AUSTRIAN FINANCIAL REPORTING AND AUDITING COMMITTEE

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Dear Hans,

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 Exposure Draft ED/2012/4 Classification and Measurement: Limited Amendments to IFRS 9 of November 2012 (ED). Principal authors of this comment letter were Peter Bitzyk, Peter Häfliger, Michael Hammer, Friedrich Hief, Heiner Klein, Philip Kudrna, Marietta Preiss, Ernst Schönhuber, Alexander Schiebel, Julia Stipek and Roland Nessmann.

AFRAC appreciates the opportunity to comment on the questions raised by the proposed limited amendments to IFRS 9 with respect to their practical application, particularly in the context of Austrian law and the particular features of Austrian financial instruments. Our comments deal with the questions raised by the classification issues as well as with the other questions, in particular with respect to business models and measurement.

GENERAL REMARKS

Respecting the efforts of the IASB to address specific application questions raised by interested parties, to take into account the interaction of the classification and measurement model for financial assets with the IASB's Insurance Contracts project, and to reduce key differences with the FASB tentative classification and measurement model for financial instruments, we nevertheless see a need for further clarifications and some adjustments.

Most importantly, we urge the Board to reconsider the following issues that are further explained in the comments to particular questions raised:

- The proposed amendment to the contractual cash flow characteristics assessment will mean that more assets may qualify for amortised cost accounting. However, relatively common features of financial instruments used in some jurisdictions – typically, widespread retail banking products – may still create the possibility of a difference in cash flows as compared with benchmark instruments, leading to measurement at FVTPL. In these cases – e.g., as explained in our comments on Q1 – measurement at fair value would in our opinion not result in a true and fair view presentation of these financial instruments.

- The interpretation of the term "not more than insignificantly" is crucial for the decision as to whether or not to value a specific debt instrument at fair value in situations where a modified economic relationship exists. We believe that the introduction of the new term is unfortunate and should be reconsidered.

- The operational application guidance currently provided is insufficient, especially when answering the question of when a detailed assessment has to be made or not. We suggest in our comments on Q1 how in our view a slightly improved classification process could eliminate most of the problems.

- On this basis as well as for operational reasons, we believe that, for classification at recognition, the classification process has to be performed at product group or product level, and not at the level of single financial instruments or at transaction level (details in comments on Q1).

- Mandatory application of the new "fair value through OCI" (FVOCI) category will increase the complexity of measurement categories again, and undermine the overarching aim of reducing the complexity of the current IAS 39. We believe that whenever a financial instrument fails the SPPI test and/or the business model 'hold to collect' test, it should in principle be classified as FVTPL. Only if the financial instrument is held within a 'collect or sell' business model should there be an option to assign it to the FVOCI category, but such designation should be optional, not mandatory.

IASB should amend IAS 39 in respect of the presentation of own credit risk in the financial statements as soon as possible, so as to not to further delay the benefit of increased relevance of this presentation until IFRS 9 is completed and in force.

CONTRACTUAL CASH FLOW CHARACTERISTICS ASSESSMENT

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?

1. The following approach to assessment should be clearly described, either in the standard, in the implementation guidance, or in the application guidance. After the assessment of the business

model within which the financial asset is held, the following sequence of tests should be applied to determine conformity of the asset's contractual cash flow characteristics.

2. If the financial asset in question satisfies all the criteria of the benchmark test for measurement at amortised cost, i.e., the cash flows are solely payments for principle and interest (SPPI), then the assessment is complete, and the financial asset should be measured at amortised cost.

3. Financial instruments with the following features should be treated the same way, thus leading to classification at amortised cost with no further testing needed:
    a. Many bank loans in Austria (in particular, government-regulated bank loans) have features which – at a first sight - would prevent classification of the payments as SPPI. The main features of these bank loans are not freely agreed between the parties: the main features and conditions of the agreement, e.g., purpose, main terms and interest rates, are determined by external bodies. Compliance with the restrictions on the use of the funds, the interest rate and other terms and conditions (e.g., collateral for the loan) are checked by the providers of the subsidies, which are usually government agencies. The justification given for this interference with freedom of contract is that the purpose for which the loan is being made is supported by public funds, generally for economic reasons or in the regional interest. Bank loans of this kind are most commonly provided for the construction of buildings, or else in support of manufacturing industry. Responsibility for making and administering these subsidised loans is transferred to the banks, which are also made responsible for parts of the documentation process. From the banks' point of view, the loans represent an extension of the product portfolio they can offer their customers. However, from the point of view of earnings, the benefit from such loans is often only the margin. This means that measurement other than at amortised cost would detract from a true and fair view, since because of the documentation that the banks are required to supply to the providers of the subsidies the loans can also not be disposed of. Products of this kind should not be assigned to the SPPI category, but should be measured and presented at amortised cost (relevant application forms and documents can be provided if IASB wishes).

    b. Additionally, there are product groups in Austria where the use of a base interest rate (typically, the Austrian average secondary market rate (SMR)) for an indefinite period is stipulated. The widespread use of the Austrian SMR was introduced for consumer protection purposes, because it reduces the volatility of the interest to be paid by consumers and facilitates the planning of future payments. The use of this interest rate is strongly supported by consumers and consumer protection organisations. We are aware that this interest rate is not the interest rate for the period, but we cannot identify any leverage effect in the interest rate, because the use of this interest rate helps the consumer to have reasonable, foreseeable payments in the future. Checking whether the projected loan repayments match the expected income of the consumer also forms an essential part of risk assessment when granting loans. As there is also no speculative element in such loans, we would propose classifying these loans at amortised cost.

    c. For financial assets where interest rates fixed for an indefinite period ("until further notice") are required by law, the conclusion is that, when the other criteria for classification at amortised cost (e.g., an appropriate business model) are met, these assets should be measured at amortised cost. The “until further notice” clause is merely intended to permit adjustment of the interest rate to reflect increased funding costs, and is generally not used for speculative purposes.

d. As in IAS 39, caps and floors that reduce the volatility of the relevant financial instruments (i.e., not embedded derivatives), or that are not already in the money at the outset, should be ignored in the SPPI assessment.

e. The use of an appropriate benchmark interest rate established not on the recognition date but at some prior time (e.g., preceding month-end rate or monthly average rate) should also be regarded as an insignificant modification only, provided that
   i. the interval does not exceed what is customary in practice, and
   ii. there have been no unusually large movements in interest rates in the period. E.g., This would be the case when for a loan granted on 5 or 15 December the interest rate at 30 November or the average interest rate for November were used, provided that there had been no significant changes in interest rates in the meantime.

f. Interest includes other components in addition to the time value of money, for example, liquidity costs. Precisely this factor was at the root of the last major crisis, and resulted in corresponding changes in Basel and EU regulatory requirements. This should not be ignored by IFRS 9. Contractual provisions that result in changes in the interest rate just because of changes in liquidity costs should not therefore be subject to a quantitative analysis as long as the qualitative analysis does not reveal hidden leverage features.

g. IFRS 9.B4.1.9B and IFRS 9.B4.1.9C should therefore be amended or expanded to cover cases in which the interest rate is agreed on the basis of the customer relationship as a whole or the resulting yield (e.g., as is often the case with loans). When subsequently there is a change in the relationship between customer and bank – for example, the bank is no longer the customer’s main banking partner – and a change in the interest rate under these conditions was contractually agreed, this should not be treated as a change in interest rate under IFRS 9 on the basis of a cash flow comparison with a hypothetical benchmark instrument. The bank would after all come to the same conclusion on the basis of a comparison with an actual new financial instrument with the same costumer. Thus the choice of a hypothetical benchmark instrument for financial assets should be based on the pricing considerations that the provider of the loan takes into account when granting a loan.

4. If one or more of the criteria in section 3 above are not met, and thus a classification under amortised cost based on a simple qualitative assessment of the relevant features cannot be made, then as a general rule and as a second step, a quantitative test should be applied to determine whether the modifications in the cash flows could lead to significant differences between the cash flows of the financial asset in question and actual or hypothetical benchmark cash flows.

a. As a first step, we suggest assessment on a global or product-level basis: as long as there have been no significant changes in the interest environment, comparisons of this kind can be made for standard financial assets in aggregate as well (adjusting for the relevant risk premium). Internal interest rate management should also be used in determining the significance of changes in the interest environment on a global or on a product-level basis.

b. Additionally, the following problems regarding the quantitative benchmark test need to be addressed:

c.
   (1) The test should – at least in our view – not be based on a comparison of cash flows, but on comparison of the present value of the cash flows.
   (2) In this comparison a new and therefore unclear technical term is used: "contractual cash flows that are more than insignificantly different from benchmark cash flows": in our view the phrase "more than insignificantly different" should be replaced by "significantly different" since "not more than insignificantly" will only result in additional interpretation problems. The introduction of a new term does not bring additional clarity into the grey area of professional judgement, which undoubtedly is required in making these assessments. In fact the opposite is true: it has to be feared that any new technical term the meaning of which is unclear will result in new interpretation problems, and prevent rather than encourage progress towards financial statements that are informative and comparable.

d.
   (1) When performing the quantitative (benchmark) test, the comparison should not be made by reference merely to cash flows, but by comparing the present value of the cash flows of the instrument in question with the present value of the cash flows of the benchmark instrument.
   (2) The result of this comparison depends on the expected interest rates used. The entity's internal interest rate risk management should be used in determining which the reasonably expected interest scenarios are. This internal focus is also supported by IFRS 9 (establishing the business model), and in the ED for IFRS 9 (General Hedge Accounting).

5. We believe that the IASB should carefully consider the above issues because, as the ED is at present formulated, relatively common features of financial instruments in some jurisdictions might lead to fair value measurement of large parts of the banks' portfolios. In particular, we believe the IASB should specifically consider whether or not the information that would result from measuring those instruments at fair value through profit and loss would be more useful for users of financial statements than measurement at amortised cost, which we believe to be the better information.

6. Additionally, the IASB should reconsider the introduction of a new term such as "not more than insignificantly" before finalising the standard, as we fear it will not increase clarity but reduce it.

7. We believe that the use of amortised cost for debt instruments with features such as those mentioned in section 3 above provides superior information for users of financial statements than

fair value measurement, as long as the intention is to collect interest and hold the originated loan until redemption.

8. As above, explicit exceptions should be made for instruments with features which may modify the economic relationship, but where measurement at amortised cost will still provide more useful information in the financial statements. A list of exceptions or examples in the standard or in the application guidance should be included, also and especially with reference to emerging markets (such as the CEE region).

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?

9. In our view, the currently available operational application guidance is not sufficient, especially in answering the question of when a detailed assessment has to be made (B4.1.9E).

10. A further substantial element of judgment will be needed to prove that modification is only associated with credit risk or only represents the time value of money where no benchmark instrument exists. Additional guidance should be included in B4.1.8A to clarify what is meant by "unrelated".

11. We are concerned that preparers of financial statements as well as auditors will interpret the currently available guidance in IFRS 9 in different ways, ultimately resulting in inconsistent application.

12. Moreover, the assessment at initial recognition as proposed will require significant implementation efforts and resources, because the assessment has to be based on all information (historical experience, current conditions and future forecasts) available to the holder at the time of initial recognition, and applying judgment. It is also unclear whether the assessment should be at transaction level or at product level.

13. To reduce the operational burden on preparers of financial statements, we propose including in the application guidance a clarifying comment that the SPPI assessment can be applied at product level (e.g., all consumer loans or mortgage loans with the same interest features can be assessed at once).

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?

14. We see the need for further clarification as described above, especially in relation to Q1.

BUSINESS MODEL ASSESSMENT

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 recognized in profit or loss in the same manner as for financial assets measured at amortized cost; and

b. all other gains and losses are recognized in OCI?

If not, why? What do you propose instead and why?

15. Seeing the need to simplify financial accounting under IAS 39 by reducing the number of rules, we accept the need for new classifications under IFRS 9. We would, however, prefer the following process of classification.

16. If a financial instrument passes the SPPI test as well as the business model test, it is to be categorised initially at amortised cost.

    a. If a financial instrument fails one of these tests, it should in principle be assigned to the FVTPL category.
    b. Only where the instrument passes the SPPI test and the business model at the same time meets the “hold and sell” requirements, should there be an option –but not an obligation – to assign the instrument to the FVOCI category on initial recognition.

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?

17. We believe that the operational application guidance for the differentiation between FVOCI (“hold and sell”) and FVTPL and between FVOCI (“hold and sell”) and amortised cost ("hold and collect") should be based on our answer to Q4 above. We are concerned that the preparers of financial statements as well as the various auditors will interpret the existing guidance in IFRS 9 in different ways, which will ultimately result in inconsistencies in the market.

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?

18. See our answer to Q4 above.

EARLY APPLICATION

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 (i.e. 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?

19. Considering the complexity arising from a phased application, we agree in principle that the early application of IFR 9 should require the application of IFRS 9 in its entirety once the standard has been finalised (except the 'own credit' provisions – see answer to Q8). We would also agree with the six-month transition period. But EU companies will only be allowed to use IFRS 9 once it has been endorsed, and this will not be the case before the Standard has been completed. Thus we do not believe that this question will be of relevance for EU companies.

OWN CREDIT PROVISIONS

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?

20. We believe that entities should be permitted to early apply the 'own credit' provisions in IFRS 9. The application of the current requirements means that improving perceptions of an entity's creditworthiness reduces earnings, and worsening perceptions of creditworthiness increases earnings. Such counter-intuitive earnings volatility proved to be very large, particularly for preparers of financial statements in the banking industry. But EU-companies will only be allowed to use IFRS 9 when it is endorsed, and this will not be the case before the Standard is completed. Thus we do not believe that this question is of relevance for EU companies.

21. We strongly encourage IASB to amend IAS 39 to allow the above mentioned 'own credit' provisions of IFRS 9 within IAS 39 (and the EU to endorse this). This would help to increase relevance in the presentation of the financial statements. This rule could be endorsed quite soon and would help all companies which are obliged to use IFRSs as endorsed by EU.

FIRST-TIME ADOPTION

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?

22. We do not have any specific comments regarding first-time adopters.

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