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Comments of the Association of German Banks on the Exposure Draft "Classification and Measurement: Limited Amendments to IFRS 9" (ED/2012/4)

18 March 2013

Ref. BdB: BI.01
Prepared by Wu

Dear Ms Flores,

We welcome the opportunity to respond to the IASB's Exposure Draft "Classification and Measurement: Limited Amendments to IFRS 9" (ED/2012/4).

Please find our comments on the exposure draft enclosed.

Yours sincerely,

Dirk Jäger
Member of the Management Board

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Comments

of the Association of German Banks on the Exposure Draft "Classification and Measurement: Limited Amendments to IFRS 9" (ED/2012/4)

18 March 2013

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Summary

The IASB's exposure draft shows that it has taken various criticisms of the already finalised IFRS 9 (2009/2010) on board. The main change is the proposed introduction of the fair value through OCI category. Among the reasons cited for introducing this new category is the need for greater alignment with US GAAP and a reduction in accounting mismatches for insurance companies. While we support convergence in principle, we consider it a somewhat dubious argument for introducing an additional measurement category in view of the very different approaches adopted by the IASB and FASB in the impairment project. And it is totally unclear at this stage – not only because IFRS 4 will be finalised only in a couple of years – whether, and if so to what extent, insurance companies will find measurement at fair value through OCI a significant improvement on IFRS 9 (2009/2010).

It is undeniable, by contrast, that the fair value through OCI category will increase the complexity of accounting, which is the exact opposite of the IASB's original objective. This is not in the interests of preparers or users. For this reason, we take the view that the amortised cost and fair value through profit or loss categories are sufficient and, moreover, can be justified by a clear business model. Nevertheless, so as not to disregard the IASB's arguments completely, we would suggest giving entities the option to use the fair value through OCI category in the event of accounting mismatches. This would accommodate the concerns of insurance companies while avoiding an excessive increase in complexity.

The important point in our view is to enable traditional banking business to continue to be accounted for at amortised cost. It should be possible to sell assets ahead of maturity without this involving a change in business model. When sales are triggered by deterioration in credit quality, the "deterioration in credit quality" criterion should not be interpreted in the sense of incurred loss. We believe it makes better sense to permit sales before an external downgrade takes place (in line with the bank's internal risk management and investment policy).

Given the current pace of regulatory developments, external factors (e.g. regulatory requirements) can make it necessary to sell significant portions of a portfolio. Such sales are normally based on a single decision taken by top management. The actual sale, by contrast, may take place over a relatively protracted period because only certain tranches can be placed on the market at any one time. In cases like this, i.e. when a single, one-off decision is implemented over a lengthy period of time, we believe that measurement at amortised cost should continue to be permissible since, as we see it, the "significant but infrequent" criterion is met.

We generally agree with the criteria for the SPPI test, but would nevertheless welcome clarification or illustrative examples of certain points.

In view of the planned introduction of a third measurement category (fair value through OCI) and the regulatory implications of any changes to accounting rules, we would advocate greater dialogue between the IASB and supervisors.

We would also like to point out that banks will need around three years to ready themselves for IFRS 9. Mandatory application of the new standard from 1 January 2015 is therefore not realistic.

Our detailed comments on the questions raised in the exposure draft are as follows.

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 instruments with a modified economic relationship should not be automatically excluded from amortised cost measurement. The proposed amendment will enable assets of this kind to be measured at amortised cost as long as the "hold to collect" criterion is satisfied.

The current guidance on prepayment options in IFRS 9 (2009/2010) could also benefit from an amendment, in our view. We believe a prepayment option at par plus accrued 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 specified in IFRS 9 B4.10 [2009/2010]). Though it is true that prepayment options speed up payments, with a prepayment option at par plus accrued interest all cash flows can still be considered payments of principal and interest. We are therefore in favour of retaining the current guidance in IFRS 9 for prepayment options which are not at par plus accrued, but believe that those at par plus accrued should not fail the SPPI test regardless of the trigger. These features meet the "solely payments of principal and interest" criterion, but the current guidance in IFRS 9 B4.10 (2009/2010) would prevent them from satisfying 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?

We would like to begin by stressing that we welcome the principles-based approach taken by the exposure draft and consequently do not believe further guidance is needed. We would nevertheless like to see the principles illustrated by one or more examples. One point concerning the SPPI test for modified economic relationships (benchmark test) is not clear to us, however. Is it always mandatory to carry out this test under the conditions mentioned in the exposure draft? Or, given the complexity of the test, can the entity opt to refrain from carrying out the test and measure the financial instrument at fair value through profit or loss? We would recommend replacing "shall" with "may" in paragraph B4.1.9B.

Nor are we quite clear on why paragraph B.4.1.8A has been inserted and on what its implications may be. An interest rate on a loan, for example, is calculated to include, among other things, refinancing and liquidity costs, a return on the bank's equity, administrative costs and a margin. Can routine components such as these not be considered "consideration for the time value of money and the credit risk"? Does some kind of "market compliance testing" have to be carried out on every transaction (i.e. is the interest rate agreed with the client consistent with the time value of the money and the credit risk)? We assume that this is not the case and that the IASB merely wishes paragraphs B.4.1.7 ff. to cover a limited number of specific transactions (e.g. interest rate mismatch features in the context of modified economic relationships). We would ask the IASB to clarify this point and/or delete paragraph B.4.1.8A.

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?

Please see our reply to question 1.

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?

We prefer the current differentiation between two business models (amortised cost and fair value through profit or loss).Our concerns regarding the fair value through OCI category are set out below in our reply to question 5. In and of themselves, the requirements for measuring financial instruments within the fair value through OCI category are acceptable, in our view.

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?

Unlike the amortised cost and fair value through profit and loss categories, fair value through OCI is not, in our view, a business model. What is more, the introduction of this additional "business model" would massively increase the complexity of the standard. The answer is not, however, to provide more interpretation or application guidance. As explained above, we advocate giving entities the option to use the fair value through OCI in the event of accounting mismatches (as a residual category or "overlay" as it were). This would enable a clearer distinction to be made between the "hold to collect" (amortised cost) and "held for trading" (fair value through profit or loss) business models and would also reduce complexity, as originally planned by the IASB. In addition, the needs of the insurance industry could be accommodated and possible accounting mismatches could be eliminated. And there would still be a move towards convergence with US GAAP.

The examples provided in paragraph B4.1.4 often mention whether the entity is a financial or non-financial entity. Yet "financial versus non-financial" is not a factor determining business model classification in the guidance in paragraphs B4.1.1 through B4.1.3. The repeated reference to an entity's financial or non-financial status in the examples might lead users to conclude that the status is a determining classification factor. Whilst we acknowledge that this provides context to the discussion, we believe the business model should be independent of the type of industry in which the entity operates. We would therefore recommend removing the description of entity types from the examples.

We are concerned that the examples provided of fair value through OCI are too broad and that the distinction between fair value through OCI and fair value through profit or loss is not clear. The first example in paragraph B4.1.4B describes a situation in which an entity is aiming to maximise the return on financial assets and will sell to reinvest the cash in assets with a higher yield when the opportunity arises. This example is deemed fair value through OCI since the sales activity is to maximise yield rather than more speculative activity based on expectations of fair value increases, which would be fair value through profit or loss. We would question whether there is a clear distinction between frequent sales to manage yield and frequent sales to maximise profit and consequently believe that the fair value through OCI classification is too broad.

To date, discussions concerning the suitability of fair value through OCI have often focused on liquidity portfolios. This does not go far enough, in our view, since there are also questions surrounding other issues. We would like to go into these below.

The key point, as we see it, is that accounting should accurately reflect a bank's business model. It should be borne in mind in this context that banks manage their business on a portfolio basis, with portfolios being put together on the basis of the bank's business model. A distinction needs to be made between the intention to generate contractual cash flows and the intention to realise profit in the near term. Even if repeated sales at frequent intervals are not a feature of the latter business model, fair value measurement is nevertheless appropriate because the portfolio is managed on a fair value basis. Sales ahead of maturity can also occur under a "hold to collect" business model without this necessarily calling the business model into question. The reasons for this are as follows. A bank's assets are financed by its liabilities (e.g. deposits). But since the bank has only limited influence over its liabilities, these are normally subject to fluctuations (e.g. customer withdrawals of deposits). Since changes in liabilities necessitate adjustments to the bank's assets, sales ahead of maturity are sometimes inevitable.

Unlike the exogenous circumstances described above, maintaining a stable interest margin is a matter of an endogenous nature. Banks often use replicating portfolios to try and maintain their interest margin at a certain level. With a view to ensuring refinancing at matched maturities, the liabilities structure is mirrored by securities with corresponding maturities on the assets side. Changes in the liabilities structure – caused, for example, by customer withdrawals – have to be replicated on the assets side to maintain the balance. Though this frequently requires assets to be sold, the original objective – namely to generate contractual cash flows – remains the same. Adjustments in the form of sales are nevertheless necessary to maintain a stable interest margin. This is in no way at odds with the objectives of an amortised cost business model, since the bank's intention in holding the portfolio continues to be to collect contractual cash flows, not to realise yields in the near term. From a portfolio management perspective, the focus is therefore still on the portfolio as a whole rather than on the level of individual transactions (in this case: sales). The IASB's focus on individual transactions (=> early sales mean removal from the amortised cost category) effectively ignores this portfolio-level view, however. Yet at the same time, the IASB permits reclassification only in the event of significant changes/sales. This reflects a portfolio perspective, with the expectation that changes of business model will be relatively infrequent. There is a lack of consistency in the IASB's argument.

With the above considerations in mind, we believe it should generally be possible to measure the following types of portfolio/instrument at amortised cost:

Liquidity/liquidity portfolios

There is general consensus that instruments ensuring day-to-day liquidity should be measured at fair value. Yet banks do not actually have "a" liquidity portfolio as such, but rather a number of individual portfolios determined by the bank's overarching business model and monitored accordingly. In our view, it should continue to be possible to apply amortised cost measurement to liquidity management instruments which are intended not for sale but as security to acquire liquidity through repos or from the ECB. This would, moreover, be a logical approach since open ECB credit facilities will continue to be eligible for inclusion in the LCR buffer. Determining the size and composition of a bank's liquidity reserves is, moreover, a conscious management decision, so amortised cost measurement, where appropriate, can also be justified from a bank management perspective.

Interest margin management
See above.

Prefunding
Banks often generate liquidity (e.g. by issuing bonds) when market conditions are favourable without having a specific target investment in mind. The plan is merely to invest in an asset which will generate regular payments of principal and interest. Until such an investment is acquired, the funds are invested in (normally short-dated) securities. As soon a suitable target investment has been found, these securities are sold and the target asset is acquired. The objective of the investment in such a case is to generate contractual cash flows. This remains the objective even after the sale; it is merely the source which is replaced. Since short-dated securities are normally acquired, the "close to maturity" criterion is likely to be satisfied. Measurement at fair value – be it through profit or loss or through OCI – would result in an accounting mismatch, since the corresponding liabilities will be measured at amortised cost.

An important aspect associated with the "hold to collect" (amortised cost) business model is early sales and their definition. The criteria proposed by the IASB ("infrequent", "insignificant") are generally acceptable, in our view. However, frequent and/or significant sales should also be permitted if there are good reasons – apart from deterioration in credit quality – for the sale.

Credit deterioration/investment policy
The "deterioration in credit quality" criterion should not be defined too narrowly, e.g. as an incurred loss. Instead, it should be determined by the bank's internal risk management (based on PD/LGD). This means banks should be able to sell an asset before any external downgrade if this is in line with their documented investment policy; they should not have to wait until a loss actually occurs. This would be consistent with the proposals put forward in IFRS 9: Impairment. Nor should deterioration in credit quality be tied solely to individual assets; it should also be possible to sell the entire portfolio. It should also be possible to take account of other aspects of business/risk management strategies (as set out in the investment policy), e.g. concentration risk.

Portfolio wind-downs
According to the exposure draft, even significant sales ahead of maturity should not preclude amortised cost measurement as long as such sales are infrequent. This means a bank is permitted to wind down significant portions of a portfolio as long as the above conditions are met and the sales are covered by the bank's investment policy. The basis for significant transactions of this kind is normally a single top management decision. The larger the amount of assets to be sold, however, the more difficult it is to place them all on the market at the same time. It is therefore normal practice in such cases for the sale to take place in tranches over an extended period (sometimes years). We take the view that sales along these lines can also be deemed "significant but infrequent" since they are based on a single decision to sell. Measurement at amortised cost should therefore be permitted. The same should apply when a management decision is taken to implement an external instruction (from supervisors, for instance). Even a series of external instructions (e.g. to reduce the size of the balance sheet) should not preclude the bank's ability to measure affected portfolios at amortised cost. Certain external events and regulatory instructions are unforeseeable and beyond the influence of the bank. Since the original objective of the portfolio remains the same, measurement at amortised cost continues to be justified.[1]

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?

No comments.

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?

No comments.

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[1] We should like to point out that the FASB's current exposure draft also takes the view that "sales that result from events that are isolated, nonrecurring, unusual and result from events that could not have been reasonably anticipated should not be inconsistent with an amortised cost business model".

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 with allowing early application of the "own credit" provisions. Given that the finalised IFRS 9 package will also have to be endorsed by the EU, however, we would suggest permitting their application while IAS 39 is still effective so as to enable the "own credit" provisions to be applied at an earlier stage.

We would also like to point out that banks will need an implementation period of around three years to prepare for IFRS 9. Mandatory first-time application of IFRS 9 from 1 January 2015 is therefore unrealistic. Apart from phase 1, this is also due to the uncertainty associated 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?

No comments.