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Supplement to ED/2009/12 Financial Instruments: Amortised Cost and Impairment

Dear Sir David,

Thank you for the opportunity to comment on the above supplementary document.

We welcome the fact that the IASB has taken some of our key concerns to the original 2009 proposals on board. This applies, for instance, to the use of an impairment model for open portfolios and to the separate (decoupled) approach to the consideration of expected loss and the determination of the effective interest rate. Owing to the very limited scope of the supplement, however, and to the open issues which the Board still has to discuss (e.g. disclosures), we have no clear picture as yet of the final composition of the impairment requirements. We would like to stress in this context that we would prefer a single impairment model both for all financial instruments at amortised cost (including financial guarantees and loan commitments) and for all portfolios (open and closed) and individual instruments.

We likewise welcome the efforts by the IASB and FASB to find a more convergent approach. The focus of convergence discussions should always be on developing standards of high quality. We have very serious reservations about the “foreseeable future” concept and its

implications (floor). This merely represents a political compromise. It is not consistent with a time-proportional approach to expected losses (IASB-only approach) since it will be unable to achieve a matching of interest revenue and losses as proposed by the IASB in its 2009 exposure draft. What is more, the floor will generate further complexity because both the floor and time-proportional credit loss allowances will always have to be calculated. For these reasons, we are strongly in favour of the IASB-only approach, i.e. a time-proportional approach to expected losses without a floor.

In addition to these concerns, it is not clear to us whether and, if so, to what extent credit loss allowances may be partially or fully drawn on. That they can be is a fundamental prerequisite for the acceptance of an impairment model in our view.

The disclosure requirements can only be assessed when the overall picture is available. It is not clear, how the proposed disclosure requirements will fit with the final model. Also, at this point in time, the FASB views on disclosure requirements are not known. The ZKA would welcome a re-exposure of the proposed final standard as it will allow constituents adequate time to review the disclosure requirements for all assets (not only those under the scope of the SD) and how the proposed requirements link to the final model.

In conclusion, we would like to point out that we consider a 60-day consultation period too short for such a major issue. Furthermore, we believe it would have made good sense for the Board to have conducted field tests to investigate the effects of implementing its proposals.

The above points notwithstanding, our replies to the questions raised in the supplementary document are as follows:

Question 1

Do you believe the approach for recognition of impairment described in this supplementary document deals with this weakness (ie delayed recognition of expected credit losses)? If not, how do you believe the proposed model should be revised and why?

We generally take the view that the proposals would enable expected credit losses to be recognised sooner. Irrespective of this point, however, we would like to reiterate our view that the impairment model which replaces the existing incurred loss model should be based on the following principles:

1. expected losses should be recognised over the life of the portfolio,
2. expected losses should be determined on a portfolio basis,
3. expected losses are the best estimates of the losses on the financial assets existing in the portfolio on the balance sheet date,
4. there should be no change in the EIR calculation from that in the current IAS 39 (this is also essential for closed portfolios),
5. impaired loans should be treated as currently under IAS 39,
6. incurred losses are the materialisation of expected losses, so expected loss allowances are built up to be used.

Though the first five principles have now been addressed, the last one does not appear to have been fully met. The approach proposed in the supplementary document does not permit full absorption of incurred losses by the allowance account previously established for the portfolio (see also our answers to subsequent questions). This can best be illustrated by the conditions that exist at the height of a credit crisis. Many bad loans will have to be transferred to the bad book at this point. If management takes a (justified) positive outlook in estimating future expected losses on the good book, it will be possible to significantly reduce allowances for the good book. Such a positive outlook would need to be based on reasonable and reliable forecasts of future events and conditions. We anticipate that this would be very difficult in practice, however, since it would involve, among other things, predicting not only the beginning and end of the economic cycle but also its depth. And even if it were feasible, there would always be a significant time lag.

Furthermore, as mentioned in our introductory remarks, we take the view that the idea of an artificial, arbitrary floor is inconsistent with a time-proportional approach to recognising expected credit losses. It would not enable interest revenue to be matched with expected losses, as originally proposed by the IASB. On top of this, a floor would increase the complexity of the impairment model. For these reasons, we are in favour of the IASB-only approach – i.e. time-proportional recognition of expected losses without a floor.

Question 2

Is the impairment model proposed in the supplementary document at least as operational for closed portfolios and other instruments as it is for open portfolios? Why or why not? Although the supplementary document seeks views on whether the proposed approach is suitable for open portfolios, the boards welcome any comments on its suitability for single assets and closed portfolios and also comments on how important it is to have a single impairment approach for all relevant financial assets.

We prefer a single impairment model both for all financial instruments measured at amortised cost (including financial guarantees and loan commitments) and for all portfolios (open and closed) and individual instruments. We have already drawn attention to the problems resulting from a floor (for more details, please also see our reply to questions 9 ff.). We believe the IASB-only approach could be successfully applied both to open and closed portfolios and to individual instruments.

Question 3

Do you agree that for financial assets in the ‘good book’ it is appropriate to recognise the impairment allowance using the approach described above? Why or why not?

Yes, we agree and would also refer you to the ZKA’s comments of 28 June 2010 on this issue.

Question 4

Would the proposed approach to determining the impairment allowance on a time-proportional basis be operational? Why or why not?

We consider the proposed approach operational. Here, too, we would refer you to the ZKA’s comments of 28 June 2010.

Question 5

Would the proposed approach provide information that is useful for decision-making? If not, how would you modify the proposal?

As mentioned above, we see no justification for the concept of a floor. In many instances, the foreseeable future (floor) will be the factor determining the expected loss allowance. Above a certain level of provision, the floor will often prevail over the time-proportional provision. If the foreseeable future was deemed to be a two-year expected loss, the floor would probably only be exceeded in rare circumstances for standard loan portfolios. In most circumstances, therefore, the time-proportional provision will be less than two years' expected losses, and the floor will be the sole determinant of the level of the good book provisions. This will not provide decision-useful information. Furthermore, the switch between the time-proportional approach and the foreseeable future (floor) over subsequent reporting periods would be confusing for users and difficult for preparers to explain.

If an entity expects substantial losses in the foreseeable future, this should be taken into account when building up the time-proportional allowance. If the existing allowance amount is considered sufficient to absorb losses, we see no need for a floor.

For this reason, we are in favour of an IASB-only approach without a floor.

Question 6

Is the requirement to differentiate between the two groups (ie 'good book' and 'bad book') for the purpose of determining the impairment allowance clearly described? If not, how could it be described more clearly?

The requirement is described sufficiently clearly, in our view. We welcome this greater alignment with risk management practices. This will enable an entity's internal practices to be reflected in its financial statements, thus providing information which is useful for decision-making.

In addition, we would recommend that the Boards and regulators work together to ensure there is a consistent definition of non-performing or "bad book" loans. This would help enhance the comparability of both financial statements and regulatory disclosures (i.e. under Pillar 3) for users in the analyst and regulatory communities.

Question 7

Is the requirement to differentiate between the two groups (ie ‘good book’ and ‘bad book’) for the purpose of determining the impairment allowance operational and/or auditable? If not, how could it be made more operational and/or auditable?

Yes, it is. Please also see our reply to question 6.

Question 8

Do you agree with the proposed requirement to differentiate between the two groups (ie ‘good book’ and ‘bad book’) for the purpose of determining the impairment allowance? If not, what requirement would you propose and why?

Yes, we do. Please also see the above replies.

Question 9

The boards are seeking comment with respect to the minimum allowance amount (floor) that would be required under this model. Specifically, on the following issues:

(a) Do you agree with the proposal to require a floor for the impairment allowance related to the ‘good book’? Why or why not?

(b) Alternatively, do you believe that an entity should be required to invoke a floor for the impairment allowance related to the ‘good book’ only in circumstances in which there is evidence of an early loss pattern?

(c) If you agree with a proposed minimum allowance amount, do you further agree that it should be determined on the basis of losses expected to occur within the foreseeable future (and no less than twelve months)? Why or why not? If you disagree, how would you prefer the minimum allowance to be determined and why?

(d) For the foreseeable future, would the period considered in developing the expected loss estimate change on the basis of changes in economic conditions?

(e) Do you believe that the foreseeable future period (for purposes of a credit impairment model) is typically a period greater than twelve months? Why or why not? Please provide data to support your response, including details of particular portfolios for which you believe this will be the case.

(f) If you agree that the foreseeable future is typically a period greater than twelve months, in order to facilitate comparability, do you believe that a ‘ceiling’ should be established for determining the amount of credit impairment to be recognised under the ‘floor’ requirement (for example, no more than three years after an entity’s reporting date)? If so, please provide data and/or reasons to support your response.

a) + b)

We support the objective of matching interest income and expected credit losses (EL) on the good book. While we still believe the EBF model could best achieve this objective, the IASB-only model is the best alternative to this approach out of those proposed in the supplementary document. There is no need to impose a floor based on a different concept (immediate recognition of losses expected to emerge in the foreseeable future) which conflicts with the original objective of matching interest income and expected losses. A further problem is that there is no clear definition or understanding of the “foreseeable future” concept. This would probably result in inconsistent application across banks, product types and portfolios, thus generating a fundamental lack of comparability. In addition, the arbitrary character of the foreseeable future concept would give rise to a lack of auditability. The floor would also result in additional operational complexity: a double set of calculations would be necessary under the common approach. Furthermore, the floor would reduce decision-usefulness because switches between the time-proportional and foreseeable future (floor) approaches over subsequent reporting periods would be confusing for users and difficult for preparers to explain. The foreseeable future (floor) would in many instances be the factor determining the expected loss allowance.

- Above a certain level of a provision, the floor will often prevail over the time proportionate provision.
- The threshold of a two-year expected loss floor would probably only be exceeded in rare circumstances for standard loan portfolios.
- Consequently, in most circumstances, the time-proportional provision would be less than two years’ expected losses, and the floor would be the only determinant of the level of the good book provisions.

c)

While we understand the Boards’ wish to include a floor to ensure that the allowance amount is sufficient to cover losses in situations where early loss patterns are experienced, we believe the

floor is unjustified from a conceptual point of view. In that context we believe that to address the concerns of insufficient level of provisions for specific portfolios with early loss patterns, where the time proportionate approach (TPA) mechanism will not provide sufficient level of provisions to cover such patterns a floor mechanism that would not dominate the loss recognition could be required.

Should the floor prove to be an unavoidable political compromise for all portfolios, it should be aligned to the regulatory requirement under Basel II and set at a maximum level of twelve months. This would ensure that the floor would not normally outweigh (and thereby negate) the time-proportional approach and enable many preparers to use existing data (with appropriate adjustments). It would also ensure that minimum allowance balances were consistent across preparers.

d)

Please see our reply to question 5.

e)

See above.

f)

See above.

Question 10

Do you believe that the floor will typically be equal to or higher than the amount calculated in accordance with paragraph 2(a)(i)? Please provide data and/or reasons to support your response, including details of particular portfolios for which you believe this will be the case.

Please see our reply to question 9.

Question 11

The boards are seeking comment with respect to the flexibility related to using discounted amounts. Specifically, on the following issues:

(a) Do you agree with the flexibility permitted to use either a discounted or undiscounted estimate when applying the approach described in paragraph B8(a)? Why or why not?

(b) Do you agree with permitting flexibility in the selection of a discount rate when using a discounted expected loss amount? Why or why not?

Yes, we agree.

Question 12

Would you prefer the IASB approach for open portfolios of financial assets measured at amortised cost to the common proposal in this document? Why or why not? If you would not prefer this specific IASB approach, do you prefer the general concept of the IASB approach (ie to recognise expected credit losses over the life of the assets)? Why or why not?

We support the IASB approach; please see our comments above.

Question 13

Would you prefer the FASB approach for assets in the scope of this document to the common proposal in this document? Why or why not? If you would not prefer this specific FASB approach, do you prefer the general concept of this FASB approach (ie to recognise currently credit losses expected to occur in the foreseeable future)? Why or why not?

We reject the FASB approach for the reasons set out above.

Question 14Z

Do you agree that the determination of the effective interest rate should be separate from the consideration of expected losses, as opposed to the original IASB proposal, which incorporated expected credit losses in the calculation of the effective interest rate? Why or why not?

We support the retention of the current IAS 39 effective interest rate model and the presentation of provisioning in a separate line of the income statement. We are also in favour of retaining the current IAS 39 guidance for variable rate instruments.

The IASB expected cash flow model mixes interest rate risk and credit risk in the calculation of the effective interest rate. The model is based on the assumption that it is possible to accurately estimate the timing of future losses over several years. It treats initial expectations of future credit losses as if they resulted from contractual terms, whereas they actually result from a failure to comply with contractual terms. This is inconsistent with banks' risk management practices (meaning that the systems required by the model are not in place). The current calculation of the effective interest rate under IAS 39 is based on identified and known components while expected loss is a calculation of estimated future credit losses. Banks manage their interest rate risk and credit risk on a different basis. For this reason, these risks should not be mixed together in the calculation of the effective interest rate. In addition, the IASB's original proposal would be complex to implement and also difficult for users to understand.

Question 15Z

Should all loan commitments that are not accounted for at fair value through profit or loss (whether within the scope of IAS 39 and IFRS 9 or IAS 37) be subject to the impairment requirements proposed in the supplementary document? Why or why not?

We support the view that the same impairment approach should apply both to loans and loan commitments since they are often managed using the same business strategy.

Question 16Z

Would the proposed requirements be operational if applied to loan commitments and financial guarantee contracts? Why or why not?

Yes, they would; please see our replies above.

Question 17Z

Do you agree with the proposed presentation requirements? If not, what presentation would you prefer instead and why?

We support the proposed presentation requirements.

Question 18Z

(a) Do you agree with the proposed disclosure requirements? If not, which disclosure requirements do you disagree with and why?

(b) What other disclosures would you prefer (whether in addition to or instead of the proposed disclosures) for the proposed impairment model and why?

In our view, disclosures should not lead to increased complexity for reporting entities or for users of financial statements. There is a risk that the sheer weight of information might result in a lack of transparency or, even worse, be incomprehensible to users.

We are concerned about the requirement to disclose the information listed in paragraph Z8 of the supplementary document for five annual periods. We do not believe that a requirement to disclose a time series would automatically increase the informational value of disclosures and would therefore ask the IASB to re-assess the need for this requirement. In addition, there should be no requirement to disclose the results of backtesting.

We support the IASB's tentative decision to abandon the idea proposed in ED/2009/12 of disclosures relating to stress tests and maturity (vintage information).

Due to the limited comment period and the desire to focus on the conceptual aspects of the combined approach model we did not have sufficient time to undertake a detailed review of the requirements set out in the SD and how they link to all assets held at amortised cost. The ZKA would therefore recommend that the Board re-expose on a limited basis the proposed final standard as it will allow constituents adequate time to review the disclosures requirements for all assets (not only those under the scope of the SD) and how the proposed requirements link to the final model.

Question 19Z

Do you agree with the proposal to transfer an amount of the related allowance reflecting the age of the financial asset when transferring financial assets between the two groups?

Why or why not? If not, would you instead prefer to transfer all or none of the expected credit loss of the financial asset?

The requirements concerning this aspect should be designed in such a way as to make practical implementation as straightforward as possible. We would suggest that two methods should be permitted. It should be possible to transfer the entire estimated expected loss on a loan from the good book to the bad book. It should also be possible to refrain from transferring provisions from the good book to the bad book and to recognise the expected loss in the bad book direct.

Yours sincerely,
on behalf of the Zentraler Kreditausschuss,
Bundesverband deutscher Banken



Dirk Jäger



Ingmar Wulfert