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**Exposure Draft ED/2009/7 „Financial Instruments: Classification and Measurement“**  
**AZ ZKA: IASB**  
**AZ BVR: EG-VSK-IAS39**

Dear Sir David,

We should like to thank you for the opportunity to comment on the Exposure Draft (ED) “Financial Instruments: Classification and Measurement“ which we gladly seize.

Whenever the ED leads to clearly better application and intelligibility as well as reduced complexity of the existing provisions, we are generally in favour of a further development of the IAS 39 rules. One key request of the G20 nations and the EU Commission during the review of IAS 39 was the mitigation of procyclicality during fair value accounting. However, the proposals which have now been submitted by the IASB fail to deliver precisely this core requirement. The proposed amendments by far exceed the requested adjustments and lead to an extension of fair value accounting.

Under the IASB’s current proposals, the classification of financial instruments shall be primarily geared towards product specific details (“basic loan features”). The way in which an entity manages its business and therefore also its instruments, is only assigned a subordinated importance by virtue of the second condition “managed on a contractual yield basis”. This means that banking products aimed at achieving a sustainable interest

surplus but do not fulfil the basic loan features will have to be measured at their fair value. However, an isolated focus on the fair value which is divorced from the business model withholds decision-useful information from the users of financial statements. Especially the fact that fair value measurement is only suitable for a part of the financial instruments has been demonstrated by the financial market crisis and this is also recognised by the IASB (BC 13).

One further key request by the G20 or, moreover, by the EU Commission was the reduction of the complexity inherent in IAS 39. In our understanding, however, the IASB proposals do not indicate any significant reduction in complexity. Hence, we feel that the implementation of the new rules is in no way borne out by a cost benefit analysis. Furthermore, there are still uncertainties with regard to the forthcoming content and practical feasibility of the two preconditions, i.e. “basic loan features” and “managed on a contractual yield basis”.

In the light of the financial market crisis, the IASB responded to the criticism levelled at IAS 39 in October 2008 by changing the rules concerning the reclassification of financial instruments. However, there are plans to in future abandon the possibility of reassigning financial instruments previously assigned to one category. Yet, because they would not meet the criterion of only having basic loan features, this would lead to a situation where several financial instruments (which had been reclassified) would have to be measured again at fair value. In our understanding this is also at odds with the requests made by the G20 nations.

We therefore suggest a classification model which is geared towards the company’s business model: The corporate purpose must not be determined by the accounting method. Quite on the contrary: the corporate purpose needs to determine the way and type of accounting. Consistency between accounting and business model including the corporate management style which is associated with this is essential for an appropriate, credible and decision-useful presentation of the economic reality. A sustainable and transparently documented change of the business purpose also needs to warrant a potential reclassification into a different category. An investor can take meaningful decisions only on the basis of such understandable, reliable and transparent information.

We feel that the breakdown of the IAS 39 review into three separate work packages (“classification and measurement“, “impairment“ and “hedge accounting“) which are also scheduled to take place at different points in time is extremely difficult. In our view, these

issues can only be assessed *en bloc*. After all, in terms of content, they are highly interrelated. In order to reach an improvement in financial reporting which is consistent *per se*, a sufficient deadline for an analysis of all the amendment proposals is absolutely necessary. Furthermore, we also feel that corresponding impact studies are indispensable.

In order to overcome the identified IAS 39 weaknesses in the short-term, amendments and additions should be preferred over changes to the system or the underlying logic. Should the IASB go ahead with its plans for adoption of the final version of the currently proposed draft standard as early as 2009 then, in our opinion, the specific points of criticism raised by the EU Commission in its letter dated 27<sup>th</sup> of October 2008 should become an integral part of the amendments.

**Question 1:**

**Does amortised cost provide decision-useful information for a financial asset or financial liability that has basic loan features and is managed on a contractual yield basis? If not, why?**

In our view, the measurement category "amortised cost" provides decision-useful information to users of financial statements whenever the instruments that are being measured constitute financial assets or financial liabilities that are not held for trading and that are being managed on a contractual yield basis within the meaning of the draft. For the purpose of classification and measurement of financial instruments, we do not feel that the use of product specific details (basic loan features) is decision-useful. *In lieu* of this, the main criterion for the classification and measurement should consist in the respective corporate business model. A measurement at amortised cost leads to decision-useful information whenever financial instruments are held on a long-term basis in order to generate a sustainable interest surplus. This is due to the fact that in such cases the valuation of the financial instruments reflects the company's economic intention.

However, the IASB's proposed criterion "basic loan features" may, in the final analysis, lead to a situation where several (classical) banking products would have to be measured at fair value; in our view this would be inappropriate. Examples for this are (structured) savings and credit products, building society products or also subordinated capital. Invariably, these products will be available to the business operation for a longer term and will be managed accordingly. Furthermore, we feel that the IASB has not paid sufficient attention to the subject of long-term liabilities aimed at corporate financing. It is perfectly

conceivable that several long-term liabilities lack any basic loan features, yet - with a view to long-term finance - that they will still be controlled on a contractual yield basis (e.g. structured savings products). In such a case, the present proposals would lead to an, in our view unacceptable, clear extension of fair value accounting to also include the liabilities side.

**Question 2:**

**Do you believe that the exposure draft proposes sufficient, operational guidance on the application of whether an instrument has ‘basic loan features’ and ‘is managed on a contractual yield basis’? If not, why? What additional guidance would you propose and why?**

In our answer to question number one we already pointed out that we feel that the criterion “basic loan feature” is not feasible for preparers of financial statements. We also feel that this criterion does not provide decision-useful information to users of the financial statements, either. Apart from this, the explanations on both criteria *per se* are rather anecdotal and, in many cases, remain unclear. In view of the rather vague language, it is not possible to gauge the impact of termination rights, several or changing interest references as well as the risks of default and/or subordinated loan agreements.

Especially in the credit sector there may be certain agreements that may alter the due date as well as the level of interest and redemption payments (for instance termination rights, debtor warrant bonds, restructuring agreements etc.). These agreements can potentially lead to a situation where - although the loan is being managed “on a contractual yield basis“ - the criterion “basic loan feature“ is not being fulfilled and where the loan would thus have to be measured at fair value. We feel that this would not be appropriate. In these cases we therefore advocate in favour of a measurement at amortised cost.

The same applies if a financial asset is acquired at a discount that reflects incurred credit losses. Pursuant to the proposals contained in the present ED, these do not possess any “basic loan features”. In the view of the IASB, this instrument is subject to major volatility with regard to its actual cash flow. We do not share this view: The price determination was informed by certain assumptions with regard to the expected cash flow which were factored in accordingly. Basically, the company assumes that the anticipated cash flow will materialise and therefore will indeed manage the product on a contractual yield basis. We feel that this intention is pivotal and that it should warrant a measurement

at amortised cost. In our view, the reasons that are being mentioned in order to back a fair value measurement are not relevant.

An identical scenario might also create problems during acquisitions of portfolios including some non-performing loans which are managed on a contractual yield basis and within the framework of so-called “business combinations” meaning that also at that juncture, we should like to endorse a measurement at amortised cost.

**Question 3:**

**Do you believe that other conditions would be more appropriate to identify which financial assets or financial liabilities should be measured at amortised cost? If so, why?**

Yes, other criteria are more appropriate to identify the decision-useful measurement benchmark. In our view, the classification philosophy for financial instruments should not primarily hinge on product specific properties, hence we object to the current proposal.

**(a) What alternative conditions would you propose? Why are those conditions more appropriate?**

We feel that the financial instruments’ holding intention (which is chiefly determined by the respective business model) is of pivotal importance for the respective classification and measurement. A measurement at amortised cost should be permissible for financial instruments which are not held for trading.

The classification model should be geared towards the company’s business model (c.f. our earlier remarks above). This safeguards consistency between accounting and business purpose. It is also the foundation for a credible presentation of the economic reality that is fit for purpose and decision-useful.

The option of a reclassification into a different category must also be available whenever there is a change in the business purpose which is sustainable. These changes must be transparently documented.

- (b) If additional financial assets or financial liabilities would be measured at amortised cost using those conditions, what are those additional financial assets or financial liabilities? Why does measurement at amortised cost result in information that is more decision-useful than measurement at fair value?**

The financial instruments which should be more or less measured at amortised cost pursuant to the classification criterion suggested under a) which is based on the business model depend on the company specific situation.

The advantage of this classification philosophy lies in the presentation of the way in which financial assets and financial liabilities contribute towards corporate success. Here, financial reporting would be geared towards the actual corporate situation. At this point, users of financial statements would be given information that would be more decision-useful than the information provided under the model proposed by the IASB.

Furthermore, the users of the information are given a more transparent view of the company's business foundation; this would facilitate a comparison between the business models of various companies.

- (c) If financial assets or financial liabilities that the exposure draft would measure at amortised cost do not meet your proposed conditions, do you think that those financial assets or financial liabilities should be measured at fair value? If not, what measurement attribute is appropriate and why?**

A fair value measurement (the exit price) constitutes decision-useful and meaningful information on financial instruments which are bought and held with a view to being sold on within the near/foreseeable future. Hence, for these financial instruments a fair value measurement is deemed to be fit for purpose.

**Question 4(a):**

**Do you agree that the embedded derivative requirements for a hybrid contract with a financial host should be eliminated? If not, please describe any alternative proposal and explain how it simplifies the accounting requirements and how it would improve the decision-usefulness of information about hybrid contracts.**

Although the abolition of the "bifurcation" may potentially reduce part of the complexity inherent in IAS 39, this nevertheless results in new problematic issues.

Whilst we generally welcome a simple treatment of embedded derivatives, there was already a practical solution for embedded derivatives that need to be segregated under the current regime. This solution consisted in the use of the fair value option. We advocate in favour of keeping this current option. Our plea is motivated by the concern that in the field of structured products, fair value accounting might see a considerable extension of its current scope. What is more, this would be at odds with the lessons learnt from the financial market crisis. Last but not least, this would go against the political goal of mitigating procyclicality for the sake of a financial markets stabilisation. To date, whenever there was disaggregated recognition, the host contract could be recognised at amortised costs. Furthermore, whenever there is hedging of individual risks only, a disaggregation in the context of hedge management may be welcome. In addition to this, it would be premature to issue any final comments on this matter at the present point in time. This is due to the fact that there is no final information on the potential new provisions regarding hedge accounting and on the treatment of “own credit” changes for structured liabilities.

**Question 4(b):**

**Do you agree with the proposed application of the proposed classification approach to contractually subordinated interests (ie tranches)? If not, what approach would you propose for such contractually subordinated interests? How is that approach consistent with the proposed classification approach? How would that approach simplify the accounting requirements and improve the decision-usefulness of information about contractually subordinated interests?**

The criterion of a “basic loan feature” is largely based on the assumption that an adequate consideration of the time value of the money and the credit risk will ensure that the interest and redemption payments of a financial instrument are in line with the market. If financial instruments are subordinated the default risk is increased (this is equally the case for issuers of lower credit standing). Hence, due to the higher risk premium, the interest rate goes up., Provided that the interest rate can be deemed as being in line with the market or risk adequate then to our minds that should qualify for the criterion of a basic loan feature. Otherwise, this would lead to derogations and case-by-case decisions. This would be inconsistent with the overall goal of reduced complexity (simplification).

Furthermore, in the context of the BC28, the criterion “basic loan feature”, provides scope for creative use and abuse: Within the framework of further structuring, subordinated

tranches that fail to qualify for “basic loans” could appear to be senior in relation to other tranches; correspondingly, they might be awarded a basic loan feature. Room for creative use is also provided by a broad senior tranche. Conversely, there are currently securitisations where the senior tranches are very differentiated and only feature minor differences in terms of risk exposure. Formally speaking, even super senior tranches have a subordinated character, because, more often than not, e.g. fees and derivatives of the special purpose vehicle will have to be settled first.

On the whole, we are of the opinion that the measurement at amortised cost is a benchmark that is also fit for purpose when it comes to other tranches. Investments into these vehicles can be of a long-term nature and include regular cash flows; hence, they are equally being managed on a contractual yield basis.

Furthermore, there has not been a sufficient clarification concerning the treatment of other subordinated instruments, e.g. structured debt and convertible bonds. For instance, profit participation rights where interest claims do not re-arise constitute hybrid capital and not equity. In our view, a fair value measurement does not supply any decision-useful information for such instruments.

**Question 5:**

**Do you agree that entities should continue to be permitted to designate any financial asset or financial liability at fair value through profit or loss if such designation eliminates or significantly reduces an accounting mismatch? If not, why?**

Accounting mismatches obstruct decision-useful financial reporting. We therefore perceive an overarching need to overcome these obstacles. Using the fair value option is one way in which accounting mismatches can be eliminated.

In general, however, we feel it is pivotal that the classification criteria for financial instruments be conceived in a way that adequately reflects the economic relations between the instruments; furthermore, the provisions on hedge accounting need to be primarily geared towards the economic facts underlying the hedging relationships. This could result in a considerable reduction of accounting mismatches in financial reporting. Any remaining issues could then be removed by means of the fair value option.

At the same time, we feel that it would be useful to allow reclassifications from and into the fair value option. Business models may change. This point has been corroborated not only by the financial market crisis. Whenever this occurs, accounting decisions need to be revised in light of these new economic realities.

**Question 6:**

**Should the fair value option be allowed under any other circumstances? If so, under what other circumstances should it be allowed and why?**

Yes, in the case of derivatives where disaggregation is mandatory, measurement at fair value should remain an option (cf. our answer under question 4a).

**Question 7:**

**Do you agree that reclassification should be prohibited? If not, in what circumstances do you believe reclassification is appropriate and why do such reclassifications provide understandable and useful information to users of financial statements? How would you account for such reclassifications, and why?**

The classification of financial instruments should seek to ensure that financial reporting gives a true and fair view of the net assets, financial position and results of operations whilst bearing in mind the going concern principle. A reclassification should be possible whenever, based on the aforementioned objective, a different classification would lead to more decision-useful or more meaningful information. We object to the IASB's proposal pursuant to which changes to the classifications after initial recognition shall not be permissible under any circumstances.

Whenever the initial holding and management strategy of financial instruments sees a change or, moreover, whenever the initial strategy turns out to be no longer economically viable, it should be possible to opt for a re-classification of these financial instruments and to subsequently measure them at amortised cost. Whenever the company changes its holding strategy - this will for instance be the case when there are illiquid markets, in the absence of price quotations or, moreover, fair values which can no longer be reliably measured— a reclassification based on the management strategy needs to remain an option in the future, too. More often than not, under such circumstances selling an instrument which has been assigned to a different category will not be worthwhile, or, moreover, will

not be possible meaning that the company will wait for the incoming interest revenue and the repayment of the principal. Reclassifications should also be possible when there is a change in the business model. This may, for instance, be the case whenever new segments are being introduced, or when the overall strategy changes.

At the same time, however, we are aware of the fact that reassignments to different classifications need to be accompanied by appropriate disclosures.

**Question 8:**

**Do you believe that more decision-useful information about investments in equity instruments (and derivatives on those equity instruments) results if all such investments are measured at fair value? If not, why?**

Users of financial statements will only be able to get decision-relevant information if the internal management processes for corporate success drivers are illustrated as realistically as possible. This does not depend on the characteristics of the respective financial instruments but rather more on their economic use or, moreover, the way in which the company intends to generate success from such use.

In our view, the mandatory fair value measurement for unlisted equity instruments where the fair value cannot be determined in a reliable manner is highly spurious. We feel that a fair value which cannot be determined in a reliable manner does not offer any decision-useful information. The use of the fair value for such equity instruments does not improve comparability, either. This is due to the fact that they may be exclusively based on company specific estimation parameters. There is no indication of any value added in terms of information, if the "at cost" exemption is abolished. Instead, this merely results in considerable extra costs for companies. In our view, it needs to remain possible to measure strategic investments, where the fair value cannot be determined in a reliable manner, at amortised cost.

**Question 9:**

**Are there circumstances in which the benefits of improved decision-usefulness do not outweigh the costs of providing this information? What are those circumstances and why? In such circumstances, what impairment test would you require and why?**

Whilst it neither enhances comparability nor increases the level of decision-useful information, the abolition of the "at cost" exemption for certain financial instruments leads to considerable additional costs (please cf. our answer to question number 8).

In the event of an abrogation of the current waiver, a fair value determination would have to be carried out on every balance sheet date whilst an impairment test is only necessary in the presence of certain trigger events which can usually be defined, observed and assessed in a clear and unambiguous way. Hence, the need for an impairment test exists in far less cases and the reasons which would cause an impairment are known due to the trigger events. This does not only result in a reduced assessment caseload but instead the superior knowledge about the triggers for such impairment tests also allows a better anticipation of this workload.

**Question 10:**

**Do you believe that presenting fair value changes (and dividends) for particular investments in equity instruments in other comprehensive income would improve financial reporting? If not, why?**

We have already pointed out on various occasions that we are against a categorical fair value measurement of long-term investments, or, moreover, strategic equity stakes. Our objection is based on the fact that this approach does not provide any decision-useful information. Unrealised fluctuations in the value of long-term investments, or, moreover, strategic equity stakes should therefore only have an impact on the profit and loss statement if there is an impairment.

Therefore,, the presentation of unrealised value fluctuations in other comprehensive income (OCI) could be meaningful. However, we feel that the IASB's proposed approach of a "fair value through equity" measurement without recycling of realised profit and loss into the profit and loss statement is a source of great concern. This is due to the fact that for management and the public at large the parameter "earnings after tax" remains an important parameter. We also have reservations over the proposal of presenting dividend

revenue in other comprehensive income. If this proposal came into force this would lead to an asymmetrical presentation of revenue and costs (accounting mismatch). This is due to the fact that whilst the funding costs and administrative costs for the instruments would have to be recognised in the P&L, profit would be shown under other comprehensive income. The profit and loss statement would no longer serve as the central reporting tool for changes in the entity's financial position.

**Question 11:**

**Do you agree that an entity should be permitted to present in other comprehensive income changes in the fair value (and dividends) of any investment in equity instruments (other than those that are held for trading), only if it elects to do so at initial recognition? If not:**

- (a) How do you propose to identify those investments for which presentation in other comprehensive income is appropriate? Why?**
  
- (b) Should entities present changes in fair value in other comprehensive income only in the periods in which the investments in equity instruments meet the proposed identification principle in (a)? Why?**

As has already been pointed out in the answer to question number 10, the OCI option constitutes an alternative for the net income effect presentation of unrealised value fluctuations in the profit and loss statement. However, the implications resulting from the use of this OCI option constitute such a high burden that, similar to the category "held to maturity", it will hardly play any role in practice. The "recognition ban" on realised revenues and dividends from these equity instruments associated with the OCI option is inappropriate for financial reporting that seeks to be adequate and simple.

**Question 12:**

**Do you agree with the additional disclosure requirements proposed for entities that apply the proposed IFRS before its mandated effective date? If not, what would you propose instead and why?**

In view of the short lead time and the complexity as well as the further need for explanation, any implementation of the proposed new requirements before the mandated

effective date would be unrealistic. Furthermore, the EU user can only draw upon the option of an exempting IFRS consolidated financial statement once the corresponding provisions have been transposed into EU law. This, too, appears unlikely given the short period of time available.

Contrary to the current, more complex provisions under IAS 39, the proposed new requirements should lead to more decision-useful, transparent and comparable financial reporting. In our mind, this begs the question why more information in the notes should become necessary when these new provisions which are supposed to promote better financial reporting are implemented before their mandated effective date.

**Question 13:**

**Do you agree with applying the proposals retrospectively and related proposed transition guidance? If not, why? What transition guidance would you propose instead and why?**

The transitional rules constitute a very high hurdle for application, even provided there will be clarification of all pending items. This is primarily due to the obligation of the retrospective application of the new requirements. After all, this will require a renewed assessment of all existing circumstances and interrelations which were instrumental in the initial classification and their renewed financial statement. Especially when there are valuation changes of financial instruments which have already been held for several years, it would become necessary to reopen, access and – if needs be - amend the accounts for fiscal years that had already been closed by means of year-end-entries or, moreover, opening entries. This leads to a huge migration effort which, in part, cannot be achieved by means of the current accounting system architecture.

The new classification rules may also have an impact on the financial statement of hedging relationships. Whenever there is a retroactive classification adjustment, it will also be necessary to have the possibility of a retroactive change of the hedge accounting effects lest this would result in a misleading presentation of hedging relationships in the annual accounts. Especially the retroactive adjustment of the underlying transaction's carrying amount will also have to be adjusted to the value which would have resulted from retroactive hedge accounting.

On a more general note, we should like to suggest that during first-time-application, an adjustment entry be made under retained earnings. The statement of previous year's figures should be waived.

**Question 14:**

**Do you believe that this alternative approach provides more-decision useful information than measuring those financial assets at amortised cost, specifically: (a) In the statement of financial position? (b) In the statement of comprehensive income? If so, why?**

We do not feel that the alternative approach will lead to decision-useful information. Apart from this, such an approach would lead to an extension of the scope of fair value accounting. We object to this on the basis of the reasons mentioned above. Moreover, the alternative proposal would reintroduce liquidity as a classification criterion. Hence, the difficult differentiation between liquid and illiquid markets would reemerge.

**Question 15:**

**Do you believe that either of the possible variants of the alternative approach provides more decision-useful information than the alternative approach and the approach proposed in the exposure draft? If so, which variant and why?**

We do not think that either of the possible variants provides more decision-useful information than the alternative approach.

Yours sincerely,

For

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