EFRAG STAFF PAPER FOR PUBLIC MEETING

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IFRS 9 Financial Instruments DEA

Dissenting opinion - draft

1 The dissenting TEG member has several different reasons for dissenting the endorsement of IFRS 9. Following the order of the EFRAG DEA, the arguments are as follows.

2 The TEG member shares the Commission's initial view, later abandoned, that the standard should be endorsed when the whole review of the financial instruments standard is completed. The reason being that this is the only way to evaluate all parts of the standard, making sure that all parts of the standard for measurement and classification of financial assets and liabilities are internally consistent. So far the most critical point that has been debated for a very long time – hedging of open portfolios – has not yet been concluded on and the result is an internally inconsistent standard in which some parts of the hedge accounting requirements require an alignment with risk management while others – portfolio hedging – continue to be a documentation exercise.

3 IFRS 9 also changes the classification categories by replacing the held-to-maturity and the loans and receivables categories with just one category with an argument of simplification. The TEG member believes that simplifications should not be made at the expense of quality, i.e. the TEG member believes that the alignment of the two categories have failed to recognize the inherent difference between tradable debt securities and originated loans with the effect that the borderline between which instruments should be measured at amortised cost and which should be measured at fair value have been drawn incorrectly. More explicitly the TEG member believes that the SPPI test puts too much focus on observable interest rates for originated loans and fail to understand the dynamics in the management of loans book and in which way they differ from the management of debt securities which are traded on a liquid market with the effect that the loans and receivables category merely is relevant for debt securities and not for originated loans.

4 The TEG member also believes that recycling should take place for equity instruments measured at fair value through OCI because the TEG member believes that the realization of fair value changes have an informative value and that the realization better aligns the P&L effects between equity instruments which have a low direct yield contra those with higher percentage of distributions of their total return. Contra arguments around the difficulty of finding a proper impairment model for those securities as a reason for non-recycling is considered weak by the TEG member since the TEG member believes that any impairment model is better than none as is the case with IFRS 9 which will never recognize impairments for equity instruments classified at fair value through OCI.

5 The TEG members also believe that reclassifications should take place when the reasons for the initial classification are not relevant anymore. IFRS 9 puts too much

focus on the business model of the entity on a portfolio level rather than focusing on if the reasons for the initial classification is still relevant when providing the principles for reclassification. Furthermore, the TEG member believes that the principles around reclassification are not consistent with the principles for hedge accounting since the latter do allow/require that hedge accounting discontinues when the hedge relationship no longer exists. The standard, as written, will give rise to accounting mismatches when the reason for choosing the fair value option is not there anymore, i.e. when the fair value option for a particular instrument does not reduce accounting volatility anymore.

6 The TEG member's strongest dissent is related to the impairment rules. The TEG member believes that P&L is overstated, at the portfolio level, if 100 % of interest income is recognized when there is an expected loss in the portfolio of assets for financial assets measured at amortised cost in P&L. However the IFRS 9 treatment of those expected losses fail to recognize that the contracts do contain a compensation for the inherent risk in the contracts. Contra to all other standards, IFRS 9 will require the recognition of a day-one loss for profitable contracts measured at amortised cost. The TEG member does not accept this simplification due to contra arguments around complexity since the complexity seems to be accepted in other standards. The TEG member also concludes that the standard is internally inconsistent in two different ways:

7 Equity is only reduced with expected losses at initial recognition if the instruments are measured at amortised cost both in P&L and in the balance sheet

8 Instruments measured at fair value in P&L have no initial recognition of expected losses at initial recognition.

9 Finally, the TEG member's most critical concern is around the endorsement criteria; "European Public Good". The reason given for changing the impairment rules was the G20's demand that IASB swiftly should make sure that loan losses was recognized earlier than had been the case with IAS39. The TEG member believes that the G20 asked for earlier recognition of loan losses to reduce the risk that financial institutions will enter into difficulties in future financial crises since the accounting rules would make sure that they would have built buffers in good times for future financial crises.

10 However, according to the TEG member, the impairment rules in IFRS 9 will have the opposite effect. IFRS 9, with a few exceptions, requires that expected losses are assessed based on the contractual maturities. According to the TEG member, this means that unlike the regulatory requirements, which focus on down turn expected losses, impairments under IFRS 9 will only be recognized based on the expected losses in the present business cycle. Therefore in good times the provisions will be small for high quality portfolios and no significant buffers will be built. Then, when the credit quality weakens in the portfolio, life time expected losses will be recognized based on the gross expected loss for a significant portion of the loan portfolios which will significantly reduce the size of equity in the financial institutions, significantly more than in the last financial crisis. To dampen this effect, the financial institutions will be incentivized, to shorten the duration of their loan portfolios already in good times to increase the possibilities of shrinking their loan portfolios quickly. The combination of these two effects are:

(a) Higher losses early in a financial crisis

(b) Shorter duration of the loan portfolios

11 Which will increase the risk that the lending capacity in Europe will shrink significantly more than in the last financial crisis. This in turn, according to the TEG member, increases the risk of worsening future financial crisis, since the lack of funding will risk that both large corporate and SMEs will have no access to funding which in turn will risk increase the defaults which in turn would risk creating even larger loan losses for financial institutions making the effect of future crisis even worse.