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**Comments by the German Banking Industry Committee on
the Exposure Draft "Classification and Measurement:
Limited Amendments to IFRS 9" (ED/2012/4)**

27 March 2013

Dear Mr Hoogervorst,

In our capacity as the German Banking Industry Committee, we are pleased to be given this opportunity to comment on the aforesaid Exposure Draft (ED/2012/4).

Our basic opinion is as follows:

- We welcome the principle-based rules of IFRS 9.
- IFRS 9 should enable an appropriate reflection of the business models of banks and should consider the management of banking transactions on a portfolio basis.
- We advocate drafting the FVTOCI category as an optional category.
- We consider 2015 to be unrealistic for first-time application as proposed by the IASB.
- We would strongly welcome greater dialogue between the IASB and regulators.

With this Exposure Draft, the IASB has picked up on various points of criticism regarding the already finalised IFRS 9 (2009/2010). The key change is the proposed introduction of the FVTOCI category. The IASB has stated that such a category would avoid differences to US GAAP rules and that measurement or recognition inconsistencies would be reduced for insurance companies.

The introduction of an FVTOCI category is seen by insurance companies to be an improvement compared to IFRS 9 (2009/2010). However, it is not yet possible to estimate how IFRS 4 and IFRS 9 will interact because IFRS 4 will not be finalised for a number of years. For banks, however, the IASB's proposed introduction of an FVTOCI category could result in

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problems with a view to the appropriate reflection of the business model in financial statements due to the unclear distinction between AC and FVTOCI. There is hence a conflict of goals between the banking sector and the insurance sector.

Furthermore, the additional FVTOCI category increases accounting complexity, so that the IASB is deviating from its original goal of reducing complexity. That is why we believe it is urgently necessary to align the FVTOCI category closely to the economic conditions (business models) because this is the only way to justify the additional effort involved.

In order to solve the dilemma between the banking sector and the insurance sector, we advocate drafting the FVTOCI category as an optional category. This would take into consideration the concerns of insurance companies while also avoiding an excessive increase in complexity. For more details, please refer to our reply to question 5.

We believe that it is generally important for the banking business model to be appropriately reflected. It must be noted here that banking transactions are managed on a portfolio basis. The bank forms its portfolios on the basis of the respective business model. A distinction must be made here between the intention to generate contractual cash flows and the intention to achieve short-term profits. Even if non-permanent (short-term) sales take place with the latter business model, measurement at fair value is correct because the portfolio is managed on a fair value basis. However, we do believe that sales (prior to maturity) can also occur with a hold-to-collect intention without this automatically questioning the business model. That is why it should (still) be possible to measure traditional banking transactions at amortised cost.

Furthermore, it is necessary that, in compliance with internal risk management and the investment policy, non-detrimental sales already be possible prior to an external downgrade because the purpose of internal risk management strategies is to identify risks at an early point in time. With a view, for instance, to current regulatory developments, external (regulatory) requirements for the sale of substantial shares in a portfolio could ensue. Regulatory requirements should not restrict measurement at amortised cost because these requirements cannot be influenced by the respective entity. Furthermore, it should be permitted to classify sales to reduce portfolios (portfolio wind-downs) at amortised cost. The actual sale of large shares is frequently drawn out over a longer period of time because only certain tranches can be placed on the market.

We also consider it to be appropriate to classify liquidity portfolios, which are used to cover liquidity risks, at amortised cost because any sale of such financial instruments is not the primary goal of the business model.

We generally agree to the rules concerning the SPPI tests. However, we would welcome selected clarification or illustrative examples. We do, e. g., believe that the benchmark test is too complex for application.

In light of the IASB's proposed introduction of a third category (FVTOCI) and the regulatory implications for financial statement amendments, we would welcome greater dialogue between the IASB and regulators.

We would like to point out that entities will need approximately another three years in order to implement IFRS 9. Therefore, mandatory first-time application of IFRS 9 by 1 January 2015 does not appear to be realistic.

Please find below our detailed comments on the Exposure Draft.

Question 1

Do you agree that a financial asset with a modified economic relationship between principal and consideration for the time value of money and the credit risk could be considered, for the purposes of IFRS 9, to contain cash flows that are solely payments of principal and interest? Do you agree that this should be the case if, and only if, the contractual cash flows could not be more than insignificantly different from the benchmark cash flows? If not, why and what would you propose instead?

We welcome the IASB's proposal that financial assets with a modified economic relationship not be generally excluded from measurement at amortised cost. This means that such assets could also be measured at amortised cost as long as the "hold-to-collect" criterion is fulfilled. This promotes the provision of useful information to users of financial statements.

With regard to prepayment options, we think that the current guidance on prepayment options in IFRS 9 (2009/2010) could benefit from an amendment. We think a prepayment option at par plus accrued interest should meet the SPPI test regardless of the trigger for prepayment (i.e. even if the prepayment is triggered by a contingent event which is not detailed in IFRS 9 B4.10 [2009/2010]). The prepayment option speeds up the payments, however, with a prepayment option at par plus accrued interest, all cash flows still meet the principle of payments for principal and interest. We hence support retaining the current guidance in IFRS 9 for prepayment options which are not at par plus accrued interest. However, when it comes to prepayment options which are at par plus accrued interest, these should not violate the SPPI test regardless of the trigger. We believe that these features meet the principle of solely payments of principal and interest, but the specific guidance in IFRS 9 B4.10 (2009/2010) would prevent them from meeting the test in certain cases.

Question 2

Do you believe that this Exposure Draft proposes sufficient operational application guidance on assessing a modified economic relationship? If not, why? What additional guidance would you propose and why?

First of all, we would like to emphasise that we welcome the principle-orientated approach of the Exposure Draft.

With a view to the SPPI test in the case of modified economic relationships (benchmark test), we are not certain whether this test - taking into consideration the preconditions referred to in the Exposure Draft - is always mandatory or whether this test - due to its complexity - can be (voluntarily) waived, meaning that the financial instrument must be measured at fair value through profit or loss (FVTPL). We believe that there are two reasons why a voluntary waiver should be possible: First of all, this approach would enable adherence to the existing principles of IFRS 9 for the SPPI test and we therefore believe that this would be in line with the IASB's intention to underpin the basic principle of IFRS 9 (refer to BC40).

With this approach, the allocation of financial instruments to the AC category in the case of a modified economic relationship and after passing the benchmark test could be interpreted as a form of exception to the basic principle of IFRS 9. The complexity of the test also supports such a solution. We therefore advocate replacing "shall" in B4.1.9B with "can".

We still do not understand why section B.4.1.8A was added, nor the consequences of this section. The interest rate agreed to with a customer in lending contains, among other things, refinancing and liquidity costs, interest on equity, administration costs and a margin. Are such customary components in contradiction with the "consideration of the time value of money and the credit risk"? Does a type of benchmark test, as a kind of market fairness test (i.e. is the interest rate agreed to with the customer in line with the time value of money and the credit risk), have to be carried out for each transaction? The way we understand this is that with sections B.4.1.7 and following the IASB only wishes to cover a (limited) part of certain transactions (e.g. interest rate mismatch features in modified economic relationships). We request that this be clarified or the section deleted.

Question 3

Do you believe that this proposed amendment to IFRS 9 will achieve the IASB's objective of clarifying the application of the contractual cash flow characteristics assessment to financial assets that contain interest rate mismatch features? Will it result in more appropriate identification of financial assets with contractual cash flows that should be considered solely payments of principal and interest? If not, why and what would you propose instead?

We believe that in addition to the cases referred to in the Amendment further clarification and application guidelines are necessary in order to ensure that certain characteristics match the SPPI criterion.

In the following cases, which cannot be summed up under the current definition of a modified economic relationship, we specifically propose clarifying amendments:

Non Recourse Assets

IFRS 9.B4.1.15 states that in some cases a financial asset may have contractual cash flows that are described as principal and interest even though the cash flows do not exclusively represent the payment of principle and interest on the principal amount outstanding. IFRS 9.B4.1.16 refers to non-recourse assets as a possible example. There is no definition provided to show if an asset is deemed to be a non-recourse asset within the meaning of IFRS 9. IFRS 9.B4.1.17 merely states that the fact that a financial asset is non-recourse does not in itself necessarily mean that the SPPI criterion has been violated. The IASB staff paper "Feedback on IFRS 9 – non-recourse assets and constant maturity assets" (September 2010) emphasises that IFRS 9 does not provide any special guidance for classifying non-recourse assets. This means that the general principles of IFRS 9 for the evaluation of the cash flow criterion according to IFRS 9.4.1.2(b) in conjunction with IFRS 9.4.1.3 must also be applied to non-recourse assets. The staff paper also notes that the reason for the information in B4.15. - 17. was to clarify that the decisive factor for the evaluation of the SPPI criterion was not the words used to describe payments but the actual nature of such payments. This is then explained using the example of non-recourse project financing for a toll-road project where interest payments are referred to as "interest" but their amount is contractually linked to the number of vehicles using the toll road. However, the fact that this is a case of non-recourse financing is not addressed in any further detail.

It remains unclear whether the SPPI criterion may be violated due to the non-recourse financing if, in the example stated, the contractual cash flows were not directly linked to the asset or project financed, but were contractually matched to the cash flow criterion (e.g. fixed interest at an interest rate that suitably reflects the time value of money and the credit risk of the project). Since this remains unclear, the application guidelines could also be loosely interpreted to read that even though the payments are not formally linked to the asset or project financed, the fact is, however, that the revenues generated from the financed asset are essentially the sole revenues available to serve the debt so that, from an economic perspective, payments depend on the asset or project financed. This may be the case, for instance, with project financing. The bank's borrower is often a special purpose entity in cases like these. In addition to the asset financed by the bank, such special purpose entities usually do not have any further major assets and have little or no equity. Furthermore, there is often no recourse to third parties, such as equity providers or sponsors. If this loose interpretation were to be taken further, the economic dependence of the payments and also generally speaking each form of corporate financing would have to be questioned if the borrower has a questionable credit rating and low equity.

We would welcome clarification stating that no special rules apply to the analysis of the SPPI criterion for non-recourse assets, so that the criterion must be evaluated on the basis of the contractual description of the cash flows. In other words, non-recourse financing must only be analysed in more depth on the basis of the SPPI criterion if the amount of cash flows from payments of principal and interest are contractually linked directly to the assets financed.

Contractually linked instruments with special characteristics

CLOs with theoretically possible investment in synthetic instruments

Certain CLOs can invest in synthetic instruments according to the eligibility criteria. This means that under the contract it cannot be ruled out that only short-term instruments which meet with the general conditions for cash flows are securitized for the entire term of the contract. In practice, however, such investments in synthetic instruments for certain CLOs are not relevant but merely represent a theoretical possibility which has not and is not used in practice (as demonstrated in trustee reports). For cases like these, an evaluation of substantiality should be introduced so that the too general wording of a contract, which in practice does (did) not result in any significant investments, is not inconsistent with the SPPI criterion.

Available Funds Cap

An AFC limits the amount of interest for each securitization tranche of a period to the income from deferred interest payments on the securitized loans and other income of the SPV. In the event of a default in payments, these are either lost or paid later without interest. This means that the interest on the tranches contains a component that is not consistent with compensation for the time value of money. On the other hand, the dependence of the cash flow on the securitized pool has in fact the characteristics of securitization. If such a link were classified as detrimental to the benchmark test, then the very nature of securitization would have to be questioned. Application example: RMBS Home Equity Loans.

Other Instruments

Average Rates

The interest rate is fixed for an interest period as the average interest rate of a reference interest rate (e.g. the EONIA average rate of the previous month in the case of monthly interest payments).

In Arrears Fixing

The interest rate is determined on the basis of the reference interest rate which matches the tenor of the interest period but which is retroactively reset at the end of the interest period.

In addition, we agree to the application of special rules for modified economic relationships and instruments with deferred interest that does not accrue additional interest (refer to IFRS) B4.1.13 Instrument G).

We think that these instruments could be assessed with the benchmark test and that they will not generally fail the test.

Question 4

Do you agree that financial assets that are held within a business model in which assets are managed both in order to collect contractual cash flows and for sale should be required to be measured at fair value through OCI (subject to the contractual cash flow characteristics assessment) such that:

- (a) interest revenue, credit impairment and any gain or loss on derecognition are recognised in profit or loss in the same manner as for financial assets measured at amortised cost; and**
- (b) all other gains and losses are recognised in OCI?**

If not, why? What do you propose instead and why?

With a view to our concerns regarding the demarcation of the FVTOCI category, please refer to our answer to question 5. We do consider the pure rules for evaluating financial instruments within the FVTOCI category to be acceptable.

Question 5

Do you believe that the Exposure Draft proposes sufficient operational application guidance on how to distinguish between the three business models, including determining whether the business model is to manage assets both to collect contractual cash flows and to sell? Do you agree with the guidance provided to describe those business models? If not, why? What additional guidance would you propose and why?

The introduction of another business model (FVTOCI) increases the complexity of the standard further. However, we do not believe that it makes sense to counteract this by drawing up further guidelines or application guidance. As already described in the foregoing, we advocate drafting the FVTOCI category as an optional category which could be used irrespective of compliance with the criteria of a third business model. This would result in a clearer distinction between the "hold to collect" (AC) and "trading" (FVTPL) business models and thus reduce complexity as originally planned by the IASB. Obviously the category FVTOCI could not be elected for a trading business model. At the same time, the requirements of the insurance sector could also be taken into account. Compared to the current mandatory form for this category, such an approach would result in two advantages: We believe that the optional form would be a better solution to the accounting mismatch that results from IFRS 4 because financial instruments could also be considered which must be allocated to the "hold to collect" business model and hence to the AC category. With the FVTOCI category in the form currently proposed, these instruments would not be available to eliminate the accounting mismatch. This open, optional form would also be available to other industries in cases where allocation to the AC category is not possible but where classification at FVTPL does not appear to be correct. Furthermore, this would also mean alignment with US GAAP. A second important advantage could result for the time when IFRS 9 comes into force.

If it were permitted to also exercise at a later point in time the option of allocation to the FC OCI category in the case of an accounting mismatch, we believe that decoupling the coming into force of IFRS 9 and IFRS 4 would also not be detrimental for the insurance sector since the accounting mismatch resulting from IFRS 4 could then be dealt with at a suitable point in time.

The examples in paragraph B4.1.4 frequently state whether the entity is a financial or non-financial entity. The financial versus non-financial status of an entity is not a factor in the business model test in the guidance on business model classification in B4.1.1 through to B4.1.3. The repeated inclusion of the financial or non-financial status of an entity in the examples might lead a user to conclude that this status is a factor in the business model classification. Whilst we acknowledge that this provides context to the discussion, we do believe that the business model should be independent of the type of industry in which the entity operates. We hence recommend that the description of entity types be removed from the examples.

With regard to the examples of FVTOCI, we are concerned that these are relatively broad and that the distinction between FVTOCI and FVTPL is not clear. B4.1.4B, Example 1, describes a situation where an entity is aiming to maximise return on financial assets and will sell to reinvest the cash in financial assets with a higher yield when the opportunity arises. This example is deemed FVTOCI since the sales activity is designed to maximise yield rather than more speculative activity based on expectations of fair value increases which would be FVTPL. We therefore question whether there is a clear distinction between frequent sales to manage yield and frequent sales to maximise profit and are hence concerned that the FVTOCI classification is too broad.

In discussions to date regarding FVTOCI, the accounting for liquidity portfolios has been a frequent topic. But we believe that this does not go far enough because there are doubts, also in other cases, which we would like to address below. We believe that it is generally important for the banking business model to be appropriately reflected. It must be noted here that banking transactions are managed on a portfolio basis. The bank forms its portfolios on the basis of the respective business model. A distinction must be made here between the intention to generate contractual cash flows and the intention to achieve short-term profits. Even if (short-term) sales do not permanently take place with the latter business model, a fair value evaluation is correct because the portfolio is managed on a fair value basis. However, we do believe that sales (prior to maturity) can also occur with a hold-to-collect intention without this automatically questioning the business model. This can be basically demonstrated with the examples shown below. The assets of a bank are financed by liabilities (e.g. deposits). Since the liabilities are only controlled by the bank to a limited extent or not at all, they are subject to regular fluctuations (e.g. a run on the bank's deposits). Changes in liability structure, however, lead to necessary adjustments on the asset side, so that sales of assets (prior to maturity) are unavoidable.

Contrary to the aforesaid exogenous situation, achieving a constant interest margin is an endogenous matter. A certain interest margin is often constantly maintained using so-called replicating portfolios. In this case and with a view to refinancing with matching maturities, the liability structure is reflected by securities on the asset side (according to the repayment periods). Changes in liability structure, for instance, due to withdrawals of customer deposits, then have to be carried out on the asset side in order to maintain the structure and this means regular sales. However, this does not change the original aim of generating contractual cash flows. But in order to keep the interest margin constant, adjustments are necessary in the form of sales. This does not contradict the aim of an AC business model.

The bank's intention with the portfolio is still to collect the contractual cash flows rather than to achieve short-term profits. From a management perspective, the focus continues to be not on individual transactions (in this case: sales), but on portfolio level.

However, since the focus of the IASB is directed to individual transactions (=> sales (prior to maturity) from the AC category), this portfolio perspective is de facto ignored by the Board. At the same time, the IASB permits reclassification only in the case of substantial modifications/sales. Here, once again, the portfolio perspective is predominant where a change is seldom likely to take place. The arguments put forward by the IASB are hence not consistent.

With a view to the information stated above, we believe that the following types of portfolios/situations should be generally measured at AC:

Liquidity/liquidity portfolios

We consider it to be particularly important to emphasise that the management of banking transactions does not mean just "the one" liquidity portfolio, but that many individual portfolios are held to secure liquidity. For each individual portfolio held to secure liquidity, the respective higher-lever business model should then be applied (as part of a single-case check). We believe that securities for liquidity management, which are not foreseen for sale but which serve as security for procuring liquidity via repos or the ECB, should (still) be measured at amortised cost. This would also be stringent because open ECB lines could also be considered in future in the LCR as liquidity stock. Determining the volume and composition of the liquidity reserve is also a deliberate management decision so that measurement at amortised cost can be justified from the perspective of managing banking transactions. In this context, we view the inclusion of references to banking supervision regulations in the draft with considerable criticism. Allocation to a category should not be determined by a banking supervision regulation but by the actual management of the asset which takes into account the implementation of the requirements of the banking supervision committee and, which we believe, in many cases does not automatically result in compliance with the FVTOCI-criteria. We therefore suggest that the reference to the requirements by the banking regulator be deleted from Example 4 in B4.1.4.

Interest margin management

See above

Pre-funding

It is often customary for banks to generate liquidity at favourable market conditions (e.g. by issuing bonds) without having a specific target investment. All that is known is that the bank is to invest in an asset with which constant principle and interest are to be generated. The bank invests in (short-term) securities until the target investment is acquired. As soon as the target investment has been decided, the securities are sold and the target investment acquired. The aim of the investment in this case is to generate contractual cash flows. This aim still remains even after the sale with the source being the only thing that has changed. As a rule, short-term securities are purchased so that the "close to maturity" criterion is fulfilled when they are sold. Measuring such financial assets at FVTPL or FVTOCI would lead to an accounting mismatch because the respective liabilities are measured at AC.

Sales prior to maturity and their definition are an important aspect in conjunction with the "hold to collect" (AC) business model. We believe that the "infrequent/insignificant" criteria set up by the IASB are generally acceptable. However, (frequent/significant) sales (prior to maturity) should also be non-detrimental if other good reasons exist – in addition to the deterioration of credit quality.

Credit deterioration/investment policy

The "deterioration of credit quality" criterion should not be too strictly defined, for instance, with a view to incurred losses. Instead, it should be more in line with internal risk management. This means that it must be possible in line with the documented investment policy to sell financial assets prior to maturity before external downgrading rather than having to wait until a loss actually occurs. In this case, a "deterioration of credit quality" should not be judged on the basis of individual assets but of the respective portfolio (so that the entire portfolio can be sold). It must also be possible to take into account other aspects of the entity's business/risk strategy (within the meaning of the investment policy), such as concentration risks.

Portfolio wind-downs

According to the Exposure Draft, sales to be measured at AC are also not detrimental as long as they are significant but infrequent. This means that the reduction of significant parts of a portfolio – as long as this is covered by the investment policy – is not detrimental as long as the conditions listed above are fulfilled. Such significant transactions typically require a decision on the part of management. However, the larger the assets to be sold, the more difficult it becomes to achieve once-off, immediate placement on the market. In cases like these, it is customary to spread the sale in certain tranches over several periods (years). We hence believe that – even if the sale of a significant amount of assets stretches over several periods – the "significant but infrequent" criteria are fulfilled because a single decision was made to sell. This is why measurement at AC should be possible. In the case of external requirements (e.g. by the regulator), such a decision by management should have an analogous effect. At the same time, regular external requirements (e.g. balance-sheet reductions, etc.) should not hinder measurement of the respective portfolio at AC. As a rule, (certain) external events or regulatory requirements are not foreseeable and cannot be controlled by an entity. Since the original aim of the portfolio remains unchanged, measurement at AC is justified.

Irrespective of the foregoing, we believe that it is correct to measure investments without a quoted market price and whose fair value cannot be reliably measured at cost in analogy to the rules of IAS 39.46(c). The necessary evaluation of the entity as per a cut-off date is out of proportion to the information supplied by such a value.

Question 6

Do you agree that the existing fair value option in IFRS 9 should be extended to financial assets that would otherwise be mandatorily measured at fair value through OCI? If not, why and what would you propose instead?

We agree to the application of the fair value option to the FVTOCI category if this is to be introduced as a mandatory category. We would welcome it if this option was not linked to conditions but made freely available for FVTOCI.

Question 7

Do you agree that an entity that chooses to early apply IFRS 9 after the completed version of IFRS 9 is issued should be required to apply the completed version of IFRS 9 (ie including all chapters)? If not, why? Do you believe that the proposed six-month period between the issuance of the completed version of IFRS 9 and when the prohibition on newly applying previous versions of IFRS 9 becomes effective is sufficient? If not, what would be an appropriate period and why?

We agree.

Question 8

Do you agree that entities should be permitted to choose to early apply only the 'own credit' provisions in IFRS 9 once the completed version of IFRS 9 is issued? If not, why and what do you propose instead?

We agree to early application of the "own credit" provisions. However, we advocate implementation already within IAS 39. Since the entire "IFRS-9 package" has yet to be endorsed by the EU, the "own credit" provisions could be applied sooner.

We would like to point out that the entities will need approximately three years in order to implement IFRS 9. Therefore, mandatory first-time application of IFRS 9 by 1 January 2015 does not appear to be realistic. Irrespective of Phase 1, this is also due to uncertainties with the impairment project.

Question 9

Do you believe there are considerations unique to first-time adopters that the IASB should consider for the transition to IFRS 9? If so, what are those considerations?

We have no comments here.

Yours sincerely
on behalf of the German Banking Industry Committee
Savings Bank Finance Group

Signed


Dr. Ralf Goebel

Signed


Diana Wieske