EFRAG STAFF PAPER FOR PUBLIC MEETING

Potential impact of IFRS 9 on investor and issuer behaviour
Note to EFRAG Board Members

Preamble

1 EFRAG staff has prepared this analysis based on what was reported by constituents in the field tests as potential issues, and discussions held by EFRAG staff with EFRAG TEG and with various stakeholders. The analysis highlights certain requirements of IFRS 9 that EFRAG staff considers are sufficiently sensitive that they might have an impact on investor or issuer behaviour. The staff is not able to assess whether any potential impact would actually materialise if IFRS 9 was endorsed. Further, EFRAG staff is not able to quantify the magnitude of any impact or to distinguish between any impact of IFRS 9 and other factors affecting financial institutions including regulatory developments and the impact of economic conditions at any stage of the economic cycle. Therefore, this analysis should be understood as contributing to the endorsement debate and should not be construed as representing any form of impact assessment. Although it has been discussed with members of EFRAG TEG, the analysis has not been approved by EFRAG TEG. It should not be regarded as representing EFRAG TEG views.

Objective

2 The objective of this note is to assess what impact, if any, IFRS 9 is likely to have on investor and issuer behaviour for the purposes of the endorsement analysis of IFRS 9.

3 The paper consider the following topics:

(a) Equity investments at fair value and long-term investments;

(b) Expected credit loss model;

(c) Debt instruments that fail the SPPI test;

(d) Own credit risk presentation; and

(e) Interaction with prudential requirements.

Equity investments at fair value and long-term investments

4 It can be argued that the requirement to measure all equity instruments, including unquoted ones, at fair value through profit or loss may negatively impact the investment appetite for equity instruments for certain long-term investors, such as insurers and certain private equity investors.

5 For insurers, measuring equity instruments at fair value through profit or loss will result in excessive volatility in profit or loss, because the insurance liabilities which are backed by these assets are measured either at cost by many insurers (based on the existing insurance contracts standard) or at current value through OCI (based on a future insurance contracts standard).

6 IFRS 9 provides an option to measure the equity instruments that are not held for trading at fair value through OCI which could reduce accounting mismatches, however insurers are unlikely to avail themselves of this option. This is because any gains or losses in those equity instruments are never reclassified from OCI to profit or loss even when the equity investments are sold, while changes in the insurance liabilities due to changes in the current rate are recognised in or reclassified to profit or loss.

7 EFRAG staff observes that the IASB has tentatively decided in the future insurance contracts standard to allow changes in insurance liabilities due to changes in interest rates to be recognised either in profit or loss or in OCI as an accounting policy choice. This will reduce the need for insurers to apply the OCI option for equity instruments, because they will have the possibility to present in profit or loss both fair value changes of the equity investments and current value changes of the insurance liabilities backed by those equity investments.

8 EFRAG staff notes that the expected increase in capital requirements is likely to play a much more significant role in moving insurers away from investing in equity investments. Furthermore, broader economic considerations such as the need for insurers to obtain a yield on their asset portfolio sufficient to meet their obligations to policy holders are likely to outweigh accounting mismatch concerns in deciding whether or not to invest in equity investments.

9 It has been brought to the attention of EFRAG staff that private equity investors in certain European jurisdictions may consider changing their strategic investment portfolios because of the undesirable effects of measuring equity investments at fair value through profit or loss. These private equity investors argue that they invest in equity investments with a long-term horizon and the fair value volatility recognised in profit or loss does not reflect the economic reality of their business since any gains or losses on their equity investments will only be realised at expiry of their investment horizon. For these private equity investors, the option to recognise fair value changes in OCI is not a solution, because the prohibition to reclassify the accumulated gains or losses from OCI to profit or loss is regarded as significantly distorting their primary performance given that these equity investments are held primarily for capital appreciation rather than dividend streams.

Expected credit loss model

10 It is noted that the potential negative effects of both 12-month and lifetime expected losses discussed below do not generally arise for stable portfolios. As a result, the effects would be observable only to the extent that portfolios:

(a) are growing in volume or their average lifetime extends; or

(b) the credit quality of portfolio deteriorates.

12-month expected losses

11 The requirement to recognise the 12-month expected losses on financial instruments up-front[1] may lead to loan providers and investors reducing lending in order to avoid recognising such losses. This may be especially applicable to entities originating or investing in assets with higher credit risk. The issue may also be escalated in periods when the lenders or investors face difficulties in achieving their desired earnings. Furthermore, in growing markets the rate of their expansion may be negatively impacted. Concerns of this kind have also been raised in financial press.

12 However, EFRAG staff notes that immediate recognition of credit losses is already required for regulatory purposes. Credit institutions applying the internal ratings based (IRB) approach for calculation of capital requirements for credit risk have to deduct the 12-month expected credit losses from their common equity Tier 1 capital. Regulatory capital is the primary consideration by banks in making business decisions therefore a similar impact from financial reporting requirements should not hit them significantly and should not be a major factor influencing for their behaviour.

13 For those banks that are not applying the IRB approach and other investors, the reduced earnings might become disincentives for writing new business. EFRAG staff, however, notes that there are other business factors such as competitive position and relationships with customers that may limit such behaviour.

14 EFRAG staff also notes that to the extent that there would be an impact it may be visible especially on lending markets with high risk, such as consumer finance, as the 12-month expected losses would be greater and the interest income may not compensate them in the period of origination. On the other hand, banks will pay more attention to credit risk before lending which in turn could curb over-rapid expansion of high risk lending markets which would also result in positive macroeconomic effects.

Lifetime expected losses

15 Lifetime expected credit losses are generally reflected in the pricing of assets for credit risk from a business perspective. From an accounting perspective there is a time mismatch resulting from an earlier recognition of losses. The lifetime expected losses on instruments with significant increases in credit risk are recognised immediately. The positive effects of assets without significant credit deterioration are recognised on accrual basis over the life of the instruments as entities account for the interest income.

16 As the lifetime expected losses will be higher for exposures with longer maturities there might be incentives to shorten the maturities of the instruments by loan providers or as a result of a demand from investors. Banks might be averse to providing new loans in times of financial crisis when they face losses on their portfolios. However, EFRAG staff notes that such behaviour would also be constrained by competitive forces because ceasing to lend would simply put the bank out of business.

17 In certain cases the requirement to recognise lifetime expected credit losses might create incentives to securitise the exposures just before significant credit

[1] IFRS requires that the loss allowance is recognised at the reporting date rather than immediately at initial recognition. However, this makes no difference as the 12-month loss affects the period when the instrument is initially recognised (except for an improbable case when the credit risk has significantly deteriorated in the first period in which case lifetime expected losses would be recognised).

deterioration occurs, i.e. near to the cut-off point between bucket one and two, in order to avoid recognition of lifetime expected losses. This is because the selling price includes offsetting effects between the expected credit losses and the seller's share in the future interest margin. However, EFRAG staff notes that it is unlikely that there would be a spiral of securitisation because of the difficulties in fully derecognising the securitised instruments in the consolidated financial statements.

Volatility in loss allowances

18 The approach in IFRS 9 is a point-in-time approach rather than through-the-cycle. As a result, it leads to forecasts of future economic conditions that react to the current stage of an economic cycle but are also more volatile than a through-the-cycle approach. The volatility will be more obvious for entities with longer-term portfolios because of higher lifetime expected losses which will be recognised in an economic downturn or reversed in times of an economic upturn.

19 If such increased volatility is not accepted by market participants evaluating the performance of lenders and investors, it might trigger a tendency to prefer instruments with shorter maturities or have some minor consequences for pricing.

20 EFRAG staff notes that the volatility results from a timely recognition of losses at the time when they are economically incurred due to significant changes in original credit losses expectations. Therefore it reflects the economics of the lending business.

Debt instruments that fail the SPPI test

21 *Investors* including lenders may face volatility in profit or loss on debt instruments not having SPPI that they do not consider appropriate and this may have an impact on their behaviour. On the other hand, the demand of investors may influence the *issuers* of the instruments.

22 EFRAG staff notes that financial assets not meeting SPPI test usually present only a minor part of the portfolios held by lenders and investors. Furthermore, many of such assets are already measured at fair value through profit or loss under IAS 39 *Financial Instruments: Recognition and Measurement* when entities choose fair value option rather than bifurcation of the embedded derivative.

23 The issue is explained with respect to the types of instruments which may be affected.

Debt securities

Investors

24 Investments in debt securities with structured features contain a non-derivative host instrument component with cash flows which are straightforward and would be SPPI if assessed separately. The host often accounts for a large portion of the cash flows of the instrument or may even dominate it. Some of such instruments may fail the SPPI test as a result of features which are not even commonly understood as structured, such as subordinated bonds for which, in certain circumstances, payments do not have to be made and no interest accrues on such delayed amounts. As a result, the requirement to measure such assets at FVPL in their entirety may not attract some investors and consequently may decrease the demand for these instruments.

Issuers

25 Issuers may be forced into splitting structured debt instruments into two separate contracts to make the instruments more attractive to investors. They may also need

to change the contractual terms of newly issued debt securities if investors' demand shifts towards less complex instruments meeting the SPPI test.

Loans

26 Standard lending practices by banks may involve some types of loans which do not contain a straightforward structuring element but still they would not meet the SPPI test. This may be the case for:

(a) Loans with interest mismatches whose effect is significant compared to benchmark instruments. EFRAG staff notes that most of the banks' concerns in this area seem to be resolved, based on recent discussions with the IASB; or

(b) Loans with prepayment fees charged to the customers in amounts which cannot be considered as a reasonable compensation for the prepayment.

27 Even when the features causing the cash flows to fail the SPPI test have the potential to alter the loan yield significantly, normally it is the underlying lending component with plain vanilla cash flows which dominates the relationship with the customer. IFRS 9 is likely to influence the extent of such products provided by banks if they want to avoid measuring the loans at FVPL. Generally two solutions are available

(a) Changing the contract terms so that they meet the SPPI test; or

(b) Splitting existing contracts into two separate contracts with the host contract being measured at amortised cost. However, this solution may be limited by the willingness of the customers to accept two separate contracts or related legal issues.

28 However, if such loan products are profitable or bring important customer relationships to the banks, the profit or loss volatility would not create sufficient incentives to consider changes.

Securitisation tranches

29 IFRS may lead to securitisation tranches being measured at FVPL to a larger extent than in under IAS 39. This may be especially relevant for lower ranking tranches which are likely to fail the SPPI test due to their riskiness or for synthetic securitisations. Longer-term investors may not find the FVPL measurement as complying with their business intentions. As a result, the demand for higher risk tranches or in the markets for synthetic securitisations may be dampened.

Own credit risk presentation

30 As a result of the IFRS 9 requirement to recognise in OCI the changes in the fair value of financial liabilities designated at FVPL (fair value option) due to changes in the issuer's own credit risk, entities may have better incentives to issue certain types of structured debt instruments such as callable bonds. In such cases the fair value option may be the best mechanism to remove accounting mismatches that would arise from the fact that derivatives are used to hedge the risks of the structured instruments.

31 Prior to IFRS 9, the entire fair value changes, including changes due to own credit risk, of such liabilities, would have been recognised in profit or loss which resulted in volatility because the own credit risk wasn't hedged. Furthermore, there was a counterintuitive result whereby the issuer would recognise a gain (loss) in profit or loss when its own credit deteriorates (improves). These factors discouraged the

issuance of those instruments and, under IFRS 9, recognition through OCI provides a solution

Interaction with prudential requirements

32 Prudential requirements in the EU relevant for the discussion in this paper result from:

(a) Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC (commonly referred to as CRD IV); and

(b) Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012 (commonly referred to as CRR).

33 Interaction between accounting and regulative treatment of financial instruments would, in certain cases, result in a reduction of the regulatory capital of credit institutions or increase in its volatility which may not be perceived as substantiated from an economic perspective. The description in the paper is based on the current regulatory guidance. EFRAG staff notes that the Basel Committee is expected to consider changes particularly as a result of the introduction of the expected credit loss impairment model. Therefore this point should be understood as a note which should not affect the final analysis of the impact of investors and issuer behaviour.

34 EFRAG staff has identified two areas of concern.

Expected credit losses

35 The issue is relevant for credit institutions applying the internal ratings based approach for calculation of the capital requirement for credit risk. Under prudential requirements, expected losses are calculated based on 12-month probabilities of default. This amount is directly deducted from the common equity Tier 1 capital. The regulatory requirements also interact with the financial reporting requirements in that a surplus of accounting allowances over the regulatory expected losses is included in the Tier 2 capital and limited to 0.6% of risk weighted exposure amounts.

36 Under IAS 39, there has been no constant excess of accounting allowances over the regulatory expected losses. Under IFRS 9, the expected credit losses will generally reach higher level than the 12-month expected regulatory losses because lifetime expected losses have to be recognised at an earlier stage than under the prudential requirements. This problem may be aggravated by the fact that the position of Tier 2 capital items has been reduced with a focus on the high quality common equity Tier 1 capital. Such changes in the structure or volume of the capital may not have been anticipated when the original prudential requirements were developed.

37 The impacts on the regulatory capital may be factored into lending and investment decisions. Banks may require higher yields on their investments in debt instruments or higher interest rates on loans. Banks which do not have sufficient capital buffers may have a tendency to prefer shorter term lending to avoid the higher impact of lifetime expected losses. In time of crises, as the credit quality of the portfolios deteriorates, the effect of lifetime expected losses might be coupled with the increase in risk-weighted exposures which may reduce the borrowing capacity of banks.

Unrealised gains and losses from instruments measured at fair value

38 Unrealised gains and losses from financial instruments measured at fair value may result in volatility of regulatory capital. Under CRR such gains and losses will be fully included in the common equity Tier 1 capital.[2] IFRS 9 brings all financial assets which do not meet the SPPI test or are not managed in a hold and collect model at fair value.

39 Concerns might relate especially to assets which fail the SPPI test and are measured at FVPL but they are held to collect contractual cash flows. Under IAS 39 such financial assets could be measured at amortised cost or be subject to bifurcation with the host contract being available for amortised cost measurement.

40 Measurement of the structured component, which causes the assets to fail the SPPI test, at FVPL is substantiated both from accounting and regulatory perspective as it captures the uncertain and often volatile part of the instrument's cash flows. However, despite bearing the structured feature, the substance of the instrument often results from its host contract component with plain vanilla cash flows. The volatility caused by measuring the host component at FVPL, as required by IFRS 9 which classifies the instrument in its entirety, may be perceived as artificial since the gains or losses gradually reverse over the life of the instrument unless the asset defaults. As a result, the volatility of the regulatory capital may discourage entities from investing in such instruments or make banks change the terms of such loan products.

Conclusion

41 As indicated in the preamble to this note, this analysis is based on EFRAG staff's understanding of both changes in IFRS 9 and current practices of banks and does in no way feature the results of an impact assessment. In this analysis EFRAG staff has tried to identify *potential negative effects only,* to contribute to identifying whether there would be any impediment to IFRS 9 being conducive to the European public good. The capacity of IFRS 9 to improve the quality of financial reporting, and hence contribute to the efficiency of capital markets supporting economic growth in the EU, has been assessed separately.

Questions for EFRAG Board members

42 Do EFRAG Board members agree with the assessment of possible investors/issuers behavioural changes due to the requirements of IFRS 9?

43 Do EFRAG Board members have additional impacts that should be assessed?

[2] The CRR provides a transitory period up to 31 December 2017 during which competent authorities may decide to partially or fully include such gains or losses in the capital. Moreover, they may decide to fully exclude gains and losses on exposures to central governments classified under IAS 39 as available-for-sale until the European Commission has adopted IFRS 9.