letter.

Most of the respondents argued that recognising a portion of expected credit losses on initial recognition was not conceptually sound; however, they agreed that the proposed approach was a pragmatic solution and a reasonable proxy to replicate the outcome of the 2009 ED in a more operational and less costly manner.

Most of the constituents supported the credit deterioration approach and agreed that the distinction between assets that had deteriorated significantly in credit quality and those that had not, was generally consistent with the way they managed their portfolios for credit risk purposes.

Some constituents highlighted the differences between the regulatory requirements and the proposals in the ED and argued that only a small number of entities, particularly large financial institutions, would be able to leverage their existing credit risk management tools and that many other entities would likely incur significant costs to implement the proposals.

Most constituents agreed with the proposed scope and noted that it was important that the same impairment model would apply to both financial assets that were measured at amortised cost and those that were measured at FV-OCI.

Many constituents noted that further guidance and clarifications were necessary, particularly on the assessment of a significant increase in credit risk and the practical expedients that could be used to make the above assessment, and also on how the proposals would apply to certain types of products. Furthermore, most constituents who explicitly commented on the proposed operational simplifications agreed that they were useful. However, many constituents raised concerns that the '30 days past due' rebuttable presumption and the reference to 'investment grade' would either be interpreted as a bright line or did not necessarily reflect when there was a significant increase in credit risk.

Most constituents raised significant concerns regarding the level and detail of the proposed disclosures. In particular, many constituents argued that some of the proposed disclosures were either operationally challenging or less decision useful.

The majority of constituents did not agree with the approach in the FASB ED, however, a many constituents highlighted the importance of convergence and encouraged the Boards to align their impairment models.

Most constituents agreed that a three-year period after the finalisation of IFRS 9 would be necessary to implement the proposals and therefore, the current mandatory effective date of 2015 should be extended.

Field-test

In April 2013, EFRAG launched - together with the National Standard Setters of France, Germany, UK and Italy - a field-test on the ED by way of written questionnaires. The response deadline was on 2 June 2013. In total, twenty-two questionnaires were received.

The participants were mainly from the banking and insurance industry. The following table provides an overview of the participants by country and industry.

Participant by country	
Germany	5
Italy	5
France	4
UK	4
Luxembourg	2
Spain	2
	22

Participant by industry	
Banking	15
Insurance	2
Other industries	4
Undisclosed	1
	22

Appendix B lists the participants to EFRAG's field-test.

Most participants agreed that the proposed impairment model would be more responsive to changes in credit quality, and therefore would result in an earlier recognition of credit losses.

The majority of participants indicated that the proposals would require significant implementation and ongoing costs. Furthermore, while most participants agreed that the proposals would be more operational compared to the IASB's previous proposals, they identified that the overall operational difficulty to implement several elements of the ED would be high. In particular, participants argued that the requirement to track changes in credit quality since initial recognition would be operationally challenging, either because the required information was not available, or because they assessed credit deterioration in a different way to that described in the ED.

Many participants were concerned that the proposals in the ED did not allow them to sufficiently rely on their existing credit risk management and regulatory practices and therefore would be required to incur significant costs to align any differences.

A significant number of participants noted that more guidance and clarifications were necessary around the assessment of a significant increase in credit risk, the practical expedients and the approaches that could be used to make that assessment. In particular, some participants were concerned that the wording in the ED implied that they would need to apply a model that used probabilities of default as explicit inputs. These participants argued that they applied various approaches to assess credit deterioration in credit risk other than an approach that was strictly based on changes in the probability of default.

Many participants confirmed that recognising a 12-month expected credit loss allowance at initial recognition did not reflect the economics of lending. Nevertheless, most participants indicated that the distinction between financial assets that had deteriorated significantly in credit quality and those that had not, was generally consistent with the way their portfolios were managed.

A significant majority of the participants found the requirements for trade receivables and lease receivables clear, however, constituents were divided as to whether the simplified approach was necessary or aligned with their existing credit risk management.

Most participants found the proposed disclosures complex, overly prescriptive and operationally burdensome, particularly the

requirement to provide reconciliation for the gross carrying amount and the associated allowance.

Participants were not specifically asked to indicate what lead time they would need to implement the proposals, however, some participants indicated that they would need sufficient lead time while other participants also mentioned that the transition requirements on the transition relief were not clear.

The detailed findings of the field-test are described in the feedback report that will be released in July 2013.

Input from EFRAG working groups and regulators

In dealing with the project, EFRAG received the invaluable advice of the EFRAG Financial instruments Working Group, the EFRAG Insurance Accounting Working Group and the EFRAG User Panel.

Finally EFRAG reached out to a number of regulators from the banking and insurance industries to take into account their perspective in the finalisation of its position.

Objective of an expected credit loss impairment model

EFRAG's tentative views and respondents' comments

EFRAG's tentative position

EFRAG noted that the recognition of a portion of expected credit losses at initial recognition was not conceptually sound. However, in the absence of a better model, the IASB should finalise its impairment requirements having that approach as a basis and taking into account EFRAG's recommendations in its draft comment letter.

EFRAG tentatively supported the proposed credit deterioration approach as it distinguished between financial assets that had deteriorated in credit quality and those that had not and thus provided useful information about the effects of changes in the credit quality of an entity's financial assets.

EFRAG did not support the approach in the FASB ED that required lifetime expected credit losses to be recognised at initial recognition as in most circumstances 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.

Constituents' comments

Most of the constituents argued that recognising an allowance equal to 12-month expected credit losses at initial recognition did not reflect the economics of lending because normally any initial credit loss expectations had already been priced. Nevertheless, constituents agreed that the proposed approach was a pragmatic solution and an acceptable proxy of the 2009 ED. Only one respondent suggested an alternative model and referred to the alternative views described in the ED.

(continues on page 8)

EFRAG's response to respondents' comments

In the light of the positive feedback from its constituents on its tentative position regarding the proposed dual measurement approach in the ED, EFRAG decided to maintain its previous position in its final comment letter.

EFRAG also noted that many constituents provided their support to proposed approach in the ED on the absence of a better model. In its final comment letter EFRAG did not suggest an alternative model; however, EFRAG provided a number of recommendations which we believe would make the model operationally more viable.

EFRAG also considered the lack of support on the proposed approach in the FASB ED. Accordingly EFRAG decided to maintain its previous position in its final comment letter. However, EFRAG noted the concerns of many constituents in Europe on the lack of convergence and the implications for preparers and users. Therefore, EFRAG urged the Boards to align where possible their proposals on impairment. In this respect EFRAG noted that the Boards' proposals on purchased credit-impaired financial assets and financial guarantees could potentially be further aligned.

EFRAG's tentative views and respondents' comments

Most of the constituents argued that the distinction between assets that had deteriorated significantly in credit quality and those that had not, was generally consistent with the way they managed their portfolios for credit risk purposes.

The vast majority of constituents did not agree that recognising an allowance at an amount equal to all expected credit losses from initial recognition reflected appropriately the economics of lending. However, many constituents highlighted the importance of convergence for preparers and users and encouraged the Boards to align their impairment models. In addition, a few of those constituents noted that they were not in favour of the notion of 'foreseeable future'.

EFRAG's response to respondents' comments

The main proposals in this exposure draft

EFRAG's tentative views and respondents' comments

EFRAG's tentative position

EFRAG tentatively accepted the proposed approach because it would result in a more timely recognition of expected credit losses and hence addresses the weakness of an incurred loss model in a pragmatic way.

Overall, EFRAG tentatively concluded that the approach in the ED achieved 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 also noted that recognising the full lifetime expected credit losses from initial recognition would not result in an appropriate balance between the representation of the underlying economics and the cost of implementation. However, EFRAG emphasised that it was undertaking a field-test in order to better substantiate its final assessment on the proposals.

Constituents' comments

Most constituents agreed that the dual measurement approach in the ED would achieve a better balance between the underlying economics and the cost of implementation compared to the approaches in the 2009 ED and the Supplementary Document.

The majority of constituents also agreed that recognising lifetime expected credit losses from initial recognition would not achieve any reasonable cost/benefit balance since the double-counting effect would be even more pronounced.

EFRAG's response to respondents' comments

EFRAG considered the feedback from its constituents who noted that the proposed model would address the criticism on the existing incurred loss model regarding the delayed recognition of credit losses. However, EFRAG understood that the proposals would require significant implementation and ongoing costs. EFRAG also acknowledged the concerns raised by many constituents on the operability and the uncertainties as to how the proposals should be applied.

Furthermore, EFRAG was concerned that the feedback from its field-test highlighted that some of the required information was not available, and that the proposals in the ED did not allow entities to sufficiently leverage on their existing risk management and regulatory practices. Therefore, while in its final comment letter EFRAG accepted the proposed approach, it suggested the IASB to consider how the model could be implemented in order to significantly increase the ability of entities to rely on their existing risk management and regulatory practices and thus achieve a better cost/benefit balance.

EFRAG noted the positive feedback from its constituents on its tentative conclusion that the proposed approach in the ED would achieve a better balance between the underlying economics and the cost of implementation compared to the IASB's previous proposals and the FASB approach. Accordingly, EFRAG decided to maintain its previous position in its final comment letter.

Scope

EFRAG's tentative views and respondents' comments

EFRAG's tentative position

EFRAG agreed with the proposed scope in the ED and supported the view that, to the extent that IFRSs will be amended to allow a FV-OCI category for debt securities, the same impairment approach should apply for both loans and loan commitments, since they are often managed within the same business strategy.

EFRAG addressed the accounting effects in equity and in profit or loss of the application of the impairment model to the FV-OCI category.

Constituents' comments

Most constituents agreed with the proposed scope of the requirements as well as with the inclusion of the FV-OCI category in the scope of the standard. Some argued to be against the introduction of the FV-OCI category and as such were against the inclusion of the FV-OCI category in the scope of the expected credit loss model.

Several constituents argued against the introduction of the FV-OCI category, but one constituent specifically disagreed with the inclusion of the FV-OCI category in the scope of the standard as the accounting would lead to non-comparable results on balance sheet level.

EFRAG's response to respondents' comments

In its final comment letter EFRAG kept its agreement with the proposed scope in the ED. A single impairment model for both financial assets at amortised cost and at FV-OCI would ensure comparability of amounts recognised in profit or loss for assets with similar economic characteristics. However, EFRAG recognised that the comparability on equity and balance sheet level was not ensured. Also, the application of a single impairment model would address one of the main complexities in the IAS 39 standard.

EFRAG's draft comment letter took already into account the different views by constituents on the application of the impairment requirement to the FV-OCI category by mentioning 'To the extent that IFRSs will be amended'.

In finalising its letter EFRAG addressed the accounting effects in the balance sheet of the application of the impairment model to the FV-OCI category.

12-month expected credit losses

EFRAG's tentative views and respondents' comments

EFRAG's tentative position

EFRAG noted to respond based on information gathered from its field-test.

Constituents' comments

Constituents noted that the leverage on existing credit risk procedures was rather limited or that it would be difficult for non-financial institutions to operationalise the standard.

It was suggested that the EFRAG comment letter should provide more information on the key differences between the regulatory and the accounting expected loss calculation. Other constituents asked to be able to rely on the Basel requirements, or use them as a proxy.

EFRAG's response to respondents' comments

Based on the findings of its field-test, EFRAG found that the reliance on probabilities of default in credit risk management was currently limited and hence the ability to use where possible current credit risk management to implement the ED.

The findings of the field-test confirmed that the possibility to rely on existing credit risk procedures was rather limited. To demonstrate this EFRAG clarified in its final letter that only a specific category of sophisticated banks had detailed statistical data on credit risk behaviour available. Even when such detailed data was available, these had to be strongly adapted to be used for accounting purposes.

To address constituents' concerns, EFRAG recommended the IASB that the final standard should provide further clarification how non-sophisticated banks could implement the standard without undue cost. EFRAG also suggested 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

EFRAG's tentative views and respondents' comments

EFRAG's tentative position

EFRAG supported the proposed approach to recognise lifetime expected credit losses when there was a significant deterioration in the borrower's ability to meet its contractual terms since initial recognition. EFRAG agreed with the approach in paragraph BC202 of the ED that an entity could apply the credit quality assessment to portfolios with similar credit risk characteristics in an absolute manner, and noted that it would be helpful if the IASB could state that explicitly in the body of the final standard.

EFRAG also agreed that the assessment for the recognition of lifetime expected credit losses should be based on changes in the probability of default.

EFRAG tentatively agreed with the proposed operational simplifications as they were necessary to make the model workable for every entity. In its draft comment letter EFRAG requested feedback from its constituents on whether the '30 days past due' rebuttable presumption appropriately reflected when there was a significant increase in credit risk and whether they would prefer an alternative period.

Constituents' comments

Timing and basis for recognition of lifetime expected credit losses

As noted earlier in this feedback statement, most constituents agreed with the credit deterioration approach and the distinction between financial assets that had deteriorated in credit quality and those that had not. Therefore, these constituents agreed that it was appropriate to recognise lifetime expected credit losses on the basis of a significant increase in credit risk.

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EFRAG's response to respondents' comments

Timing and basis for recognition of lifetime expected credit losses

EFRAG noted the positive feedback from its constituents on its tentative position regarding the timing and the basis for the recognition of lifetime expected credit losses. Hence, EFRAG decided to maintain its previous position in its final comment letter. However, EFRAG suggested the IASB to clarify on which time horizon entities should base their calculations on certain type of products which allowed reprising for a specified period.

Application guidance

EFRAG considered the concerns raised by its constituents regarding the wording in the ED on the principle of credit deterioration and suggested the IASB to amend paragraph 8 in the ED to clarify 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.

EFRAG acknowledges the concerns of its constituents who noted that the relative approach proposed in the ED was not aligned with the way they assessed credit deterioration. EFRAG reiterated its suggestion to the IASB to explicitly state in the body of the final standard that entities could assess credit deterioration to portfolios with similar credit risk characteristics in absolute manner. EFRAG believes that this will reduce the cost of the assessment.

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EFRAG's tentative views and respondents' comments

Most constituents agreed that the assessment of when to recognise lifetime expected credit losses should consider only changes in the probability of default occurring rather than changes in expected credit losses (i.e. credit loss given default).

Although these constituents did not justify their support, they requested further clarifications and provided a number of suggestions regarding the use of practical expedients that in their view would make the assessment more operational. These suggestions are further discussed below in the feedback statement.

<u>Application guidance</u>

Many constituents noted that further guidance and clarifications were necessary, particularly on the assessment of a significant increase in credit risk and the practical expedients that could be used to make the above assessment. These constituents were concerned that the wording in the ED was too restrictive and suggested the IASB should clarify that various other approaches could be used to make the above assessment. Some constituents questioned whether the 12-month probability of default was an acceptable approach, while other constituents noted that the 12-month probability of default was widely used for regulatory purposes and therefore should be the default approach to assess credit deterioration. In their view, the above suggestion would reduce the operational burden.

Some constituents requested further guidance on the application to credit card portfolios, while other constituents suggested that the final standard should include explain how the proposals would apply to certain type of long-term products which did not require any payments until maturity.

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EFRAG's response to respondents' comments

EFRAG considered the feedback from its constituents who requested further guidance and clarifications on the assessment of a significant increase in credit risk and the practical expedients that could be used.

Therefore, in its final comment letter EFRAG emphasised that further guidance and clarifications were necessary to ensure a common understanding and consistent application. In particular, EFRAG suggested that the more guidance should be provided on credit card portfolios when the constructive period over which credit was offered was longer than the contractual cancellation period. EFRAG also noted that it would be helpful if the standard include further guidance on how to calculate expected credit losses on instruments that required payments only at maturity.

EFRAG noted that some of its constituents preferred the 12-month probability of default to be used as the default approach to assess credit deterioration since such a measure was already been used for prudential purposes. In its final comment letter EFRAG suggested the IASB to consider how the proposals could be implemented to allow entities to leverage more on their existing risk management and regulatory practices.

<u>Operational simplifications</u>

EFRAG acknowledged that some constituents felt that the '30 days past due' rebuttable presumption was too conservative. However, EFRAG did not agree with these views and understood that the proposed criterion in most circumstances would reflect a significant increase in credit risk.

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EFRAG's tentative views and respondents' comments

Operational simplifications

Constituents who provided feedback on the proposed operational simplifications agreed with EFRAG's comments and found the proposed simplifications useful as they would reduce the operational costs. Those constituents who agreed with the '30 days past due' rebuttable presumption argued that in most scenarios it was a good basis for a presumption of an increase in credit risk. In addition, these constituents also noted that entities should be able to rebut that presumption by using statistical and behavioural information on portfolios with similar credit risk characteristics. Constituents from the insurance industry, who agreed with the proposed exception for financial assets with low credit risk, noted that the above proposal would be helpful and generally appropriate for debt securities with low credit risk.

A few constituents did not support the proposed operational simplifications. Those constituents who did not agree with the '30 days past due' rebuttable presumption argued that it was not conceptual and did not necessarily reflect when there was a significant increase in credit risk. Furthermore, some of these constituents added that the '30 days past due' criterion was not appropriate for all types of portfolios and would prefer to use it as an indicator. Regulators from the banking industry were concerned that entities would use the above criterion as the primary indicator and ignore other available information.

Furthermore, only a few constituents did not support the low credit risk exception. Regulators from the banking industry argued that the 'investment grade' category was not homogenous and could not be uniformly regarded as 'high credit quality'. In their view, the references to the 'investment grade' in the ED were too broad and should be removed.

Nevertheless, a significant number of constituents raised concerns on the application guidance on the low credit risk exception.

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EFRAG's response to respondents' comments

Nevertheless, EFRAG maintained its previous position that in its view the '30 days past due' rebuttable presumption did not drive the accounting but only the amount of work in order to assess credit deterioration.

EFRAG also noted that many constituents expressed concerns on the clarity of the guidance on the low credit risk exception. To address those concerns, in its final comment letter EFRAG suggested the IASB to ensure that the relevant guidance in the final standard would be clear to avoid that the proposed simplifications would be interpreted as a bright line.

EFRAG considered the fact that most participants in its field-test indicated that the proposed simplifications did not raise any significant operational concerns unlike with the assessment of a significant increase in credit risk which was considered operationally challenging. Therefore, in its final comment letter EFRAG decided to maintain its previous support on the proposed simplifications because as they were to make the model workable for every entity.

Symmetry of the model

Finally, in the light of the positive feedback received regarding the symmetry of the model and the re-establishment of the credit loss allowances, EFRAG decided to maintain its previous position in the final comment letter.

EFRAG's tentative views and respondents' comments

In particular, these constituents found the related example in the ED confusing and inconsistent with the general principle of the ED which required lifetime expected credit losses to be recognised only after significant credit deterioration. Some of the constituents suggested the IASB should also clarify the relationship between internal and external credit ratings.

Overall, constituents, including those constituents who supported the proposed operational simplifications suggested the IASB should ensure that they are not interpreted as bright lines.

Symmetry of the model

Most constituents agreed that the impairment model should be symmetrical and allow entities to re-establish their loss allowance back to the 12-month expected credit loss when the criteria for the recognition of lifetime expected credit losses were no longer met. These constituents argued that such an approach was reflective of the real life economics and would allow fair presentation of their financial position.

EFRAG's response to respondents' comments

Interest revenue

EFRAG's tentative views and respondents' comments

EFRAG's tentative position

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

Constituents' comments

Most constituents agreed with the proposed requirements, but some preferred a non-accrual approach when there is objective evidence of impairment.

Also, some constituents noted that the possibility to use a discount rate between the risk free rate and the effective interest rate reduced comparability between entities and could lead to double counting of credit risks.

EFRAG's response to respondents' comments

In its final comment letter EFRAG kept its agreement that interest revenue should be calculated on a net basis when there is objective evidence of impairment.

EFRAG disagreed with the use of a non-accrual approach when there is objective evidence of impairment as this could lead to a highly judgmental decision as to whether cash flows represent interest or principal which can result in the time value of money not being fully recognised in the impairment allowances.

EFRAG agreed that an estimate of expected credit losses should reflect the time value of money and supported the flexibility in choosing the discount rate. EFRAG agreed with the concern made by constituents that the choice in the discount rate could potentially lead to double-counting when the credit risk would be reflected in both the cash flows and the discounted rate, which would result in a lower impairment allowance. When entities took credit risk into account by incorporating it into the interest rate and then considered open portfolios where the original effective interest rate was used, it would be wrong to use the risk free rate for discounting, it would need to be a credit-adjusted rate instead to be in line with the objective of the standard. To address constituents' concern EFRAG suggested the Board to emphasise that the objective of discounting was to reflect the time value of money.

Disclosures

EFRAG's tentative views and respondents' comments

EFRAG's tentative position

EFRAG tentatively supported the proposed disclosures because they would increase transparency and comparability and provide relevant information about the credit quality of an entity's financial assets and its risk management activities.

EFRAG suggested the IASB should develop an alternative form of disclosure about experience adjustments, which would allow users to understand the quality of earlier accounting estimates.

However, EFRAG noted that it was undertaking a field-test in order to better substantiate its final assessment on the proposals.

In its draft comment letter EFRAG requested feedback from its constituents on whether the proposed disclosures gave rise to operational concerns and whether they were appropriate for all types of entities.

Constituents' comments

Most constituents raised concerns about the volume and level of detail regarding the proposed disclosures. In particular, many constituents argued that some of the disclosures would be operationally challenging, for example the requirement to provide reconciliation for the gross carrying amount and the associated allowance. In addition, a few constituents questioned whether the reconciliation for the gross carrying amounts would provide useful information to users.

Other constituents felt that the requirement to provide information about modifications and write-offs over the remaining life of the instruments would be burdensome and less decision useful for users.

(continues on page 18)

EFRAG's response to respondents' comments

EFRAG acknowledged that many constituents raised concerns on the volume and level of detail of the proposed disclosures. EFRAG shared those concerns and noted that the proposed disclosures were likely to be excessive more particularly for non-financial institutions. Notwithstanding the above concerns, EFRAG understood that in principle, most constituents supported the disclosure objectives.

Therefore, EFRAG decided to revise its previous position in the final comment letter, and while it supported the proposed disclosure objectives, EFRAG urged the IASB to ensure that the level of disclosures in the final standard would be proportionate for non-financial institutions.

EFRAG considered the feedback from its constituents who indicated that the operational difficulty to comply with the proposed disclosures would be high. Therefore, in its final comment letter EFRAG encouraged the IASB to consider the carefully the findings of its filed-test and review the level of proposed disclosures in order to balance appropriately the cost for preparers and benefits for users.

EFRAG noted the views of those constituents who argued that the proposed disclosure on write-offs would be burdensome. EFRAG agreed that the proposal would not necessarily provide useful information to users after the year of modification. Hence, in its final comment letter EFRAG suggested that the information on modifications should be limited to the year of modification.

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EFRAG's tentative views and respondents' comments

Some constituents also raised concerns that the proposal in the ED which allowed entities to cross refer to another document would create auditability and practicability issues. Overall, constituents commented on the operational difficulty or clarity for most of the proposed disclosures.

EFRAG's response to respondents' comments

EFRAG acknowledged that many constituents raised concerns regarding the disclosures on reconciliations. However, EFRAG also considered that users had indicated that the particular disclosure was useful to their analysis. Therefore, EFRAG decided not to recommend the elimination of the above disclosure.

EFRAG noted that its constituents did not propose any other disclosures to be included in the final standard. Nevertheless, EFRAG understood that management judgment would play a fundamental role in the proposed model. Consequently, EFRAG decided to maintain its previous position and suggest the IASB to develop an alternative form of experience adjustments which would allow users to understand the quality of an entity's earlier estimates.

EFRAG noted the positive feedback from its constituents on its tentative views regarding the duplication of disclosures. Hence, in its final comment letter EFRAG decided to recommend that all the relevant disclosures should be placed in IFRS 7 *Financial Instruments*.

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

EFRAG's tentative views and respondents' comments

EFRAG's tentative position

EFRAG agreed with the proposed treatment of financial assets whose contractual cash flows were modified but was of the opinion that the standard needed to clarify when a modification resulted in derecognition.

Constituents' comments

Most constituents agreed with the proposed requirements.

Several constituents noted that modifications to an existing contract could be made for other reasons than increased credit risk, for example for commercial reasons. As for many business models contractual changes were a standard practice, the IASB should consider the interaction of the impairment and the modification accounting models

One constituent cautioned that modifications should not be used as a means for reclassifying loans from impaired to performing status and noted that the mere relief provided by a restructuring should not in itself be considered as an indicator of recovery in the borrower's repayment capacity.

One constituent noted that the list of events which indicated an objective evidence of impairment contained concessions given to a borrower, for economic or contractual reasons relating to the borrower's financial difficulty. As a result the constituent suggested dealing with modifications separately from the IFRS 9 project as it was unclear how one should measure impairment in case of such modifications.

EFRAG's response to respondents' comments

EFRAG acknowledged that modifications for commercial reasons were very common. However, EFRAG noted that the ED did not describe modification losses as impairment losses. Also, EFRAG recognised that modifications of financial assets which were a consequence of deteriorations in credit risk could potentially be used to avoid a measurement of lifetime expected loss allowances.

EFRAG noted that concessions which were noted as an indicator of an objective evidence of impairment, referred clearly to situations where the lender was in "financial difficulty", thus in an deteriorating credit risk situation. Consequently, these concessions were not to be identified with concessions made for commercial reasons.

Consequently, in order to address constituents' comments, EFRAG asked the IASB to clarify in the final standard 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.

Application of the model to loan commitments and financial guarantee contracts

EFRAG's tentative views and respondents' comments

EFRAG's tentative position

EFRAG noted to respond based on information gathered from its field-test.

Constituents' comments

Most constituents agreed with the application of the model to loan commitments and financial guarantee contracts. Some constituents noted that the IASB and FASB should align the scope of their projects with regard to financial guarantees both Boards should either include or exclude financial guarantees.

EFRAG's response to respondents' comments

In its final comment letter EFRAG supported that loan commitments and financial guarantee contracts should remain within the scope of the proposed impairment model as in many cases these were subject to the same risk management practices as lending. In addition, EFRAG believed 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 agreed with constituents that the application of the model to financial guarantees was an area where the projects of the IASB and FASB Boards could converge. Consequently, EFRAG included this request in its final letter.

Simplified approach for trade receivables and lease receivables

EFRAG's tentative views and respondents' comments

EFRAG's tentative position

EFRAG tentatively supported the proposed simplified approach for trade receivables and lease receivables. However, EFRAG noted that further application guidance was necessary regarding the application of the proposals to lease receivables.

Constituents' comments

Most of the constituent supported the proposed simplified approach and agreed that it would make the proposals understandable and more operational for non-financial entities, while allowing entities to apply the same impairment model to all financial assets.

However, one constituent from the leasing industry noted that as a result of the revised exposure draft on leases, the impairment proposals would apply on a different unit of account compared to the existing practice because the residual value of the underlying asset would be excluded. That constituent was concerned that lessors would be forced to recognise an impairment loss even when the investment in the lease would still be recoverable; therefore, it argued that the unit of account should be the investment in the lease.

EFRAG's response to respondents' comments

EFRAG noted the positive feedback from its constituents regarding the simplified approach. EFRAG also requested feedback from its constituents during its field-test. However, although most constituents found the proposals on trade receivables and lease receivables clear, they did not provide a clear view as to whether the simplified approach was necessary or aligned with their existing risk management practice.

EFRAG considered the concerns of its constituents regarding the unit of account for lease receivables. However, EFRAG TEG members agreed with the boards' conclusion in the revised exposure draft on leases that both the lease receivable and the right retained in the underlying asset met the definition of an asset; therefore, these distinct assets should be assessed separately for impairment. Furthermore, some EFRAG TEG members believed that it would not be appropriate to offset credit losses on the lessee with fair value changes of the residual value of the underlying asset. Therefore, EFRAG decided to maintain its previous position in the final comment letter.

Financial assets that are credit impaired on initial recognition

EFRAG's tentative views and respondents' comments

EFRAG's tentative position

EFRAG agreed with the proposals for financial assets that were credit impaired on initial recognition.

Constituents' comments

Most constituents agreed with the proposed requirements for financial assets that were credit impaired on initial recognition.

One constituent agreed in principle with the proposed requirements but preferred that the decoupling of interest revenue and loss allowances would also be applied to this type of assets.

Another constituent noted there was an inconsistency between defining impairment as an event that has occurred and including financial instruments in the scope of the ED that have just been originated. For this reason the constituent agreed with the proposals for purchased credit impaired assets, but not for originated credit impaired assets. The constituent thought that originated credit impaired instruments could not be treated identical as purchased credit impaired instruments as the first ones did not have any history. For that reason the constituent could not see any valid argument to classify the financial asset into stage 3 at inception. The only other line of argument where one could potentially claim that an originated credit-impaired instrument had a history would be a modification that led to derecognition of the old and recognition of the new financial instrument. In that instance, any impairment charges should have been recorded when the old instrument was derecognised.

EFRAG's response to respondents' comments

In its final comment letter EFRAG kept its agreement with the proposals for financial assets that were credit impaired on initial recognition.

EFRAG in principle agrees that a single expected credit losses model for all types of financial assets would improve comparability. However, EFRAG believes that the application of the general model to purchased or originated credit-impaired assets would not faithfully represent the underlying economics of this type of assets.

The decision to treat originated and purchased credit impaired financial assets identically was taken by the IASB and FASB Boards to address the confusion amongst US users on the different treatment of these financial assets currently in US GAAP.

EFRAG supported this decision as the underlying credit situation of a lender, and thus the estimation of lifetime expected credit losses, cannot be different depending on the structure of the financial transaction used to finance that lender. One can finance a lender by buying existing debt of the lender in which case the credit risk will be reflected in the purchasing price of the loan or one can grant a new loan to the lender. In the latter case, a rational decision would be to reflect the increased credit risk of the lender in the interest rate charged to the lender. For this reason the draft standard recognised that originated credit impaired assets would occur only rarely. Also, the draft standard explicitly mentioned that originating financial assets at a low credit quality was not a sufficient reason to fall within the scope of the requirements for purchased and originated impaired financial assets.

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EFRAG's tentative views and respondents' comments

EFRAG's response to respondents' comments

Additionally, an objective evidence of impairment at initial recognition needed to be present before the financial asset would fall within the scope. Such objective evidence of impairment would present itself earlier when the increased credit risk of the lender was not reflected in the interest rate charged.

Effective date and transition

EFRAG's tentative views and respondents' comments

EFRAG's tentative position

EFRAG strongly believed that entities should have at least three years to implement IFRS 9 after the completion of all phases of IFRS 9.

Constituents' comments

Most constituents believed a three-year implementation period would be appropriate, some believed it needed to be more or less.

Several constituents preferred aligning the application date for IFRS 9 with other standards such as IFRS 4 phase 2. Some constituents defended to permit an early application of both standards as a pragmatic solution for insurers.

Some constituents required further aligning with the implementation of the leasing or revenue recognition standards.

One constituent noted the proposals might not be easy to adopt even for sophisticated institutions as for many portfolios and assets, models would need to be significantly modified in terms of probability of default, loss given default and discounting. For portfolios on a standardised approach, entirely new models would have to be developed. Above all else, methodologies for estimating lifetime expected loss for assets in stage 2 would have to be derived.

Paragraph C2 of the ED was found to be unclear by some constituents. Absent information about original credit quality, the ED proposes a short cut method with recognition of a 12-month expected credit loss for loans with low credit risk at transition, while all other assets would have a lifetime expected loss provision. The shortcut was not available when the past due status was used. Therefore it was believed that paragraph C2 should explicitly state that, regardless of whether or not original credit quality information was available, information about past due status and other relevant information available at transition could be used to assess whether lifetime expected loss should be recognised on transition.

EFRAG's response to respondents' comments

In its final comment letter and based upon comments received as well as the operational difficulties identified by constituents in the field-test, EFRAG defended an implementation period of a full three years after publication.

EFRAG was of the opinion that the implementation period could only be reduced if substantial changes were made 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.

EFRAG agreed that an implementation period of three years would be necessary. EFRAG did not agree to make this period longer to align the implementation timing with other standards in development for the reason that the impairment model was seen as an answer to the deficient provision practices during the financial crisis in 2008. EFRAG did not support postponing the implementation of the standard beyond the time entities would normally need to implement it as the disadvantage of continuing to work with deficient provision practices would outweigh the benefits of the technical alignment of the standards. In addition, the advantage for a particular group of companies would come at the expense of the disadvantage for all companies of continuing to work with the current provision practices.

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EFRAG's tentative views and respondents' comments

EFRAG's response to respondents' comments

Finally, allowing but not requiring insurance companies to implement IFRS 9 early would result in a large number of implementation and presentation issues, especially for banking insurance groups.

EFRAG agreed with the comment that paragraph C2 of the transition requirements needed further clarification as entities should keep the possibility to rebut the 30 days past due expedient where it is used and consequently asked the IASB to address this point.

Appendix A – List of comment letters

National Standard Setters

Accounting Standards Committee of Germany (ASCG)

Comissão de Normalização Contabilísta (CNC)

Dutch Accounting Standards Board (DASB)

Danske Revisorer (FSR)

Financial Reporting Council (FRC)

Instituto de Contabilidad y Auditoria de Cuentas (ICAC)

Norwegian Accounting Standards Board (NASB)

Organismo Italiano di Contabilità (OIC)

Associations-Organisations

ACTEO – AFEP – MEDEF

Federation of European Accountants

Institute of Chartered Accountants of Scotland (ICAS)

Institute of Chartered Accountants in England and Wales (ICAEW)

Preparers

Barclays

British Bankers Association

German Banking Industry Committee

German Insurance Association

Leaseurope

Volkswagen

Regulators

Basel Committee

Consultants

Aguilonius

Appendix B – List of participants in EFRAG's field-test

Participant	Industry	Country
Allianz	Insurance	Germany
AXA	Insurance	France
Barclays	Banking	United Kingdom
Bayerische Landesbank	Banking	Germany
BBVA	Banking	Spain
BCEE Lux	Banking	Luxembourg
Banque Internationale à Luxembourg	Banking	Luxembourg
BNP Paribas	Banking	France
BPCE	Banking	France
Deutsche Bank	Banking	Germany
HSBC	Banking	United Kingdom
Intesa San Paolo	Banking	Italy
CaixaBank	Banking	Spain
Lloyds	Banking	United Kingdom
Mediobanca	Banking	Spain
Standard Chartered	Banking	United Kingdom
Unicredit	Banking	Italy
Alcatel Lucent	Other Industries	France
Daimler	Other Industries	Germany
Telecom Italia	Other Industries	Italy
Volkswagen	Other Industries	Germany
Undisclosed	Undisclosed	Undisclosed