EFRAG
European Financial Reporting Advisory Group

Draft Comment Letter

Comments should be submitted by 18 March 2013 to Commentletters@efrag.org

XX March 2013

International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

Dear Sir/Madam,

Re: Exposure Draft Classification and Measurement: Limited Amendments to IFRS 9

On behalf of the European Financial Reporting Advisory Group (EFRAG), I am writing to comment on the Exposure Draft *Classification and Measurement: Limited Amendments to IFRS 9 (proposed amendments to IFRS 9 (2010))* issued by the IASB on 28 November 2012 (the 'ED').

This letter is intended to contribute to the IASB's due process and does not necessarily indicate the conclusions that would be reached by EFRAG in its capacity as advisor to the European Commission on endorsement of definitive IFRS in the European Union and European Economic Area.

EFRAG welcomes the IASB's decision to consider making limited amendments to IFRS 9 *Financial Instruments* (2010). We note that changes to the original requirements have been proposed based on feedback received from constituents and also to consider the interaction with the future IFRS on insurance contracts and the differences with the FASB's tentative classification and measurement model. In particular, we appreciate that the IASB has considered our request to address accounting mismatches that may arise from the application of different measurement models to financial assets and insurance liabilities.

However, we have a number of concerns regarding the proposals, which are described in detail in our responses to the questions in the ED set out in the Appendix.

In our view, there are still certain financial assets that do not pass the contractual cash flow characteristics assessment, despite the fact that an amortised cost measurement would provide more useful information than measurement at fair value. As explained in paragraph 18 of the Appendix, we believe that the IASB should reconsider the treatment of financial assets with regulated interest rates and financial assets with early automatic redemption features. However, these are only examples and more instruments might exist.

In this respect, we intend to share with the IASB the findings arising from a fact finding exercise, which EFRAG is organising with its partners, that aims to identify the high level reasons for the changes from a current amortised cost measurement under IAS 39 to a fair value basis under IFRS 9 and to understand the accounting effects of the IASB's decision to not reintroduce bifurcation for financial assets.

We believe that the definition of interest in IFRS 9 should be revised to clarify that it includes other components which are inherent in any theoretical definition of interest (e.g. liquidity risk). We recommend that the IASB modifies the definition of interest and to further explore the appropriateness of the definition in light of the recent tentative decisions on the insurance contracts project.

EFRAG has in the past expressed support for maintaining the possibility of bifurcation of hybrid financial assets and has proposed a new approach consistent with the principles in IFRS 9. EFRAG wishes to understand how constituents would strike the balance – having as objective the effectiveness of financial reporting – between requesting bifurcation of hybrid financial assets to be available on this new basis and encouraging the IASB to complete IFRS 9 as quickly as possible.

With regards to the introduction of a third business model in IFRS 9, EFRAG TEG members have divergent views on the IASB's proposals in the ED. Some EFRAG TEG members agree with the IASB's proposals, whereas some other members believe that the measurement category at fair value through other comprehensive income (FV-OCI) should rather be introduced in IFRS 9 as an option at initial recognition for companies to avoid accounting mismatches like those arising from the interaction between the classification and measurement requirements in IFRS 9 and the future IFRS on insurance contracts. Some EFRAG TEG members are also concerned that the application of the new requirements is unclear. These members believe that there are uncertainties both with the dividing line between amortised cost and FV-OCI and between fair value through profit or loss and FV-OCI.

Finally, we note that the ED includes in its basis for conclusions the IASB's analysis of the likely effects that will result from the proposed amendments covering, among other aspects, the comparability and usefulness of the financial information that would result from the ED and the likely effect on costs for preparers and users of financial statements. In this respect, we appreciate the step forward that the IASB has taken integrating for the first time effect analysis into the standard setting process.

If you would like to discuss our comments further, please do not hesitate to contact Anna Vidal, Panagiotis Papadopoulos or me.

Yours sincerely,

Françoise Flores

EFRAG Chairman

APPENDIX

Background information for EFRAG's constituents

1 *IFRS 9* Financial Instruments*, which contains the classification and measurement requirements for financial assets, was originally issued in November 2009. The requirements for financial liabilities were added to IFRS 9 in October 2010.*

2 *In November 2011, the IASB decided to consider making limited amendments to IFRS 9 in order to address specific application issues and concerns raised by constituents regarding the implementation of IFRS 9. Furthermore, the IASB wanted to reconsider the classification and measurement requirements in IFRS 9 in light of the future IFRS on insurance contracts and to achieve closer alignment of the IASB's and the FASB's classification and measurement models.*

3 *The IASB agreed that any amendments should be as targeted as possible, this to minimise the cost and disruption to those who are already applying IFRS 9 or have prepared themselves to apply this standard. Consistently, the scope of the project was limited to consider the following topics:*

(a) *The contractual cash flows characteristics assessment of financial assets;*

(b) *The need for bifurcation of financial assets and, if pursued, the basis for bifurcation; and*

(c) *The basis and the scope of a possible third classification category for debt instruments measured at fair value through other comprehensive income.*

4 *In January 2012, the project became a joint project with the FASB. The boards concluded their joint deliberations in July 2012. In general terms they have been able to more closely align their respective classification and measurement models, some differences though would still remain.*

5 *Since then, the IASB has separately discussed additional changes it would like to propose to other aspects of IFRS 9 for inclusion in the Exposure Draft, including the relief to accelerate the 'own credit' requirements for financial liabilities in IFRS 9 and changes in the existing transition requirements.*

6 *The IASB issued the Exposure Draft* Classification and Measurement: Limited Amendments to IFRS 9 *(the ED) on 28 November 2012. We note that the ED includes in paragraphs BC114-BC160 the IASB's analysis of the likely effects that will result from the proposed amendments covering, among other aspects, the comparability and usefulness of the financial information that would result from the ED and the likely effect on costs for preparers and users of financial statements.*

EFRAG's responses to the questions raised in the exposure draft

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?

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?

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?

Notes for EFRAG's constituents

7 *Under IFRS 9, a financial asset is eligible for a measurement category other than at fair value through profit or loss (FV-PL) if its contractual cash flows solely represent payments of principal and interest. Interest is defined as consideration for the time value of money and the credit risk associated with the principal amount outstanding during a particular period of time. In addition, the standard provides application guidance, including illustrative examples, on how the principle should be applied.*

8 *Since the publication of IFRS 9, the IASB has received many questions on the application of the contractual cash flow characteristics assessment to particular financial assets, notably financial assets that contain an 'interest rate mismatch feature'. That is, the interest rate is reset or resettable but the frequency of the reset does not match the tenor of the interest rate (e.g. a financial asset for which its interest rate is reset monthly to a three-month interest rate). Constituents were concerned that the current application guidance in IFRS 9 could be interpreted in ways that would preclude some financial assets from being classified at amortised cost, even though the contractual cash flows of such instruments would represent economically solely payments of principal and interest.*

9 *Paragraphs B4.1.7-B4.1.9E in the ED propose to amend the application guidance in IFRS 9 to clarify that if the financial asset only contains components that are principal, the consideration for the time value of money and for credit risk but the economic relationship between these components is modified, the financial asset might still be an 'eligible instrument' for a measurement category other than at FV-PL. This would be the case if its cash flows are not more than insignificantly different compared to the cash flows resulting from a benchmark instrument.*

10 *The benchmark instrument is defined as a comparable financial asset, whether actual or hypothetical, that is identical in all respects with the financial asset being evaluated, except that it does not contain the modification in the economic relationship. In the previous example, the cash flows arising from the financial asset for which its interest rate is reset monthly to a three-moth interest rate would be compared with those arising from an instrument with the same credit quality and terms but with an interest rate that is monthly reset to one-month interest rate.*

11 *The assessment described above would be performed by the holder on initial recognition, based on all available information (historical experience, current conditions and future forecasts) and applying judgement. Subsequently, it would not be reconsidered.*

12 *An entity need not perform a detailed assessment, but only if it is clear, with little or no analysis, that the cash flows on the financial asset could or could not be more than insignificantly different from the benchmark cash flows.*

13 *Financial assets with components other than principal, the consideration for the time value of money and for credit risk, would not be eligible for bifurcation. Instead, those financial assets would be classified and measured in their entirety at FV-PL. For example, a financial asset with an equity conversion option would not have contractual cash flows that are solely principal and interest and would be measured at FV-PL because the return on the instrument would not only reflect the time value of money and the credit risk of the instrument; rather, the return would be linked to the value of equity.*

14 *The IASB decided not to reintroduce bifurcation as the proposed changes to the contractual cash flows assessment were expected to decrease the need to bifurcate financial assets, because insignificant features that modify the relationship between principal and interest would no longer cause the instrument to be measured in its entirety at FV-PL. However, this decision does not affect the existing bifurcation requirements in IFRS 9 for financial liabilities and the 'own credit' requirements for financial liabilities designated under the fair value option which would remain unchanged.*

15 *It is also important to note that under the proposed amendments to IFRS 9, entities might have to measure an eligible instrument subsequently either at amortised cost or at fair value through other comprehensive income (FV-OCI) depending on the business model within which it is held. The proposed introduction in IFRS 9 of a third business model is explained in the next section.*

EFRAG's response

EFRAG agrees with the clarifications made in the contractual cash flow characteristics assessment; however we are concerned that there are still certain financial assets that do not pass the assessment, for different reasons, despite the fact that an amortised cost measurement would provide more useful information than measurement at fair value.

EFRAG believes that the definition of interest should be revised to clarify that it includes other components which are inherent in any theoretical definition of interest (e.g. liquidity risk). We recommend that the IASB modifies the definition and to explore further the appropriateness of the definition in light of the recent tentative decisions on the insurance contracts project.

Clarification made in the contractual cash flow characteristics assessment

16 EFRAG agrees that a financial asset with a modified economic relationship could be considered an eligible debt instrument for the purposes of IFRS 9 when its contractual cash flows would not be more than insignificantly different from the benchmark cash flows of a regular debt instrument. In those cases we believe that, as the contractual cash flows are economically almost indistinguishable, requiring the same treatment would be consistent with the underlying objective of existing IFRS 9, which is to identify simple debt instruments that could be eligible for a measurement category other than FV-PL.

17 EFRAG is aware that many constituents welcome the clarifications made in the wording of the contractual cash flows characteristics assessment. These constituents have indicated that they expected some financial assets, which would not have met the original assessment, to qualify for amortised cost measurement; in particular, those that contain interest rate mismatch features.

18 EFRAG is however concerned about a number of instances in which financial instruments might not pass the contractual cash flow characteristics assessment despite the fact that measurement at amortised cost provides more useful information. These instances include, inter alia:

(a) *Extensively regulated jurisdictions* – In markets where pricing of financial assets is extensively regulated by local authorities, the regulated practice might become the accepted structure for the time value of money for all or part of financial assets; therefore, a 'benchmark instrument' might not exist.

If a similar term structure was applied to deposits received from customers, which represent financial liabilities for financial institutions and are necessary to support their lending activities, these deposits would most likely be measured at amortised cost and would not be bifurcated as they meet the 'double-double' test included in IFRS 9 for bifurcation of financial liabilities. Therefore, if financial assets were measured at FV-PL, a significant accounting mismatch would arise.

If this is indeed the case, EFRAG believes those financial assets should generally also be considered eligible instruments provided that their interest rate represents the legal pricing basis in the jurisdiction for such type of transactions and provides a reasonable proxy for the time value of money.

(b) *Regulated financial assets that are closely linked to financial liabilities* – A similar accounting mismatch might arise in other jurisdictions with regulated pricing for specific financial instruments (such as 'Livret A deposits') if the returns on the financial assets and financial liabilities covered under the scheme are identical (or match each other closely). In those jurisdictions financial institutions might act as intermediaries collecting deposits from customers and handing them over to other institutions for various reasons (e.g. the need of certain Governments to finance particular activities).

The loans to the government yield the same interest rate as the deposits received from customers, which are regulated by the government or other authorities. Depending on the formula used, the interest rate might not only reflect market interest rates and variables (e.g. Eonia, Euribor, and inflation) but also include specific spreads, caps and floors imposed by the specific regulation. Furthermore, the government or other authorities might have discretion to modify the rate obtained from applying the formula. As a consequence, these financial assets usually contain a modest interest rate mismatch feature and their cash flows might not represent in practice solely payments of principal and interest.

However, the contractual cash flows arising from the financial assets and the related liabilities would be economically similar thereby limiting the net risk exposure of financial institutions that hold this type of instruments. These circumstances suggest that is not appropriate to assess the financial assets against an unrelated generic financial asset (benchmark instrument), rather we believe that the selection of a measurement basis for the financial assets should consider the linkage with the financial liabilities that are measured at amortised cost.

(c) *Financial assets with early automatic redemption features* – We believe that the current guidance in IFRS 9 should clarify that a financial asset with an automatic early (partial) redemption feature linked to credit risk deterioration of the issuer and that prepays principal and accrued interest should not be excluded from measurement at amortised cost.

For example, such contractual terms might be included in debt instruments issued by companies operating in the infrastructure sector and usually require an automatic early (partial) redemption of the principal if certain credit risk related performance milestones are not achieved.

In our view, the accounting effects of prepayment options and automatic redemption features linked to the credit risk of the issuer are identical if not the same. However, the current guidance in paragraph B.4.1.12 regarding contractual terms that change the timing or amount of the payments of principal and interest only allows certain types of prepayment or extension options to be eligible for a measurement category other than FV-PL.

19 EFRAG believes that the IASB should carefully consider the above issues before finalising the standard. In particular, we believe the IASB should specifically consider whether or not the information that would result from measuring those instruments at FV-PL would be more useful for users of financial statements.

20 EFRAG notes that – for various reasons – not many constituents have made significant progress in their assessments of the impact of IFRS 9 and that other financial instruments may exist for which the ‘principal and interest’ criterion as currently drafting might lead to similar issues. In this respect, we note that EFRAG and its partners are organising a fact finding exercise on how the proposed new requirements would affect the current classification and measurement of financial assets. One of the objectives is to identify in the group of financial assets that are currently measured at amortised cost under IAS 39, those financial assets that would be measured on a fair value basis under IFRS 9 and to understand the high level reasons for those changes. We intend to share with the IASB the findings arising from this exercise once it would be finalised.

Question to EFRAG’s constituents

21 Are you aware of any other financial assets that would not pass the contractual cash flow characteristics assessment and for which, in your view, measurement other than at FV-PL would provide more useful information? If so, please describe the financial assets and why you believe that measurement at other than FV-PL provides more useful information.

Solely payments of principal and interest

22 The ED does not propose any changes to the existing definition of interest in IFRS 9, which is described as consideration for the time value of money and for the credit risk associated with the principal amount outstanding during a particular period of time for the purpose of the contractual cash flows characteristics assessment.

23 EFRAG believes that the definition should be revised to clarify whether it includes other components that are inherent in any theoretical definition of interest and to state explicitly in the body of the standard that liquidity risk is one of those components. We note here that paragraph BC4.22 in IFRS 9 (2010) indicates that credit risk may include a premium for liquidity risk.

24 EFRAG notes that the IASB defines interest in a more comprehensive manner in the project on insurance contracts. In that project, when a top-down approach is applied, entities adjust a current reference yield curve for the market risk premium for expected and unexpected losses. Furthermore, that project acknowledges that there exist additional adjustments such as for the liquidity risk inherent in the current yield curve and indicates how to deal with them for the purposes of determining an appropriate discount rate. Moreover, we understand that the IASB is aware that differences might arise in practice when entities apply the top-down approach compared to a risk-free rate plus a liquidity premium. This suggests that the notion of interest is not exclusively limited to the consideration for the time value of money, liquidity risk and for credit risk.

25 EFRAG recommends therefore that the IASB modify the definition of interest in IFRS 9 and to explore further the appropriateness of the definition in light of the recent tentative decisions on the insurance contracts project

Bifurcation

Notes for EFRAG's constituents

IASB's bifurcation approach in IFRS 9

26 *In accordance with IFRS 9, financial assets are classified in their entirety on the basis of the nature of their contractual cash flow and the entities' business model, whereas financial liabilities are eligible for bifurcation based on the 'closely-related' bifurcation criteria that were previously contained in IAS 39.*

27 *The IASB sought to abolish bifurcation for both financial assets and liabilities when it was developing IFRS 9, however, this would have meant that many more financial liabilities would have had to be measured at fair value, which also raised concerns about accounting for changes in own credit risk in profit or loss.*

28 *In response to these concerns, the IASB decided to retain bifurcation of financial liabilities. This explains why IFRS 9 is asymmetrical in the sense that it only provides bifurcation for financial liabilities – with specific requirements to present in OCI the own credit risk where a financial liability is measured at FV-PL in its entirety – but not for financial assets.*

Constituents' past reactions

29 *After the issuance of IFRS 9, some constituents raised very significant concerns on the IASB´s approach to bifurcation. At the time, these concerns were justified as follows:*

(a) *Components of some financial assets are managed in a separate way, therefore, bifurcation leads to more relevant information;*

(b) *Bifurcation would enable preparers to account for the host financial asset in accordance with their business model while providing more assurance that risks arising from embedded derivatives are accounted for in the financial statements;*

(c) *Accounting mismatches might be more easily addressed;*

(d) *A relatively insignificant feature could result in a financial asset being measured at FV-PL in its entirety; and*

(e) *Symmetry in bifurcating financial assets and financial liabilities is important.*

30 *Others approved of IFRS 9 because of the complexity of the "closely related" guidance on bifurcation. They said that if bifurcation had to be maintained, it should follow a more principles-based approach.*

EFRAG's past recommendation

31 *When EFRAG commented in September 2010 at the request of the IASB on the FASB financial instrument exposure draft, it argued in favour of bifurcating hybrid financial assets, on the basis of a new approach, described in the basis for conclusions in the current ED as the "principle and interest" approach.*

32 *EFRAG's "principle and interest" approach is explained hereafter.*

33 *Provided that the financial instrument is not held for trading, is not a derivative, and has contractual cash flows that do not represent solely payments of principal and interests, an entity would measure the identified host component at amortised cost and the derivatives(s) at fair value through profit or loss when:*

(a) *the entity can separately identify within the contractual cash flows and reliably measure a component of cash flows that meets the characteristics of the instrument test in IFRS 9 ('the host component');*

(b) *the entity manages the host component within a business model whose objective is to hold the financial instrument in order to collect (or pay) the contractual cash flows of the identified host component;*

(c) *the cash flows other than those comprising the identified host component would meet the definition of a derivative (or derivatives) if they were a separate contract; and*

(d) *the entity does not designate the entire contract at fair value through profit or loss to reduce an accounting mismatch.*

If one (or more) of the conditions from (a) to (d) is (or are) not met, the entity shall measure the contract in its entirety at FV-PL. The assessment for classification and separation done at initial recognition is irrevocable.

34 *Moreover, EFRAG staff conducted a study on bifurcation that was discussed by EFRAG TEG in January 2011. The main findings of the study, which were shared with the IASB and with IFASS members in March 2011 in New York, indicated the following:*

(a) *Requirements on bifurcation of embedded derivatives in IAS 39 were seen as complex and burdensome. However, after a learning process, the rules were sufficiently well understood.*

(b) *Bifurcation was used in certain situations to avoid the consequences of fair value measurement of the entire hybrid instrument.*

(c) *Bifurcation was not used always where possible. Instead, as an alternative, the fair value option was sometimes used.*

(d) *The main source of complexity in the rules of IAS 39 was considered to be the ambiguity regarding the way a hybrid instrument should be split.*

(e) *Financial institutions used bifurcation, fair value option and hedge accounting interchangeably, depending on the accounting treatment that was best suited according to the specific instrument (or portfolio).*

35 *After the IFASS meeting in New York a survey of IFASS members was initiated and EFRAG's analysis and proposals were deemed of interest by most participants, a majority of whom however did not wish the IASB to reopen IFRS 9 classification and measurement requirements.*

36 *EFRAG is aware that a number of constituents who have in the past expressed significant concerns about the elimination of bifurcation for hybrid assets would now consider a swift completion of IFRS 9 preferable.*

IASB's recent developments

37 *In November 2011, the IASB agreed that the scope of project would include a reconsideration of the need for bifurcation of financial assets and, if pursued, the basis for bifurcation.*

38 *The IASB discussed the topic in its April 2012 meeting, where it explored various approaches, among them, the 'principal-and-interest' bifurcation and the 'closely-related' bifurcation. In respect of these approaches, paragraphs BC49-BC72 of the ED note:*

(a) *Consistency with IFRS 9 – A no-bifurcation approach for financial assets is consistent with the original requirements in IFRS 9, which require an assessment of the contractual cash flows of financial assets in their entirety. For financial liabilities, the reasons supporting their bifurcation, as explained in paragraph 27 above, still remain valid and constituents have indicated that the closely-bifurcation approach works well in practice.*

(b) *Contradictory outcomes – The assessment of the contractual cash flow characteristics of financial assets does not align well with a closely-related bifurcation approach, since their combination might lead to counterintuitive classification outcomes while overriding the results of the first assessment (e.g. a simple financial asset with closely related embedded derivatives that fails the contractual cash flow characteristics assessment could be measured at FV-PL in its entirety whereas a more complex financial asset could be bifurcated).*

(c) *Unit of account – A 'principal-and-interest' bifurcation approach that is based on whether the components of a financial asset are separately managed would be an instrument-by-instrument assessment, thus, it would be inconsistent with the business model assessment that requires the* *management of financial assets to be assessed at a higher level of aggregation. In addition, such an approach would require a change in practice with largely similar outcomes for financial liabilities, and would introduce new concepts for both financial assets and liabilities.*

39 *The IASB decided not to change the closely related bifurcation approach for financial liabilities and not to require or permit bifurcation for financial assets. This decision was also based on the expectation that the proposed clarification in the contractual cash flow characteristics assessment would decrease the need for bifurcation of financial assets. That is, insignificant features that modify the relationship between principal and interest might no longer cause an instrument to be measured in its entirety at FV-PL.*

40 *In respect of the expected outcome above, we note that EFRAG and its partners are organising a fact finding exercise on how the proposed new requirements would affect the current classification and measurement of financial assets. Among other objectives, we aim to identify and understand the high level reasons and impacts for the following changes:*

(a) *in the group of financial assets which can be bifurcated under IAS 39, those for which bifurcation is no longer allowed under IFRS 9 and would be measured at FV-PL; and*

(b) *in the group of financial assets that contain a closely related embedded feature and are measured in their entirety at amortised cost under IAS 39, those which would be measured at FV-PL under IFRS 9.*

41 *We intend to share with the IASB the findings arising from this exercise once it would be finalised.*

Questions to EFRAG's constituents

42 Do you believe that the proposed clarification in the contractual cash flow characteristics assessment would decrease the number of financial assets to be measured at FV-PL in their entirety so that the request for reintroducing bifurcation in IFRS 9 is no longer justified? Please explain why.

43 Are you aware of any circumstances in which, from your point of view, bifurcation might still be needed? If so, please provide a description of the financial assets concerned.

44 Do you believe that EFRAG should still urge the IASB to reintroduce bifurcation for financial assets on the basis of a principal-and-interest' approach as described in paragraph **Error! Reference source not found.**, having in mind that finalising the appropriate requirements might delay the completion of IFRS 9, however not require re-exposure?

Implementation costs

45 If it is not clear, with little or no analysis, whether a modification could result in cash flows that are more than insignificantly different or not from the benchmark cash flows, entities would need to perform a detailed assessment before classifying and measuring financial assets. The proposed application guidance indicates that in that case entities could consider either an actual or a hypothetical 'benchmark instrument' and should consider variables that affect the instrument's future cash flows, for example, how yield curves are expected to move over the life of the financial asset. Although entities would not need to consider every possible

scenario, EFRAG believes that the assessment would not be a straightforward exercise as compared to assessing whether the financial asset yields an appropriate economic return on initial recognition.

46 Furthermore, where an actual ‘benchmark instrument’ does not exist, entities might incur significant operational costs to construct hypothetical financial assets as a basis for the assessment. In this respect, EFRAG notes that the ED allows entities to use either an actual or a hypothetical financial asset irrespective of whether an actual benchmark is available or not. The ED does not however provide specific guidance on how hypothetical benchmarks should be constructed.

47 We believe that using hypothetical benchmarks might introduce further complexity into the assessment and increase the possibilities of inconsistent application in practice. In this respect, we note that participants in our field-test on the general hedging accounting Review Draft have raised significant concerns regarding the proposals on the use of hypothetical derivatives. The most important concern is the prohibition to reflect in a hypothetical derivative the basis risk in cross currency interest rate swaps.

48 For the above reasons we believe that the implementation of the criteria ‘more than insignificantly different’ might require disproportionate efforts for preparers and we recommend the IASB to require the use of actual benchmarks where they exist.

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

(b) all other gains and losses are recognised in OCI?

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?

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?

Notes for EFRAG’s constituents

49 *IFRS 9 provides a mixed measurement model whereby a financial asset qualifies for amortised cost if the financial asset is held within a business model whose objective is to hold assets in order to collect contractual cash flows (and satisfies the contractual cash flow characteristics assessment explained in the previous*

section). All other financial assets are to be measured at FV-PL, which is defined as the residual category. In addition, the standard allows an entity to make an irrevocable election at initial recognition to present fair value gains and losses on an investment in an equity instrument in other comprehensive income; however, recycling to profit or loss is not allowed for those equity instruments and there is no business model on which eligible debt instruments are measured at fair value through other comprehensive income (FV-OCI).

50 *The ED proposes to introduce a new business model in IFRS 9 under which eligible debt instruments are managed both to collect contractual cash flows and to sell. If eligible debt instruments are held within such a business model, entities would be required to measure those instruments at FV-OCI.*

51 *The underlying premise for the new FV-OCI measurement is that two sets of information are relevant (i) fair value information on the balance sheet, and (ii) amortised cost in profit or loss. Therefore, paragraphs 5.7.1 and 5.7.1A in the ED propose that:*

(a) *Interest revenue, credit impairment and gains or losses on derecognition would be recognised in profit or loss in the same manner as for assets measured at amortised cost; and*

(b) *Other gains and losses would be recognised in OCI.*

52 *The ED provides application guidance on the types of business activities that would qualify for the FV-OCI business model. The ED indicates that this would be the case when the entity's key management has made a decision that it will both hold and sell financial assets to achieve the objective of the business model within which the financial assets are held. For example, to maximise the yield while matching the duration of liabilities.*

53 *Furthermore, the ED also states that:*

(a) *If an financial institution is required by its regulator to routinely sell significant volumes of financial assets to demonstrate that the assets are liquid, the entity's business model is not to hold financial assets to collect contractual cash flows; and*

(b) *If an entity (i) manages financial assets with the objective of maximising cash flows through their sale, (ii) manages and evaluates a portfolio of financial assets on a fair value basis, or (iii) holds portfolios that meet the definition of held for trading, the entity's business model is neither to hold financial assets to collect contractual cash flows, nor to manage assets both to collect contractual cash flows and to sell.*

54 *The ED proposes to extend the current eligibility condition in IFRS 9 for designating financial assets under the 'accounting mismatch' fair value option to eligible debt investments that would otherwise be measured at FV-OCI. Thus, an entity might measure those debt instruments at FV-PL if doing so would eliminate or significantly reduce an accounting mismatch.*

55 *The ED also proposes to extend the existing reclassification requirements in IFRS 9 to the FV-OCI category and provides mechanics for the reclassification of eligible debt instruments into and out of the FV-OCI measurement category as a result of a change in the business model. Entities would be required to prospective*

reclassify financial assets when the business model changes; however, such changes are expected to be rare in practice.

56 *Regarding the amortised cost measurement category, the ED intends to clarify the 'hold-to-collect' objective by providing additional implementation guidance on the frequency and nature of sales that would prohibit financial assets from qualifying for amortised cost measurement.*

57 *The ED would allow for sales of financial assets classified at the amortised cost category if there is credit deterioration such that instruments no longer meet the entity's documented investment policy. In this scenario sales would be considered consistent with the 'hold-to-collect' objective irrespective of their frequency and significance. Sales for other reasons would also be allowed if they are infrequent (even if significant) or insignificant both individually and in aggregate (even if frequent).*

58 *Current IFRS 9 refers to a broader range of circumstances in which asset sales would not compromise the 'hold-to-collect' objective such as sales where financial assets do no longer meet the entity's investment policy criteria, to rebalance a portfolio due to changes in expected duration or to fund capital expenditures. The only condition is that all these sales should be infrequent. Most of these circumstances have been considered in the ED through the proposed examples provided in the application guidance.*

59 *Finally, it should be noted that the existing measurement requirements in IFRS 9 for equity instruments remain unchanged; therefore, recycling to profit or loss would not be allowed for those equity instruments.*

EFRAG's response

60 As a general comment, EFRAG believes that IFRS 9 should be based on a limited number of measurement categories and provide a clear rationale for each of those categories, as this would result in more useful reporting information while making IFRS 9 easier to apply by preparers by avoiding complexity.

61 Notwithstanding the general comment above, EFRAG TEG members have divergent views on the IASB's proposals to introduce a third business model in IFRS 9. The views of EFRAG TEG members can be summarised as follows:

(a) View 1: Eligible debt instruments should be mandatorily measured at FV-OCI if they are held within a business model whose objective is both to collect contractual cash flows and to sell – the approach taken by the ED.

(b) View 2: Entities should be able to elect at initial recognition to measure eligible debt instruments at FV-OCI if by doing so accounting mismatches are reduced or eliminated.

View 1: Eligible debt instruments should be mandatorily measured at FV-OCI if they are held within a business model whose objective is both to collect contractual cash flows and to sell

62 Some EFRAG TEG members support the IASB's proposal to introduce a category that is measured at fair value through OCI for eligible financial assets that are managed within a business model whose objective is both to collect contractual cash flows and to sell. In their view, this measurement category will address the feedback from those constituents who questioned the appropriateness of the existing categories under IFRS 9, including the interaction with the accounting for

insurance liabilities, while providing useful information about the financial assets classified in this measurement category.

63 These EFRAG TEG members are aware that some constituents have highlighted concerns that the current two-measurement categories approach in IFRS 9 is too limited to allow them to properly reflect their business models, particularly where entities hold some financial assets in a portfolio either to collect contractual cash flows or to sell and realise fair value changes. These constituents do not believe that the measurement category at FV-PL would appropriately reflect this business model and noted that the available-for-sale category in IAS 39 was useful for those strategies in which an entity holds financial assets for as long as it wants but would sell them when there is a good market opportunity.

64 These EFRAG TEG members agree that depending on the business model under which financial assets are held, there might be different ways of presenting the information arising from amortised cost and fair value so as to be meaningful and useful. In particular, they believe that cost information in profit or loss and fair value information on the balance sheet are both measurement attributes relevant for financial assets that are managed under a business model whose objective is both to collect the contractual cash flows and to sell. Presenting these two sets of information would result in information more representative of the entity's performance since:

(a) The income statement would provide information on how entities perform in terms of managing interest rate or liquidity risk and the credit quality underlying their investment strategy, since it would reflect interest income by using the effective interest method and credit impairment losses/reversals through the application of the same impairment methodology as for financial assets measured at amortised cost. Therefore, the short-term volatility in interest rates and changes in credit spreads, which might reverse over time, would not be reflected in profit or loss, thus promoting the transparency where entities manage financial assets to maximise the contractual yield. In addition, profit or loss would also reflect gains and losses arising from derecognition, providing relevant information when entities manage financial assets to maximise the total return of financial assets; and

(b) The balance sheet would provide fair value information of the financial assets which are part of the entities' investing activities. As entities would combine holding and selling financial assets to achieve their investment objective, they agree that fair value information is more useful than amortised cost.

65 These EFRAG TEG members note that users have indicated that the combination of fair value and amortised information would be helpful provided that the different measurement categories are appropriately defined.

66 Furthermore, these EFRAG TEG members agree that the introduction of the proposed FV-OCI measurement category would be consistent with the overall approach in IFRS 9 whereby the classification of eligible instruments is determined based on the business model under which they are hold with the objective of providing useful information. In addition, they believe that it would address most of the concerns raised by insurers when considered in conjunction with the IASB's tentative decision to present in OCI the changes in insurance liabilities arising from changes in the discount rate. Some accounting mismatches would still remain because not all the financial assets backing insurance liabilities would be measured at FV-OCI.

67 These EFRAG TEG members agree that the definition of the third business model should not change the underlying principles in IFRS 9 or restrict the use of amortised cost in the measurement of financial assets. In this respect, they understand that the IASB expected that part of the financial assets that would have been measured at FV-PL would fall within the FV-OCI category. They also note here that paragraph BC30 in the ED indicates that the IASB did not seek to increase or reduce the use of fair value measurement with the introduction of the third business model, rather it sought to ensure that relevant information is provided.

68 For the reasons above, some EFRAG TEG members support the third business model where eligible instruments managed both in order to collect contractual cash flows and for sale would be measured at FV-OCI.

69 Finally, these EFRAG TEG members also provide the following comments:

<u>Fair value option</u>

70 These EFRAG TEG members agree that the existing fair value option in IFRS 9 should be extended to financial assets that would otherwise be mandatorily measured at FV-OCI. This extension would eliminate, or at least mitigate, new accounting mismatches that could arise as a result of measuring eligible debt instruments at FV-OCI. For example, if (i) the financial asset is measured at FV-OCI and the liability at FV-PL, or (ii) the financial asset is measured at FV-OCI and the liability at amortised cost. In such cases, they agree that financial statements could provide more relevant information if both the asset and the liability were measured at FV-PL.

71 Notwithstanding their support to extend the fair value option, they believe that in order to understand the effects that this proposal would have on insurers, it should be considered in the context of the IASB's tentative decision in its project on insurance contracts to require the presentation in OCI of changes in the insurance liabilities arising from changes in the discount rate. Leaving participating contracts aside, insurers might not be able to use in practice the fair value option currently included in IFRS 9, since accounting mismatches would not arise if the financial assets funding those insurance liabilities are measured at FV-OCI. Therefore, if this tentative decision in the insurance contracts project would be included in the final standard, on which they do not express an opinion at this moment, insurers might be precluded from electing the fair value option.

<u>Interaction with other phases of IFRS 9</u>

72 They note that the ED does not make any consequential amendments to paragraph 6.5.8 of the Review Draft *General Hedge Accounting,* which indicates that in fair value hedges the gain or loss on the hedging instrument should be recognised in profit or loss or OCI, if the hedging instrument hedges an equity instrument for which an entity has elected at inception to measure at FV-OCI. They understand that the gain or loss on the hedging instrument should be also recognised in OCI if the hedged item is an eligible debt instrument measured at FV-OCI.

73 They believe that the IASB should carefully consider this interaction with the general hedging proposals in the finalisation of this ED.

View 2: Entities should be able to elect at initial recognition to measure eligible debt instruments at FV-OCI if by doing so accounting mismatches are reduced or eliminated

74 Some EFRAG TEG members note that the main underlying objective of the IASB's proposal was to address a specific issue for a single industry – the accounting mismatches arising for insurance companies. However, these members believe that the approach taken in the ED would unnecessarily increase in general complexity in the accounting for financial assets.

75 These EFRAG TEG members acknowledge that some insurers have raised concerns about the potential accounting mismatch that might arise in profit or loss due to the interaction between the accounting for financial assets under IFRS 9 and the accounting for insurance liabilities under the future insurance contracts standards. If a financial asset portfolio held by an insurer qualifies for amortised cost, an accounting mismatch would arise because insurance liabilities would be measured at a current value through profit or loss (fulfilment value) according to the proposals in the Exposure Draft *Insurance Contracts*. Those insurers indicated that a possible way to reduce accounting mismatches would be to introduce a FV-OCI measurement category for financial assets in conjunction with recognising the effects of changes in the interest rate associated with the liabilities in OCI.

76 Some of the EFRAG TEG members that support view 2 also believe that the dividing lines between measurement categories (i.e. between FV-OCI and FV-PL and between FV-OCI and amortised cost) are not clear enough. For example, this would be the case when entities renegotiate a loan before its contractual maturity (business practice to act before competitors attract their customers) and when they dispose financial assets through securitisations either by sales out of the group or for financing purposes selling assets to other entities within the group. In these two circumstances some could argue that there is a dual purpose, or even argue that those financial assets should be measured at FV-PL.

77 Furthermore, these EFRAG TEG members are aware that some constituents, in particular in the banking industry, are concerned that the introduction of the FV-OCI measurement category would force entities to classify there financial assets that would have been measured at amortised cost if the third business model did not exist. Those constituents believe that the proposals in the ED would change the principles in IFRS 9 (2010) for the amortised cost measurement category, instead of providing clarification, and, as a consequence, restrict the use of amortised cost in the measurement of financial assets. In this respect, those constituents do not agree with paragraph BC30 in the ED, in particular, that the IASB expected that part of the financial assets that would have been measured at FV-PL would fall within the FV-OCI category, as they believe the transfer would be from amortised cost to FV-OCI.

78 These EFRAG TEG members note that the concern above is much related to how the business model test and the application guidance for the amortised cost measurement category in IFRS 9 (2010), were interpreted by those constituents, in particular, the level and frequency of sales allowed.

79 For the above reasons, EFRAG TEG members supporting view 2 believe that the measurement category at FV-OCI should only be introduced in IFRS 9 as an option for companies to avoid accounting mismatches like those arising for insurance companies. In the view of these members, entities should be able to elect at initial recognition to measure eligible financial assets at FV-OCI if by doing so eliminate or reduce an accounting mismatch that would otherwise arise from measuring financial assets and the related liabilities on different bases.

Questions to EFRAG's constituents

80 Do you support View 1 or View 2 above? Please explain why.

81 The basis for conclusions in the ED (paragraph BC30) indicate that interested parties have raised concerns that the introduction of the FV-OCI measurement category would increase the use of fair value relative to IFRS 9 (2010) and that the IASB did not seek however to increase or reduce the use of fair value measurement. In addition, the IASB notes that in some cases financial assets that would have been measured at FV-PL could be measured at FV-OCI as a result of the proposals.

Do you believe that the introduction of the FV-OCI measurement category would increase the use of fair value relative to IFRS 9 (2010)? Please explain why.

82 Are there any additional arguments that have not been identified 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 (ie including all chapters)? If not, why? Do you believe that the proposed six-month period between the issuance of the completed version of IFRS 9 and when the prohibition on newly applying previous versions of IFRS 9 becomes effective is sufficient? If not, what would be an appropriate period and why?

Notes for EFRAG's constituents

83 *Currently more than one version of IFRS 9 can be applied and entities are able to early apply only particular phases of IFRS 9. For example, an entity can choose only to apply the classification and measurement requirements for financial assets (IFRS 9 (2009)) or to apply those for both financial liabilities and financial assets (IFRS 9 (2010)).*

84 *The ED proposes that once IFRS 9 is finalised, entities should no longer be permitted to early apply previous versions of IFRS 9. Instead, when IFRS 9 is completed, entities would only be able to adopt IFRS 9 as a whole. However, entities that already apply part of IFRS 9 before it is completed would be able to continue applying that part and not be required to apply the full IFRS 9 until the mandatory effective date.*

85 *However, for the first six months after completion of the full IFRS 9, entities would still be able to adopt earlier versions of IFRS 9, this to provide relief to those entities that might have been preparing to early apply a version of IFRS 9 before the standard is finalised.*

EFRAG's response

Considering the complexity arising from a phased application, EFRAG agrees with the proposal in the ED that after IFRS 9 is finalised, an entity early applying IFRS 9 should be required to apply IFRS 9 in its entirety.

We also agree with the six-month transition period, but believe that the IASB should clarify the wording used.

86 EFRAG has noted in the past that phased introduction of IFRS 9 might reduce comparability between entities for some time. Although this is an important concern, we believe that preparers should not be prevented from applying improved new standards if this results in more useful and relevant information.

87 EFRAG believes in general that an appropriate balance of the benefits and related costs resulting from early application needs to be struck. In the particular case of IFRS 9, we note that such a balance might be more difficult to achieve due to the complexity – in the transitional provisions and consequential amendments – arising from a phased introduction, this due to the number of possible permutations of adoption dates.

88 For example, we believe that paragraph 7.1.1A is a clear illustration of the complexity arising from a phased introduction. The application of this new paragraph might not be a straightforward exercise, since the affected preparers would need to carefully consider which paragraphs in IFRS 9 have been amended, added or deleted by the ED and which ones not. If the IASB decides to proceed with the phased introduction of IFRS 9, we envisage further more complexity in the IASB's maintenance activity than at present. That might in turn undermine the easy understanding and application of the standard, and reduce the comparability of financial statements under IFRSs.

89 EFRAG, therefore, agrees with the proposal in the ED that after IFRS 9 is finalised, an entity early applying IFRS 9 should be required to apply IFRS 9 in its entirety. In this respect, we understand that IFRS 9 will be finalised once the IASB issues the proposals in this ED, impairment and general hedge accounting; in other words, the final IFRS 9 would not include the requirements regarding macro hedge accounting.

90 We also agree with the six-month transition period proposed by the ED on the basis that is a practical expedient that provides relief to those constituents that have dedicated significant resources in preparation for the initial application of an individual phase of IFRS 9. However, we believe that the IASB should clarify the wording used in the ED, since the description of this transition period is not clear enough.

91 For example, if IFRS 9 were finalised on 30 April 2013, entities would only be permitted to choose to early apply previous versions of IFRS 9 before 31 October 2013, which raises the question whether an entity would need to publish interim financial statements in order to qualify for the relief. Accordingly, we recommend that the IASB clarify its intention, in particular, whether entities would need to publish interim financial statements or the relief is meant to cover annual periods beginning six months after the full IFRS 9 is finalised.

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?

Notes for EFRAG's constituents

92 *The IASB addressed in IFRS 9 (2010) the concerns about presenting changes in a liability's credit risk in profit or loss by requiring to present in OCI the change in the fair value of liabilities that is attributable to changes in the issuer's own credit when those liabilities are designated as at fair value through profit or loss under the fair value option. IFRS 9 further requires that amounts presented in OCI will not subsequently be recycled to profit or loss.*

93 *The own credit requirements were not incorporated in IAS 39, because the IASB believed it was inappropriate to amend IAS 39 given the active project to replace it with IFRS 9 in the short term.*

94 *Constituents recommended the incorporation of the requirements for the presentation of own credit in IAS 39 as an interim solution when the IASB decided in December 2011 to defer the mandatory effective date of IFRS 9 to 1 January 2015.*

95 *Since then, the request to accelerate the application of the own credit requirements has intensified mainly for the following reasons:*

(a) *The effective date of IFRS 9 may be deferred again depending on the finalisation of the general hedge accounting and impairment phases of the project and/or to achieve alignment of the effective date of the insurance contracts project;*

(b) *Markets continue to be volatile and own credit gains or losses remain significant, accentuating the concern about the usefulness of financial reporting when an entity is experiencing own credit deterioration; and*

(c) *As a result of the amendments to the classification and measurement requirements for financial assets proposed in the ED, entities that have not already applied the requirements are unlikely to consider early applying IFRS 9 before the limited amendments are finalised.*

96 *The own credit issue was not initially included in the scope of the limited amendments to IFRS 9. However, the IASB has decided to allow entities to early apply only the requirements for the presentation of fair value gains or losses attributable to changes in the issuer's own credit risk, once IFRS 9 is finalised, without the need to early apply IFRS 9 in its entirety. Paragraph 7.1.1B in the ED includes this exception to the new transition requirements proposed in the ED as they have been explained in the previous section.*

EFRAG's response

EFRAG believes that entities should be permitted to early apply the 'own credit' provisions in IFRS 9. EFRAG reiterates its request to amend IAS 39 so as to not further delay the benefit of increase relevance in the presentation of the financial statements.

97 EFRAG agrees that entities should be permitted to choose to early apply the 'own credit' provisions once IFRS 9 is finalised; however, EFRAG reiterates its request to amend IAS 39 to align it to the requirement in IFRS 9 regarding the accounting for own credit risk on financial liabilities measured at fair value.

98 EFRAG is concerned that the relief being provided would only be available once the remaining phases of IFRS 9 have been finalised and the final standard is published.

99 EFRAG has previously urged the IASB to consider incorporating the own credit risk requirements into IAS 39 so as not to delay the benefit of increased relevance in presentation while avoiding unnecessary lack of comparability.

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?

EFRAG's response

EFRAG does not have any specific comments regarding first-time adopters.

100 EFRAG does not have any specific comments regarding first-time adopters.