DZ BANK's Comments on EFRAG's Draft Comment Letter (DCL) on FASB's Exposure Draft on the Accounting for Financial Instruments

EFRAG does not support the proposals in the FASB Exposure Draft as it believes that they do not give appropriate emphasis to the business model; nor would the proposals be capable of reflecting the range of business models that exist. We fully agree with these statements.

In EFRAG's view that we also share, the FASB proposals do not provide a basis for a high-quality standard on accounting for financial instruments. Like EFRAG we are supportive of the broad direction set by the IASB in its project to replace IAS 39 Financial Instruments: Recognition and Measurement. Therefore, we agree that the directions set by the IASB should form the basis for the development of a converged standard.

We have only selected comments to the following topics:
1. Greater Emphasis to the Business Model
2. Separate Accounting for Embedded Derivatives
3. Cost Exception for Investments in Unquoted Equity Instruments
4. Credit Impairment and
5. Hedge Accounting

1. Greater Emphasis to the Business Model
The principle defining the boundaries between amortised cost and fair value measurement should, according to paragraph 82(a) of the DCL, more closely reflect the business model adopted for the different contractual cash flows present in a financial instrument, giving great emphasis to the business model. We strongly support that proposed direction of future development of accounting for financial instruments.

2. Separate Accounting for Embedded Derivatives
We support the view that separate accounting for embedded derivatives should remain possible for assets as well as for liabilities based on the arguments outlined in paragraph 81 of the DCL.
In addition, we think that the notion of bifurcation provides for a reasonable extent of fair value measurements, thereby preventing an undifferentiated extension of the use of that measurement principle. Additionally, the fair value option should also remain to be available.

EFRAG would, as formulated in paragraph 82 of the DCL, welcome joint efforts of the FASB and the IASB for the development of converged requirements leading to the identification of embedded derivatives and the classification of financial instruments. The aim of these efforts should be to improve the classification criteria and achieve a simple, symmetrical and principle-based approach to the bifurcation of embedded derivatives. We fully agree with this statement.

3. Cost Exception for Investments in Unquoted Equity Instruments
EFRAG believes, as stated in the recommendations section of the cover letter, that equity investments not held-for-trading should be accounted for differently from equity investments held-for-trading and measured at fair value through profit or loss. Specifically, equity investments not held-for-trading should be measured at fair value with changes in fair value recognised in other comprehensive income, subject to an impairment test.

We recommend that EFRAG adds a sentence saying that for the measurement of unquoted equity instruments an exception should be available. Entities should be allowed to measure such investments at cost, if their fair value cannot be measured reliably. We do not consider the guidance in IFRS 9 that says that cost might be representative of fair value in specific circumstances as very helpful in practice, since the requirements for such an assumption are rather strict.

4. Credit Impairment
In general, we want to point out that we do not see a clear shift away from the incurred loss model when considering the FASB's proposals on the impairment of financial assets. We doubt that because of the abolition of the probability threshold losses will be recognised earlier than at present to any significant degree. Furthermore, we do not consider it consistent with FASB's proposals to disregard future events when estimating cash flows.

We agree with EFRAG's statement that an expected loss model does have advantages compared to an incurred loss model. However, we note significant weaknesses of IASB's expected cash flow approach as well, which have partially been addressed by paragraph 116 of the DCL.
Such weaknesses are implementation costs and effort for applying the effective interest rate method, non-applicability for open portfolios and incompatibility with the internal business models of entities.

For these reasons we support EFRAG's criticism and call on both standard setters for a credit impairment approach that takes into account the economic reality and the limitations of data processing systems of financial institutions.

We advocate the introduction of the so called ELLP Approach developed by the European Banking Federation. The ELLP Approach would separate the calculation of effective interest revenue and expected losses on a portfolio basis. This notion of decoupling is also reflected by paragraph 129 of the DCL. The ELLP Approach would allocate the estimated cash flows and effects of changes of estimates over the life time of the portfolios.

When recognizing the adjustments due to changes of estimates we favour allocating them over the remaining time until maturity, notwithstanding whether the change results from past or future events.
EFRAG proposes to differentiate between changes which result from past and future events. With regard to past events EFRAG proposes to immediately recognize the effects in profit or loss, whereas

in case of future events the changes should be allocated until maturity. We consider this differentiated approach as very impracticable .

5. Hedge Accounting

According to paragraph 138 of the DCL EFRAG is not convinced that the FASB's proposals would result in substantial simplification. We do, however, see a simplification in the FASB's proposal regarding effectiveness measurement, as less documentation would be necessary and the fact that the hedge relationship is effective would not have to be demonstrated for each reporting date.
In addition, the claim for detailed implementation guidance, as contained in paragraph 139, clearly contradicts the aim of reducing the complexity of hedge accounting and the use of judgement.