EFRAG STAFF PAPER FOR PUBLIC MEETING

This paper has been prepared by the staff of EFRAG for discussion at a public meeting of the EFRAG Board. The paper does not represent the official views of EFRAG or any individual member of the EFRAG Board or EFRAG TEG. The papers are made available to enable the public to follow the discussions in the meeting. Tentative decisions are made in public and reported in EFRAG *Update*. EFRAG positions as approved by the EFRAG Board are published as comment letters, discussion or position papers or in any other form considered appropriate in the circumstances.

Jonathan Faull
Director General, Financial Stability, Financial Services and Capital Markets Union
European Commission
1049 Brussels

[XX Month] 2015

Dear Mr Faull

Adoption of IFRS 9 *Financial Instruments*

Based on the requirements of the Regulation (EC) No 1606/2002 of the European Parliament and of the Council on the application of international accounting standards we are pleased to provide our opinion on IFRS 9 *Financial Instruments*, which was issued by the IASB in July 2014.

The objective of IFRS 9 is to replace IAS 39 *Financial Instruments: Recognition and Measurement* with a principle-based and less complex standard. IFRS 9 becomes effective for annual periods beginning on or after 1 January 2018, with earlier application permitted. Appendix 1 to this letter provides a summary of the changes introduced by IFRS 9.

IFRS 9 was developed in stages and EFRAG sought views, conducted field tests and commented on every stage of that development.

Although the assessment of IFRS 9 has led us to identify some potential concerns, we have concluded that IFRS 9 would provide financial reporting that meets the qualitative characteristics of relevance, reliability, comparability and understandability and the true and fair view principle. We have also assessed that IFRS 9 would lead to prudent accounting. The basis for our conclusions is provided as Appendix 2 to this letter.

We have also assessed whether IFRS 9 would help improve financial reporting. We have identified that IFRS 9 would bring a distinct improvement in the accounting for basic lending instruments, in the impairment of financial assets and hedge accounting over the existing requirements in IAS 39, whilst bringing different but still relevant accounting for financial instruments other than basic lending instruments. This includes our consideration of when a fair value through profit or loss measurement is required, and does not trigger any concern that IFRS 9 could have an adverse impact on financial stability because of an inappropriate use of fair value.

Further, improvements in the impairment of financial assets meet the G20 request in the wake of the financial crisis to implement a forward looking impairment model that leads to early recognition of expected credit losses, and the changes brought to hedge accounting remedy the long-standing criticism that IAS 39 was excessively restrictive in requiring that hedging strategies eligible for hedge accounting were recognised on an instrument-by-instrument basis.

We have considered and concluded that IFRS 9 would not put European companies at a competitive disadvantage compared to companies complying with US GAAP. Indeed, we are of the view that the contrary would apply in that IAS 39 and the US GAAP requirements for the accounting for financial instruments held a lot of similarities. Therefore we conclude that IFRS 9, as an improvement over IAS 39, will compare favourably overall to current US GAAP. In particular, we have concluded that the IFRS 9 impairment model brings more relevant information than the US GAAP impairment model. By using lifetime credit losses in all cases, US GAAP makes no allowance for the fact that financial institutions are compensated for expected credit losses through the interest rate that they charge to borrowers and therefore applying lifetime credit losses in all cases distorts the reporting of the entity's performance. Whilst the 12 month expected loss allowance has the limitations of a practical expedient, it has the merit of getting closer to reflecting economic reality. Consequently, we conclude that the overall IFRS 9 impairment model with its emphasis on credit deterioration provides more relevant information for investors.

The implementation of IFRS 9 will undoubtedly trigger significant implementation costs. We have however concluded that the benefits derived from the improvements summarised above would outweigh the costs.

We have also considered, on the assumption of normal business behaviour, whether the changes triggered by IFRS 9, especially through the impairment model, could have an effect on the pricing and maturity of lending instruments in the EU, in order to identify any potential adverse effect on economic growth. Our conclusions are derived solely from our understanding of IFRS 9 and general business knowledge and have not been substantiated by quantitative analysis. We first note that in many cases no ongoing impact should be expected, unless an entity experiences rapid expansion in its credit activities or when the credit quality of portfolios deteriorates over time. In the first instance, we note that the expansion in credit activities is in itself a contribution to economic growth and we would expect that competitive forces will help keep the potential for expansion unaffected. In the second instance, we note the potential for IFRS 9 to affect the entity's management of existing portfolios, which could eventually result in increased securitisations. In some cases this may have an impact on new business. Finally we believe that the potential effects of a change in the impairment model may be partially subsumed into the effects of increased cost of capital due to the more stringent regulatory framework developed after the financial crisis. This in our view indicates that European institutions have already struck the balance between the need for financial stability and the support to economic growth.

Based on the above we have concluded that IFRS 9 would improve the quality of financial reporting and hence support an improved efficiency of capital markets, without creating adverse effects on the European economy. Our overall conclusion is therefore that IFRS 9 is conducive to the European good. The detailed basis for our conclusions is provided as Appendix 3.

As a result of the above conclusions we conclude that IFRS 9 meets all endorsement criteria and therefore recommend that it be adopted in the EU.

In addition to our assessment of whether IFRS 9 meets the endorsement criteria we have considered at your request the interrelationship between the future requirements for the accounting for insurance contracts (the future revised IFRS 4) and IFRS 9; and the use of the IAS 39 carve-out, where we have concluded that it will remain available in accordance with the purpose for which it was intended. These issues are addressed in more detail in Appendix 4 to this letter.

Finally we note that none of our efforts to gather information about the use of practical expedients provided in IFRS 9 and some form of quantitative analysis of the effects of the impairment model on the level of allowances for credit losses that would need to be recognised at the time IFRS 9 is first implemented have been successful. Our attempts

have convinced us that obtaining information about implementation decisions by individual companies and a quantitative analysis would delay the endorsement of IFRS 9 to such an extent that, in our view, would be detrimental to the European public interest.

On behalf of EFRAG, I would be happy to discuss our advice with you, other officials of the European Commission or the Accounting Regulatory Committee as you may wish.

Yours sincerely

Roger Marshall
Acting President of the EFRAG Board

Appendix 1: Understanding the main changes brought by IFRS 9

Background of the Standard

1 IFRS 9 replaces almost all parts of IAS 39 *Financial Instruments: Recognition and Measurement*. Work on replacing IAS 39 was accelerated following the financial crisis when interested parties, including the G20, the Financial Crisis Advisory Group and the Financial Stability Board highlighted a number of areas in financial instruments accounting that needed to change. These included, inter alia, the timeliness of recognition of credit losses, the complexity of multiple impairment models and the reporting in profit or loss of changes in own credit worthiness.

2 The overall scope and recognition/derecognition model of IFRS 9 *Financial Instruments* are materially the same as IAS 39, but there are significant changes to:

(a) Classification and Measurement;

(b) Impairment; and

(c) Hedge Accounting.

How the issues have been addressed

3 IFRS 9 changes the classification requirements for financial assets, using a single approach for all types of financial assets. Only basic lending instruments are potentially eligible for measurement at amortised cost and all other financial assets are measured at fair value. Measuring all non-basic lending instruments at fair value has led to the elimination of the multiple impairment models in IAS 39 and the design of a single model based on the principle of expected, rather than incurred, credit losses results in earlier recognition of credit losses. The hedge accounting requirements more closely align hedge accounting with risk management practices.

What has changed?

Classification and measurement

Financial Assets

4 The classification and measurement approach for financial assets in IFRS 9 is based upon the contractual cash flow characteristics of the financial assets, and for financial assets that are assessed to be 'basic lending instruments' the entity's business model for managing the financial assets.

5 IFRS 9 distinguishes basic lending instruments as having contractual cash flows that are assessed as being Solely Payments of Principal and Interest ('SPPI') on the principal amount outstanding from other instruments, with contractual cash flows that are not assessed to be SPPI.

6 Within the assessment of payments being SPPI, 'principal' is the fair value of the financial asset at initial recognition, which changes over time to reflect any repayments of that principal. Interest is described broadly, as including consideration for the time value of money, credit risk, other basic lending risks (such as liquidity risk), costs (such as administrative costs) and a profit margin consistent with a basic lending arrangement.

7 All financial assets that have contractual cash flows that are not assessed as being SPPI are measured at fair value, with changes in the fair value presented in profit or loss. This is because the IASB decided that fair value is the best predictor of future net cash inflows for these assets. This includes equity instruments for which the IASB

has nonetheless introduced an irrevocable option at inception on an instrument-by-instrument basis to be accounted for at fair value through Other Comprehensive Income ('OCI'), without no impairment losses recognised in profit or loss and no reclassification in profit or loss of gains or losses upon derecognition.

THE BUSINESS MODEL WITHIN WHICH FINANCIAL ASSETS ARE MANAGED

8 For basic lending instruments, the financial reporting depends upon the business model the entity uses to manage the assets in order to generate cash flows - by collecting contractual cash flows, selling financial assets or both. The business model is assessed on a level that reflects how basic lending instruments are managed to achieve a particular business objective. The business model does not depend upon management's intentions for an individual instrument, and is therefore determined on a higher level of aggregation, but IFRS 9 acknowledges that a single reporting entity may have more than one business model for managing its financial assets and therefore classification need not be determined at the reporting entity level.

9 The business model for managing basic lending instruments is a matter of fact rather than an assertion, and the standard states that it is typically observable through the activities that the entity undertakes to achieve the objectives of the business model. Evidence of the nature of the business model includes:

(a) How the performance of the business model and the financial assets held within that business model are evaluated and reported to the entity's key management personnel;

(b) The risks that affect the performance of the business model and the way in which those risks are managed; and

(c) How managers of the business are compensated.

10 Basic lending instruments that are managed within a business model whose objective is to hold assets in order to collect contractual cash flows are measured at amortised cost, with interest income and impairment losses presented in profit or loss.

11 Basic lending instruments that are managed within a business model whose objective is achieved by both collecting contractual cash flows and selling financial assets have the same presentation in profit or loss as basic lending instruments that are managed within a business model whose objective is to hold assets in order to collect contractual cash flows. However, for the balance sheet, such financial assets are measured at fair value. The difference between an instrument's amortised cost measurement (which is used to calculate the presentation in profit or loss) and its fair value is presented in OCI, with reclassification in profit or loss upon derecognition.

12 Basic lending instruments that are managed within any other business model are measured at fair value through profit or loss.

13 There is an irrevocable option at initial recognition to designate basic lending instruments at fair value through profit or loss if such designation eliminates or significantly reduces a measurement or recognition inconsistency (sometimes referred to as an 'accounting mismatch').

DETERMINING WHETHER CASH FLOWS ARE SOLELY PAYMENTS OF PRINCIPAL AND INTEREST

14 IFRS 9 provides extensive guidance to assist in determining whether contractual cash flows are SPPI. For contractual cash flows to be SPPI they must include returns consistent with a basic lending arrangement, for example, if the contractual cash

flows include a return for equity price risk then that would not be consistent with the contractual cash flows being SPPI.

MODIFICATIONS OF CONTRACTUAL CASH FLOWS

15 Although IFRS 9 does not change the existing derecognition requirements for financial assets, the modification requirements of IFRS 9 have raised uncertainty whether an impact in profit or loss should be recorded in profit or loss or not in all cases.

WHEN A BUSINESS MODEL CHANGES

16 Because the classification model for basic lending instruments is based upon the business model within which those financial instruments are managed, IFRS 9 requires reclassification if that business model changes. Such changes are expected to be very infrequent, and must be significant to the entity's operations and demonstrable to external parties, for example when the entity acquires, disposes of or terminates a business line. No other reclassification is permitted. In comparison to IAS 39, IFRS 9's requirements are more restrictive. Consequential amendments to IFRS 7 *Financial Instruments: Disclosures* require detailed disclosures about such reclassifications (including the amount of financial assets moved into and out of different measurement categories and a detailed explanation of the change in business model and its effect).

IMPROVING CONSISTENCY IN THE DEFINITION OF EQUITY INSTRUMENTS

17 The definition of equity instruments mirrors the accounting requirements for the issuer under IAS 32 *Financial Instruments: Presentation*. Financial instruments are therefore not classified as equity instruments if they include a contractual obligation for the issuer to transfer cash or another financial asset, even if the amount of cash to be received is not fixed or determinable, or is based on entity-specific variables (for example shares in open ended investment funds or shares puttable to the issuer at fair value).

Financial Liabilities

18 Except for the accounting for changes in own credit risk described below, all IFRS 9 requirements for financial liabilities are carried forward from IAS 39, including the bifurcation of particular embedded derivatives. As a result, many financial liabilities, apart from derivatives, financial liabilities held-for-trading or financial liabilities that an entity designates under the fair value option, will continue to be measured at amortised cost.

CHANGES IN OWN CREDIT RISK

19 IFRS 9 introduces new requirements for the accounting and presentation of changes in the fair value of a financial liability when the entity has chosen at inception to measure that financial liability at fair value under the fair value option. This responds to criticism that it was counterintuitive for an entity to recognise a gain in profit or loss due to a deterioration of its own credit standing. Under IFRS 9, a change in fair value due to the change in the credit risk of the liability is reported in OCI unless such presentation would create or enlarge an accounting mismatch in profit or loss. The accumulated amounts presented in OCI are not reclassified to profit or loss if the liability is repaid early.

Impairment

20 The impairment section of IFRS 9 reflects a fundamentally different approach to that of IAS 39 in that the loss recognition model is based on 'expected' rather than

'incurred' losses. This change was designed to address concerns raised during the financial crisis that IAS 39, as it was implemented, recognised impairment losses on financial assets too late. The model in IFRS 9 is conceptually a 'loss allowance' model, recognising a provision for expected credit losses on financial assets before any losses have been incurred and updating the amount of expected credit losses recognised at each reporting date to reflect changes in the credit risk of financial instruments. Credit losses are the present value of the difference between the contractual cash flows that are contractually due to the entity and the cash flows that the entity actually expects to receive.

21 The expected credit losses model applies to financial assets measured at amortised cost, debt instruments measured at fair value through OCI, loan commitments and financial guarantee contracts that are not measured at fair value through profit or loss, lease receivables that are within the scope of IAS 17 *Leases* and trade receivables or contract assets within the scope of IFRS 15 *Revenue from Contracts with Customers*.

22 The loss allowance model requires an entity to base its measurement of expected credit losses on reasonable and supportable information, including historical, current and forward-looking information, which is available without undue cost or effort. It has three stages:

(a) Stage 1: At the reporting date, if credit risk on a financial instrument has not increased significantly since initial recognition, an entity shall measure the loss allowance for that financial instrument at an amount equal to 12-month expected credit losses.

12-month expected credit losses are the portion of lifetime expected credit losses that represent the expected credit losses that could result from default events that are possible within 12 months from the reporting date. The 12-month expected credit losses loss allowance amount is intended to be a proxy for the amount of credit losses expected to be covered by interest margin over the next 12 months.

(b) Stage 2: At each reporting date, if the credit risk increases significantly from initial recognition, full lifetime expected credit losses are recognised. As a practical expedient, entities may assume that the credit risk has not increased significantly if the financial instrument is determined to have low credit risk at the reporting date.

(c) Stage 3: A financial asset reaches stage 3 if it is specifically identified as credit-impaired. At this stage, recognition of interest revenue changes as described below and expected credit losses continue to be recognised on a lifetime losses basis.

23 In stages 1 and 2, interest revenue is calculated on the gross carrying amount of the financial asset. However, in stage 3, interest revenue is calculated based on the gross carrying amount less the loss allowance.

24 For purchased or originated credit-impaired financial assets the cumulative changes in lifetime expected credit losses since initial recognition are recognised as a loss allowance.

25 The new model is accompanied by enhanced disclosures about expected credit losses and credit risk. For example, entities are required to provide information that

explains the basis for their expected credit loss calculations and how they measure expected credit losses and assess changes in credit risk.

Hedge Accounting

26 The requirements in IAS 39 for hedge accounting were widely regarded as rule-based, difficult to implement and inconsistent with risk management practices. The main changes to the hedge accounting requirements in IAS 39 have been made to meet the objective of reflecting risk management practices. As a result, IFRS 9 retains the three hedge accounting models from IAS 39 but with some changes to the fair value and cash flow hedge accounting models.

27 IFRS 9 expands the range of hedged items to include items such as risk components of non-financial items, aggregated exposures, net positions and layer components of items. The range of hedging instruments is also expanded: for example non-derivative financial instruments measured at fair value can be used to hedge risks other than foreign exchange risk. IFRS 9 provides better incentives to designate options as hedging instruments since the volatility of the time value is presented through OCI rather than profit or loss.

28 The hedge effectiveness requirements needed to qualify for hedge accounting have changed so they are less rules-based. Hedged items and hedging instruments need to be connected through an economic relationship, and value changes that result from that economic relationship should not be dominated by credit risk. A designated hedging relationship is required to reflect what is actually being hedged and the entity is required to document the arrangement in advance and identify how hedge effectiveness will be assessed and the sources of hedge ineffectiveness. Any hedge ineffectiveness is recognised in profit or loss.

29 IFRS 9 introduces the concept of 'rebalancing'. Rebalancing refers to adjustments to the designated quantities of either the hedged item or the hedging instrument of an existing hedging relationship for the purpose of maintaining a hedge ratio. This allows entities to respond to changes that arise from the underlying instrument or risk variables. However, entities may not voluntarily de-designate the hedge accounting relationship when the hedge accounting relationship continues to reflect the risk management objective.

30 Credit risk is not a hedgeable risk. However, IFRS 9 permits an entity to designate a credit risk exposure at fair value through profit or loss. As an alternative to hedge accounting, the use of the fair value option is extended for own-use contracts.

Macro-hedging practices

31 IFRS 9 does not address specific accounting for open portfolios of hedged items or macro hedging: this is part of a separate IASB project. Consequently, entities can elect to apply IAS 39 to account for the portfolio fair value hedge of interest rate risk.

32 IFRS 9 also provides entities with an accounting policy choice between applying the hedge accounting requirements of IFRS 9 and continuing to apply the existing hedge accounting requirements in IAS 39 for all hedge accounting. This accounting policy choice is intended to remain available until the work on macro hedge accounting has been finalised.

When does the Standard become effective?

33 The Standard has a mandatory effective date of annual periods beginning on or after 1 January 2018 with early application permitted. The section of IFRS 9 on the

presentation of changes in own credit risk can be applied prior to adopting the rest of IFRS 9.

Appendix 2: EFRAG's technical assessment on IFRS 9 against the endorsement criteria

This appendix sets out the basis for the conclusions reached in the technical assessment made, by EFRAG on IFRS 9.

In its comment letters to the IASB, EFRAG points out that such letters are submitted in EFRAG's capacity of contributing to the IASB's due process. They do not necessarily indicate the conclusions that would be reached by EFRAG in its capacity of advising the European Commission on endorsement of the definitive IFRS in the European Union and European Economic Area.

In the latter capacity, EFRAG's role is to make a recommendation about endorsement based on its assessment on the final IFRS or Interpretation against the technical criteria for the European endorsement, as currently defined. These are explicit criteria which have been designed specifically for application in the endorsement process, and therefore the conclusions reached on endorsement may be different from those arrived at by EFRAG in developing its comments on proposed IFRSs or Interpretations. Another reason for a difference is that EFRAG's thinking may evolve.

Does the accounting that results from the application of IFRS 9 meet the technical criteria for EU endorsement?

1 EFRAG has considered whether IFRS 9 meets the technical requirements of the European Parliament and of the Council on the application of international accounting standards, as set out in Regulation (EC) No 1606/2002, in other words that IFRS 9:

(a) is not contrary to the principle of 'true and fair view' set out in Article 4(3) of Council Directive 2013/34/EU; and

(b) meets the criteria of understandability, relevance, reliability, and comparability required of the financial information needed for making economic decisions and assessing the stewardship of management.

2 EFRAG's assessment on whether the technical requirements are met are included in this appendix in the following paragraphs:

(a) Relevance: paragraphs 5 - 97;

(b) Reliability: paragraphs 98-118;

(c) Comparability: paragraphs 119 - 151; and

(d) Understandability: paragraphs 152- 165.

3 In providing its assessment on whether IFRS 9 results in relevant, reliable, understandable and comparable information, EFRAG has considered all the requirements of IFRS 9. EFRAG has, however, focused its assessment on the requirements it considered most significant in relation to each of the criteria. EFRAG has accordingly focused on guidance that:

(a) Is fundamental to the accounting for financial instruments and/or to IFRS 9;

(b) Has been subject to substantial debate (evidenced by the comments EFRAG has received from constituents including participants in EFRAG's field-tests of the Exposure Drafts);

(c) May be problematic to apply (evidenced by the results of EFRAG's field-tests); and

(d) Is raised by the European Commission in its request for endorsement advice dated 8 December 2014.

4 EFRAG has assessed the IFRS 9 requirements related to:

(a) Classification and Measurement;

(b) Impairment; and

(c) Hedging.

Relevance

5 Information is relevant when it influences the economic decisions of users by helping them evaluate past, present or future events or by confirming or correcting their past evaluations.

6 EFRAG considered whether IFRS 9 would result in the provision of relevant information – in other words, information that has predictive value, confirmatory value or both – or whether it would result in the omission of relevant information.

Classification and Measurement

7 Following the criteria set out in paragraph 3 above, EFRAG has focused its assessment on requirements related to:

(a) Classification of financial assets;

(b) Measurement; and

(c) Classification of financial liabilities: own credit risk.

8 The classification and measurement approach for financial assets in IFRS 9 is based upon the contractual cash flow characteristics of the financial assets, and for financial assets that are assessed to be simple lending instruments, the determination of the entity's business model for managing the financial assets.

CLASSIFICATION OF FINANCIAL ASSETS

CONTRACTUAL CASH FLOW CHARACTERISTICS

9 Amortised cost is a relatively simple measurement technique using the effective interest rate to allocate interest over the relevant periods. It is only applied to financial assets with contractual cash flows that are solely payments of principal and interest and should be consistent with a basic lending arrangement[1].

10 EFRAG notes that the contractual cash flows test generally provides relevant information in relation to financial assets that have solely payments of principal and

[1] EFRAG notes that the concept of basic lending is not defined in IFRS 9, although the Standard does clarify that the form of which need not be the one of a loan.

interest. It excludes instruments with contractual features giving rise to exposure to risks or volatility unrelated to a basic lending arrangement, such as leverage or changes in equity prices or commodity prices.

11 EFRAG also notes that even when contractual cash flows could not be considered as being solely payments of principal and interest they are ignored if those features are:

(a) 'non-genuine', i.e. if they affect cash flows only on the occurrence of an event that is, extremely rare, highly abnormal, and very unlikely; or

(b) possible impacts of those features are 'de minimis', that is, the magnitude of the impact is trivial or minor.

12 EFRAG notes that it may be argued that certain types of financial instruments might be viewed as being basic lending agreements but IFRS 9 does not consider their contractual cash flows as being solely payments of principal and interest. These financial instruments include:

(a) Financial assets with interest mismatch features: these are generally variable rate instruments whose interest rate is periodically reset using a different rate from the one matching the maturity of the financial instrument. Such mismatches may also be implicitly present in instruments with managed interest rates where the variable rate is set at the bank's discretion and may not fully track the current market rate. Interest mismatches also arise with 'lagged rates' such as 12-month Euribor as fixed one month ago reset every 12 months. It may be argued that the requirement to measure these instruments at fair value is less prudent because it requires recognition of gains on financial assets that are unlikely to be realised under the business model in which the assets are held.

In many cases, especially for loans, qualitative testing would be sufficient to assess whether the interest mismatch feature are solely payments of principal and interest. Such a test is focused on whether the contract terms have been designed to provide compensation only for the time value of money and other basic lending risks or whether the contract contains some structuring elements. Quantitative testing would in most cases only be required where qualitative testing does not provide a conclusion.

EFRAG assesses that in many cases this should remove the concerns raised for loans having interest rate mismatched features. In those cases they should result in amortised cost measurement if held in the appropriate business model.

(b) Instruments for which in certain cases (such as insolvency of the debtor) payments do not have to be made and no interest accrues on the deferred amounts are not considered as having solely payments of principal and interest. This may be the case for certain types of subordinated debt instruments. EFRAG notes that subordination in itself does not preclude amortised cost measurement and the issue arises due to the additional feature.

EFRAG assesses that for those instruments described in the previous paragraph the contractual cash flows test requiring that they are measured at fair value through profit or loss would not bring relevant information as such instruments are generally viewed as basic lending instruments.

13 Overall EFRAG assesses that, except for a few specific cases for example the one described in paragraph 12(b), the application of the contractual cash flow test will

increase the relevance of the resulting information. In accordance with the late adjustments to the solely payment of principal and interest test made by the IASB, instruments which are basic lending instruments in the market in which they are contracted are expected to pass the cash flow characteristics test and (subject to additionally fulfilling the business model criterion) qualify for amortised cost. EFRAG therefore believes that the application of the solely payment of principal and interest test provides a sound basis to aggregate financial instruments into those that qualify for amortised cost and those that qualify for fair value in the balance sheet.

MODIFICATION OF CONTRACTUAL CASH FLOWS

14 For financial assets, a modification gain or loss is recognised in profit or loss whenever there is a modification in contractual cash flows that does not result in derecognition. Some constituents from the 2013 field-test Expected Credit Losses raised concerns about this requirement as it leads to the recognition of losses even when the terms of financial assets are modified due to commercial reasons rather than credit deterioration reasons.

15 IFRS 9 does not change existing derecognition requirements for financial assets. Nevertheless the modification requirements in IFRS 9 have raised uncertainty whether an impact in profit or loss should be recorded or not. EFRAG assesses that in some cases it would not be relevant to report an impact in profit or loss when modifications occur. This is the case when clients have a prepayment right on loans as in such cases banks have no unconditional right to receive all initially scheduled cash flows throughout the contractual life of the loan. Hence, when prepayment occurs, there is no real economic loss that should be reflected in profit or loss. Upon prepayment debtors may get another loan enjoying lower interest rate if the rates have declined in the meantime. EFRAG understands that in some jurisdictions derecognition of the original loan is applied in these cases, reporting the difference between carrying amount and repayment amount, if any, to profit or loss. The above analysis does not change even when a bank has economically hedged its interest position resulting from the loans as such economic hedges are mostly done on portfolio level taking into account the risk of prepayments. However, when the entity changes commercial terms under the existing contract so that the customer enjoys more favourable conditions (e.g. decrease of interest rate to the current market level), IFRS 9 requires a modification gain or loss to be recognised in profit or loss even though the two situations are economically the same.

16 EFRAG assesses that reporting a modification gain or loss for commercial renegotiations does not result in relevant information as this could be considered as accounting for an opportunity loss. In contrast, EFRAG assesses that reporting a modification loss due to a deterioration of credit risk would result in relevant information as it would provide information about the extent of losses resulting from renegotiations as a result of credit rather than market events.

BUSINESS MODEL

17 Taking into account the business model in determining the accounting for financial assets provides a basis for increased relevance. However, the application of the business model test in IFRS 9 is limited to the accounting for basic lending instruments. Only assets which have cash flows which are solely payments of principal and interest can subsequently result in amortised cost or fair value through OCI or fair value through profit or loss measurement based on the business model in which they are managed. Assets not having solely payments of principal and interest are automatically measured at fair value through profit or loss and the business model does not play a role in their classification. EFRAG assesses the combination of the criteria of contractual cash flows and business model for basic lending instruments as providing relevant information.

18 Some constituents have argued that financial assets should be subject to a business model assessment regardless of the outcome of the contractual cash flow test. One might also propose as a solution the possibility to bifurcate the instrument in which case only the 'basic lending' host component would be subject to business model assessment.

19 EFRAG notes that absent from being accounted for at fair value through profit or loss financial instruments other than basic lending instruments would require a specific impairment model, that IAS 39 impairment models have shown their limits in relevance, and that in the course of the development of IFRS 9 no fully satisfactory alternative has been identified. EFRAG therefore notes that arguments for having the business model play a role for financial instruments other than basic lending instruments have to balanced against those observations. In addition, to meet the relevance requirement in IAS 1 *Presentation of Financial Statements*, entities should segregate the presentation of financial assets on their balance sheet. Also, IFRS 9 provides an option for equity instruments to be measured at fair value through other comprehensive income which allows entities to distinguish different business models for equity investments. Finally, it is noted that the fair value option can be used to address potential accounting mismatches and hence support relevant accounting.

MEASUREMENT

20 The measurement of basic lending instruments is based on both the business model and the cash flow characteristics. The following discussion considers the measurement for each business model.

BUSINESS MODEL: HOLD TO COLLECT

21 Provided an entity's business model is to collect contractual cash flows and the cash flow characteristics represent solely payments of principal and interest then amortised cost measurement provides useful information about future cash flows both in the statement of financial position and in profit or loss. It provides information about the asset's performance through the generation of interest revenue and helps in predictions of future interest streams.

22 An entity's business model can be to hold basic lending instruments to collect contractual cash flows even where sales of those financial assets occur or are expected to occur in the future because sales are incidental to the objective of holding to collect contractual cash flows. Issues do not arise when a sale is made because of a credit deterioration of a counterparty or when an asset is sold close to the maturity of the financial asset and the proceeds from the sale approximate to the collection of the remaining contractual cash flows. Under IFRS 9, sales are not inconsistent with the hold to collect business model if they are infrequent (even if significant in value) or insignificant in value either individually or in aggregate (even if frequent). EFRAG assesses that this additional guidance on sales avoids unnecessary restrictive rules and strengthens the relevance of the business model.

BUSINESS MODEL: HOLD TO COLLECT AND SELL

23 If the objective of an entity's business model is achieved by both collecting contractual cash flows and selling financial assets, the measurement related to this business model is based upon fair value in the statement of financial position, while the effect on profit or loss would be the same as if the basic lending instruments were measured at amortised cost, i.e. including impairment. The difference between the fair value and amortised cost is presented in other comprehensive income.

24 EFRAG notes that entities might invest in debt instruments to generate yield but with an intention to sell if the price is advantageous or if it is necessary to periodically

adjust or rebalance the entity's net risk, duration or liquidity position. In those instances both fair value and amortised cost information is relevant in helping financial statement users to understand performance and to predict future cash flows because of the two potential value realisation paths that can be taken.

25 Unlike the hold to collect business model, selling assets is integral to achieving the objective of the hold to collect and sell business model. In addition, there is no threshold for the frequency or the value of sales that must occur in this business model. Therefore, EFRAG assesses that reasons, the frequency, timing and value of sales constitute relevant distinguishing factors between the hold to collect and the hold to collect and sell business models.

OTHER BUSINESS MODELS

26 Where entities manage basic lending instruments primarily with the objective of realising cash flows through the sale of the assets, fair value provides useful information about future cash flows in both the statement of financial position and profit or loss because it reflects the return that could have been achieved at reporting date and is the best available estimate of future cash flows. Consequently, EFRAG assesses that fair value through profit or loss measurement provides relevant information for those financial assets.

27 The measurement category at fair value through profit or loss includes both financial assets managed in respective business models and those that fail the contractual cash flows test because of not having solely payments of principal and interest. Some constituents have argued that this might obscure reported results of trading portfolios because of mixing them with gains and losses from other assets and thus impair the relevance of the fair value information provided. EFRAG understands these concerns, however notes that entities are not precluded from presenting or disclosing results from trading portfolios separately from other instruments in the fair value through profit or loss category if they consider such information relevant.

OPTION TO DESIGNATE A FINANCIAL ASSET AT FAIR VALUE THROUGH PROFIT OR LOSS

28 IFRS 9 contains an option to designate a financial asset as at fair value through profit or loss. EFRAG assesses that the option results in relevant information because the option is available to reduce accounting mismatches that result from measuring related assets or liabilities on different bases. One may argue that irrevocable designation at inception may bring some limitation to the relevance of the information. However EFRAG believes that this limitation is the price to pay for reliability and understandability in how the option is used.

29 The use of the option to eliminate an accounting mismatch results in more prudent information because it prevents a gain being recognised without the corresponding effect from the other components of the accounting mismatch because changes in all components are recognised in profit or loss.

RECLASSIFICATIONS

30 IFRS 9 requires financial assets to be reclassified between measurement categories when, and only when, the entity's business model for managing them changes. Reclassifications are expected to be very infrequent.

31 In many circumstances reclassifications in IFRS 9 will provide relevant information because they reflect information on the change in the business model of entities. However, EFRAG notes that certain restrictions on reclassifications in IFRS 9 may reduce the relevance of the information in certain circumstances. For example, if a market vanishes (for example when liquidity disappears) the entity may not have the

practical ability to operate in accordance with the desired business model, and may for example, decide to transfer portfolios of loans that were actively traded to its banking book. In specifying that such circumstances would not qualify as a change in business model, IFRS 9 prohibits reclassifications in such circumstances and therefore may result in information that reduces relevance if viewed from the perspective of usefulness for future cash flows assessment.

INVESTMENTS IN EQUITY INSTRUMENTS

32 The option to present changes in the fair value of equity instruments in other comprehensive income unless the equity instrument is held-for-trading ensures that entities do not have to recognise volatility in profit or loss. This provides relevant information for some investments, such as those held as a strategic holding or as part of a long term investment business model.

33 However, gains and losses on investments in equity instruments remeasured through other comprehensive income will never impact profit or loss even when the investment is sold (dividends impact profit or loss immediately). Also no impairment loss will ever be recognised in profit or loss, and EFRAG notes that this introduces a unique accounting treatment in IFRS. This may be considered as limiting the relevance of the information, especially if such gains or losses upon resale, or impairment losses, would be viewed as indicative of the primary performance of the investor and useful for assessing stewardship.

CLASSIFICATION OF FINANCIAL LIABILITIES: OWN CREDIT RISK

34 When an entity designates a financial liability to be measured at fair value through profit or loss in its entirety, IFRS 9 requires that the changes in the fair value due to changes in the credit risk of that liability (own credit risk) are presented in other comprehensive income. An exception to this requirement is if doing so would create or enlarge an accounting mismatch in profit or loss, in which case an entity presents all gains or losses on that liability (including the effects of changes in the credit risk of that liability) in profit or loss.

35 This requirement significantly improves the relevance of reported net profit or loss. The reason is that it avoids counterintuitive reporting of gains in profit or loss when the own credit standing of entity deteriorates and the reporting of losses when the credit standing improves.

36 The requirement that presentation in other comprehensive income does not apply if such presentation would create or enlarge accounting mismatch in profit or loss further contributes to the relevance.

37 The possibility to early apply the provisions for own credit risk separately from other parts of IFRS 9 will increase relevance of the financial information for those entities which use fair value option for financial liabilities.

38 The accumulated change in fair value due to the entity's own credit risk on financial liabilities for which fair value option has been taken is never reclassified to profit or loss. IFRS 9 argues that when an entity repays the contractual amount, the cumulative effect of changes in the liability's credit risk over its life will net to zero because the liability's fair value will ultimately equal the contractual amount due. EFRAG recognises that this may be often the case. However, in situations where the repayment is less than the contractual amount (for example, due to early repurchase), the lack of reclassification may diminish the relevance of the information especially if gains resulting from repurchase of liabilities are perceived as part of the performance of the entity. EFRAG understands these views but also notes that these

concerns would be mitigated to some extent because the amount of such gains or losses has to be disclosed.

Impairment

39 Following the criteria set out in paragraph 3 above, EFRAG has focused its assessment on requirements related to:

(a) General approach;

(b) 12-month and lifetime expected credit losses;

(c) Determining significant increases in credit risk;

(d) Simplified approach for trade receivables, contract assets and lease receivables;

(e) Measurement of expected credit losses; and

(f) Purchased or originated credit-impaired assets.

GENERAL APPROACH

40 The expected credit loss impairment model is based on a forward-looking approach that takes into account internal information, such as internal default rates and delinquencies, and external information, such as borrower-specific, market and macro-economic indicators, in estimating the credit loss allowance.

41 The size of the loss allowance is determined by the credit risk status of the financial instruments and in particular by information whether the financial instrument is subject to credit risk deterioration or not. It ensures that full economic losses, i.e. those which are not reflected in initial pricing of the instruments, are recognised on timely basis. This provides useful information to users of financial statements.

42 EFRAG assesses that the model using comprehensive credit risk and forward-looking information provides an appropriate basis for users to understand the extent of expected credit losses resulting from credit risk of financial instruments. Further, it is a prudent approach as it recognises potential credit losses early in the life of a financial asset. As a result, EFRAG considers the approach brings relevant information for assessing the likelihood of collection of future contractual cash flows.

12-MONTH AND LIFETIME EXPECTED CREDIT LOSSES

43 The expected credit losses model in IFRS 9 distinguishes between recognition of 12-month and lifetime expected credit losses.

44 12-month expected credit losses are recognised as a loss allowance at each reporting date as long as there is no significant deterioration in the credit risk since initial recognition of the instrument. The relevance of recognition of 12-month expected credit losses may be questioned as it is an arbitrary measure of credit losses which lacks a conceptual basis. It can be deemed to overstate losses at initial recognition as there is no economic loss if credit risk is reflected in the initial price of the instrument.

45 However, this lack of a conceptual rationale is outweighed by the following practical considerations:

(a) More conceptual approaches have been explored and abandoned as they were deemed not to be operational. In contrast, the 12-month expected credit loss is

designed to make the requirements in IFRS 9 operational. The inputs used for the calculation of 12-month probabilities of default are already tracked by many financial institutions for prudential regulatory requirements; and

(b) Even though the recognition of 12-month expected credit losses may overstate losses at initial recognition it addresses the criticism that accounting models do not provide for timely recognition of impairment losses. From this perspective, 12-month expected credit losses can be viewed as a compromise between the non-recognition of losses at the instrument's inception, which might be conceptually sound, and application of prudence to provide timely recognition of impairment losses.

46 Some have claimed that, in all cases, recognition of full lifetime expected credit losses at inception would provide more relevant information. EFRAG disagrees with this view, as such an approach would lead to recognising losses on creditworthy financial assets significantly in advance of:

(a) any economic losses; and

(b) compensation for credit risk that is expected to accrue throughout the life of the instrument.

47 In the cases of instruments which are known to have an early loss pattern and the early losses are expected to occur within the next 12 months, the effect would be captured by the 12-month expected credit losses being higher than for instruments without such loss pattern.

48 IFRS 9 requires recognition of full lifetime expected credit losses when the credit risk of the instrument increases significantly. The assessment is required to be made on the basis of all forward-looking information that is available, i.e. having full lifetime credit losses recognised in advance of any default. Users of financial statements will be able to clearly distinguish between financial assets for which credit risk has increased significantly since initial recognition and those for which credit risk has not, and have indicated that this is useful information to them. Significant increases in credit risk will affect profit or loss through the recognition of lifetime expected credit losses and disclosure will provide information about volume of exposures subject to significant credit deterioration.

49 Contractual terms of some instruments provide for repricing of interest rate to reflect increases in credit risk. Upon such repricing, if adequate to the increase in credit risk, no economic loss arises. However, IFRS 9 requires that the general principle is applied and lifetime expected losses are recognised in such cases. EFRAG assesses this treatment as relevant since it keeps the objective to recognise lifetime expected credit losses for any significant increases in credit risk and avoids operational difficulties connected with assessment on whether the increase in credit risk is adequate.

50 Consequently, EFRAG assesses that the model including the 12-month approach for all instruments for which credit risk is appropriately priced and requiring recognition of lifetime expected credit losses when credit risk is assessed as increasing significantly provides relevant and timely information on expected credit losses to users of the financial statements.

51 EFRAG also assesses that the impairment model respects the G20's declaration calling on accounting standard setters 'to strengthen accounting recognition of loan-loss provisions by incorporating a broader range of credit information' since it

(a) considers all relevant credit information, including macroeconomic factors, and

(b) the forward-looking approach provides for a timely recognition of credit losses as result of:

(i) 12-month expected credit losses assigned to all credit exposures; and

(ii) early recognition of economic losses upon significant credit deterioration when full lifetime expected losses have to be recognised. This also ensures that the losses will react to deteriorating economic conditions in a timely manner.

52 The requirement to recognise expected credit losses embodies a notion of prudence to its full extent, as it anticipates the recognition of impairment compared to an incurred loss model. As mentioned in paragraph 45(b), the recognition of 12 month expected credit losses can be viewed as compromise between the non-recognition of losses at the instrument's inception, which might be conceptually sound, and application of prudence to provide timely recognition of impairment losses.

DETERMINING SIGNIFICANT INCREASES IN CREDIT RISK

53 The assessment of the change in credit risk since inception avoids absolute thresholds that could lead to a misstatement of credit losses depending on whether such a threshold is too low or too high in relation to a specific instrument. This factor contributes to the relevance of the information.

54 EFRAG notes that a relative assessment on credit risk deterioration may lead to different loss allowances on financial assets with the same counterparty depending on the timing when such financial assets were contracted. However, EFRAG considers that an economic assessment on initial credit loss expectations and subsequent changes in expectations provide more relevant information than an absolute assessment based on the counterparty's credit risk level because credit risk at inception is assumed to be included in the pricing of the instrument and it is therefore the effect of the change that will result in economic losses.

55 IFRS 9 permits 12-month expected credit losses to be recognised irrespective of the change in credit risk from initial recognition provided that the financial asset's credit risk is assessed as low at the reporting date. For this purpose, entities may use internal systems that are consistent with globally understood definitions of low credit risk. An external rating of 'investment grade' may be an example of a financial instrument considered as having low credit risk.

56 Based on publically available long-term global default rates for investment grade companies, EFRAG assesses that the effect of the 'low credit risk' simplification on the timing of recognition of lifetime expected credit losses, and the amount of expected credit losses should not be significant. This confirms the IASB's observation. Therefore, the practical expedient does not impair the relevance of the information provided.

57 Concerns have been raised in respect of how the distinction between a 12-month expected losses and full lifetime expected losses addresses loans which have historical loss patterns indicating the likelihood of losses occurring in early years however not within the 12-month period.

58 Early loss pattern relates to higher than average default rates in a specific period for a particular portfolio. The impairment model is able to capture the proportion of the early loss pattern which relates to those higher default rates which occur within the

next 12-months-time span as already indicated in paragraph 47. Only those cases where an early loss pattern is initiated beyond the 12-month horizon the model would not be able to capture. This might be viewed as impairing relevance of the model for loans with such loss patterns. However, this needs to be balanced by the fact that recognition of lifetime expected losses is not frontloaded by the model. EFRAG agrees with such approach for the reasons explained in paragraph 46.

SIMPLIFIED APPROACH FOR TRADE RECEIVABLES, CONTRACT ASSETS AND LEASE RECEIVABLES

59 The simplified approach consists in recognising the loss allowance for full lifetime expected credit losses on those trade receivables and contract assets without a significant financing component. This is because most of such assets have a maturity that is less than one year, so the lifetime expected credit losses and the 12-month expected credit losses would generally be equal. Therefore, a credit deterioration event would not have an effect on the loss allowance. As a result, the simplified approach provides users with relevant information.

60 The simplified approach is extended, as an accounting policy choice, to trade receivables and contract assets with a significant financing component and lease receivables. EFRAG notes that using the lifetime expected credit loss approach for these assets may impair relevance of the information due to a loss of benefits of the general model distinguishing between 12-month and lifetime expected credit losses, given that trade receivable and contract assets with a significant financing component and lease receivables would generally mature after more than 12 months. The accounting policy choice was introduced in order to provide operational relief to preparers in specific business areas. EFRAG assesses that the benefits of this simplification outweigh the limited relevance.

MEASUREMENT OF EXPECTED CREDIT LOSSES

61 IFRS 9 defines expected credit losses as the expected present value of all cash shortfalls over the remaining life of the financial instrument. The term 'expected value' implies that the measurement is based on a probability weighted outcome determined by evaluating a range of possible loss scenarios and using probabilities of default as weights. EFRAG assesses that the expected value approach provides an appropriate basis to inform users about the current likely effect of credit risk.

62 The calculations of expected credit losses are focused on the contractual period over which the entity is exposed to credit risk which aligns the model with the definitions of assets, liabilities and expenses in the Conceptual Framework. The exception from using contractual periods is applicable to revolving credit facilities such as credit cards and overdrafts. EFRAG notes that, in these particular cases, the consideration of the time beyond the contractual period provides relevant information. The requirement aligns accounting with risk management practices and properly captures the actual extent of expected credit losses. For such facilities, the contractual cancellation period is usually very short and is not actively enforced as a part of the lenders' day-to-day credit risk management process. They generally continue to extend the credit and cancel the facilities only when an observable negative credit event occurs. As a result, the expected credit losses are estimated over the expected exposure to credit risk. EFRAG assesses that such an approach is fully consistent with a forward-looking expected credit loss model and therefore will bring relevant information.

PURCHASED OR ORIGINATED CREDIT-IMPAIRED ASSETS

63 In the case of financial assets which are purchased or originated at a deep discount that reflects the expected credit loss (credit-impaired at initial recognition), initial lifetime expected credit losses are included in the estimated cash flows at inception

when calculating the credit-adjusted effective interest rate of the asset. As a result, initial expected credit losses decrease the interest income over the life of the asset and there is no loss allowance at initial recognition. Subsequent changes in cash flow estimates result in impairment gains or losses.

64 EFRAG considers that this approach properly captures the specifics of financial assets which are credit-impaired at initial recognition. Recognition of interest income reflects the initial expectation of credit losses with the fair value reflecting the deep discount. If, due to changes in cash flows estimates, the economic value changes the asset holder incurs economic gains or losses which are accounted for as impairment allowances. Such measurement provides relevant information about the amount, timing and uncertainties of future cash flows from purchased or originated credit impaired assets.

<u>Hedging</u>

65 Following the criteria set out in paragraph 3 above, EFRAG has focused its assessment on requirements related to:

(a) Objective of hedge accounting;

(b) Qualifying hedging instruments;

(c) Qualifying hedged items;

(d) Hedge effectiveness requirements;

(e) Accounting for the time value of options; and

(f) Designation of a component of a nominal amount.

OBJECTIVE OF HEDGE ACCOUNTING

66 IFRS 9 describes the objective of hedge accounting as to represent, in the financial statements, the effect of an entity's risk management activities that use financial instruments to manage exposures arising from particular risks that could affect profit or loss or in particular cases other comprehensive income.

67 EFRAG assesses that this objective provides relevant and prudent information in that both the hedged item and the hedging instrument are measured on the same basis in respect to profit or loss, thus ensuring that gains and losses are recognised in the same period rather than permitting the early recognition of gains.

68 However, under IFRS 9, hedge accounting is not mandatory. Entities can choose not to apply hedge accounting even when applying economic hedging for different reasons. EFRAG assesses that such a voluntary decision to apply hedge accounting is useful as risk management may include a large variety of strategies and actions that do not involve the use of financial instruments, for example, when insuring risks or in the case of supply management. In such cases, the information provided by the general accounting is sufficiently relevant without the need to supplement it with information added by specific hedge accounting requirements.

69 However, there may be cases – other than where the accounting mismatch is immaterial or when the entity elects to use the fair value option – where economic hedges are applied and hedge accounting could be used. In these cases, entities that elect not to apply the hedge accounting provisions of IFRS 9 are not providing all the relevant information that could be made available, i.e. they would not reflect their economic hedging in the financial statements.

70 Once initiated however, a hedging relationship cannot be discontinued unless the risk management objective for that relationship changes. Instead, the hedging relationship can be rebalanced to continue to meet the qualifying criteria. IFRS 9 distinguishes between an entity's risk management strategy and the risk management objective for a particular hedging relationship. The risk management strategy is established at the highest level at which an entity determines how it manages its risk. A risk management strategy is typically in place for a longer period, whereas a risk management objective applies at the level of a particular hedging relationship. It relates to how the particular hedging instrument that has been designated is used to hedge the particular exposure that has been designated as the hedged item.

71 EFRAG assesses that the inability to discontinue a hedging relationship unless the risk management objective for that relationship has changed provides useful information. This is because by initiating hedge accounting the entity has decided that doing so would recognise the offsetting effects in profit or loss from using hedging instruments for mitigating risks. The relevant nature of the resulting information does not disappear when market circumstances change. Only when the risk management objective for the hedging relationship changes, a re-assessment on the resulting information and thus a discontinuation of the hedge relationship is required.

72 In addition, IFRS 9 does not limit hedge accounting to risks that affect profit or loss, but also risks that affect other comprehensive income, in the case of investments in equity instruments for which an entity has elected to present changes in fair value in other comprehensive income. EFRAG assesses that this results in relevant information as it aligns hedge accounting with the accounting for investments in equity instruments for which an entity has elected to present changes in fair value in other comprehensive income.

QUALIFYING HEDGING INSTRUMENTS

73 IFRS 9 requires that qualifying hedging instruments must be generally designated in their entirety. Hence derivatives embedded in financial assets are not eligible as hedging instruments on a stand-alone basis. Except for some embedded derivatives in own use contracts, participants in the 2012 field-test on general hedge accounting did not indicate that designation of a separated embedded derivative as a hedging instrument was a common practice. In addition, the results from the 2013 field-test on classification and measurement showed that bifurcation for measurement purposes was rarely used. Instead the fair value option was used because it was operationally easier and cheaper to apply.

74 EFRAG notes that a few constituents raised concerns that relevance would be impaired if embedded derivatives could not be used as hedging instruments as regards:

(a) asymmetry in using embedded derivatives as hedging instruments resulting from applying bifurcation only for financial liabilities and non-financial items and not for financial assets; and

(b) entities which have been applying bifurcation of financial assets under IAS 39 and relied on the bifurcated embedded derivatives as hedging instruments would no longer be able to do so.

75 EFRAG notes that financial assets with embedded derivatives, due to their contractual cash flow characteristics, are likely to be measured at fair value through profit or loss. IFRS 9 allows the designation of such financial instruments as hedging instruments. This in effect would lead to similar outcome as if the financial asset was

subject to bifurcation and the embedded derivative designated separately as a hedging instrument. However, EFRAG also notes that the need to designate the hedging instruments in its entirety may limit the situations in which the hedge effectiveness requirements for such hedges would be met.

QUALIFYING HEDGED ITEMS

NON-FINANCIAL RISK COMPONENTS

76 EFRAG notes that IFRS 9 allows entities to designate financial and non-financial risk components as eligible hedged items as well as aggregated exposures. EFRAG assesses that in particular the eligibility of non-financial risk components (for example commodity price risk and some risk components of insurance liabilities) will improve the relevance of hedge accounting relationships of entities. This because it may permit corporates to reflect risk management of their business by relying on risk components which are directly related to their business.

SUB-LIBOR ISSUE

77 EFRAG observes that financial institutions often include core demand deposits with a low or zero interest in their hedging strategies. The interest rate risk being hedged are not the low or zero interest cash flows but rather the benchmark interest rate on the market (e.g. LIBOR), hence the nomenclature "sub-LIBOR issue". A sub-LIBOR-related issue is also found in certain cash flow hedging strategies of some utility entities where the designated hedged item can be higher than the actual cash flow risk exposure due to dynamic changes subsequent to the designation of the actual cash flow exposures being hedged.

78 EFRAG additionally observes that such hedging strategies are not aimed at hedging the interest rate risk of core demand deposits in isolation, but rather a net position of assets and liabilities in portfolios whereby hedged items can be added and/or removed continuously (i.e. open portfolios of hedged items).

79 EFRAG acknowledges that such hedging strategies pose challenges for hedge accounting other than those which are addressed by IFRS 9. Nevertheless, this omission is not in alignment with the objective of the Standard.

80 Also EFRAG notes that the argumentation for prohibition of designating as the hedged item a component of a cash flow that is higher than the total cash flows of the entire item, was based on an assumption that interest rates have a natural floor of zero. In the light of current market circumstances such analysis may not be correct in all circumstances.

81 Hence, EFRAG assesses that the absence of a solution for the sub-LIBOR issue may impair the relevance of the information for hedging strategies relying on sub-LIBOR hedging.

CREDIT RISK

82 IFRS 9 considers that credit risk is not a separately identifiable risk component and hence does not qualify for designation as a hedged item on risk component basis. However, EFRAG notes that economic hedges of credit risk using credit derivatives are used by some entities. It could therefore be argued that a standard on hedge accounting ought to address these practices.

83 EFRAG notes that the pricing of credit risk in credit derivative markets and debt instrument markets are not always strongly correlated because of:

(a) possible uncertainties about what measures may be considered as a credit event triggering a pay-out on the credit derivatives;

(b) cheapest-to-deliver options (i.e. at the moment a credit event occurs, the credit risk protection buyer can choose to deliver the cheapest financial instrument issued by the entity) affects the price of credit derivatives; or

(c) liquidity and speculative factors in the credit derivative markets generally leading to a higher volatility in credit spreads in credit derivative markets than in the debt instruments.

84 EFRAG generally assesses that the degree of the lack of correlation goes beyond what can be considered as an economic relationship between the hedged item and the hedging instruments. This holds for credit risk positions for which no credit event has occurred when all of the factors (a) to (c) mentioned above play a role.

85 In case a credit event has occurred, EFRAG assesses that effective protection against impairment would be provided in case of bankruptcy when the factors (a) to (c) tend to have minor effect. However, for other credit events, such as restructuring, there are factors other than credit risk which influence the value of the asset and the effective hedge may fail.

86 Consequently EFRAG assesses that a hedge accounting solution which does not take into account credit risk provides relevant information in some cases. On the other hand, in cases when the credit risk is economically effectively hedged by credit derivatives the absence of hedge accounting would result in a lack of relevance. However, EFRAG also notes that these concerns may be alleviated by IFRS 9 providing a special type of fair value option applicable for financial instruments whose credit risk is managed by credit derivatives.

HEDGE EFFECTIVENESS REQUIREMENTS

87 EFRAG notes that the hedge accounting model is based on a general notion of offset between gains and losses on the hedging instrument and the hedged item. EFRAG assesses that hedge effectiveness requirements put reasonable boundaries on effective economic relationships and provide relevant information because:

(a) There must be an economic relationship between the hedging instrument and the hedged item means that their values generally move in the opposite direction with respect to the same risk, which is the hedged risk;

(b) Even when there is an economic relationship between the hedging instrument and the hedged item the effect of credit risk may result in the offset becoming erratic: as a result, IFRS 9 requires that that effect is not dominant; and

(c) The hedge ratio must be the same as that resulting from the quantities of the hedging instruments and hedged that the entity actually uses in their economic hedges. This requirement limits the space for designating hedge relationships in an improper way to achieve particular accounting outcome (such as cash flow hedges designated in an 'underhedge' position leading to recognition of ineffectiveness in cash flow hedge reserve rather than in profit or loss).

88 IFRS 9 allows the application of 'proxy hedging' which means that hedging instruments need not be directly designated in respect of items to which they economically relate. Such economically hedged items do not meet criteria for qualifying hedged items, e.g. they are net positions in interest rate risk or they are core deposits. Instead, a hedged item meeting the qualifying criteria is designated,

e.g. variable-rate financial assets serving as a proxy for hedges of core deposits. Such designations are permitted as long as they reflect the risk management objective in relation to the hedging instrument. EFRAG assesses that proxy hedges are an important element which enables to reflect actual risk management practices in hedge accounting and thus result in a relevant information.

89 Consequently, EFRAG assesses that the hedge effectiveness requirements result in information on risk amounts that are being hedged and put reasonable boundaries on effective economic relationships to qualify for hedge accounting.

HEDGING STRATEGIES NOT MEETING THE QUALIFYING CRITERIA FOR HEDGE ACCOUNTING

90 Not all hedging strategies meet the qualifying criteria for hedge accounting. In addition some risk management hedging strategies do not fit the accounting techniques of a fair value or a cash flow hedge (e.g. hedges of basis risk of variable rate instruments).

91 EFRAG notes that the disclosures require a description of how dynamic risk management strategies are reflected by using the static hedge accounting techniques permitted by IFRS 9. Further, the disclosures prescribe a tabular format that separates information by type of hedge risk, the risk category and risk management strategy.

REBALANCING

92 If a hedging relationship ceases to meet the hedge effectiveness requirement relating to the hedge ratio but the risk management objective for that hedge relationship remains unchanged, an entity shall adjust the hedge ratio (i.e. rebalance) so that it meets the qualifying criteria again.

93 As argued in paragraph 71 above, EFRAG assesses that by initiating hedge accounting an entity is aware that doing so would require recognising the offsetting effects in profit or loss from using hedging instruments for mitigating risks. The relevant nature of the resulting information does not disappear when market circumstances change. Consequently, it is logical to rebalance the hedge relationship in such circumstances and the resulting information has the same relevant quality as the information before rebalancing the hedge relationship.

ACCOUNTING FOR THE TIME VALUE OF OPTIONS

94 When an entity separates the intrinsic value and time value of an option contract and designates as the hedging instrument only the change in intrinsic value of the option, the change in fair value of the time value is recognised in other comprehensive income. This treatment is considered to provide relevant information as the intrinsic value of the option gives rise to offsetting changes in relation to the hedged risk. The time value of the option, paid at inception as an option premium and economically considered as a cost of hedging, is outside the hedging relationship and its fair value volatility does not affect profit or loss.

DESIGNATION OF A COMPONENT OF A NOMINAL AMOUNT

95 A layer component that includes a prepayment option is not eligible to be designated as a hedged item in a fair value hedge if the prepayment option's fair value is affected by changes in the hedged risk, unless the designated layer includes the effect of the related prepayment option when determining the change in the fair value of the hedged item.

96 EFRAG notes that in their risk management, entities assume that prepayments are not part of the layer being hedged, for example when hedging a bottom layer. Not

allowing this possibility when hedging a (bottom) layer impairs the relevance of the resulting information as it is not in line with risk management practice.

Overall conclusion on relevance

97 EFRAG's overall initial assessment is that, on balance, IFRS 9 would result in the provision of relevant information and therefore it satisfies the relevance criterion.

Reliability

98 EFRAG also considered the reliability of the information that will be provided by applying IFRS 9. Information has the quality of reliability when it is free from material error and bias and can be depended upon by users to represent faithfully what it either purports to represent or could reasonably be expected to represent, and is complete within the bounds of materiality and cost.

99 There are a number of aspects to the notion of reliability: freedom from material error and bias, faithful representation, and completeness.

Classification and Measurement

100 Following the criteria set out in paragraph 3 above, EFRAG has focused its assessment on the requirements related to:

(a) The business model and the contractual cash flow characteristics assessment; and

(b) Investments in unquoted equity instruments.

THE BUSINESS MODEL AND THE CONTRACTUAL CASH FLOW CHARACTERISTICS ASSESSMENT

101 Assessment on the business model within which basic lending instruments are managed should consider all relevant available evidence (e.g. objective information, such as business plans, how managers of the business are compensated and the amount and frequency of sales activity). IFRS 9 also provides application guidance and examples related to the activities that are commonly associated with each of the three business models. In addition, the business model is assessed at a level that reflects the way groups of basic lending instruments are managed together to achieve a particular business objective and is observable through the particular activities that the entity undertakes to achieve the particular business objective. As such, a business model is a matter of fact rather than an assertion, which helps produce information which is verifiable.

102 The assessment of the contractual cash flow characteristics will often be unambiguous. However, in some cases, deciding whether the cash flow characteristics criterion is met will require assessment of contractual provisions that do or may change the timing and/or amount of the contractual cash flows. Thus the implementation of the cash flow characteristics criterion requires judgement to ensure that financial assets are classified into the appropriate category. IFRS 9 includes substantial guidance on specific contractual features and terms, which indicate in which cases the cash flow characteristics test is expected to be met and thus are expected to result in reliable classification.

103 EFRAG notes that having the hold to collect and the hold to collect and sell as two separate business models might increase complexity for preparers. This because preparers will have to classify similar solely payment of principal and interest compliant financial assets between the amortised cost category and the fair value through other comprehensive income category, requiring judgement to evaluate the distinguishing factors for each portfolio.

INVESTMENTS IN UNQUOTED EQUITY INSTRUMENTS

104 IFRS 9 requires all investments in equity instruments, and derivatives over them, to be measured at fair value. This includes investments in, derivatives over, unquoted equity instruments that cannot be measured reliably. When acquiring equity investments EFRAG expects entities mostly to have reliable data to measure those instruments at fair value as otherwise they would refrain from acquiring them at the fair value used in the transaction. In cases where such data are based upon unobservable inputs disclosures are able to provide the essential information to users. Consequently, EFRAG assesses that the cases where it would not be possible to measure reliably non-quoted equity instruments seems to be rare.

105 In those rare cases, measuring unquoted equity investments at fair value may result in gains being recognised beyond what the exercise of caution in conditions of uncertainty would command. However, the use of cost may delay the recognition of losses, as evidence of decrease in value for unquoted equity investments could be untimely or unclear. Moreover, if these were carried at cost, the holder would still need to determine a recoverable amount; for an equity investment, this would imply the use of a valuation methodology that is not very different from a fair value assessment.

Impairment

106 Following the criteria set out in paragraph 3 above, EFRAG has focused its assessment on requirements related to:

(a) Assessment on significant increase in credit risk and calculation of expected credit losses; and

(b) Practical expedients.

ASSESSMENT ON SIGNIFICANT INCREASE IN CREDIT RISK AND CALCULATION OF EXPECTED CREDIT LOSSES

107 An assessment of the significant increase in credit risk takes into consideration only the changes in the risk of a default occurring rather than changes in the amount of expected credit losses. This aligns the assessment of changes in credit risk with the way probabilities of default are generally tracked in practice and provides reliable information about the practices of the holder of the financial asset. EFRAG also notes that further alignment with credit risk management practices is achieved because risk management generally focuses on those instruments with credit deterioration in assessing appropriate actions to be taken to mitigate credit risk.

108 Entities will need to exercise judgement when assessing the existence of a significant increase in credit risk to determine whether 12-month or lifetime expected credit losses are recognised. Entities will also need to decide the most appropriate techniques for measuring expected credit losses in accordance with the measurement principles using information about past events, current conditions and forecasts of future conditions. The judgements and estimates will be based on multiple sources of information combining internal and external data including forward-looking and macroeconomic information which is available on a reasonable and supportable basis. An exhaustive search for the information is not required if it entails undue cost or effort. The subjective nature of these factors brings tension on the reliability of the information being provided.

109 The level of judgement required by IFRS 9 for recognition of expected credit losses is substantial as the financial information is being prepared taking into account high levels of uncertainty. To balance the use of judgement, disclosures require extensive

information related to the inputs, assumptions and estimation techniques used. This contributes to the reliability of the information.

110 Some believe that the limitation put to the search for information on the basis of undue cost or effort would trigger a lack of reliability. EFRAG does not share this view as IFRS 9 requires that all information that is available on a reasonable and supportable basis should be used. Going beyond what is available to the entity would not increase reliability as it could lead to spurious estimates and would raise the question whether the impairment model would be operational. Entities are required to use their best efforts to calculate the expected credit losses but the extent to which the information is available to individual entities differs and IFRS 9 acknowledges this.

111 The forward-looking approach in IFRS 9 using unbiased information about past events, current conditions and forecast economic conditions supported by disclosure requirements is designed to faithfully represent the current financial position rather than smoothing performance over the expected economic cycle. This enhances the reliability of the information.

PRACTICAL EXPEDIENTS

112 IFRS 9 provides for practical expedients when assessing significant increases in credit risk. The assessment can be based on 12-month rather than lifetime probabilities of default, entities can compare current credit risk with threshold for credit risk at origination or can perform the assessment at counterparty rather than at individual instrument level. These practical expedients are in line with current credit risk management approaches.

113 When calculating expected credit losses entities can use practical expedients such as a provision matrix. This is to address practical approaches which use loss rates mainly based on delinquency status usually applied to trade receivables but they can also be found in the area of retail exposures.

114 All of the practical expedients can be applied only if doing so is consistent with the underlying principles. IFRS 9 brings additional safeguards which illustrate and should ensure their proper application. Therefore, EFRAG considers that practical expedients do not impair the reliability of the information.

Hedging

115 Following the criteria set out in paragraph 3 above, EFRAG has focused its assessment on the requirements related to qualifying hedged items.

QUALIFYING HEDGED ITEMS

116 IFRS 9 expands the notion of 'costs of hedging' so as to include foreign currency basis spreads, the reason for this being that foreign currency basis spreads are considered as a charge to exchange one currency into another in a forward market. Foreign currency basis spreads are an economic phenomenon that exists because of a number of factors such as the credit risk embedded in the underlying reference rates of the currencies or the demand and supply for a particular financial product.

117 The fair value of a cross-currency interest rate swap will include a pricing element that reflects the exchange of two currencies (i.e. the foreign currency basis spread). In contrast, the hedged item does not include such a pricing element as it is expressed in a single currency and would thus not offset the basis spread. This is not due to ineffectiveness but rather to the fact that the foreign currency basis spread is not a characteristic of the hedged item, but rather a consequence of the possible exchange of the hedged item's currency for another currency. Consequently, EFRAG

assesses that considering foreign currency basis spreads as costs of hedging instead as ineffectiveness provides reliable information.

Overall conclusion on reliability

118 EFRAG's overall initial assessment is that based on the above analysis, on balance, IFRS 9 would raise no concerns about risk of error or bias and therefore it satisfies the reliability criterion.

Comparability

119 The notion of comparability requires that like items and events are accounted for in a consistent way through time and by different entities, and that unlike items and events should be accounted for differently.

120 EFRAG has considered whether IFRS 9 results in transactions that are:

(a) economically similar being accounted for differently; or

(b) transactions that are economically different being accounted for as if they are similar.

Classification and Measurement

121 Following the criteria set out in paragraph 3 above, EFRAG has focused its assessment on the requirements related to:

(a) Classification and measurement of financial assets; and

(b) Measurement options;

CLASSIFICATION AND MEASUREMENT OF FINANCIAL ASSETS

122 IFRS 9 provides a logical structure and a clear rationale for the classification and measurement of financial assets by providing a space for only a few accounting choices. Under IFRS 9, subject to some restrictions resulting from the solely payment of principal and interest test, similar debt instrument financial assets which are managed in the same way are classified in the same way for accounting purposes. Consequently, differences in financial reporting between reporting periods for an individual entity, and between different entities in a particular reporting period, will reflect the differences in the underlying economics.

123 IFRS 9 provides application guidance, including examples, about the activities that are commonly associated with the three business models, which will enhance the consistency in how the business model criterion is applied and hence enhance the comparability of the information provided.

124 IFRS 9 makes reclassifications between measurement categories mandatory when, and only when, there has been a change in the entity's business model. Those reclassification requirements will enhance comparability because an entity will generally account for its financial instruments consistently over time and only reclassify when the entity's business model changes.

125 IFRS 9 requires hybrid contracts with financial asset hosts to be classified in their entirety. This ensures the same classification approach for hybrid contracts, which will result in consistency and comparability for similar financial assets that are managed in a similar way and contain similar cash flow characteristics. However, if cash flows similar to hybrid contracts are replicated through two separate contracts

each contract will be classified separately which may result in a different financial reporting treatment.

126 Although IFRS 9 states that the business model is a matter of fact, it also acknowledges that judgement is needed to assess the business model for managing particular financial assets. For example, IFRS 9 does not include 'bright lines' for assessing the impact of sales of financial assets. Instead, it requires that entities consider the reasons, timing, significance and frequency of sales activity and whether the sales activity and the collection of the contractual cash flows are each integral or incidental to the business model. Because judgement is needed to assess the reasons, frequency, timing and significance of sales activity, economically similar portfolios might result in different classification and measurement categories (e.g. portfolios of instruments that are held for liquidity management), thus impairing the comparability of the information in respect of how the financial assets are managed.

MEASUREMENT OPTIONS

127 The option in IFRS 9 for changes in the fair value of equity instruments (that are not held for trading or contingent consideration) to be presented in other comprehensive income reduces comparability because the same instruments which are managed in the same way by different entities will not be accounted for in the same way. A similar reasoning is valid for financial instruments designated at fair value through profit or loss. However, EFRAG assesses that there are valid reasons for existence of these options because they enable entities to avoid excessive volatility in profit or loss in cases when they do not consider it to be economically substantiated or they can show the effects of their risk management practices.

MODIFICATIONS OF FINANCIAL ASSETS

128 IFRS 9 does not change existing derecognition requirements for financial assets. As a result there remains in IFRS 9 is a lack of clarity on whether a modification in contractual cash flows would result in derecognition of the financial asset. Entities could apply different interpretations with different accounting impacts for gains and losses upon modification and subsequent measurement.

129 For example, entities may conclude that modification due to business reasons lead to substantial changes in the terms of the contract and, as a result, to derecognition of the original asset based on an assertion that the new terms reflect current market conditions. This would avoid recognition of modification losses. Other entities may not be able to derecognise the modified assets based on an argument that the contract still exists and was only subject to decrease in interest rate. This would lead to recognition of modification losses. Different accounting outcomes depending whether the asset is derecognised or not may also occur in the area of modifications due to financial difficulties of debtors.

130 EFRAG assesses that judgement will be required in particular cases to decide whether derecognition will be required or not. Also, additional disclosures according to IAS 1 *Presentation of Financial Statements* would be required reducing the lack of comparable information to users.

Impairment

131 Following the criteria set out in paragraph 3 above, EFRAG has focused its assessment on requirements related to:

(a) General approach;

(b) Recognition of expected credit losses;

(c) More than 30 days past due rebuttable presumption;

(d) Financial instruments that have low credit risk at reporting date;

(e) Definition of default; and

(f) Transition.

GENERAL APPROACH

132 The approach brings a uniform calculation basis for impairment applicable to all financial instruments in its scope. EFRAG assesses this leads to comparable information.

RECOGNITION OF EXPECTED CREDIT LOSSES

133 The expected credit loss model is based on principles and, except for a few practical expedients, avoids bright lines and thresholds. Application of the principles will inevitably lead to subjective judgements, assessments and estimates. Subjectivity is also introduced by the requirement to use reasonable and supportable information available without undue cost or effort. Varying levels of sophistication in the models that entities have developed to support these assessments and estimates could be considered as obstacles to comparability. Disclosures that accompany those estimates are however expected to provide users with sufficient insight in the bases for the judgements and estimates used and would therefore support overall an appropriate level of comparability.

134 Practical expedients in the assessment on significant increases in credit risk and measurement of expected credit losses are discussed in paragraph 112 of the section for reliability. EFRAG assesses that they should not hinder comparability as they have to be applied consistently with the general recognition principles.

135 Further, EFRAG notes that the issue of consistent application is likely to be most prominent upon initial application as entities are developing their understanding of the assessments that they are required to make. To support initial application, IASB has set up an Impairment Transition Resource Group to help preparers interpret and apply IFRS 9 consistently.

MORE THAN 30 DAYS PAST DUE REBUTTABLE PRESUMPTION

136 The more than 30 days past due threshold serves as a backstop to determine significant increase in credit risk. IFRS 9 states that it is not an absolute indicator and an entity can rebut the presumption. As a consequence, IFRS 9 will not lead to spurious uniformity that will hinder comparability. IFRS 9 also requires disclosures on whether and how the presumption has been rebutted which EFRAG considers as leading to information that can be deemed comparable.

FINANCIAL INSTRUMENTS THAT HAVE LOW CREDIT RISK AT REPORTING DATE

137 An entity may assume that the credit risk on a financial instrument has not increased significantly since initial recognition if the financial instrument is determined to have low credit risk at the reporting date. That is, an entity has an instrument-by-instrument choice whether to apply the low credit risk simplification or not. Furthermore, an entity may assess low credit risk using internal ratings based on globally understood definitions of low credit risk. This would decrease comparability between entities due to the instrument-by-instrument choice and the different internal rating grades.

138 On the other hand, this addresses some of the concerns raised by participants in the 2013 ED *Financial instruments: Expected Credit Losses* field-test relating to the

interpretation of the threshold as a bright line and the difficulty of mapping internal ratings to external ratings. Furthermore, disclosures are required with respect to if and how financial instruments are considered to have low credit risk including respective classes of financial instruments. As a result, EFRAG considers that the operational benefits provide an adequate offset to the lack of comparability in applying the practical expedient of low credit risk.

DEFINITION OF DEFAULT

139 IFRS 9 does not provide a definition of default. However, it includes a rebuttable presumption that default does not occur later than 90 days past due unless an entity has reasonable and supportable information to use a more lagging default criterion. As a consequence, some entities may rebut the 90 days past due presumption and some may not; this will be based on different economic contexts and the ability to reflect those different economic contexts is expected to lead to comparable information. Also, disclosure requirements relating to an entity's definitions of default, including the reasons for selecting those definitions are required. EFRAG assesses that enhancing the relevance of financial information in bringing operational benefits for entities and insights into the entity's risk management will not negatively affect comparability.

TRANSITION

140 At the date of initial application, an entity shall use reasonable and supportable information to determine whether there has been a significant increase in credit risk since initial recognition. However, if such a determination would require undue cost or effort, lifetime expected credit loss is recognised for each exposure unless the credit risk is low in which case 12-month expected credit loss is recognised. As a result, comparability of the information may be reduced.

141 Entities that can determine the credit risk of instruments at initial recognition will apply the relative assessment. It means that they will track the changes in the credit risk in compliance with the standard impairment model. On the other hand, entities that cannot assess the significant increase in credit risk for particular instruments upon transition will use an absolute assessment as allowed in the transition provisions and will determine whether the current level of the credit risk is low or not and recognise 12-month or lifetime expected credit losses accordingly. Such assessment will be applicable until derecognition of the instruments.

142 The loss of comparability upon transition may be significant as potentially a large proportion of financial instruments may end up with an absolute rather than relative assessment. Such a situation will persist until derecognition of those instruments. However, the balancing effect is the provision of operationality of the model upon transition which EFRAG assesses to provide an adequate compensation.

<u>Hedging</u>

143 Following the criteria set out in paragraph 3 above, EFRAG has focused its assessment on the requirements related to:

(a) Objective and scope of hedge accounting;

(b) Macro hedging and application of IAS 39; and

(c) Accounting for time value of options.

OBJECTIVE AND SCOPE OF HEDGE ACCOUNTING

144 Hedge accounting is not mandatory. Hence when entities are able to choose whether to use hedge accounting or not, EFRAG assesses that this impairs the comparability of financial statements. In addition in certain cases, depending on the risk position entities can choose to apply a fair value hedge or a cash flow hedge. EFRAG assesses that the possibility to use one hedge accounting mechanism or another impairs the comparability of the financial statements.

MACRO HEDGING AND APPLICATION OF IAS 39

145 IFRS 9 describes the objective of hedge accounting as to represent, in the financial statements, the effect of an entity's risk management activities that use financial instruments to manage exposures arising from particular risks that could affect profit or loss or in particular cases other comprehensive income. IAS 39 hedge accounting does not require reflecting the effect of an entity's risk management activities.

146 IFRS 9 permits an entity to apply some or all of the hedge accounting requirements in IAS 39 instead of those in IFRS 9 for the portfolio fair value hedge of interest rate risk. This choice may be considered to impair comparability between entities. However, the accounting policy choice between IFRS 9 and IAS 39 is a response to the lack of an appropriate solution for macro hedge accounting. EFRAG assesses that the benefit for preparers to choose the requirements of IAS 39 for this type of hedge relationship and continue existing practices outweighs the disadvantage of a lack of comparability.

ACCOUNTING FOR TIME VALUE OF OPTIONS

147 IFRS 9 requires separating the intrinsic value and the time value of an option contract and to designate only the change in the intrinsic value as the hedging instrument. IFRS 9 further prescribes two methods to account for the time value of an option contract depending on whether the hedged item is a transaction related item or a time-period related hedged item.

148 Accounting the same way for transaction related and time-period related hedged items would be accounting alike for unlike items. So a different accounting provides comparable information.

Transition

149 IFRS 9 can be applied early before its effective date 1 January 2018. As a result, users may not obtain comparable information if some entities decide to adopt the IFRS 9 before it becomes effective. However, considering the challenges in implementing the new requirements, EFRAG generally does not expect early application by entities with extensive use of financial instruments in their business. Therefore, EFRAG assesses that the loss of comparability resulting from the early adoption possibility should be negligible.

150 IFRS 9 permits, but does not require the restatement of prior periods upon transition, if the necessary information is available without the use of hindsight. Not restating comparative periods will result in information which, at the entity level, is not comparable between the periods at the time of transition. With regards to the prior period, information will not be comparable between those entities that decide to restate the prior period and those that do not. However, the possibility not to restate prior periods provides significant operational relief in transition to IFRS 9 and EFRAG considers that the loss of comparability is substantiated in terms of the relief.

Overall conclusion on comparability

151 EFRAG's overall initial assessment is that, based on the above, IFRS 9 as a whole satisfies the comparability criterion.

Understandability

152 The notion of understandability requires that the financial information provided should be readily understandable by users with a reasonable knowledge of business and economic activity and accounting and the willingness to study the information with reasonable diligence.

153 Although there are a number of aspects to the notion of 'understandability', EFRAG believes that most of the aspects are covered by the discussion above about relevance, reliability and comparability.

154 As a result, EFRAG believes that the main additional issue it needs to consider, in assessing whether the information resulting from the application of IFRS 9 is understandable, is whether that information will be unduly complex.

Classification and Measurement

155 With regards to classification and measurement, and taking into account the comment made in paragraph 153 , EFRAG considers that the information resulting from IFRS 9 is not unduly complex, as the requirements in IFRS 9 are generally principle-based.

Impairment

ASSESSMENT ON PRINCIPLES FOR RECOGNITION OF IMPAIRMENT

156 The general applicability of the model to credit risk bearing exposures significantly increases its understandability to the users. The expected credit loss model is built on clear principles which further contributes to the understandability.

157 Practical application of the principles for assessment on increases in credit risk and calculation of expected credit losses may require complex approaches. However, there are extensive disclosure requirements included in the consequential amendments to IFRS 7 which are focused on providing information that helps users in understanding how an entity has assessed credit risk and measured its expected credit losses including information about an entity's credit risk management practices. Considering that the assessment on understandability assumes knowledgeable users, EFRAG assesses that the principles of impairment recognition fulfil the criteria for bringing understandable information.

ASSESSMENT ON EXCEPTIONS AND PRACTICAL EXPEDIENTS

158 IFRS 9 brings a number of practical expedients and exceptions which might bring issues of understandability. They are discussed together with reasons for their existence in the sections for relevance, reliability and comparability. EFRAG considers that the reasons for existence of the exceptions and practical expedients are substantiated. As a result, potential complexity is outweighed by benefits brought by these exceptions.

Hedging

159 Following the criteria set out in paragraph 3 above, EFRAG has focused its assessment on the requirements related to:

(a) Accounting for qualifying hedging relationships; and

(b) Amendments to IFRS 7.

ACCOUNTING FOR QUALIFYING HEDGING RELATIONSHIPS

160 IFRS 9 retains the three types of hedge accounting relationships in IAS 39:

(a) Fair value hedges;

(b) Cash flow hedges; and

(c) Hedge of a net investment.

161 Although some small changes are made to the accounting for these hedge relationships, the mechanics of these three types of hedging relationships are well understood and, consequently, no issues are expected on understandability of their application.

AMENDMENTS TO IFRS 7

162 IFRS 9 requires an entity to present the disclosures on hedge accounting in a single note or separate section in its financial statements. These disclosures encompass information on:

(a) The risk management strategy for each risk category that an entity decides to hedge;

(b) The amount, timing and uncertainty of future cash flows; and

(c) The effects of hedge accounting on the financial position and performance.

163 It could be argued that by collecting only the disclosures of those risks an entity decides to hedge account for in one place without requiring the same for those risk exposures which an entity decides not to hedge account for, it would be difficult for users to understand the risk management of an entity. However, IFRS 9 only deals with hedge accounting (in addition to classification and measurement and impairment). In addition, hedge accounting is optional, not mandatory so while all entities will have risk exposures, only some of them will be hedge accounted for.

164 Consequently, EFRAG agrees that the disclosures on hedge accounting do not allow a full understandability of the risk management of an entity by users. However, this is not the objective of IFRS 9. EFRAG assesses that by collecting all disclosures on hedge accounting in one place through IFRS 7, IFRS 9 increases the understandability of the information for users.

Conclusion on understandability

165 In EFRAG's view, due to the above reasons, IFRS 9 does not introduce any new complexities that may impair understandability. Therefore, EFRAG's overall initial assessment is that IFRS 9 satisfies the understandability criterion in all material respects.

True and Fair

166 EFRAG's initial assessment is that the information resulting from the application of IFRS 9 would not be contrary to the true and fair view principle.

Conclusion

167 For the reasons set out above, EFRAG's initial assessment is that IFRS 9 satisfies the technical criteria for EU endorsement and EFRAG should therefore recommend its endorsement.

Appendix 3: Assessing whether the amendments are conducive to the European public good

Background

1 The IAS Regulation states that an international accounting standard can only be adopted if it is conducive to the European public good.

2 EFRAG has considered, based on an assessment of whether the amendments are likely to improve the quality of financial reporting and on a cost-benefit analysis [and on evidence brought to its attention by constituents], whether it would be conducive to the European public good to adopt IFRS 9 *Financial Instruments*. This appendix sets out EFRAG's assessment of IFRS 9 with respect to this requirement and explains the methodology behind that assessment.

Assessing IFRS 9 with respect to the European public good

3 EFRAG believes that adoption of an international accounting standard is conducive to the European public good if it would improve financial reporting. This is because improved financial reporting, by its very nature, improves transparency, lowers the cost of capital and assists in the assessment of management stewardship.

4 IFRS 9 replaces IAS 39 *Financial Instruments: Recognition and Measurement* and therefore EFRAG's assessment of whether adoption of it would result in improved financial reporting includes a comparative analysis between the financial reporting outcomes of IAS 39 and IFRS 9.

5 However, it is possible that other factors and circumstances, including the costs of adoption, could be such that, even if a standard improves financial reporting, the overall impact of adoption would not be conducive to the European public good. EFRAG's analysis with respect to the European public good is therefore based on two strands:

(a) Is the financial reporting required by IFRS 9 an improvement over the financial reporting required by IAS 39?

(b) Are there any other factors or circumstances, including a balance between the costs and benefits, that would mean adoption is not conducive to the European public good?

6 EFRAG's overall assessment of whether adoption of IFRS 9 is conducive to the European public good is based on these analyses.

Is the financial reporting required by IFRS 9 an improvement over the financial reporting required by IAS 39?

7 EFRAG has focused its assessment on the areas it considers most significant in the change from IAS 39 to IFRS 9:

(a) Classification and measurement of financial assets;

(b) Impairment of financial assets;

(c) Hedge accounting; and

(d) Financial liabilities under the fair value option: own credit risk.

Classification and measurement of financial assets

8 IFRS 9 introduces significant changes to the accounting for financial assets, using a different model than IAS 39 and with different restrictions on when they can be reclassified.

9 Under IAS 39 financial assets are classified into four categories, which determine subsequent measurement, presentation of changes and reclassification requirements:

(a) Fair value through profit or loss;

(b) Held-to-maturity;

(c) Loans and receivables; and

(d) Available For Sale.

10 In considering how the classification and measurement approach of IFRS 9 compares to the IAS 39 approach, EFRAG believes the following aspects of IAS 39 need to be considered:

(a) accounting designations based on intent are constrained by rules such as tainting in order to provide consistency over time in the measurement;

(b) bifurcation of embedded derivatives require the separation of complex or volatile cash flows from a 'simple' host instrument, unless those complex or volatile cash flows were assessed as being 'closely related' to the host.

11 The classification and measurement requirements of IFRS 9, and a description of the changes from IAS 39, are set out in Appendix 1.

12 A classification approach based on the entity's business model increases the relevant nature of the resulting information, as it reflects an entity's purpose in respect of that asset. IFRS 9 introduces reliance on the business model in the accounting for basic lending instruments. EFRAG assesses this as providing more relevant information compared with the accounting for basic lending instruments in IAS 39. The business model is based on factual information rather than on an accounting designation as required under IAS 39. The business model test also allows the provision of information on a higher level of aggregation than an instrument-by-instrument basis and consequently simplifies the accounting. EFRAG assesses that for these reasons users will be provided with more understandable and reliable information on all basic lending instruments

13 An exception to this positive assessment could be made in relation to embedded derivatives as IFRS 9 is based on the whole of the financial instrument, even though some entities may manage cash flows of an embedded derivative separately from a host contrast. However, evidence from EFRAG's field-testing of the IFRS 9 requirements is that the IAS 39 bifurcation model was very rarely applied in practice. Instead, entities found it operationally easier to designate entire instruments at fair value through profit or loss.

14 Under IFRS 9 all financial assets other than certain basic lending instruments are measured at fair value through profit or loss, regardless of the business model that applies to them. Whilst IAS 39 categories were not specifically reliant on an entity's business model, the various categories of measurement, together with the ability to bifurcate embedded derivatives and instrument-by-instrument designation, allowed

an entity to reflect, to a large extent, their business intent in the accounting for financial assets.

15 For this reason, some think that IAS 39 provided more relevant information when financial assets other than basic lending instruments were held to collect contractual cash flows. This criticism that IFRS 9 does not allow the business model to influence the measurement of financial assets other than basic lending instruments is partly mitigated by the option included in IFRS 9 to account for equity instruments at fair value through OCI which opens the possibility of distinguishing between equity instruments held for trading and equity instruments that are invested for the longer term. When this option is taken only dividends are presented in profit or loss. Fair value gains and losses are not reclassified into profit or loss upon derecognition and no impairment loss is recognised in profit or loss, potentially reducing the understandability of the returns on equity instruments. However, the IAS 39 impairment model has been significantly criticised particularly during the financial crisis. EFRAG does not believe it would be appropriate to have a reporting model that included reclassification gains (or losses) on disposal, but did not require impairment to reflect losses if the instrument was not disposed of.

16 In summary, EFRAG believes that:

(a) The IFRS 9 'whole of asset' classification model that takes account of the business model provides more comparable information and is less operationally complex than the model in IAS 39 that relies on management intent and discretion as to identification of cashflows that represent embedded derivatives;

(b) IFRS 9 may provide less relevant information than IAS 39 when entities hold complex financial instruments or equity investments to collect their cashflows;

(c) The level of aggregation in IFRS 9 is more appropriate than the instrument-by-instrument approach of IAS 39; and

(d) IFRS 9 may result in a less relevant depiction of performance with relation to investments in equity instruments. However, avoiding this reduction would require introduction of additional complexity, with the development of an additional impairment model for equity investments that also addressed the identified problems with the IAS 39 model.

Reclassifications

17 EFRAG assesses that the reclassification requirements under IFRS 9 are more restrictive than those in IAS 39 and do not allow entities to address particular situations. This may reduce the relevance of the resulting information. For example, if an active market vanishes, an entity's existing business model, including how the assets are managed and performance assessed, may not have changed. However, because the entity may not have the practical ability to operate in accordance with the existing business model, it may need to change its business model in the short term. The lack of reclassification under IFRS 9 in such circumstances may reduce the relevance of the information provided. However, circumstances in which such reclassifications are necessary, for example the recent financial crisis, are expected to be rare.

Conclusion on Classification and Measurement

18 The overall comparison of the IFRS 9 Classification and Measurement requirements with those of IAS 39 does not lead to a conclusion that IFRS 9 is superior in all

respects. Whilst the accounting for basic lending instruments will improve financial reporting, it is not possible to reach the same conclusion for all financial assets.

19 For equity instruments that are measured at fair value through OCI, the fact that changes in fair value other than dividends are not recycled into profit or loss and no impairment loss is recognised in profit or loss impairs the ability of users to easily assess the performance of the entity's investment activities by relying on profit or loss.

20 Accounting for financial instruments other than basic lending instruments and equity instruments at fair value through other comprehensive will provide relevant information under IFRS 9, but that will be in a different manner from the relevance of the information provided under IAS 39. There is no indication that IFRS 9 changes will have a detrimental effect on financial stability as a result of greater volatility arising from any increase in the use of fair value.

Impairment of financial assets

21 In assessing whether the impairment requirements of IFRS 9 constitute an improvement to those of IAS 39, EFRAG has focused on:

(a) The scope of the impairment model;

(b) The expected credit loss model;

(c) Measurement of impairment for FV-OCI category; and

(d) The use of judgement and the role of probability weighting.

<u>The scope of the impairment model</u>

22 Under IAS 39, different impairment requirements apply depending on the nature and categories of the financial assets, with different guidance for assets at amortised cost, Available For Sale debt instruments, Available For Sale equity instruments and investments in equity instruments measured at cost when the reliability exception applies.

23 In contrast to the above-mentioned IAS 39 requirements, the use of fair value through profit or loss (or the option for equity instruments) for all instruments other than basic lending instruments results in the need in IFRS 9 for one single impairment model only that applies to all basic lending instruments that are managed in hold to collect and hold to collect and sell business models.

24 EFRAG believes that having a single impairment model will reduce complexity and potentially more closely align impairment requirements with credit risk management practices.

25 EFRAG also notes that the introduction of a single model is achieved at the cost of introducing options such as the option for the accounting for equity instruments at fair value through OCI without recycling because of the lack of an appropriate impairment model for equity instruments. The recognition of losses on equity instruments in OCI without any recognition in profit or loss even when the instrument can be deemed impaired may not appropriately reflect an entity's performance in the view of certain investors who would usually expect to have all impairment losses included in profit or loss.

26 Therefore EFRAG believes that the benefits of a single impairment model are reduced by the lack of recognition of losses in profit or loss on equity instruments that

are measured at fair value through OCI because of the difficulty to find an appropriate impairment model for equity instruments. EFRAG notes that the IAS 39 impairment guidance for equity instruments, which requires an impaired loss to be recognised where there was significant or prolonged decline in their fair value below cost, has been difficult to apply and resulted in diversity in practice.

The expected credit loss model

27 Under IAS 39, no impairment is recognised unless and until a loss event occurs after the initial recognition of a financial asset. During the recent financial crisis, this 'incurred loss' approach was criticised for resulting in delayed recognition of losses and for being difficult to understand and apply.

28 The IFRS 9 expected credit losses model (ECL) is a forward looking model aimed at addressing this criticism of 'too little, too late' by requiring the recognition of a day-one loss representing 12-month expected credit losses for all financial assets that are not measured at fair value through profit or loss (but with operational simplifications for lease receivables, trade receivables and contract assets). Full lifetime expected credit losses are recognised where there has been a significant deterioration in creditworthiness. The size and moment of transition from 12-month expected credit losses to lifetime expected credit losses provides clear information to users of financial statements on the credit quality of the underlying portfolios.

29 EFRAG notes that while the IFRS 9 impairment model will result in the accounting for expected credit losses at initial recognition even though those losses are also reflected within the carrying amount of the financial asset which is initially at fair value, the early recognition of expected credit losses is likely to improve investors' confidence in the reporting of financial instruments. However, the increased reliance on estimates may reduce the reliability of the impairment measures.

The use of judgement and the role of probability-weighting

30 Under IAS 39, entities are allowed to estimate, based on management judgement, impairment losses as either a single amount or as a best estimate from a range of possible amounts. This is sometimes criticised as lacking sufficient reliability as it is not clear why an entity would pick one number from a range of possible outcomes as its best estimate of the impairment loss.

31 In contrast, IFRS 9 does not allow expected credit losses to be measured using the most likely outcome or as the entity's best estimate of the ultimate amount because the expected credit losses model requires the measurement to reflect the probability-weighted cash shortfalls through the use of the probability of default and the loss given default.

32 EFRAG believes that probability-weighting improves the reliability of the impairment amount calculated. However, the benefits of probability-weighting may be outweighed by the amount of judgement required under IFRS 9 when compared with IAS 39.

33 IAS 39 requires less judgement in that impairment is recognised only when a credit loss event occurs. In contrast, the IFRS 9 expected credit loss model requires assessment of credit deterioration and estimates for all applicable financial assets. It is expected however that such estimates are already at least partly available to support entities' credit risk management. Where IFRS 9 would require that they are further enhanced, this development could be deemed beneficial to the entity as a whole, for example through bringing more robust credit pricing methodologies.

Measurement of impairment for FV-OCI category

34 Under IAS 39, the impairment of debt instruments that are classified as Available For Sale is calculated based on changes in fair value. This approach has been criticised because factors unrelated to credit risk, such as interest rates, are a key driver of fair value changes. Under IFRS 9, the impairment loss is measured as the present value of contractual cash shortfalls discounted using an effective interest rate. The impairment loss is recognised in profit or loss and the fair value adjustment is recognised in OCI.

35 EFRAG assesses that the requirements of IFRS 9 will address the criticisms of IAS 39 and improve the relevance of financial information: performance reported in profit or loss is based on amortised cost while fair value is presented in the balance sheet.

Conclusion with respect to impairment

36 EFRAG assesses that IFRS 9 significantly improves the disclosures about the way impairment losses are calculated and recognised, including how significant changes in credit quality are taken into account. This results in transparency which in turn will enhance investors' confidence. More importantly, the use of the expected credit loss model will reduce the current potential for overstatement of profit or loss. This is caused by reporting interest income in advance of recognition of the credit losses that income compensates for.

General hedge accounting

37 The hedge accounting categories are substantially unchanged and access to the EU carve-out remains. EFRAG has focused its assessment on the areas which it considered the most affected by the change from IAS 39 to IFRS 9. Hence, this chapter addresses the following topics:

(a) Reflecting risk management;

(b) Eligible hedged items;

(c) Eligible hedging instruments;

(d) Effectiveness testing and rebalancing; and

(e) Treatment of credit risk.

Reflecting risk management

38 In contrast to IAS 39, the objective of hedge accounting under IFRS 9 has been clearly defined and is to represent in the financial statements the effect of an entity's risk management activities that use financial instruments to manage exposures arising from particular risks that could affect profit or loss or in particular cases OCI.

39 EFRAG assesses that putting the risk management strategy of an entity central to the objective of hedge accounting enhances the relevant nature of the resulting information. Reflecting in the financial statements how an entity manages its risks provides more information to users than hedge accounting information under IAS 39, where that link is not necessarily clear.

Eligible hedged items

40 IFRS 9 allows a broader category of hedged items, including risk components of non-financial items, net positions (in particular circumstances), portfolio layers for both

cash flow hedges and fair value hedges (in particular circumstances) and aggregated exposures.

41 EFRAG assesses that IFRS 9 provides more possibilities for designation of hedged items than IAS 39. Consequently, IFRS 9 provides better opportunities for designating hedge accounting relationships that reflect risk management strategies.

Eligible hedging instruments

42 IFRS 9 provides a wider range of possible hedging instruments than IAS 39 and notably allows non-derivative financial instruments to be designated as hedging instruments for all hedgeable risks if these non-derivative financial instruments are measured at fair value through profit or loss.

43 In contrast to IAS 39, embedded derivatives bifurcated from financial assets are no longer eligible as hedging instruments. However, under IFRS 9 financial assets including such embedded derivatives are likely to be measured at fair value through profit or loss, and thus be eligible hedging instruments.

44 New requirements relating to using options as hedging instruments allow the deferral of changes in the time value of options through OCI. The timing of reclassification to profit or loss depends on the nature of the underlying hedged item (i.e. whether it is transaction-related or time-period related). This change improves the financial reporting of hedge-accounted risk management strategies that use options.

45 When hedging foreign currency risk entities can designate either the spot rate or the forward rate under both IAS 39 and IFRS 9. However, IFRS 9 permits an entity that designates only the change in the spot element as the hedging instrument to apply the accounting for the time value of options to the forward element of a forward contract.

46 Unlike IAS 39, under IFRS 9 foreign currency basis spreads are considered as costs of the hedge relationship and changes can be recognised through OCI.

47 EFRAG assesses that, with the exception of embedded derivatives bifurcated from financial assets, IFRS 9 provides a wider range of possible hedging instruments than IAS 39. Consequently, IFRS 9 provides entities with a greater possibility in designating hedge accounting relationships in order to reflect their risk management strategy.

Effectiveness testing and rebalancing

48 Under IAS 39, the effectiveness of the hedge accounting relationship has to be able to be reliably measured and is expected to be highly effective prospectively. It is also subject to ongoing stringent quantitative tests.

49 Under IFRS 9 hedge effectiveness is measured on a more principle and qualitative basis.

50 In contrast to IAS 39, IFRS 9 does not permit voluntary de-designation of hedge accounting relationships if the risk management objective remains identical, but permits rebalancing of the hedge relationship.

51 EFRAG assesses that the removal of the stringent quantitative test improves hedge accounting possibilities for many risk management strategies and also removes a 'bright-line' rule.

52 EFRAG assesses that the possibility of rebalancing a hedge accounting relationship helps to reflect better hedge accounting relationships in the financial statements consistently with risk management practices.

Treatment of credit risk

53 IAS 39 does not provide a specific solution for dealing with credit risk. IFRS 9 states that the credit risk of a debt instrument cannot be isolated and thus does not meet the eligibility criteria to be designated as a hedged item. However, IFRS 9 provides an option to designate financial instrument at fair value through profit or loss when specific conditions are fulfilled, including reducing or eliminating an accounting mismatch, such as when a credit default swap is used to hedge an investment.

54 EFRAG notes that economic hedges of credit risk using credit derivatives are a common practice. It could therefore be argued that a standard on hedge accounting should address these practices. The limitation on qualifying credit risk as a hedged item may be seen as diminishing the relevance of reported results when management has actually hedged that credit risk. However EFRAG also acknowledges that the pricing in credit derivative markets and cash markets are not always strongly correlated, supporting the IASB's assertion that credit risk of a debt instrument cannot be isolated. The clear prohibition will also increase comparability.

Conclusion with respect to hedge accounting

55 Overall, EFRAG assesses that the hedging requirements in IFRS 9 provide more relevant information than those in IAS 39 because they permit a better reflection of an entity's hedging practices.

Classification of financial liabilities: own credit risk

56 If an entity measures a financial liability at fair value under the fair value option, IAS 39 requires the entire fair value change to be presented in profit or loss. This means that changes in the credit risk of a financial liability affect the primary measure of performance even when the liability is not held for trading. There was a counterintuitive result whereby the issuer would recognise a gain (loss) in profit or loss when its own credit deteriorates (improves).

57 When an entity elects to measure a financial liability at fair value through profit or loss in its entirety, IFRS 9 requires that the changes in fair value due to changes in the entity's own credit risk are presented in OCI. An exception to this requirement is if doing so would create or enlarge an accounting mismatch in profit or loss, in which case an entity shall present all gains or losses on that liability (including the effects of changes in the credit risk of that liability) in profit or loss.

58 EFRAG assesses that this requirement improves the relevance of reported profit or loss by removing the counterintuitive impact of the IAS 39 requirement as an entity will generally not realise the effects of changes in the liability's credit risk unless that liability is held for trading.

Conclusion with respect to whether IFRS 9 is an improvement over IAS 39

59 For the reasons given above, and particularly with respect to the impairment and hedging requirements, EFRAG believes that IFRS 9 is an improvement over IAS 39 and will lead to higher quality financial reporting.

Other factors or circumstances that might mean that endorsement of IFRS 9 is not conducive to the European public good

60 EFRAG has analysed a number of other factors and circumstances to assess whether adoption would not be conducive to the European public good. These

include the costs and benefits of adoption and consideration of other matters identified by EFRAG working groups and members of the EFRAG Board:

(a) the impact of lack of convergence;

(b) the impact on investor behaviour, including their investment decisions;

(c) the overall costs and benefits of adoption.

The impact of lack of convergence

61 In the letter requesting advice on endorsement, it was noted that 'IFRS 9 is not converged with US GAAP, in particular in the accounting for impairment. The impact of this lack of convergence for globally active financial institutions, in particular, banks should be analysed.'

62 IAS 39 was substantially converged with US GAAP, but subsequent changes to US GAAP and the publication of IFRS 9 changed the situation. EFRAG's analysis on the lack of convergence follows the three main areas of IFRS 9:

(a) Classification and measurement;

(b) Impairment; and

(c) Hedging.

Classification and measurement

63 The classification and measurement requirements of US GAAP have not materially changed and are substantially the same as IAS 39. An analysis of whether financial reporting under IFRS 9 is an improvement over financial reporting under IAS 39 is included in paragraphs 7 to 59 above. The analysis with respect to classification and measurement is also valid in respect of a comparison with US GAAP.

64 EFRAG has identified one potential significant change to the US GAAP classification and measurement requirements, which is in relation to equity instruments. US GAAP currently requires 'non-marketable' equity instruments to be held at cost less impairment and 'marketable' equity instruments (other than equity-method investments where the investor has significant influence over the investee) to be classified as either Held For Trading (at fair value through profit or loss) or Available For Sale (at fair value through OCI and with recycling on disposal). It is proposed that this requirement in US GAAP be changed to require all equity instruments to be held at fair value with changes presented in profit or loss. Certain entities may take a proposed election in relation to some investments without a readily determinable fair value, and measure them based on cost, less impairment, plus or minus observable price changes of an identical or similar investment of the same issuer.

65 Given that there is no proposal to allow fair value changes to be presented in OCI (as in IFRS 9) EFRAG assesses that impact of lack of convergence in this regard is that entities reporting under US GAAP will potentially have significantly higher volatility in reported profit or loss.

66 In addition, it should be noted that for some US GAAP requirements, classification and measurement is driven by legal form (for example whether the financial instrument meets the definition of a 'Debt Security' or is a mortgage loan) rather than by economic substance. EFRAG believes that an approach based on economic substance is superior to one based on legal form and that therefore IFRS 9 is more appropriate in this regard.

Impairment

67 In analysing the impact of lack of convergence in impairment requirements, EFRAG has considered:

(a) the proposed US GAAP requirements; and

(b) whether IFRS 9 or the proposed US GAAP requirements more appropriately reflect the economics of credit losses on financial instruments.

68 EFRAG has also considered what it believes to be the quality of resulting financial information for users.

69 The proposed US GAAP guidance has not yet been finalised and EFRAG's analysis is based on its understanding of the tentative decisions to date. The proposed US GAAP requirements differ depending both upon the legal form of the instrument (whether the legal form of the instrument meets the definition of a Debt Security) and the measurement basis applied to it with significant differences between:

(a) Financial assets (including Debt Securities[2]) measured on an amortised cost basis; and

(b) Financial assets other than Debt Securities which are classified as Held For Sale (and measured at the lower of cost and fair value) and Debt Securities classified as Available For Sale (measured at fair value with qualifying changes presented in OCI).

70 For financial assets (including Debt Securities) measured on an amortised cost bass, similar to IFRS 9, the proposed US GAAP model takes a loss allowance approach based on expected credit losses.

71 However, there is a key difference between proposed US GAAP requirements and IFRS 9 in that the proposed US GAAP model uses a single basis for measuring the loss allowance. This basis (known as 'Current Expected Credit Losses') is based on expectations, as at the reporting date, of credit losses for the lifetime of the financial instrument. It does not distinguish, as IFRS 9 does, between financial assets based on whether there has been a significant deterioration in credit quality since initial recognition.

72 Under the proposed US GAAP model, a day-one loss allowance is recognised in profit or loss for an entity's expectations of credit losses for the lifetime of the financial instrument. In contrast, IFRS 9 requires a day-one loss allowance equivalent to the 12-months expected credit losses. When there is a significant deterioration in a financial instrument's credit quality IFRS 9 requires the loss allowance to be measured at lifetime expected credit losses.

73 IFRS 9 therefore requires a loss allowance following deterioration of approximately the same as the proposed US GAAP requirements do from day-one.

74 In analysing these different requirements, EFRAG has considered the business model of lending, in which financial institutions, especially banks, are compensated for expected credit losses through the interest rate charged to borrowers. EFRAG

---

[2] For financial asset Debt Securities to be measured at amortised cost the entity must have chosen to classify them as Held To Maturity. Due to associated tainting requirements very few entities make material use of the Held To Maturity classification.

does not believe the proposed US GAAP model appropriately reflects the economics of lending, because using a lifetime expected credit losses model in all circumstances does not reflect that expected credit losses are compensated for through the interest charged to borrowers and distorts the reporting of an entity's performance: at day-one no economic loss has been suffered, but one is reported.

75 Although the 12-month expected credit losses allowance in IFRS 9 has the limitations of a practical expedient, EFRAG believes that it has the significant merit of being closer to an appropriate depiction of economic reality than the proposed US GAAP model. In addition, IFRS 9 provides significantly more information to users of financial statement, because a significant deterioration in credit quality results in a transition from 12-month to lifetime expected credit losses, highlighting to users how the credit quality of an entity's financial assets has changed.

76 For financial assets (other than Debt Securities) that are classified as Held For Sale, US GAAP would continue to require such financial assets to be held at the lower of [amortised] cost (without impairment) and market (fair value). This includes financial assets which are reclassified from Held For Investment to Held For Sale, in which case any existing loss allowance in excess of the difference between amortised cost and fair value is reversed.

77 For financial assets that meet the definition of 'Debt Securities', US GAAP requires them to be classified as Available For Sale unless they are Held For Trading or designated as Held To Maturity. The proposed US GAAP CECL impairment model does not apply to financial assets classified as Available For Sale. The existing impairment requirements, which are similar to those for amortised cost financial assets in IAS 39 – and have equally raised reliability issues in practice - would materially remain.

78 EFRAG believes the impairment requirements for IFRS 9, including for financial instruments held at FV-OCI, are significantly superior to the proposed US GAAP requirements for these instruments. This is because:

(a) the classification of financial instruments as held for sale is driven by management intent and will be susceptible to use as a tool for earnings management, as fair value will usually be higher than amortised cost less loss allowance; and

(b) in relation to Debt Securities classified as AFS the impairment requirements of IAS 39/current US GAAP were heavily criticised for delayed recognition of losses. Given the lack of material changes in proposed US GAAP requirements for these instruments, such criticism is still valid. Although fair value changes would be recognised in OCI, delayed recognition in profit or loss of such impairment would remain an issue.

79 EFRAG's assessment is therefore that the lack of convergence between IFRS and US GAAP for impairment requirements means that financial reporting required by IFRS 9 will:

(a) more appropriately depict the economics of lending transactions than US GAAP;

(b) reduce the impact of management intent and consequent possibility of earnings management with respect to classification as Held For Sale; and

(c) address the criticisms regarding delayed recognition of impairment losses, on all applicable financial assets, unlike the proposed US GAAP requirements, which do not address the criticisms for AFS Debt Securities.

Hedging

80 No material changes have been made to US GAAP with relation to hedging requirements, which remain substantially the same as IAS 39. A project to revise hedging requirements has started, but it is at its initial stages.

81 Given the improvements for hedge accounting in IFRS 9 over IAS 39, as identified in paragraphs 37 to 0 above, EFRAG believes that IFRS 9 can be assessed as leading to significantly improved financial reporting when compared to US GAAP.

82 Furthermore, portfolio fair value hedge accounting of interest rate risk, which was developed for and included in IAS 39 at the request of European banks, does not yet exist in US GAAP. Although these requirements have not yet been revised to benefit from the other change in IFRS 9 that hedge accounting must reflect the economic effects of hedging strategies their inclusion keep IFRS superior to US GAAP in this area also.

Conclusion – Impact of lack of convergence

83 For the reasons explained above, and more particularly the differences in the impairment model and hedge accounting, EFRAG believes that IFRS 9 will lead to higher quality financial reporting when compared to current US GAAP and proposed changes to impairment requirements.

Impact on investor and issuer behaviour

84 In assessing the impact on issuer behaviour EFRAG has also considered any potential changes made by investors who report under IFRS, such as financial institutions, on their own investment decision making (for example due to wishing to avoid certain financial reporting consequences).

85 This analysis is based on what was reported by constituents in the field-tests as potential issues, and input from other stakeholders including in EFRAG Financial Instruments and Insurance Accounting Working Groups. The analysis highlights certain requirements of IFRS 9 that EFRAG considers sufficiently sensitive that they might have an impact on investor or issuer behaviour.

86 However, EFRAG is not able to assess whether any potential impact would actually materialise. Furthermore, EFRAG 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 the impact of economic conditions at any stage of the economic cycle and regulatory developments and attitude to the accounting model. Therefore, this analysis should not be construed as representing any form of impact assessment.

87 This analysis considers the following topics:

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

(b) Expected credit loss model for basic lending instruments;

(c) Financial assets other than basic lending instruments; and

(d) Presentation of changes in own credit risk on financial liabilities under the fair value option.

Equity investments at fair value and long-term investments

88 Some constituents have argued that the requirement to measure all equity instruments, including unquoted ones for which a fair value is not reliability determinable, at fair value through profit or loss may negatively impact the investment appetite for equity instruments of certain long-term investors, including some insurers and private equity investors.

89 For some insurers, measuring equity instruments at fair value through profit or loss may result in volatility in profit or loss that does not reflect the economics of their business, because the insurance liabilities which are backed by these assets are measured either at cost (based on the existing insurance contracts standard that allows the use of local GAAP) or at current value through OCI (based on a future insurance contracts standard). EFRAG notes that those insurers that already measure their insurance liabilities at current value through profit or loss (on the basis of the existing insurance contracts standard) do not have this issue.

90 IFRS 9 provides an option to measure equity instruments that are not held for trading at fair value through OCI which could reduce accounting mismatches, however some insurers are unlikely to avail 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. Those insurers argue that the lack of reclassification makes it more difficult to portray the performance of their investment activities.

91 EFRAG 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 wishing to avoid accounting mismatches 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.

92 EFRAG believes that the expected change in capital requirements brought about by Solvency II is likely to play a much more significant role than financial reporting in determining the investment behaviour of insurance companies. 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.

93 It has been brought to the attention of EFRAG 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 on reclassification of 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 for basic lending instruments

94 EFRAG has identified some potential negative effects of both 12-month and lifetime expected losses. However, it should be noted that these generally do not 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.

95 The recognition from day-one of 12-month expected losses on financial instruments may lead to higher provisions for lenders expanding their portfolios (including new entrants to a market) or lenders originating or investing in assets with higher credit risk. This may lead to lenders changing their pricing strategies in order to appropriately reflect credit risk being undertaken, which in turn may increase the cost of lending on consumers.

96 However, EFRAG notes that immediate recognition of credit losses is already required for regulatory purposes. Regulatory capital is an important consideration by banks in making business decisions and in most cases banks would include that impact in their pricing. Therefore, EFRAG assesses that the new financial reporting requirements should have a limited impact of their own, if any, on banks' pricing strategies.

97 To the extent that the day-one provision will result in additional consideration of credit risk in lending decisions and credit pricing, EFRAG believes that this is a positive economic effect due to reduction in credit mispricing.

98 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 timing 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.

99 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 with longer maturities in times of financial crisis when they face losses on their portfolios. However, assuming the demand for loans with longer maturities continues, EFRAG notes that such a short-termism behaviour would be constrained by competitive forces because ceasing to lend would simply adversely reflect on the bank's market share as well as the ability to build a long-term relationship with clients.

100 In certain cases the requirement to recognise lifetime expected credit losses might create incentives to securitise financial instruments just before significant credit deterioration occurs, i.e. near to the cut-off point between stage 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.

101 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.

102 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.

103 EFRAG 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.

Financial assets other than basic lending instruments

104 Lenders may face volatility in profit or loss due to financial assets that are assessed as not being basic lending instruments due to their cash flow characteristics (i.e. they are assessed as not being solely payments of principal and interest). This may have an impact on their behaviour. On the other hand, the demand of investors for complex and leveraged returns may influence the issuers of such instruments.

105 EFRAG's field-testing has shown that only a small portion of financial assets that are managed through the banking book have cashflows that are assessed as not being solely payments of principal and interest. When lenders do issue such assets they are frequently already measured in their entirety at fair value through profit or loss under IAS 39 due to the use of the fair value option, avoiding the operational complexities of bifurcation.

106 EFRAG therefore does not believe there will be significant changes, due to financial reporting changes in the availability of financial assets other than basic lending instruments.

107 IFRS 9 may lead to securitisation tranches being measured at fair value through profit or loss to a larger extent than under IAS 39. This is especially relevant for lower ranking tranches which are likely to fail the solely payments of principal and interest test due to their riskiness or for synthetic securitisations. Longer-term investors may not find the FVPL measurement consistent with their business intentions. As a result, all other things remaining equal, the demand for higher risk tranches or in the markets for synthetic securitisations may be dampened.

Presentation of changes in own credit risk on financial liabilities under the fair value option

108 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.

109 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 own credit risk was not 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.

Conclusion on impact on investor and issuer behaviour

110 This analysis is based on EFRAG's understanding of both changes in IFRS 9 and current practices of financial institutions and is not a full impact assessment. In this analysis EFRAG 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 in paragraphs 7 to 59 of this Appendix.

EFRAG's evaluation of the costs and benefits of IFRS 9

111 EFRAG has considered whether, and if so to what extent, implementing IFRS 9 in the EU might result in incremental costs for preparers and/or users, and whether those costs are likely to be exceeded by the benefits to be derived from its adoption.

112 EFRAG's evaluation is based upon the results of its field-tests of the various parts of IFRS 9 and additional input from constituents, including in EFRAG working groups.

One-off costs for preparers

Classification and Measurement

113 The one-off costs will depend on the individual circumstances of the entity, i.e. the type (and diversity of) business models for its financial assets as well as the contractual cash flow characteristics of the instruments.

114 Preparers are expected to incur significant one-off costs to undertake the initial analysis of business models and contractual cash flows on transition; to develop new processes, systems and controls; to develop valuation systems for specific financial assets which were previously measured at amortised cost; to adjust the accounting systems to accommodate the calculation of modification losses; to prepare disclosures related to transition; to obtain expert advice for compliance and explaining to users of financial statements the differences between the information produced under IAS 39 and IFRS 9.

115 The fact that upon transition to IFRS 9 there is no requirement to restate the financial information for previous periods will help contain the costs for preparers in implementing IFRS 9.

116 Entities that issue contracts that are within the scope of IFRS 4 *Insurance Contracts* will need to consider the possibility of accounting mismatches between IFRS 9 and their current accounting for insurance contracts when implementing IFRS 9. They will then need to reassess the application of IFRS 9 when the new insurance contracts standard 4 becomes effective in order to reflect their asset-liability management appropriately. Even though this may not result in doubling the costs of implementing IFRS 9, some doubt the benefits of the first implementation effort. This is further discussed in Appendix 4.

Impairment

117 The costs of applying the expected credit loss model will vary depending on the diversity of investment strategies and the sophistication of existing credit risk management systems.

118 Participants in the EFRAG field-test of the 2013 ED *Financial instruments: Expected Credit Losses* identified that there would be further significant cost including costs for development and roll-out of systems, tools and processes for collecting data, tracking credit risk and calculating expected credit losses. New systems and controls will also be required in order to integrate information produced for credit risk management or other business purposes into their financial reporting process.

119 In determining significant increases in credit risk, entities will need to develop systems for tracking the credit risk at initial recognition, identifying increases in credit risk on a timely basis at the level of both individual instrument and collectively. The transitional relief significantly reduces the costs with respect to instruments recognised before the application of IFRS 9 because the lifetime expected credit losses can be recognised with respect to the current level of credit risk or the past due status.

120 Calculation of expected credit losses will require development of systems for collecting historical information about defaults, loss rates, and behavioural aspects of exposures. At the time of transition to IFRS 9, many entities will lack sufficient historical data and the entities will have to find reliable methods for extrapolating the short-term observations over the period of the life of their exposures. Measurement of expected credit losses will require systems for projection of future conditions affecting the exposure and for their extrapolation beyond the horizon of reasonable forecasts. This may include adjustments of through-the-cycle parameters calculated by financial institutions for prudential regulatory purposes. Calculations are based on present values and the introduction of discounting at the instrument's effective interest rate to the reporting date will bring additional challenges.

Disclosures

121 The implementation costs to comply with the disclosure requirements will impose a significant burden on preparers. As identified in EFRAG's field-tests, disclosure requirements are comprehensive and are frequently prescriptive rather than principle-based.

122 With respect to specific disclosure requirements, participants in the field-test highlighted the costs of reconciliations between opening and closing balances for the gross carrying amount of financial assets and loss allowances because the data in the accounting and risk systems have to be combined and other information may need to be collected.

123 EFRAG also expects that additional costs will be incurred by preparers to explain to users specific aspects of applying the new impairment model to support the users' understanding of the information presented.

Hedging

124 Because IFRS 9 requires prospective application of the hedging requirements, EFRAG assesses that the main one-off costs are expected to be:

(a) educating staff and preparing new reporting systems and procedures for the disclosure requirements;

(b) costs of collecting information about hedge of risk components of non-financial items (i.e. commodity risk); and

(c) updating of the documentation for existing hedging relationships.

Other costs

125 As highlighted in the field-test, entities will incur high one-off costs to:

(a) educate and train personnel;

(b) define roles and responsibilities and new procedures and workflows; and

(c) update the accounting system, including the disclosures for the annual report.

Ongoing costs for preparers

Classification and Measurement

126 One of the main ongoing costs of applying IFRS 9 will be the need for entities to monitor the frequency and magnitude of sales in order to decide whether there is a change in the classification of financial assets. Entities will also incur costs in classifying new financial assets with respect to meeting the solely payments of principal and interest criteria.

127 IFRS 9 requires some financial assets to be measured at fair value on an ongoing basis. IFRS 7 already requires disclosure of the fair value of financial instruments. However, calculation of fair value for inclusion in the primary statements rather than disclosure may result in additional cost.

128 There will be also new disclosure requirements which will result in the need to capture more data than under the current disclosure requirements in IFRS 7 (e.g. additional disclosures about investments in equity instruments measured at fair value through OCI, disclosures for reclassifications).

Impairment

129 The principle of using reasonable and supportable information available without undue cost or effort allows the entities to consider the level of sophistication of their credit risk management systems and thus alleviates the cost burden. However, this also implies that the availability of information will improve and the threshold for undue costs will lower over time. Entities are likely to further develop their impairment systems which will bring some costs on an ongoing basis.

130 The ongoing cost of measuring a loss allowance at an amount equal to 12-month expected credit losses will be higher for financial institutions that do not use an internal-ratings based approach for regulatory purposes.

131 For non-financial institutions, the calculation of 12-month and lifetime expected credit losses are a new concept that would not normally be required for other management purposes. As a result, they are unlikely to have applied such a calculation in the past. This will require ongoing monitoring of systems and processes.

132 For both financial and non-financial institutions, ongoing costs will be incurred in connection with obtaining calculation inputs and improving their quality over time.

Hedging

133 The ongoing costs will be different from entity to entity and depend on an entity's facts and circumstances so it is difficult to provide a general assessment of the impact. The size of the ongoing costs will be influenced by the type of hedging instruments and hedged items each individual entity uses, as well as their implementation of hedge accounting in terms of processes and systems.

134 IFRS 9 generally keeps the mechanics of hedge accounting for fair value, cash flow and net investment hedges the same, which will reduce the costs of transition to

IFRS 9. Further, IFRS 9 permits entities to apply the IAS 39 requirements for the portfolio fair value hedge of interest rate risk while accounting for all other hedge relationships according to IFRS 9. Consequently, the introduction of IFRS 9 would not adversely affect the ability and costs for portfolio fair value hedge activities. In addition, the migration from macro cash flow hedge requirements under IAS 39 to the hedge accounting requirements of IFRS 9 should not lead to extra costs for preparers as the new requirements do not change how risk components of financial items can be designated as hedged items.

135 As indicated in EFRAG's field test on general hedge accounting, ongoing costs may relate to application of the hedge ratio and rebalancing. However, as these requirements have been further clarified in the finalisation process of IFRS 9, these costs may be lower than initially assessed.

136 In determining hedge effectiveness, entities need to assess the effect of credit risk on the hedge relationship. This may bring some operational complexities, although the application of the hedge effectiveness requirements has been simplified compared to the ones required under IAS 39. However, as the assessment is to be done on a 'should not dominate' basis, the costs related to this assessment are not expected to be extremely high.

137 Although used for an economic hedge IFRS 9 does not consider the hypothetical derivative as a method in its own right for assessing hedge effectiveness. It is one possible way of determining an input for other methods. One may argue that this could increase the operational cost of preparers, however EFRAG notes that other methods exist to demonstrate hedge effectiveness. Consequently, EFRAG believes that the impact on operational cost for preparers may be minimal.

138 IFRS 9 expands the notion of 'costs of hedging' so as to include foreign currency basis spreads, the reason for this being that foreign currency basis spreads are considered as a charge of forward exchanging one currency into another. Such an approach is a practical expedient and thus cost-reducing.

139 When an entity separates the intrinsic value and time value of an option contract and designates as the hedging instrument only the change in intrinsic value of the option, the change in fair value of the time value is recognised in OCI. However the accounting treatment differs depending on whether the option hedges a transaction related hedged item or a time-period related hedged item. This may lead to an increase in operational costs for applying the hedge accounting requirements.

<u>Other ongoing costs</u>

140 Other ongoing costs are expected to be:

(a) Collecting the relevant disclosures;

(b) Ongoing system development and training;

(c) Maintenance of systems and management of data, models and processes;

(d) Complex ongoing processes and procedures; and

(e) Audit costs.

Conclusion – costs for preparers

141 Overall, EFRAG's initial assessment is that IFRS 9 is likely to result in significant costs for preparers related to implementation of IFRS 9 and ongoing costs of complying with the standard.

One-off costs for users

142 EFRAG's initial assessment is that users may have to incur one-off costs to read and understand IFRS 9 and the impact on the classification of financial instruments, including the available options, and the immediate impact of the impairment requirements. The mechanics of hedge accounting for fair value, cash flow and net investment hedges are already well known by users, which will not lead to any additional cost.

143 EFRAG assesses that users will have to organise special meetings with preparers in order to understand how they have implemented the standard and the implications for their organisation. EFRAG assesses that these one-off costs will be significant.

144 Users will incur particularly high costs for understanding the financial statements of entities that issue contracts within the scope of IFRS 4 *Insurance Contracts.* This is because the effective dates for IFRS 9 and the forthcoming insurance contracts standard are not aligned. Classification and measurement of financial assets following IFRS 9 may have to be reassessed at the moment of implementing the forthcoming insurance contracts standard.

Ongoing costs for users

Classification and Measurement

145 The ongoing costs for users are generally unlikely to be significant since the requirements will lead to relevant, understandable and comparable information and it is not expected that users will have to restate financial statements. Changes in an entity's business model and consequential costs of analysis are expected to be rare.

Impairment

146 The assessment of changes in credit risk since initial recognition and calculation of expected credit losses inherently involves a significant amount of subjectivity and therefore reduces the verifiability and comparability of reported amounts. On the other hand, disclosures help in improving the verifiability and comparability. Analyses of all the information available is likely to result in ongoing costs for analysis applied by users of financial statements.

Conclusion – cost for users

147 Overall, EFRAG's initial assessment is that, based on the above analysis, IFRS 9 is not likely to result in significant costs for users after the transition. However, at transition costs will be incurred in understanding the new financial reporting.

Benefits for preparers and users

Classification and Measurement

148 The extent of the benefit for preparers will depend on existing practices and the industry within which the preparer operates.

149 For financial assets that are assessed as having contractual cash flows that are solely payments of principal and interest, classification and measurement aligned with the entity's business model would mean that the entity's internal management and financial reporting would be better aligned. This is expected to result in lower ongoing costs for preparers, but identifying and documenting business models will result in costs being incurred.

150 For financial assets that are assessed as having cash flows that are not solely payments of principal and interest, the removal of the complex rules regarding bifurcation of embedded derivatives means that it is simpler to identify the cash flows

that are measured at fair value (i.e. it is all of the contractual cash flows of the financial asset, not just some).

151 Users will benefit from relevant and transparent information because the classification and measurement requirements in IFRS 9 will reflect how the cash flows of financial assets are expected to be realised given the entity's business model and the nature of the contractual cash flows. However, if the effective date of IFRS 9 is not aligned with a new insurance contracts standard, users of financial statements of insurers may face two significant changes within a relatively short period of time.

Impairment

152 Users of financial statements will benefit from the information about expected credit losses being provided on a timely basis. This will help them to predict future cash flows on financial instruments.

153 Furthermore, the model provides a link between the pricing of an asset, credit quality upon initial recognition and the deterioration in credit quality over time. As a result, users will be able to distinguish between instruments for which the credit risk increased significantly and resulted in economic losses and instruments with no significant credit deterioration for which the credit losses are largely absorbed by the interest cash flows.

154 Users will be assisted by comprehensive disclosures that will help them understand the models, assumptions and inputs used to recognise expected credit losses. They will also find information about the absolute level of credit risk of financial instruments.

155 Preparers will benefit from the fact that existing credit risk management processes are capable of being leveraged to fulfil the IFRS 9 requirements.

Hedging

156 The hedging requirements of IFRS 9 are expected to bring the following benefits for preparers and users:

(a) Better consistency between accounting and risk management;

(b) Less need for non-GAAP information to explain hedge accounting to users; and

(c) Availability of standardised and more transparent information resulting in a better understanding of an entity's performance.

157 Given the objective of hedge accounting which is to be explained in the disclosures, under IFRS 9, hedge accounting requirements will be more closely aligned with risk management making it easier for them to explain how their risk management functions and users the opportunity to better understand these activities. This should contribute to better economic decision making through improved financial reporting. This is especially the case for corporates as the standard allows for hedge accounting of non-financial risk components which will better reflect commercial reality.

158 The new hedge effectiveness requirements, including the possibility to rebalance a hedge accounting relationship, will benefit users and preparers as effectiveness will be assessed based on the (continuing) existence of an economic relationship between hedged item and hedging instrument and not based on breaches of bright lines.

159 IFRS 9 considers the time value of an option as a premium paid for protection against risk and, consequently, aligns the accounting for the time value with the risk management perspective. This will be beneficial for users and preparers as the time value paid is treated as a cost of hedging instead of as held for trading with the resulting volatility recognised in profit or loss.

160 IFRS 9 requires comprehensive information to be disclosed in a single note to allow users to understand the effects of hedge accounting on the financial statements. In addition, the disclosures provide a higher level of transparency on hedge accounting activities which would permit users to more readily develop their view of an entity's risks and how they are hedge accounted for.

Conclusion – benefits for preparers and users

161 Overall, EFRAG's initial assessment is that users are likely to benefit from IFRS 9, as the information resulting from it will be relevant and transparent and therefore will enhance their analysis.

162 Also, EFRAG's initial assessment is that preparers are likely to benefit from IFRS 9 due to the reasons stated above.

Overall conclusion regarding costs and benefits

163 EFRAG's initial assessment that is based on all practical expedients being available to preparers is that the overall benefits for preparers and users in implementing IFRS 9 are likely to outweigh costs for both preparers and users associated in implementing those requirements.

164 EFRAG acknowledges that this may not be the case for insurers, unless the effective date of IFRS 9 and the forthcoming insurance contracts standard are aligned.

165 When taking into account the benefits of a simpler classification and measurement model and the production of information that is easier to understand, the impairment model resulting in timelier recognition of credit losses and comprehensive disclosures, better possibilities for hedge accounting reflecting risk management practices, EFRAG believes that the benefits of IFRS 9 outweigh the associated costs.

Overall assessment with respect to the European public good

166 EFRAG believes that IFRS 9 will generally bring around improved financial reporting when compared to IAS 39. As such, its adoption is conducive to the European public good in that improved financial reporting improves transparency, lowers the cost of capital and assists in the assessment of management stewardship.

167 EFRAG has considered whether there are any other factors that would mean adoption is not conducive to the public good. The other factors considered were:

(a) The impact of lack of convergence with US GAAP;

(b) The implications for issuers, including with respect to their investment decisions; and

(c) The costs and benefits of adoption.

168 In assessing these issues, EFRAG has identified some areas where it is possible that adoption of IFRS 9 may not be conducive to the European public good. However, taking into account the improved financial reporting brought about by IFRS 9, EFRAG, on balance, believes adoption of IFRS 9 is conducive to the European public good.

169 In making this assessment, EFRAG highlights the important linkages between IFRS 9 and the forthcoming insurance contracts standard: especially with respect to mandatory effective dates. EFRAG believes alignment, if possible, between these dates would reduce the costs for preparers and users.

Appendix 4: Endorsement Advice: IFRS 9 *Financial Instruments* – Matters for Consideration

1 This Appendix to EFRAG's Draft Endorsement Advice Letter describes how EFRAG considered the matters raised by the European Commission in the Appendix to the letter requesting endorsement advice on IFRS 9 *Financial Instruments*.

Status of the matters for consideration

2 The following table identifies how the matters for consideration have been addressed in the [draft] endorsement advice.

Matter for consideration	Where addressed
1. Insurance accounting: Inter-relationship between IFRS 9 and IFRS 4 Revised (not yet finalised)	(not yet finalised)
2. Use of Fair Values	Appendix 3, paragraphs 7 to 20
3. Impairment	Appendix 3, paragraphs 21 to 36
4. Hedging	Appendix 4, paragraphs 3 to 9
5. Convergence	Appendix 3, paragraphs 61 to 83
6. Prudence	Incorporated within Appendix 2

Insurance accounting: Inter-relationship between IFRS 9 and IFRS 4 Revised (not yet finalised)

Note to EFRAG Board members: please refer to the document prepared for ASAF on insurance for this issue and consider whether additional information should be sought through the public consultation on the draft endorsement advice or before public consultation.

Hedging

3 The EU carve-out affects a number of paragraphs in IAS 39 *Financial Instruments: Recognition and Measurement*. IAS 39 will continue to contain these paragraphs even though IFRS 9 has deleted all other parts of IAS 39 applied.

4 The paragraphs affected by the carve-out can continue to be accessed, and entities applying IFRS 9 can do this in one of two ways:

(a) An entity may elect to continue to apply all of the hedge accounting requirements in IAS 39, rather than applying the hedge accounting requirements in IFRS 9 (Scope 1); or

(b) An entity that elects to apply the IFRS 9 hedge accounting requirements may elect to apply the IAS 39 requirements for fair value hedge accounting of the interest rate exposure of a portfolio (Scope 2).

Scope 1: Apply the hedge accounting requirements of either IAS 39 or IFRS 9

5 The transitional provisions of IFRS 9 include an accounting policy choice allowing entities to continue to apply the hedge accounting requirements of IAS 39 instead of the requirements of IFRS 9 for all of their hedges. This accounting policy choice is made when an entity first applies the Standard.

6 In order for this accounting policy choice to be effective for entities which rely on the carve-out, the paragraphs of IAS 39 which relate to the carve-out need to remain in existence. This is the case with the amendments that IFRS 9 makes to IAS 39.

Scope 2: Application of IFRS 9 and IAS 39 portfolio fair value hedge

7 IFRS 9 permits that for a fair value hedge of the interest rate exposure of a portfolio of financial assets or liabilities (and only for such a hedge), an entity may apply the hedge accounting requirements in IAS 39 instead of those in IFRS 9. In that case, the entity must also apply the specific requirements for the fair value hedge accounting for a portfolio hedge of interest rate risk and designate as the hedged item a portion that is a currency amount.

8 This means that an entity would be able to apply the carve-out to a portfolio fair value hedge of interest rate risk (and only for such a hedge), while applying IFRS 9 to all its other hedges.

Update of the EU carve-out necessary for editorial reasons

9 IFRS 9 slightly changes one of the carved-out paragraphs of IAS 39, without affecting the substance of the carve-out. As a consequence, it would be necessary for a legal expert to assess whether an update of the relevant paragraph is needed.