Financial Reporting Council

Francoise Flores
Chairman
EFRAG
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28 March 2013

Dear Francoise

EFRAG's Draft Comment Letter on the IASB's ED/2012/4 "Classification and Measurement: Limited Amendments to IFRS 9"

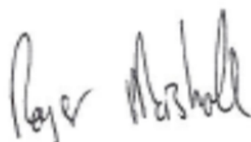
The FRC is pleased to have the opportunity to comment on EFRAG's draft comment letter to the IASB on its Exposure Draft (ED) ED/2012/4 "Classification and Measurement: Limited Amendments to IFRS 9".

Our response to the IASB is attached to this letter. Our response was based on views expressed by our constituent at the roundtable we held on IFRS 9 on 25 February 2013. You will note that we raise a number of concerns with the proposals in the ED which are similar to those raised by EFRAG TEG members. In addition, we are concerned that the effective date for IFRS 9 no longer seems to be realistic given the progress on the other phases of the project.

Detailed responses to questions for constituents are included in the Appendix to this letter.

Should you have any queries about the comments in this letter please do not hesitate to contact either me or Seema Jamil-O'Neill at 020 7492 2422 or s.jamiloneill@frc.org.uk .

Yours sincerely



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Appendix A – Response to Detailed questions to constituents

Q21 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.

Some such financial assets are included in our answer to question 1 in our response to the IASB. We have not identified any other financial assets that would meet the criteria in your question.

Q42 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.

Q43 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.

Q44 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 as described in paragraph 33, having in mind that finalising the appropriate requirements might delay the completion of IFRS 9, however not require re-exposure?

We do not believe that 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. However, this does not change our view that bifurcation of financial instruments is not necessary for the application of the IASB's classification and measurement model for financial assets in IFRS 9.

Q80 Do you support View 1 or View 2 above? Please explain why.

Q81 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.

Q82 Are there any additional arguments that have not been identified above?

We support View 2 for the reasons set out in paragraphs 74-79 of your draft comment letter.

Financial Reporting Council

Hans Hoogervorst
Chairman
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EC4M 6HX

28 March 2013

Dear Hans

ED/2012/4 "Classification and Measurement: Limited Amendments to IFRS 9"

The FRC is pleased to have the opportunity to comment on the IASB's Exposure Draft (ED) ED/2012/4 "Classification and Measurement: Limited Amendments to IFRS 9".

We note that the IASB issued this ED to:

1. reduce differences with the FASB's tentative decisions in this area;
2. take into account the interaction with the Insurance Contracts project; and
3. address implementation issues raised with IFRS 9.

We do not believe that the proposals in the ED meet any of these objectives. This is because:

1. the ED proposals, although going some way to align the model with that under consideration by the FASB, introduce unnecessary complexity in financial reporting, without providing a clear principles-based justification for the third business model.

2. we have received feedback from insurance industry representatives suggesting that the proposals would not fully address their issues. In this respect, we think that the IASB should address any concerns specific to insurance accounting as part of the Insurance Accounting project. This approach would ensure that the financial instruments project is not held up to address the needs of one of the many different types of industries that would be applying the requirements.

3. in relation to the proposed changes in the ED to address IFRS 9 implementation issues we have the following concerns:

    - **Definition of the business model is not principles based**
      We believe that the third business model introduces unnecessary complexity in financial reporting, without providing a clear underlying principle. The introduction of the Fair Value through Other Comprehensive Income (FVOCI) Category and the way it has been articulated in the ED can lead to the business models being interpreted as accounting constructs. Taking this and other feedback from our constituents into account, we do not believe that IASB should implement the third business model. However, if it were to continue with the proposals in the ED, we believe that a consideration of the

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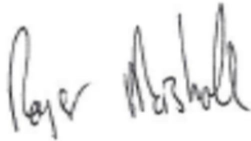
underlying commercial business models could shed light on the principles behind the three categories. Our response to question 4 in the appendix to this letter includes ways in which we think the principles could be articulated so as to clarify the rationale for the three separate business models.

- **The SPPI test needs further work**
  We are concerned that additional clarifications in the ED on financial assets with a modified economic relationship between principal and interest are likely to further reduce the number of financial assets that qualify to be held as at amortised cost. We also think that this anti-abuse approach in the ED has a potential to create complexity, both for preparers assessing how to categorise financial instruments and users trying to understand that rationale. We believe that it may be better to devise a principles-based test that considers the purpose of the cash flows and whether the instrument will achieve just compensation for time value of money and credit risk or whether it will lead to additional risks being taken on balance sheet i.e. through leverage.

Responses to the detailed questions in the ED are included in the Appendix A to this letter.

Should you have any queries about the comments in this letter please do not hesitate to contact either me or Seema Jamil-O'Neill at 020 7492 2422 or s.jamiloneill@frc.org.uk.

Yours sincerely



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Appendix A – Response to Detailed questions

Contractual cash flow characteristics assessment

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?

1. We 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.
2. The IFRS 9 requirement that only instruments where cash flows represent "solely payments of principal and interest" can be measured at amortised cost we understand this requirement is being interpreted in a narrow way. As a result, a number of financial instruments with early repayment features, such as variable rate mortgages, which are interest driven products and classified as "held to collect" would not be permitted to be accounted for at amortised cost. We agree that some improvements and clarifications were needed on the types of instruments that qualify as having contractual cash flows that are solely payments of principal and interest.
3. However, the focus in the ED on a market interest rate as being the only benchmark is problematic for entities where the financial products are interest based but do not precisely follow a market benchmark. Other instruments where there are no commercial or real-life benchmarks also appear to be compromised in terms of their ability to account for those instruments at amortised cost.
4. The ED specifically discounts the reasons for the rates being set in such a way as not relevant. B4.1.9C states that "if modification could result in cash flows that are more than insignificantly different from the benchmark cash flows, the financial asset does not meet the condition in paragraphs 4.1.2(b) and 4.1.2A(b)." That is to say that contractual cash flows are not SPPI. That same paragraph goes on to state that, "the reason for the rate being set in this way is not relevant to the analysis. For example, the conclusion would be unchanged whether the rate is required to be set in this way to provide consumer protection or is included in a bespoke structured product to achieve a particular economic outcome."
5. This clarification seems to be acting as an anti-abuse measure, put in place to ensure that any non-standard financial instruments are measured at fair value. We think that this anti-abuse approach in the ED has a potential to create complexity, both for preparers assessing how to categorise financial instruments and users trying to understand that rationale. Additional complexity has the potential of opening a principles based standard open to structuring opportunities.
6. We believe that it may be better to devise a principles-based test that considers the purpose of the cash flows and whether the instrument will achieve just compensation for time value of money and credit risk or whether it will lead to additional risks being taken on balance sheet i.e. through leverage. Although, such a principle is referred to elsewhere in the ED application guidance (e.g. in the ED paragraph B4.1.9), it is

presented as a secondary consideration to or a by-product of the modified economic relationship test. Other parallels exist in the guidance to IAS39 which make references to the commercial transactions that commonly take place in particular jurisdictions (e.g. in IAS 39, AG33) which could also be reference for this purpose.

7. We also believe that further clarification in the ED on the notion of interest may be helpful. A clarification that states that interest also compensates for liquidity risk may be helpful in addressing questions on the assessment of whether an instrument's cash flows represent SPPI.

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?

8. Please see our response to question 1 in terms of our views on the test for assessing a modified economic relationship itself.

9. However, we do believe that additional examples of different types of financial instruments and how the SPPI test is envisaged to apply to them would help with the implementation of the principles of IFRS 9. In this respect, we note that the Basis for Conclusions states that additional guidance on regulated financial instruments is to follow. We would welcome this additional guidance. We also believe that additional guidance could be included on instruments with caps and floors, amortising interest components, automatic early redemption features, redemption rights contingent on future events, etc.

10. Additionally, we are concerned that "more than insignificant" is being introduced to the IFRS literature as quantitative measure when it appears that what is being asked for is whether the change is "material". We think it would be more consistent to use terms and notions that already exist in IFRS rather than adding to its nomenclature.

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?

11. We do not believe that the proposed amendment to IFRS 9 will achieve the IASB's objective of clarifying the application of the contractual cash flow characteristics assessment to financial asset that contain interest rate mismatch features. Please see answers to questions 1 and 2 for more detail.

Business model assessment

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?

12. We do not support the introduction of this third business model in the form articulated in the ED. Although the Board has attempted to address the needs of insurance companies , we believe the solution is deficient and does not constitute a business model in the real, commercial sense.

Needs of insurance companies

13. We understand that, insurance companies are not convinced that the FVOCI category meets all their needs. A number of insurers have raised concerns that portfolios that are held with the intention of meeting liabilities as they arise will not produce sufficient sales frequency to meet the criteria for the FVOCI category. Others note that portfolios where derivatives are used to manage interest, credit or other risks will not meet the criteria for the FVOCI category either. Similarly, portfolios holding financial assets that do not meet the SPPI test will not qualify for this category either.

14. As the ED on accounting for insurance contracts has yet to be issued and the final insurance accounting standard is unlikely to be issued until 2014. We believe that it is difficult to provide coherent comments on implications for accounting for the asset side of an insurance company's balance sheet without considering the impact on the liability side. We therefore recommend that the IASB consider and expose the implications for insurance companies once the project on accounting for insurance liabilities is closer to being finalised.

Business model – fact or judgement

15. The ED describes this business model where assets are managed both in order to collect contractual cash flows and for sale. However, this assertion ignores the fact that financial asset portfolios held at FV-PL are also likely to hold financial assets for sale, but where contractual cash flows are also likely to be collected until the sale occurs. In fact, generating cash flows through trading is the real commercial objective of the FV-PL portfolio and the contractual cash flows are just a by-product.

16. Similarly, paragraph B4.1.2A of the ED states that the business model is a matter of fact. However, we believe that judgement plays a much bigger part in how an entity manages its financial assets. A large number of financial assets are capable of being held at amortised cost, at FVOCI or at FV-PL (although there are clearly exceptions

to this). It is the management's decision that determines how best to manage those assets in the context of the company's business.

17. It may be possible to consider the types of portfolios that are likely to be categorised as FVOCI to understand the commercial substance. The ED identified liquidity portfolios held by banks and larger corporates as the most likely candidates for this category. These are held to generate on-going cash flows to ensure a supply of liquid assets. It may be the case that this could be viewed as a distinct type of business model which would merit its own accounting, although detailed work would be needed to refine the concept.

18. We believe that, for the third category to continue to exist, it is important that it has a clear, principles-based objective, such as noted in the paragraph above. However, if this is not possible then we cannot support this third category of business model which appears to be no more than an accounting construct.

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?

19. We believe that further work is needed to clarify the distinctions between the three categories and to make the proposals operational. As noted in our answers above, the distinctions between the three categories have been muddied due to the way the FVOCI category has been articulated. Further work on the underlying principle should help to clarify the model itself.

20. In particular, it is unclear how the frequency and significance of sales should be assessed when trying to determine whether a portfolio of financial assets fails to meet the criteria for measurement at amortised cost. For example, it is unclear whether the quantum of sales is to be compared with the opening position of the portfolio, the closing position, or the absolute size. Similarly, what impact does an unanticipated event outside the company's control have on its ability to measure a portfolio at amortised cost?

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?

21. Yes. Fair value option was originally introduced to permit entities to classify financial assets in accordance with business model and eliminate accounting mismatch. Both reasons continue to exist.

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?

22. We agree with the proposed approach to early application. The phased approach to early adoption of the standard creates complexity and replacing it with a simpler approach that require all phases to be applied from the same date would improve comparability

23. We also agree with the six month transition period proposed in the ED as this will permit entities that have already begun work on adopting the earlier phases to adopt the standard as soon as the final component is available for adoption.

24. We note, however, that adoption of the standard in the EU will determine the actual ability of EU companies to apply the standard. As such, it is important the IASB does all it can to finalise the other phases of the standard so that it can be put forwards for adoption in the EU.

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?

25. We note that, investors continue to be concerned about the presentation of gains and losses on financial liabilities designated at fair value. As a result, we support the IASB's proposals to permit early adoption of the "own credit" provisions in IFRS 9.

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?

26. We have no comments regarding first time adopters.

Appendix B: Detailed comments on ED

1. Paragraph 4.1.4 is amended as follows:

   "A financial asset shall be measured at fair value through profit or loss unless it is measured at amortised cost in accordance with paragraph4.1.2 or at fair value through other comprehensive income in accordance with paragraph 4.1.2A. However an entity may make an irrevocable election for particular financial assets in this measurement category to present in other comprehensive income subsequent changes in fair value (refer to paragraph 5.7.5)."

   Paragraph 5.7.5 refers to the election to present in FVOCI equity instruments that are not held for trading. We think it would be clearer for paragraph 4.1.4 to state that this election is permitted for certain equity instruments. We suggest the following wording:

   "…However an entity may make an irrevocable election to present in other comprehensive income the subsequent changes in fair value for equity instruments within the scope of this IFRS that are not *held for trading* (refer to paragraph 5.7.5)."