European Financial Reporting Advisory Group

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

Feedback to Constituents

May 2013

Summary of contents

Introduction

Objective of this feedback statement

EFRAG published its final comment letter on the IASB ED/2012/4 *Classification and Measurement: Limited Amendments to IFRS 9* on 16 April 2013. This feedback statement summarises the main comments received by EFRAG on its Draft Comment Letter and explains how those comments were considered by the EFRAG Technical Expert Group (EFRAG) during its technical discussions.

Background to the Exposure Draft

In November 2011, the IASB decided to consider making limited amendments to IFRS 9 in order to:

(a) Address specific application issues and concerns raised by constituents regarding the implementation of IFRS 9;

(b) Consider the interaction between the classification and measurement requirements in IFRS 9 and the Insurance Contracts project; and

(c) Achieve closer alignment of the IASB's and the FASB's classification and measurement models.

The IASB agreed that any amendments should be as targeted as possible to minimise the cost and disruption to those who are already applying IFRS 9 or have prepared themselves to apply this standard. Consistently, the scope of the project was limited to consider the following topics:

(a) The contractual cash flows characteristics assessment of financial assets;

(b) The need for bifurcation of financial assets and, if pursued, the basis for bifurcation; and

(c) The basis and the scope of a possible third classification category for debt instruments measured at fair value through other comprehensive income.

During its deliberations the IASB decided not to change the existing bifurcation requirements for financial liabilities and to not introduce bifurcation for financial assets. This decision was based on the expectation that the proposed clarification in the contractual cash flow characteristics assessment would decrease the need for bifurcation of financial assets, because insignificant features that modify the relationship between principal and interest would no longer cause the instrument to be measured in its entirety at FV-PL.

In November 2012, the IASB published the Exposure Draft (the ED) that proposed limited amendments to IFRS 9 issued in 2010. In particular, the ED:

(a) Clarifies the existing classification and measurement requirements regarding the amortised cost category;

(b) Introduces a fair value through other comprehensive income (FV-OCI) measurement category for particular financial assets that contain contractual cash flows that are solely payments of principal and interest; and

(c) Also proposes that once IFRS 9 is finalised, entities should no longer be permitted to early apply previous versions of IFRS 9. Instead, when IFRS 9 is completed, entities would only be able to adopt IFRS 9 as a whole. However, the ED proposes that entities would be allowed to early apply only the requirements for the presentation of fair value gains or losses attributable to changes in the issuer's own credit risk, without the need to early apply IFRS 9 in its entirety.

Further details are available on the EFRAG website.

EFRAG draft comment letter

EFRAG published a draft comment letter on the proposed ED in December 2012. In that letter EFRAG welcomed the IASB's decision to consider making limited amendments to IFRS 9 and appreciated the effort made to address accounting mismatches arising from the application of different measurement models to financial assets and insurance liabilities. However, EFRAG expressed a number of concerns on the proposals.

In particular, EFRAG was concerned that there were still financial assets that would not pass the contractual cash flow characteristics assessment, for different reasons, despite the fact that an amortised cost measurement would provide more useful information. In this respect, EFRAG invited constituents to provide with more examples than those already identified in the draft comment letter.

In addition, EFRAG noted that the definition of interest in IFRS 9 should be revised to clarify that it includes other components which are inherent in any theoretical definition of interest (e.g. liquidity risk).

EFRAG did not reach a consensus on the IASB's proposal to introduce an additional business model in IFRS 9. EFRAG had two distinct views and invited constituents to comment on these. Some EFRAG TEG members agreed with the approach in the ED that eligible debt instruments should be mandatorily measured at FV-OCI if they are held within a business model whose objective is both to collect contractual cash flows and to sell, whereas other EFRAG TEG members believed that the FV-OCI measurement category should be introduced as an option at initial recognition to address accounting mismatches.

EFRAG requested its constituents' views on the IASB's decision not to introduce bifurcation for financial assets, in particular, (i) whether they were aware of any circumstances in which bifurcation might still be needed, and (ii) how they would strike the balance – having as objective the effectiveness of financial reporting – between requesting bifurcation of hybrid financial assets on a basis consistent with the principles in IFRS 9 and encouraging the IASB to complete IFRS 9 as quickly as possible.

EFRAG also sought input from the EFRAG Insurance Accounting Working Group and Financial Instruments Working Group on a number of targeted areas of the ED to help them formulate a final view, in particular, on the introduction of an additional business model into IFRS 9.

Comments received from constituents

Twenty nine comment letters were received from constituents in time to be considered in the April EFRAG TEG meeting and are available on the EFRAG website.

The comment letters received came from national standard-setters, business associations, professional organisations, listed companies and EU authorities. The following table provides an overview of the respondents by type and country:

Respondent by type		*Respondent by country*	
Associations-Organisations	12	Germany	9
National Standard Setters	9	European respondents	5
Banks	4	France	4
Regulators	2	UK	3
Insurance companies	1	International respondents	1
Investors	1	Denmark	1
	29	Italy	1
		Netherlands	1
		Norway	1
		Portugal	1
		Spain	1
		Sweden	1
			29

The appendix to the feedback statement lists the respondents who commented on EFRAG's draft comment letter.

Most of the constituents agreed with the proposed clarifications on the contractual cash flow characteristics assessment; however, they felt that the assessment was too restrictive and would result in different traditional lending products and simple debt instruments to fail the assessment.

The majority of constituents raised concerns about introducing FV-OCI measurement in IFRS 9 in the way proposed by the ED. Many constituents felt that it was difficult to define an additional business model other than the amortised cost and fair value through profit or loss (FV-PL) and believed that the IASB's definition focused too much on the level of sales activity. In particular, constituents argued that the dividing lines between measurement categories were not clear enough.

Furthermore, constituents were divided as to whether and how FV-OCI measurement should be introduced into IFRS 9. A significant number of constituents believed that the IASB's proposals would introduce more complexity in the accounting for financial assets. Most of these constituents suggested introducing FV-OCI measurement as an option to avoid accounting mismatches, whereas a few of them preferred the current dual model in IFRS 9.

Other constituents, including insurance companies, supported FV-OCI measurement although they proposed alternative definitions to characterise the underlying business model or provided various recommendations, for example, to introduce this measurement basis as an unrestricted option into IFRS 9.

Constituents generally agreed to early apply the own credit provisions in IFRS 9; however they argued that a narrow-scope amendment to IAS 39 was a preferable solution.

Finally, constituents generally agreed to apply the standard in its entirety once IFRS 9 will be finalised, however they emphasised that the current mandatory effective date of 2015 was no longer realistic and therefore should be extended.

Contractual cash flow characteristics assessment – Clarifications proposed

EFRAG's tentative views and respondents' comments

EFRAG's tentative position

EFRAG agreed with the clarifications made in the contractual cash flow characteristics assessment; however was concerned that there were still certain financial assets that did not pass the assessment, for different reasons, despite the fact that an amortised cost measurement would provide more useful information than measurement at fair value.

Constituents' comments

The majority of respondents found the clarifications to be useful and agreed that in general terms, a financial asset with a modified economic relationship should not be automatically excluded from being an eligible instrument.

However, a significant number of constituents expressed concerns that the clarifications do not go far enough. In particular, these constituents identified a number of financial assets and traditional banking products that might fail the contractual cash flow characteristics assessment although they were managed to 'hold-to-collect' or both to 'hold-to-collect' and sell. These financial assets include financial instruments with regulated interest rates and those with early automatic redemption features.

Respondents provided a number of suggestions that in their view would improve the contractual cash flow characteristics assessment. These suggestions are further discussed in the feedback statement.

EFRAG's response to respondents' comments

EFRAG maintained its tentative support on the proposed clarifications; however reiterated its concerns that there are still many financial assets that would not pass the assessment.

In its final comment letter EFRAG noted that its constituents identified a number of financial assets that are held to collect contractual cash flows and could be inappropriately measured at FV-PL including financial assets with early redemption features or regulated interest rates that are common in many jurisdictions.

EFRAG believes that financial assets with regulated interest rates should generally be considered eligible instruments provided that their interest rate represents the pricing basis that is compulsory in the jurisdiction for such type of transactions and is intended to provide a reasonable proxy for the time value of money.

EFRAG considered the feedback from its constituents and suggested that the current guidance in IFRS 9 should be expanded to clarify that a financial asset with an automatic early (partial) redemption feature linked to credit risk deterioration of the issuer should not be excluded from measurement at amortised cost (or FV-OCI), provided that the financial asset prepays only principal and accrued interest.

In this context, we intend to share with the IASB the results arising from a field test that EFRAG conducted with National Standard Setters (ANC, ASCG, FRC and the OIC) and that was aimed at obtaining evidence on how IFRS 9 (as modified by the ED) would affect the current classification and measurement of financial assets.

Contractual cash flow characteristics assessment – Definition of interest

EFRAG's tentative views and respondents' comments

EFRAG's tentative position

EFRAG commented that the definition of interest in IFRS 9 should be revised to clarify that it includes other components which are inherent in any theoretical definition of interest, and recommended that the IASB modifies the definition of interest and to explore further the appropriateness of the definition in light of the recent tentative decisions on the insurance contracts project.

Constituents' comments

Many respondents felt that the proposed definition of interest in the ED was too narrow and unclear. These respondents argued that the interest rate also included several other components than just credit risk and time value of money including a profit margin, administrative and liquidity costs.

Respondents referred to paragraph BC4.22 in IFRS 9 (2010) which indicates that credit risk may include a premium for liquidity risk. Furthermore, many respondents were concerned that paragraph B4.1.8A in the ED would require FV-PL measurement when entities receive compensation for components other than time value of money and credit risk.

EFRAG's response to respondents' comments

In its final comment letter EFRAG commented that the IASB should clarify that the definition of interest in IFRS 9 (and the related application guidance) was not meant to be inconsistent with how entities determine interest of financial assets in practice, for example by including a reasonable profit margin and a premium for liquidity risk and considering other entity-specific factors such as the expected future behaviour of customers, provided that the resulting interest reflects market transactions.

EFRAG also expressed its concern that if paragraph B4.1.8A of the ED was taken literally, it would require FV-PL measurement in almost all circumstances.

Contractual cash flow characteristics assessment – Bifurcation

EFRAG's tentative views and respondents' comments

EFRAG's tentative position

EFRAG noted that in the past it expressed support for maintaining the possibility of bifurcation of hybrid financial assets and proposed a 'principal and interest approach' consistent with the principles in IFRS 9. In its draft comment letter EFRAG requested feedback from its constituents regarding bifurcation and how they would strike the balance between requesting bifurcation of hybrid financial assets to be available on this new basis and encouraging the IASB to complete IFRS 9 as quickly as possible.

Constituents' comments

Respondents who provided feedback on bifurcation were generally divided as to whether bifurcation should be introduced for financial assets. Those respondents who were against introducing bifurcation argued that past experience had indicated that the bifurcation requirements were complex and burdensome. In addition, they were concerned that it if the IASB would reconsider bifurcation it would delay the finalisation of IFRS 9.

Those respondents who were in favour argued that bifurcation would provide useful information about each component when they were managed separately. In addition, some respondents noted that bifurcation would be helpful to avoid accounting mismatches and address the concerns that many financial assets might not be eligible for measurement other than FV-PL, including instruments with certain prepayment options and those with insignificant equity features.

Furthermore, these respondents argued that the bifurcation requirements were not complex and that the requirements were retained for hybrid contracts with non-financial host and financial liabilities.

EFRAG's response to respondents' comments

EFRAG considered the feedback from its constituents who were concerned that a number of hybrid instruments might fail the contractual cash flow characteristics assessment although they were managed to collect contractual cash flows. If the IASB were to follow EFRAG's recommendations on the definition of interest and for some specific financial assets, most of these instruments were expected to continue to fail the assessment.

EFRAG was concerned about the usefulness of information that would result from measuring the financial assets referred above at FV-PL when an entity manages the individual components of those assets separately, and when an entity holds a financial instrument to collect the cash flows but it contains features that could significantly impact the fair value of the instrument.

EFRAG acknowledged that many constituents did not support introducing bifurcation for financial assets. However, EFRAG understood that among those constituents some were mainly concerned about further delaying the finalisation of IFRS 9 rather than against bifurcation as such.

Accordingly, EFRAG decided to recommend the IASB to introduce bifurcation for financial assets based on an approach consistent with the contractual cash flow characteristics assessment. EFRAG believes that such an approach would be consistent with the underlying requirements of IFRS 9 and also address the concerns expressed by its constituents. In EFRAG's view, entities should bifurcate financial assets that fail the contractual cash flow characteristics assessment, unless entities elect (either at the entity-level or on a portfolio-level) to measure these financial assets in their entirety at FV-PL due to the excessive cost of bifurcation.

Contractual cash flow characteristics assessment – Use of benchmark instruments

EFRAG's tentative views and respondents' comments

EFRAG's tentative position

EFRAG observed that entities might incur significant operational costs to construct a hypothetical benchmark and noted that the ED did not provide specific guidance on how such instruments should be constructed.

EFRAG tentatively concluded that applying the *'more than insignificantly different'* criterion when comparing the cash flows of a financial instrument to the cash flows of a benchmark instrument might require disproportionate efforts for preparers. EFRAG also recommended the IASB to require the use of actual benchmarks where they exist.

Constituents' comments

Some respondents noted that if hypothetical benchmarks had to be constructed that would result in significant implementation costs and mentioned that the application guidance was not operational in practice. These respondents were concerned that they would need to perform a detailed and burdensome assessment and felt that the cost of the proposed benchmark test in many cases would be disproportionate to the resulting benefits. However, a few respondents believed that in many circumstances a simple assessment should be sufficient.

EFRAG's response to respondents' comments

EFRAG acknowledges the concerns about the lack of guidance in the ED regarding the use of benchmarks instruments. However, EFRAG notes that some of those concerns could be addressed if the IASB clarified that the objective of using a benchmark instrument is to assess whether a financial asset yields an appropriate economic return at initial recognition considering the nature of the financial asset.

EFRAG also considered the concerns about the need to perform detailed assessments for each individual financial asset; however, we understand that in many circumstances entities would not need to repeat such a detailed assessment or construct hypothetical instruments for each and every financial asset, as many will be very similar.

To address constituents' concerns EFRAG recommended the IASB to clarify whether the assessment is always required, and indicate that actual benchmarks, where available, should be used in order to keep the assessment as simple as possible and to avoid inconsistent application in practice.

Business model assessment

EFRAG's tentative views and respondents' comments

EFRAG's tentative position

EFRAG agreed that measurement at FV-OCI could provide relevant information in certain circumstances and noted that users had indicated that the combination of fair value and amortised cost information would be helpful in their analysis.

However, EFRAG TEG members held different views regarding the introduction of an additional business model in IFRS 9. Some EFRAG TEG members agreed with the approach in the ED that eligible debt instruments should be mandatorily measured at FV-OCI if they are held within a business model whose objective is both to collect contractual cash flows and to sell, whereas other EFRAG TEG members believed that the FV-OCI measurement category should be introduced as an option at initial recognition to address accounting mismatches.

Constituents' comments

Many constituents felt that it was difficult to define an additional business other than the amortised cost and FV-PL. In particular, they found that the distinction between the definition underlying the proposed FV-OCI business model and the ones supporting the existing amortised cost and FV-PL business models was not clear enough to justify a different accounting treatment. In addition, they noted that the IASB's proposals put too much stress on the level of sales activity.

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EFRAG's response to respondents' comments

EFRAG considered the limited support for an additional business model as defined in the ED, the concerns about the lack of clarity of the proposed definition and the divergent views among constituents as whether and how measurement at FV-OCI should be introduced in IFRS 9. Accordingly, EFRAG decided to revise its position in the final comment letter.

In its final comment letter, EFRAG noted that any additional business model that requires a different accounting treatment should be supported by a robust definition. In this regard, EFRAG agreed that the additional business model, as proposed in the ED, was not sufficiently clear so as to differentiate it from the current business models in IFRS 9.

Nevertheless, EFRAG believes that measurement at FV-OCI is necessary as part of a solution to address insurers' concerns about accounting mismatches and performance reporting and considered the following approaches during its discussions:

- If FV-OCI measurement were to be introduced as a mandatory measurement category, it would not fully address the concerns raised by insurance companies, while creating additional complexity in the current dual model in IFRS 9 for all types of companies;
- If FV-OCI measurement were to be introduced as an option to eliminate or reduce accounting mismatches, it would require significant changes in the current approach in IFRS 9. For such an option to be operational and effective, it would be necessary

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EFRAG's tentative views and respondents' comments

Constituents were generally divided among the following views whether FV-OCI should be:

(a) Mandatory (the ED approach);

(b) An option to address accounting mismatches or unrestricted;

(c) Introduced as a residual category; and

(d) Introduced at all.

Those constituents who supported the proposed approach in the ED argued that in their view a business model in which financial assets are both held to collect and to sell did exist and would provide useful information, and therefore should be mandatory.

A significant number of constituents were in favour of introducing a FV-OCI measurement model as an option in order to avoid accounting mismatches. These constituents argued that adding a third measurement category to IFRS 9 would increase complexity and found it difficult to distinguish between the business models 'hold-to-collect' and 'held-for-trading'. Furthermore, they were concerned that entities would be forced to classify certain financial assets at FV-OCI that otherwise would have been classified at amortised cost. Notwithstanding these concerns, they acknowledged that addressing the insurers' concerns about accounting mismatches was important; therefore they proposed that the use of the FV-OCI should be optional. In their view that would allow a clearer distinction between the various measurement categories and create the minimum disruption to entities that have already begun to prepare to adopt IFRS 9 assuming a dual measurement model.

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EFRAG's response to respondents' comments

to define explicitly the business model underlying FV-PL measurement. The IASB would have to assess whether the current definition of 'held for trading' in IAS 39 for this purpose (which was also carried forward in IFRS 9) has caused problems in practice; and

- If FV-OCI measurement were to be introduced as an unrestricted option for all types of entities, it would impair comparability across entities and jurisdictions.

EFRAG considered the fact that the Insurance Contracts project has not yet been finalised and that it was difficult to identify at this stage all the issues that may arise from the interaction between classification and measurement of financial assets and insurance liabilities.

Accordingly, in the absence of an additional business model being clearly identified, EFRAG recommended the IASB to introduce FV-OCI measurement as part of its project on insurance contracts rather than proceeding with the introduction of an additional measurement category in IFRS 9. In particular, EFRAG believes that insurers should use FV-OCI measurement for financial assets in certain circumstances to be defined once the interaction between IFRS 9 and the future IFRS on insurance contracts is clear enough.

EFRAG's tentative views and respondents' comments

Constituents from the insurance industry noted that it was very difficult to assess the ED because the project on insurance contracts has not yet been finalised; however, they were concerned that the IASB has not considered sufficiently the interaction between the long-term nature of insurance liabilities and the financial assets backing those liabilities. In their view, measurement at FV-OCI was necessary to address accounting mismatches; however they noted that distinct measurement basis should be considered (for the financial assets) in order to appropriately reflect different types of insurance contracts and how are managed. Accordingly, they believed that FV-OCI should be introduced in IFRS 9 as an option but not limited to avoid accounting mismatches.

Some respondents believed that the IASB should define the FV-PL category and introduce the FV-OCI as residual category. These respondents provided different views as to how FV-PL should be defined, for example, they suggested to use the current definition of 'held for trading' or to represent the long-term investor's business model.

Other respondents suggested that the FV-OCI category should not be introduced at all. These respondents believed that the current dual measurement model was robust and transparent and would lead to consistent application. In their view, the FV-OCI category would introduce unnecessary complexity without providing more decision useful information.

EFRAG's response to respondents' comments

Early application

EFRAG's tentative views and respondents' comments

EFRAG's tentative position

In its draft comment letter EFRAG considered the complexity that would arise from a phased approach and therefore agreed with the proposal in the ED that after IFRS 9 is finalised, an entity early applying IFRS 9 should be required to apply IFRS 9 in its entirety.

EFRAG also agreed with the six-month transition period because it would provide relief to those constituents that have dedicated significant resources in preparation for the initial application of the classification and measurement phase of IFRS 9 but noted that the IASB should clarify the wording used in the ED, since the description of that transition period was not clear enough.

Constituents' comments

Most of the respondents who provided feedback on the early application of IFRS 9, agreed that the standard should be applied in its entirety once it is finalised to enhance comparability. However, many of those respondents argued that the current mandatory effective date of 2015 is no longer realistic and should be extended given that they expected three years would be needed to implement the proposals. Some of the respondents were concerned about the interaction between the IFRS 9 project and Phase II of IFRS 4 and suggested that the effective date of IFRS 9 and the forthcoming standard on Insurance Contracts should be aligned. A few respondents mentioned that insurers should not be required but rather permitted to adopt IFRS 9 before the mandatory effective date of the Insurance Contracts standard.

EFRAG's response to respondents' comments

In the light of the comments received EFRAG decided to maintain its tentative position regarding the phased approach; however EFRAG added that there should be more clarity on the mandatory effective date of IFRS 9, since 1 January 2015 seems no longer realistic considering the current IASB's timetable for completing the remaining phases of IFRS 9 (i.e. impairment and hedge accounting).

In order to assist constituents in their planning, EFRAG suggested that it would be particularly helpful if the IASB confirmed as soon as possible any changes in the effective date of IFRS 9.

Own credit provisions

EFRAG's tentative views and respondents' comments

EFRAG's tentative position

EFRAG noted that entities should be permitted to early apply the 'own credit' provisions in IFRS 9, and reiterated its request to amend IAS 39 so as to not further delay the benefit of increase relevance in the presentation of the financial statements.

Constituents' comments

The majority of the respondents who commented on the proposed own credit requirements in the ED, agreed that entities should be allowed to early apply the own credit provisions in IFRS 9. However, they stressed that a narrow-scope amendment to IAS 39 would be a preferred and timely solution for European entities. Some of these respondents mentioned that the accelerated application of these requirements should be mandatory.

A few respondents argued that any amounts recognised in other comprehensive income arising from own credit risk should be recycled to profit or loss and believed that the fair value of the liability that is attributable to changes in the issuer's own credit risk should include only the credit risk observed at inception (i.e. 'frozen credit spread' approach).

EFRAG's response to respondents' comments

In the light of the positive feedback from its constituents on its tentative position regarding the own credit provisions EFRAG decided to maintain its previous position in its final comment letter. However, EFRAG reiterated its concern that the relief would only be available as an option once the remaining phases of IFRS 9 have been finalised.

EFRAG also noted the views of those constituents who were in favour of using the so-called 'frozen credit spread' approach. EFRAG notes that in its comment letter in response to the IASB's ED *Fair Value Option for Financial Liabilities*, it was supportive of such an approach; however users opposed as it would create complexity and lacked clarity. EFRAG believes that there is no reason to amend its comment letter at this stage given the IASB's discussion on the Conceptual Framework.

List of respondents

Associations-Organisations:
Association for Financial Markets in Europe (AFME)
Association of German banks
Association of German Banks & German Insurance Association
BUSINESSEUROPE
Federation Bancaire Francaise (FBF)
Fédération Franchise des Sociétés d'Assurances (FFSA)
Federation of European Accountants (FEE)
German Banking industry committee
Institute of Chartered Accountants in England and Wales
Institute of Chartered Accountants of Scotland (ICAS)
Swedish Bankers' Association
The German Insurance Association (GDV)

Banks:
BNP Paribas Fortis, Belfius and KBC
Commerzbank
Deutsche Bank
DZ Bank

Insurance companies:
Allianz

Investors:
Long Term Investors Club

National Standard Setters:
Accounting Standards Committee of Germany (ASCG)
Autorité des Normes Comptables (ANC)
Comissão de Normalização Contabilística (CNC)
Danish Accounting Standards Committee (DASC)
Dutch Accounting Standards Board (DASB)
Financial Reporting Council (FRC)
Instituto de Contabilidad y Auditoria de Cuentas (ICAC)
Organismo Italiano di Contabilità (OIC)
The Norwegian Accounting Standards Board (NASB)

Regulators:
ESMA
European Banking Authority (EBA)