Deutsches Rechnungslegungs Standards Committee e.V.

Accounting Standards Committee of Germany

DRSC

ASCG • Joachimsthaler Str. 34 • 10719 Berlin

Dr Andreas Barckow
Chair of the
International Accounting Standards Board
Columbus Building
7 Westferry Circus / Canary Wharf
London E14 4HD

Financial Reporting Technical Committee
Phone: +49 (0)30 206412-12
E-Mail: info@drsc.de

Berlin, 28 January 2022

Dear Andreas,

IASB RfI – *Post-implementation Review IFRS 9 – Classification and Measurement*

On behalf of the Accounting Standards Committee of Germany, I am writing to comment on the Request for Information *Post-implementation Review IFRS 9 – Classification and Measurement*, issued by the IASB on 30 September 2021 (herein referred to as 'RfI'). We appreciate the opportunity to comment on the proposals.

As far as we are aware, all relevant issues as regards the classification and measurement of financial instruments have been addressed in the RfI. In particular, the "spotlights" comprise the most relevant and crucial instruments which deserve thorough discussion and presumably require clarification.

Overall, we deem the classification and measurement requirements to be principles-based, and we consider them to generally provide useful information. Nevertheless, the complexity of IFRS 9 in these respects is higher compared to its predecessor IAS 39.

Among our findings, we first like to highlight that applying the SPPI test to financial instruments with ESG and/or variability features appeared to be the most relevant and most urgent issue. In deliberating how those financial instruments should be classified as an asset, we have acknowledged that as a first step the IASB should reiterate the general principle of when measuring financial assets at amortised cost or at Fair Value through OCI (FVtOCI) – including the effective interest rate (EIR) method – leads to decision-useful information. Reconsidering the idea of basic lending arrangements and which of its characteristics lead to amortised cost measurement – including the question of whether instruments with ESG and/or variability features warrant to be measured at amortised cost (also under cost-benefit constraints) – should follow as a second step.

In this regard, we like to note that considering the classification of those specific instruments as a financial asset is not the only challenge. Instead, there is also a debtor's perspective where those instruments are classified and measured as a financial liability, and where IFRS 9 has a different accounting model including potential separation of embedded derivatives.

ESG features in financial assets and liabilities are expected to be increasingly relevant, as they are expected to help transform economies to be more sustainable and resilient. Therefore, we suggest separating this issue from the PiR and making it an own project with high priority.

Secondly, we acknowledge that the issue of equity instruments at FVtOCI and the related "non-recycling" of gains and losses is still considerable, as it has become even more relevant after the issuance of IFRS 9. We acknowledge that whether the current requirements are deemed appropriate or not depends on the specific business model and/or the investment strategy of an entity. The assessment of whether the requirements for classifying equity instruments at FVtOCI are deemed appropriate also touches on the more general question of whether equity instruments and debt instruments should be treated alike or not.

Thirdly, we like to point to the modification issue of financial assets and liabilities. In our experience, it is not only the existence of different or insufficient wording for modifications (as mentioned in the RfI), but also the (questionable) interaction of modification vs. impairment vs. derecognition (not being explicitly mentioned in the RfI) that deserves attention and potentially needs clarification.

As regards the remaining sections of the RfI, we have identified some minor issues.

For more details on our findings, we refer to our responses to the questions of the RfI which are laid out in the appendix to this letter. If you would like to discuss our comments further, please do not hesitate to contact Jan-Velten Große (grosse@drsc.de) or me.

Yours sincerely,

Sven Morich

Vice President

Appendix – Answers to the questions in the RfI

Question 1 – Classification and measurement

Do the classification and measurement requirements in IFRS 9

(a) enable an entity to align the measurement of financial assets with the cash flow characteristics of the assets and how the entity expects to manage them?

(b) result in an entity providing useful information to the users of the financial statements about the amount, timing and uncertainty of future cash flows?

We agree that the classification and measurement requirements as a whole are a principles-based and useful set of requirements. Overall, we consider them to provide useful information.

While it is not considered an issue, we like to mention that there are a few circumstances under which the measurement base for financial instruments has changed during transition from IAS 39 to IFRS 9. However, those remaining circumstances that involved changes as regards classification and measurement are considerable. The most prominent reason for measurement changes is the non-bifurcation of financial assets with embedded derivatives, resulting in the entire instrument being classified at FVtPL, thus leading to higher volatility in profit or loss. Another case for measurement changes is certain fund investments (including private equity financing) which had been classified as "available for sale" (ie. FVtOCI) under IAS 39, while these are measured at FVtPL under IFRS 9.

Q2 – Business model

(a) Is the business model assessment working as intended?

(b) Can the business model assessment be applied consistently?

(c) Are there any unexpected effects arising from the business model assessment? How significant are these effects?

We confirm that, to our knowledge, the business model assessment does not constitute fundamental challenges or unexpected effects. The only point for discussion was whether, and why, there could be situations that led to a change in the business model.

We take the view that, as intended, there are few circumstances and have been few situations under which changes in the business model occurred and reclassification was required. However, this partly results from the requirements (and respective examples given in IFRS 9) being very, if not too restrictive. As changes of the business model can be necessary and sensible, eg. in case of regulatory reasons, we would welcome further examples to be added to IFRS 9.

Common circumstances that are not allowed for – but might warrant – reclassification are loan syndications. In particular, the requirements for assessing the business model for loan syndications are challenging since determining at initial recognition the two portions of loans that are expected to be sold and to be retained, respectively, is difficult, if not virtually impossible. In many cases, the portion intended to be sold deviates from the portion finally being sold, due to changed market conditions. If so, the portion of "failed" syndication would be measured at FVtPL until maturity, although the holder's intention is to hold and collect. Therefore, classifying the "two portions" at initial recognition without the ability to reclassify (the deviating amount) when the syndication has been closed has the potential to result in a measurement attribute that is less relevant to users.

This said, under specific circumstances the requirements could appear narrow. Overall, more flexibility to reclassify failed syndications might be beneficial for both prepars and users of financial statements. .

Some constituents, mainly non-financial entities, feel the requirements for assessing the business model to be unduly complex. For many of those entities, considering the business model is rather irrelevant as the business model rarely affects the classification of a financial instrument.

Q3 – Contractual cash flow characteristics

(a) Is the cash flow characteristics assessment working as intended?

If, in your view, useful information could be provided about a financial asset with cash flows that are not SPPI (that is, measured at FV-PL) by applying a different measurement approach (that is, using AC or FV-OCI) please explain: (i) why the asset is required to be measured at FV-PL (that is, why ... cash flows are not SPPI); and (ii) which measurement approach you think could provide useful information?

(b) Can the cash flow characteristics assessment be applied consistently?

(c) Are there any unexpected effects arising from the cash flow characteristics assessment? How significant are these effects?

Generally, we consider the contractual cash flow characteristics (CCC) assessment to be well-understood and to be part of a robust and principles-based scheme for classifying financial assets. We are aware that the CCC assessment involves the SPPI criterion as the main criterion, of which the definition or understanding of "interest" is a sub-criterion. The "interest" element obviously is the most challenging. Therefore, our following comments mainly focus on the interest issue.

Overall, we support the SPPI criterion as an inevitable condition (along with the business model criterion) for measuring certain financial assets at amortised cost. We also fully concur with the idea of "basic lending arrangements", which is pictorial for financial assets for which amortised cost provides the most decision-useful measurement base.

Given recent developments in business and financing practices, the definition and under-standing of interest in this respect increasingly appear challenging. As is explicitly described as "Spotlight 3.1", ESG elements are the most apparent trend causing challenges. While the issue and its very recent discussion appear largely political, our discussion – and the following comments – focus on a conceptual perspective.

We are convinced that financial instruments with ESG features will become more and more relevant, and soon will (if not already) appear to be usual or common. This said, we think that the current understanding of basic lending arrangements and the nature of payments they comprise is on the way to fundamentally change. This is proven as current discussions tried to sort out how these fit into the understanding of "interest" payments and, consequently, of "basic lending arrangements" – with no consensus.

Addressing the challenge of the CCC assessment (including the SPPI test) in light of financial instruments with ESG and/or variability features would, from our perspective, require two steps – thereby answering the two main questions:

- The first step is to reiterate, and potentially clarify, the general principle of why (and which) financial assets warrant being classified at amortised cost – along with interest to be recognised applying the effective interest rate (EIR) method. This would involve answering the key question of ***whether*** and why ***instruments with ESG and/or variability features*** should be ***measured at amortised cost or at FVtOCI***. This also touches on considerations about whether the EIR method is sufficiently robust and applicable for this set of instruments and leads to decision-useful information, and a fair presentation in the statements of financial position and performance.
- The second step is to reconsider, and potentially amend, the criterion for defining which characteristics of a financial instrument lead to the use of the EIR method. This second step would include answering the question of ***to what extent*** (ie. "which") ***instruments with ESG and/or variability features should use the EIR method***. This would involve the consequential question of whether and how the CCC criterion might require to be amended. Apart from these technical aspects, this would also touch on cost-benefit constraints from both, the users' and the preparers' perspectives.

This said, our view is that both steps require re-consideration, in the light of new market developments, of whether the definition of interest and the current rationale underpinning the idea of a basic lending arrangement are still robust elements of the CCC assessment as one criterion – along with the business model assessment as another criterion – for classifying financial assets.

Assuming – as a result of the first step – that (at least some) instruments with ESG and/or variability features should be measured at amortised cost, we think searching for a solution – as the second step – should focus on how the <u>current definitions of "interest" and "basic lending arrangements" in IFRS 9 could be amended</u>. We have identified two alternatives – and clearly prefer the second. The first is: <u>retaining these two current definitions, but adding an exemption</u> allowing for certain financial instruments with ESG and/or variability elements (yet to be defined or ring-fenced) to be measured at amortised cost, although failing the SPPI test. The second is: amending these two definitions to allow those instruments to be considered as ”basic lending arrangements” and (at least some) ESG features to be an interest/pricing component.

Obviously, both alternatives are based on the same premise: We are confident that financial instruments comprising ESG features will become common financing instruments. Our conviction derives from the following line of thinking: The current understanding and definition of interest comprise four elements – compensation for time value of money, for liquidity and credit risk, for other costs, and a profit margin. This understanding is well-known and has been broad consensus based on which lending arrangements are “basic” so far. In our eyes, this might not hold for the future. Already as of now, the defined interest elements have proven, while accepted, as partly unclear and hard to distinguish (eg. which part compensates for risks and which part is the remaining profit). Recently, when discussions around the nature of ESG elements emerged, they appear partly compensating for risk, the remainder appears to be something else (yet to be defined). Currently, many stakeholders start understanding that ESG features are part of a new understanding of interest. Maybe these elements constitute a new pricing/interest component, maybe they are part of another existing component, or both.

This all said, we take the view that it seems worth and appropriate to think about amending the definition of “interest” by adding another component – ie. a new “interest building block”. We acknowledge that it seems difficult to depict this component, and to label it. However, if the way how to solve the “interest issue” were determined, developing the particular definition and determining which (ESG and/or other) features shall be comprised – and which not – would be easier to start with. The latter one is surely an exercise which stakeholders should, and will, be ready to participate in. For the time being, it appears too early in the review process for making more precise suggestions as regards the definition of those components.

Following the previous arguments, it is to be expected that such financial instruments with ESG and/or variability elements held under a ‘hold to collect and sell’ business model would also continue to provide useful information when classified at FVtOCI applying the EIR method.

Overall, we feel that providing clarity on these issues is urgent. Therefore, we suggest resolving these issues separately from other issues that potentially emerge from this PIR as a stand-alone and high-priority project.

Finally, we like to point to another aspect. As regards financial instruments with ESG features, considering their classification as financial assets is not the only challenge, as there is also the debtor’s perspective where those instruments are classified and measured as a financial liability. For some constituents, in particular non-financial entities applying IFRSs, this perspective is indeed the main question when examining the accounting implications of ESG elements. The question is whether those features comprise an element for which separation from the host contract is (or should be) required, or allowed. While we have yet no straight proposal on how to answer this question, one potential idea is that a financial instrument – as an asset – failing (or meeting) the SPPI criterion could determine whether the same instrument

– as a liability – does (or does not, respectively) comprise an embedded element to be separated from the host.

Q4 – Equity instruments and other comprehensive income

(a) Is the option to present fair value changes on investments in equity instruments in OCI working as intended?

(b) For what equity instruments do entities elect to present fair value changes in OCI?

Initially, we like to state that the FVtOCI option for equity instruments is broadly used for investments in the insurance industry and, to a lesser extent, in other sectors like banking. For both sectors, investments in equity instruments as well as in debt instruments are part of the same overall investment strategy. Therefore, especially these sectors perceive the current requirements still creating room for discussion, if not for improvement. Contrary to this, other (non-financial) sectors do not challenge the current requirements, in particular the non-recycling issue. These deviating views result from different business models: While in many industries the FVtOCI measurement mainly applies to strategic investments, in some others (especially insurance) a significant population of equity instruments is classified at FVtOCI.

Notwithstanding this, assessing the requirements for classifying and measuring equity instruments involves assessing the respective requirements for debt instruments. Considering both is a high-level subject of general principles that basically affect all sectors. For long, two issues have emerged and have been subject to controversial debate, and both have not been solved so far:

1. Distinguishing equity from debt instruments – which remains, to some extent, unsatisfactory and artificial.
2. Nature and extent of a different accounting treatment for equity and debt instruments.

The main aspect of the latter is that for instruments measured at FVtOCI, recycling vs. non-recycling is perceived by a majority of stakeholders as constituting a disruption in recognising gains and losses over the entire investment period. This involves three sub-issues: (i) the (appropriate) timing for recognising gains/losses, (ii) the distinction of impairments vs. other changes in fair value, and (iii) the understanding of the nature of other comprehensive income.

While arguments for or against the current requirements in IFRS 9 (and IAS 32) are well known and have not fundamentally changed over time, their assessment might have changed since the issuance of IFRS 9 and might be different for different stakeholders.

As of today, entities within nearly all sectors have sufficient experience in accounting for investments under IFRS 9. We are aware that most insurance companies have not applied IFRS 9 yet, but after having implemented the requirements they are able to determine and anticipate whether, and how, the IFRS 9 requirements comprise challenges on accounting for their investments. Both, current experience as well as anticipations underline our view that the non-recycling of gains and losses in the FVtOCI option for equity instruments (vs. recycling for debt instruments) constitutes a disparity, thus appears inappropriate, under particular business models.

Given this disparity persisting, distinguishing equity from debt instruments is extremely, but unnecessarily crucial. This assessment surely holds for any business model. If, instead, accounting for both types of instruments were aligned, this would – at least for certain business models or investment strategies – better reflect the economics of such investments that involve both types of instruments.

Overall, it seems worth reconsidering whether, and for which business models or industries, the current classification scheme for equity and debt instruments (comprising different measurement bases as well as different earnings' recognition patterns, and involving the distinction of both) appears appropriate or whether, instead, measuring equity instruments and debt instruments alike could be a favorable principle. Considerations in this regard may also have to include the impairment model for the affected instruments.

Q5 – Financial liabilities and own credit

(a) Are the requirements for presenting the effects of own credit in OCI working as intended?

(b) Are there any other matters relating to financial liabilities that you think the Board should consider as part of this PIR (apart from modifications, which are discussed in Section 6)?

To our knowledge, the requirements work as intended.

We are neither aware of unintended consequences nor of any other matters.

Q6 – Modifications to contractual cash flows

(a) Are the requirements for modifications to contractual cash flows working as intended?

(b) Can the requirements for modifications to contractual cash flows be applied consistently?

First, we like to confirm that there is a different wording for modifications of financial assets and financial liabilities, which has led to difficulties in practice. While this is mentioned in the RfI as an issue, we are aware that many entities have developed accounting practices under IFRS 9 overcoming those difficulties. However, this goes along with some diversity in practice. This said, we would not oppose were the current wording of the modification requirements eventually be clarified, as this issue has been discussed for years but was not brought nearer to a solution.

Nonwithstanding this, we like to point to another (and more urgent) issue not mentioned in the RfI. In our view, the interaction of <u>modification vs. impairment vs. derecognition</u> requirements deserves attention and needs clarification. This may be illustrated by two common examples:

- Given financial instruments with “stage 3 impairments”, modifications often are an obvious consequence. If so, it is unclear, thus challenging, how to separate (and separately recognise) “modification” losses from impairments or write-offs.
- Given a financial instrument being modified due to legal requirements, this sort of a “non-active” modification may lead to derecognition. If so, derecognition appears counterintuitive or even inappropriate.

If clarifying the modification requirements was intended, we suggest not only improving the different wording for (financial) assets and liabilities in this respect, but also addressing the interaction with derecognition (or partial derecognition) and with impairment requirements, which appears as a useful and comprehensive approach for addressing the modification issue.

Q7 – Amortised cost and the effective interest method

(a) Is the effective interest method working as intended?

(b) Can the effective interest method be applied consistently?

In general, we deem the EIR method working as intended.

However, we like to note that applying the EIR method can be challenging whenever interest rates are subject to conditions and/or estimates. While this is apparently not a new finding, the room for inconsistent application has increased and still is increasing, along with the increasing number and variety of financial instruments with ESG and/or variability features.

Although this issue is already acknowledged as “Spotlight 7” in the RfI, we think that its implications might be underestimated. While instruments with ESG features might currently be the most prominent set of examples for the EIR method to be challenging – and the amortised cost measurement to be on trial –, there are also other cases (eg. most recently the TLTRO III programme) with interests rates subject to variability.

The more interest rates depending on “features” and estimates become usual, the more the EIR method and its implication reach their limits. One challenging aspect is the principle behind the implication of whether, and why, changes in (estimated) cash flows lead to adjusting the EIR or to adjusting the carrying amount (“catch-up”). Another challenging aspect is that whenever the EIR method is applied inconsistently, applying the EIR method – and measuring financial instruments at amortised cost – might appear inappropriate. Hence, the latter aspect constitutes a vicious circle of inconsistent application of the EIR and reservations regarding amortised cost measurement. One way of unbundling could be relaxing the requirements for adjusting the EIR (see IFRS 9.B5.4.5 et seqq.).

To sum up, we underline that the issue of “applying amortised cost measurement and the EIR method” is closely related to the issue of “contractual cashflow characteristics” (ie. to what extent uncertain cash flows allow for amortised cost measurement). Therefore, we conclude that both issues need to be considered, and solved, jointly.

Q8 – Transition

(a) Did the transition requirements work as intended?

(b) Were there any unexpected effects of, or challenges with, applying transition the requirements?

Apart from the high (one-off) transition and implementation costs, we have not identified ongoing challenges or unexpected follow-up effects.

In addition, we like to pass on comments from insurance companies among our constituency, which note that the relief provided for those initially applying IFRS 9 and IFRS 17 at the same time has brought a considerable benefit and has helped to overcome transition challenges.

Q9 – Other matters

(a) Are there any further matters that you think the Board should examine as part of the PIR? If yes, what are those matters and why should they be examined?

(b) Considering the Board's approach to developing IFRS 9 in general, do you have any views on lessons learned that could provide helpful input to the Board's future standard-setting projects?

We have understood, and fully agree, that issues resulting from requirements in IFRS 9 other than those on classification and measurement (eg. on impairment or on hedge accounting) are not in the scope of this PIR.

However, we like to note that the requirements for <u>disclosures on financial instruments</u> (being part of IFRS 7) have undoubtedly increased reporting quantity – while increased reporting quality or benefits have yet to be examined, in particular outside financial services industry. Since these requirements are neither in the scope of this PIR nor expected to be in the scope of the subsequent part(s) of the PIR of IFRS 9, we suggest additionally considering their review. If the IASB finalises its project '*Disclosure Initiative—Targeted Standards-level Review of Disclosures*' and decides to also review existing disclosure guidance in IFRSs, IFRS 7 would be a good candidate for such a review.

Another area of concern and worth being noted is the <u>interaction of IFRS 9 requirements with other IFRSs</u>. Since the initial application of IFRS 9, several targeted discussions of specific issues have emerged, each addressing a potential conflict of selected requirements – eg. classification of financial guarantees (IFRS 9 vs. IFRS 4/17), presentation of factoring and similar agreements (IFRS 9 vs. IAS 1/7), considering fees when determining the transaction price (IFRS 9 vs. IFRS 15), or financial instruments with regulated pricing elements, eg. the TLTRO program (IFRS 9 vs. IAS 20). Our perception is that these issues, and presumably some more, deserve to be gathered and then considered jointly as part of the IFRS 9 review.