CFA Society United Kingdom

5th July 2013

IASB
30 Cannon Street
London EC4M 6XH
United Kingdom

Dear IASB,

The Financial Reporting and Analysis Committee (FRAC) of the Chartered Financial Analyst Society of the UK (CFA UK) would like to respond to the exposure draft "Financial Instruments: Expected Credit Losses".

CFA UK represents more than 10,000 investment professionals working across the financial sector. For advocacy purposes in the field of financial reporting, these members are represented by the Financial Reporting and Analysis Committee.

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?
We accept the 12-month model as a compromise. As we have said in previous submissions, we believed the incurred loss model reflects economic reality and that many of the problems lay in the way it has been implemented. But given that it is politically impossible to stick to that approach, we are content to accept the 12-month expected loss model since it minimises the upfront provisioning (compared with lifetime provisioning on day 1). But there is still an element of double counting since credit quality will already be reflected in the pricing of the loan.
Since there were mixed views among FRAC members, the issue of convergence with US GAAP was raised. If that is a priority, is there a case for compromising on the provisioning period? While 12 months was regarded by some as arbitrary, the idea of "foreseeable future" gained little support because of potential for differing management approaches and manipulation. 12 months is at least seen as a reasonable forecasting period.

(ii) the effects of changes in the credit quality subsequent to initial recognition?
One of the reasons we have supported the IASB's proposals over those of the FASB is that the model follows the underlying credit position more closely. We believe that the trigger should be as objective as possible and based on hard data, although it is impossible to avoid some manipulation of any particular provisioning model.

If not, why not and how do you believe the proposed model should be revised?
There was some concern about the complexity of both the diagram in the illustration of the proposed expected credit loss model and the interest revenue model. The effective interest rate approach, which found some support from users when it was advocated a few years ago, could have provided a route to a simpler measurement model. We note that assets that are credit-impaired at initial recognition qualify for the simplified approach.

(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?

We appreciate that the FASB model is simpler to apply. However, it can be used to recognise a worst-case scenario and if things do not go as badly as that, the company will be able to recognise profits in the future. We do not want a return to profit smoothing via a provisions pool.

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?

We agree that 12 months is a sensible amount. This number is the furthest that many believe can realistically be forecast. Indeed company valuations are usually based on the 1-year forward P/E or EV/EBITDA ratios, so assessing credit quality on this basis would be in line with typical company valuation. This number is more sensible than recognising lifetime expected credit losses as there is a possibility that the credit quality of the impaired asset could improve over that time.

(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)?

There is still some support for the 2009 ED for the reasons stated above. We understood that the proposal was abandoned because it was too difficult for banks to implement. So the aim since then has been to find a compromise solution. Upfront provisioning does not reflect the underlying economic reality, but a 12-month window limits the scope for manipulation and keeps the accounting closer to a faithful representation.

The trigger for switching from 12 months to whole-life becomes very important in the proposed model (see response to question 5).

(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, with the proviso about the complexity of the proposed model.

We do not think the costs of implementation would be significant. While we do not know exactly how much it would cost to implement, we assume that companies will have this data already.

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?

Overall we agree with the proposed scope of this Exposure Draft. However, we are not supportive of the FVOCI model as has been mentioned in other responses.

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 assume it is since it is the result of compromises on the 2009 proposals. From an analyst's and investor's point of view, it is an appropriate forecasting period. It will also be useful to have the information on the expected lifetime losses on which recognition of the 12-month portion is based.

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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?

Management will control the trigger. We agree with the proposed requirement, but are concerned about interpretation of the phrase "significant increase" because it sounds as though management will have too much control over when the loss allowance is switched from 12 months to lifetime. Given the dependence on management's view of the probability of default and the loss given default, users will be concerned about consistency of approach between companies and inevitably want considerable transparency over the assumptions.

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

The objectivity of the trigger. A combination of the short, 30-day arrears period and a long list of factors (including subjective assessment of the economic cycle) that might increase credit risk means that the current proposals look like a "hair trigger". The concern is that they might invite management to switch to lifetime provisions. This raises questions over the objectivity of the trigger and the hardness of the data on which it is based. We believe that 90 days past due is a better period of time than 30 days to assess whether a lifetime expected credit loss allowance should be applied.

It is worth pointing out that whereas paragraph 42 covers significant deterioration it does not cover significant improvements, which would lead to a switch back.

(b) 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?

There is no better alternative. While the switch from a 12-month to a lifetime expected loss allowance seems arbitrary, we do not think that there is a better alternative. Any such switch should be explained in the notes.

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?

We still have concerns about complexity so suggested simplifications, which would reduce cost, should be considered. But the over-riding factor is to stick as closely as possible to a faithful representation of the underlying economic reality.

(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, but frequent switching back and forth is not desirable. This is why it would be better if the initial trigger were not so sensitive in terms of arrears and if the hard data elements of the decision were emphasised over subjective judgments. In advocating 90 days rather than 30, we still support the idea of a "rebuttable presumption" because this forces management to explain why they have not acted on this hard evidence.

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, and it can make it easier to forecast if the calculation of interest revenue follows changes in the credit quality of the loan as reflected in expected losses. We note the disconnect between recognising expected losses upfront and an increased credit risk in one way for the loan loss account and the balance sheet, but in a different way for the P&L. Is the aim to avoid gyrations on the latter as assets move between buckets?

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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?
Yes, for assets that are impaired there should be a switch to calculating interest revenue on the amortised cost basis.

(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?
It is also sensible that the interest revenue approach is made on a symmetrical basis.

Question 7
(a) Do you agree with the proposed disclosure requirements? Why or why not? If not, what changes do you recommend and why?
Overall, yes, with the addition noted in (c) below.

(b) Do you foresee any specific operational challenges when implementing the proposed disclosure requirements? If so, please explain.
We believe that management would have the information required and it is just a matter of providing it in a useful format.

(c) What other disclosures do you believe would provide useful information (whether in addition to, or instead of, the proposed disclosures) and why?
We think that there should be more disclosure on how the loss allowance can revert back from lifetime to 12 months. Paragraph 27 requires disclosure of impairment losses as a separate line item but it seems to group gains and losses together so there would be no transparency of improvements, or even of losses if they were offset by improvements.

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?
Yes.

Question 9
(a) Do you agree with the proposals on the application of the general model to loan commitment and financial guarantee contracts? Why or why not? If not, what approach would you prefer?
No opinion.

(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.
No opinion.

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?
Yes.

(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.

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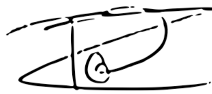
Question 12
(a) What lead time would you require to implement the proposed requirements? Please explain the assumptions that you have used in making this assessment. As a consequence, what do you believe is an appropriate mandatory effective date for IFRS 9? Please explain.
(b) Do you agree with the proposed transition requirements? Why or why not? If not, what changes do you recommend and why?
(c) Do you agree with the proposed relief from restating comparative information on transition? If not, why?
Implementation is a practical matter for negotiation with preparers of accounts. We note, however, that there has been some frustration at the length of time it has taken to make this accounting change and so any further delay should be minimised. There should be sufficient comparative information for users to see a historic continuity and to understand the effect of the change to the new model.

Question 13
Do you agree with the IASB's assessment of the effects of the proposals? Why or why not?
We do not think that the analysis of the effects on users of financial statements is complete (BC212-BC216). Those paragraphs seem to mainly justify the proposals even though they are not what users might want in an ideal world.

We look forward to discussing the issues raised in this response.

Yours sincerely,



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