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5 July 2013

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

***Re: Comments on Exposure Draft "Financial Instruments: Expected Credit Losses"***

Dear Sir or Madam,

We welcome the opportunity to comment on the Exposure Draft *"Financial Instruments: Expected Credit Losses"* (hereafter, "the ED"). The following comments are prepared by the Financial Instruments Technical Committee established within the Accounting Standards Board of Japan (ASBJ).

***Overall Comments***

1. We support the efforts by the International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) (hereafter, "the Boards"), to review accounting standards relating to credit losses on financial assets against the criticism that loan loss recognition lagged during the global financial crisis. Also, we continue to believe that it is critical for the Boards to develop a common impairment model, despite the Boards having issued different proposals.

2. When developing an improved impairment model, there are various matters to consider (including how the financial information is audited and the interaction with financial supervisory regulations.) However, we believe the most important matter to consider is to properly portray the relationship between interest income (which includes consideration for bearing credit risks) and credit costs in the statement of comprehensive income, while ensuring that necessary credit losses that can be reasonably estimated are recognised on a timely basis. In our view, properly reflecting the relationship in the statement of comprehensive income would be critical to financial statement users, because such information would be helpful for them to analyse the profitability of an entity's credit risk taking operations, and to predict future net cash inflows into the entity. Looked at from this angle, despite some shortcomings, we believe that the impairment model proposed in the ED is generally conducive to fulfilling these requirements.

3. However, we have heard a significant concern from financial statement preparers with regard to the practical application of the proposed approach, because it requires that the measurement objective of expected credit losses changes when the credit risk relating to the financial asset *increases significantly* following initial recognition (this is often called the "relative approach.") In our understanding, this relative approach effectively requires an entity to track the credit risk of the financial instrument from initial recognition to each reporting date, which an entity does not usually carry out in its regular credit risk management practices.

4. The Boards' deliberations to date suggest that when developing the impairment model, consideration should not just be given to whether the model is capable of providing relevant information to users, but also to if the model enables financial statement preparers to faithfully represent the economic reality while striking an appropriate cost-benefit balance. In addition, the proposed model may not be seen as yielding a reasonable outcome, because the levels of provisions required for the same borrower would differ depending on when the financial instruments originated, while an entity's source of repayment is the same. Accordingly, we believe that further improvement is necessary.

5. An impairment model for credit losses would have a significant impact on financial institutions (especially banks) as they conduct large-scale credit risk taking businesses. As part of credit risk management operations, they maintain information that can be used for the purpose of recognition and measurement of expected credit losses. Hence, when considering a possible impairment model, it would be important to consider whether, and if so, how an entity can utilise such information. By doing so, financial statement preparers can achieve faithful representation, without undue costs and efforts. In this regard, we note that the objective of credit risk management (that is, to maximise recovery of contractual cash flows from borrowers) is generally the same across financial and non-financial institutions, while the degree of precision may differ significantly. Therefore, when considering an optimal impairment model, thinking first about its application to financial institutions would also benefit non-financial institutions.

6. Based on the above considerations, we have explored a possible alternative impairment model. In other words, we have explored the alternative model that (i) encompasses characteristics necessary to provide relevant information to financial statement users in predicting future net cash inflows to the entity (as explained in paragraph 2 of this comment letter), (ii) enables making faithful representation about

the economic reality by financial statement preparers while also striking an appropriate cost-benefit balance, and (iii) may be acceptable to the Boards. Based on our deliberations, we recommend the Boards consider the alternative impairment model which includes the following characteristics (hereafter, the "ASBJ's alternative approach"). For further details, please refer to paragraphs 22 to 51 of this comment letter.

(1) Classify financial assets into two categories, based on the credit status of borrowers as at each reporting date.

(2) Classify financial assets whose contractual cash flows have been recovered and are expected to be recovered in accordance with the manner originally anticipated as "category-1," and classify the remaining financial assets as "category-2." Considering that category-2 financial assets are the ones whose contractual cash flows have not been recovered as originally anticipated, these financial assets would presumably be monitored and managed on an instrument-by-instrument basis, for example by securing collateralised assets and entering into significant modifications to the contractual terms, so as to maximise recovery of contractual cash flows.

(3) For financial assets classified as category-1, recognise the expected credit losses for financial instruments at an amount equal to the one-year expected credit losses.

(4) For financial assets classified as category-2, recognise the expected credit losses for financial instruments at an amount equal to the lifetime expected credit losses. The expected credit loss of a financial asset shall be calculated at an amount equal to the present value of the recoverable amount over deducted from its carrying amount.

7. The ASBJ's alternative approach is based on the so-called "absolute approach" in that it requires an entity to classify financial assets into different categories based on the information as at each reporting date. However, our proposal would address the concerns expressed over the absolute approach during the IASB's deliberation (please refer to paragraphs 48 to 50 of this comment letter.) Our comments on specific questions of the ED are detailed in the following paragraphs.

***Comments on Questions in the ED***

**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?

(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?

**The Main Proposals in the 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?

(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?

***General Views on the Proposed Impairment Models by the IASB and the FASB***

8. The ED proposes that a loss allowance (or provision) at an amount equal to 12-month expected credit losses should be recognised initially, and lifetime expected credit losses should be recognised after significant deterioration in credit quality. This contrasts with the FASB's proposed approach that recognises all contractual cash flows not expected to be collected as expected credit losses.

9. Development of an improved impairment model is challenging, because there are various matters to consider. Views on an optimal impairment model vary significantly, depending on opinions about which matters should be prioritised. For example, some may be interested in an entity's profitability of credit risk taking operations, while others may be interested in solvency of an entity. Therefore, in developing an improved impairment model, we believe that what is important is to have a clear understanding about what should be accomplished.

10. When considering the priority, we note that the proposed standard is applicable to the business model where entities hold financial assets with the objective of collecting their contractual cash flows, because the ED suggests that the proposed standard applies to financial assets measured at amortised cost or FV-OCI.

11. We also note that the *Conceptual Framework for Financial Reporting* (hereafter, the "IASB's Conceptual Framework") explains that users of financial statements need information to help them assess the prospects for future net cash inflows to an entity[1]. In light of this, we believe that emphasis should be placed on the following matters in the development of an improved impairment model for financial assets measured at amortised cost or FV-OCI.

    (1) For the statement of comprehensive income – The relationship between interest income (which includes consideration for bearing credit risks) and credit costs should be properly reflected, while ensuring that necessary expected credit losses that can be reasonably estimated are recognised on a timely basis. For the financial assets measured at amortised cost or OCI, we believe that properly portraying this relationship would enhance the decision-usefulness of information relating to the performance of an entity[2].

    (2) For the statement of financial position – A necessary amount of allowance should be recognised for credit costs (this means that allowances should not be understated nor overstated. Therefore, the notion of "sufficiency" is not the sole determinant for the level of allowance.). We note that a reasonable range of estimates should be permitted to achieve faithful representation, because the estimate of credit costs is highly uncertain and cannot be determined accurately in

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[1] See paragraph OB3 of "The Conceptual Framework for Financial Reporting," Chapter 1 *The Objective of General Purpose Financial Reporting*

[2] See paragraph OB16 of "The Conceptual Framework for Financial Reporting," Chapter 1 of *The Objective of General Purpose Financial Reporting*

all respects[3].

12. In light of the matters in the previous paragraph, although the FASB's proposed approach may have the advantage in regards to understandability, consistency with the credit risk management practice of entities (as it does not require tracking of credit risks), and relevancy to an entity's solvency analysis, we are of the view that it would fail to reflect the economic reality, as it requires recognition of lifetime expected credit losses for all assets.

13. On the other hand, although it may not be as theoretical as the approach proposed in the IASB's 2009 Exposure Draft (hereafter, the "2009 ED"), we think that the proposed model in the ED has a potential of providing relevant information to financial statement users who are interested in profitability of an entity's credit risk taking operations, if the proposed model is sufficiently operational.

14. In our view, the IASB's proposed approach has the advantage in that it separates the measurement objective of expected credit losses into 12-month expected credit losses and lifetime expected credit losses. We believe that setting the measurement objective as 12-month expected credit losses initially would contribute to effective matching between interest income and credit costs while, for those financial assets that have deteriorated in credit quality, it would be necessary to recognise a loss allowance at an amount equal to lifetime expected credit losses. When the ASBJ staff reached out to financial statement users, equity analysts expressed views that confirmed the ASBJ staff's analysis.

15. However, financial statement preparers have voiced significant concerns over the practical application of the IASB's proposed approach because the IASB's approach requires that the measurement objective changes when the credit risk of the financial asset *increases significantly* following initial recognition (this is often called the "relative approach.") In our understanding, this relative approach effectively requires tracking credit risk on the financial instrument from initial recognition to each reporting date.

***Views on an Optimal Impairment Model***

16. In light of the matters described in paragraph 11 of this comment letter, we are generally of the view that the impairment approach proposed in the 2009 ED would be considered as more theoretically appropriate, albeit with some shortcomings (for

[3] See paragraph QC15 of "The Conceptual Framework for Financial Reporting," Chapter 3 *Qualitative Characteristics of Useful Financial Information*

example, these approaches presume a too simple and unrealistic credit loss recognition pattern.) That approach taken in the 2009 ED is distinctive in that it requires that interest income be recognised on the basis of credit adjusted effective interest rates.

17. However, feedback from stakeholders (both domestically and internationally) has suggested that although such an impairment model could be applied to an individual financial instrument, its application to an open portfolio would be extremely difficult. In other words, although these approaches themselves may be capable of providing relevant information, it would be difficult for an entity to faithfully represent the economic reality, if the existing credit risk management and information systems were not changed substantially. This is because financial institutions holding a large volume of financial assets may not be able to utilise information maintained for their credit risk management purposes; therefore, they would have to rely on alternative data which may not necessarily be precise. As a consequence, the resulting information would not be sufficiently relevant for financial statement users. Some of the reasons are explained below:

    (1) *High volume of debt financial instruments held by financial institutions* – Financial institutions hold a large volume of debt financial instruments and usually manage them on a portfolio basis rather than on an instrument-by-instrument basis. They often have a strategy to maintain a portfolio's risk profile at the desirable level through purchases and sales of individual instruments. In other words, except for limited major investments, their focus is usually the risk profile of a portfolio as a whole rather than that of individual instruments.

    (2) *Consistency with credit management practices in financial institutions* – In most cases, after underwriting loans to borrowers, financial institutions may not raise an interest rate even if the borrowers' credit risk has significantly deteriorated since inception. Therefore, after underwriting, financial institutions usually focus on minimising credit costs rather than maximising credit spreads. Financial institutions thus monitor a static level of borrowers' credit risks periodically rather than changes in the credit risk on a financial instrument. This means that available information capable of capturing changes in credit risks is very limited under their existing information system.

18. We understand that this is the major reason why the IASB decided to explore different approaches including the approach proposed in the Boards' Supplementary Document

(SD) *Financial Instruments: Impairment* issued in 2011 (hereafter, "the SD"). However, despite that the IASB's proposed approach in the ED has in part alleviated practical challenges (for example, in terms of estimating expected cash flows), we do not believe that it has addressed the problems to that point that it enables financial statement preparers to make faithful representation without undue costs or efforts. In fact, financial statement preparers continue to be concerned about the practical challenges of the approach proposed in the ED. This is because this relative approach would effectively require tracking of credit risk on the financial instrument from initial recognition to each reporting date.

19. In addition, depending on the extent of increase in credit risks from initial recognition, the proposed approach may require an entity to classify financial assets of the same borrower into different stages; thus requiring recognition of different degrees of credit losses. Although the pricing may differ depending on the timing of initial recognition, we are of the view that this is not reasonable, because the source of the repayments from a borrower is the same.

20. Having regard to the discussion by the Boards to date, we believe that when developing an impairment model, consideration should not just be given to whether the model is capable of providing relevant information to users, but also to if the model enables financial statement preparers to faithfully represent the economic reality without imposing undue costs or efforts. For these reasons, we believe that further improvement is necessary to the IASB's proposed impairment model.

21. Having considered these matters, we have explored a possible alternative impairment model that would meet the matters described in paragraph 11 of this comment letter. In the following paragraphs, we will explain a proposed alternative impairment model that we believe is capable of providing relevant information to users but that can also achieves faithful representation while ensuring an appropriate cost-benefit balance.

***A Possible Alternative Approach***

<u>*The ASBJ's Alternative Approach*</u>

22. For the reasons stated in previous paragraphs, we have explored an alternative model that (i) encompasses characteristics necessary to provide relevant information to financial statement users in predicting future net cash inflows to the entity (as explained in paragraph 11 of this comment letter), (ii) enables making faithful representation by financial statement preparers while striking an appropriate cost-benefit balance, and (iii) may be acceptable to the Boards. Based on our

deliberations, we recommend the Boards consider the alternative impairment model which includes the following characteristics:

(1) Classify financial assets into two categories, based on the credit status of borrowers at each reporting date.

(2) Classify financial assets whose contractual cash flows have been recovered and are expected to be recovered in accordance with the manner originally anticipated as "category-1," and classify the remaining financial assets as "category-2." Considering that category-2 financial assets are the ones whose contractual cash flows have not been recovered as originally anticipated, these financial assets would be monitored and managed on an instrument-by-instrument basis, for example by securing collateralised assets and entering into significant modifications to the contractual terms, so as to maximise the recovery of contractual cash flows.

(3) For financial assets classified as category-1, recognise the expected credit losses for financial instruments at an amount equal to the one-year expected credit losses.

(4) For financial assets classified as category-2, recognise the expected credit losses for financial instruments at an amount equal to the lifetime expected credit losses. The expected credit loss of a financial asset shall be calculated at an amount equal to the present value of the recoverable amount deducted from its carrying amount.

*Explanation of the ASBJ's Alternative Approach*

*(Classifying Financial Assets into Two Categories)*

23. Some may hold the view that classification of debt instruments into multiple categories would be almost impossible, because the deterioration in borrowers' credit standings occurs gradually. However, in practice, when the recovery of contractual cash flows is not expected from financial assets as originally anticipated, entities usually segregate these assets from the rest of the assets in their credit risk management process. In such a case, entities might well manage these financial assets not only on the basis of a probability-of-default (PD) statistic but increased attention is often paid to a loss-given default (LGD) statistic. To put it another way, it may be possible to distinguish credit risk management practices into those with particular emphasis on the PD and those with increased attention to LGD.

24. In our view, when establishing a possible impairment model, focusing on this difference in credit risk management processes would contribute to properly

portraying interest income and credit costs during reporting periods, while ensuring that necessary expected credit losses that can be reasonably estimated are recognised on a timely basis (see paragraph 11(1) of this comment letter.) This is the primary reason why we are proposing classification of financial assets into two categories.

25. This approach (requiring classification of financial assets into two categories on the basis of entities' credit risk management) is similar to the approach proposed in the SD which required classification of financial assets into 'good book' and 'bad book.' As part of the feedback process to the SD, stakeholders expressed a particular concern that this approach would be arbitrary, because entities with lax credit risk management practice may have to recognise lesser expected credit losses. In order to address such concern, the ASBJ's alternative approach does not just rely on entities' credit risk managements, although our proposal and the SD's approach would yield similar conclusion in many cases. Specifically, our proposal refers to the history and expectation as to the recovery of contractual cash flows, in addition to the credit risk management practice.

26. Simultaneously, we propose that the Boards develop robust application guidance which illustrates situations where credit risk management is expected to be undertaken on a more individual basis. For example, the application guidance should state that financial assets whose contractual terms have been substantially modified be classified as category-2, because they are usually managed on an individual basis. In addition, the application guidance should also state that financial assets that meet the criteria relating to objective evidence of impairment as set out in IAS 39 *Financial Instrument: Recognition and Measurement* be classified as category-2. Following this, purchased or originated credit impaired financial assets should be classified as category-2.

27. Furthermore, using the examples in paragraph B20 of the ED, the application guidance may also include the following examples as indicators in determining if financial assets are classified as category-1 or category-2.

    (1) Whether the external credit rating or the credit spread for the borrower has decreased below a certain level.

    (2) Whether the internal credit rating for the borrower has decreased below a certain level.

    (3) Whether the actual or expected financial position and performance of the

borrower are adverse as a result of changes in business conditions or the regulatory environment of the borrower.

(4) Whether covenants stated under the loan agreement have been breached.

*(Calculation of Expected Credit Losses for Financial Assets Classified as Category-1)*

28. For financial assets classified as category-1, it is expected that credit risks are usually monitored and managed on a portfolio basis. Accordingly, for these assets, calculating expected credit losses on a portfolio basis is consistent with the entity's credit risk management. As for the measurement objective, we think that one-year expected credit losses after the reporting date would be appropriate for the reasons stated in the following paragraphs.

29. As stated in paragraph 11(1) of this comment letter, we believe that what is important is to properly portray the relationship between interest income and credit costs, while ensuring that necessary credit losses that can be reasonably estimated are recognised on a timely basis. We note that fulfilling the objective is not always easy, because the former point is to ensure matching between income and expense, while the latter point is to address uncertainties in accounting estimates.

30. However, when we have the measurement objective of one-year expected credit losses, the period over which an entity recognises interest income would coincide with the period for which an entity estimates expected credit losses, due to the fact that an accounting period is usually a one-year period. In addition, some existing provisions of IFRSs require an entity to make estimation over a one-year period from the reporting date, in light of estimation uncertainties. For example, when assessing whether the going concern assumption is appropriate, an entity is usually required to assess its ability to continue as a going concern for the twelve months from the end of the reporting period. Accordingly, a one-year period would be considered as a reasonable time-frame in light of ensuring a reasonable estimate of expected credit losses. Furthermore, taking into account the historical data obtained over the last 10 years in Japan, we are of the view that our proposal would generally meet the abovementioned factors.

31. It is presumed that an entity usually calculates expected credit losses on the basis of portfolio balance times loss ratios which are developed on the basis of an entity's historical loss experience, because the historical data is highly verifiable and is more likely to achieve faithful representation. However, considering that historical experience does not necessarily reflect future trends, updating for current conditions

and reasonable and supportable forecasts of future events and economic conditions at the reporting date would be necessary.

32. In many cases, loss ratios could be developed by averaging historical loss experience over several past periods, as updated as necessary, to calculate one-year expected credit losses. However, if credit losses are not expected to occur ratably throughout the contractual period of the financial assets, the effect on how credit losses would emerge should be taken into account in calculating expected credit losses.

33. In addition, it is not necessary that financial assets in category-1 be aggregated as a single portfolio. Rather, they should be appropriately disaggregated according to their nature and risk profiles. In disaggregating financial assets, internal credit risk ratings of financial institutions might be used. Applicable loss ratios for each portfolio would differ each other, if they were developed based on historical experience and adjusted necessary.

34. For financial assets classified as category-1, discounting expected credit losses to arrive at the present value may not be necessary. This is because the effect of discounting would often be insignificant for financial assets as category-1, and that the effect of discounting may not be calculated precisely because expected credit losses are normally calculated on the basis of the portfolio balance times the loss ratio.

*(Calculation of Expected Credit Losses for Financial Assets Classified in Category-2)*

35. By definition, financial assets classified as category-2 are usually managed on an instrument-by-instrument basis. Accordingly, we may well expect that an entity possesses information necessary to reasonably estimate the expected cash flows of financial assets over their remaining periods.

36. Because of that, we believe that it is appropriate to estimate expected cash flows over the remaining life of individual financial assets (which is the remaining life of a contractual period, taking into account expected prepayments) and to discount any expected losses using the effective interest rate. In addition, interest income should be recognised for these assets, as the effects on discounting are unwound with the passage of time; hence, those financial assets would not have a non-accrual status.

37. Separate presentation may be appropriate for credit losses on financial assets classified as category-1 and category-2, because the period of time over which an entity estimates expected credit losses may differ significantly.

*(Application to non-financial institutions)*

38. As mentioned in paragraph 5 of this comment letter, the impairment model for credit losses has a significant impact on financial institutions. Accordingly, we initially focused on an optimal impairment model for financial institutions when we explored possible alternative approaches. Nevertheless, application to non-financial institutions is equally important, because credit losses also incur in these entities.

39. We note that though the degree of precision in credit risk management by non-financial institutions may be very different from that of financial institutions, the objectives and general approaches to credit risk management would be consistent between financial institutions and non-financial institutions. That means that when an entity does not expect to collect cash flows from financial assets as originally anticipated, both financial and non-financial institutions aim to minimise the incurrence of credit losses with the different levels of credit risk management practice. Thus, it may be possible to presume that financial assets can be classified into at least two categories with different levels of credit risk management, regardless of the types of entities. Accordingly, we believe that the ASBJ's alternative approach would also be generally applicable to non-financial institutions.

40. However, some entities possessing a large volume of trade receivables may not perform credit risk management on an individual basis even for those financial assets classified as category-2 due to the cost-benefit balance. In such a case, an entity may not maintain information necessary to make reasonable estimates of expected cash flows on an individual basis. Where that situation applies, we think that the use of practical expedients (such as a provision matrix method) should be permitted.

*Benefit of the ASBJ's Alternative Approach*

41. As stated in paragraphs 11 to 14 of this comment letter, although it may not be perfect, we believe that the ASBJ's alternative approach would address important points in the development of an expected credit loss model (including, proper matching between interest income and credit costs in the statement of comprehensive income, addressing increased uncertainties in the estimate and appropriately reflecting anticipated future losses in the statement of financial position) with consideration for the cost-benefit balance. Furthermore, we believe that the ASBJ's alternative approach has the following benefits.

*(Response to the Concerns Expressed in Global Financial Crisis)*

42. The ASBJ's alternative approach explicitly requires that an entity recognise a certain amount of expected credit losses for financial assets classified as category-1. In other

words, an entity must recognise credit losses for financial assets on which there is no objective evidence of impairment. Accordingly, our model would address concerns cited during the financial crisis over lagging recognition of impairment losses.

43. In addition, as with the proposal in the ED, our proposal requires an entity to estimate credit losses based on the best available information that incorporates reasonably available information, including those about past events, current conditions and reasonable and supportable forecasts of future events and economic conditions at the reporting date. This would also contribute to addressing the concerns cited during the financial crisis.

*(Consistency with the Entity's Credit Risk Management)*

44. The ASBJ's alternative approach is developed based on the credit risk management that is expected to be undertaken entities (including those of financial institutions). Therefore, we expect that entities could utilise the existing information maintained for their credit risk management purposes to faithfully represent their expected credit losses, without making significant changes to their information systems. In addition, such information is generally considered highly reliable, because the information is often examined and inspected by financial supervisory authorities.

45. Furthermore, our proposal could avoid the risk of having significant inconsistency between financial information based on accounting standards and financial information prepared for supervisory purposes, because the credit risk management processes of financial institutions are often established to meet supervisory requirements. When the ASBJ staff reached out to stakeholders, financial statement users were of the view that it would be confusing if the financial statements prepared on the basis of accounting standards and supervisory requirements result in different level of provisioning. Although general purpose financial reporting prepared in accordance with accounting standards should not be determined by the information needs of financial supervisors[4], sharing the Boards' decisions and rationales on a timely basis would be helpful to have a common understanding among key stakeholders.

46. Moreover, unlike the approach proposed in the ED, the ASBJ's alternative approach does not require an entity to assess deterioration of credit risks from the inception of financial assets. Accordingly, our approach addresses the criticism of the IASB's

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[4] See paragraph OB9 of "The Conceptual Framework for Financial Reporting," Chapter 1 *The Objective of General Purpose Financial Reporting*.

approach that the tracking of changes in credit risks is almost impossible. The ASBJ's alternative approach also addresses the criticism that it is counterintuitive to recognise 12-month expected credit losses for some loans while life-time expected credit losses are required for other loans to the same borrower, when the source of the borrower's cash flow is the same.

47. Lastly, as stated in paragraphs 38 to 40 of this comment letter, we believe that our approach could also be applicable to non-financial institutions.

*(Response to the Criticism to the Absolute Approach)*

48. We are aware that there is a criticism to the absolute approach that segregates financial assets into different categories based on the credit standing of borrowers at each reporting date. For example, some have suggested that subprime loan lenders may have to recognise excessive expected credit losses based on the absolute approach, because that approach may require recognition of life-time expected credit losses at their initial recognition.

49. In this regard, the ASBJ's alternative approach requires that financial assets be classified in category-1 or category-2, based on whether their contractual cash flows have been recovered and are expected to be recovered as originally anticipated (in other words, the classification is made on the basis of how these assets are monitored and managed.)

50. Even in case of subprime lending, lenders usually monitor and manage the credit risk of financial assets at a portfolio level until credit risks of financial assets deteriorate to the point where they do not expect that contractual cash flows will be recovered as anticipated. This means that based on the ASBJ's alternative approach, even for subprime lenders, many loans starts in category-1 at their initial recognition. Accordingly, we believe that the ASBJ's alternative approach could alleviate the criticism raised of the absolute approach.

*(Response to the Concerns against Recognition of Day-One Losses)*

51. Under the presumption that an entity originates or purchases financial assets under arm's length conditions, the transaction price of an individual financial asset should be equal to its fair value. Therefore, the credit loss should not be recognised at initial recognition so as to appropriately reflect the economic reality[5]. Although the ASBJ's alternative approach might fall short of resolving the concern entirely, we think that

[5] Paragraph 58 of IFRS 13 "Fair Value Measurement"

our approach would significantly alleviate the concern, as it requires an entity to recognise expected credit losses on a portfolio basis. By doing so, we may be able to avoid the explicit question as to whether day-one losses should (or should not) be recognised, because a portfolio consists of financial assets with different inception dates and contractual maturities.

**Scope**

**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?

52. We are of the view that the scope of financial assets included in the ED is generally appropriate, because the accounting for expected credit losses should be the same, regardless of whether they are measured at amortised cost or FV-OCI.

53. However, we wonder if the practical expedient similar to that proposed by the FASB's proposed Accounting Standards Update *"Financial Instruments - Credit Losses (Subtopic 825-15)*[6]*"* should be provided.

54. We understand that the purpose of the practical expedient proposed by the FASB was to provide operational relief primarily to bond holders who have limited access to borrowers' information. For such bondholders, it is often difficult to obtain objective information about the borrowers' credit status other than through external credit ratings, thus it would be difficult for them to achieve faithful representation. Accordingly, when credit losses are expected to be insignificant we think that trying to segregate fair value changes attributable to credit risk from those attributable to other risks may not always result in useful information for financial statement users.

55. If this is the case, we recommend the IASB consider allowing operational relief where credit losses on the individual asset are expected to be insignificant for financial assets measured at FV-OCI.

**Assessing When an Entity Shall Recognise Lifetime Expected Credit Losses**

[6] See paragraph 825-15-25-2 of the FASB's Proposed Accounting Standards Update *"Financial Instruments - Credit Losses (Subtopic 825-15)."*

**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?

***Question (a): Proposed Requirement to Transfer Stage-1 to Stage-2 on the Basis of a Significant Increase in Credit Risk since Initial Recognition***

56. As stated in paragraphs 17 to 19 of this comment letter, we have concerns over the proposed requirement to transfer financial assets from stage-1 to stage-2 on the basis of a significant increase in credit risk since initial recognition.

***Question (b): Sufficiency of Guidance***

*Practical expedient for financial instruments with low credit risk*

57. Paragraph 5 of the ED states that if the credit risk on a financial instrument is low at the reporting date, a transfer from stage-1 to stage-2 would not be necessary. It also explains that a loan that has an internal credit risk rating equivalent to the external credit rating of 'investment grade' would be considered to have a low credit risk. We understand that this is a practical expedient designed to alleviate a practical burden.

58. Although it is provided as an example, stakeholders consider that the requirement draws a hard line at the investment grade rating and they have expressed concerns that the requirement does not accomplish the intended purpose of alleviating the practical burden. If the IASB continues to believe that providing this practical expedient is necessary, we recommend that the IASB revisit the requirement.

*Application of the model to an open-portfolio*

59. As part of the explanation of measurement on an individual or collective basis, paragraph B26 of the ED states that a financial instrument (or subgroup) *may* be removed from a portfolio and added to a different portfolio, or the expected credit losses may be estimated individually for that financial instrument (or subgroup).

60. Notwithstanding this explanation (including paragraphs B17-B19 of the ED), we are not clear how a significant increase in credit risk since initial recognition would be assessed for a portfolio. For example, if an entity expects as at the reporting date that 5 out of 100 financial assets will incur credit losses, while it originally expected that 2 out of 100 financial assets would incur credit losses, it is not clear whether these particular financial assets should be separated from the portfolio, and if so, when and how many of them should be.

61. In our view, except for extremely unusual cases, it is difficult to decide whether to transfer a portfolio as a whole from stage-1 to stage-2, because the level of credit deterioration of financial assets differs for each financial asset and their loss-given defaults are different despite that they may share similar risk characteristics. Therefore, we recommend that the IASB clarify the application of the credit deterioration model to an open-portfolio, if the IASB were to proceed with this proposal.

***Question (c): Probability of a Default Occurring***

62. We support the proposal in the ED.

***Question (d): Proposed Operational Simplification***

63. Paragraph 9 of the ED states the rebuttable presumption that financial assets should be transferred from stage-1 to stage-2 when contractual payments are more than 30 days past due. Financial statement preparers expressed significant concern regarding this requirement, because there are many instances where contractual payments become more than 30 days overdue although the borrower does not experience any credit deterioration (this is the case where a borrower has simply neglected a wire-transfer.) Although the requirement can be rebutted based on other persuasive information, it would be significantly burdensome for entities holding a large volume of financial assets to rebut the presumption on a case-by-case basis.

64. Assuming that the IASB's intention is to deal with situations where there might be credit deterioration for financial assets (while avoiding other instances), we recommend that the IASB set out the objective of the requirement instead of trying to

specify the number of days. In parallel, providing examples that illustrate the situations to which this requirement applies would also be helpful so as to promote a clear understanding of the requirement.

***Question (e): Proposed Requirement to Transfer Stage-2 to Stage-1***

65. We support the proposal in the ED.

**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?

(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?

66. The ED proposes various models in relation to interest revenue. Except for purchased or originated credit-impaired financial assets at initial recognition, it also permits that time value of money for the calculation of expected credit losses on financial assets should be any reasonable rate that is between (and including) the risk-free rate and the effective interest rate. We understand that these requirements are provided based on feedback from stakeholders expressing concerns about the practical application of discounting expected credit losses on financial assets in an open-portfolio.

67. We are of the view that the interest rate used to calculate interest revenue and the discount rate used to calculate the expected credit losses (and amortised costs) should be consistent. In theory, interest revenue should be recognised over time, as the effect of the discounting is unwound. Using an interest rate other than the effective interest rate as the discount rate would be inconsistent with the notion of amortised costs, because it effectively permits recognition of the effect on changes in interest rates, which is irrelevant to credit risks.

68. We also note that some stakeholders expressed a preference to have a non-accrual status, because the ED permits the use of practical expedients (e.g., the use of a provision-matrix) and that not all financial assets are explicitly discounted. In addition, a non-accrual status may be consistent with the notion in the revenue recognition standards, where revenue would not be recognised until an entity becomes certain as to the collectability of the consideration.

69. Accordingly, we recommend that the IASB re-deliberate these issues, before finalising the standard.

**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?

(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?

70. We generally support the proposed disclosure requirements in the ED. However, we have the following comments.

***Disclosures of a Reconciliation of the Opening Balance to the Closing Balance of the Gross Carrying Amount and the Associated Loss Allowance***

71. Paragraph 35 of the ED proposes to require that a reconciliation from the opening balance to the closing balance of the gross carrying amount and the associated loss allowance of financial assets to be disclosed in the notes to financial statements. Financial statement preparers expressed concerns about the proposal, because they are not sure if the benefit would outweigh the cost.

72. Such roll-forward information could be relevant for financial statement users to better understand changes in the credit risks of an entity's financial assets. This is because it explains why the allowance for credit losses changed during a reporting period by disclosing the break-down of net changes in the balance during the period (such as, current period provisioning, reversal, and write-offs charged against the allowance). On the other hand, financial statement preparers expressed the view that if an entity were to provide roll-forward information particularly about trade receivables

(including the ones whose contractual periods are relatively short), the practical burden would be significant because an entity would need to trail the information about allowances for receivables that have no beginning or ending balance at reporting dates.

73. Accordingly, we recommend that the IASB revisit the proposed requirement by considering whether this requirement is still necessary in light of the cost-benefit balance, and if the roll-forward information is still found to be necessary, we recommend the IASB consider whether and how the requirement could be simplified.

***Disclosures by Credit Risk Rating Grades***

74. Paragraph 44 of the ED proposes to require that an entity disclose, *by (at least three) credit risk rating grades*, the gross carrying amount of financial assets and the amount recognised as a provision for loan commitments and financial guarantee contracts in a grade.
75. Although such information would be relevant for financial statement users who are interested in the distribution of borrowers with different credit risks, challenges may exist in implementing the proposal. For example, some financial statement preparers expressed their concerns that such a disclosure may harm the business relationship with their customers.
76. In addition, others expressed the view that by its nature, such information is highly subjective. This is because entities other than financial institutions do not always classify their financial assets into three categories or more in their credit risk management practices, and this categorization may be solely for the purpose of meeting this disclosure requirement. As stated in paragraph 39 of this comment letter, there is a presumption that all entities classify financial assets into at least two categories (i.e., good one and bad one) as part of their credit risk management practices, but we are not sure if they have sufficient information to classify financial assets into three or more credit risk grades. If the IASB were to retain the proposed disclosure requirement, we recommend that the IASB provide guidance about how credit risk rating grades should be assessed, in order to promote comparability of the information.

***Disclosures by Incorporation or by Cross-Referencing from Financial Statements to Some Other Statement***

77. Paragraphs 31 and 32 of the ED proposes to permit that disclosure requirements in the ED be given in the financial statements or incorporated by cross-referencing from the financial statements to some other statement (i.e., disclosures that is available to users

of financial statements on the same terms as the financial statements and at the same time). We understand that similar disclosure requirement already exists in other standards (e.g., IFRS 7 *Financial Instruments: Disclosures*) and it has a potential to reduce the volume of disclosures in annual reports.

78. However, financial statement users may find it difficult to refer to that information if it is disclosed in reports other than the document containing the financial statements (such as, risk reports). Therefore, we recommend that the IASB consider restricting the application of this requirement to situations where such information is disclosed in the document that contains the financial statements.

**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?

79. While we generally agree with the proposed treatment of financial assets on which contractual cash flows are modified, some board members disagreed with part of the proposal. They are of the view that the effective interest rate of financial assets should be updated based on the modified terms, and the effect of changes in the modification to contractual terms should be recognised prospectively rather than when contractual cash flow are modified.

80. In addition, we are unclear about when and how financial assets should be derecognised upon modifications to their contractual cash flows. In its September 2012 meeting, the IFRS Interpretations Committee noted that the analogy of paragraph 40 of IAS 39 Financial Instruments: *Recognition and Measurement* relating to financial liabilities could be applied to financial assets, and that a substantial change of terms (*whether effected by exchang*e or by modification) would result in derecognition of the financial asset. We understand that the IASB did not opt for development of the related requirement due to its resource constraints and its potential wide-ranging effects.

81. However, due to the importance of this accounting treatment, stakeholders expressed the view that such a requirement should be clarified at the standard level. Accordingly, we recommend that the IASB clarify when and how modification of the contractual

cash flows should be accounted for as derecognition of financial assets before finalising the standard.

**Application of the Model to Assets That Have Been Modified But Not Derecognised**

**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.

82. We understand that the proposal in the ED has been based on views expressed by constituents that impairment requirements for all credit exposures should be aligned irrespective of their type (for example, whether they are loans or loan commitments). We are also aware that both loan commitments and loans are subject to credit risk management by financial institutions.

83. Generally, we think that the information based on internal risk management often provides good insight for the prospects of future net cash inflows into an entity. Therefore, we agree that it is often desirable to align an entity's risk management and accounting, so as to better portray the economics of the entity's activities.

84. However, loan commitments differ greatly from loans in that they do not give rise to cash outflows before the loans are drawn down. In addition, the credit risk exposures for which loss allowances should be recognised are unclear, because the timing and amount of cash outflows are usually outside the controls of the underwriters of the loan commitment contracts (usually, financial institutions).

85. Due to the aforementioned nature of loan commitments, we think that the application of the proposal in the ED would give rise to the following challenges that should be resolved.
    (a) It is unclear how to predict the timing and amount of which the loan commitments will be drawn down, because loan commitments do not usually specify the timing and amount of future draw-downs. Thus, the expected credit losses are conditional upon the future event that an entity cannot control.

(b) For the reason stated in (a) above, the question may arise whether recognition of a liability is consistent with the definition of a liability under the IASB's Conceptual Framework. This includes if there exists a past event that warrants recognition of a liability, and if the loan commitment gives rise to a present obligation, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits (or it is considered as a future commitment[7].)

**Exceptions to the General Model – Simplified Approach for Trade Receivables and Lease Receivables**

**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?

86. As for the proposed simplified approach for short-term trade receivables, we generally agree with the proposal, as we understand that in practice, processes would not change significantly because of the proposed requirements of the ED.

87. On the other hand, financial statement preparers expressed concerns over the proposed set of requirements for lease receivables. Leasing companies have a relatively large amount of credit risk exposure on aggregate, and contractual periods are normally 3-5 years long. Therefore, the practical impact on the use of the simplified approach is significant, while we believe that this approach (that effectively recognises lifetime expected credit losses for all assets) does not faithfully represent the economic reality as stated in paragraph 12 of this comment letter.

88. Compared with banks, leasing companies have infrequent access to the financial information of lessees to monitor their credit risks (for example, the access to financial information may be once a year.) and their credit risk management system is not as sophisticated, because credit exposures of a contract are much smaller than those of banks. Therefore, it is almost impossible for them to track the credit risk on the

[7] Paragraphs 4.4 and 4.15-4.19 of Chapter 3: *Qualitative characteristics of useful financial information* in the IASB's Conceptual Framework

financial instrument from initial recognition to each reporting date.

89. We note that similar discussion applies to instalment receivables and credit card receivables. In light of these effects, we recommend that the IASB revisit the proposed requirements.

**Exceptions to the General Model – 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?

90. We support the proposal in the ED.

**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.
> (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?

***Question (a): Proposed Lead Time***

91. We have heard from stakeholders (in particular, financial statement preparers) that three-year would be necessary to implement the proposal, if the IASB were to finalise the proposal without changes (especially, with regard to the relative approach that requires tracking of credit risks).

***Question (b): Proposed Transition Requirements***

92. Although we understand that the IASB will consider the application of the proposed standard to first-time adopters in combination with other phases of the financial instruments project, once the entire package of financial instrument standard is more

visible, we would like to reiterate that it is important for the IASB to publish its proposal at the same time that it finalises the transitional requirements for the first-time adopters.

* * * * *

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

Yours sincerely,

Atsushi Kogasaka
Chairman of the Financial Instruments Technical Committee
Vice Chairman of the Accounting Standards Board of Japan