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Supplement to ED/2009/12, Financial Instruments: Impairment  
April 1, 2011

Dear Sir David,

We appreciate the opportunity to comment on the Supplement to Exposure Draft ED 2009/12, Financial Instruments: Impairment (the "Supplement"). This cover letter gives context to the detailed responses to specific questions posed in the Supplement, which are set forth in the pages that follow.

Allianz Group is a global financial services company operating within the insurance, asset management and banking markets. As of December 31, 2010, we had investments and loans totaling approximately €457 billion, many of which measured at amortized cost. Accordingly, not only are we familiar with the current incurred-loss model approach to impairment, but the potential impact of a new impairment model is very significant to us from both a financial statement and operational cost perspective. As such, we hope our comments and observations are deemed both relevant and useful to you in your deliberations of this important topic. Given, however, the narrow window for analyzing the Supplement and providing related comments, our response is limited to those areas in which we are most immediately concerned. Topics outside the scope of the Supplement, such as measurement, are not addressed.

In general, we welcome the IASB deliberations to date and the direction of the overall discussion, including the consultation of the Expert Advisory Panel (the "EAP") on operational implications. We support the development of an expected loss model and the efforts to seek convergence with the FASB on these issues. We emphasize the importance of a principles-based impairment model that can be applied to all instruments eligible for amortized cost under IFRS 9, including not only loans, but other types of fixed income investments such as bonds, which generally make up a significant share of asset portfolios for long-term investors such as insurance companies, pension funds, endowments and foundations. Moreover, we highlight the importance of reducing complexity in the accounting for financial instruments, a topic of importance highlighted in recent years by the Financial Crisis Advisory Group and others.

Regarding the specific proposals outlined in the Supplement, we welcome certain items. For example, we support the proposals with regard to decoupling (ie, the separate determination of the effective interest rate from the consideration of expected losses) and the availability of options to allocate expected losses based on straight-line or annuity methods, discounted or undiscounted, in the time-proportional model. We agree that these practical expedients may alleviate some of the operational burden that would have resulted from the proposals in ED 2009/12.
Nevertheless, there are areas of the Supplement that raise some concern:

- It is apparent from the Supplement and relevant staff papers used in the preceding deliberations that many of the concepts introduced by the Supplement were designed largely with a bank lending business in mind. However, we note that loans are only one subset of instruments eligible for amortized cost measurement under the IFRS 9 classification and measurement rules. Accordingly, it is critical that an expected loss model not be designed with just one specific type of financial instrument in mind.

- We consider the concept of a good book and bad book to be more suited for lending operations. While such a concept may not necessarily be incompatible with non-loan investments, we note that different criteria would likely need to be used for determining the split between good book and bad. As explained in the detailed responses that follow, we prefer the use of internal risk management processes in conjunction with clearly defined and consistently applied criteria.

- Although we welcome the efforts to achieve convergence in the context of this project, we do have some concerns about the minimum impairment loss allowance (ie, floor) amount. Indeed, the introduction of the floor concept can be seen as effectively blurring the underlying principles of the expected loss model. Moreover, it may raise questions related to complexity and comparability.

- Finally, we are wary of prescriptive, rules-based standards. Some aspects of the Supplement, such as the specific mandate of the partial catch-up method as opposed to other alternatives considered feasible by the EAP, appear to us to be overly prescriptive. As noted above, we support the development of a sound, principles-based standard.

Details regarding all points noted above can be found in the pages that follow. We would be pleased to discuss our comments with you.

Yours sincerely,

Dr. Susanne Kanngiesser
Head of Group Accounting
Question 1

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

Yes. We believe that the Supplement to Exposure Draft ED/2009/12, Financial Instruments: Impairment (the "Supplement") deals with the shortcoming noted above by introducing expected credit losses into impairment loss recognition rules. The ultimate extent to which the Supplement incorporates expected losses, however, must be evaluated in the context of other key considerations including the reduction in complexity, as discussed in further detail below.

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 are cognizant of the commitments made by the IASB and FASB in response to requests by the Group of Twenty Finance Ministers and Central Bank Governors to reduce the complexity of accounting standards for financial instruments, as well as achieve a single set of high quality, global accounting standards. We support theses commitments.

To that extent, we consider that a single impairment model for all assets measured at amortized cost is preferable to a fragmented collection of different impairment approaches. From our perspective, applying the proposal in the Supplement to closed portfolios and single instruments does not raise additional concerns beyond those commonly identified in applying the Supplement's approach to open portfolios. Nevertheless, we emphasize the importance of a principles-based impairment model that can be applied to all instruments eligible for amortized cost measurement under IFRS 9, including not only loans but other types of fixed income investments such as bonds, which generally make up a significant share of asset portfolios for long-term investors such as insurance companies, pension funds, endowments and foundations.
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?

Question 4

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

Question 5

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

In general, we support the idea of recognizing expected credit losses over the lifetime of a financial asset. However, as discussed further in our response to Question 9, we have certain concerns regarding the introduction of the minimum allowance amount (floor).

With regard to the determination of the time-proportional impairment allowance, we appreciate the board's deliberations with the Expert Advisory Panel (the "EAP") on operational implications of the new impairment model. Although we note that the EAP discussed the operational feasibility of two alternative approaches, it appears that the Supplement clearly prescribes only one of the EAP's discussed approaches (ie, the 'partial' catch-up approach in favour of the 'no' catch-up approach), seemingly without any clear rationale explaining this determination. In general, and as noted elsewhere in this response, we support the allocation of expected credit losses over time based upon the link between expected losses and an instrument's pricing. Furthermore, we welcome the availability of reasonable simplifications (eg, choice of straight-line vs. annuity approaches). However, we question the decision to mandate one specific method for expected loss estimates, especially if it is not the only available method consistent with the underlying principles. Indeed, we do not consider this to be consistent with a principles-based standard.

The introduction of an impairment loss allowance combined with immediate loss recognition of "non-performing" financial assets would provide decision useful information. Nevertheless, as discussed further below, we question whether there is not further room to reduce the complexity of the Supplement's proposal.

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?
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?

Question 8

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

In general, we would answer "yes" to Questions 6-8.

We support the recognition of expected losses over time for "performing" assets (ie, the good book) and the immediate recognition of losses for "non-performing" assets (ie, the bad book). Moreover, we are in favour of using credit risk management systems in conjunction with clearly defined and consistently applied internal criteria to determine whether assets belong in either the good book or the bad book. Naturally, this involves some trade-off in terms of comparability, as entities may have different approaches to credit risk management depending, for example, on the nature of the investor and the type financial assets concerned. While certain staff papers have suggested that loans which are a certain number of days past-due belong in the bad book, we would not necessarily apply such criteria to an open portfolio of bonds. For example, we consider that clearly-defined and objective criteria such as events of default and restructurings would be sufficient to transfer bonds into the bad book. So long as decisions are based on sound processes and consistently applied, however, we consider the differentiation requirement sufficiently operational and auditable. Indeed, we prefer the Supplement’s principles-based approach to distinguishing good book and bad book to a rules-based approach.

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?
Question 9 (continued)

(e) For the foreseeable future, would the period considered in developing the expected loss estimate change on the basis of changes in economic conditions?

(f) 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?

(g) 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.

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.

As noted above, we have concerns regarding the introduction of the minimum allowance amount (floor). In particular, we remain to be convinced that the requirement to estimate an expected loss for the “foreseeable future” at every period is truly worth the increase in complexity that it causes.

Our understanding is that the intention of the floor is to ensure an adequate level of provisioning for financial assets that may have early loss emergence patterns. As the intention does not relate to all financial assets within scope of the Supplement (e.g., early loss emergence patterns may only be observed at certain points in the economic cycle or may only be associated with certain types of credits such as loans to early stage companies), it can therefore be questioned whether the proposed floor requirement is sensible to mandate for all preparers at all times. Alternatively, if a significant loss is considered imminent, certain preparers may consider a transfer to the bad book appropriate, thereby obviating the need for a floor under many circumstances.

In terms of how the floor would typically compare to the time-proportional impairment loss allowance in terms of amount, the answer depends on several different factors, and the prescribed comment period does not allow for us to provide a fully conclusive response based on quantitative data. Nevertheless, some of the critical variables involve how long the “foreseeable future” period is, the weighted average age of assets in the good book and under what conditions an entity’s credit risk management processes require assets to be transferred from good book to bad.
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?

In general, we are supportive of the overall flexibility related to using discounted amounts. Depending on the overall maturity of a certain portfolio, for example, certain preparers may or may not consider it appropriate to discount lifetime expected credit losses. Moreover, and consistent with our remarks on determining the time-proportionate impairment loss allowance, we are opposed to prescriptive rules for calculating the appropriate discount rate.

Rather than advocate specific measurement techniques, we would prefer a standard that outlines clear principles which enable preparers to calculate and utilize discount rates that are appropriate for how they respectively manage credit risk. Certain paragraphs of the Exposure Draft ED/2010/8, Insurance Contracts, for example, clearly emphasize substance over form:

"An insurer shall recognise the residual margin determined at initial recognition as income in profit or loss over the coverage period in a systematic way that best reflects the exposure from providing insurance coverage, as follows:

(a) on the basis of the passage of time, but
(b) on the basis of the expected timing of incurred claims and benefits, if that pattern differs significantly from the passage of time."

Consistent with our responses to other questions, we would recommend a strong, principles-based approach rather than a prescriptive, rules-based approach.

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?

We would prefer to recognise expected credit losses over the life of the assets. As noted above in our response to Question 9, we have concerns about the floor concept as introduced in the Supplement.
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 recognize currently credit losses expected to occur in the foreseeable future)?

No. We prefer the recognition of expected credit losses over the life of the assets as we support the principle that the expected credit loss is economically related to the pricing of the financial instrument. In principle, we believe that focusing on only a portion of an asset’s lifetime may decrease transparency and run the risk of ignoring credit risks of rare situations.