27 March 2013

Our ref: ICAEW Rep 52/13

Your ref: ED/2012/4

Hans Hoogervorst
Chairman
International Accounting Standards Board
30 Cannon Street
London
EC4M 6XH

Dear Hans

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

ICAEW is pleased to respond to your request for comments on ED/2012/4 *Classification and Measurement: Limited Amendments to IFRS 9.*

Please contact me should you wish to discuss any of the points raised in the attached response.

Yours sincerely

Eddy James FCA
Technical Manager
Financial Reporting Faculty

T +44 (0)20 7920 8701
E eddy.james@icaew.com

ICAEW REPRESENTATION

ED/2012/4 CLASSIFICATION AND MEASUREMENT: LIMITED AMENDMENTS TO IFRS 9

Memorandum of comment submitted in March 2013 by ICAEW, in response to IASB's exposure draft ED/2012/4 *Classification and Measurement: Limited Amendments to IFRS 9* published in December 2012.

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INTRODUCTION

1. ICAEW welcomes the opportunity to comment on the exposure draft ED/2012/4 *Classification and Measurement: Limited Amendments to IFRS 9* published by the IASB on 28 November 2012, a copy of which is available from this link.

WHO WE ARE

2. ICAEW is a world-leading professional accountancy body. We operate under a Royal Charter which obliges us to work in the public interest. ICAEW's regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the UK Financial Reporting Council. We provide leadership and practical support to over 140,000 member chartered accountants in more than 160 countries, working with governments, regulators and industry in order to ensure that the highest standards are maintained.

3. ICAEW members operate across a wide range of areas in business, practice and the public sector. They provide financial expertise and guidance based on the highest professional, technical and ethical standards. They are trained to provide clarity and apply rigour, and so help create long-term sustainable economic value.

4. The Financial Reporting Faculty is recognised internationally as a leading authority on financial reporting. The Faculty's Financial Reporting Committee is responsible for formulating ICAEW policy on financial reporting issues, and makes submissions to standard setters and other external bodies. The faculty also provides an extensive range of services to its members, providing practical assistance in dealing with common financial reporting problems.

THE BIGGER PICTURE

Introduction

5. Before turning to the specifics of these proposals, we thought it would be sensible to first step away from the detail and look at the bigger picture. This section therefore provides some high level observations not only on the financial instruments project and its interaction with the insurance project but also on wider financial reporting issues.

We believe that financial reporting should reflect an entity's business model

6. The idea of reflecting entities' business models in financial reporting is not a new one as assumptions about business models have always been implicit in financial reporting standards. For example, it has always been the case that different entities will account for similar assets in different ways depending on what its role is in their business model - so the same asset might be a fixed asset in one entity, an investment property in another and an item of inventory in a third, depending on their business model. Likewise, revenue recognition is also tied to the interpretation of an entity's business model and therefore differs from sector to sector and entity to entity. The role of business models is therefore already pervasive in financial reporting as we know it. However, explicit references to business models are a more recent phenomenon which has mainly emerged as part of the project to replace IAS 39.

7. There are, of course, some practical difficulties that flow from the business model approach that reflect the reliance on management intentions and the diversity and changeability of business models. However we are nonetheless broadly supportive of such an approach as we believe that if financial reporting is to tell us how successful an entity's business model has been, we would expect it to reflect the model on which it is reporting.

8. We are therefore supportive of the Board's attempts to put the business model at the heart of IFRS 9. However, an entity's business model is more than a mere accounting construct. It is, put simply, how a business creates, delivers and captures value. Standard-setters should not, therefore, seek to put parameters on what an entity's business model can or cannot be. Unfortunately, this is exactly what the Board appears to be doing.

9. It is essential that the Board takes the time to get this right. The current quick fix proposed may, in the short-term, appear to solve some of the problems of application and international comparability that the Board have highlighted. It may also, at first glance, appear to solve the conundrum that is how IFRS 9 should interact with the insurance contracts project. But, as we discuss further below, many of these perceived successes are unlikely to endure. If the Board does not find a way of truly reflecting entities' business models in their financial statements, we believe that they will have to return to it again and again as more and more application issues arise. We therefore urge them to rethink their current proposals.

What is being proposed is not really a business model approach

10. Putting aside the characteristics of the instrument, the proposals focus on reporting financial instruments based on an entity's business model. However, what the Board is proposing is so restrictive that it will, in our view, not enable entities to do just that in many situations. The complexity and diversity of different entities' actual business models simply does not fit into the standardised accounting classifications resulting from the Board's generic assessment.

11. Business models are often about more than just groups of homogenous assets. In reality they may also relate to portfolios containing a wide variety of assets (for example, some portfolios may include bonds, gilts, commercial properties, equities and derivatives) or may recognise the inherent link between groups of financial assets and related financial liabilities. The relationship between financial assets and financial liabilities is particularly important to understanding how financial services businesses derive value and banking businesses and insurance business do this in different ways.

12. Therefore, the restrictions of the proposed model will be felt most acutely in the banking and insurance sectors, where business models are often complex and the linkage between financial assets and financial liabilities particularly important. The current draft simply does not reflect how either do business. Moreover, it will result in some financial assets being classified in ways that do not reflect their business models.

13. In practice, the proposals would result in financial assets being classified primarily based on their nature rather than on the entity's business model. In this regard it is moving closer to the IAS 39 model and if this is the direction that the Board wishes to pursue we would encourage them to be more open about this and to drop the reference to business models within the standard. Classification primarily based on the nature of the instrument would also enable the Board to align its approach with that of the US standard-setters. While this may be desirable in some regards, we are not convinced that this is the correct path to follow. We continue to encourage the Board to put the development of high-quality principals-based standards first. The pursuit of a converged solution is a secondary consideration.

14. We would prefer the Board to explore ways in which it could develop a purer business model driven reporting framework. We make some suggestions as to how this could be achieved in the more detailed analysis of the exposure draft below.

FVOCI is not a panacea

15. The feedback the Board received after publishing the 2010 version of IFRS 9 suggests that many businesses – particularly those in the financial sector – felt that the two category classification model did not adequately reflect their business models and that some financial assets would consequently be classified in a manner that they felt was inappropriate. The Board has responded by proposing that a third category should be introduced that would allow certain financial assets to be measured at FVOCI. While this may resolve some concerns and mean that some financial assets are measured in a more appropriate manner in some circumstances, it is by no means a panacea.

16. Many banks continue to struggle to see how their business models fit into the framework being proposed. On the one hand, many may welcome the introduction of a FVOCI category because they see it as an improvement on IFRS 9's original model, which would have forced certain assets to be held at FTVPL because they did not meet the hold to collect business model. But on the other hand, they often contend that if the financial reporting is to truly reflect their business model then certain of these assets should best be measured at amortised cost. It seems that many of them would actually prefer a two category model but with a more principles-based, business model-centric approach to determining how groups of financial assets and/or financial liabilities are measured. In particular, for those portfolios which fund amortised cost deposits and are seen as an extension of the amortised cost business model, FVOCI may be preferable to FTVPL in that net income does not contain accounting mismatches, but the balance sheet is not matched and the movements through OCI are merely the balancing figure and meaningless in the context of the entity's actual business model.

17. Many in the insurance sector acknowledge that the introduction of a FVOCI category would reduce mismatches between how they manage some classes of their business and how they report their financial performance. However, they also contend that the proposals could, for other classes of business, introduce significant mismatches due to the interaction of the proposals and the tentative decision in IFRS 4 to mandate the use of OCI for movements in insurance liabilities. To ensure a fair presentation of an insurer's performance, we believe that there must be the opportunity to present changes in insurance liabilities and the associated backing assets together – either in net income or in OCI. As currently drafted, the restrictive nature of the proposed model does not adequately reflect insurers' business model represented by long-term asset-liability management strategies.

18. Both banks and insurers simply want the accounting to reflect their business models, including the inter-relationship between financial assets and financial liabilities. Unfortunately it appears that by focusing only on homogenous portfolios of assets it will be an almost insurmountable challenge to set accounting classifications resulting from the Board's generic assessment of business models. It is certainly one that is unlikely to be overcome unless the Board abandons what is increasingly looking like a rules-driven regime and truly embraces a business model driven approach.

Introducing a sector specific standard for the insurance industry – rather than just insurance contracts – may be necessary

19. In our view, the Board should not make hasty changes to IFRS 9 in order to accommodate the possible outcome of an insurance contracts project that – even after 17 years or so – is still in progress. It would be preferable for the Board to wait until the final proposals from the insurance contracts project are published before deciding on how related assets should be accounted for. Only then will it be in a position to make a more balanced assessment of whether introducing a mandatory third measurement category is appropriate.

20. A more holistic approach to insurance accounting would be welcome. Although we are not generally supportive of industry-based standards, given the complexity of the sector's business models, it may be that the insurance industry is the exception and would be best served by an industry-specific standard.

Financial statement presentation needs further consideration

21. We reiterate our long-standing concern about the lack of a clear conceptual basis behind which items are reported in profit or loss and which are reported in OCI and urge the Board to better articulate what types of gains and losses should be presented where and in which circumstances they should be recycled as part of its recently restarted project on its *Conceptual Framework*.

The effective date of IFRS 9 should be further deferred

22. In our representation letter in response to ED/2011/3 *Mandatory Effective Date of IFRS 9,* while we strongly agreed that the mandatory effective date of IFRS 9 should be postponed, we questioned whether an effective date of 1 January 2015 would be achievable. It seems that our assessment was correct as it appears increasingly unlikely that the remaining phases of the project will be completed in time to allow for adoption in 2015.

23. We note the consequential amendment within the expected credit loss exposure draft that would remove the effective date from IFRS 9, which is helpful. Nonetheless, we recommend that the Board act promptly to start the due process necessary to formally delay the effective date of IFRS 9. Doing so would allow companies sufficient time to prepare for the significant changes that lie ahead. This is particularly important for US foreign private issuers who, in the absence of a change to the existing standard, will need to start preparing to adopt the 2010 version of the standard for 2015.

24. We also reiterate our belief that the timing of the mandatory introduction of IFRS 9 and the new insurance standard will require careful consideration to avoid successive changes for insurers. The mandatory adoption date for both of these standards should be three years after their finalisation. Introducing these standards with non-concurrent effective dates could result in unforeseen problems for some entities, particularly insurers and bancassurers.

25. The remainder of this response assumes that the Board is unable to take the time needed to properly develop an accounting model that reflects varying business models and provides feedback on the assumption that IFRS 9 is finalised along the lines of the exposure draft.

MAJOR POINTS ON THIS EXPOSURE DRAFT

Overall we do believe the proposed amendments have met their objectives

26. We note that the proposed amendments to the 2010 version of IFRS 9 have three objectives:

- To address specific application questions;
- To take into account the interaction with the IASB's insurance project; and
- To reduce key differences with FASB's financial instrument model.

27. In our view, the exposure draft does not fully address the valid concerns raised by the application questions. Moreover, it potentially creates more issues than it resolves with the insurance project which, in any case, has not yet been finalised.

28. In addition, we do not support reducing differences with FASB at the price of reducing the quality of IFRS reporting. In our view, the introduction of a mandatory FVOCI category, together with the perceived narrowing of the amortised cost category, is not an improvement to IFRS 9. Therefore, overall we do not support the proposed amendments.

29. Putting to one side the eventual outcome of the insurance contracts project, we have sympathy for many of the arguments in the alternative views on the exposure draft set out by Messrs Cooper and Engström. In particular, the introduction of a FVOCI category results in:

- Additional complexity.
- Additional confusion about the purpose of OCI and recycling.
- The risk that the IFRS 9 categories are interpreted in a manner which undermines the concept of the business model.
- Changes for the benefit of convergence with US GAAP which may not result in the highest quality standard, which are not consistent with the FASB text on business models and which may not in fact result in convergence if the Boards end up with different impairment models.

- The risk that there is such little difference in practice with IAS 39 that the overall costs of implementing a new standard may exceed any benefits.

We do not support seemingly arbitrary restrictions on the use of amortised cost where its use reflects the business model

30. The Board has stated that the clarifications to the ‘hold to collect’ business model are not intended to narrow the scope of this category when compared to that in the original standard. However, by putting a much more direct emphasis on the volume of sales – rather than on the reasons for those sales and how they fit within an entity’s business model – it appears that the clarifications do just that. Where the main purpose of a portfolio and its underlying business model is to ‘hold to collect’, and sales are incidental to the business model, we do not agree that this should fall into the FVOCI category merely as a result of concerns about the actual or potential frequency of such sales.

31. While the 2010 version of the standard had not yet been widely applied and the constituency has not yet developed a common understanding of how the ‘hold to collect’ business model should operate in practice, the proposed clarifications together with the existence of the FVOCI category appear to restrict unduly the scope of amortised cost. For banks, this may have the undesirable consequence of making the actual business model essentially irrelevant and FVOCI effectively the default category with broadly the equivalent of IAS 39 ‘loans and receivables’ and ‘held to maturity’ items being capable of meeting the ‘hold to collect’ business model, with all portfolios that are not trading or derivatives being included in FVOCI. If that is the result in practice, it would be more straightforward to base classification on the type of instrument, as is the case under IAS 39, without reference to the business model.

32. It is likely that banks will not consider that the outcome properly reflects their view of their business models. Therefore the proposals do not represent an improvement to existing practice under IAS 39. Moreover, their application will result in financial statements that continue to be difficult to relate to their underlying business.

33. We note that the changes to hedge accounting were intended to better reflect risk management in financial reporting, which we regard as a step in the right direction. In this context, a classification and measurement standard that is likely to be interpreted in way that makes business models essentially irrelevant would be disappointing.

34. Another undesirable consequence could be that portfolios that are considered to be part of a ‘hold to collect’ business model are divided so that sales only occur out of the half of the portfolio that is classified as FVOCI even though there is little difference in the purpose and management of the portfolio as a whole. Such interpretations could result in the accounting failing to represent the entity’s business model and one of the main benefits of IFRS 9 being lost.

35. In our view, a better solution would be to maintain two classifications while putting a greater emphasis on the objectives of the business model, how such portfolios are managed and the reasons for sales being within the objective of the business model. For example, a documented business model for a bank’s liquidity portfolio could be to maintain the portfolio within established risk parameters (credit, interest rate risk and liquidity) to match the amortised cost liabilities which the portfolio funds. Sales necessary to achieve this objective, which are not of a trading nature, will depend on the operation of the markets and changes to the related liabilities and should not call into question the business model. Nor should sales necessary to meet regulatory requirements, such as those made in order to optimise the portfolio and reduce the cost of holding it. Sales outside the established risk parameters would need to be investigated to see if they indicate a change in business model. Such an approach – and retaining the insurance rebalancing example – would, in our view, clarify the scope of the amortised cost category and make it possible to better reflect an entity’s business model while maintaining two categories.

36. Even under a three category model, putting a greater emphasis on the objectives of the business model would also clearly differentiate the IASB business models from those of the FASB. Since the FASB proposals use identical labels but different language to describe the business models, the IASB will either need to adopt the FASB language (if the intention is to converge fully) or clearly explain where their model is different. Otherwise, market practice is likely to result in IFRS 9 being interpreted in line with US GAAP even if there are differences in the wording.

We question whether FVOCI meets users' needs

37. In the banking context, we have difficulties understanding the 'hold to collect and sell' business model. Rather than being a meaningful way to describe a business model, it seems like an accounting construct to address portfolios which are generally 'hold to collect' but which will fail to qualify as such as a result of the volume of sales. It is asserted that it provides useful information for net income to be reported on an amortised cost basis and for sales to be separately disclosed in line with the disclosure requirements for amortised cost. It is also asserted that it is useful for fair values to be reported in the balance sheet. This results, however, in balancing figures being reported in OCI which will be difficult for preparers to describe and for users to understand.

38. While we agree that amortised cost information is useful in net income, we do not agree that including fair values on the balance sheet is so important that it should impair the usefulness of OCI and the financial statements as a whole and produce different – and as a result confusing – views of the entity's business model across the primary statements. Rather disclosure of fair values, including roll forwards of fair value balances for these portfolios which would show the entire fair value movement for the period (rather than reporting some in net income and some in OCI), seems more straight forward and more likely to meet users' needs. Since these fair values are unlikely to be level 3 and since the disclosure can be mandated for interim reporting, users would have no concerns about the quality or timeliness of this information.

39. The introduction of FVOCI with recycling for debt securities further exacerbates confusion over the purpose of net income and OCI and highlights inconsistency of treatment with equity securities that are also FVOCI without recycling and the treatment of 'own credit' for certain liabilities where the component of fair value taken to OCI is also not recycled on derecognition of the liability.

40. Nevertheless, we strongly agree that amortised cost provides the most useful information in net income for the portfolios that are likely to fall within the FVOCI category. Therefore, if it is not possible to clarify 'hold to collect' as we suggest or to provide fair value disclosure as suggested above, we would accept the introduction of a FVOCI category as being a less bad solution than including such portfolios at fair value through profit or loss. This is because we believe it is fundamentally important to ensure that the income statement and net income reflect the business model of the entity as closely and as clearly as possible, in spite of the fact that the balance sheet will not do so. A FVOCI category may also be a business model relevant to some insurance businesses, in which case it would be helpful for it to be appropriately articulated within this context.

We question whether a mandatory FVOCI category works appropriately with the insurance proposals

41. Insurance accounting is particularly difficult as a result of the wide variety of contracts which vary depending on local regulatory and tax rules which makes it unlikely that a single form of accounting will satisfy all concerns and gain universal agreement.

42. The matching of assets and liabilities – whereby insurance liabilities, guarantees and related assets, including derivatives, are managed together – is central to the business model of insurers. While we believe that the accounting should reflect this linkage, it is not adequately reflected in the exposure draft and its interaction with the current proposals for IFRS 4 phase

2. For example under the proposals, FVOCI is required to be used where the entity has a business model that involves both 'hold to collect' and selling. Some insurers may have large portfolios with insufficiently frequent or significant sales to qualify for FVOCI and this will give rise to an accounting mismatch as their portfolios will be required to be carried at amortised cost. Other insurers may have investments in financial assets which do not qualify for FVOCI because they do not meet the solely payments of principle and interest (SPPI) test or because they hold derivatives or equities as part of their overall investment strategy. This may result in assets that are managed together and which back the same portfolio of insurance contracts being reported in three different ways: some at FVTPL, some at FVOCI and others at amortised cost. If related changes in assets and liabilities are reported in different places, performance reporting becomes meaningless.

43. To adequately reflect insurers' asset-liability matching strategies, one solution could be allowing FVOCI measurement to be available where it is consistent with the business model eg, for all asset classes that back insurance contract liabilities.

44. While insurers do use simple debt instruments to match insurance liabilities, the asset strategy is often more complex and may involve, for example, the use of derivatives to diversify credit exposure and manage interest rate risk. Other asset classes held to match insurance liabilities may include investments in equities, investment properties, mortgages and other loans. If insurers' business models are to be adequately reflected with matching in OCI, the availability of FVOCI would need to be extended to cover a wider scope of asset classes without limitation due to cash flow characteristics. Failure to do so would arguably create unnecessary accounting mismatches which would obscure the financial performance reporting for users.

45. Although IFRS 9 has a FVOCI category for equity instruments, the restriction on recycling means that this approach is not consistent with the nature of the insurance liability. This is particularly so for participating contracts, where the investment returns (including gains and losses) are ultimately passed to the policyholder.

46. Notwithstanding the above, there are circumstances where FVTPL provides better information. We therefore welcome the proposed introduction of the FVTPL option for assets that would otherwise be classified as FVOCI. However, we believe that an unconditional option to classify both assets and insurance liabilities at FVTPL should be available. We interpret the IASB's current definition of a business model as requiring assets which are managed with regard to both collection of cash flows and for sale to be classified as FVOCI. As currently drafted the definition of a 'held to collect and for sale' business model will require debt instruments backing certain insurance contracts to be classified as FVOCI, while other assets backing these contracts will be classified as FVTPL. This inconsistent income statement treatment for assets managed together backing the same contracts would result in an accounting mismatch which would obscure the financial performance reporting for users. The FVTPL option due to accounting mismatch in IFRS 9 may not be available for these contracts if IFRS 4 Phase 2, as currently proposed, requires interest rate movements on liabilities to be reported in OCI. As such, the interest rate movements would be reported in OCI for the liability and for some of the assets but other assets (eg, derivatives) would have their interest rate movements reported in profit or loss; therefore, there is a need for an unconditional FVTPL option.

47. The above views are tentative because, in order to assess fully the impact on insurers, we would need to first understand the inter-linkage of the Board's accounting alternatives for assets and liabilities in both IFRS 9 and IFRS 4. Once the insurance project is finalised and there is a better understanding of the balance of concerns about volatility in profit or loss versus concerns about complexity and the creation and elimination of accounting mismatches, the Board will be better placed to assess the interaction between a finalised financial instrument standard and insurance contracts and thus any consequential amendments may be needed either to IFRS 9 or to the insurance standard. It may also be possible – and we would prefer this approach to be investigated by the Board – to restrict amendments only to correct those impacts that arise from the interaction of IFRS 9 and the insurance standard, thus leaving IFRS 9 intact for other entities.

We are not convinced that the solely payments of principle and interest test will adequately address concerns

48. While we agree that some notion of materiality may need to be explicitly included in the SPPI test, we are concerned that the test in the exposure draft will be interpreted in an overly restrictive manner and will not result in all financial assets which are in a reasonable 'hold to collect' business model being classified appropriately.

IAS 39 should be amended to expedite the availability of the 'own credit' provisions

49. We agree that entities should be permitted to early adopt the 'own credit' provisions of IFRS 9. However, we are concerned that this option will only be available once the remaining phases of IFRS 9 have been finalised which may be some time yet. We therefore request the Board to further expedite the availability of these requirements by amending IAS 39 to align it to IFRS 9's requirements regarding 'own credit' gains and losses. In addition, pending the future promised work on OCI in the Conceptual Framework project, we believe that recycling through profit or loss should be required when the liability is derecognised.

RESPONSES TO SPECIFIC QUESTIONS

Question 1

Do you agree that a financial asset with a modified economic relationship between principal and consideration for the time value of money and the credit risk could beconsidered, for the purposes of IFRS 9, to contain cash flows that are solely payments of principal and interest? Do you agree that this should be the case if, and only if, the contractual cash flows could not be more than insignificantly different from the benchmark cash flows? If not, why and what would you propose instead?

50. IFRS 9's use of the term 'solely'– and the example of instrument B in the standard's application guidance – could have resulted in a very narrow interpretation of SPPI. This could have meant that even minor deviations from what would be considered to be the 'perfect' instrument would have resulted in financial assets that otherwise would be classified as amortised cost failing the SPPI test and thus being classified as fair value through profit or loss. Therefore, we agree that some improvements were needed to the standard to introduce some notion of materiality into the test. We also agree that the introduction of a notion of materiality into the test will result in the exercise of judgement.

51. However, we are not convinced that there is sufficient clarity for entities to assess whether there is a modified economic relationship and whether cash flows are more than insignificantly different from benchmark cash flows. Nor are we convinced that such an assessment results in an appropriate identification of instruments which should quality for amortised cost in all circumstances.

52. Our concerns are particularly acute where there is no obvious modification or benchmark because the instrument's terms are those that are either the only terms available in that market or are the only terms available for that particular type of instrument. Examples of these situations include constant maturity rate loans in China and loans to government organisations supported by Livret A deposits in France. In these circumstances, it would only be possible to try to compare the actual instrument to a hypothetical instrument which does not exist and may not even be legally possible in the relevant jurisdiction. We neither believe that such a comparison is a valid basis on which to classify the instrument nor one which will result in consistent application in practice and across jurisdictions.

53. We suggest that the consideration of whether there is a modification should be more clearly based on the legal terms and conditions which are required or which are typical for that type of transaction in the jurisdiction in question. In this context, it may be helpful to build on the language in IAS 39 AG33(d) which assessed embedded foreign currency derivatives in the context of what is 'routinely denominated in commercial transactions' or 'commonly used in the economic environment in which the transaction takes place'. Reference could also be made to the legal or regulatory requirements in the particular jurisdiction where it is necessary to differentiate features required by law or regulation over which neither party to the contract has control from unique features which have been included by the parties to the contract to achieve a particular economic effect. If necessary, such a reference could be limited to address only features uniquely available to market participants within a particular jurisdiction, rather than allowing loans with the same features using different accounting in different jurisdictions depending on the legal environment.

54. We note that field testing may reveal that 'not insignificant' is interpreted so restrictively that a broader quantitative threshold may be more appropriate, perhaps signalled using the term 'not significantly different'. This may help expand the scope of appropriate amortised cost accounting more generally as well as assisting where there is no obvious modification or benchmark.

55. We also suggest that further consideration be given to what is meant by 'interest' in terms of time value of money and credit risk. It may be helpful to include the idea that time value of money includes a premium for liquidity risk (and other elements which may be included by markets or individuals in determining the appropriate interest rate) as noted in BC4.22 in the text of the standard. This could help address questions of whether how the market price is determined has a bearing on whether loans qualify as SPPI and questions arising with regard to negative interest. In addition, it may help to clarify that the test is only needed to assess where there are modifications to the economic relationship between principal and interest and that other contractual cash flow characteristics/contractual provisions/contractual terms are assessed in accordance with other parts of IFRS 9. We suggest that terminology should be standardised in this area or the difference between these terms explained.

Question 2

Do you believe that this Exposure Draft proposes sufficient, operational application guidance on assessing a modified economic relationship? If not, why? What additional guidance would you propose and why?

56. We believe that the assessment could result in a purely theoretical test in circumstances where there is no legally available alternative. While additional operational application guidance may be of assistance, it could not address the fundamental problem of the test being divorced from the legal and economic circumstances of the particular market and instrument.

57. While determining whether an outcome is 'more than insignificant' will require the exercise of judgement, at this stage the relationship of this term to 'material' is not clear. It seems that the notion of significance is being used in other places in IFRS 9 (eg, in relation to sales permitted from the amortised cost category and possibly in relation to impairment). It may be that the notion will develop into its own fixed numerical threshold, which could result in an essentially rules-based standard. Alternatively, significance may come to be assessed for each instrument individually – or in relation to the portfolio as a whole or to the financial statements as a whole – resulting in different thresholds in different circumstances. As has been the case for 'materiality', it may be helpful for more guidance to be provided as to how such assessments are expected to be made and whether they include both quantitative and qualitative factors.

58. It may also be helpful to provide guidance on whether the test is intended to be based on present values or on absolute cash flows, particularly where the assessment needs to be made over time. Alternatively, clarification that there are no specific requirements in relation to how the test is to be performed could be helpful.

59. In addition, there is a good understanding of why leverage and features which are embedded derivatives do not qualify as SPPI. What may be more difficult to understand is why interest rate mismatch features not previously considered to contain leverage, and which just change how market interest rates are determined or applied, should not qualify as SPPI, particularly where under IAS 39 they would not be considered to be embedded derivatives (or would be closely related embedded derivatives). Such interest rate mismatch features could be implicit in setting the interest rate – in which case it seems unlikely they would be included in an assessment – rather than explicit in the contractual terms. Since the embedded derivative rules remain for liabilities and, in some cases, there are assets and liabilities with the same features for which the host asset may no longer both be accounted for at amortised cost, it would be helpful if the basis for conclusions included a detailed comparison of the differences that can be expected and their rationale. This may help with the assessment of whether the difference from the benchmark is significant.

60. Alternatively – and particularly if the notion of business models is not retained – it may prove more cost effective to use the existing embedded derivative rules. This could be in conjunction with making amendments to the basic IAS 39 classification and measurement approach (with or without retaining bifurcation for assets) or by replacing SPPI with the embedded derivatives rules. Such an approach would solve the issues with SPPI and with instrument G.

61. The additional text in the exposure draft places greater emphasis on mismatch features than the previous version of the standard so it would be helpful to better explain why such features are inconsistent with payments of principal and interest and why it is appropriate for such instruments to be classified as fair value through profit or loss even though they may be within a ‘hold to collect’ business model. This is particularly a concern where the contractual term does not have a significant impact on the instrument’s fair value (which may be the case for terms which appear to fail SPPI but which were not considered to be embedded derivatives), which calls into question why fair value through profit or loss provides more useful information than amortised cost when this better reflects the business model.

Question 3

Do you believe that this proposed amendment to IFRS 9 will achieve the IASB’s objective of clarifying the application of the contractual cash flow characteristics assessment to financial assets that contain interest rate mismatch features? Will it result in more appropriate identification of financial assets with contractual cash flows that should be considered solely payments of principal and interest? If not, why and what would you propose instead?

62. IFRS 9’s original requirement that financial assets could only be measured at amortised cost if they passed a ‘business model’ test and a ‘contractual cash flows’ test appeared to many at first glance to be a neat solution. It was anticipated that it would mean that where a bank had a relatively straightforward loan or mortgage book that it held with the intention of collecting the related contractual cash flows, those assets would be measured at amortised cost whereas more complex assets would be measured at fair value through profit or loss.

63. While the revised SPPI test may work in many situations, there remain loans for which the business model is ‘hold to collect’ that will be forced into fair value through profit or loss where this classification does not seem appropriate. Local regulations and business practices in certain countries mean that what in local terms are straightforward loan or mortgage books will fail the ‘contractual cash flows’ test as those cash flows cannot be considered ‘solely’ payments of principal and interest. This is particularly true for products where there are interest rates and reset features specified by regulation or market practice. Many feel that carrying these assets at fair value through profit or loss is simply the ‘wrong’ answer and we appreciate why the Board has moved to clarify its requirements in this area. We agree that something needs to be done to avoid certain financial assets with a ‘modified economic relationship’ being classified and measured inappropriately. However, we do not believe that the Board has found a solution that fully solves this conundrum and that is operational globally.

64. Suggestions for alternative approaches and potential additional guidance are set out in the answers to questions 1 and 2 above.

Question 4

Do you agree that financial assets that are held within a business model in which assets are managed both in order to collect contractual cash flows and for sale should be required tobe measured at fair value through OCI (subject to the contractual cash flow characteristicsassessment) such that:

(a) interest revenue, credit impairment and any gain or loss on derecognition are recognised in profit or loss in the same manner as for financial assets measured atamortised cost; and

(b) all other gains and losses are recognised in OCI?

If not, why? What do you propose instead and why?

65. We are not in favour of the introduction of a mandatory third business model. We have difficulties understanding the 'hold to collect and sell' business model. Rather than being a meaningful way to describe a business operation, it seems like an accounting construct to address portfolios which are generally 'hold to collect' but which will fail to qualify as such as a result of the volume of sales. It may be that it can be better articulated in the context of some insurance businesses.

'Hold to collect' business model

66. The Board has stated that the clarifications to the 'hold to collect' business model are not intended to narrow the scope of this category when compared to that in the original standard. However, we note that:

- 'It is expected that an entity may sell some financial assets that it holds with an objective of collecting contractual cash flows. Very few business models entail holding all instruments until maturity.' (IFRS 9 BC4.19).
- 'Sales or transfers of financial instruments before maturity would not be inconsistent with a business model with the objective of collecting contractual cash flows, as long as such transactions were consistent with the business model, rather than with a business model that has the objective of realising changes in fair values.'(IFRS 9 BC4.21).
- Disclosure is required of derecognition of financial assets classified at amortised cost to provide 'transparency in situations where an entity has measured financial assets at amortised cost on the basis of having an objective of managing those assets in order to collect the contractual cash flows but regularly sells them.' (IFRS 9 BC4.45).

67. The exposure draft, by putting a much more direct emphasis on the volume of sales – rather than on the reasons for those sales and how they fit within an entity's business model – appears to narrow the scope of the amortised cost category and to make it essentially rules based.

68. In our view, contrary to B4.1.2A, the business model is more a matter of judgement than a matter of fact. Where the main purpose of a portfolio and its underlying business model is to 'hold to collect', and sales are incidental to the business model, we do not agree that this should fall into the FVOCI category merely as a result of concerns about the actual or potential frequency of such sales. While the 2010 version of the standard had not yet been widely applied and the constituency has not yet developed a common understanding of how the 'hold to collect' business model should operate in practice, the clarifications together with the existence of the FVOCI category appear to unduly restrict the scope of amortised cost.

69. This may have the undesirable consequence of making the actual business model essentially irrelevant and FVOCI effectively the default category with broadly the equivalent of IAS 39 'loans and receivables' and 'held to maturity' items being capable of meeting the 'hold to collect' business model, with all portfolios that are not trading or derivatives being included in FVOCI. If that is the result in practice, it would be more straightforward to base classification on the type of instrument, as is the case under IAS 39, without reference to the business model.

70. It is likely that banks will not consider that the outcome properly reflects their view of their business models. Therefore the proposals do not represent an improvement to existing practice under IAS 39. Moreover, there application will result in financial statements that continue to be difficult to relate to their underlying business.

71. We note that the changes to hedge accounting were intended to better reflect risk management in financial reporting, which we regard as a step in the right direction. In this context, a classification and measurement standard that is likely to be interpreted in way that makes business models essentially irrelevant would be very disappointing.

72. Another undesirable consequence could be that portfolios that are considered to be part of a 'hold to collect' business model are divided so that sales only occur out of the half of the portfolio that is classified as FVOCI even though there is little difference in the purpose and management of the portfolio as a whole. Such interpretations could result in the accounting failing to represent the entity's business model and one of the main benefits of IFRS 9 being lost.

73. Therefore, in our view, a better solution would be to put a greater emphasis on the objectives of the business model, how such portfolios are managed and the reasons for sales being within the objective of the business model. For example, a documented business model for a bank's liquidity portfolio could be to maintain the portfolio within established risk parameters (credit, interest rate risk and liquidity) to match the amortised cost liabilities which the portfolio funds. Sales necessary to achieve this objective will depend on the operation of the markets and changes to the related liabilities and should not call into question the business model. Sales outside the established risk parameters would need to be investigated to see if they indicate a change in business model. Such an approach – and retaining the insurance rebalancing example – would, in our view, clarify the scope of the amortised cost category and make it possible to better reflect an entity's business model while maintaining two categories.

74. Such an approach would also clearly differentiate the IFRS business models from those of the FASB. Since the FASB proposals use identical labels but different language to describe the business models, the IASB will either need to adopt the FASB language (if the intention is to fully converge) or clearly explain where their model is different. Otherwise, market practice is likely to result in IFRS 9 being interpreted in line with US GAAP even if there are differences in the wording.

A third category may not best meet users' needs

75. We question whether the FVOCI category best meets users' needs in the banking context. Mixing amortised cost in net income with fair value in the balance sheet with the differences being taken to other comprehensive income could result in entries in OCI which make little sense. Initial impairment allowance will be debited to net income but credited to OCI assuming the financial asset is initially measured at fair value and its fair value has not changed as a result of credit. If amortised cost information is useful in net income, it is not clear what additional benefit is achieved from this mixed approach that is not achieved by the much more simple approach of separate disclosure of fair value information. Rather disclosure of fair values, including roll forwards of fair value balances for these portfolios which would show the entire fair value movement for the period (rather than putting some in net income and some in OCI), seems more straight forward and more likely to meet users' needs. Since these fair values are unlikely to be level 3 and since the disclosure can be mandated for interim reporting, users would have no concerns about the quality or timeliness of this information.

76. The introduction of FVOCI with recycling for debt securities further exacerbates confusion over the purpose of net income and OCI and highlights inconsistency of treatment with equity securities that are also FVOCI without recycling and the treatment of 'own credit' for certain liabilities where the component of fair value taken to OCI is also not recycled on derecognition of the liability.

A third category does not address all insurers' concerns

77. Insurance accounting is particularly difficult as a result of the wide variety of contracts which vary depending on local regulatory and tax rules which makes it unlikely that a single form of accounting will satisfy all concerns and gain universal agreement.

78. The matching of assets and liabilities – whereby insurance liabilities, guarantees and related assets, including derivatives, are managed together – is central to the business model of insurers. While we believe that the accounting should reflect this linkage, it is not adequately reflected in the exposure draft and its interaction with the current proposals for IFRS 4 phase 2. For example under the proposals, FVOCI is required to be used where the entity has a business model that involves both 'hold to collect' and selling. Some insurers may have large portfolios with insufficiently frequent or significant sales to qualify for FVOCI and this will give rise to an accounting mismatch as their portfolios will be required to be carried at amortised cost. Other insurers may have investments in financial assets which do not qualify for FVOCI because they do not meet the solely payments of principle and interest (SPPI) test or because they hold derivatives or equities as part of their overall investment strategy. This may result in assets that are managed together and which back the same portfolio of insurance contracts being reported in three different ways: some at FVTPL, some at FVOCI and others at amortised cost. If related changes in assets and liabilities are reported in different places, performance reporting becomes meaningless.

79. To reflect adequately insurers' asset-liability matching strategies, one solution could be allowing FVOCI measurement to be available where it is consistent with the business model, eg, for all asset classes that back insurance contract liabilities.

80. While insurers do use simple debt instruments to match insurance liabilities, the asset strategy is often more complex and may involve, for example, the use of derivatives to diversify credit exposure and manage interest rate risk. Other asset classes held to match insurance liabilities may include investments in equities, investment properties, mortgages and other loans. If insurers' business models are to be adequately reflected with matching in OCI, the availability of FVOCI would need to be extended to cover a wider scope of asset classes without limitation due to cash flow characteristics. Failure to do so would arguably create unnecessary accounting mismatches which would obscure the financial performance reporting for users.

81. Although IFRS 9 has a FVOCI category for equity instruments, the restriction on recycling means that this approach is not consistent with the nature of the insurance liability. This is particularly so for participating contracts, where the investment returns (including gains and losses) are ultimately passed to the policyholder.

82. Notwithstanding the above, there are circumstances where FVTPL provides better information. We therefore welcome the proposed introduction of the FVTPL option for assets that would otherwise be classified as FVOCI. However, we believe that an unconditional option to classify both assets and insurance liabilities at FVTPL should be available. We interpret the IASB's current definition of a business model as requiring assets which are managed with regard to both collection of cash flows and for sale to be classified as FVOCI. As currently drafted the definition of a 'held to collect and for sale' business model will require debt instruments backing certain insurance contracts to be classified as FVOCI, while other assets backing these contracts will be classified as FVTPL. This inconsistent income statement treatment for assets managed together backing the same contracts would result in an accounting mismatch which would obscure the financial performance reporting for users. The FVTPL option due to accounting mismatch in IFRS 9 may not be available for these contracts if IFRS 4 Phase 2, as currently proposed, requires interest rate movements on liabilities to be reported in OCI. As such, the interest rate movements would be reported in OCI for the liability and for some of the assets but other assets (eg, derivatives) would have their interest rate movements reported in profit or loss; therefore, there is a need for an unconditional FVTPL option.

83. The views above are tentative because, in order to assess fully the impact on insurers, we would need to first understand the inter-linkage of the IASB Board's accounting alternatives for assets and liabilities in both IFRS 9 and IFRS 4 respectively. Once the insurance project is finalised and there is a better understanding of the balance of concerns about volatility in profit or loss versus concerns about complexity and the creation and elimination of accounting mismatches, the Board will be better placed to assess the interaction between a finalised financial instrument standard and insurance contracts and thus any consequential amendments may be needed either to IFRS 9 or to the insurance standard. It may also be possible – and we would prefer this approach to be investigated by the Board – to restrict amendments only to correct those impacts that arise from the interaction of IFRS 9 and the insurance standard, thus leaving IFRS 9 intact for other entities.

Other considerations

84. While it could be argued that the FVOCI category is necessary for convergence with US GAAP, we do not support convergence which reduces the quality of the final standard. For the reasons set out above, we believe that a higher quality standard would result from ensuring that the accounting appropriately reflects the business model as set out in paragraph 73 above. Alternatively, where amortised cost is the more useful measurement for net income, more understandable information on fair values would be provided through disclosure as set out in paragraph 75 above. In any case, financial instrument accounting may not in fact result in convergence if the Boards end up with different impairment models. Therefore we do not place a high priority on convergence.

85. As we have stated in responses to many of the minor improvements projects, there is a cost to any accounting change and likely to be significant cost to both preparers and users in implementing and understanding a new financial instrument standard. The FVOCI category will give rise to the risk that there will be such little difference in practice between IFRS 9 and the outcomes of IAS 39 (or that relatively simple amendments could be made to IAS 39 to achieve the same results) that IFRS 9 will fail to achieve a cost-benefit test for its being worthy of implementation.

86. It should be noted that many commentators suggested that the IASB should make amendments to IAS 39 to address the issues arising from the financial crisis rather than embarking on a major new project. If the major changes to the outcomes for classification and measurement is that amortised cost impairment is recognised in profit or loss with respect to the previous 'available for sale' category and fair value movements on certain liabilities relating to 'own credit' are recognised in OCI rather than profit or loss, it would appear that these outcomes could more easily be achieved within IAS 39 without the cost and effort of implementing an entirely new standard. Given the likely interpretation of the exposure draft as essentially only allowing IAS 39 'loans and receivables' and 'held to maturity' to be measured at amortised cost, the promise of having classification reflect the business model, which would at least have been a better articulation of the IAS 39 categories, seems lost. Some may question why it has taken since 2008 to get to this position.

87. We strongly agree that amortised cost provides the most useful information in net income for the portfolios that are likely to fall within the FVOCI category. Therefore, if it is not possible to clarify 'hold to collect' as we suggest or to provide fair value disclosure as suggested above, we would accept the introduction of a FVOCI category as being a less bad solution than including such portfolios at fair at fair value through profit or loss. The rest of the questions are answered under the assumption that the FVOCI category is introduced.

Question 5

Do you believe that the Exposure Draft proposes sufficient, operational application guidance on how to distinguish between the three business models, including determining whether the business model is to manage assets both to collect contractual cash flows and to sell? Do you agree with the guidance provided to describe those business models? If not, why? What additional guidance would you propose and why?

88. We believe that further work is needed in order to more clearly delineate between the three categories and to, thus, make the proposals operational in practice. Establishing a clear boundary between FVOCI and amortised cost is particularly important. Similarly the boundary between FVOCI and fair value through profit or loss remains unclear. Further clarification, which emphasises the need to exercise judgement, would be helpful.

89. The basis for conclusions explains that the difference between items that are classified at amortised cost and those that are categorised at FVOCI is the frequency and volume of sales made out of the relevant portfolio. It is unclear just how the frequency or significance of sales should be assessed to determine whether a portfolio fails to meet the 'hold to collect' criteria. For example, is the quantum of sales compared to the portfolio at the start of the period without adjustment for purchases during the period or is it compared to the absolute size of the portfolio at the point in time. Concerns about assessing significance more generally are included in the answer to question 2 above.

90. In addition, sales are permitted if the credit quality of an asset 'has deteriorated'. It is not clear how this should be applied in an expected loss environment or whether other credit quality characteristics, which are relevant to the documented investment policy for a portfolio, such as concentration risk, should also be considered. At the very least, the drafting should ensure that sales that were permitted in 'held to maturity' portfolios under IAS 39 are still acceptable for 'hold to collect'. For example, a specific reference to events outside the entity's control that could not be anticipated may be helpful rather than reliance such occurrences being 'infrequent'.

91. It would appear that all loans originated in loan syndication businesses, where the originator intends to hold a portion of each individual loan and sell the remainder, would be within the FVOCI category. This seems an unnecessary change from IAS 39 where it was possible to consider that the portion of the loan intended to be retained would be at amortised cost and the portion of the loan intended for sale would be at fair value through profit or loss. It would be helpful to clarify that the business model can be applied to portions of financial instruments in such situations.

92. We also suggest that the interaction of the business model, the rules concerning change in business model in IFRS 9 and IFRS 5 which uses similar terminology, 'assets held for sale' should be considered. For example, the measurement of financial instruments is outside the scope of IFRS 5. If it is considered that a disposal group with portfolios of financial assets meets the IFRS 5 criteria as held for sale, this could be considered to result in a change in business model for the financial assets even though the business as a whole is held for sale and the on-going business model of the portfolios may be unchanged (for example, if the business will be sold as a going concern). IFRS 9 would place the timing of the recognition of the change in business model prospectively as at the start of the first reporting period following the change in business model. The rest of the disposal group will be reclassified when the criteria in IFRS 5 are met. This may result in different dates for the reclassification of financial assets and other assets and liabilities in the disposal group. IFRS 9 would measure the reclassified financial assets at fair value through profit or loss. This could result in fair value gains as well as losses being recognised in profit or loss which would be inconsistent with non-current assets in the disposal group which would be measured at the lower of carrying amount and fair value less costs to sell. These interactions should be reviewed for any unintended consequences and the standards clarified as necessary.

Question 6

Do you agree that the existing fair value option in IFRS 9 should be extended to financial assets that would otherwise be mandatorily measured at fair value through OCI? If not, why and what would you propose instead?

93. Yes. We support extending the fair value option to financial assets without restriction. That is, a fair value option may be necessary, particularly to allow insurance business models to be properly portrayed whether or not there is an accounting mismatch that would otherwise have been created as a result of the portfolio being mandatorily measured at FVOCI.

Question 7

Do you agree that an entity that chooses to early apply IFRS 9 after the completed version of IFRS 9 is issued should be required to apply the completed version of IFRS 9 (ie including all chapters)? If not, why? Do you believe that the proposed six-month period between the issuance of the completed version of IFRS 9 and when the prohibition on newly applying previous versions of IFRS 9 becomes effective is sufficient? If not, what would be an appropriate period and why?

94. Eliminating the current complex phased approach to early application of IFRS 9 and replacing it with a simpler requirement for all phases to be applied from the same date would improve comparability. We therefore agree that, once IFRS 9 is finalised, an entity wishing to early adopt the new standard must do so in its entirety.

95. Furthermore, from an insurance industry perspective, the revised IFRS 9 should not be finalised before IFRS 4 – or at least an exposure draft thereof - is available. The timing of the mandatory effective dates of IFRS 9 and IFRS 4 will require careful consideration. Otherwise it may call into question the usefulness of financial reporting for users of an insurer's financial statements in the period between the adoption of the two standards, as users will experience two major changes in quick succession.

96. We also agree with the six-month transition period proposed in the exposure draft as this will provide relief to those entities that have already begun preparations to adopt earlier phases of IFRS 9 on the date that the final component of the standard is issued.

97. We note, however, that the option to early adopt IFRS 9 – either in part or in its entirety – is at this juncture a purely academic one for entities within the EU as they will not be able to do so until the standard has been endorsed.

Question 8

Do you agree that entities should be permitted to choose to early apply only the ‘own credit’ provisions in IFRS 9 once the completed version of IFRS 9 is issued? If not, why and what do you propose instead?

98. We agree that entities should be permitted to early adopt the ‘own credit’ provisions of IFRS 9. It is widely acknowledged that the current requirements produce results that are at best counter-intuitive and at worst misleading. Replacing them would improve the quality of financial reporting and we are pleased that the Board recognises that this should be done sooner rather than later.

99. However, we are concerned that this option will only be available once the remaining phases of IFRS 9 have been finalised which, given the on-going debate about what constitutes an appropriate impairments model, may be some time yet. We, therefore, once again urge the Board to further expedite the availability of these requirements by amending IAS 39 to align it to IFRS 9’s requirements regarding ‘own credit’ gains and losses. We note it would also be more consistent with the inclusion of the FVOCI category to require recycling of ‘own credit’ gains and losses on derecognition of the liability.

Question 9

Do you believe there are considerations unique to first-time adopters that the IASB should consider for the transition to IFRS 9? If so, what are those considerations?

100. We do not have any specific comments regarding first-time adopters.

E eddy.james@icaew.com