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Accounting Standards Committee of Germany

® IFRS-Fachausschuss

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Hans Hoogervorst
Chairman of the
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Berlin, 1 July 2013

Dear Hans,

IASB ED/2013/3 Financial Instruments: Expected Credit Losses

On behalf of the Accounting Standards Committee of Germany (ASCG), I am writing to provide our views on the IASB's ED/2013/3. We appreciate the opportunity to provide our view.

We believe that the IASB's ED overall represents a balanced proposal for capturing expected credit losses. Whilst, conceptually, we would have preferred a solution along the lines of the original 2009 ED, which foresaw a link between the amount of interest recognised by an entity and any credit losses anticipated and priced into the respective instrument. Ideally, this would not have led to any impairment charges until there were clearly signs of a credit deterioration in the instrument. We acknowledge that pursuing that route did not seem feasible due to insurmountable operational challenges, especially in the context of open portfolios.

Hence, in our view, the current proposal strikes a reasonable and appropriate balance in maintaining the fundamental objective of showing any credit deterioration of financial instruments, whilst at the same time trying to achieve a result in the income statement of the lender that is akin to the outcome had the original proposals been pursued.

Taking into account the population of financial assets held by entities in our jurisdiction, it is in these two areas where we believe that the IASB approach is demonstrably superior to the FASB's proposal:

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Präsidium:
Dr. h.c. Liesel Knorr (Präsidentin), Dr. Rolf Ulrich (Vizepräsident)

- Most financial assets originated or purchased are not anywhere near to an impairment; hence, it seems conceptually questionable as to why one would then treat good and bad assets alike and account for their expected losses on a lifetime basis.
- Recognition of lifetime expected losses on assets that are not individually or collectively impaired distorts their interest income by frontloading the impairment charge without concurrently considering the contractual (and expected!) future interest income to be earned.

We acknowledge that both, under the IASB's and the FASB's approach, any expected credit losses of an instrument would effectively be fully (FASB) or partially (IASB) double-counted, as its fair value should already encompass any expected credit losses at initial recognition of the instrument. Having said that, recognition of a 12-months allowance to us represents the "cost" one has to pay for achieving a result in the income statement that is in line with where the Board would have landed under its original proposals, in that changes in the original credit quality would adjust the interest income for the respective period(s).

Notwithstanding our preference for the IASB model over the FASB approach, we echo the concerns of many that see the Boards potentially not reaching convergence. Even if we concede that the environment and the business models of American financial institutions differ rather sharply from those of their European counterparts (e.g. in terms of products, investment horizons, etc.), we believe that finding a solution that would make the financial statements on either side of the Atlantic *comparable* should remain a priority for both Boards. The precise methodology need not be the same and different approaches might be acceptable, as long as they are reflective of differences in instruments/environments and as long as they lead to a similar accounting treatment were they applied in each other's context.

Absent our general remarks we note a few areas where we encourage the IASB to reconsider its proposals. These include the discount rate, the accounting treatment for originated credit-impaired instruments, and some of the disclosures where we fail to see them meeting the cost benefit criterion.

Please find our detailed comments on the questions raised in the ED, and also comments on two additional issues not covered by the questions, in the appendices to this letter. If you would like to discuss our views further, please do not hesitate to contact me.

Yours sincerely,

Liesel Knorr

President

Appendix A – Answers to the questions of the exposure draft

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?

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?

We agree with the basic idea of introducing an impairment model that is based on expected credit losses. We further agree with the model as it reflects a dual measurement approach, i.e. as it does not propose to recognise full lifetime expected losses for all items within the scope at initial recognition. In addition, we basically agree with a significant credit deterioration being the criterion for setting the distinction. Consequently, we would not agree with any model that proposed to recognise a loss allowance equal to lifetime expected credit losses at initial recognition.

From a conceptual point of view we are not convinced that a loss allowance amount that equals a 12-months loss is an appropriate surrogate for a partial (or even proportionate) loss allowance. In particular, we note the following concerns:

- Recognising expected credit losses at initial recognition does not seem conceptually defendable unless one recognises expected interest income at that point in time, too.
- The recognition of expected credit losses at initial recognition leads to double-counting, as long as financial instruments initially are to be recognised at fair value (since the fair

value already captures all anticipated credit losses, as is acknowledged in the ED's Basis for Conclusions (cf. BC28-29)).

- The proposed model does not fully reach all of the objectives set for this project. While it is an improvement and achieves providing better information about credit loss expectations, it does not safeguard avoiding the undesired "cliff effects" in impairment accounting. This is particularly true for assets migrating into stage 2 or 3.

For these conceptual concerns, we would have preferred the model contained in the original 2009 ED (in particular the integrated approach), paired with some elements of the 2011 Supplementary Document. Thus, it is only with some reservation and in acknowledging the practical difficulties that we agree with the model's feature of recognising a loss allowance that represents a "partial" recognition of the total expected credit losses as the default situation, and of recognising total expected credit losses only under defined circumstances. Please find more details on this issue in our answer to Q4.

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?

(a) We agree.

(b) We agree (if the IASB were to finalise its proposals in this regard – notwithstanding our disagreement we submitted in our comment letter dated 8 March 2013 on that ED/2012/4).

Question 4

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

Notwithstanding our conceptual concerns noted in our answer to Q1, we accept the proposal for practical reasons. The definition of a 12-months loss in Appendix A coupled with the additional explanation in BC63 seems understandable and appropriate. Nonetheless, when considering some of the details, the 12-months loss amount raises questions and operational difficulties:

- Entities in regulated industries (esp. in the banking sector) prefer using the same data they already use for regulatory purposes, i.e. a 12-months loss calculated in accordance with Basel requirements should equally be acceptable for use in this impairment model. In this regard we do not agree with the Board's argument in BC193 that those Basel cal-

culations generally do not reflect economic characteristics and, thus, are basically inappropriate. Especially when considering all the necessary input factors for the expected loss calculation, we believe that there will inevitably be a range of outcomes for any two entities, even if these entities had similar exposures.

- The unrestricted range of permitted discount rates appears overly broad. Conceptually speaking, we concede that there are different methodologies to arrive at risk-adjusted present values: One could either reflect the credit risk in the cash flows and then discount them at the risk-free rate, or adjust the discount rate for any credit risk and use it to discount the nominal cash flows. In any case, discounting should only reflect the timing of the cash flows, i.e. the time value of money. The way the requirements are drafted currently seem to allow for a free choice from any rate within a range that has the risk-free and the fully risk-adjusted rate at either end. This could potentially lead to an entity double-counting the risk, thus leading to a lower impairment allowance, which does not seem appropriate. Hence, we suggest the Board redraft the requirements by setting the objective of discounting (i.e. to reflect the time value of money). This would effectively avoid an entity picking an inappropriate rate. If an entity usually calculates the present value by discounting nominal cash flows with a risk-adjusted rate, but does no longer have the original EIR available (e.g. in an open portfolio context), an entity should still be required to estimate an appropriate discount rate that is reflective of the risk in the portfolio. It would only be in rare cases that discounting at a risk-free rate would then be appropriate (i.e. if substantially all of the assets in the portfolio were risk-free).

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?

(a) + (b) We agree with the basic criterion of credit deterioration and also with the measure of "significance" for distinguishing between 12-months losses and lifetime losses. However, we see a lack of clarity as regards the term "significance". We see "significant" being used in different circumstances and with different meanings, sometimes being used with a quantita-

tive connotation, see e.g. IAS 28. Further, this term is used in the context of classification (in IFRS 9), there being the measure for permissible sales but with a seemingly different meaning.

Hence, we propose clarifying this term for the purpose of using it in the specific context of impairment (though we acknowledge that this would not solve the issue of different meanings of the same term throughout IFRSs.)

Further, we would like to mention that in the list of examples in B20 each bullet mentions the degree of "significant", except B20(e). This raises the question of whether *any* credit rating downgrade (B20(e)), even an insignificant, would require a transfer to stage 2. We therefore believe that either all B20 examples should consistently bear the qualifier "significant", or, as "significant" is an overall criterion, that the qualification is redundant in any of the B20 examples.

(c) We agree that changes in the PD are the basis for assessing whether a significant deterioration has occurred. However, if this implies that changes in expected losses (or LGD) should not encompass the degree of deterioration, we see practical challenges as to the fact that changes in the PD and changes in the LGD often are inseparable, e.g. when using external ratings.

For practicability reasons we also suggest changing the requirement in B11. We would prefer if using the 12-months PD for assessing the degree of deterioration was made the default, not the exception (which requires proof of there not being any different outcomes).

(d) We consider the proposed simplifications to be useful. From a conceptual perspective, the combination of the (basic) relative criterion with two (absolute) thresholds could cause confusion, which is why we suggest the IASB clarify their interrelationship. Further, the following details in relation to these simplifications remain unclear:

- The simplification for an item with a low (absolute) credit risk always being stage 1 appears conceptually wrong. As per the wording in para. 6, in the case of low credit risk "the criterion in para. 5 is not met". This would mean that the credit standing of the asset **has not deteriorated significantly**. We deem this suggesting an unintended quantification of the degree of significance. Given the maximum possible deterioration within the entire range of "investment grade", para. 6 would explicitly say that this was never considered a significant deterioration. We think the IASB rather wanted to say that in the case of a low credit risk the **"absolute" risk is not significant**, thus, the instrument shall remain in stage 1. This would mean that, in terms of this exception, even if the deterioration was

significant, the **consequence of recognising lifetime losses does not apply**. Hence, the wording in para. 6 should be modified.

- We think that the guidance in B15 similarly leads to an unintended specification as to when a deterioration was deemed "significant". The numeric example appears unhelpful, as this was only meant to portray how the initial credit quality should be taken into account. We ask the IASB to clarify this through words rather than by way of a numeric example as the latter implicitly quantifies the degree of significance.
- It was brought to our attention that the same simplification might lead to a (wrong) reversal of its argument, which is that if the credit risk deteriorates below investment grade this would (inevitably) lead to a transfer to stage 2. We deem a further clarification being worthwhile to avoid this interpretation.

(e) Yes, we agree.

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?

(a) We agree that there are circumstances where interest should no longer be calculated on a gross basis, so we are in agreement with the Board's proposal for a net solution. Notwithstanding our agreement we would like to flag two issues though:

- Whilst being in line with the current requirements in IAS 39 for interest recognition on impaired assets, the solution seems to differ from the Board's latest thinking in the project on Revenue Recognition. If such divergence was intended we suggest the Board clarify why the approaches should differ.
- Looking at the FASB's proposal for impaired assets, we believe that a non-accrual concept might be an equally valid alternative. We suggest the two Boards reconsider this area jointly.

(b) We agree that calculation of interest revenue should change if an asset becomes impaired after initial recognition.

(c) We agree with the approach being symmetrical.

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?

(a) + (b) We consider some of the proposed disclosures causing operational challenges and, furthermore, not meeting the cost-benefit criterion.

- The reconciliation of gross carrying amounts (para. 35) in particular seems operationally difficult, with very limited usefulness. Instead, we propose point in time disclosures of the gross carrying amount for the opening and the closing balance of the reporting period.
- Disclosing the write-off policy (para. 37) for all assets that are subject to enforcement activity could include items that were written off a long time ago. We deem this information the less useful the longer the period since the write-off occurred. Thus, we propose to delete this requirement.
- Similarly, disclosing details about modifications (para. 38) subsequent to modification could involve items that were modified far in the past. Hence, their information usefulness fades with the passage of time while causing (increasing) operational efforts. Thus, we propose deletion of this requirement.

(c) We would not suggest further disclosures.

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?

When considering these proposals, we acknowledge that the current requirements in IAS 39 (as well as those in IFRS 9) for determining whether a modification results in derecognition or not are insufficient and unclear. With the publication of this ED such guidance becomes even more crucial. We also refer to a recent discussion of the Interpretations Committee on restructured Greek government bonds dealing with a similar issue on the same (unclear) requirements.

In addition, we consider the following aspect causing confusion about impairments following a modification: Applying the new proposals in circumstances where a modification did not lead to derecognition may result in different scenarios as regards the resulting "stage", depending on the criterion of significant deterioration. The proposed list of examples for "objective evidence of impairment" contains "concessions" that can be similar to modifications, and

would require a move to stage 3. Given this, it might be unclear or even contradictory how one should measure impairment in case of a modification or such concessions. We suggest the Board deal with this issue separately from the IFRS 9 project, but in a holistic, more comprehensive way.

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.

(a) Yes, we agree.

(b) No, we do not see significant challenges for matters of presentation.

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?

(a) + (b) We deem the simplified approach useful. In particular, we expect the optional use for trade receivables and lease receivables to be applied by the majority of entities in our jurisdiction. Hence, measuring 12-months losses and determining the significance of credit deterioration would be an issue mainly affecting the financial and insurance industries (or respective segments of groups in other industries).

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?

We disagree with proposed accounting for originated credit-impaired assets. We believe that there is an internal inconsistency in defining impairment as an event that **has occurred** (i.e. after initial recognition), yet including instruments that have just been originated. If a credit event happened at or around the date of origination, our expectation would be that these circumstances clearly be reflected in the terms of the instrument. We understand the logic for purchased credit-impaired (PCI) instruments, as one could argue that the buyer always acquires an instrument with its history, i.e. at acquisition the buyer could no longer have the expectation of collecting all of the contractual cash flows. For an instrument, that has just

been issued, though, we fail to analogise to the PCI instrument, as the originated instrument does not have any history. Therefore, we cannot see any valid argument to classify it into stage 3 at inception. The only other line of argument where one could potentially claim that an originated credit-impaired instrument had a history would be a modification that led to derecognition of the old and recognition of the new instrument. In that instance, any impairment charges should have been recorded when the old instrument was derecognised.

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?

(a) We consider a sufficient lead time to be important for implementing this new model. As, for entities with material insurance business, the requirements of IFRS 9 are deeply interrelated with the new IFRS 4 requirements, and as the finalisation of IFRS 4 amendments is still pending, we suggest a mandatory effective date of IFRS 9 that is identical with the respective date for IFRS 4. As of today, we deem a mandatory date of 1 January 2018 appropriate, presuming this would allow for a lead time of approximately three years with early application allowed.

(b) Yes, we agree.

(c) We consider this relief useful, or even necessary. However, the urgency of not restating comparative figures depends on the lead time before mandatory application. The longer the lead time the more feasible it is for entities to provide restated figures.

Question 13

Do you agree with the IASB’s assessment of the effects of the proposals? Why or why not?

As a standard setting body we did not conclude on the IASB's effects analysis.

Appendix B – Other issues not covered by questions of the exposure draft

Presentation of loss allowance account

We consider the guidance as to whether presentation of a loss allowance account on the face of the statement of financial position was allowed, required, or not allowed to be unclear. While the ED often mentions that a loss allowance shall be "recognised" (e.g. paras. 3, 14, B13, B16) or "measured" (e.g. paras. 10, 12, 33, 38(a), 44, B11), we deem this not similar to "presenting" a loss allowance, since presentation of a loss allowance is specified in the ED separately (see headline and introduction before para. 23 and see para. 3, third phrase). Moreover, since para. 3 (third phrase) explicitly prohibits separate presentation of a loss allowance account if the financial instrument was a debt instruments *measured at FV-OCI*, this might suggest that it is (still) allowed for those instruments measured at amortised cost. However, this should be clarified.

This lack of clarity is further caused by another reference: The ED refers to IFRS 7.16A (which is added to IFRS 7 through ED/2012/4) and, in addition, proposes to delete IFRS 7.16 (see Appendix D of this ED). Since both requirements relate to "disclosures", we are not sure whether this would determine presentation. Even more, if the wording in the ED distinguishes "presenting" loss allowances from "recognising" or "measuring" loss allowances, this would put into question whether the existing requirements in IAS 39 (in particular, para. 9 definition of "amortised cost", and para. 63) determine presentation or not.

Individual or collective perspective

The ED often gives the impression that the expected loss model and its particular requirements are designed from an individual instrument's perspective. Although determinations or assessments within the new model may explicitly be made from either an individual or a collective basis (subject to certain conditions being met), the specific wording in the ED ("*a* financial asset" or "*a* financial instrument", e.g. paras. 3, 4, 5, 6, 7, 8, B13, B14, B15) always refers to an individual instrument. We suggest the IASB carefully reconsider and clarify whether, or when, mentioning "a financial instrument" equally comprises several, or a portfolio of, financial instruments.