Institute of Certified Public Accountants in Israel
לשכת רואי חשבון בישראל

1906/33760

July 29, 2013

International Accounting Standards Board
30 Cannon Street
London EC4M6XH
United Kingdom

Dear Sir/Madam,

Re: **Exposure Draft – Financial Instruments: Expected Credit Losses**

We appreciate the opportunity to respond to the Exposure Draft "Financial Instruments: Expected Credit Losses" issued by the International Accounting Standards Board (IASB). This response represents the views of the Institute of Certified Public Accountants in Israel.

We agree that the accounting framework for recognizing credit losses should move from the current incurred losses model towards an expected losses model. The experience accumulated during the last financial crisis shows that not only were credit losses recognized too late, thereby providing less relevant information to users of financial statements, but they also boosted the turmoil in financial markets.

We also agree with the notion that the recognition of credit losses should evolve as the credit quality of a financial asset deteriorates. However, as explained below, we believe that these credit losses should only reflect deterioration in credit quality that was not priced in the fair value of the financial asset (i.e., credit losses that were not anticipated when the transaction was entered into).

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We concur with the view held by the IASB that the 2009 ED most faithfully represent the link between the pricing of a financial asset and the expected credit losses at initial recognition. According to the 2009 ED model, expected losses would have been reflected in the yield on the financial asset. However, the current proposed model decouples the measurement of credit losses from the measurement of the financial asset itself, thereby allowing the recognition of day one losses.

In our view, even if one might find the current proposed model less costly, we do not believe that the operational challenges of the 2009 ED can be overcome by a model, which results in a recognition of day one losses in cases where the financial asset was acquired and priced at fair value. We believe that such a result could mislead users of financial statements.

In fact, we agree with many of the arguments made in the alternative view on the exposure draft, amongst others that:

1. The 12-month expected credit loss lacks conceptual foundation.
2. The recognition of a loss at initial recognition is contradictory to the IASB's own conceptual framework, given that the result fails to faithfully represent the transaction at its fair value. We believe that this is also contradictory to concepts that are established in IFRS 13 and other sections of IFRS 9, since the transaction results in a financial asset which is initially recorded at an amount that is lower than fair value.
3. The proposed model would result in double-counting of the expected credit losses at initial recognition (see the example given in paragraph AV3 of the ED).
4. It is unclear why the proposed model establishes a loss allowance for the vast majority of the less risky assets, while no such allowance is recognized for the riskier assets that are credit-impaired at initial recognition.

Moreover, the complexity of having multiple impairment models was identified as a weakness in the existing accounting standards. Nonetheless, establishing different treatment for various financial assets that are credit-impaired at initial recognition, as opposed to other financial assets, retains some complexities that were associated with IAS 39.

In our view, the IASB should adopt a single method model that would apply to all financial assets.

We are aware that it may be argued that the proposed model can be suitable for the presentation of <u>portfolios</u> of financial assets. Nevertheless, we do not believe that this can justify using a model that results in unfair presentation of individual financial assets.

Please find attached an appendix containing responses to some of the questions that were included in the ED.

Sincerely yours,

A. Inbar

Adir Inbar
Chair of the Professional Council

Arnon Ratzkovsky
Chair of the Financial Reporting Standards Committee

Appendix – response to some questions that were included in the ED

Question 1(a)

Do you agree that an approach that recognizes 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?

Answer

As mentioned in our preface, we do not believe that recognizing even a portion of expected credit losses at initial recognition reflects the economic link between the pricing of financial instruments and the credit quality at that point in time. This is because a financial instrument is initially recognized at fair value, which already incorporates the expected credit losses. However, in our view, the effects of changes in the credit quality subsequent to initial recognition are faithfully represented.

Question 1(b)

Do you agree that recognizing 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?

Answer

We do not agree that the proposed model faithfully represents the underlying economics of financial instruments. See our preface and response to the previous question.

Question 2(a)

Do you agree that recognizing 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 faithful representation of the underlying economics and the cost of implementation? If not, why not? What alternative would you prefer and why?

Answer

As mentioned in our preface, even if one might find the current proposed model less costly, we do not believe that the operational challenges of the 2009 ED can be overcome by a model, which results in a recognition of a day one loss in cases where the financial asset was priced at fair value. We believe that such a result could mislead users of financial statements. Moreover, the 12-month expected credit loss lacks conceptual foundation.

Question 2(c)

Do you think that recognizing 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?

Answer

We believe that recognizing the lifetime expected credit losses at initial recognition would not achieve a better balance between the faithful representation of the underlying economics and the cost of implementation than this ED. Such a solution would be considered even less neutral than the model proposed in this ED.

Question 4

Is measuring the loss allowance (or provision) at an amount equal to 12-month expected credit losses operational? If not, why not and how do you believe the portion recognized from initial recognition should be determined?

Answer

Although we do not agree with the concept of recognizing 12-month expected credit losses, we believe that it is nonetheless operational, since most entities can make predictions regarding the following 12 months. The ability to use historical experience / provision matrix makes the model more operational.

Question 5(a)

Do you agree with the proposed requirement to recognize 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?

Answer

We agree with the notion that more credit losses should be recognized as the credit risk increases. Although we do not agree with recognizing credit losses at initial recognition, we believe that recognizing the lifetime expected credit losses on the basis of a significant increase in credit risk since initial recognition is appropriate and faithfully reflects the underlying economics of the transaction.

Question 5(b)

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

Answer

The term "default" is critical to appropriately implement the requirements of the proposed model. Unfortunately, this term is not defined in the ED and thus might be subject to different interpretations that would lead to diversity in practice. Furthermore, when determining if a significant deterioration in credit risk has occurred, an entity should compare the probability of a default at initial recognition with the probability of default at the reporting date, while taking into account the passage of time. We expect this comparison to be operationally challenging as it requires complex estimations. We recommend adding further guidance in this matter or introducing practical expedients.

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?

Answer

We agree that this treatment faithfully represent the link between the pricing of a financial asset and the expected credit losses at initial recognition, as expected losses would be reflected in the yield on the financial asset. However, as mentioned in our preface, the complexity of having multiple impairment models was identified as a weakness of existing accounting standards.