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Mr Hans Hoogervorst
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5 July 2013

Dear Mr Hoogervorst

Exposure Draft ED 2013/3 Financial Instruments: Expected Credit Losses

Deloitte Touche Tohmatsu is pleased to respond to the International Accounting Standards Board's ('the Board's) Exposure Draft, ED/2013/3 *Financial Instruments: Expected Credit Losses* ('the exposure draft').

We support the Board's efforts to improve the accounting for recognition of credit losses on financial assets (currently subject to the requirements of IAS 39 *Financial Instruments: Recognition and Measurement* (IAS 39) and to be replaced by a new chapter in IFRS 9 *Financial instruments* (IFRS 9)) by addressing the weaknesses in the existing incurred loss model that were observed during the global financial crisis. We agree with the Board's objective of recognising and measuring credit losses of financial assets within the scope of the exposure draft on the basis of an entity's current expectations about the collectability of contractual cash flows. An impairment model that is based on expected credit losses that incorporates information about past events, current conditions, and reasonable and supportable forecasts of future events and economic conditions as at the reporting date avoids the inherent problem in an incurred loss model, under which there may be delayed recognition of credit losses because objective evidence of impairment may not be identified timely in practice. Further, we support the Board's decision to develop a single impairment objective for all types of financial assets within the scope of the exposure draft.

Whilst we are supportive of the Board's objectives, we are concerned that the approaches to meet those objectives taken by the Board and by the Financial Accounting Standards Board (FASB) in Accounting Standards Update, *Financial Instruments – Credit Losses* are significantly different. We strongly encourage the boards to converge their guidance on expected credit losses because we believe that converged guidance on this topic is critical to supporting well-functioning global capital markets.

We are supportive of the basic elements of the Board's proposed impairment model such as differentiating financial assets on the basis of credit quality and basing the impairment measurement on expected losses. However, we have concerns about certain aspects of the model. For example, we do not agree with the Board's proposal to require entities to use a relative credit quality assessment. A relative credit deterioration model creates accounting anomalies (e.g., a credit loss allowance for similar financial assets may be measured differently based on different starting points) and adds operational complexity by requiring entities to track movements in an asset's credit quality relative to its initial credit standing. On the basis of our outreach with entities with operations globally, we believe that certain entities may not have credit risk management systems sophisticated enough to track movements in an asset's credit quality relative to its initial credit standing on an ongoing basis.

The proposed impairment approach permits an entity, in measuring the allowance for cash flows not expected to be received, to determine as the discount rate any reasonable rate that is between (and including) the risk-free rate and the effective interest rate. We agree with use of the effective interest rate but are concerned with the proposed approach to allow the use of a reasonable discount rate within a range. We recommend that the Board instead requires that entities use the effective interest rate if it is reasonably determinable and permit the use of the risk-free rate (or, alternatively, the benchmark interest rate) in cases when it is not feasible to make a reasonable estimate of the effective interest rate. Further, we agree that use of practical expedients consistent with the impairment measurement principles should be permitted as discussed in B34 and B35 of the exposure draft. In addition, we believe that the Board should include, as an additional example, practical expedient methods that use developed loss statistics on the basis of the ratio of the amortised cost basis written off because of credit loss applied to the current amortised cost basis (as discussed in the FASB's proposal).

With respect to measuring interest revenue, we disagree with the proposal to measure interest revenue on originated credit-impaired financial assets based on the net carrying amount. Such an approach is unnecessarily complex (as it requires entities to have different interest recognition systems for originated loans depending on the credit quality of assets and is not consistent with the Board and the FASB's decisions in the revenue project which focuses on the recognition of revenue for the amount the entity expects to be entitled and not on what it expects to receive. Any concerns on the gross effect on line items in the performance statement can be addressed through presentation.

For purchased credit-impaired assets (PCI), we recommend recognising an allowance both at initial recognition and subsequently that includes those contractual cash flows not expected to be collected (i.e., including those embedded in the purchase price at acquisition). Recognition of an allowance at initial recognition for purchased financial assets assists users in making comparisons to similar originated assets. However, with regards to interest revenue recognition on these assets we agree that the effective interest rate should be determined based on the purchase price and expected cash inflows. Similar to our point above, subsequent changes to the allowance should not affect interest revenue and any increases in revenue and the allowance due to the unwinding of discounting can be addressed through presentation.

As noted in the response from Deloitte & Touche LLP in the U.S. to the FASB's proposals, we also have concerns about the FASB proposed impairment approach. One significant concern, as noted above, is that the FASB proposed impairment model requires recognition of full lifetime expected credit losses for all financial assets, particularly at inception of these financial assets. We believe that full lifetime expected credit losses may be appropriate for individual financial assets (or a portfolio of financial assets with similar credit quality) that have a low credit quality because there is a higher likelihood that a loss will be experienced shortly. However, for other financial assets (whether evaluated individually or as a portfolio of assets with similar credit quality) requiring recognition of full lifetime expected credit losses at inception distorts the measurement of performance and comprehensive income of the entity for a particular period with respect to that asset or portfolio of assets (i.e., financial statements would potentially not reflect decision-useful information about the timing of losses). It also requires preparers and auditors to consider forecasts about economic data and conditions for periods far into the future. Because the level of precision necessarily decreases in forecasts for distant periods, some parties are likely to encounter significant operational challenges and complexity when incorporating the forecasts into measurements reflected in the financial statements.

In light of our concerns with both the IASB's and FASB's proposed models, we propose another approach that we believe retains many aspects of both boards' proposals and remains faithful to their objectives. This recommended approach is discussed below.

Recommended approach

Our recommended approach retains some key principles of the Board's proposed model because it (1) is based on expected credit losses, (2) distinguishes between financial assets that are of high credit quality and those that are not, and (3) limits the future period examined for expected credit losses for particular high quality loans. However, our recommended approach uses an absolute assessment of credit quality instead of using relative credit quality assessment as proposed by the IASB. We understand that the boards had considered, and decided against, using an absolute assessment of credit quality when discussing the approach that has evolved into the IASB's proposal. On the basis of our outreach with entities with operations globally, we believe that many entities monitor their credit quality at a point in time without tracking status from initial recognition. In addition, an absolute assessment of credit quality avoids accounting anomalies when similar economics of financial assets are measured differently.

Under our recommended approach, an entity would continue to monitor the credit quality of its financial assets during the reporting period. We believe that when it becomes apparent for a financial asset or assets that, on the basis of credit indicators and other relevant factors, it is not highly probable that the entity will collect all contractual cash flows when due, the entity should immediately recognise all expected credit losses (i.e., those estimated credit losses for the remaining life of the asset or for the average remaining life for the portfolio of assets).[1] Generally, entities would assess whether such indicators and relevant factors exist at the most granular level reasonable without undue cost and effort, which in some cases may result in their making such assessments on a portfolio basis (i.e., portfolio of similar assets).

For financial assets or portfolios of assets for which it is highly probable that all contractual cash flows will be collected when due, the entity would still recognise an allowance for credit losses expected over the next 12 months (or another appropriate specific period that the boards deem appropriate). This allowance is necessary for the entity to account for the uncertainty associated with the credit evaluation process and the relatively smaller probability that a loss will occur over the next 12 months (or other specific period). On the basis of limited outreach, 12 months appears to be a reasonable and supportable forecast period. However, we suggest that the boards perform additional research to determine whether longer periods may be appropriate.

Modified gross-up approach

Should the Board decide not to consider our recommended approach, an alternative would be to explore the impairment approach described in the alternative view (often referred to as a 'gross-up approach'), with certain modifications. Under this approach, an entity would recognise a loss allowance for the lifetime expected credit losses at initial recognition of the financial asset and increase the gross carrying amount of the asset by the same amount. In our modification to this proposed approach, the entity would recognise the adjustment to the gross carrying amount that was recognised at inception into earnings over the period over which losses are expected to be realised in a manner that reflects how the losses are expected to be realised. Because actual losses usually do not occur rateably over the life of the instrument and may occur in a period that is well before the end of an asset's life, we believe that it would be more appropriate to recognise increases in the gross carrying amount over the period and in a manner in which the credit losses are expected to be realised instead of amortising the increase over the life of the instrument. If this approach is pursued it would be important to obtain feedback from preparers of financial statements about whether this approach would be operational (e.g., are entities able to reliably estimate the period over which the losses should be recognised?) and from financial statement users about whether the gross-up approach produces decision useful information.

If you have any questions concerning our comments, please contact Veronica Poole or Andrew Spooner in London at +44 20 7007 0884 or +44 20 7007 0204 respectively.

[1] For an asset or portfolio of assets that are not of high credit quality, it would not be appropriate to use any period less than the full remaining expected term (i.e., lifetime losses), though it is likely that this period is relatively short and that more precise information is available for use in estimating expected credit losses.

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Yours sincerely

Veronica Poole
Global IFRS Leader

Appendix

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?

(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?

As noted in the response from Deloitte & Touche LLP in the U.S. to the FASB on their proposed impairment model, we have concerns about the requirement in that proposal to recognise full lifetime expected credit losses (including when discounted using the original effective interest rate) for all financial assets, particularly at inception of these financial assets. Recognition of full lifetime expected credit losses may be appropriate for individual financial assets (or a portfolio of financial assets with similar credit quality) that have a low credit quality because there is a higher likelihood that a loss will be experienced. However, for other financial assets (whether evaluated individually or as a portfolio of assets with similar credit quality) requiring recognition of full lifetime expected losses at inception distorts the measurement of performance and comprehensive income of the entity for a particular period with respect to that asset or assets (i.e., financial statements would potentially not reflect decision-useful information about the timing of losses). It also requires entities and auditors to consider forecasts about economic data and conditions for periods far into the future. Because the level of precision necessarily decreases in forecasts for distant periods, some parties are likely to encounter significant operational challenges and complexity when incorporating the forecasts into measurements reflected in the financial statements.

In addition, as noted in our cover letter, we support an impairment model that differentiates financial assets on the basis of credit quality and limits the forecast period for particular financial assets. However, our significant concern about the IASB's proposed model is that it requires entities to use a relative credit quality assessment instead of an absolute evaluation of an asset's credit quality. We believe that a relative credit deterioration model creates accounting anomalies because a credit loss allowance for similar assets may be measured differently. For example, assume that two loans were originated at the same time and in the same amounts, one with a 5% probability of default (PD) at initial recognition and the other with a 20% PD. Further assume that at the end of the reporting period, the entity estimates that the credit risk for the loan with the initial PD of 5% has increased to a PD of 20% (which is presumed to be a significant increase), while the credit risk for the loan with initial PD of 20% has remained the same. Under the proposal the allowance for the loan with significant increase in credit risk to 20% would be measured using the lifetime expected credit losses approach, while the allowance for the loan without any change in credit risk would still be measured using the "12-month expected credit losses" approach. Although some may argue that different contractual interest rates for the two loans would justify such an approach, we have concerns about relying on the original contracted interest rate as a basis for creating this non-comparability in measurement. Also, the relative credit risk assessment could result in recognising a higher allowance for credit losses for the instrument with a lower credit risk. In the example above, should the credit risk for the loan with the initial PD of 5% increase significantly to PD of 15%, the allowance on that loan that would equal the lifetime expected credit losses could have been higher than the allowance for the loan with a higher PD of 20% because there was no change in the credit risk. In the IASB's proposal, it is also unclear what percentage of change in credit risk would be considered significant, which can also create lack of comparability when applying the relative credit quality assessment approach.

In addition, on the basis of our outreach with entities with operations globally we believe that certain entities may not have credit risk management systems to track movements in an asset's credit quality relative to its initial credit standing on an ongoing basis. Rather, many entities use an absolute evaluation to monitor the credit quality of assets at a point in time without tracking status from initial recognition. Therefore, the costs of requiring a relative assessment are likely to outweigh the benefits, if any, provided to users of financial statements.

In light of our concerns about the relative credit risk assessment, as noted in our cover letter, we believe that the boards should consider requiring entities to perform an absolute assessment of credit quality.

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?*

We believe that the proposed approach 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 exposure draft and the Supplementary Document, except for the concerns we expressed about the proposed approach in the cover letter and our response to Question 1.

On the basis of our limited outreach with entities with operations globally, 12 months appears to be a reasonable and supportable forecast period. However, we suggest that the boards perform additional research to determine whether longer periods may be appropriate.

As detailed in our response to Question 1 we do not support recognising a loss allowance equal to the lifetime expected credit losses from initial recognition for all financial assets in the scope of this guidance.

As described in the cover letter and our response to Question 1 our proposal is an alternative approach similar to the IASB's proposal but based on an absolute assessment of credit quality. Should the Board not pursue such an approach we do believe there is some merit in exploring the 'gross-up approach' included as an alternative view in the exposure draft subject to recognising the adjustment to the asset balance arising on initial recognition in earnings on the basis of the expected pattern of loss.

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 with the proposed scope. We also agree that for financial assets that are mandatorily measured at FVOCI in accordance with the exposure draft on classification and measurement of financial instruments, the accounting for expected credit losses should be as proposed in this letter. Such an approach reflects consistency in an impairment approach for financial assets that have the same cash flow characteristics (i.e., are solely payments of principal and interest) or the same credit exposure (e.g., a written loan commitment or a financial guarantee of a loan).

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?

For financial assets or portfolios of assets for which it is highly probable that all contractual cash flows will be collected when due, measuring the loss allowance (or a provision) at an amount equal to 12-months expected credit losses appears to be a reasonable and supportable forecast period and we do not foresee major operational difficulties with such measurement. However, the boards should perform additional research to determine whether longer periods may be appropriate. In addition, we believe that such forecast period should remain the same throughout financial reporting periods (i.e., it should not change because of changing economic circumstances).

Discount rate

The proposed impairment approach permits an entity, in measuring the allowance for cash flows not expected to be received, to determine as the discount rate any reasonable rate that is between (and including) the risk-free rate and the effective interest rate. We are concerned that this approach grants too much latitude and will result in lack of comparability. We recommend that the Board instead require that entities use the effective interest rate if it is reasonably determinable and permit the use of the risk-free rate (or, alternatively, the benchmark interest rate) in cases when it is not feasible to make a reasonable estimate of the effective interest rate. We agree that use of practical expedients consistent with the impairment measurement principles should be permitted as discussed in B34 and B35 of the exposure draft. In addition, we believe that the Board should include, as an additional example, practical expedient methods that use developed loss statistics on the basis of the ratio of the amortised cost basis written off because of credit loss applied to the current amortised cost basis.

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?*

For the response on Question 5(a)-(c) and (d), please refer to our cover letter and the response on Question 1.

Question 5(b) – The boards should clarify and/or provide an example about how revolving credit facilities would be measured considering that there is no contractual term that entities would consider in discounting expected cash flows.

Question 5(e) – We generally agree that the proposed model should allow for 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. However, for objectively impaired assets, it is not clear what the accounting consequences would be for interest that has not been recognised if the criteria for the recognition of lifetime expected credit losses are no longer met.

Question 6

(a) *Do you agree that there are circumstances when interest revenue calculated on a net carrying amount (amortised cost) rather than on a gross carrying amount can provide more useful information? If not, why not, and what would you prefer?*

(b) *Do you agree with the proposal to change how interest revenue is calculated 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?*

(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?*

We do not agree with this proposal. We believe that interest revenue should be calculated by applying the effective interest rate to a gross carrying amount for all originated financial assets. This is because it allows users of financial statements to separately evaluate credit exposure on those assets from the interest income that the entity is entitled. This approach is also consistent with the boards' decisions in the revenue project, which focused on the recognition of revenue for the amount the entity expects to be entitled and not on what it expects to receive. In addition, it may be operationally burdensome and unnecessarily complex to continually change the base amount (i.e., amortised cost) in systems for calculating interest income as well as reverting back to a calculation on the gross carrying amount in certain instances.

Question 7

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

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

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

While we understand and agree with the need for transparent disclosures about the assumptions in and process of estimating credit losses, we are concerned with the extent and effectiveness of the proposed disclosures, in particular disclosures in paragraph 40(a) and 40(b) of the exposure draft. In addition, the disclosures in paragraphs 39 and 42 seem duplicative. Finally, paragraph 44 requires that an entity always disaggregates its portfolio across at least three grades; it is not clear to us how entities would do this if, for example, they internally only have two grades.

We suggest that the Board consider field testing any incremental disclosures to those already required by IFRS 7 *Financial Instruments: Disclosures*.

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?

We agree with the IASB's proposal that if the contractual cash flows of a financial asset are renegotiated or otherwise modified and that modification does not result in derecognition of the financial asset, the entity would adjust the gross carrying amount of the asset to reflect the revised contractual cash flows. However, the proposed guidance can only be adequately applied if it is clearly understood when modification of a financial instrument results in derecognition and when it does not. Because IAS 39 and IFRS 9 do not provide such guidance, we believe that the Board should take on a project to clarify when it is appropriate to derecognise a financial asset due to modification of its terms.

We generally agree with the proposed disclosures about modifications and believe that they would be decision-useful to users of financial statements. However, we suggest that the Board obtain feedback from preparers of financial statements on whether the proposed requirements are operational, in particular the need to track modifications until derecognition.

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Question 9

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

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

We agree with the proposed guidance on the application of the general model to loan commitments and financial guarantee contracts and do not foresee any significant operational challenges that may arise from the proposal.

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?*

In the context of the proposed model, the Board's proposed simplified approach for trade and lease receivables seems reasonable. However, we believe that applying the simplified approaches would not be necessary under our recommended approach because our approach would incorporate absolute assessment of credit quality that we do not expect to be operationally burdensome as entities would be likely to utilise their current credit monitoring process to evaluate whether it is highly probable that cash flows will be collected when due.

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?

We disagree with the IASB's proposed approach for purchased financial assets that are credit-impaired on initial recognition. For purchased credit-impaired assets (PCI), we recommend recognising an allowance at initial recognition that includes those contractual cash flows not expected to be collected. This approach helps improve the comparability for PCI assets and assets that are not PCI, and gives financial statement users decision-useful information (e.g., the amount of contractual cash flows not expected to be collected). Disclosures about the amount of the current allowance embedded in the purchase price at acquisition should be considered so that financial statement users can understand what amount of the allowance has not been reflected in earnings.

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?*

Based on our outreach performed in later 2012 and included in the Deloitte Third Global IFRS Banking Survey published in January 2013[2], we believe that a minimum of two years is appropriate to allow information systems to be updated and implementation issues to be considered. We are, however, aware that the standard would apply to different types of entities and therefore would encourage the Board to obtain feedback from preparers about whether additional implementation time may be necessary. We also believe that the transition and effective date for this exposure draft should be coordinated with the transition and effective date for the final standard on classification and measurement of financial instruments under IFRS 9.

Our understanding of the retrospective application requirement being proposed is that it would allow for entities to record the cumulative effect of the transition in retained earnings of the period of adoption (i.e., prior periods are not required to be restated using the new impairment measurement methodology in any final IFRS). We agree with such an approach.

We also support the transition impairment measurement expedient that the Board has proposed should it go forward with its relative credit standing approach.

We encourage the Board to also consider whether relief from comparative requirements (other than the exception to use fair value) should be provided to first-time adopters of IFRSs.

Question 13

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

Except for our concerns about the IASB's proposed approach expressed in the cover letter and in our responses above, the Board's assessment is appropriate.

Other comments

We suggest that paragraph 9(b)(i) of IAS 10 *Events after the Reporting Period* be modified instead of deleted to clarify that an entity may need to adjust the allowance for expected credit losses when, for example, subsequent bankruptcy that occurred after the reporting period resulted in significantly different amounts of credit losses than the amounts of credit losses that resulted from the bankruptcy that the entity expected and considered in estimating its expected credit losses.

[2] http://www.iasplus.com/en/news/2013/01/third-global-ifrs-banking-survey-2014-still-far-from-land