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Ref.: BAN/AKI/TSI/SRO

Dear Ms. Flores,

Re: FEE Comments on EFRAG's Draft Comment Letter on IASB Exposure Draft Classification and Measurement: Limited Amendments to IFRS 9

(1) FEE is pleased to provide you with its comments on the EFRAG Draft Comment Letter regarding the IASB Exposure Draft Classification and Measurement: Limited Amendments to IFRS 9 (the "ED").

General support

(2) Generally, we support the direction of the proposals in the ED. Like EFRAG, we welcome the fact that the IASB considers the interaction with the project to revise IFRS 4 Insurance Contracts in the finalisation of IFRS 9 Financial Instruments. In respect of addressing accounting mismatches, the proposals in the ED represent a step forward but do not wholly address concerns.

(3) The actual changes proposed could be considered in many respects more complex than current provisions in IAS 39 Financial Instruments: Recognition and Measurement and IFRS 9 (2010). There is a risk of issuing a new standard which is at least equally complex and not fully understandable, when one of the original aims for replacing IAS 39 was to reduce complexity. This risk needs to be kept in mind when finalising the standard and complexity reduction should be implemented wherever achievable.

Interaction with future IFRS on Insurance Contracts and Accounting mismatches

(4) The introduction of the new measurement category of financial instrument Fair Value through Other Comprehensive Income (FVOCI) will help reduce inter alia the accounting mismatches between the measurement of financial assets and the related insurance contracts liabilities by recognising FV gains and losses in OCI. This provides a strong justification for the reintroduction of this measurement category following the IASB's tentative decision on IFRS 4 Phase II, according to which, in order to remove the short-term volatility from the profit and loss line, gains and losses attributable to changes in market discount rates for insurance contracts shall be recognised in OCI.

(5) However, as noted by EFRAG we believe that there are still many concerns regarding the proposals in the ED.

(6) The proposed new category of FVOCI will not avoid all accounting mismatches. As noted above, we understand the IASB tentatively agreed on a mandatory use of OCI for effects of changes in interest rates in insurance contracts. Therefore, accounting mismatches will remain, where assets of an insurer do not qualify for FVOCI under the proposals in this ED (e.g. derivatives used to hedge interest rate risks or instruments measured at amortised cost), unless solved through the hedge accounting proposals.

(7) Many argue that the new categorisation of financial instruments proposed in the ED diminishes the clear impact of the “business model” as a primary characteristic to decide the category into which a particular financial instrument should be placed. Therefore we support the view that this category should be made available only if it reduces or mitigates accounting mismatch. It should not be mandated, since what might be right for banks in terms of accounting will not necessarily be right for insurance contracts accounting or general businesses and vice versa. Hence an option with respect to the use of the new measurement category would be helpful to avoid accounting mismatches.

(8) For insurance contracts with participating features, where the mirroring approach applies, insurers should be allowed to present changes in insurance contract liabilities in OCI consistently with the presentation of changes in the directly linked underlying items. In any case, the IASB should provide for an appropriate interaction between the accounting for financial assets pursuant to IFRS 9 and the accounting for insurance contract liabilities.

(9) The approach proposed in paragraph 7 is closely linked with the amortised cost category definition, which should ensure that standard debt instruments routinely used in traditional banking are eligible to remain in the amortised cost category. Debt instruments that are part of a wider held to collect model, measured at fair value whether through OCI or profit or loss, creates accounting mismatches and provides less useful information to users.

Amortised cost category definition

(10) We agree with EFRAG that there are still certain financial assets that do not pass the contractual cash flow characteristic assessment and for which an amortised cost (AC) measurement would provide more useful information than measurement at fair value. Our concerns therefore remain regarding those assets that will not pass the test despite their consistency with the “held to collect” business model. For examples of such instruments, please refer to our detailed response to the questions included in the Appendix to this letter.

(11) We agree with EFRAG that the definition of interest in IFRS 9 should be revised and that it would make sense to have it aligned with the recent tentative decisions on the insurance contracts project, i.e. widening the definition and to clarify that it includes other inherent components (such as liquidity risk), if a definition is necessary at all.

(12) In order to foster simplification and plain language, we recommend replacing the term “more than insignificant” by “significant” when assessing any contractual terms of an instrument, which should in theory not change the final result but would be clearer. It would also avoid the perception that there is a third category which is neither insignificant nor significant. We support the view that only significant leverage, yield curve mismatch or any other significant deviation from the definition should require the fair value categorisation.

(13) Regarding the business model considerations, we are of the view that more attention should be paid to the portfolios used to manage liquidity. We propose that the definition of amortised cost should also encompass the business model applicable to liquidity portfolios with predetermined portfolio characteristics such as duration and credit risk profile, where individual purchases and sales are clearly justified by the goal to retain the predetermined portfolio characteristics.

(14) In summary, the proposals may still be too restrictive and in some cases create unintended or unreasonable accounting mismatch or force traditional banking instruments held to collect contractual cash-flows into the fair value measurement category. Therefore, as described above it would be appropriate to further review the amortised cost definition and also to allow FVOCI on an optional basis for instruments outside the trading portfolio that otherwise would be in FVPL but to a limited extent also in amortised cost, in order to reduce or eliminate an accounting mismatch.

Bifurcation

(15) Regarding the issue of “bifurcation” of hybrid financial assets, FEE’s position has been that the long term objective of a principles-based standard should be a single classification approach for hybrid contracts with financial hosts. Therefore, in order to meet the objective of reducing complexity in financial instruments accounting, we agreed in this respect with the direction of the IASB proposals to eliminate bifurcation of embedded derivatives for financial assets and currently retaining the rules for embedded derivatives in financial liabilities. However, from a principles point of view we question why liabilities are not treated in the same way as assets.

Recycling

(16) Regarding the issue of “recycling”, the amended proposal demonstrates the lack of principles in the various IFRSs and in this particular case also inside the same standard on financial instruments, since fair value changes in the equity securities classes are not recycled and fair value changes in the debt securities classes are proposed to be recycled on realisation or impairment. We would reiterate our long-standing position that IASB needs to formulate its principle-based position in the recycling debate.

(17) Since we are not aware of any justifiable principle-based criterion to decide that some items should be recycled and others not, we conclude that recycling should be in general either required or prohibited. Since the IASB stresses the prominent position of the net income line in the performance statement, recycling of all relevant OCI items on realisation or impairment seems to be the logical response.

Effective date

(18) Generally users prefer to see larger changes implemented to the same effective date, in order to get a stable basis that allows for comparisons over time. From an accounting systems' point of view it would be preferable not to have two distinct effective dates for IFRS 9 and IFRS 4 when revised. However, from a practical point of view, it might be acceptable to end up with two different effective dates in the case that the insurance contracts project is to be finalised at a significantly later date, provided that early application is allowed and at least the outcome of the insurance project is clear in order to allow a proper categorisation. If we end up with two different effective dates, as a minimum reclassifications should be allowed on the effective date of the later standard to avoid accounting mismatches.

(19) Given the current scheduled timing of the IFRS 9 phases, we believe the current mandatory application date of 2015 is no longer realistic. Taking into account the complexity and the number of changes expected to the accounting systems and processes, we continue to believe that at least 24 months implementation period should be envisaged to allow for a well-managed practical and effective implementation.

(20) It would be helpful to confirm a change in the application date of IFRS 9 as soon as possible to assist project planning, particularly for entities which are foreign private issuers in the USA. In addition the counterintuitive result of the current treatment of 'own credit' should be resolved as soon as possible. Maybe an amendment to IAS 39 might solve this issue more quickly.

Our responses to the questions in the Invitation to comment on the ED as well as to additional questions to constituents posed by EFRAG are included in the Appendix to this letter.

For further information on this letter, please contact Tibor Siska, Project Manager at the FEE Secretariat on +32 2 285 40 74 or via email at tibor.siska@fee.be.

Yours sincerely,

André Kilesse
President

Olivier Boutellis-Taft
Chief Executive

Contractual cash flow characteristics assessment: a modified economic relationship between principal and consideration for the time value of money and the credit risk

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?

Question to EFRAG's constituents
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.

(21) In general, the proposals of IASB are moving in the right direction, but we agree with EFRAG that there are still certain financial assets that do not pass the contractual cash flow characteristics assessment and for which an amortised cost measurement would provide more useful information than measurement at fair value. Our concerns therefore remain regarding those assets that will not pass the test despite their consistency with the "held to collect" business model. Examples of such instruments include:

- Regulated financial assets that are closely linked to specific financial liabilities (e.g. "Livret A" deposits in France, Building Savings products offered by Bausparkassen in central Europe);
- Mortgage loan with floating rate in reference to short-term prime rate which is set by individual banks rather than markets;
- Financial assets with early automatic redemption feature in the case of specified negative performance event; and
- Retail loans based on an average Euribor 3 month rate for a period of interests of 1 year without refixing in the course of the year.

(22) In order to allow certain financial assets that are part of a normal banking business to continue to be measured at cost, we believe that further clarification is needed on the amortised cost definition in addition to that already provided by the IASB. In order to foster simplification and plain language, we recommend replacing the term "more than insignificant" by "significant" when assessing any contractual terms of an instrument, which should in theory not change the final result but would be clearer. It would also avoid the perception that there is a third category which is neither insignificant nor significant. We support the view that only significant leverage, yield curve mismatch or any other significant deviation from the definition should require the fair value categorisation.

Solely payments of principal and interest

(23) We agree with EFRAG that the definition of interest in IFRS 9 should be revised and that it would make sense to have it aligned with the recent tentative decisions on the insurance contracts project, i.e. widening the definition and to clarify that it includes other inherent components (such as liquidity risk), if a definition is necessary at all.

Bifurcation

Questions to EFRAG's constituents

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.

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.

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, having in mind that finalising the appropriate requirements might delay the completion of IFRS 9, however not require re-exposure?

(24) Regarding the issue of "bifurcation" of hybrid financial assets, FEE's position has been that the long term objective of a principles-based standard should be a single classification approach for hybrid contracts with financial hosts. Therefore, in order to meet the objective of reducing complexity in financial instruments accounting, we agreed in this respect with the direction of the IASB proposals to eliminate bifurcation of embedded derivatives for financial assets and retaining currently the rules for embedded derivatives in financial liabilities. However, from a principles point of view we question, why liabilities do not follow the same principle as assets.

(25) We are aware that bifurcation would allow preparers to isolate plain traditional banking parts of instruments and measure them at amortised cost, however we noted that current bifurcation in IAS 39 is one of the most complex areas where users are struggling to understand the presentation and lot of inconsistencies are experienced.

Business model assessment: the 'fair value through other comprehensive income' measurement category for financial assets that contain contractual cash flows that are solely payments of principal and interest

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

(26) From a conceptual point of view, we prefer the classification of financial assets at either amortised cost or at fair value through profit or loss, e.g. for the following reasons:

- The measurement at fair value through other comprehensive income has no generally-accepted conceptual basis and there is no consistent policy on 'recycling' in IFRSs.
- The IASB states in paragraph BC21 that, for some financial assets, measurement at fair value through other comprehensive income would reflect their performance better than measurement at either amortised cost or at fair value through profit or loss. However, there is, at present, neither a definition nor a principle for measuring and presenting performance within IFRSs. In respect of performance, the meaning of other comprehensive income is particularly unclear.

(27) Nevertheless, we have sympathy with the argument that only two measurement categories might result in an inappropriate interaction between the accounting for financial assets pursuant to IFRS 9 and the accounting for insurance contract liabilities under the Insurance contracts project, and that introducing an additional fair value through other comprehensive income measurement category could address such problems.

(28) For contracts with participating features, where the mirroring approach applies, insurers should be allowed to present changes in insurance contract liabilities in OCI consistently with the presentation of changes in the directly linked underlying items. In any case, the IASB should provide for an appropriate interaction between the accounting for financial assets pursuant to IFRS 9 and the accounting for insurance contract liabilities.

(29) We are of the view that the separately presented three business models are not conducive to the desired reduction of complexity. Further, it seems unfeasible to distinguish clearly between the proposed business models, in particular outside a 'hold to collect' business model. For example, we doubt whether it is possible to differentiate appropriately between:

- Managing assets with the objective to maximise return through selling and reinvesting when an opportunity arises (paragraph B4.1.4B, Example 1); and
- Managing assets and evaluating performance on a fair value basis with collection of contractual cash flows being only incidental (paragraph B4.1.6).

(30) An option (instead of a requirement) allows entities to avoid interruptions if they have already started preparing for the initial application of IFRS 9 assuming a 'two-measurement-category classification approach'. Therefore we would prefer to see the FVOCI model optional only and limited to instances where this reduces or eliminates accounting mismatch.

(31) Consequently, there will not be a need to allow an option to move from FVOCI to FVPL category. Principally, provided the business model is the key classification characteristic, we do not see any need for options other than those based on reduction or elimination of an accounting mismatch. Therefore we propose to allow FVOCI on an optional basis for instruments outside the trading portfolio that otherwise would be in FVPL but to a limited extent also in amortised cost, where opting for FVOCI reduces or eliminates an accounting mismatch.

Questions to EFRAG's constituents

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

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.

Are there any additional arguments that have not been identified?

(32) This is the key question of the proposal and we support the View 2 that entities should be able to elect at initial recognition to measure eligible debt instruments at FVOCI if by doing so accounting mismatches are reduced or eliminated. However, this view is closely linked to the final definition of the amortised cost category from both the instrument characteristics and the business model point of view, where we present our position in our answer to Questions 1 – 3 and in paragraph 32.

(33) The potential increase of the financial instruments measured at fair value needs to be analysed through the decision making tree. Financial instruments which do not meet the amortised cost characteristic would not be affected. Financial instruments which meet the amortised cost characteristic and would be measured at fair value due to the fair value business model would theoretically not be affected either since these would be just split into two subcategories – FVPL and FVOCI.

(34) However, we are of the view that more and specific attention should be paid to the portfolios used to manage liquidity. We propose that the definition of amortised cost should also encompass the business model applicable to liquidity portfolios with predetermined portfolio characteristics such as duration and credit risk profile, where individual purchases and sales are clearly justified by the goal to retain the predetermined portfolio characteristics. This would also decrease the volatility of the regulated capital for certain regulated financial institutions. Furthermore, the proposed business model does not prevent preparers in practice to construct a new FVOCI portfolio from instruments that they would subordinate the amortised cost in the case the FV needs to be reflected in the income statement. This provides an additional argument why we prefer to use this category for the reduction or elimination of the accounting mismatch only.

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?

(35) As stated in our answer to Question 8 below we support permitting early adoption of changes in own credit risk in OCI without early adopting the rest of IFRS 9. We agree with the need to apply the rest of the standard in its entirety and are of the view that the proposed period between the issuance of the completed version of IFRS 9 and the prohibition on newly applying previous versions of IFRS 9 should be extended to approx. 12 months due to the complexity of the standard and lead time needed for implementation.

(36) Generally users prefer to see larger changes implemented to the same effective date, in order to get a stable basis that allows for comparisons over time. From an accounting systems' point of view it would be preferable not to have two distinct effective dates for IFRS 9 and IFRS 4 when revised. However, from a practical point of view, it might be acceptable to end up with two different effective dates in the case that the insurance contracts project is to be finalised at a significantly later date, provided that early application is allowed and at least the outcome of the insurance project is clear in order to allow a proper categorisation. If we end up with two different effective dates, as a minimum reclassifications should be allowed on the effective date of the later standard to avoid accounting mismatches.

(37) Given the current scheduled timing of the IFRS 9 phases, we believe the current mandatory application date of 2015 is no longer realistic. Taking into account the complexity and the number of changes expected to the accounting systems and processes, we continue to believe that at least 24 months implementation period should be envisaged to allow for a well-managed practical and effective implementation. It would be helpful to confirm a change in the application date of IFRS 9 as soon as possible to assist project planning, particularly for entities which are foreign private issuers in the USA. In addition the counterintuitive result of the current treatment of 'own credit' should be resolved as soon as possible. May be an amendment to IAS 39 might solve this issue more quickly.

Presentation of 'own credit' gains or losses on financial liabilities

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?

(38) Yes, see above. Furthermore, it is important to isolate this counterintuitive result as soon as possible.

(39) Moreover, in order to address the concerns about the availability of the own credit requirements for early application, the IASB should, in our view, amend IAS 39 to incorporate the own credit requirements of IFRS 9. Given the fact that the process of replacing IAS 39 needs much more time than expected and is still on-going, the IASB should separate the application of the own credit requirements from the overall IFRS 9 timeline.

(40) Furthermore, the accelerated application of the new 'own credit' provisions should not be an option. Rather, it should become mandatory as early as possible.

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?

(41) As mentioned above, early adoption should be allowed, which should resolve all the issues (e.g. restating the previous 12 months period) that first-time adopter would face when transitioning to IFRS 9.