KSR

KOMITET STANDARDÓW RACHUNKOWOŚCI

27 June 2013

IFRS Foundation
30 Cannon Street
London EC4M 6XH
United Kingdom

Dear Sir/Madam,

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

The Polish Accounting Standards Committee (PASC) is pleased to respond to the request for comments on the modified IASB Exposure Draft *Financial Instruments: Expected Credit Losses,* published on 7th March 2013 (referred to as ED thereafter), concerning expected credit loss model for financial instruments.

The PASC is generally supportive of the direction and principles articulated in the ED, that is recognizing expected loss at the moment of initial recognition of financial instruments. In the opinion of the PASC, a need exists to further refine the standards within the current framework. The implementation of the new standard would allow to address one of the basic issues stemming from the current approach, i.e. great flexibility in application of valuation methods (including methods based on statistical models).

Although the comments by the PASC refer predominantly to the banking sector, the ED will impact all financial institutions. This may strongly affect their financial ratios and reporting.

The ED is fundamentally different from the IAS 39 with respect to approaching credit loss. It assumes departure from the incurred loss model and its replacement with the expected loss model.

The proposed changes aim for more timely loss recognition. However, if accepted in its current form, this standard will not support the achievement of the ultimate goal of the project, which is, to provide the receiver of financial information with objective knowledge on the degree of an institution's exposure to future credit losses. The proposed changes continue to leave much space to subjective judgment which may have severe implications on the value of allowances and speed of problem identification. From the methodological perspective, it should be noted that the proposed solutions raise some concerns with respect to their internal consistency, among others.

Yours sincerely,

Joanna Dadacz

Chairman
Polish Accounting Standards Committee

Cc: EFRAG

The detailed conclusions from the analysis by the PASC are listed below:

1. The 12-month expected credit losses

According to par. 4 of the standard, in the case of credit exposures for which there has been no deterioration in the quality of financial instruments, the institution will be able to value such exposures based on the losses forecasted for the next 12 months. This approach differs from the current approach through the establishment of the single reference period equal to 12 months for all exposures and for all institutions. This should have a positive impact on the comparability of financial statements. At present, the value of IBNR allowances depends directly on the loss identification period – the longer the loss identification period, the greater the value of allowances. It should be kept in mind that this relationship is approximately linear.

Notwithstanding the above benefit, at the implementation stage of the requirement in question the results of the financial sector may be subject to severe deterioration resulting from the required additional allowances. Therefore, in transitional period it will be crucial for the banks with significant risk exposures to come up with a plan to increase allowances gradually, so as to avoid the risk of credit loss at the moment of allowance accumulation over the one year period. Such event would be particularly severe to the banks that have large portions of retail exposure in their portfolios, and so they will have to increase their allowances repeatedly. Only the banks that use conservative approach in their loss estimation (extended period for loss identification) should not experience any significant changes.

2. Lifetime expected losses in the case of severe deterioration in the credit quality of the issuer and where there are no indications for loss recognition.

In accordance with par. 5 of the standard, in the case of exposures for which a significant increase in credit risk has been noted in comparison to the initial recognition in the balance sheet, the financial institutions should measure the expected loss for the entire period in which they are holding the financial instrument.

A. Significant individual exposures

In the case of significant individual exposures, whose valuation is based on the analysis of forecasted cash flows, nothing should change in the way the expected losses are estimated. Nevertheless, the process of estimating those cash flows will be triggered even before an indication for credit loss appears, especially for cases where the maturity exceeds 30 days. Theoretically, this should result in more timely loss recognition, as well as more precise valuation of credit exposures. However, there is a risk related to the human resources capacity of financial institutions. The analysis of forecasted cash flows is a time consuming tool. Any increase in the number of customers subject to such analysis may affect the quality of the estimates applied. Because of the time constraints and challenges faced by the human resources capacity, the quality of the cash flows affected by the estimated credit loss can deteriorate as well.

Furthermore, the presentation of such exposures is equally important. Several questions appear in this matter. In the case of expected credit loss recognition, should such exposures be still presented as “no credit loss” (i.e. in an active portfolio – without the actual stated indication for credit loss). In other words, can one assume that there is a lack of indication for expected credit loss at the very moment of its recognition? A credit loss is a result of estimates of cash flows, thus, the analyst would have to estimate that not all cash flows will be realized (the debtor will lose its credit worthiness), which should be the basis to presume a deteriorated financial or economic condition. Perhaps valuation on a portfolio basis (without the cash flow analysis) would be a better approach for the exposures in question. In such case, these exposures could be classified as exposures without credit loss (but valued by using parameters taking into account higher risk). This should solve the problem of the excess burden of analysts.

B. Insignificant individual exposures

a) Given that the standard does not include any description of the method that should be used to determine the probability of entering into credit default in a given time horizon, different institutions will use different approaches, e.g. with respect to the assumptions used to estimate the degree of inter-period relationship of the events of an entry or a lack of entry into credit default (affecting the allocation of 1-year probabilities of default to the probabilities of default in a longer time horizon). This should cause differences in results and negatively affect the comparability of the data presented in the financial statements.

b) In the case of exposures with a relatively long maturity (e.g. collateralized mortgage loans), there are some difficulties in estimating the probability of entering into credit default for periods far into the future. These difficulties come from both the lack of historical data for some markets (e.g. emerging markets) or products, as well as from the fact that for those markets and products that have historical data, the historical data can misrepresent future conditions. Given the requirement of credibility of a financial statement, another challenge can be found in the requirement to recognize the value of potential losses the time evolution of the collateral in relation to the changing value of the exposition. Assuming fixed values of LGD (loss given default) for each of "n" number of periods (years) in which a default event may happen is incorrect for the methodological standpoint, at least given the degree of collateral coverage of the exposure that changes over time (the exposure value – in the case of settling receivable payments on time – is a diminutive function of time, and the value of collateral is not a monotonic function of time).

c) In the case of exposures overdue for 30 days the probability of entering into default in a 1-year time horizon is extremely high (at times exceeding 50%). If this probability were to be the basis for arriving at the value of the allowance for the entire period (lifetime), then the value of such allowance would approximate the allowance from exposures already in the state of default. This may mean that it would be more appropriate to determine a much lower threshold for the number of days overdue that would signal a need for a lifetime allowance. Allowing the institutions flexibility in determining the appropriate number of days overdue (as stated in par. 9) – without the simultaneous indication of alarming levels for the probability of default – will negatively affect the comparability of the values of allowances among institutions.

d) The expected lifetime losses for the holding period can be difficult to estimate also because of the difficulties in determining the actual length of the holding period of an instrument. The length of a holding period can be significantly shorter than the duration stated in the contract (i.e. loan prepayments, insurance contract lapses). In that case, determining the lifetime probability of default for the holding period will cause the allowances to be overstated. Further problems can arise from determining the holding period for products whose specificity allows for automatic extension of the holding period after meeting certain criteria or in the case of a lack of a contract termination. Paragraph 17 of the standard indicates that the maximum period to be considered should be derived from the contract in force, even when business experience suggests using longer periods. One should also consider allowing the use of shorter periods than those stated in the contract, if rational data can support this. In that case, such practice would improve the quality of estimates.

3. Recognition of a significant deterioration in credit quality

A. One should deem inconsistent an approach according to which the exposures with an investment grade, independently of the direction and dynamics of change in that rating over time and despite recognition of significant increase in their credit risk, are to be burdened with allowances reflecting losses expected in 12 months, whereas the exposures with a lower credit quality would be assigned lifetime allowances.

Example 1:

Bank A is in possession of a debt instrument, whose issuer had an S&P rating of AAA at the moment of initial recognition. Because of the deterioration in credit standing, the rating of the issuer decreased to the level of BBB- (a 9 rating grades drop). The only allowance recognized is for the 12-month period.

Bank B is in possession of a debt instrument, whose issuer had an S&P rating of BBB- at the moment of initial recognition. Because of the deterioration in credit standing, the rating of the issuer decreased to the level of BB (a 2 rating grades drop). Such drop causes reclassification from the investment grade to speculative grade. In this situation, it would be safe to assume a lifetime allowance.

The above example indicates that banks which have in their portfolios exposures on the verge of the investment grade (lower boundary BBB-) and speculative grade (upper boundary BB+) can experience unfair competitive environment because of the potential risk of their capital being burdened with disproportionately higher allowances than their true risk profile would indicate (lifetime allowances instead of one-year allowance).

B. There have been no relative or absolute changes in the levels of probability which would induce the necessity for creating lifetime allowances instead of one-year allowances. One should agree with the observations stated in paragraphs B12-B15 of the standard. These observations indicate that the impact on the differences in levels pertains to both the inputs used for probability of entering into default and the instrument's maturity, which impedes arriving at concrete measures. Nevertheless, the expression "significant increase in the level of credit risk" is more quantitative than qualitative in nature and should thus be expressed quantitatively. The lack of a precise definition causes vast flexibility for interpretation and will result in the differentiation of approaches assumed by different institutions. This will result in accumulation of differences on the level of allowances that will not be explained by the differences in the actual level of risk exposure.
C. According to par.5 of the standard (with exclusion of the exposure with an investment grade rating), in the case of significant increase in the level of credit risk as compared to the moment of recognition, a lifetime allowance should be created. Depending on the structure of the portfolio of exposures, the assumption above may result in that the risk measure corresponding to the level of allowances may not meet the monotony criterion. This criterion states that the relatively higher degree of risk should be accompanied by higher level of allowances. The above risk measure disregards the actual absolute level of risk. This case can be illustrated by the following example:

Example 2:

Bank C is in possession of credit exposures in its portfolio. At their recognition, these exposures were assigned a risk grade based on the internal rating model that is equivalent to the B grade by S&P. No changes in the risk level were observed at the reporting date. The only allowance created was a 12-month allowance.

Bank D is in possession of credit exposures in its portfolio. At their recognition, these exposures were assigned a risk grade based on the internal rating model that is equivalent to the BBB+ grade by S&P. A significant increase in the risk level was observed at the reporting date, which caused the rating to decrease to level B+ (a drop by 3 grades). Given the above, a lifetime allowance was created.

The example above demonstrates that although Bank D has lower level of absolute risk than Bank C, it will be charged with a lifetime allowance, while the former will be charged with a 12-month allowance. This situation indicates that the risk measure applied does not meet the monotony criterion and may mislead the reader of the financial reports with respect to the actual credit risk levels at both of these institutions.

4. Recognition of future events in valuation process

On one hand, the implementation of such approach will allow for a faster identification of negative changes and creation of appropriate allowances. On the other hand, it may turn into an incentive for the banks to look into the future too optimistically and indicate that any current financial problems of their clients are only temporary and will improve in the near future (and this may be used to rationalize lacks of allowances or their undervaluation). Restricting the potential for inappropriate optimism of financial institutions may be a great challenge for supervision authorities.

5. Discounting cash flows

Paragraph B29 of the appendix gives flexibility to choose the discount rate from a range between the risk free rate and an effective interest rate. This is not a correct approach. One can expect that the majority of financial institutions will choose the lowest value in that range, so that it arrives at the highest value of discounted cash flows. Moreover, such flexibility in choice can result in a situation, where the value of discounted cash flows will exceed the gross book value. When recognizing the indication for credit loss and analyzing the cash flows, banks may assume that there is no rationale for credit loss recognition even if the full credit amount has not been paid off.

Furthermore, the risk free rate does not seem to be the appropriate rate to be used in the credit loss analysis, because the financial instruments analyzed bear risk and this risk is reflected in the effective interest rate. It would be incorrect to conclude that a financial institution would not incur losses on financial instruments because the value of cash flows exceeds the profits that it would earn by investing the capital at the risk free rate. Taking on additional risk without appropriate risk premium and risk return on the investment should be considered as inefficient capital management.

6. Backtesting

In order to analyze the appropriateness of the applied approach, financial institutions should use backtesting to periodically verify the applied models. In the case of backtesting of parameters used to calculate expected losses in the loan's lifetime, banks will again encounter the problem of data insufficiency. In reality, they will only have to verify the assumptions stated for the purpose of determining those parameters, i.e. if the basis parameter was the probability of default in one year horizon, then backtesting would be restricted to the verification of that parameter.

7. Disclosures

According to par. 44 of the standard, financial institutions will have to disclose their gross book value and allowances on the financial assets classified by rating categories. In the opinion of the PASC, this is a good solution, which will facilitate comparisons among credit portfolios of individual banks. However, taking into account significant differences in rating models of individual financial institutions, the PASC suggest that aside from the rating category, banks should also disclose the appropriate default probability range because this is the key parameter here. An alternative solution would be a requirement to map the internal rating scale of a financial institution with the scale identified by the IASB.