Deutsches Rechnungslegungs Standards Committee e.V.
Accounting Standards Committee of Germany
IFRS-Fachausschuss

DRSC e. V. • Zimmerstr. 30 • 10969 Berlin

Telefon +49 (0)30 206412-12
Telefax +49 (0)30 206412-15
E-Mail info@drsc.de

Hans Hoogervorst
Chairman of the
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH

United Kingdom

Berlin, 28 March 2013

Dear Hans,

IASB ED/2012/4 Classification & Measurement: Limited Amendments to IFRS 9

On behalf of the Accounting Standards Committee of Germany (ASCG), I am writing to provide our views on the IASB's ED/2012/4. We appreciate the opportunity to comment on this exposure draft, and we welcome the IASB's initiative to address concerns raised by constituents as regards the application of the current version of IFRS 9 and to consider the interaction with the project on insurance contracts.

Whilst we are supportive of the objective of the proposals made, we do not concur with all suggested amendments. Specifically,

- we believe that the clarifications around the SPPI criterion are a step in the right direction, though we feel that even under the new proposals many instruments regarded as "normal" lending transactions would be scoped out from measurement at amortised cost. We do not believe that the IASB intended to discriminate against lending conventions that have developed in some jurisdictions;
- we understand that the introduction of a third business model and the corresponding measurement at fair value through OCI would help insurance entities in addressing the potential accounting mismatches. We are fully supportive of that objective; however, we do not believe that the proposals are the best means to achieve that goal. We provide an alternative solution as well as suggestions as to how the Board's proposals could be strengthened should the Board wish to continue with its approach; and

- finally, we believe that the Board should make a robust statement as to the effective date of the final version of IFRS 9. Given the concurrent developments in the project on insurance contracts we suggest an effective date of 2018 for all entities, with early adoption allowed.

Please find our detailed comments on the questions raised in the ED in the appendices to this letter. If you would like to discuss our views further, please do not hesitate to contact me.

Yours sincerely,

Liesel Knorr
President

Appendix A – Answers to the questions of the exposure draft

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 ED 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?

Whilst we agree with the objective of the IASB to clarify the cash flow characteristics principle when evaluating instruments with modified economic relationships, we do not believe that the proposed guidance is sufficiently clear and operational yet. Whilst some of the clarifications are helpful and acknowledged, most of our constituents feel that the clarifications do not reach far enough. This is because the proposed amendments seem to fall short of meeting the underlying concept of the classification – being to depict normal lending transactions. We fully acknowledge that the difficulty is to define what "normal" means and in what circumstances. However, the current drafting would discriminate against well-accepted lending transactions that have features which have not been put in to achieve a structuring result but for other reasons. Thus, we agree with the Board that instruments with a modified economic relationship between principal and interest may (and in many cases should) qualify for amortised cost treatment, but we do not concur with the Board's view that this would only be permissible if the cash flows would not be significantly different from the benchmark cash flows.

Firstly, we note that the terms "insignificant" / "not significant" are used several times throughout the document with potentially different meanings, which does not help constituents in getting a clear understanding of what precisely is meant in each case. If the term was to be understood as a *de minimis* clause, we would regard the clarification as being unnecessary since this would already be captured by the general materiality provisions pertaining to all IFRSs (in which case even factors not regarded typical in normal lending transactions should not cause the financial asset to fail the SPPI test, provided they are really non-substantive to the overall instrument). If insignificant was meant to capture something other than “very small” or “little”, we would appreciate if the IASB used a different terminology to make this point clearer (e.g. if insignificance would not only be considered quantitatively but also qualitatively); we believe this issue becomes even more prevalent when thinking about translating the requirements into other languages.

Secondly, whilst we understand the Board’s desire to keep the permissible modifications limited, we do not believe that the principle is operational on a world-wide scale: If the benchmark was meant to establish the use of a global benchmark, then the test would likely lead to many instruments not passing the threshold. This is due to the fact that practices in a particular market might have evolved over time which are considered normal and the benchmark in that particular market (in other words, what is regarded as a “modification” from an absolute point of view might not be a modification locally since there is no benchmark instrument in that particular market which had been modified). We understand that this seems to be the case in many Eastern European countries as well as in jurisdictions where the rate is set by a government authority or a regulator (such as in China). On the other hand, if the benchmark was meant to establish the use of *the* benchmark in the market in which a financial asset is transacted, we understand that instruments with substantially the same features may be classified differently depending on where they are entered into, thus impairing comparability across entities and jurisdictions. On balance, though, we believe that the Board should give greater weight to the fact that an entity’s financial statements ought to show how an entity will likely realise the cash flows of its investment. And if there is no other way than realising even such instruments through holding them for collection, then measurement of the item at amortised cost seems to provide more decision-useful information to the readers of the financial statements.

On a similar point we do suggest the Board revisits its guidance on prepayment features. It does not make much sense to us to disqualify instruments from an amortised cost treatment if an embedded prepayment feature represents, in substance, a protection for the lender. The inclusion of a prepayment option always has an economic reason, which may or may not always be linked to credit risk. If an instrument contained a prepayment feature leading to a redemption amount that is not substantially different to the amortised cost of the financial asset, we feel that such feature should be regarded as being in line with the SPPI criterion and should hence qualify for an amortised cost measurement

Thirdly, and more to the underlying principle as to what constitutes interest, we believe that the proposed definition is too tight when encompassing only time value of money and credit risk. In the Basis for Conclusions the IASB already admits that a liquidity risk premium could be inherent in the interest rate, and we consider that market participants would generally also include a reasonable profit margin in the interest rate (e.g. when borrowing in one market and lending in another). Whilst we have learned during outreach meetings that it was not the intention of the Board to disallow for these factors to be included in the interest rate – which we appreciate and acknowledge –, it does not make the understanding easier as to which factors may or may not be included in the interest rate without tainting the SPPI criterion. We understand that the Board may not wish to provide constituents with a rule set of interest rate components deemed ok; nonetheless, we suggest reconsidering the apodictic wording of “only time value of money and credit risk” if other components are deemed permissible (perhaps by exchanging the word “only” with “mainly” or “predominantly” and by adding further examples to clarify the intended understanding). Alternatively, the Board may wish to clarify that the term “time value of money” is intended to capture normal market conditions and may, thus, include a liquidity spread as well as a profit margin. We feel this is necessary in order to clarify the underlying principle of normal lending transactions.

Further, it is not clear to us whether the Board envisages the benchmark test to be carried out on a nominal or discounted cash flow or on yet another basis (e.g. differences in effective interest rates). Depending on how the test is performed, results might differ rather hugely, thus leading to incomparability between entities and jurisdictions. We suggest clarifying this point before finalising the amendments.

Lastly, we would welcome the inclusion of an explicit statement that any assessment of instruments as (dis)qualifying for SPPI was to be performed only at initial recognition or if the terms of the instrument are changed by the parties after initial recognition, but not in cases where market conditions change. Our reasoning is based on the same principle contained in legacy IFRIC 9 *Reassessment of Embedded Derivatives*.

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?

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

Question 5

Do you believe that the ED 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?

We considered the objective of the IASB for making the amendments and understand that one key driver for the amendment was to accommodate a solution for the insurance business. Given the tentative decisions made in the insurance project, a measurement attribute "Fair Value through OCI" (FVTOCI) was needed on the asset side in order to avoid accounting mismatches arising on insurance contracts that are not being accounted for using the proposed mirroring approach. We acknowledge that need and approve of it. However, we have doubts whether the way this accommodation is drafted in the ED is actually the best way to alleviate the concerns raised. Specifically, we hear concerns in industries other than the insurance sector that do feel that the new proposals represent a significant change vis-à-vis the classification they already made. We have also analysed the dissenting views provided by the two board members who state that the inclusion of a third business model adds complexity to the classification model that they feel is unnecessary and not adding value.

Our first preference would have been not to introduce another mandatory measurement model. We believe that an intention to "hold *and* sell" is actually not a business model in its own right but the absence of a business model to either hold or sell. It is a state under which the final decision as to what to do is simply deferred until sometime in the future. Most entities have a desire to hold and invest excess liquidity, but in our view that might not constitute a fully-fledged business model in its own right. Rather than *constituting* an identifiable separate business model a strategy to "hold and sell" financial instruments can be the *result* of an entity's underlying business model, e.g. in cases where excess liquidity is invested until for a desired investment becomes available, or where investments fund insurance liabilities. In fact, entities rarely – if ever –

lock instruments away until maturity; rather, they are constantly re-evaluating them for adverse changes in market terms, which may then lead to risk management driven action (and not the business unit that originally contracted the asset). Hence, we do not concur with the statement introduced in ED IFRS 9:B4.1.2A: We feel that the Board is comingling different layers of an entity's management when stating that *"[t]he entity's business model for managing the financial assets is a matter of fact that can be observed by the way the business is managed and its performance is evaluated by the entity's key management personnel"* as those that manage the assets and evaluate their performance are not necessarily the same business units that acquired/originated the assets in the first place. The same would be true for any hedging decisions being made: These are generally not invoked by the business units that acquired or originated the assets, but at another (higher) layer charged with a holistic asset liability management view.

We believe that the introduction of another measurement category based on a business model definition adds to the complexity of the classification model and puts pressure on defining both ends of this new category. As we see it, neither the current "Amortised Cost" (AC) category nor the "Fair Value Through Profit or Loss" (FVTPL) category are defined rigorously enough in order to clearly identify as to when entities should use the new category:

- Under the AC category, the intention of the entity should be to hold the instrument for collection of the contractual cash flows. However, an entity may sell some of these instruments without tainting its classification provided the sale occurs because of deteriorating credit quality of the asset or the sales *"are infrequent (even if significant) or insignificant individually or in aggregate (even if frequent)"* (cf. ED IFRS 9:B4.1.3). Neither the term "infrequent" nor the term "insignificant" are defined in IFRS 9 – see our respective remark made with regard to defining the SPPI criterion – and are interpreted by many as a *de minimis* clause (by making reference to the current tainting provisions for sales out of the held-to-maturity category under IAS 39, where the same terminology is used; cf. IAS 39.9). Hence, the uncertainty already prevalent under the current version of IFRS 9 is not removed when assessing whether, how often and how many financial assets may be sold without questioning the initial classification.
- Further, even if a higher than permissible amount (wherever this threshold might be) was sold, the entity's business model might not have changed. Neither the current version of IFRS 9 nor the amendment contain any guidance as to what consequences would arise from such sales – on the remaining instruments, on future classifications, on the assessment whether past classifications are appropriate from an *ex post* perspective under IAS 8 etc.

- The FVTPL category is currently intended to be a residual, thus containing more assets than merely those that are classified as held-for-trading under IAS 39 (notwithstanding instruments that do not meet the SPPI test). Hence, the underlying logic seems to be that even financial assets that are not acquired or incurred principally for the purpose of selling them in the near term are to be measured at fair value with changes in fair value recognised in profit or loss. Under the new proposals some instruments are now to be classified into the FVTOCI category without making clear as of when the selling behaviour of the entity would cast doubt that this classification was actually appropriate in the first place; again, the issue seems to be how often and how many financial assets can be sold before questioning the classification made.

It is for these reasons that we believe a two class model is less complex and operationally superior to the three class model proposed by the IASB. Whilst we understand the basic rationale underlying the proposals, yet we are not convinced that the proposals are operational and robust enough in order to be applied consistently across entities and jurisdictions. Having said this we do not deny at all that there may be (and presumably are) more business models than just “hold for collection” and “hold for sale”; however, we believe that these other models cannot be defined clearly enough without the introduction of a lot of rules, making it undesirable to pursue this route in the first place. Equally, we do not deny that there is value in having both, amortised cost and fair value information for a set of instruments where the intent as to how to use these instruments is not clear at initial recognition. We should point out that the disclosures currently mandated by IFRS 7 even foresee a presentation of the fair values of those financial instruments that are measured at amortised cost in the statement of financial position.

We have considered an alternative approach to the proposed amendments, an outline of which is reproduced in Appendix B. According to this proposal a two class approach would be retained, though the order of the existing categories would be reversed to address the operationality issues around permissible sales out of the AC category. We suggest defining the FVTPL category taking the current definition in IAS 39 of “held for trading”, which we believe is meant to portray something similar to “hold to sell” and is well understood by and in practice, and classifying the remaining plain vanilla instruments as to be measured at amortised cost. We acknowledge that such classification would capture less instruments in that FV category than is currently the case in IFRS 9, though all non-“plain vanilla” instruments would still be directed to that category. In comparison to the IASB’s proposal the key difference would be the asset’s measurement attribute in the statement of financial position; there would be almost no difference as regards the presentation in the statement of profit or loss as under both, the IASB's proposal, and our approach instruments would be measured at amortised cost (we acknowledge that there is likely to be a difference due to the fact that the IASB's reliance on the FVTPL category being the residual will lead to some plain vanilla instruments still being classified as at fair value through profit or loss where our approach might lead to an amortised cost classification). As stated above, though, the fair value information is not lost and can be depicted in the notes. In order to achieve the desired solution for the insurance business, we suggest providing a FVTOCI option for all assets otherwise measured at amortised cost. That option would have to be exercised at initial recognition and would be irrevocable. However, and contrary to the fair value option currently in IAS 39/IFRS 9, the option would not be based on an accounting mismatch concept for the reasons outlined in Appendix B.

If, nonetheless, the IASB wishes to proceed with a mandatory third measurement category, we have a number of suggestions as to how the proposals could be made more operational.

- Firstly, we believe it would be easier if the newly introduced category would be made the residual rather than a defined and mandatory class. As already outlined above it seems extremely difficult to state clearly which financial assets the "middle category" would encompass (beyond the mere desire to have something in between the other two) because the Board would have to define two border lines.
- If the FVTOCI category was to become the residual, a definition of the FVTPL category would be needed. Here, the Board could consider following our alternative approach in using the current held-for-trading category as per IAS 39, enlarged for non-"plain vanilla" instruments in addition to the already mentioned derivatives in subparagraph (c).
- In our view residual FVTOCI category would still be the appropriate category encompassing typical debt portfolios of insurance companies as described in Example 3 of the ED IFRS 9:B.4.1.4.B, for which collecting contractual cash flows and selling instruments to rebalance the portfolio are both done to fulfill the general objective to fund insurance liabilities. We suggest that the IASB retain this example, which clarifies that this type of portfolio would typically fall in the FVTOCI category, and thereby ensure that the objective of the ED to address the interaction of the classification and measurement of financial assets and the accounting for insurance contracts liabilities is still met.

- If the current AC category was to be retained in generally the same form, we suggest the IASB work on the wording of B4.1.3 as this paragraph still is not clear as to its underlying rationale. As we understand from discussions with Board members and staff on the issue, an entity would have to look into the reasons for why a sale occurred, rather than at the exact number or the amount of sales; we believe this would be a helpful clarification that should be brought into the main body of the text. As regards the reason of sales, we note that the existing limitation to credit events only seems to be even more restrictive than the current permissible sale events listed in IAS 39.AG16 et seqq. which we suggest the Board consider for inclusion into IFRS 9. Further, we do not believe that the revised wording of *"infrequent (even if significant) or insignificant individually or in aggregate (even if frequent)"* provides clarity as to which sales are actually viewed permissible without casting doubt as to the initial classification of the instrument. We feel that these words need to be worked on in order to provide constituents with a better understanding as to how this category should be used in the eyes of the Board.
- Lastly, we have already touched the issue of when asset sales occur that are deemed significant and where the business model has not changed as a consequence of this sale. In such cases IFRS 9 would not allow for a reclassification of the assets. If a decision to sell has been made but will be executed over a certain period rather than in a single point in time, we believe the IASB should consider adding an IFRS 5-like treatment in order to pull forward potential losses on the assets to be sold, if these losses are not due to credit losses (which would be captured under the proposed amendments). In other words, we suggest adding a requirement to apply a "fair value less cost to sell" treatment to these assets, with the last carrying amount being the cap.

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?

We agree.

Additionally, we would like to point the IASB at an issue that we believe should be considered before finalising the approach. If the IASB proceeded with the proposed three measurement category approach, insurance entities might find themselves put in a situation where an accounting mismatch between the assets and the insurance liabilities could arise. Such would be the case where debt assets are held for collection and would thus have to be measured at amortised cost, whilst the impact of discount rate changes on the insurance liabilities would be measured at current value with changes in current value recorded in OCI. A certain portion of an insurer's debt portfolio is typically held to maturity based on the nature of these investments (e.g. private debt). In cases like these, we suggest the IASB establish an option to classify these assets into the FVTOCI category in order to avoid an accounting mismatch otherwise arising in equity, which would not provide decision-useful information to readers of the financial statements.

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?

We agree with the proposal that after its completion only the final and complete version of IFRS 9 will be available for early application. We also concur with the proposal to provide a six-month period between the issuance of the completed version of IFRS 9 and when the prohibition to use any previous versions becomes effective. We note, though, that in order for IFRS 9 to become effective in the European Union, it would have to be endorsed for use by the Commission, which we understand will take some time anyway.

On a somewhat related note we would like to ask the Board to provide more clarity as to the envisaged timeline. We are aware of the fact that many preparers in Germany have actually put their implementation projects on hold pending a robust signal as to when the final standard might become effective – noting that the current effective date in IFRS 9 of 1 January 2015 seems implausible. On the basis that the IASB has tentatively decided to allow insurance entities apply the revised version of IFRS 4 and IFRS 9 at the same time, and given that the envisaged effective date for a revised IFRS 4 is 1 January 2018, it would seem appropriate to have that effective date apply to all entities whether or not they have insurance business. We acknowledge that this would mean having the revised financial instruments standard become effective ten years after the outbreak of the financial crisis. However, we feel that even if the effective date was set to be 2016 – notwithstanding that financial institutions need sufficient time to adjust their systems, particularly for the new impairment provisions – this would still be eight years from the start of the financial crisis, so this argument does not seem to carry much weight anyway. Given that the IASB is about to abolish complex transition requirements in IFRS 9, which we highly appreciate, it seems counterintuitive to reintroduce different effective dates for different constituencies. Hence, we suggest the Board consider an effective date that is reliable and applicable for its entire constituency and make that date known at the earliest point in time possible. Since IFRS 9 is already applied by some entities in other parts of the world and the Board explicitly allowed for an early adoption of phases already completed, we further believe that the IASB should provide an option to early adopt as the comparability argument put forward in the revenue recognition project does not hold for this project.

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?

We are supportive of an accelerated application of presenting fair value changes due to own credit risk in OCI. However, we do not consider the proposal of introducing it as an option (to early adopt) and only via IFRS 9 in its final version being the preferred solution. Rather, the provisions should become mandatory (given that they apply only in cases in which an entity has used the fair value option for its financial liabilities, so providing yet another option on an option does not appear to make much sense) and better be introduced as quickly as possible to both IFRS 9 and IAS 39. Given that the IASB just proposed to amend IAS 39 for novations of derivatives, we fail to see the argument provided by the Board in BC97 and 104 not to change IAS 39. Given that IFRS 9 might not become effective for a number of years, we believe that a timely amendment to IAS 39 to accelerate what is generally seen as better accounting is warranted.

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?

We are not aware of any such issue being relevant to entities in our jurisdiction.

Appendix B – Alternative approach for introducing a third measurement category

Background

(1) Most of our constituents seem to understand the underlying objective of the classification criteria in IFRS 9. Where they have struggled is basically in two areas: (a) What exactly qualifies as SPPI in cases where the cash flows are not purely a reflection of time value of money and credit; and (b) how does the “hold to collect” business model differ from the current “held to maturity”/“loans and receivables” categories in IAS 39 – specifically: what is regarded a “permissible sale” under IFRS 9.

(2) German constituents welcome the IASB’s move to clarify the SPPI test, esp. as regards modifications of an ideal or benchmark instrument. Whilst some of the clarifications are helpful and acknowledged, most constituents feel that the clarifications do not reach far enough. This is because the amendments proposed seem to fall short to meet the underlying concept of the classification – being to depict normal lending transactions. We fully acknowledge that the difficulty is to define what “normal” means and in what circumstances. However, the current drafting would discriminate against well-accepted lending transactions that have features which have not been put in to achieve a structuring result but for other reasons. This is particularly true for prepayment provisions for which we believe that the principle contained in IAS 39 currently is more helpful in this regard, i.e. if prepayment occurs at an amount not significantly different from the amortised cost of the instrument, then the instrument would still qualify for amortised cost treatment (all other things being equal).

(3) One of the main concerns we have repeatedly come across is the permissible sale issue. Whilst we understand the underlying logic – the collection of cash flows is the way the entity intends to retrieve its investments and, thus, amortised cost seems a better reflection of that intent – the difficulty in this comes from viewing the entity holistically and not on a per-instrument basis (which is the basis for classifying the instrument initially). Entities – and financial institutions in particular – rarely invest in assets and lock them away to maturity, for a number of reasons:

- They may be forced to sell the investment because a regulator demands proof of them being liquid instruments;

- They may be forced to sell because customers demand their deposits back, so a repayment of debt requires a sale of an asset – this is similar to an insurer having to pay whenever the insured event occurs;
- They may seek an investment that is not available at the time the cash arises, so they make an interim investment to bridge the time until the desired investment becomes available;
- There may be a change in intent no longer to invest in a particular asset class (e.g. a board decision to no longer engage in certain sovereign state bonds);
- …

(4) Currently, IAS 39 provides that certain types of sales out of the held-to-maturity category are permissible without tainting the underlying intent to hold (cf. IAS 39.9 and AG16 et seqq.). These include

- Sales that happen close to maturity;
- sales that occur after the entity has substantially collected its investment;
- sales that are attributable to an isolated event that is beyond the entity's control, is non-recurring and could not have been reasonably anticipated by the entity:
  - i. a significant deterioration in the creditworthiness of the issuer
  - ii. a change in tax laws;
  - iii. a major business combination/major disposition
  - iv. a change in statutory/regulatory requirements; and
- sales that are of an insignificant amount only.

(5) Equally, IFRS 9 provides for permissible sales (cf. IFRS 9:B4.1.3). Nonetheless, the question has arisen as to "how many" and "how often" would not taint the original objective. The problem for practice is that, for some asset(s) (classes), it may be very hard to assess *ex ante* whether or not there is a likelihood of the instrument not being held. Obviously, and with hindsight, time will tell whether the entity has acted according to its initial classification.

(6) Our constituents have raised various concerns in this regard. These concerns seem to focus on the appropriate classification of <u>bonds</u> rather than loans as loans tend to be held for the collection and are usually not sold before maturity (and, provided the SPPI test was met, would qualify for AC treatment). Bonds are more difficult to evaluate in cases where, at initial recognition, there is no clear intent to either hold or sell. We understand that the Board strived to propose its new category for exactly this type of instruments. However,

having considered the examples raised by our constituents we do not believe that the category is defined robustly enough to distinguish it clearly from the other two.

(7) Specifically, IFRS 9:B.4.1.3 states: "[A]n entity's business model can be to hold financial assets to collect contractual cash flows *even when sales of financial assets occur*" (emphasis added). However, the Board carries on to state that "if *more than an infrequent number of sales* are made out of a portfolio, the entity needs to assess whether and how such sales are consistent with an objective of collecting contractual cash flows." (emphasis added). Hence, the amortised cost category already provides for a mixed attribute where the majority of assets should be held to collect, but some may be sold without negating classification of the majority.

(8) Thus, the question is where the boundary line between the AC category and the adjacent category should be drawn. It is important to note that this issue arises equally under the current version of IFRS 9 and the new proposals as the IASB did not change the wording for defining the AC category. Therefore, we believe that the same pressure on the border line that exists in the current version will persist if the new proposals were finalised.

The approach

(9) The ASCG considered the objective of the IASB for making the amendments and understands that one key driver for the amendment was to accommodate for a solution for the insurance business. Given the tentative decisions made in the insurance project, a measurement attribute "Fair Value through OCI" (FVTOCI) was needed on the asset side in order to avoid accounting mismatches arising. We acknowledge that need and approve of it. However, we have doubts whether the way this accommodation is crafted in the ED is actually the best way to alleviate the concerns raised. Specifically, we hear concerns in industries other than the insurance sector that do feel that the new proposals represent a significant change vis-à-vis the classification they already made – notwithstanding the difficulties mentioned in paras. 5 et seqq. above.

(10) We have also analysed the dissenting views provided by the two board members who state that the inclusion of a third business model adds complexity to the classification model that they feel is unnecessary and not adding value.

(11) We have taken these points into consideration and have sketched the following model as an alternative to the proposal. We fully acknowledge that there is not *the* best model and that every model has shortcomings. Nonetheless, we believe that our proposal could add

to the debate and might form a basis from which the board might find a solution that is acceptable to most.

(12) The model is based on the assumption that a third business model should not be introduced. We believe that a model to "hold and sell" is not a business model in its own right but the absence of a business model to either hold or sell. Rather, it is a state under which the final decision as to what to do is simply deferred until some time in the future. Most entities have a desire to hold and invest excess liquidity, but in our view that does not constitute a fully-fledged business model in its own right. So the basis for our model is to stick with two categories (which may or may not constitute business models).

(13) The current classification in IFRS 9 foresees a "hold to collect" business model, with all other instruments not meeting this definition be allocated to a residual category.

(14) In the current version of IFRS 9, the Board has decided to define the AC category as consisting of only plain vanilla instruments (those that meet the SPPI test) and are held in a "hold to collect" business model. Based on our experience, clearly defining what (still) meets a "hold to collect" model if sales occur has proven unsatisfactory. Indeed, upon deliberating the proposed amendments it became clear to the ASCG that there are fundamentally different views as to what permissible sales constitute and, hence, how the category could be defined robustly across industries. We have been made aware that banks largely consider many investments as qualifying for AC treatment whereas the insurance business seem to consider they hardly meet the requirements – the difference being exactly the interpretation of what constitutes "an infrequent number of sales" or "some sales". As stated above, that issue will not go away if the IASB were to finalise its proposals because the paragraph is not touched upon.

(15) One alternative would be to clarify these undefined terms in order to make their application more robust. We understand that the Board did not want to reintroduce the tainting rules currently sitting in IAS 39; on the other hand, we believe that the IASB did not intend to provide entities with a free choice, either. It may be difficult (if not impossible) to clarify the principle such that it becomes operational and is understood and applied consistently across industries and jurisdictions, esp. if the Board does not want to create a bright line to state "an percentage of X" or "a number of Y" is permissible.

(16) It is for this reason only that the ASCG is suggesting to reverse the order of defining the categories. Rather than defining what "hold to collect" means, we suggest taking the current definition in IAS 39 of "held for trading" which we believe is meant to portray something similar to "hold to sell" and is well understood by and in practice. In other words, we

would define the "hold to sell" category and make the other the residual in order to solve the issue of otherwise having to define what constitutes permissible sales.

(17) Our proposal would retain the SPPI test and see it work exactly the same way as the IASB intended it to work. Whilst the cash flow and the business model tests are meant to have equal weighting, we believe that it will be easier from a practical point of view if entities would first separate the population of financial assets into those that meet the SPPI test ("plain vanilla instruments") and those that do not. The latter group would be measured at FVTPL as envisaged by the IASB, the former would be evaluated for the business model.

(18) The remaining group of plain vanilla items would then be tested for whether they are held with a view to sell (i.e. trading). If that was the case, these instruments would be measured at FVTPL; if not, they would be measured at amortised cost. At this stage it is important to note a few points:

- The fact that instruments are not classified as "held for sale" does not mean that they will be "held for collection"; i.e. we would not define the other business models that may or may not exist;
- Only instruments that are plain vanilla could ever qualify for AC treatment; any instrument not meeting the SPPI test must be measured at FVTPL;
- Compared to the proposal in the ED, the ASCG's approach would have not led to a different measurement of these assets in the income statement as the Board would foresee an AC-like treatment for items in its middle category (FVTOCI), too;
- The difference in balance sheet presentation would be bridged with the disclosure requirements that already exist in IFRS 7, so the FV of the items can be depicted easily and the AOCI amount computed by comparing the FVs and the carrying amounts.

(19) In addition to the above, we would amend the current measurement provisions in IFRS 9 in one respect, being a situation where an entity has decided to no longer hold an asset or a portfolio of assets for collection of cash flows and where this change in intent does not lead to a change in business model. For these situations, we believe there is a potential that losses might be deferred until the point in time where the sale actually occurs, if these losses are not attributable to impairments and thus caught by the proposals for Phase II. We would envisage an IFRS 5-like treatment for these assets, i.e. a FV less cost to sell notion with the carrying amount being the cap.

(20) In order to address the solution for the insurance business, we suggest providing a FVTOCI option for all assets otherwise measured at AC. That option would have to be exercised at initial recognition and would be irrevocable. However, and contrary to the FV

option currently in IAS 39/IFRS 9, the option would not be based on an accounting mismatch concept. The reason not to tie the option to the existence of an accounting mismatch stems from the fact that approx. 90% of a life-insurer's business in Germany is participating as defined in the insurance project. Given the IASB's tentative decision to mirror the measurement of the assets held when measuring the insurance liability (thus reversing the measurement sequence), by definition there would not be an accounting mismatch. Still, we believe that the possibility to treat participating and non-participating business alike and have the underlying assets accounted for similarly is desirable from the perspective of comparing insurance entities with participating and non-participating business.

(21) The following is a summary of the key points of the model. They are being reproduced to ease the discussion of the main issues, but should not be viewed in isolation.

- Apply SPPI criterion to separate plain vanilla from non-plain vanilla instruments; for instruments that are non-plain vanilla measure @FVTPL
- For the plain vanilla instruments test whether business model is to "held for trading" as per IAS 39; if yes measure @FVTPL
- The remaining plain vanilla instruments for which there is no intention to trade would be classified as AC
  - o No business model test for this group ("non-trading")
  - o No difference in P&L presentation compared to IASB draft proposals (→ AC presentation)
  - o Difference in B/S presentation, however the same information can be obtained through the IFRS 7 disclosures already in existence
- For the AC category an "unrestricted" FVTOCI option would be available
  - o Must decide at initial recognition
  - o Irrevocable
  - o BUT: not limited to accounting mismatches as this would not help life insurers!
- Add an IFRS 5-like treatment for asset (portfolio)s for which a decision to sell has been made but will be executed over an extended period (→ anticipate losses that are not due to impairments [and, thus, will not be caught by the impairment proposals] and do not wait for them to be presented only upon final sale)