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International Accounting Standards Board
30 Cannon Street
London
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United Kingdom

Our Reference: 2013/JE/C1/IASB/130

RE: Exposure Draft – Financial Instruments: Expected Credit Losses

Dear IASB Members:

The International Organization of Securities Commissions (IOSCO) Committee on Issuer Accounting, Audit and Disclosure (Committee 1) thanks you for the opportunity to provide our comments regarding the International Accounting Standards Board (IASB or the Board) Exposure Draft, ED/2013/3, Financial Instruments: Expected Credit Losses ('the' or 'this' Exposure Draft).

IOSCO is committed to promoting the integrity of international markets through promotion of high quality accounting standards, including rigorous application and enforcement. Members of Committee 1 seek to further IOSCO's mission through thoughtful consideration of accounting and disclosure concerns and pursuit of improved transparency of global financial reporting. The comments we have provided herein reflect a general consensus among the members of Committee 1 and are not intended to include all of the comments that might be provided by individual securities regulator members on behalf of their respective jurisdictions. One Committee 1 member has participated in the preparation of this letter but because of the ongoing work of its national standard setter in this area has not concluded its own related work.

We have organized our letter in two sections. The first provides some general observations regarding the Board's proposal and the second answers selected questions from the Exposure Draft's Invitation to Comment.

General Observations

Project Objective

We continue to support the development of a financial asset impairment approach that incorporates more forward-looking information about credit losses into the amortized cost model than does the

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current incurred loss model. We agree with the objective of preventing delayed recognition of credit losses, and believe that the requirement to wait until a loss is "incurred" to recognize a credit loss is a weakness in the existing model.

Convergence

We support the efforts taken by the IASB and the Financial Accounting Standards Board (FASB) to try to develop a common approach to financial asset impairment recognition. We understand that during the most recent individual deliberations each Board has focused on separate primary approaches to improving financial asset impairment accounting.

We support convergence of the IASB's final standard and the FASB's final standard to the extent possible, without unduly delaying a high quality final Standard. Accordingly, the Boards should try to find and converge to a solution that is supportable both intellectually and practically, and we realize this may result in modifications to what the Board has proposed. We remain supportive of the idea of a final standard that encompasses the concept of expected losses as long as the approach chosen continues to serve the best interests of, and provides transparency to, investors.

Overall Proposal in the Exposure Draft

We think it is important that an expected loss impairment model take into consideration the economic link between an instrument's interest rate and expected credit losses. The origination of a debt instrument at market terms does not represent an economic loss or decrease in an entity's financial position. We therefore believe that a conceptually pure expected loss approach would recognize in profit and loss:

- Credit expectations that were properly factored into the initial pricing of a debt instrument pursuant to an arm's length transaction over time, and
- Changes in the credit expectations not initially priced into the terms of the instrument immediately.

We think an approach that recognizes impairment for all instruments, including those with no changes in credit expectations, based on the present value of credit adjusted cash flows discounted at the original effective rate (which includes compensation for expected credit losses), results in a double counting of expected losses. In our opinion, this measure would be the least consistent with the underlying economics of a lending arrangement.

Considering the various possibilities, we then evaluated the respective trade-offs between all of the following approaches to recognizing expected credit losses which the Board has considered.

- 2009 Exposure Draft, under which an entity would include the initial estimate of lifetime expected credit losses for a financial asset in determining the effective interest rate, and the initial estimate of credit losses would be allocated over the expected life of the asset as interest income is recognized. Impairment losses would result only after initial recognition of the financial asset from an adverse change in the estimate of expected credit losses;

- The Supplementary Document, under which an entity would also effectively recognize the initial estimate of lifetime expected credit losses over time but based on a time proportionate method versus as part of the effective interest rate;

- The FASB's current Exposure Draft, under which an entity would recognize the initial estimate of lifetime expected credit losses discounted using the original effective interest rate on day one, and subsequently recognize the changes therein; and

- The approach included in the Exposure Draft, under which an entity would recognize—for financial assets that have not experienced a significant increase in credit risk since initial recognition—a loss allowance at an amount equal to expected credit losses due to possible default events during the next 12 months from a given balance sheet date. This serves as a proxy for the recognition over time of those credit losses that the entity originally expected. For those instruments which have experienced a significant increase in credit risk since initial recognition, the entity recognizes the lifetime expected credit losses. These serve as a proxy for the recognition of credit losses that have not inherently been priced into the terms of the instrument.

Most Committee 1 members believe what is proposed in the IASB's current Exposure Draft provides a practical approach to meeting the objective of the project.

While the IASB Exposure Draft's approach could result in delayed recognition of some economic credit losses relative to an approach which takes into consideration lifetime projected losses upon initial recognition, we believe it is an improvement to the incurred loss concept used today, as described in IAS 39. Also, while not perfectly reflective of the underlying economics, most Committee 1 members believe that the measurement approach in the IASB Exposure Draft will provide decision-useful information that is directionally consistent with the economics, because the recognition guidance factors in consideration of credit deterioration.

We are mindful of the negative trade-offs associated with having a 12-month bright line for measuring expected losses related to debt instruments that have not yet experienced significant credit deterioration, and are therefore open to whether there could be improvements made to the Exposure Draft's approach.

One Committee 1 member does not support the measurement approach included in the Exposure Draft, because of concerns regarding day one loss recognition associated with the 12-month expected credit loss measurement for instruments that have not experienced a significant increase in credit risk. This member supports an approach more consistent with the objective of separately accounting for the credit expectations initially priced into the terms of a debt instrument and the changes in credit expectations since initial recognition.

Specific Aspects of the Proposal

We wish to highlight the following observations about the proposed approach contained in the Exposure Draft.

Instruments for Which There Has Not Been a Significant Increase in Credit Risk since Origination

We agree that the 12-month expected credit loss measurement simplification is not conceptual, and therefore such a measurement will not perfectly reflect the underlying economics. Given our concerns regarding the ability of entities to faithfully identify and recognize credit risk in the manner that it was priced into the terms of a debt instrument, most Committee 1 members support an approach that, while not conceptually pure, will provide users with decision-useful information. As noted above, one member is concerned that the 12-month expected credit loss measurement will not result in decision-useful information, because of the potential understatement of the financial asset at day one and potential overstatement of revenue recognized over the life.

Trigger to Move From Expected Credit Losses for the Next 12 Months to Full Expected Credit Losses

We think the description of the threshold for moving to a provision for full expected credit losses is a critical element of the Exposure Draft's approach that, by its nature, necessitates the use of judgment. In order to aid consistency of application and enforceability, we believe additional context should be provided regarding the mindset management should use to assess "significant deterioration", e.g., describing what significance is in relation to.

Disclosures

We understand that moving to a more forward-looking impairment model will increase the importance of subjective estimates, and believe that adequate disclosures that provide users with sufficient information about the assumptions and models that underlie those estimates are crucial.

Implementation Guidance

We are supportive of simplifications that can be applied in a manner consistent with the project's objective. Although we think it may be appropriate to assume financial instruments that have "low" credit risk as of the measurement date have not experienced a significant increase in credit risk, we are not sure whether the concept as currently drafted will be appropriately understood. To ensure this simplification is applied consistently with the overall objective, we suggest focusing the description on a level of credit risk that is low enough that regardless of the initial credit risk, an increase in risk to that level would not be viewed as significant.

We acknowledge there is a range of acceptable methods for determining discount rates used to measure credit losses, but we are concerned that allowing entities to select a rate that is between the risk-free rate and the effective interest rate may limit comparability. We believe that defining a rate in the guidance, for example the original effective rate, would decrease complexity and improve comparability.

We are also supportive of the Board providing specific guidance addressing consideration of past-due status in the evaluation of whether an instrument has experienced a significant increase in credit risk. We believe the analysis of whether the significance threshold is met should be based on whether the amount of increase in risk is such that the full lifetime expected loss measurement becomes more reflective of the underlying economics than the 12-months expected loss measurement.

Responses to the Board's Questions in the Exposure Draft

Question 1

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

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

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

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

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

Question 2

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

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

(c) Do you think that recognising a loss allowance at an amount equal to the lifetime expected credit losses from initial recognition, discounted using the original effective interest rate, achieves a better balance between the faithful representation of the underlying economics and the cost of implementation than this Exposure Draft?

Although we believe there is an economic link between the interest rate charged and initial credit loss expectations, we understand that it is very difficult to measure this linkage precisely. So while we see conceptual merit to an impairment approach consistent with the 2009 Exposure Draft, we understand that attempting to isolate and separately measure expected losses originally priced into a debt instrument would be challenging to operationalize due to the complexities inherent in pricing debt instruments. Additionally, we are concerned that investors would not have transparency around the very subjective judgments underlying a measurement of changes in all expected credit losses not priced into the terms of a debt instrument. For fact patterns that involve incorporating projections of the impact on borrowers of changes in economic conditions many years out into the future, we think verifying and enforcing the use of reasonable judgments required for such estimates will be very difficult.

12-month expected credit loss measurement

We understand that the 12-month expected credit loss measurement for debt instruments that have not experienced significant credit deterioration is meant to operationalize the concept of recognizing credit losses that were factored into the pricing of the debt instrument consistent with market terms over the life of the instrument. We agree with the statement in BC61 that the justification for this simplification is not conceptual, and therefore such a measurement will not perfectly reflect the underlying economics. Given our concerns regarding the ability of entities to faithfully identify and recognize credit risk appropriately priced into the terms of a debt instrument, most of our Committee 1 members support the approach included in the current ED. To the extent that the 12-month expected credit loss measurement can be applied in a consistent manner, most believe that the measurement can provide decision-useful information. One of our Committee 1 members does not believe the 12-month expected loss measurement will provide decision-useful information, because of the manner in which it results in recognition in profit and loss of credit expectations that have been priced into the financial asset consistent with market terms. See our response to question 4 for our thoughts on the ability to operationalize the 12-month expected loss measurement.

Evaluating significant deterioration

We understand that a credit loss measurement for instruments that have experienced significant deterioration that is based on lifetime expected cash flows discounted using a rate between the risk free rate and the original effective rate is meant to operationalize the concept of recognizing changes in credit quality not factored into the pricing of the instrument. We also see this as an operational shortcut that does not truly isolate the economic phenomena the measurement is meant to capture.

However, given the difficulty and related measurement uncertainty of any approach that tries to measure all changes in credit quality subsequent to initial recognition, most members support using an approach that includes a recognition threshold for all expected credit losses that is based on changes in observable information. One trade-off of such an approach is that depending on the threshold used, there could be a delay in recognition of expected losses (particularly with a high threshold) or there could be recognition of credit losses related to credit quality at initial recognition (particularly with a low threshold). Also, the application of the threshold will require a high degree of judgment, and it is therefore important for the description of the threshold in the standard to be sufficiently clear to promote application in a reasonably comparable manner. See our response to question 5 for our thoughts on the "significant increase in credit risk" guidance.

As previously noted, considering the respective trade-offs between the 2009 Exposure Draft approach, the Supplementary Document on Financial Instruments: Impairment (without the foreseeable future floor) approach, an approach that initially recognizes lifetime expected credit losses discounted using the original effective interest rate, and the approach included in this Exposure Draft, most members believe the current Exposure Draft provides the most practical approach to meeting the objective of the project. We remain open to whether there could be improvements made to the ED's approach, as we are mindful of the negative trade-offs associated with having a 12-month bright line for measuring expected losses related to debt instruments that have not yet experienced significant credit deterioration.

Due to concerns regarding day one losses, one member supports an approach more consistent with the objective of recognizing credit expectations initially priced into the terms of a debt instrument over time and changes in credit expectations since initial recognition immediately.

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?

We agree that financial assets that are mandatorily measured at FV-OCI should be measured for impairment. Our members that agree with the measurement approach described in this Exposure Draft also agree with applying this approach to financial assets that are mandatorily measured at FV-OCI. Although not all members support the introduction of the FV-OCI category (see our April 5, 2013 letter in response to the Classification and Measurement ED), we believe that both the amortised cost and FV-OCI categories, if included in IFRS 9, should be subject to the same impairment requirements which will improve comparability of amounts recognised in profit and loss for assets with similar economic characteristics. We agree with the Board that a single expected credit loss model reduces a source of complexity as compared to allowing multiple impairment approaches.

Question 4

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

We believe preparers are in the best position to provide the Board with information regarding the availability of data and processes necessary to implement the 12-month expected credit loss measurement. Based on the nature of the types of estimates we think are necessary to do such a measurement, we believe it would be possible for preparers to operationalize the approach in a manner consistent with providing comparable and verifiable financial information.

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?

We think the description of the lifetime expected credit loss measurement threshold is a critical element of the Exposure Draft's approach that, by its nature, necessitates the use of judgment. Given the goal of providing investors with a comparable measure, we believe additional context should be provided regarding the mindset used to assess significance. While we agree that a bright-line quantitative threshold is not appropriate, we believe the concept of significance should be linked more closely to the underlying premise of the model. We understand that premise to be that partial recognition of lifetime expected losses is appropriate when the instrument's credit risk is generally consistent with the risks considered in the initial pricing. When a significant portion of the current credit risk has not been factored into pricing, a full lifetime expected loss measurement becomes more reflective of the underlying economics.

We find paragraph B20 to be a very comprehensive list of potential sources of information that should be considered in making the assessment. To the extent that some of the sources of information are stronger indicators than others, it would be helpful to distinguish those. Particularly for the non-borrower specific information relevant to assessing an increase in credit risk (e.g., forecasts of adverse changes in economic conditions related to interest rates or unemployment), it would be helpful to include more examples of how such available observable information should factor into the evaluation.

We are supportive of simplifications that can be applied in a manner consistent with the project's objective. Although we think it may be appropriate to assume financial instruments that have "low" credit risk as of the measurement date have not experienced a significant increase in credit risk, we are not sure whether the concept as currently drafted will be appropriately understood. We note that an example provided in paragraph 6 of low credit risk is credit risk equivalent to an external credit rating of 'investment grade'. We note that there is not a universal description of 'investment grade', but that some descriptions include instruments with characterizations that could be viewed as different from the low credit risk concept described in the ED. We understand that under the current proposal, a downgrade from AAA to BBB would not trigger the assessment of recognition of lifetime expected losses, meaning that a potentially large increase in credit risk would not be considered significant. However, probabilities of default vary significantly for longer maturities as one moves toward the lower end of the investment grade range (BBB as compared to AAA).[1] For example, the cumulative probabilities of default vary between 0% and 1.06% for AAA instruments and 0.24% and 7.22% for BBB instruments over a 1-year to a 15-year time horizon. To ensure this simplification is applied consistently with the overall objective, we suggest focusing the description on a level of credit risk that is low enough that regardless of the initial level of credit risk, an increase in risk to this new level would not be viewed as significant. Otherwise, management might inappropriately apply this "relative magnitude of the increase in credit risk that could still result in maintaining investment grade test" to decisions more broadly, including what is considered a significant increase in credit risk for non-investment grade instruments, resulting in comparability issues and earnings management incentives.

We are also supportive of the Board providing specific guidance addressing consideration of past-due status in the evaluation of whether an instrument has experienced a significant increase in credit risk. We believe there could be various situations in which a payment delay more than 30 days past the due date would not appear to indicate a significant increase in credit risk, including when such a delay is consistent with the initial credit risk expectation. The extent to which a payment delay is indicative of increased credit risk could depend on the legal environment, recovery provisions and general economic conditions. We are concerned that any bright-line stipulation will have a tendency to operate more as a rule, and we believe the guidance should focus on the principle. For example, for situations in which some payment delays are expected, but that a 31-day delay could be viewed as an early indicator of potential default risk, we believe the analysis of whether the significance threshold is met should be based on whether the amount of increase in risk is such that the full lifetime expected loss measurement becomes more reflective of the underlying economics.

Most members agree with the symmetrical treatment of changes in credit risk, so that improvements to credit can result in a measurement being once again based on a 12-month expected credit loss measurement once the lifetime recognition threshold is no longer met. However, of the members who support the 12-month expected loss measurement some members believe that it is better to recognize subsequent improvements in credit risk by retaining the lifetime measurement and not returning to the 12-month expected credit loss measurement. These members believe that the original economic characteristics of the instrument have changed and as a result, the use of a simplified model should no longer be appropriate. These members agree with the recognition of the economic gain from the improvement (as referred to in BC 78-79), but a smaller gain related only to the decrease in the measurement of expected lifetime losses.

Question 7

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

[1] See table with cumulative probabilities of default in IASB Staff Paper 5B November, 2012, p.26.

(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?

We are supportive of the expanded disclosures as described in this Exposure Draft and recommend amending IFRS 7 to reflect these disclosures. Given the level of judgment involved in measuring expected credit losses, we believe it is important for a final standard to include qualitative and quantitative disclosures, generally as outlined in the ED.

We believe sufficient disclosures about the inputs and assumptions used in estimating expected credit losses are essential, because even with expanded implementation guidance we expect that these factors will vary from reporting entity to reporting entity. We agree with the IASB's assessment in paragraph BC184 of the Exposure Draft that 'any attempts to reflect expected credit losses will be subject to measurement uncertainty and will place greater emphasis on management's judgment and the quality of the information used.' We believe expanded disclosures are necessary given the increased judgment inherent in this Exposure Draft.

We question whether requiring entities, as proposed in paragraph 44, to disaggregate their portfolio across at least three credit grades for disclosure purposes is necessary for all entities to meet the objective of providing increased comparability, transparency and useful information to investors. Depending on the business models for certain entities, there may be fewer than three credit risk grades applicable to financial assets. In those situations, entities would be forced to make additional judgments regarding bucketing of assets which is inconsistent with their existing business model. This judgment would add an additional level of complexity and potentially reduce transparency.

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?

The Exposure Draft would affect modified financial assets where modification does not result in derecognition. To the extent a modification does not result in derecognition, we agree with the treatment proposed in the Exposure Draft. However, we believe further guidance than currently provided in IAS 39 should be provided to clarify which modifications result in derecognition.

Also, we understand based on paragraph 19 of the Exposure Draft that under the proposal modifications can result in gains in profit or loss. It is not clear to us the circumstances that would lead to gain recognition.

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?

We support the proposed simplified approach for trade and lease receivables. While we acknowledge that a simplified approach for trade and lease receivables might reduce comparability across all financial assets, we believe the proposal appropriately balances the benefits with the costs.

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We appreciate your thoughtful consideration of the comments raised in this letter. If you have any questions or need additional information on the recommendations and comments that we have provided, please do not hesitate to contact me at +202-551-5300.

Sincerely,

Julie A. Erhardt
Chair
Standing Committee No. 1
International Organization of Securities Commission