The Corporate Reporting Users' Forum

June 29, 2013

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

Dear Sir/Madam,

Comments on the Exposure Draft "Financial Instruments: Expected Credit Losses"

The Corporate Reporting Users' Forum Japan(CRUF J) welcomes the opportunity to provide comments on the Exposure Draft "Financial Instruments: Expected Credit Losses". CRUF J was established in Tokyo in December 2009, and has been holding monthly meetings since then. Currently the members count 18, which include buy-side and sell-side equity analysts, credit analysts and portfolio managers.

Preamble

We, as the financial statement users, deeply regret that the IASB and the FASB have so far failed to develop the common accounting standard on impairment. We had expected that the converged impairment model to be proposed through the two boards' rigorous joint deliberation on the financial instruments, including impairments. We strongly urge the two boards to continue their efforts to develop the single impairment model to assure the comparability among the financial statements of financial institutions both in the United States and the rest of the world. In that regard, one of our respondents tried to find the way to merge the two different models proposed by the IASB and FASB.

Answer to Question 1

We agree with the IASB views on (a) and (b).

- We agree with the IASB's view. The original effective interest rate reflects the expected credit losses at initial recognition as a certain spread added to the risk-free rate. This means that the initial expected credit losses of a financial instrument must be reflected in the amount of that instrument measured at initial recognition, i.e. the present value of the future contractual cash flows discounted by the original effective interest rate. It should be double counting of the expected credit losses, if those losses are deducted as a loss allowance. If the initial expected losses are to be deducted as a loss allowance, the contractual cash flows of the financial instrument must be discounted by the credit-adjusted effective interest rate, instead of the original effective rate. Then, the loss allowance should be recognized as the amount equal to the present value of the expected credit losses discounted by the credit adjusted effective rate. By doing so, double counting of expected credit losses can be avoided at the time of initial recognition.

- We admit that it is not logically consistent to accept the accounting treatment proposed by the IASB's 2013 ED model to recognize the twelve month expected losses as defined on the page 30 of the 2013 ED. Having said that, we believe there are such theoretical rationales to the 2013 ED proposal as follows;

  - Financial institutions manage credit losses of the portfolio of financial instruments. It is very natural to expect a certain amount of credit losses within one year for the portfolio of young vintage, even if the credit risks of the individual financial instruments are reflected in the initial effective interest rate. If so, we believe the economic fundamentals are best represented by recognizing the certain amount of expected credit losses at initial recognition. Given the reporting period of one year, we believe it should provide financial statement users with useful information to recognize the expected credit losses incurred by the trigger events expected to occur within the next twelve months on the portfolio of financial instruments, the credit quality of which has not deteriorated significantly.

  - We think FASB's CECL model, which requires the recognition of full expected credit losses at initial recognition, is a simpler model than the IASB's 2013 ED model in the sense that it does not need any trigger such as the deterioration of the credit quality. However, no financial institutions could foresee the subprime loan crises as well as the failure of Lehman Brothers before they happened. Our experience during the recent financial crises suggests it is practically impossible to estimate accurately full credit losses over the lifetime of any financial instrument. We believe the reliable forecasting period should be twelve months at best. We expect the accounting treatment proposed by the FASB's CECL model should quite too often end up with the recognition of additional impairment losses as the credit quality deteriorates more significantly than initially expected. We do not believe the CECL model could completely eliminate the cliff effect, which should also be the case with IASB's 2009 ED model.

- We believe the distinction between the Stage 1 assets (i.e. performing assets) and Stage 2 and 3 assets (i.e. nonperforming assets) should enable the financial statements to reflect more faithfully the underlying economic reality of the change in the credit quality over the lifetime of the financial instruments. Such distinctions should show the financial statement users the fact that the credit quality of the assets deteriorated significantly during the latest reporting period, providing them with useful information. It is a prerequisite for this information to be useful that the deterioration in the credit quality is clearly defined to judge if a group of financial assets is Stage 1 or other Stages.

- Some of CRUF-J members suggested that they would support the IASB's 2013 ED model only as a preliminary, second-best choice before the further deliberation on the impairment by the two Boards leads to the more converged impairment model. They believe that it is good enough for now that the clear criteria are set and rigorously be applied to distinguish the Stage 1 assets (performing assets) and Stage 2 and 3 assets (non-performing assets).

- Meanwhile, one member supports the FASB model, which provides users with information on the total expected credit losses estimated by a reporting entity. He argued that 2013 ED model does not give any idea on the total expected credit losses which a reporting entity expects to be incurred on the financial assets, whereas users could estimate them indicated in the credit adjusted effective interest rates used in 2009 ED model.

- Other minority views of CRUF-Japan include:

  - One member does not agree IASB on (a) of Question 1. He believes, for example, it is reasonable to recognize twelve-month expected losses as a loss allowance for financial instruments with five-year or shorter maturity, whereas the time-proportionate approach should be taken for loss allowance of the financial assets with longer maturity than that.

  - Another member advocates that the reporting entity should include the expected credit losses from the events reasonably foreseeable even beyond twelve-month time horizon at initial recognition, while he agrees in principle with the ED proposal requiring a reporting entity to recognize twelve-month expected credit losses on initial recognition. He believes such an approach would enable an accommodation with the FASB's CECL model.

Answer to Question 2

- We agree with IASB on (a) and (b), whereas we do not on (c);
  - We compared the three models, IASB 2009 ED model, 2013 ED model and FASB's CECL model, in respect to the three criteria such as the "neutrality" to depict faithfully the underlying economic reality; the "feasibility" to be judged through the practical cost considerations; and the "conservativeness", the attribute desired from the financial stability point of view. We would conclude the IASB 2013 ED model is the best balanced among the three models to achieve these sometimes competing three objectives.
  - While IASB's 2009 ED model was developed to satisfy the neutrality as well as the conservativeness, it should be abandoned because it is prohibitively expensive to implement.
  - We recognize the FASB's CECL model to be the most conservative among the three. We believe, however, it is the least neutral, given its inherent double counting of the expected credit losses at initial recognition. It is difficult to compare directly the implementation cost of the FASB model and that of the IASB 2013 ED model because the measurement requirements for the full expected loss of FASB's CECL model and the lifetime expected loss of IASB's 2013 ED model are not necessarily the same. Generally speaking, however, the FASB model appears to be more costly to implement than the IASB 2013 ED model, as the former requires a reporting entity to measure the full expected losses on all financial assets held, whereas the latter only require s the entity to measure the lifetime expected losses only for those financial assets, the credit quality of which have deteriorated significantly since the initial recognition. We suspect that it is not easy for the financial institutions, particularly those non-U.S. headquartered, to be fully compliant with the FASB model. We doubt if the FASB model is feasible to implement from the global point of view.
  - Some of the CRUF-J members doubt if the financial institutions could make reliable estimates for the expected losses beyond twelve months. They do not rule out the possibility that some institutions could make reasonably reliable estimates. They believe, however, that such institutions should be a minority and the others cannot. If so, they doubt the comparability of the full expected credit losses among the reporting entities on top of the problems with the neutrality and the feasibility.
  - There are also the following minority views.

- ✧ One member does not agree with the IASB on (a) of question 2, because he does not believe the time-proportionate approach for loss allowances costly.

- ✧ Another member does not agree with IASB on (a) – (c) of Question2. He believes that the recognition of twelve-month expected credit losses should not be required to those financial institutions that have the ability to estimate the lifetime expected credit losses with reasonable level of confidence.

<u>Answer to Question 4</u>

- We do not see much problem for non-financial institutions to implement ED proposal as they should adopt the simplified method. We also do not see problem for any financial institutions to measure the twelve-month expected losses at initial recognition. We believe that those institutions should have the historical data enough to make reasonably reliable estimates of twelve-month expected losses at initial recognition, because they are supposed to be the expert on risk management and should be subject to the prudential regulation. Thus we believe the financial statement users as well as the stake holders of financial institutions would naturally expect the financial institutions should have the ability to make such estimates. There may be some costs to be incurred to adjust to the new impairment model, departing from the accounting practice based upon the existing impairment model. Yet these costs must not be permanent but just transitional. We believe it would be feasible to make forward-looking estimates based upon the relevant information including current economic condition, within the practically acceptable cost constraints.

- Meanwhile, some other members believe they do not have sufficient knowledge to make any comment on this question because they are not the preparers.

Answer to Question 5

(a) We agree with the ED's proposal. The current incurred loss model requires a certain trigger event before a reporting entity establishes sufficient loan loss reserve; as a result, the incurred loss model has been under fire because it allows an entity to recognize too little impairment losses too late. The 2013 ED model introduces somewhat judgmental criteria of the significant increase in the credit risks to recognize the lifetime expected credit losses. It appears that a reporting entity can establish the sufficient loan loss reserve against the Stage 2 assets, which have not necessarily become delinquent but for which such risks appear to have become significantly higher. This resembles the accounting practice of Japanese financial institutions to establish the specific loan loss reserve.

(b) We are concerned that the 2013 ED may not provide the sufficient guidance. The ED's guidance says that a reporting entity should recognize the lifetime expected credit losses with rebuttable presumptions when the credit rating on a financial instrument is downgraded to non-investment from investment, or the assets becomes past due more than thirty days. It is easy to understand this requirement as far as the individual assets concern. However, it is not very clear how this guidance could be applied to the portfolio of financial assets. We are also concerned that the 2013 ED model may rely too much on credit ratings, given our experiences through the financial crises which was triggered by sub-prime loan problem and culminated in the failure of Lehman Brothers.

(c) We agree with the ED's proposal. The judgment on the expected credit losses should begin with the estimation of the probability of default and be based upon the PD. We believe change in the LGD should be reflected in the expected credit losses. The LGD should become the issue only when the PD deteriorates more than a certain level. We think the trigger proposed by the 2013 ED has become easier to comprehend by focusing on the change in the PD.

(d) We agree with the ED's proposal. A sophisticated impairment model is needed only when the business model of a reporting entity requires holding a large portfolio of financial assets as is the case with financial institutions. Otherwise, we believe that a simplified version of the 2013 ED model appears to suffice to depict the underlying economic reality faithfully.

(e) We agree with the ED's proposal. The credit risk of financial instruments could increase or decrease, depending upon the economic circumstances. The underlying economic reality should not be faithfully represented, should the lifetime expected losses continue to be recognized when the PD of the portfolio of financial assets appears to have declined significantly. We also believe the financial institutions should have an incentive to recognize the lifetime expected credit losses earlier, if the reversal of the loan loss allowance is allowed. Having said that, to ensure the impairment model to be reasonably conservative, it may be necessary for the IASB to deliberate the additional guidance on the cases where the criteria for the recognition of the lifetime losses are no more satisfied.

Answer to Question 6

(a) We agree with the ED's proposal.

(b) We agree with the ED's proposal. The objective evidence of impairment appears to imply the cases where the interest payment has been past due for some time or the equivalent situations. In such cases, we believe that the reporting entity should have recognized the lifetime expected credit losses and established the same amount of loan loss reserve. Accordingly, the net carrying amount, i.e. the gross carrying amount of the financial assets minus the corresponding amount of the loan loss reserve, must be equal to the present value of the expected recoverable amount of the impaired assets. The original, non-credit adjusted effective interest rate should be used to discount the cash flows from the recovery of the impaired assets. If so, we believe it is reasonable to calculate the accrued interests by multiplying the amortized cost, or the present value of recoverable future cash flows, by the original effective interest rate. The interest revenue calculated by this way should provide users with useful information.

    Contrarily, we believe it is not appropriate for a reporting entity not to change the way to calculate the interest revenue despite the objective evidence of impairment. Such a calculation should lead to the overstatement of the interest revenue, by allowing the interest accrued on the impaired, or unrecoverable, portion of the gross carrying amount.

(c) Basically we agree with the ED's proposal. The symmetrical approach which allows the reversal should give an incentive for the financial institution to recognize credit impairment losses earlier. Having said that, it appears that the financial assets which have migrated to the Stage 3 would rarely be upgraded to the Stage 2. The management should be required to make a measured judgment on the reversal. Additional guidance may be needed to prevent the arbitrary reversal from the Stage 3 to the Stage 2.

Answer to Question 7

(a) We agree with the ED's proposal.

- Disclosure on the amounts arising from expected credit losses

    (i) We believe a reconciliation of the gross carrying amount and loss allowance, or provision, gives users with clues to analyze that how the quality of assets changed over the last reporting period.

    (ii) We, as the users, need to assess how realistic and reliable the expected credit loss estimated by the entity's management in comparison with the peer group companies. The inputs and assumptions used measuring in twelve month and life-time expected losses are very essential for us to conduct this assessment.

- Disclosure on the effect of the deterioration and improvement in the credit risk of financial instruments.

    (i) We agree that the proposed items here are important and useful for us to better understand the change in credit quality of the financial instruments held by a reporting entity.

    (ii) We reiterate our need to assess how realistic and reliable the expected credit loss estimated by the entity's management in comparison with the peer group companies.

It is a prerequisite for us to conduct this assessment to know inputs and assumptions used in determining whether a significantly increase in credit risk has occurred.

(iii) It is very important for users the overall quality of assets at the time of financial distress of the reporting entities. Particularly in the case of financial institutions, the information on the financial assets that are evaluated on an individual basis should help users to understand how the entity manages the financial instruments that have in fact gone bad.

(b) We do not foresee any specific operational challenges for the proposed disclosure requirements as long as a reporting entity can prepare their financial statements according to the impairment model proposed by the 2013 ED.

(c) We believe that the proposed disclosure requirements would just set the minimum standards for what should be disclosed regarding the asset quality. For example, one of the CRUJ-J members believes that the Board should accept the voluntary disclosure on the performing assets (i.e. the Stage 1 assets) such as follows;

- The reporting entity should be permit to disclose the events and affect the expected credit losses and be foreseen to occur beyond the twelve-month time horizon with reasonable degree of confidence. It should be up to the entity's decision if it discloses only the qualitative information or those quantitative as well.

We, however, do not need too much boilerplate information during the time without any serious financial stress. It is very difficult to predict exactly what kinds of information are needed ahead of financial crises. In the case of financial institutions subject to the prudential regulations such as Basel III, we understand the more detailed disclosure on their asset quality as well as the capital adequacy would be disclosed to meet the prudential purpose. Thus users can use both information disclosed based on financial reporting and regulatory purposes to analyze the financial health of financial institutions. We hope these two types of information would be mutually reinforcing rather than overlapped.

Answer to Question 11

We agree with the ED's proposal. Theoretically, purchase price of financial assets that are credit-impaired on initial recognition should be based upon the present value of the future cash flows adjusted to the lifetime expected credit losses. This means that (the present value of) the lifetime expected credit losses should already be reflected at the time of initial recognition. The credit-adjusted effective interest rate must be applied to discount future cash flows of such impaired financial assets at initial recognition. Thereafter, the interest revenue should be accrued on the gross carrying amount, by multiplying it by the adjusted effective interest rate. If there is any deference between the contractual interest rate and the effective interest rate, the amount due to this difference should be reflected in the difference between the purchase price and the principal amount expected to be recovered at the maturity. We believe such recognition and the measurement should reflect the underlying economic reality of the financial assets that are credit-impaired on initial recognition.

We hope our comments will contribute to the forthcoming deliberations in this project.

Yours sincerely,

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