



Carlos Montalvo
Executive Director

Mr Hans Hoogervorst
Chairman of the IASB
30 Cannon Street
London EC4M 6XH

Großbritannien

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

Dear Mr Hoogervorst,

The European Insurance and Occupational Pensions Authority (EIOPA) welcomes the opportunity to comment on the IASB's Exposure Draft Financial Instruments: Expected Credit Losses (ED).

EIOPA as part of the European System of Financial Supervisors was established to strengthen the stability of the financial system, transparency of markets and financial products as well as the protection of policyholders, pension scheme members and beneficiaries within the European Union.

EIOPA fully supports the development of a single set of global, high quality financial reporting and accounting standards and therefore, appreciates the opportunity to provide input to the development of an international accounting standard on financial instruments.

The ED states that the main objective in developing this proposal is to provide users of financial statements with more useful information about the expected credit losses on financial assets and on commitments to extend credit. EIOPA is generally supportive of the direction and principles presented in the ED.

However, EIOPA notes that the ED focuses on the treatment of financial instruments measured at amortised cost and principally addresses the accounting for loans and financial instruments by originators of loans, as opposed to, the accounting for acquired debt securities. Insurers generally do not originate loans, but invest in financial instruments, particularly those that would fall in the third classification category.

As such, it can be expected that insurers would not have the same level of information regarding financial instruments held at amortised cost as a bank issuing comparable instruments. Regarding financial instruments of the third category that are measured at fair value through other comprehensive income, EIOPA believes it will be difficult to apply and difficult for users to understand how impairment charges as suggested in the ED differ from the assessment of the credit risk as required by the fair value measurement. It is, therefore, unclear how to distinguish between a negative fair value movement and one relating to an impairment charge. For these reasons, we would welcome more guidance and detailed examples as to how the principles presented in the ED could be applied to such instruments in an insurer's financial statements, including when and how these instruments would be assessed on a collective basis.

Furthermore, EIOPA has concerns regarding the conceptual soundness of providing an exception for low credit risk assets which allows keeping financial instruments within a low credit risk category (stage 1) although their credit quality has significantly deteriorated.

Whilst we have not explicitly addressed the questions raised in the ED, in the attached appendix we have outlined a number of aspects of the ED that are relevant to insurers and some more general amendments to the current proposals that the IASB may wish to consider.

We note that the proposals will not apply to financial guarantee contracts where the entity has decided to apply IFRS 4 but with this in mind, we believe that the treatment of financial guarantee contracts according to IFRS 4 phase II and IFRS 9 should not be materially different. Therefore, it is difficult to provide a definitive view on this point until IFRS 4 phase II is finalised.

If you have any questions or wish to discuss this further with us, please feel free to contact Ms Sandra Hack at Sandra.Hack@eiopa.europa.eu.

Kind regards,



Carlos Montalvo

Appendix

1. We believe that the 12 month time horizon lacks a conceptual basis as highlighted by the Board itself in the basis for conclusions. However, we believe that the proposed model is nonetheless an improvement over the current IAS 39 incurred loss model, and especially for the amortised cost model, as it achieves an acceptable balance between the faithful representation of the underlying economics and the cost of implementation. In particular, EIOPA supports the proposed approach because it:
 - results in a more timely recognition of expected credit losses compared to the current standard; and
 - improves the valuation of the liabilities stemming from loan commitments and financial guarantees.

Application of the proposals to financial instruments measured at fair value through other comprehensive income

2. EIOPA acknowledges that if the proposals in the Exposure Draft 2012/4 “Classification and Measurement: Limited Amendments to IFRS 9” are implemented by the IASB, financial instruments measured at fair value through other comprehensive income (FVOCI) should be included within the scope of this ED.
3. Notwithstanding this view, EIOPA believes that the presentation of expected credit losses for assets that are held at FVOCI has the potential of creating confusion:
 - due to the practical difficulty of distinguishing negative fair value movements from changes in credit risk; and
 - the level of aggregation in the presentation of impairment as outlined in the ED. We are not confident that the disclosures are sufficiently granular to demonstrate the impairment charge relating to amortised cost and FVOCI.
4. If the proposals pertain, we would recommend that the IASB at a very minimum require disclosures outlining:
 - what portion of OCI is attributable to day 1 impairment charges; and
 - what portion of gains on sale of FVOCI items is effectively a reversal of day 1 impairment charges not realised.

Exception to an application of the lifetime expected credit losses when the credit risk remains low

5. The ED implies that a financial instrument is of low credit risk (paragraph 6), if a default is not imminent and any adverse economic conditions or changing circumstances may lead to, at most, a weakened capacity of the borrower to meet its contractual cash flow obligations on the financial instrument. This principle is an exception to the general principle requiring a changeover to measurement based on lifetime expected credit losses in the case of “significant deterioration”. From the guidance provided in the ED, it is difficult to determine:

- for a bond moving from “AAA” to “BBB” whether it should still be considered as being of low credit risk because it retains “investment grade” status and therefore be assessed within the 12-month expected credit losses; and
- for a bond moving from “BBB” to “BB” (i.e. downgraded by fewer notches but no longer classified as “investment grade”) whether it should be deemed to have suffered a significant deterioration in credit quality and therefore should be assessed on the basis of lifetime expected credit losses.

EIOPA believes that the ED requires an entity’s management to make two crucial judgement calls:

- (a) whether a significant deterioration has occurred; and
- (b) what low credit risk is.

6. EIOPA would like to highlight two operational concerns on the conditions proposed in order to assess whether the credit risk is still to be considered low when the credit risk has increased significantly:

- the criterion of the imminent default does not seem to be particularly useful because on the one hand one can expect that the credit quality of an asset would experience a significant deterioration before default is imminent whilst on the other hand this requirement introduces a relatively high threshold before moving to the lifetime expected loss assessment; and
- as extreme scenarios can occur, irrespective of the credit quality as indicated by the current rating, and lead the borrower to fail to meet their obligations one could argue that this second criterion could rarely, if ever, be met.

Consequently, we are not convinced that this exception is appropriate.

7. If the IASB does decide to maintain this exception, we would recommend that the IASB defines the notion of “low credit risk” and, if needed, of “default” for the purposes of these proposals. In addition we would also recommend that the IASB either defines the term “investment grade” to ensure consistent application by entities or avoids using that reference. EIOPA believes that it would be beneficial to remove the exception and replace it by principles regarding how entities should assess the terms “low credit risk” and “significant deterioration in credit risk”.

Discount rate

We have some concerns regarding the IASB’s proposal that an entity can choose the discount rate it uses to reflect the time value of money for the calculation of expected credit losses. We believe that providing this choice to entities (albeit that the rate used needs to be disclosed) reduces the consistency and comparability of financial statements. We believe as a principle that the effective interest rate should be used.