

Exposure Draft Classification and Measurement: Limited Amendments to IFRS 9

EFRAG Draft Comment Letter: Question to EFRAG's constituents, paragraph 21.

Input from BNP Paribas Fortis, Belfius and KBC.

Some considerations on mortgage loans at variable interest rate in Belgium

Context

In Belgium clients have the choice between mortgage loans at an interest rate that is fixed for the entire life of the loan or mortgage loans for which the interest rate is reset at predefined dates.

Mortgage loans with variable interest rate have a final maturity that extends beyond the first period with a fixed interest rate. Various formulas are available such as:

- 1-1-1, meaning that the interest rate is reset every year;
- 3-3-3, meaning that the interest rate is reset every three years;
- 5-5-5, meaning that the interest rate is reset every five years;
- 10-5-5, meaning that after a 10-year period at a fixed interest rate, the interest is reset every five years, and other variations with a fixed period of 15 or 20 years.

Interest rate reset features

Mortgage loans with variable interest rates are subject to a government regulation which aims at protecting the client against unexpectedly high increases of interest rates at the interest date.

- (a) The interest rate should be reset by **reference to an index** which is determined by the Belgian government on a monthly basis. These indices are set by reference to the interest rate on Belgian sovereign debt.

Ten indices are available, for loans with interest rate reset periods varying from one year to ten years.

Index	Referenced to	Frequency of interest rate reset
Index A	treasury bills 12 months	Annual
Index B	linear bonds 2 year	Biannual
Index C	linear bonds 3 year	Three year period
Index D	linear bonds 4 year	Four year period
Index E	linear bonds 5 year	Five year period
Index F	linear bonds 6 year	Six year period
Index G	linear bonds 7 year	Seven year period
Index H	linear bonds 8 year	Eight year period
Index I	linear bonds 9 year	Nine year period
Index J	linear bonds 10 year	Ten year period

Mortgage loans for which the rate is reset annually, the interest rate should be reset with reference to index A. When interest is reset biannually, the reset should be done by reference to index B, and so on.

- (b) At interest reset date the new interest rate is determined using the following equation.

New interest rate = old interest rate + (new reference index -/- old reference index)

- (c) However the change in interest rate is subject to certain limitations. The law determines that the new interest rate should not increase above a maximum threshold compared with the original interest rate. In addition the maximum increase in interest rate should never be higher than the maximum decrease in interest rate.

For example, for a loan with annual interest rate reset (1-1-1 formulae) an increase in interest rate is limited to 1% of the original interest rate for the first year, 2% for the second year and 3% for the third year.

Comments

There is some doubt that these mortgage loans at variable interest rate will meet the SPPI-criteria in IFRS 9 and thus will qualify for classification and measurement at amortised cost.

Example 1

A mortgage loan based on the 5/5/5 formulae that has a maturity of 12 years will be subject to interest rate reset at the end of year 10 in accordance with the above mentioned guidance. The new interest rate for the remaining two year period will be determined by reference to the index E which is the five-year interest rate on government bonds.

Example 2

A mortgage loan, based on the 5/5/5 formulae, with a 3% interest rate for the first five years is subject to interest rate reset at the end of year 5. The reference index E at loan origination is 2,4%. At interest reset date the reference index E has increased to 5,5%.

- The new interest rate is 6,1%, or 3% (old interest rate) + 3,1% (differential between the old and the new reference index E or 5,5% -/- 2,4%).
- However considering the above mentioned caps, the increase of the contractual interest at the reset date is limited to 2% maximum. Therefore the new interest rate for the next five-year period will be set to 5%.

According to the Limited Amendments to IFRS 9 on Classification and Measurement the interest rate reset in both examples should be considered as 'a modified economic relationship' because the interest feature changes the economic relationship between the principal and the interest as a consideration for the time value of money and the credit risk of the mortgage loan.

- In example 1 there is a mismatch between the five year reference rate and the tenor of the last interest period which is two years.

- In example 2 the new interest rate does not reflect the time value of money at interest reset date because of the legally required cap.

In accordance with the proposals in the ED/2012/4 the bank should assess in both examples the significance of the modified cash flows in order to conclude if the reviewed cash flows of the mortgage loans are consistent with the notion of solely principal and interest. The bank should compare the modified cash flows of the mortgage loan with a benchmark financial asset that does not contain the modification. Several concerns arise on the operability of the modified relationship guidance.

- As interest reset features are determined by law and thus apply to all banks, there may be no benchmark financial instruments that are priced without those specific interest reset features.
- Mortgage loans typically are products with a relatively long tenor. It may therefore be quite difficult to assess at origination date which interest rate scenarios are 'reasonably possible'. For example, variable rate mortgage loans that are originated in the current environment of low interest rates are likely to be subject to an increase in interest rate on future interest reset dates. A relatively small increase in interest rates may trigger the application of the cap at interest reset date and lead to breaching the SPPI test. It will therefore be important assess if and when inflation is expected to occur. Considering the long tenor of mortgage loans, this will involve a lot of judgment and could cause different banks to report the same type of loan on a different measurement basis (amortised cost versus fair value). This will affect the comparability and transparency of the financial statements.

We have serious concerns about the appropriateness and usefulness of the modified economic relationship guidance for this type of activity. If this guidance would lead to disqualifying the variable interest rate mortgage loans from classification and measurement at amortised cost, a part of the core business of retail banks would be reported at full fair value (although the banks still intend to hold the loans till maturity to collect the contractual cash flows) while mortgage loans at fixed rate which are managed under the same business model of 'hold to collect the cash flows' would be measured at amortised cost. We have doubts on the usefulness of such financial information.