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Hans Hoogervorst
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27 March 2013

Exposure Draft Classification and Measurement: Limited Amendments to IFRS 9

Dear Mr Hoogervorst,

The European Banking Authority (EBA), which has come into being as of 1 January 2011 as per Regulation (EU) 1093/2010, welcomes the opportunity to comment on the IASB's Exposure Draft ED/2012/4 Classification and Measurement: Limited Amendments to IFRS 9.

The EBA has a strong interest in promoting sound and high quality accounting and disclosure standards for the banking and financial industry, as well as transparent and comparable financial statements that would strengthen market discipline.

The EBA welcomes the efforts of the IASB to improve financial reporting in the area of financial instruments as requested by the G20 and in this regard supports the use of a mixed attribute model. A mixed measurement model provides decision-useful information and reflects the business model and the contractual cash flow characteristics of the entities.

We generally welcome the proposals on the contractual cash flow characteristics as these clarifications will help to solve many of the practice issues faced by the banking industry. However, we are concerned with the use in the accounting standards of terms like "significant" and "insignificant" which without a clearer articulation may not be consistently applied. In addition, there are some particular areas where additional guidance would help to better understand the principles of the proposals. We refer to benchmark or hypothetical benchmark instruments and to the term "not more than insignificantly different".

The EBA welcomes that the IASB has introduced additional guidance regarding the amortised cost category and it is our understanding that these clarifications are not intended either to reduce or to increase the use of amortised cost but simply to present more clearly the requirements for the classification in each category. To this end, it would be helpful if the Board were to clarify that the additional guidance has not been introduced with the intention of changing the objectives and principles already set out in IFRS 9 in respect of the "Hold to collect" business model.

The amortised cost category will encompass a business model where assets are held to collect and will allow the classification of loans and bonds at amortised cost if they comply with the contractual cash flow characteristics requirements. We are concerned that terms like "infrequent or insignificant" are not adequately explained in the proposal, or understood by users, and therefore could result in inconsistent application and reduced comparability of the financial statements. For these reasons, we recommend the introduction of disclosures to help the user to understand the business model of hold to collect.

We have included in the appendix some specific comments on the regulatory liquidity portfolios. We understand that it may be possible to stratify such portfolios depending on the practical application of the regulatory requirements, in such a way so as to achieve a classification of these portfolios at amortised cost. We suggest that the IASB consider further whether sales due to a regulatory requirement would necessarily lead to a change in the business model.

The EBA has concerns regarding the proposal to introduce a new category for financial assets that are managed both in order to collect contractual cash flows and for sale. We consider that it will introduce unnecessary complexity in the accounting of financial instruments without being clear that it will lead to more decision-useful information.

In addition we believe that the dividing line between the fair value through profit or loss and fair value through other comprehensive income (OCI) categories is not clear and therefore could result in inconsistent application in practice and introduces significant scope for management judgement that does not currently exist under IFRS 9.

However, if the IASB decides to continue with the proposal of a third category on the grounds of promoting convergence with the FASB and in order to address some of the insurance concerns, it should ensure that the business models are sufficiently robustly defined and sufficient application guidance is provided to ensure consistent, understandable and proper application among institutions.

Our detailed comment on the Exposure Draft (ED) has been provided in the appendix of this letter.

If you have any questions regarding our comments, please feel free to contact Mr. Michel Colinet (+32.2.220.5247) in his capacity as Chairman of the technical group that coordinated this comment letter.

Yours sincerely

(signed)

Andrea Enria

CC: Mr Michel Colinet, Chairman of the Technical Group

Appendix

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?

Response

The EBA agrees with the proposals in the Exposure Draft 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 to contain cash flows that are solely payments of principal and interest. We see that the additional guidance provided in the Exposure Draft will address many of the practice issues that preparers have encountered with the current IFRS 9.

However, there remains a risk that depending on the interpretation the clarification could lead to a narrow definition of the concept of "Solely Payment of Principal and Interest (SPPI)" and therefore disqualify some debt instruments from the amortised cost category which should be eligible for (and indeed the IASB might expect to be included in) this category. In particular, we consider that the IASB needs to assess whether there are other components that should also be part of interest, such as liquidity risk or other components.

We agree with the principle that an instrument should qualify for the amortised cost category only if its contractual cash flows are "not more than insignificantly different" from those of a benchmark instrument. However, and more generally, we suggest to the Board to set a clearer and more consistent articulation (within standards and throughout standards) of terms like "insignificant", "significant" or "material" so as to help ensure that those terms can be consistently understood by all stakeholders. In particular, we are concerned on the limited guidance to help applying that principle consistently (see question 2).

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?

Response

The introduction of the notion of a benchmark instrument will help to determine the relevance of the modification. The EBA understands that in many circumstances a simple assessment should be sufficient and therefore there will be no need to perform a detailed assessment. If this was not the case, then it could be burdensome for entities to perform repeated assessments about the modified economic relationship.

The Exposure Draft does however not contain guidance on the meaning and use of benchmark and we believe that the IASB should include in the standard additional guidance about the use of benchmarks or the creation of hypothetical benchmarks that could help preparers in the application of the standard and also to better understand the principles behind the classification of an instrument at amortised cost.

We are also concerned with some of the terms use in the Exposure Draft which could lead to an inconsistent application of the Standard. The Exposure Draft proposals use the terms "more than insignificant leverage" or "more than insignificantly different from the benchmark cash flows". Although we recognise that judgement needs to be applied and standards should not establish bright lines, some guidance or additional examples would reduce the possibilities of inconsistent application.

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?

Response

We think that the guidance provided in the Exposure Draft will address many of the concerns that preparers have with the current IFRS 9 about its application to specific instruments and, in particular, issues related to instruments which contain an interest mismatch feature.

However, we are also concerned that there are other financial instruments where the appropriate treatment is not clear. For this reason, we consider that the IASB could improve the exposure draft by carrying-out a fact finding exercise to have a more comprehensive view of instruments that are used in the market today.

Different markets may have different practices and products sold to customers could have some particularities linked to the jurisdiction or country where the products are offered. For instance, in some countries there are instruments whose interest rate refers to a legal formula (regulated instruments). Another example is related to perpetual debt instruments whose deferred coupons do not accrue interest and in some cases this could be due to clauses that have a small effect on their fair values compared to basic instruments. We would ask the IASB to look at the principles of its proposals to determine the appropriate classification of such financial instruments on the basis on whether classifying them at fair value through profit or loss always conveys the most useful information to users.

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?

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

Response

The IASB has proposed a new category mainly to promote convergence between the IASB and the FASB tentative classification models and to help to address the interaction with the Insurance Contracts project.

The EBA is concerned by the introduction of a third category where assets managed in order to collect contractual cash flows and for sale are required to be measured at fair value through OCI.

During the past years there have been demands to reduce the complexity of the accounting standards for financial instruments[1]. That said the IASB decided to replace IAS 39 and issued in November 2009 the part of IFRS 9 dealing with the classification and measurement of financial instruments.

IFRS 9 proposed a two category-framework (amortized cost and fair value), which characterized the different ways of measuring a financial asset that presumably convey most relevant and useful information on its expected cash flows given the instrument's structure and "business model" (i.e. its management basis).

The Board proposes now to introduce a new category for financial assets where the objective is to hold to collect and sell. This new category introduces a presentation difference as changes in fair value are recognised in OCI instead of profit or loss. Therefore, the IASB proposes three categories to differentiate among business models (hold to collect, hold to collect and sale and hold to sale).

When analysed against the previous demands for reducing complexity, it seems clear that this proposal introduces an additional layer of complexity in trying to determine the measurement basis that best reflects a financial asset's expected cash flows. The two business model approach under current IFRS 9 is more robust, transparent and easier to understand.

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[1]For instance, the G20 (London, April, 2009) required accounting standard setters to "take action by the end of 2009 to reduce the complexity of accounting standards for financial instruments" or the report by the Financial Crisis Advisory Group (July 2009) made a similar recommendation "The Boards should give highest priority to their project to simplify and improve their standards on financial instruments".

In particular, we have some concerns about the dividing line between the fair value through profit or loss and fair value through OCI and also about the additional value that this new category would introduce.

IFRS 9 4.4 permits the reclassification of financial assets when the entity changes the business model for managing those financial assets. The guidance provided within the Application Guidance clarifies that such changes are expected to be infrequent and that such changes must be determined by Senior Management as a result of external and internal changes and must be significant to the entities operations and demonstrable to external parties. The Application Guidance also sets out that a change in intention related to particular financial assets (regardless of significant changes in market conditions) is not considered a change in business model.

What is not clear from reading the proposed modifications to IFRS 9 is where the dividing line is between a business model under which management intend to “hold to collect and sell” and a business model under which management intend to “hold to sell”. In the absence of a clear distinction between the different business models there is a risk that significant freedom will be afforded to the preparers of the financial statements to manage profit or loss through their designation (both initially and through reclassification) between fair value through profit or loss and fair value through other comprehensive income depending on the reporting outcomes sought in any given reporting period.

We concur with the alternative views expressed by Messrs Cooper and Engström, in AV5 accompanying the Exposure Draft, that a business model under which financial assets are “held to collect and sell” is not easily differentiated from a business model under which financial assets are “held for sale” which may lead to divergent application in practice. Furthermore, in the examples included in the ED, it is stated that the objective of yield maximization falls into the hold to collect and sell business model, but it is not clear how this would differentiate from a pure trading business model. We believe that the original two business model approach should be retained rather than the proposed three model approach which introduces an additional layer of complexity.

Considering the impairment project, the fair value through OCI category also adds complexity as to how to accommodate the amortised cost based impairment model to fair value through OCI debt instruments.

In addition, we could see that the amortised cost category will encompass financial assets that were previously classified in the Available for Sale category but that due to the restrictive nature of the held to maturity category (“the tainting rules”) were not classified at amortised cost. Therefore, the introduction of a third category could lead to a somewhat artificial distinction between fair value changes recorded in profit or loss and those taken to OCI. In fact, as stated by Hans Hoogervorst (20 June 2012), “the distinction between net income and OCI… lacks a well-defined foundation”, and the only reason that has been used by the IASB to justify such distinction is to provide “a pragmatic way of shielding the P&L from volatility in the balance sheet that does not truly reflect the financial performance of the entity” (Hans Hoogervorst, 9 February 2011).

The lack of conceptual distinction between OCI and profit or loss makes it more difficult to have a clear principle that would help to understand the difference between the two categories, and accordingly we find no additional value in pushing an asset's fair value movements into OCI on the sole basis of two different business models where their dividing lines are blurred. In particular, this distinction may not shield the profit or loss but rather exclude a part of the entity's performance.

However, and taken into account the concerns previously expressed, if the IASB decides to introduce a third category in the grounds of promoting convergence with the FASB and in order to address some of the insurance concerns, we believe that this category should be robust enough to avoid the possibility of earnings management and designed so as to ensure consistency in the classification of financial assets among institutions. If the third category is introduced it is vital that the dividing line with fair value through profit or loss is clear and that sufficient guidance is provided.

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?

Response

Guidance on how to distinguish the three business models

Subject to our answer to question 4, the EBA believes that the new application guidance for the determination of the entity's business model is generally useful but might in some respect, as explained below, lack clarity and could potentially lead to difficulties in practice.

We understand that the additional guidance and examples for determining whether selling activities are consistent with a "hold to collect" business model aim only at clarifying the characteristics of this business model (as originally defined in IFRS 9), with no intention of reducing the extent of this business model. We suggest to the Board to clarify that it had no intention to change the IFRS 9 initial objective and principles on the "Hold to collect" business model and, in addition to compare IFRS 9 amended with IAS 39 (as done in paragraph BC152), to compare IFRS 9 amended with the current IFRS 9 on whether the amendments would – all being equal – not result in more financial assets being reported at fair value.

Furthermore, we are concerned that terms like "… infrequent (even if significant) or insignificant both individually and in aggregate (even if frequent)" could result in inconsistent application and reduced comparability of financial statements.

As indicated above, we are also concerned about the difficulty to make a clear delineation between the different asset categories and the risk that transfers take place too easily between categories, without indications of changes in relation to the business models.

To address these concerns without endangering the principle-based approach used by the Board, we suggest introducing additional disclosure requirements whereby reporting entity should explain how they have defined and applied the “infrequent” and “insignificant” tests in their classifications of financial instruments and, why no change was made to their business model definition. Such disclosure should notably include indication (possibly aggregated) on amounts, frequency and nature of sales during the covered period.

As already indicated in our answer to Question 1 we, more generally, suggest that the Board clarifies the articulation or graduation between the terms used, such as “insignificant”, “significant”, “material” ... so as to help ensure consistent application of the standard(s).

Special case: Liquidity portfolio

As you may be aware, the Basel Committee (BCBS) issued in January 2013 a document entitled “Basel III: The Liquidity Coverage Ratio and liquidity risk monitoring tools” which sets out new regulatory requirements on liquidity risks and liquidity portfolios. These requirements are in the process of being reflected in the European revised prudential framework under the CRD IV. While technical specifications are still being developed in this area, it can be expected that banks will have to “periodically monetize a representative proportion of the assets in the stock through repo or outright sale, in order to test its access to the market, the effectiveness of its processes for monetization, the availability of the assets, and to minimize the risk of negative signalling during a period of actual stress.” (BCBS document, Par. 30).

The draft CRR requirements state (art. 405 (e)) that: “a portion of the liquid assets (…) is periodically and at least annually liquidated via outright sale or repurchase agreements for the following purposes:

- to test the access to the market for these assets,
- to test the effectiveness of its processes for the liquidation of assets,
- to test the usability of the assets,
- to minimize the risk of negative signalling during a period of stress.”

Against this background we paid particular attention to the example 4 included by the Exposure Draft under the guidance B4.1.4.

While we are still analysing the interaction between these prudential requirements and the future implementing measures on the so-called “liquidity portfolios”, we would at this stage assume that banks should be able under IFRS 9 to split up their regulatory liquidity portfolio among the different accounting categories, depending on their business model, how such portfolios (or parts thereof) are managed, and the nature of the financial instruments included therein. This would mean that financial assets designated as part of a liquidity portfolio for prudential regulatory purposes could be classified at amortised cost or at fair value depending on the selling activities of the portfolio against which the business model assessment is being made. Therefore, those assets which are determined as not being subject (ex ante and ex post) to frequent and significant sales could qualify for the amortized cost category.

One of the difficulties that might however be faced in practice is to understand the term "routinely" as used in the example 4 and how this term interacts with the terms "frequent" and "infrequent" used otherwise. It is also the case that the prudential frameworks allow the use of true sales or repos which need to be carried out periodically and at least annually. Depending on the practical application (the importance of repos and the level of sales), it may be possible to recognise a liquidity portfolio of the entity at amortised cost. Therefore, we consider that the requirements of the prudential frameworks have additional elements that are not necessarily represented in example 4.

It could also be considered whether example 4 is relevant as the sales take place on supervisors' request and the question is whether these sales entail a change in the entity's business model. Therefore, if assets classified at amortised cost are subject to sales upon documented external request of the supervisors (i.e. with no connection with the entity's business model), arguably this should not by itself be considered sufficient to conclude that the entity's business model is not to hold financial assets to collect contractual cash flows. However, we could see that appropriate safety nets should be established to make sure that the sales come from a regulatory requirement and to ensure that there has not been a change in the business model.

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?

Response

The EBA agrees that a fair value option should be extended for financial assets measured at fair value through OCI to address accounting mismatches.

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 (i.e. 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?

Response

The EBA supports the proposal of the Exposure Draft that if an entity chooses to early apply IFRS 9, the complete version of IFRS 9 (i.e. including all chapters) should be applied.

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?

Response

The EBA has had a long standing position that it is not decision-useful for users to recognise gains and losses on own credit risk in profit or loss.

Therefore, we agree with the proposal to early apply the "own credit" provisions in IFRS 9. However; we consider that the IASB could also introduce an amendment to IAS 39 to allow its early application.

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?

Response

We don't have any comment on this issue.