

THE CHAIRPERSON



Floor 46, One Canada Square,
London E14 5AA UNITED KINGDOM

t: +44(0) 20 7382 1770

f: +44(0) 20 7382 1771

www.eba.europa.eu

+44(0)20 7382 1765 direct
andrea.enria@eba.europa.eu

EBA/2015/D/138

Roger Marshall, EFRAG Board Acting President
European Financial Reporting Advisory Group
EFRAG
35 Square de Meeûs
B-1000 Brussels

26 June 2015

Subject: The EBA's views on the adoption of IFRS 9 Financial Instruments (IFRS 9)

Dear Mr Roger Marshall,

Following the IASB publication in July 2014 of IFRS 9: *Financial instruments* (IFRS 9) which replaces the current requirements in IAS 39 *Financial Instruments: Recognition and Measurements* (IAS 39), the European Commission (Commission) launched the endorsement process of the Standard in the EU in December 2014. To this end, the Commission requested EFRAG to provide its endorsement advice in accordance with the Regulation (EC) No 1606/2002 of the European Parliament and of the Council on the application of international accounting standards.

The EBA, as an observer in the EFRAG Board, is pleased to support the work of EFRAG towards providing endorsement advice to the Commission by providing input, in particular, from a prudential supervisory perspective.

The EBA has a strong interest in promoting sound and high quality accounting and disclosure standards for the banking and financial industry, as well as transparent and comparable financial statements that would strengthen market discipline.

The EBA's view on IFRS 9 is based on a qualitative assessment of the impact of IFRS 9 and on outreach activities with several European constituents. The EBA has already informally contributed to the discussions on IFRS 9 during the EFRAG Board meetings. The views provided in this letter are expressed for the purpose of providing an input for the draft endorsement advice published by EFRAG on 4 May 2015, on the basis of the information currently available to the EBA, which is of a qualitative nature. It is the EBA's understanding, via the outreach activities performed towards some banks, audit firms and banking associations, that reliable quantitative data relating to the impact of the adoption of IFRS 9 for EU banks are not yet available.

The EBA supports the timely adoption of IFRS 9 in the EU and the effective application of the Standard on 1 January 2018. IFRS 9 is, overall, an improvement compared to IAS 39 in the accounting for financial instruments; the changes on credit loss provisioning should contribute in addressing the G20's concerns about the issue of 'too little, too late' recognition of credit losses and improve the accounting recognition of loan loss provisions by incorporating a broader range of credit information.

In particular, the EBA supports the movement from an 'incurred' to an 'expected' credit loss model which should result in the earlier recognition of credit losses. In this respect, IFRS 9 is expected to address some prudential concerns and contribute to financial stability. The expected credit loss model is more aligned with existing regulatory practices (for banks¹ using an internal ratings-based (IRB) approach) which require the calculation of expected credit losses rather than incurred credit losses in order to determine banks' regulatory capital requirements.

The EBA conducted a preliminary qualitative assessment of the impact of IFRS 9 on investor and issuer behaviours including the impact on lending practices. The EBA found that whilst accounting may be one of the drivers of changes in these behaviours and practices, there are other aspects that have an influence on them (such as regulation, state of the economy and market competition) and therefore it is not possible at this stage to isolate the impact of the application of IFRS 9 on existing investor and issuer behaviour and lending practices.

The EBA acknowledges that the principles-based nature of some of the requirements of IFRS 9 may increase the use of judgment and that there are some aspects, related to the high quality and consistent implementation of IFRS 9, which should be addressed in the future in order to ensure that the application of the Standard is consistent with the objectives of IFRS 9. The EBA welcomes the work of the Basel Committee on Banking Supervision (BCBS) in the development of Supervisory Guidance on accounting for expected credit losses and the establishment by the IASB of the IFRS Transition Resource Group for Impairment of Financial Instruments (ITG) to provide support to stakeholders on the implementation of the impairment provisions of IFRS 9.

In addition to the support of the timely endorsement of the Standard, the EBA supports the application of the Standard on a single effective date for banks in the EU on 1 January 2018 in order to ensure, among other aspects, robust and high quality implementation of the Standard as well as comparability of banks' financial position.

Finally, the EBA is aware of several interactions with the prudential regulatory framework which will have to be analysed further during the implementation period in particular when quantitative impacts of the Standard become available.

¹ In this letter the reference to "banks" should be understood as "institutions" in accordance with Article 4.1.(3) of Regulation 575/2013 (CRR)

The EBA's overall views and supporting analysis on IFRS 9, including the impact on financial stability and investor and issuer behaviours, are set out in the Appendix to this letter.

Yours sincerely,

A handwritten signature in black ink, which appears to read 'Andrea Enria', is positioned below the closing text.

Andrea Enria

CC: Françoise Flores, EFRAG TEG Chairman

Encl: Appendix IFRS 9

Appendix

This Appendix sets out the EBA's main views on IFRS 9. To support its assessment, the EBA performed outreach activities with European constituents including banks, banking associations and audit firms.

Due to the operational changes that banks will have to undertake before applying IFRS 9 and the required investments in resources (for example the development of expected credit loss models which make use of 'point-in-time' estimates rather than 'through-the-cycle' estimates which are used for IRB banks; the tracking of the credit quality of the debtor; and the use of forward-looking information), it is not possible to separately identify and quantify the exact impact from the application of IFRS 9 currently. Therefore, the EBA's opinion is based on a qualitative assessment of the impact of IFRS 9.

The EBA's main view on the endorsement of IFRS 9

The EBA supports the timely endorsement by the European Commission of IFRS 9 which is, overall, an improvement compared to IAS 39. Timely endorsement should allow sufficient time for banks to make the necessary changes to achieve high quality application of the Standard by 1 January 2018. The timely endorsement of IFRS 9 will also provide certainty to banks which is necessary in order to prepare for its effective application.

The EBA sees merits in the classification and measurement model of IFRS 9 which will allow better consideration of the banks' business model and the characteristics of financial instruments. For instance, IFRS 9 removes the hold-to-maturity requirement and associated tainting rules which rendered the classification of quoted debt at amortised cost under IAS 39 difficult. In addition, IFRS 9 is more aligned to the risk management practices of entities, e.g. by incorporating more principles-based general hedge accounting requirements.

Overall, IFRS 9 requirements on expected credit losses are an improvement over the requirements in IAS 39, since they are based on the notion of 'expected' losses (requiring the use of forward looking information) rather than on 'incurred' losses and hence should lead to an earlier recognition of credit losses, affecting more financial assets and at a higher amount, which should work towards addressing some supervisory concerns.

A further improvement attributable to IFRS 9 compared to IAS 39 is the inclusion of the presentation of the impact of own credit risk of financial liabilities designated at fair value through profit or loss within other comprehensive income, rather than within profit or loss. This

avoids the recognition of a counter-intuitive impact in profit or loss such as gains when the own creditworthiness of an entity deteriorates and which may not be possible to be realised.

The EBA acknowledges that the principles-based nature of some of the requirements of IFRS 9 may increase the scope for judgment (such as in the evaluation of whether a financial asset meets the 'solely payment of principal and interest' ('SPPI') criterion or in the interpretation of a 'significant increase in credit risk') and hence may raise application issues. Similarly, some requirements (such as the identification and appropriate use of forward-looking information and the tracking of changes to credit risk) may create operational challenges in their implementation. However, on balance, we are of the view that the conceptual improvements offered by IFRS 9 outweigh the application and implementation challenges.

In this context, considering the importance of high quality, robust and consistent application of the new Standard, the EBA welcomes the current work of the Basel Committee on Banking Supervision in the development of a supervisory Guidance on Impairment² and the commitment of the IASB (through the IFRS Transition Resource Group for Impairment of Financial Instruments 'ITG') to enhance the robust and consistent implementation of the Standard.

In addition, from the outreach activities performed, the EBA understands that the main impact of IFRS 9 for banks will most likely be due to the new impairment requirements rather than the requirements on classification and measurement or general hedging. As mentioned above, we understand that the new impairment model should lead to an earlier recognition of credit losses, affecting more financial assets and at a higher amount than the current IAS 39.

Impact on financial stability

The EBA has considered whether IFRS 9 addresses prudential concerns and from that perspective whether it contributes to financial stability. The IFRS 9 expected credit loss model should contribute to financial stability by addressing the issue of timely recognition of expected credit losses, which was also a call from the G20.

IFRS 9 should lead to more timely recognition of provisions than IAS 39 (predominantly due to the earlier recognition of provisions for all exposures and the use of a broader range of information which includes forward-looking information). The EBA supports earlier recognition of provisions in

² The Basel Committee on Banking Supervision published on 2 February 2015 a consultative document on accounting for expected credit losses (<http://www.bis.org/bcbs/publ/d311.htm>). The objective is to provide banks and supervisors with guidance on supervisory requirements for sound credit risk practices to encourage a high quality, robust implementation and consistent application of an expected credit loss accounting model across all jurisdictions. The guidance emphasises the need for timely and adequate recognition of credit losses and includes specific supervisory requirements for jurisdictions applying IFRS such as: the consideration of forward-looking information and use of macro-economic factors; the collective and individual assessment of credit risk; the assessment of significant increases thereof; and the views on the use of practical expedients and simplifications in IFRS 9.

that the timely recognition of credit losses by banks contributes to the safety and soundness of the banking sector.

The additional disclosure requirements under IFRS 9 as compared to IAS 39, in particular those related to impairment and general hedge requirements, should also contribute to financial stability. More specifically, they will provide increased transparency to investors which should promote market discipline and produce an improvement in the assessment of the position of banks. The additional disclosure requirements will increase the level of transparency of banks' activities and risk profile providing useful insights for users of the financial statements, including supervisors.

On first application of IFRS 9, the impact for a bank will depend on several factors at the time of application, including bank-specific factors, such as the characteristics of the financial assets of a bank that may drive their classification and measurement; the level of provisions under IAS 39 and IFRS 9; and market and macro-economic conditions.

On classification and measurement, where the main changes apply to the asset side, there will probably be some shifts from amortised cost measurement to fair value measurement and vice versa on initial application of IFRS 9. This will depend on the business model and the characteristics of the instruments (including their complexity). For example, some instruments which could have been measured at amortised cost under IAS 39 (for instance, the host contract after the bifurcation of the embedded derivative) may not meet the 'SPPI' criterion and will need to be measured at fair value through profit or loss³ in their entirety under IFRS 9. Conversely, the removal of the hold-to maturity category and related tainting rules will allow the measurement of basic listed debt instruments (so long as this is consistent with the business model of an entity ('hold to collect')) at amortised cost which could have been measured at fair value under IAS 39. It is therefore difficult to ascertain whether there will be significantly more financial assets measured at fair value or amortised cost as compared to IAS 39.

The EBA understands that the interaction between IFRS 9 and the revised IFRS 4 *Insurance contracts* may have an impact on the classification and measurement of the financial instruments of banking groups holding insurance subsidiaries. In this regard, we understand that the IASB is currently considering this issue as part of the re-deliberations of IFRS 4 in order to address constituents' concerns. The EBA's view is that this should not be an impediment to the timely adoption of IFRS 9.

Interaction with prudential requirements

The impact of the replacement of IAS 39 with IFRS 9 needs to be considered since the Standard interacts with some existing prudential requirements – for example the capital treatment of

³ Except for equity instruments where IFRS 9 includes the option to measure them at fair value through OCI

provisioning; the prudential filters on the previous Available-for-Sale category under IAS 39; the classification under IFRS 9 of the regulatory liquidity portfolios held as buffers; and the supervisory reporting requirements (e.g. FINREP). Below is a description of some of the interactions between the accounting and the prudential requirements. This should not be considered an exhaustive list.

These interactions need to be further assessed to consider if and to what extent the regulatory framework would need to be revised in light of the interaction with the changes from IFRS 9, in particular the impact on own funds of the expected credit loss models used for accounting purposes. The EBA will also contribute to the developments at the BCBS and will collaborate with the Commission should changes be required at the legislative level.

However, the EBA has not identified at this early stage any major issue related to the interaction between IFRS 9 and prudential requirements which could be an impediment in the timely adoption of the Standard.

- Capital treatment of provisioning

The capital treatment of provisioning is different for banks using the standardised approach (SA) and those using the IRB approach.

SA approach

Impairment allowances are considered in the exposure value. However, 'general' allowances (general credit risk adjustments according to Regulation 575/2013 - CRR) are included in Tier 2 up to a limit of 1.25% of risk-weighted assets (RWAs).

IRB approach

Banks need to compare the impairment allowances under the accounting rules with the regulatory expected losses (EL). Any shortfall of impairment allowances compared to the EL is deducted from Common Equity Tier 1 (CET1). Any excess of impairment allowances compared to the EL is added to Tier 2 capital up to a limit of 0.6% of the RWAs.

It should be considered if and to what extent the regulatory framework described above should be revised in light of the interaction with the Standard. For instance, attention is drawn to the Commission Regulation 183/2014 (EBA RTS on Credit Risk Adjustments) which lays out the requirements related to the specification of the calculation of specific and general credit risk adjustments and may need to be amended in light of the changes to IFRS 9.

The requirements for the measurement of expected credit losses are different for regulatory and for accounting purposes. For instance, there are differences in the calculation of the probability of

default (PD) and the loss given default (LGD) (for prudential purposes the PD is estimated in many cases through the cycle and always based on 12 month time horizon and the LGD is based on a downturn in economic conditions). Nevertheless, banks under the IRB approach may benefit from existing experience and use the data, methods and processes for regulatory requirements as necessary for the measurement of accounting expected credit losses. This should, for those banks applying the IRB approach, alleviate some of the cost burden by leveraging on the use of existing resources.

- Prudential filters

Under Article 35 of the CRR, *institutions shall not make adjustments to remove from their own funds unrealised gains or losses on their assets or liabilities measured at fair value*. The CRR includes a transitional period⁴ for the removal of prudential filters which were applied to the Available-for-Sale category of financial assets under IAS 39. Under IFRS 9, the Available-for-Sale category of classification and measurement will not exist, and financial assets which are classified in the fair value through other comprehensive income category under IFRS 9 will not be subject to prudential filters under the CRR.

As a reminder, the EBA submitted on December 2013 a technical advice to the Commission on the possible treatments of unrealised gains measured at fair value other than including them in Common Equity Tier 1 without adjustment under Article 80(4) of the CRR.

- Liquidity buffer

The CRR requires banks to hold a minimum liquidity buffer within their assets. This liquidity buffer, amongst other requirements, is subject to a liquidity test. This means that a representative sample of these assets shall regularly, and at least once a year, be monetised (via outright sales or repos). These regulatory requirements may have to be considered in the classification of assets in different categories under IFRS 9 (see also Example 4 of IFRS 9 B4.1.4). Based on our outreach, we understand that banks will still be able to classify some of the assets included in the liquidity buffer at amortised cost and others at fair value (subject to meeting the IFRS 9 criteria for classification and measurement)

⁴ Article 467 and 468 of the CRR include the transitional provisions for unrealised gains and losses. In addition, under Article 467 of the CRR institutions may not include in any element of own funds unrealised gains or losses on exposures to central governments classified in the 'Available for Sale' category of the EU-endorsed IAS 39, if permitted by the competent authority and this treatment was applied before 1 January 2014. This treatment shall be applied until the European Commission has adopted a regulation on the basis of Regulation (EC) No 1606/2002 endorsing the International Financial Reporting Standard replacing IAS 39.

- Reporting requirements for supervisory purposes

The introduction of IFRS 9 will have an important impact on the reporting requirements for supervisory purposes (i.e. FINREP). The EBA will assess which changes need to be made in the current reporting templates to adapt for IFRS 9 and will consider if needed providing adequate implementation period for the changes to be introduced.

- Prudent valuation adjustments

On January 2015 the EBA submitted to the Commission the Regulatory Technical Standard (RTS) which lays out the requirements related to the prudent valuation adjustments of fair valued positions⁵. As IFRS 9 may result in shifts between measurement methods and therefore changes to the scope of financial instruments measured at fair value, this will result in a change of those financial instruments subject to prudent valuation requirements.

Impact on investor and issuer behaviours

At this stage and based on the outreach activities conducted by the EBA, it is too early to have a complete understanding of the changes that IFRS 9 may bring to investor and issuer behaviours, including their lending practices (for example on pricing, maturity, types of product), as these impacts may not be visible until the Standard is in place and applied by banks.

However, based on the feedback received, the EBA believes that the impact on investor and issuer behaviours, including the impact on lending practices will likely depend on several additional factors other than IFRS 9 (such as market competition as well as changes related to regulation and state of the economy), which may be stronger drivers of changes in practices and behaviours than those related to the application of IFRS 9.

Single effective application date of IFRS 9

The EBA supports the timely endorsement of the Standard by the Commission, including the application of the Standard on a single effective date for all EU banks of 1 January 2018.

The EBA's view is based on the following considerations:

- Banks may need to undertake significant operational changes including developing models and internal processes in order to ensure high quality implementation of IFRS 9. Hence, banks would likely need a sufficient transitional period in order to achieve this in a robust manner and so an earlier application of IFRS 9 than January 2018 may not be feasible in practice.

⁵ <https://www.eba.europa.eu/regulation-and-policy/market-risk/draft-regulatory-technical-standards-on-prudent-valuation>

- Different application dates among EU banks may lead to less comparability of the financial position of banks applying IFRS 9 and those applying IAS 39 and therefore may have an adverse impact on the supervisory assessment. In addition, the assessment of information provided by banks for supervisory reporting will become more complex and operationally burdensome if it is based on two sets of accounting standards (IAS 39 and IFRS 9).

The EBA believes that the Commission could consider the early application of the amendments introduced by IFRS 9 to allow the presentation of the changes in own credit risk within Other Comprehensive Income⁶, rather than the Profit or Loss. This is in line with the EBA's long-standing position that it is not useful to recognise these gains and losses in Profit or Loss⁷. It should also be noted that from a prudential perspective, own credit risk is removed from own funds.

⁶ IFRS 9 (paragraph 7.1.2) allows the early application of these requirements.

⁷ See EBA response to question 8 of the Exposure Draft Classification and Measurement: Limited Amendments to IFRS 9 (<http://www.eba.europa.eu/documents/10180/16112/2013-03-27--Let-to-Hoogervorst---IASB---signed-.pdf>)