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March 31, 2011

Re: Supplement to ED/2009/12 Financial Instruments: Amortised Cost and Impairment

Dear Sir David,

Commerzbank AG, the second largest credit institution in Germany and one of Europe's major banks, is pleased to respond to the "Supplement to ED/2009/12 Financial Instruments: Amortised Cost and Impairment" (the "SD").

We appreciate the efforts of the IASB to address some of the deficiencies of the Expected Cash Flows Model proposed in the ED/2009/12. In particular we welcome the de-coupling, the development of an impairment model for open portfolios and the Good Book/Bad Book distinction. These changes would allow banks to achieve a much higher alignment of their provisioning methodology with internal credit risk management.

We also understand that the proposed model represents a political compromise made in order to achieve convergence with US GAAP and that this should be considered when evaluating the proposed joint model in the SD. However, we still have the following concerns with the joint model:

- As the loan loss allowance cannot be fully used to absorb credit losses when they occur, we fear
 that the model, instead of achieving a stabilising effect, would lead to a pro-cyclical reduction of
 regulatory capital. We have already raised this concern in our earlier comment letter to ED/2009/12.
- The establishment of a floor is not consistent with the rationale of the model originally proposed by the IASB, whose goal is to ensure an alignment between interest recognition and expected losses. Furthermore, a floor based on the concept of the "foreseeable future" does not provide meaningful information for users as it sets false incentives and undermines comparability. Therefore, we believe that the floor should be removed from the model.
- Even though we welcome in principle a model with time-proportional Expected Loss recognition, we believe that the backward-looking nature of the proposed time-proportional model (based on the ratio between "Weighted-Average Age" and "Weighted-Average Life") is not consistent with the forward-looking nature of the Expected Loss.



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Although none of the approaches in the SD fully satisfies our significant concerns, we understand that it would take a long time for the Boards to review the fundamental principles, and hence we recognise the need to express a preference for one of the models in the SD. We have based our preference on the capability of the model to align interest recognition and loan loss provisioning in the financial reports.

From this perspective, we can support neither the FASB approach nor the joint approach. Furthermore, the joint proposal combines two conflicting concepts, imposing an overlay of immediate recognition of impairment losses based on "foreseeable future" (floor) onto the matching principle, which would convey inconsistent information in the financial reports.

Therefore, we would favour the IASB approach (time-proportional without floor), despite the fact that it has a backward-looking nature that is not consistent with the forward-looking objective of an expected loss model.

We elaborate further our concerns and recommendations below.

Missing usability of the loan loss allowance and impact on regulatory capital

We believe that the proposed time-proportional impairment approach continues to not allow for full usability of the loan loss allowance to cover impairment losses when they occur. This will increase procyclicality in profit & loss which is carried forward directly to Tier I capital. Furthermore this pro-cyclical effect is boosted by the ongoing initiatives by the Basel Committee on Banking Supervision, which is currently imposing stricter minimum capital requirements (Basel III).

Furthermore, we believe that the pro-cyclical effect as described above could also have a negative impact on the stability of the financial system. Especially in times of high credit losses, banks would experience a significant regulatory capital reduction. In order to meet regulatory capital requirements, this would give rise to tighter lending policies that will have negative impacts on the economy.

Hence, we emphasise again our expectation that the IASB and the Basel Committee will further review this issue.

Inconsistency of the floor

We believe that introducing a floor for the loan loss allowance would contradict the goal of aligning interest recognition with loan loss provisioning. Based on our analysis, we expect the floor to come into effect especially at the beginning of a loan life. This would introduce a significant day-one loss element.

At the same time, we have concerns on the concept of "foreseeable future":

- It would result in penalising banks with a higher ability to foresee future losses, as these banks would have to set up relatively higher loan loss allowances.
- It would result in a lower degree of comparability due to the different interpretations of "foreseeable future" in practice.



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We strongly believe that a floor is not consistent with the rationale of a proper expected loss impairment model. However, if, for political reasons, a floor has to be incorporated, we would demand that the floor should be based on the same time period for all entities in order to ensure comparability. This floor should be limited to a 1-year time-horizon, as a 1-year expected loss is the amount for which financial institutions could provide the most relevant and most validated loss estimations since it is already required and applied under Basel II.

Time-proportional recognition of expected losses

We are concerned with the concept of the time-proportional approach proposed in the SD, which we view to be backward-looking. Incorporating this into a forward-looking expected loss impairment model would lead to results that are not economically meaningful and would be difficult to interpret. It could hardly be argued that two loans with the same remaining lifetime and the same expected loss over the remaining lifetime will have a different loan loss allowance because one of them has a longer original lifetime (and thus its time-proportion would be higher). This logic would encourage arbitrage. However, we acknowledge that at this point of time it might be difficult to develop a new approach, despite our belief that the above issue represents a major inconsistency and is a shortcoming of the SD. Therefore, we suggest that the Boards discuss this issue again in due time when sufficient practical experience has been obtained.

Due process

We believe that the publication of the SD does not follow the spirit of the IASB's due process.

The SD covers only some aspects of an overall expected loss impairment model for determining credit losses in open portfolios. There are other aspects (e.g. methods of measuring credit losses, definitions of "write-off", interest revenue recognition, etc.) that are not included. In our view, it is not possible to develop an opinion on a new standard without having a full overview across all accounting requirements. Therefore, we expect the IASB to re-expose the impairment model in its entirety. In this context it is crucial to ensure that there will be only one single impairment model applicable to all financial assets at amortised cost.

At the same time, we believe that the proposals in the SD are significant and that the IASB should have given constituents the appropriate time to understand and analyse their impacts. Given the short comment period and the fact that it coincides with the annual reporting period, the IASB has not provided this opportunity.

Consequentially, we believe that the planned 30th June 2011 should not be seen as the binding deadline for the publication of the final impairment model.



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Our detailed responses to the invitation to comment questions are included in the Appendix to this letter. Our views expressed in this comment letter may be subject to change at a later stage as and when we obtain a more complete picture, including those areas that are currently out of scope in the SD.

We thank the Board for considering our comments and would be pleased to meet with the Board or its staff at your convenience to discuss our concerns raised in this comment letter.

Kind regards,

COMMERZBANK Aktiengesellschaft

Joerg Erlebach

Head of Group Risk Controlling &

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Appendix

General

Question 1

Do you believe the approach for recognition of impairment described in this supplementary document deals with this weakness (i.e. delayed recognition of expected credit losses)? If not, how do you believe the proposed model should be revised and why?

While we acknowledge that the proposed impairment model represents a significant improvement to the ED/2009/12, allowing banks to implement an Expected Loss Approach with much higher alignment with internal credit risk management, we believe that the proposed approach still has significant weaknesses in reflecting the economic rationale of loan transactions (consistency of establishing loan loss provisions with interest recognition in the financial reports), which are listed below:

- The loan loss allowance cannot be fully used to absorb credit losses when they occur. As a consequence, instead of achieving a stabilising effect, the model would lead to a procyclical reduction of regulatory capital.
- The establishment of a floor is not consistent with the rationale of the model originally proposed by the IASB, whose goal is to ensure an alignment between interest recognition and expected losses.

Scope - Open Portfolios

Question 2

Is the impairment model proposed in the supplementary document at least as operational for closed portfolios and other instruments as it is for open portfolios? Why or why not? Although the supplementary document seeks views on whether the proposed approach is suitable for open portfolios, the boards welcome any comments on its suitability for single assets and closed portfolios and also comments on how important it is to have a single impairment approach for all relevant financial assets.

We believe that the same impairment model for expected losses in the good book should apply to all financial instruments measured at amortised cost. The introduction of different impairment models for instance for closed portfolios would add an additional and unnecessary layer of complexity to loan loss measurement.



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We also observe that closed portfolios are an exception and arise only in the case of run-off businesses. Nevertheless, in this case we see no economic difference which could justify a different impairment measurement for run-off businesses, as the underlying nature for expected loss estimation remains unchanged.

Differentiation of credit loss recognition

Question 3

Do you agree that for financial assets in the 'good book' it is appropriate to recognise the impairment allowance using the approach described above? Why or why not?

No.

Although moving towards an expected loss impairment model is a step in the right direction, in our view the joint model is not appropriate for recognising the impairment allowance, since in our view it has significant weaknesses, which can be summarised as follows:

- The loan loss allowance cannot be fully used to absorb credit losses when they occur. As a consequence, instead of achieving a stabilising effect, the model would lead to a procyclical reduction of regulatory capital.
- The establishment of a floor is not consistent with the rationale of the model originally proposed by the IASB, whose goal is to ensure an alignment between interest recognition and expected losses.
- Even though we welcome, in principle, a model with time-proportional Expected Loss recognition, we believe that the backward-looking nature of the proposed time-proportional model (based on the ratio between "Weighted-Average Age" and "Weighted-Average Life") is not consistent with the forward-looking nature of the Expected Loss. It can be hardly argued that two portfolios with the same expected loss and remaining life will have a different loan loss allowance because one of them has a longer average lifetime (and thus its time-proportion is higher).

Although none of the approaches in the SD fully satisfies these significant concerns, we understand that it would take a long time for the Boards to review the fundamental principles, and hence we recognise the need to express a preference for one of the models in the SD. We have based our preference on the capability of the model to align interest recognition and loan loss provisioning in the financial reports.

From this perspective, we can support neither the FASB approach nor the joint approach. Furthermore, the joint proposal combines two conflicting concepts, imposing an overlay of immediate recognition of impairment losses based on foreseeable future (floor) onto the matching principle, which would convey inconsistent information in the financial reports.



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Consequently we would favour the original IASB approach (time-proportional without floor), despite the fact that it has a backward-looking nature that is not consistent with the forward-looking objective of an expected loss model.

Question 4

Would the proposed approach to determining the impairment allowance on a time-proportional basis be operational? Why or why not?

We point out that remarkable implementation efforts (with significant costs) will be necessary to collect all information and data which are required for impairment measurement under the time-proportional impairment model without floor. This relates for instance to the collection of a loan loss data history to estimate the lifetime expected loss (currently only the 12 months expected loss is estimated, as required for capital adequacy purposes), the estimation of the economic life of financial assets and so forth. Furthermore, all new information will have to be subject to rigorous backtesting in order to make the results auditable and reliable for decision-making purposes.

All of this represent a major challenge to financial institutions and will require significant changes to the current internal processes, IT systems, etc. Therefore we expect that IASB will grant entities a sufficient time to implement the new impairment methodology. We do not expect that any effective date before 01.01.2015 will be realistic.

Additional complexity would be caused by introducing the concept of foreseeable future (which we do not support, as stated in our answer to question 9) to the time-proportional model, since this would require the introduction of a second model.

Question 5

Would the proposed approach provide information that is useful for decision-making? If not, how would you modify the proposal?

No.

The joint model (time-proportional with floor) combines two different concepts for the loan loss allowance. This results in the possibility that, within the same financial institution, the allowance is measured for some portfolios with the time-proportional approach and for other with the expected loss for the fore-seeable future (floor). Additionally, this results in the risk of switching between those concepts over subsequent reporting periods. This would be misleading and would not result in useful information.

Furthermore, we believe that to the extent that the floor applies, additional misleading results would arise. This is due to the fact that the floor introduces a day-1 loss, which penalises loan granting and



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introduces a high degree of P&L volatility, which is not justified by the underlying rationale of loan transactions.

Furthermore, we are concerned with the low degree of comparability arising from the concept of fore-seeable future. Separate entities with different capability to estimate loan losses for the future will be likely to have different time horizons for their foreseeable future. Since we expect that the floor will be applicable in many portfolios if it is set significantly higher than 12 months, this difference in foreseeable future will also result in hardly comparable loan loss allowances.

The loan loss allowance represents key information in financial statements' analysis for financial institutions, and we firmly believe that any concept which would significantly reduce the degree of comparability across entities or over time cannot result in useful financial information for decision-making. We also do not believe that this issue can be resolved by requiring extensive disclosure in the notes to the financial statements.

Question 6

Is the requirement to differentiate between the two groups (ie 'good book' and 'bad book') for the purpose of determining the impairment allowance clearly described? If not, how could it be described more clearly?

We support, in principle, to align the treatment of good book and bad book with the entity's internal credit risk management.

However, we fear that proposed differentiation in the SD does not allow a clear distinction between the two books, as banks usually have different stages and degrees of uncertainty about collectability of contractual loan payments; furthermore, these stages might also differ significantly across banks.

Therefore, it is, in our view, important to clarify that a transfer into the bad book should occur as soon as there is evidence supporting that contractual cash flows from a given financial asset at amortised cost will not be recoverable in full. For financial institutions, this would be consistent with the definition of default under Basel II.

This distinction criterion also has the advantage of clarifying that loans subject to a closer risk monitoring without meeting Basel II default criteria (e.g. loans in the watchlist) are typically not included in the bad book.



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Question 7

Is the requirement to differentiate between the two groups (ie 'good book' and 'bad book') for the purpose of determining the impairment allowance operational and/or auditable? If not, how could it be made more operational and/or auditable?

As long as it is ensured that the distinction between the two books is consistent with internal credit risk management and that the definition of a default event under Basel II could be applied (as described in our answer to question 6), we believe that the differentiation is operational and auditable.

Question 8

Do you agree with the proposed requirement to differentiate between the two groups (i.e. 'good book' and 'bad book') for the purpose of determining the impairment allowance? If not, what requirement would you propose and why?

Yes.

Minimum impairment allowance amount

Question 9

The boards are seeking comment with respect to the minimum allowance amount (floor) that would be required under this model. Specifically, on the following issues:

- (a) Do you agree with the proposal to require a floor for the impairment allowance related to the 'good book'? Why or why not?
- (b) Alternatively, do you believe that an entity should be required to invoke a floor for the impairment allowance related to the 'good book' only in circumstances in which there is evidence of an early loss pattern?
- (c) If you agree with a proposed minimum allowance amount, do you further agree that it should be determined on the basis of losses expected to occur within the foreseeable future (and no less than twelve months)? Why or why not? If you disagree, how would you prefer the minimum allowance to be determined and why?
- (d) For the foreseeable future, would the period considered in developing the expected loss estimate change on the basis of changes in economic conditions?



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- (e) Do you believe that the foreseeable future period (for purposes of a credit impairment model) is typically a period greater than twelve months? Why or why not? Please provide data to support your response, including details of particular portfolios for which you believe this will be the case.
- (f) If you agree that the foreseeable future is typically a period greater than twelve months, in order to facilitate comparability, do you believe that a 'ceiling' should be established for determining the amount of credit impairment to be recognised under the 'floor' requirement (for example, no more than three years after an entity's reporting date)? If so, please provide data and/or reasons to support your response.

In our view, the objective of the new impairment methodology should be to adequately portray the economics of the transactions (achievement of a high degree of alignment between interest recognition and loan loss provisioning) and, based on this perspective, we believe that the floor through its day-1 loss effect and missing link to interest recognition undermines this objective.

Furthermore, we do not believe that it is appropriate to base the floor on the concept of foreseeable future, as this would result in penalising more sophisticated banks with a higher capability to foresee future losses (as these banks will have to set up a higher loan loss allowance). The degree of flexibility for the foreseeable future (depending on the ability to foresee losses) would also result in a lower degree of comparability of the loan loss allowance across entities. Additionally, the foreseeable future floor results in the risk of switching between these two concepts over subsequent reporting periods. This would be misleading and would not result in useful information.

However, we acknowledge that it is desirable to have the same set of impairment rules for IFRS und US GAAP preparers and that the introduction of a floor might be unavoidable (even though not consistent with the rational of the time-proportional model) to achieve accounting convergence. Therefore, we believe that the floor should not be based on the concept of foreseeable future but on the 12-month expected loss. This would have the advantages of ensuring a higher degree of comparability across entities (and over time) and of mitigating the day-1 loss issue and the inconsistency with a loan loss recognition which is aligned with interest recognition. Furthermore, we believe that the estimation of a floor for the 12-month expected loss would allow the use of expected loss data currently employed for regulatory capital purposes, which represent the most relevant and validated loss estimations available in financial institutions.



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Question 10

Do you believe that the floor will typically be equal to or higher than the amount calculated in accordance with paragraph 2(a)(i)? Please provide data and/or reasons to support your response, including details of particular portfolios for which you believe this will be the case.

Given the short comment period of the SD and the fact that it coincides with the annual reporting period, we have not been given the appropriate time for a valid analysis of the impacts of the proposed impairment methodology. Therefore it was not possible to analyse in depth in which cases the floor is likely to be the binding requirement.

In general, the longer the period for the foreseeable future is set, the more likely the floor would be the binding requirement for determining the loan loss allowance diluting the time-proportional approach.

Flexibility related to using discounted amounts

Question 11

The boards are seeking comment with respect to the flexibility related to using discounted amounts. Specifically, on the following issues:

- (a) Do you agree with the flexibility permitted to use either a discounted or undiscounted estimate when applying the approach described in paragraph B8(a)? Why or why not?
- (b) Do you agree with permitting flexibility in the selection of a discount rate when using a discounted expected loss amount? Why or why not?

(a)

Yes.

We understand that entities use different methodologies for measuring the expected loss of their loan portfolio and that it is therefore not possible to impose the same methodology on all entities.

(b)

Yes.



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We agree that the IASB should permit flexibility in the selection of a discount rate when using a discounted expected loss amount. The prescription of a single discount rate is inconsistent with the objective of an alignment with internal credit risk measurement and management.

By granting flexibility in the discount rate, it is recognised that it is neither possible nor meaningful to impose the same discount rate in situations in which the lifetime expected loss for the portfolio is calculated differently.

Approaches developed by the IASB and FASB separately

Question 12

Would you prefer the IASB approach for open portfolios of financial assets measured at amortised cost to the common proposal in this document? Why or why not? If you would not prefer this specific IASB approach, do you prefer the general concept of the IASB approach (ie to recognise expected credit losses over the life of the assets)? Why or why not?

Yes.

If we were required to choose one of the three impairment models described in the SD, we would prefer the IASB approach without floor.

Question 13

Would you prefer the FASB approach for assets in the scope of this document to the common proposal in this document? Why or why not? If you would not prefer this specific FASB approach, do you prefer the general concept of this FASB approach (i.e. to recognise currently credit losses expected to occur in the foreseeable future)? Why or why not?

No.

We do not agree with the FASB approach to require full recognition of credit losses expected to occur in the foreseeable future. This approach results in a day-1 loss recognition and does not fulfil the matching principle between interest recognition and loan loss provisioning. Thus, it fails to reflect the economic nature of the underlying loan transactions.



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Question 14Z

Do you agree that the determination of the effective interest rate should be separate from the consideration of expected losses, as opposed to the original IASB proposal, which incorporated expected credit losses in the calculation of the effective interest rate? Why or why not?

Yes.

The introduction of decoupling represents in our view one of the most significant improvements to the original impairment model proposed in the ED/2009/12. In our view, it is important that the decoupling will also apply to the areas (like closed portfolios and single instruments) which are currently out-of-scope.

Scope - loan commitments and financial guarantee contracts

Question 15Z

Should all loan commitments that are not accounted for at fair value through profit or loss (whether within the scope of IAS 39 and IFRS 9 or IAS 37) be subject to the impairment requirements proposed in the supplementary document? Why or why not?

Yes.

At most financial institutions (like ours), the expected loss is calculated jointly for on- and off-balance sheet exposures (as they are both included in the Exposure at Default), and therefore it would in our view be an improvement if both could be subject to the same impairment methodology.

Question 16Z

Would the proposed requirements be operational if applied to loan commitments and financial guarantee contracts? Why or why not?

Yes.

We believe that the requirements are operational for both loan commitments and financial guarantee contracts.



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Presentation

Question 17Z

Do you agree with the proposed presentation requirements? If not, what presentation would you prefer instead and why?

Yes.

We agree with the proposed presentation approach to require impairment losses to be presented separately from interest revenue (de-coupling). However, as mentioned in our answer to question 2, this should apply consistently to impairment of all financial assets at amortised cost

Disclosure

Question 18Z

- (a) Do you agree with the proposed disclosure requirements? If not, which disclosure requirements do you disagree with and why?
- (b) What other disclosures would you prefer (whether in addition to or instead of the proposed disclosures) for the proposed impairment model and why?

Given the short comment period and the great number of issues which had to be discussed for the SD, it was not possible to analyse in depth the consequences and implications of the proposed disclosure requirements. However, even after a cursory analysis, we have some significant concerns regarding the proposed disclosure requirements. For instance, we are concerned with the reconciliation of nominal amounts of loans in the bad book and with the requirement to disclose comparative information for five periods for the data listed in paragraph Z8 of the SD. We do not believe that disclosure of unnecessarily long time-series improves the quality of disclosed information.

Furthermore, we point out that a comprehensive evaluation of the new disclosure requirements is not possible, as several crucial areas are still open. In particular, consistent with our concerns with the disclosure requirements of the ED/2009/12, we would welcome the decision not to require disclosure for stress-testing and vintage-analysis.



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Question 19Z

Do you agree with the proposal to transfer an amount of the related allowance reflecting the age of the financial asset when transferring financial assets between the two groups? Why or why not? If not, would you instead prefer to transfer all or none of the expected credit loss of the financial asset?

We would point out that all three alternatives lead to the same overall results in the P&L and B/S. Therefore, we believe that the final standard should not specify what amount can be transferred and rather require that the method used be consistent with internal management and processes. Appropriate disclosures of the chosen methodology should be required to enhance transparency of financial information.