AUSTRIAN FINANCIAL REPORTING AND AUDITING COMMITTEE

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Sir David Tweedie
Chairman
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
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Dear Sir David,

On behalf of the Austrian Financial Reporting and Auditing Committee (AFRAC), the privately organised standard-setting body for financial reporting and auditing standards in Austria, I appreciate the opportunity to comment on the IASB's *Request for Information ('Expected Loss Model') Impairment of Financial Assets: Expected Cash Flow Approach*. Principal authors of this comment letter were Julius Gaugusch, David Grünberger, Ingrid Jacob, Erich Kandler, Heiner Klein, Michael Laminger, Helmut Sorger and Roland Nessmann.

General remarks

We see and understand the political will and IASB's intention to reduce pro-cyclicality in financial reporting by taking into account not only losses incurred but also those expected in impairment. On the other hand, we see a need to harmonise earnings with the provisions for risks associated with those earnings.

What we are not sure of yet is whether the expected loss model – only the main features of which are described in this information request – could be a solution for both of these problems:

– For the purposes of financial reporting, solutions must ultimately not result in unacceptable levels of costs for the entities involved.

– Many entities – not only in the financial sector, but also outside it – will not have the data necessary to calculate expected losses over the whole lifetime of financial assets on a portfolio and individual loan basis.
– Managing boards are jointly and indivisibly responsible for entities' accounts. An approach similar to that already applied in some countries, e.g. Spain, where an external body calculates a factor which all entities in its jurisdiction must use in their financial statements would relieve them of part of the burden of their core responsibility, at least in part, and would reduce comparability, unless a worldwide solution were agreed upon.
– What we still feel is missing in the request is clear guidance how to handle incurred losses. In our view, incurred losses still have to be accounted for; to take into account only expected losses seems not to be sufficient for financial statements. The relation between incurred and expected losses is not sufficiently clear yet.

In addition to these general remarks, we set out below some more detailed comments on the questions raised in the paper.

Specific comments

Q1. *Is the approach defined clearly? If not, what additional guidance is needed, and why?*

From a theoretical, macroeconomic point of view the approach is clear. However, detailed guidance is needed on differences between this approach and the similar, but not identical Basel 2 approach, e.g., the use of a one-year PD in the Basel 2 calculation and the calculation of an expected loss over the expected lifetime of a financial asset, and on how these differences are to be reduced.

From our point of view, the main purpose of this change should be to match the earnings and the corresponding credit risks of holding a financial asset.

As discussed above, many of the issues seem neither to have been sufficiently discussed nor are yet decided, especially with respect to cost-benefit constraints, so that a conclusive opinion on possible effects of the implementation of this model is not yet possible.

Q2. *Is the approach operational (ie capable of being applied without undue cost)? Why or why not? If not, how would you make it operational?*

The approach is not operational. Some obvious problems are:

- Entities not currently using Basel 2 have no experience of working with these categories, and generally do not have adequate databases for the purpose.
- The databases used for Basel 2 calculations under the IRB approach cannot be used for this calculation, because very few entities – if any – have databases incorporating the whole lifecycle of assets, especially under varying assumptions about future economic development.
- If this information has not been maintained by reporting entities, then it must be decided who will generate it, and for which counterparties, or at least for which sectors or classes of counterparties with similar risk characteristics.
- This information should, if we understand the paper correctly, be used in calculating the applicable EIR and book value of a financial asset at initial recognition. Given the problems outlined above, this will necessarily result in an initial loss. We do not see this as correct.
- How are "incurred", as opposed to "expected" losses to be treated? Are there additional notes or "additional losses"?

In order to make the approach operational, a simpler approach than the Basel 2 IRB approach needs to be developed and implemented (e.g., only a limited number of classes/portfolios). Such a simplified approach, however, might be at variance with existing Basel 2 IRB portfolios, or with detailed control systems used by entities for other purposes. Thus, the development of a robust, comparable, and easy to implement and handle system seems to be a crucial factor.

Q3. *What magnitude of costs would you incur to apply this approach, both for initial implementation and on an ongoing basis? What is the likely extent of system and other procedural changes that would be required to implement the approach as specified? If proposals are made, what is the required lead time to implement such an approach?*

For most sectors the costs would be high and – in our view – would far outweigh the benefits, which are more on a macroeconomic level. Reporting entities can already reach similar effects in financial reporting by making extensive use of losses incurred. Especially for entities outside the financial sector, a simple and robust approach must be developed, if implementation is to be compatible with cost-benefit considerations. As an aside, the decision-usefulness of such information in the financial statements of entities in the non-financial sector also still remains to be considered.

Entities already using the Basel 2 IRB approach would need to align their Basel 2 classes with those used by the originator of the expected loss figures.

As discussed above, the calculations can only be made on the basis of external data (prepared by whom?), which would reduce the responsibility of management boards for their financial statements, e.g., for the correct classification of counterparties into classes of similar risk characteristics.

Q4. *How would you apply the approach to variable rate instruments, and why? See the Appendix for a discussion of alternative ways in which an entity might apply the expected cash flow approach to variable rate instruments.*

In our view, the original EIR calculated at first recognition should not be changed subsequently. We are concerned that the approach to accounting for variable rate instruments outlined in the staff paper could ultimately have severe repercussions on economic behaviour, and thus prejudice the decision neutrality of accounting systems.

Please do not hesitate to contact me if you wish to discuss any aspect of our comment letter in more detail.

Kind regards,

Romuald Bertl
Chairman