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Comments to the EFRAG's draft comment letter on the FASB exposure draft Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities.

Erste Group does not prepare financial statements under US GAAP and therefore does not write its own comment letter on the FASB exposure draft. We appreciate the opportunity to comment on the EFRAG's draft comment letter because this is the best way to express our opinion on some aspects of the current reform of financial instruments reporting.

We agree with the comments written by EFRAG on the particular questions raised by the FASB ED. Therefore we only comment on some issues and give also two specific comments to the answers written by EFRAG. We can group our answers into 3 areas.

1. Convergence between IFRS and US GAAP

Referring to the fact that the financial instruments reporting reform is a part of the convergence project between IASB and FASB we consider the current status of reform as a paradox. During the last decade the IFRS and US GAAP financial instruments standards were quite converged in the areas of classification and measurement and hedge accounting. Two years ago a common discussion paper starting the financial instruments reporting reform was issued.

However the subsequent development seems to be rather strange to us. We understand that IASB was under higher pressure to act more promptly and FASB had more time to bring a comprehensive reform of financial instruments reporting. However the deliberations on the reform were always done jointly. Therefore we do not understand the current outcome when we can read highly diverged proposals for financial instrument standards. The areas of classification and measurement and impairment are dissimilar. And also the hedge accounting deliberations go their own way on both sides. Something must have gone wrong in the reform as regards convergence.

The result of convergence cannot be that the (proposed) standards have completely different wording, are based on different notions and that the differences should be reconciled. The boards should find a

way to solve this adverse situation. The solution rests in having converged principles and not in reconciling the figures based on diverged standards.

We know that EFRAG is aware of this and these issues are addressed in the draft comment letter. If possible more emphasis might be added in describing the adverse situation of the financial instruments reform project in which we currently are as regards convergence.

2. Asymmetry in classification and measurement of financial assets and liabilities – question for EFRAG constituents if they support efforts by IASB in the directions specified in paragraphs 80-82 of the comment letter

Erste Group has sent 3 inputs as regards these issues.

i. *Comment letter to the EFRAG´s draft comment letter on the ED Fair Value Option for Financial Liabilities*
   Here we addressed especially the asymmetry in accounting for financial liabilities and financial assets with which strongly disagree. IASB has not provided any well substantiated reasons for asymmetrical treatment. We also expressed support for retaining the concept of embedded derivatives both for financial assets and liabilities with possible improvements.

ii. *Presentation on critical loan products sent via ESBG and separate word document with explanations of the issues and products*
   Here we summarised the cases of standard loan products in the Erste Group portfolio which will be or may be fair valued in the new IFRS 9 environment.

iii. *Document on managing the risks in structured products*
   The document was focused on describing the structured risks management at Erste Group and supporting the concept of embedded derivatives because it reflects the way the risk is managed.

As can be read from opinions we strongly support all EFRAG activities aimed at developing good and long-lasting financial instrument standards which would be based on:
- symmetrical treatment in classification and measurement of financial assets and liabilities,
- retaining embedded derivatives with developing better principle based requirements in this area.

Therefore we support the activities in directions as drafted in the paragraphs 80-82.

3. Specific comments

In the paragraph 46 we can find a sentence: “EFRAG remains to be convinced of the advantages of measuring financial instruments at fair value in the statement of financial position and retaining traditional concept of performance in profit or loss, while reporting a ’residual’ in OCI. Before extending the use of OCI to financial instruments held for collection or payment of contractual cash flows, EFRAG believes that a proper debate is necessary on fundamental issues related to performance reporting such as (a) the notion of performance and the impact of business models on it, (b) the content of performance statements and (c) recycling.“

This seems to be in contradiction to the basic message in the draft comment letter that EFRAG supports the mixed measurement model with amortised cost and fair value. Is really the long term objective of EFRAG to have the FV through OCI measurement method for debt instruments held for collection or payment of contractual cash flows and thus the full fair value measurement model as proposed in the FASB exposure draft? From other parts of the draft of the comment letter we understand that no and this we fully support. We propose this part to be redrafted to avoid confusions.

In the paragraphs 98 and 99 EFRAG presents its opinion that application of FASB's impairment model would lead to profit or loss impact on initial recognition. EFRAG also expresses dissent with it.

Indeed in our opinion the proposed impairment model would automatically lead to first day losses. Assume that a loan has 8% contractual rate (=EIR) and thereof 3% is charged to a customer to offset the future expected credit losses. The reporting date comes immediately after providing the loan. Then discounting of the cash flows expected to be collected reflecting the 'risk free' 5% rate by 8% EIR would lead to 1st day loss.

Because the ED does not discuss the 1st day loss issue at all which is very strange we tried to look for a possible interpretation in which such loss would not arise. The exposure draft says that collectability of cash flows shall include all available information relating to *past events and existing conditions* but shall *not* consider *potential future* events beyond the reporting date. Would this mean that until something bad happens and the new condition is existing the cash flows estimates should reflect the 8% contractual rate and this would result in no impairment loss? Even such interpretation, however, seems to be flawed because information relating to past events and existing conditions says that such losses are expected and therefore should be reflected in the estimates. This inevitably causes day 1 losses.

Therefore we are of opinion that the issue of first day losses should be properly discussed in the basis for conclusions unless FASB changes its impairment model. The best way to develop impairment model by FASB would be to use the findings of IASB outreach activities and the work of expert advisory panel. These additional activities of IASB (disregarding the exposure draft on impairment model) can serve as a good example of thorough discussions which should be always performed when developing any good accounting model. As a result of these activities we hope that also IASB will change its expected loss model proposed in the exposure draft into a more practicable one.

If you have any questions regarding our comments do not hesitate to contact us.

Yours sincerely,

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