AFRAC
AUSTRIAN FINANCIAL REPORTING AND AUDITING COMMITTEE

C/O KAMMER DER WIRTSCHAFTSTREUHÄNDER
SCHOENBRUNNER STRASSE 222–228/1/6
A-1120 VIENNA
AUSTRIA

TEL	+43 (1) 81173 228
FAX	+43 (1) 81173 100
E-MAIL	office@afrac.at
WEB	http://www.afrac.at

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

Dear Hans,

On behalf of the Austrian Financial Reporting and Auditing Committee (AFRAC), the privately organised standard-setting body for financial reporting and auditing standards in Austria, I appreciate the opportunity to comment on Exposure Draft ED/2013/3, Financial Instruments: Expected Credit Losses (ED). Principal authors of this comment letter were Peter Bitzyk, Bernhard Gruber, Peter Häfliger, Michael Hammer, Friedrich Hief, Heiner Klein, Caroline Pranzl, Marietta Preiss, Alexander Schiebel, Michael Svitek, Michael Zotlöterer and Roland Nessmann.

AFRAC appreciates the opportunity to comment on the questions raised by the proposed changes in the accounting treatment of impairment of financial instruments because of their importance for the whole finance industry, and hence for industry in general.

General remarks

AFRAC considers the changes in the treatment of impairment of financial instruments in the accounting standards to be closely connected with and of considerable importance to the calculation of ratios for supervisory purposes.

Since this ED governs the accounting treatment of impairment of financial instruments for all industries, we see a major need to reduce the burden on preparers of general purpose financial statements by reducing the number of – in our view much too detailed and unnecessary – disclosures, as explained in our answer to Q 7 below.

We also see a strong need to align the requirements of financial and supervisory reporting: if the reporting requirements, e.g., for the calculation of the 12-month expected loss, are not identical, we

strongly recommend allowing the option of using the 12-month expected loss calculated for supervisory purposes for financial accounting purposes as well. This is to avoid problems in controlling and managing financial instruments, as well as to keep the burden of financial reporting at an acceptable level.

Objective of an expected credit loss impairment model

Question 1

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

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

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

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

From the point of view of financial theory, the approach proposed in the ED is not entirely correct, but it should be supported as a close approximation, for practical reasons and for the sake of simplicity. The decisive factor is the clear distinction between the different stages of impairment.

(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?

See answer to Q 1(a) above.

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?

Yes (see answer to Q 1(a) above).

(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)?

Yes.

(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?

No.

Scope

Question 3

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

In principle, we agree. We are however against the wording "mandatorily measured at FVOCI", because – as have already explained in our CL on limited amendments to IFRS 9 – we see FVOCI as an option for financial instruments otherwise measured at FVPL. Thus, we prefer the wording "measured at FVOCI". We would also point out that the inclusion of leasing receivables cannot be conclusively evaluated until there is a leasing standard available.

(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?

See answer to Q 3(a), above.

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?

Yes, it is operational; however, it should be permitted for amounts calculated under supervisory regulations to be acceptable for the purposes of IFRS 9.

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?

Yes, we agree.

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

The proposals do not provide sufficient guidance. The existing information in the guidelines is self-contradictory, since a 5% worsening of the PD is something completely different to a 30-day delinquency, which is considered to carry the presumption of such a sharp increase in risk (although this may be rebutted by circumstances at group level) that the priced-in risk margin is no longer adequate, and an additional provision as part of the lifetime expected losses must be made.

(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?

Yes, taking the collateralisation into account and any change in it that would better reflect the economic risk is in all events to be preferred on the grounds of simplicity to the change in PD proposed in the ED.

(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?

In principle we agree with the simplifications. The ED suggests that in the case of a 30-day delinquency there is a rebuttable presumption that the risk has increased sharply. Since a 30-day delinquency cannot considered a significant increase in risk in all countries or regions, the presumption should also be rebuttable at the portfolio level and not at the individual loan level. It would be desirable to make expressly clear that rebuttal at portfolio level is permissible.

(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?

Yes, we agree.

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?

Yes; we see taking it into account for Level 3 as equivalent to unwinding in IAS 39 AG93, which should also be mentioned in the Standard (BC?).

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

In principle we see this as correct for Level 3 assets, but see also our answer to Q 5(b).

(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?

Yes, we agree.

Disclosure

Question 7

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

Given the need for information about financial instruments and the underlying assumptions, we would strongly recommend reducing the disclosures in line with the principles set out in paragraph 29: the decision usefulness of disclosures is to a certain extent reduced by the amount of information which has to be provided under some standards. The cost benefit ratio has also to be taken into account. Information should only be provided if really useful for an understanding of the risk position of the preparer, is not in conflict with professional secrecy and is understandable for non-specialists.

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

- Paragraph 35 (see also example in IE72) and paragraph 36: The reconciliation of the balances from one period to the next period proposed in the ED is very difficult to prepare and requires the collection and storage of cash flow data. The costs of this are very high.

Since this information is not at present used – except perhaps by a few individual banks – because it has no additional value, in our view the additional costs are out of all proportion to any incremental benefits.

For this reason, we believe that reconciliation of opening and closing balances for loss allowances should be sufficient to provide users with relevant information about credit risk. The opening and closing balances of loss allowances can be directly compared with gross carrying amounts of the financial assets. But the information about movements of the gross carrying amounts during the period is redundant.

- The information about modified loans required under paragraph 38 is more detailed than what is currently required under IFRS 7, and there are significant differences between paragraph 38 and the EBA's published forbearance standards. In particular, under the new EBA draft ITS, loans can recover: loans that have been performing for two years are no longer required to be disclosed as forborne exposures. This is not possible under the ED for IFRS 9: once a stage 2 loan has been modified, the information must be disclosed in the notes until the loan is repaid or written off. Both as a means of reducing costs and as an aid to better user understanding, we recommend that under IFRS exposures that have been performing for two years after modification should no longer be required to be disclosed.

- Paragraph 39: The disclosures required here are too complicated to be useful for decision-making. The paragraph 39 disclosures should be simplified to give an overview of the situation that satisfies the decision usefulness criterion.

- Paragraph 40: The present disclosure requirements under IFRS 7 are much less detailed and more than sufficient for general purpose financial statements. They should not be unnecessarily expanded. Some examples are given below.

- Paragraph 40a requires "a discussion of the quality of the collateral and an explanation of any changes in quality as a result of deterioration or changes in the collateral policies of the entity." Given the large number of collateral securities held by many enterprises, a blanket description would be difficult to provide, and a discussion of each category of collateral would tend to make the notes unmanageable.

- Paragraph 40c requires that for financial instruments for which there is objective evidence of impairment quantitative information about the extent to which collateral reduces the severity of expected credit loss should be provided. These data are not collected centrally because they are not used in risk management. Nor is the information required under the Basel Accords. Cash flow data would need to be collected as a basis for the impairment calculations. Strictly speaking, shadow pricing would also have to be used, to establish what the customer would have had to pay in the absence of collateral. The information required is neither clearly defined, unambiguous, nor relevant for decision-making, and the incremental cost of collecting it is very high. The information is also of very doubtful benefit to users.

- Paragraph 44 requires an analysis in considerable detail of carrying values by risk categories

(see also IE73 and 74). Since this is information that is already available, the cost of preparing the tables will be reasonable, but burdening the notes with excessive disclosures stands in stark contradiction to IASB's avowed aim of making the notes more comprehensible.

- Paragraph 45: The ED requires the disclosure of carrying values of assets and provisions for loan commitments and guarantee commitments that are valued individually and whose credit risk has increased significantly since initial recognition. This means that stage 2 loans must be labelled as valued individually or valued on a portfolio basis. This information is of no additional value for risk management, and would not be used by internal risk managers. In our view it is not clear what benefits this disclosure requirement is intended to have.

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

As mentioned in our answer to Q 7(a) above, we fear an information overload: for decision usefulness as well as for cost benefit reasons, we strongly recommend reducing the information to what is essential for decision-making.

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?

This provision needs fundamental rethinking. In our view, negotiation of slightly lower interest rates on the basis of customers' improved creditworthiness should under no circumstances result in the recognition of an accounting loss, which would be the effect of discounting the renegotiated payments streams with the original EIR. Conversely, an increase in the interest rate that has not yet been reflected in a change in credit rating necessarily results in an accounting profit if the payments streams are discounted using the original EIR, even though it is associated with increased risk. The alternative however – derecognition of the old loan and recognition of a new one – reflects the economic realities, i.e., it is earnings neutral. In our opinion, therefore, where a loan agreement is modified by renegotiation of the interest rate, the only sensible EIR to use is the current one.

Example

Notional amount of original loan	1,000
Interest rate of loan	Euribor plus 200 bp
No fees, etc	
Effective interest rate at initial recognition	Euribor plus 200 bp
Maturity	6 years
Customer credit rating at initial recognition	BBB
Customer credit rating after 3 years	A

With its improved credit rating the customer renegotiates the interest rate of the loan: the bank agrees to reduce the interest rate to Euribor plus 100 bp. Euribor plus 100 bp is the arm's length interest rate that the customer would currently pay in the market.

Result if the loan is treated as repaid and a new loan granted	
Loan is repaid at interest reset date at its nominal amount	
Book value	1,000
Payment by customer	1,000
Effect on P&L	**0**
Notional amount of new loan	1,000
Interest rate of loan	Euribor plus 100 bp
No fees, etc	
Effective interest rate at initial recognition	Euribor plus 100 bp
Maturity	3 years
Result if the loan is treated as modified, i.e., interest rate of existing loan is reduced	
Notional amount of modified loan	1,000
Interest rate of loan	Euribor plus 100 bp
No fees, etc	
Remaining maturity	3 years
Present value of modified loan using effective interest rate of Euribor plus 200 bp	
Present value	973
Book value	1,000
Present value (as above)	973
Effect on P&L	**-27**

Although for business purposes the results are identical, the effect on profit and loss is different, which in our view is unjustified. This has led other international standard setters (e.g., FASB) to consider how misinformation of this kind in connection with impairment can be avoided.

In our view it is also not sufficiently clear which modifications of financial assets should lead to their derecognition and which are merely modifications of the original agreement.

Application of the model to loan commitments and financial guarantee contracts

<u>Question 9</u>

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

In general, we agree, but we would suggest that the wording should be changed to “irrevocable loan commitments”.

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

We suggest that the wording should be changed as in (a) above. As mentioned already, in the General remarks as well as in some answers to the questions above, the use of figures calculated for supervisory purposes in general financial reports should be allowed as an option.

Exceptions to the general model

Simplified approach for trade receivables and lease receivables

<u>Question 10</u>

(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?

In general, we agree, but see our answer to Q 3(a) above: the final decision with respect to leasing cannot be made until a standard is approved.

(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?

Yes, we agree.

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?

Yes, we agree.

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.

All EU enterprises must wait until the standard is endorsed. We would therefore suggest that a longer interval after the IASB has published the standard – say, between 24 and 30 months – is appropriate.

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

We do not agree. For retail lending, the absence of an initial PD should not automatically require a stage 2 rating, as would be the case under this ED. There should be a provision that when the new IFRS 9 is first adopted and the three stages are initially applied, retail loans should be assumed to be stage 1 assets unless recognition of impairment was already required under IAS 39. If significant deterioration occurs after initial classification, the procedure should be as under IFRS 9.

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

Yes, we agree.

Effects analysis

Question 13

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

In principle, we see some aspects of the assessment in a thoroughly positive light, although – as will

be clear from our answers above – we do not always agree with the IASB. In particular, as we have made clear in our comments above on disclosure requirements, we believe that these tend – and especially in the cases mentioned – to go beyond what is currently required. With respect to the other issues as well, there is no need for us to repeat what we have said above. What seems to us to be essential – given that what precipitated the new regulations was the financial crisis – is that enterprises, and in particular financial and insurance institutions, are not so overwhelmed by the many and various new accounting and supervisory regulations, that they neglect the practical business realities because they are too busy complying with regulatory requirements.

It is important that the new regulations for, e.g. impairment (indicators, existence, assessment, valuation, disclosure) adopted by supervisory authorities and standard setters around the world are as far as possible standardised, so that preparers and users of financial statements can understand the principles and so that the application of the regulations is the same the world over.

Please do not hesitate to contact me if you wish to discuss any aspect of our comment letter in more detail.

Kind regards,

Romuald Bertl

Chairman