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Exposure Draft ED/2012/4, Classification and Measurement: Limited Amendments to IFRS 9

Dear Françoise,

We appreciate the opportunity to comment on the IASB's Exposure Draft, *Classification and Measurement: Limited Amendments to IFRS 9* (the "ED"). This cover letter summarizes the position of Allianz Group regarding this phase of the IAS 39 replacement project, and gives context to the detailed responses to specific questions posed in the ED, which are set forth in the pages that follow.

Allianz Group is a global financial services company operating within the insurance and asset management market segments. As of December 31, 2012, we had loans and investments of approximately €520 billion. As such, any change to the current classification and measurement approach for financial assets would be very significant to us from both a financial statement and operational cost perspective. We trust that our comments and observations are deemed both relevant and useful to you in your deliberations of this important topic.

We welcome the introduction of the FV-OCI measurement category in IFRS 9

We see the introduction of the FV-OCI category as a very positive development and believe it represents a significant improvement to existing IFRS 9. This category provides insurers with the ability to account for debt instruments at fair value while enabling the presentation of profit or loss on an amortized cost basis, which would align with the decisions in the insurance contracts project to present interest rate driven changes of the insurance liability in OCI and best reflects the long-term nature of the insurer's business. We appreciate the efforts that the IASB has taken to re-open IFRS 9, and we would like to thank the IASB for taking the considerations of the insurance industry into account.

It is our strong view, that the FV-OCI measurement category for financial assets in IFRS 9 is a key element of a suitable solution for insurance accounting. The FV-OCI category is essential in its interaction with the decision in the insurance contracts project to present interest rate driven changes of the insurance liability in OCI. This enables insurers to present a current balance sheet, reflecting fair value information of investments and the current fulfillment value of insurance liabilities, as well as presenting an income statement which reflects the long-term nature of the business.

We propose an unconditional option to use FV-OCI or amortized cost for simple debt instruments

For the insurance industry it would be preferable to define the measurement category for assets backing insurance contracts based on our asset-liability-management business model, taking into account the interaction between assets and liabilities. However we understood that the Board prefers to define the measurement categories for financial assets in IFRS 9 independently from the liabilities and our insurance specific business model, but based on the trading activities within a specific portfolio ("business model").

In addition, the FV-OCI category needs to be defined in a way that the vast majority of our debt instruments are captured. Otherwise an accounting mismatch with the measurement and presentation of insurance liabilities will occur and no consistent picture of the financial position and performance of the underlying business will be provided to the users of our financial statements.

The ED proposes a definition of the "hold and sale" business model which should match in the most cases our asset management strategy for debt instruments. However, certain sub-portfolios managed on a individual basis might not meet the "hold and sale" definition because due to their nature they are usually held until maturity. The resulting mandatory amortized cost measurement would create an accounting mismatch with the insurance liabilities. In addition, discussions over the last months have demonstrated that the dividing line between amortised cost measurement and FV-OCI measurement in IFRS 9 is difficult to draw and potentially will lead to major problems in the practical application for preparers, auditors and regulators. Different industries have different needs which are difficult to meet under the current proposal.

Given these arguments, we believe that there should be no arbitrary split between business models of banks and insurers in dependence of the frequency of sales of financial assets as currently proposed in IFRS 9 between a business model "hold to collect" - with some sales possible and "hold and sell" - with more frequent sales. We think that an <u>unconditional option to either select amortized cost or FV-OCI treatment for all assets which (a) meet the cash flows characteristics test as simple debt instruments and (b) are not held in a trading category</u> (as defined in IAS 39) provides a better approach. We see the following reasons for this:

- A trading category is easier to define than the currently proposed business model definitions for amortized cost and FV-OCI, thus with an unconditional option, the complexity to define the diving line between amortized cost and FV-OCI disappears.
- Banks and insurers are able to select the measurement category which best fits to their specific business models without constraints to avoiding accounting mismatches.
- Still comparability and transparency are ensured, as the measurement in profit or loss is the same for amortized cost and FV-OCI debt instruments, including the same impairment rules. Fair value information would be available in the balance sheet for instruments classified at FV-OCI or in the notes for those classified at amortized cost.
- The cash flow characteristics test plus the definition of a trading business model would still ensure that non-simple debt instruments and trading assets are measured at FV-PL.
- The option to select between amortized cost and FV-OCI must be unconditional as there should be no constraints to irrevocably elect these categories at inception and no preference should be expressed by the standard itself.

- § Having the possibility to select amortized cost or FV-OCI will enable banks, insurers as well as other industries to use the presentation category of simple debt instruments in the balance sheet which best reflects the nature of their business model while ensuring that the performance information in profit or loss remains comparable as no differences occur there.

We propose to broaden the 'eligible' debt definition

We believe the 'eligible' debt definition ('contractual cash flow characteristics test') is too narrow as it too often triggers FV-PL classification. In particular, we believe that debt assets which are insignificantly different from simple debt instruments, i.e. assets which are priced similar to simple debt instruments, should not be mandatorily classified as FV-PL. Examples of such debt assets are originated infrastructure debt instruments and certain mortgages.

As such, we believe the proposed amendment to incorporate the notion of 'insignificant deviation' in cash flows for debt assets, which contain interest rate mismatch features, is a step in the right direction to broaden the 'eligible' debt definition.

Moreover, if at the level of the economic relationship between principal and interest insignificant modifications are tolerable, we believe that this principle should be applied to all insignificant deviations from the 'pure principal and interest' rule as well. As such, we propose additional amendments which are not included in the ED. For example, we propose that IFRS 9 should be amended to ensure that 'automatic early redemption rights' and redemption rights which are contingent on future events will not trigger FV-PL treatment.

In the Appendix, we included several debt asset examples with features that trigger FV-PL treatment under IFRS 9, even though no embedded derivatives are bifurcated under IAS 39, and we believe an amortized cost or FV-OCI treatment of these debt assets would provide more useful information about the performance of these investments.

We accept the decision of the Board not to reintroduce bifurcation of financial assets, however this should not lead to a situation where a significant number of our debt investments need to be measured at FV-PL on a mandatory basis.

Interaction between IFRS 4 and IFRS 9 needs to be considered prior to finalisation of both standards

As our views have consistently highlighted, the interaction between assets and liabilities is of fundamental importance to how we manage our business. As the IFRS 4 exposure draft is not yet available, our assessment of IFRS 9 cannot be finalised until such time as we are then able to assess both draft standards together.

In the light of the interaction between IFRS 4 and IFRS 9 we would also like to draw your attention to our concerns about no recycling of OCI for equity instruments. This restriction means that the treatment of equities is not consistent with the accounting for an insurer's corresponding liabilities. This is particularly so for participating contracts, where the investment returns (including gains and losses) are ultimately passed to the policyholder. As such, we believe a transfer of the amounts from OCI to profit or loss should be possible if a sale of equity instruments occurs. In case impairment rules are deemed necessary by the Board, we would propose to introduce a simple rule based approach.

The mandatory effective date of IFRS 9 must be aligned with IFRS 4 for insurers

Due to the interaction of assets and liabilities, we believe insurers should not be required to adopt IFRS 9 before the mandatory effective date of IFRS 4. Following the IASB decision in 2012 to move away from alignment of the effective mandatory dates for IFRS 9 and IFRS 4, insurers would need to apply IFRS 9 for annual periods beginning on or after 1 January 2015.

As the IFRS 4 Exposure Draft is not yet available, this means our assessment of IFRS 9 cannot be finalised until the point in time both (draft) standards have been released. Moreover, insurers would, in practice, have to undertake two significant conversion exercises within a short period of time. This staggered approach to implementation of two fundamental accounting standards will give rise to complexity and significant operational costs for the insurance industry. It may also put into question the usefulness of financial reporting for users during this period, as users will experience two major changes in an insurer's financial statements in very short succession.

As such the mandatory effective date for IFRS 9 should be aligned with the expected adoption date for IFRS 4 in 2018, so that insurers would not be required to adopt these two significant changes on a piecemeal basis, whereas voluntarily early adoption should still be possible to address the needs of other reporting entities.

The appendix to this letter sets out our views on the detailed questions posed in the exposure draft. If you would like to discuss the content of this letter with us, please do not hesitate to contact us.

Yours sincerely,

Dr. Susanne Kanngiesser
Head of Group Accounting

Dr. Roman Sauer
Head of Group Accounting Policy Department

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 be considered, 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?

Yes, we agree that a financial asset with a modified economic relationship, where the cash flows are insignificantly different from the cash flows in a benchmark instrument, should be eligible for a measurement basis other than FV-PL. However, as outlined in our answer to the EFRAG's question to the constituents below, we propose further amendments to the cash flow characteristics test.

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?

Yes, we believe this amendment will help to clarify the application of the contractual cash flow characteristics assessment to financial assets which contain interest rate mismatch features. As such, we believe no additional guidance is necessary on this specific issue.

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?

We believe that the amendment will help to clarify the contractual cash flow characteristics assessment for debt assets that contain interest rate mismatch features. However, we have strong concerns that the amendment will not identify all debt instruments which should be eligible for amortised cost or FV-OCI measurement. There are other relevant features (e.g. redemption rights) in debt instruments which should also not trigger FV-PL treatment. For more details, we refer to the EFRAG's question to the constituents below.

Question to EFRAG's constituents:
21 Are you aware of any other financial assets that would not pass the contractual cash flow characteristics assessment and for which, in your view, measurement other than at FV-PL would provide more useful information? If so, please describe the financial assets and why you believe that measurement at other than FV-PL provides more useful information.

Yes, we are aware of several financial assts which will be classified as FV-PL and for which we believe FV-PL treatment is not appropriate. The reasoning is as follows: If debt assets are purchased to match the duration of participating insurance contracts, a FV-PL treatment would lead to an accounting mismatch and thus would not reflect the economic substance of these investments and our business model. In particular, we believe that debt assets which are insignificantly different from simple debt instruments, i.e. assets which are priced similar to simple debt instruments, should not be mandatorily classified as FV-PL.

The following examples contain features, which we believe trigger FV-PL treatment under IFRS 9, even though these features do usually not have to be separately accounted for as embedded derivatives under IAS 39. We believe that an amortized cost or FV-OCI treatment provides more relevant information about the performance of these investments and expected future cash flows.

The examples relate to

- The point in time and the size of interest rate payments (Examples A)
- Automatic early redemption rights (Example B)
- Contingent redemption rights (Example C)
- Debt assets with insignificant equity features (Example D), and
- Prepayment above fair value (Example E).

Example A: Preference shares

In several countries (e.g., Germany), preference shares have the following features: For a fixed time period (e.g., eight years), a fixed coupon is paid annually. After the end of this time period, the issuer has a right to redeem the instrument. If the issuer does not exercise its redemption right, a variable interest rate (e.g., three months Euribor) with a fixed step-up is paid annually for an unlimited period of time (i.e. no maturity date). After a certain time period (e.g., five years), the issuer is obliged to pay all unpaid coupons. Thus, from an issuer's view, the preference shares are treated as a liability as the payments are not in the discretion of the issuer (see IAS 32.AG26).

- The step-up represents an incentive ("economic compulsion") for the issuer to exercise its redemption right at the end of the fixed interest rate period. Under IFRS 9, we believe the step-up feature (incentive) triggers FV-PL treatment as it does not only represent interest on the principal outstanding but also an incentive for the issuer to exercise its redemption right. We encourage the IASB to amend IFRS 9 to ensure that such instruments will be eligible for a measurement category other than FV-PL.
- Moreover, an issuer's right to defer interest payments without being obligated to pay interest on the accrued interest, also triggers a FV-PL treatment (see IFRS 9.B.4.14, Instrument G). Again, we believe that amortized cost / FV-OCI treatment should be possible for such financial instruments.

Example B: "Automatic" early redemption features

We believe a critical issue is that "automatic" early redemption features can trigger FV-PL treatment even in the case that such features are directly related to a credit risk deterioration of the underlying debt. An example are "cash-sweep" features, included in infrastructure debt instruments. These features require an "automatic" early (partial) redemption of the principal if certain credit risk related performance milestones (e.g. asset / debt or free cash flow / interest payment ratios) are not achieved.

As such automatic redemptions are neither in the discretion of the issuer nor in the discretion of the holder, a literal reading of IFRS 9.B.4.1.12 would indicate that such "automatic" redemption features would trigger FV-PL treatment as they do not represent (a) a change in a variable interest rate, (b) a prepayment option, or (c) an extension option. However, as these early redemptions are triggered by credit risk changes of the infrastructure debt instrument, we believe the IASB should amend IFRS 9 in order that such features do not lead to FV-PL treatment.

Example C: Redemption rights which are contingent on future events

Redemption rights of the holder (or of the issuer), which are contingent on future events, trigger a FV-PL classification if such future events are not directly related to a credit risk deterioration of the underlying debt (see IFRS 9.B4.1.10(a)(i)). Examples are redemption rights which are contingent on the (1) disposal of certain assets of an industrial company, (2) suspension of the issuer's shares from trading, (3) failure to execute an IPO, (4) changes in the issuer's future revenues, EBIT or net income.

We believe that such a treatment is not appropriate for the following reason: If there is a debt asset with no redemption rights (fact pattern (i)) or a debt asset with unconditional redemption rights (fact pattern (ii)), a financial asset is eligible for a measurement category other than FV-PL. We believe that the aforementioned future events should not represent a FV-PL trigger as the occurrence of such events only represent a switch from fact pattern (i) (events have not occurred and redemption is not possible) to fact pattern (ii) (events have occurred, redemption is now possible), and both fact patterns, in isolation, do not trigger FV-PL treatment. Thus, we propose that the IASB will reconsider paragraph IFRS 9.B4.1.10(a)(i).

Example D: Debt assets with insignificant equity features

If at the level of the economic relationship between principal and interest insignificant modifications are tolerable, we believe that this principle should be applied to all insignificant deviations from the 'pure principal and interest' rule as well. As such, we believe that debt assets which are insignificantly different from simple debt instruments, i.e. assets which are priced similar to simple debt instruments, should also not be mandatorily classified as FV-PL. Examples are:

- Debt assets with insignificant equity features: e.g., deep out of the money convertible bonds and insignificant equity distribution rights (e.g. a fixed annual interest payment of CU500 and an expected annual dividend payment of only CU1).
- Insignificant changes of the size of the coupon and/or principal payments driven by the performance of the issuer (e.g. revenues, EBITDA or net income).

Example E: Prepayment above fair value

For prepayment options of the issuer, where the redemption amount is above fair value, we believe the redemption amount also represents a critical issue. Example: The prepayment amount is calculated with the following formula: The outstanding coupons and principal amount are discounted with

- a current swap rate only (close to a risk free rate) or
- with a swap rate plus 50% of initial credit spread.

Based on such formulas, interest rate declines may lead to a significant increase of the redemption amount above fair value (in particular for debt assets with a long time to maturity).

As such formula based redemption amounts are above the fair value of the debt asset, the issuer's redemption right represents an 'out of the money call option`. Moreover, as the redemption amount is *always* above the fair value of the debt asset (and thus, the call option is *always* out of the money), the probability of its exercise is low. But we believe, generally, the feature is still regarded as *'genuine'* in the meaning of IFRS 9.B4.1.18.

IFRS 9.B4.1.10(b) states: "The prepayment amount substantially represents unpaid amounts of principal and interest on the principal amount outstanding, which may include reasonable additional compensation for the early termination of the contract". As the increase of the redemption amount may be higher than a 'reasonable additional compensation', we believe that such debt assets would be classified as FV-PL.

Side-remark: Under IAS 39, prepayment above fair value does not represent embedded derivatives which require bifurcation. The reasoning is as follows: The fair value of the redemption (call) right is always out of the money and thus always zero. Consequently, the value of the redemption right does not change and thus, we believe, the definition of an (embedded) derivative is not met (IAS 39.11(b) and IAS 39.9(a)).

<u>Questions to EFRAG's constituents</u>
42 Do you believe that the proposed clarification in the contractual cash flow characteristics assessment would decrease the number of financial assets to be measured at FV-PL in their entirety so that the request for reintroducing bifurcation in IFRS 9 is no longer justified? Please explain why.
43 Are you aware of any circumstances in which, from your point of view, bifurcation might still be needed? If so, please provide a description of the financial assets concerned.
44 Do you believe that EFRAG should still urge the IASB to reintroduce bifurcation for financial assets on the basis of a principal-and-interest' approach, having in mind that finalising the appropriate requirements might delay the completion of IFRS 9, however not require re-exposure?

We believe the reintroduction of the embedded derivative concept is not needed as long as we achieve a broadening of the simple debt definition ('contractual cash flow characteristic test'). If this is not possible it might be necessary to reconsider our views regarding the treatment of embedded derivatives.

As such, we believe that several types of securities in the international capital markets commonly have numerous derivative-like features that would not be considered as 'eligible' debt assets. Often times, such derivative features are considered to be immaterial, and in those cases we do not feel it is appropriate for an entire hybrid financial instrument to be classified solely on that basis (see above example D). Such a treatment would seem to advocate 'form over substance', and run counter to other IFRSs.

Moreover, we also recognize that by never bifurcating, in certain cases, an embedded derivative feature may cause a contract that otherwise clearly has simple debt features and is in substance, appropriate for measurement at amortized cost or FV-OCI, to be measured at FV-PL in its entirety. For example, we consider a convertible bond which can be bifurcated into a debt instrument with an equity derivative (conversion right).

<u>Question 4:</u>
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 to be measured at fair value through OCI (subject to the contractual cash flow characteristics assessment) 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 at amortised cost; and
(b) all other gains and losses are recognised in OCI?
If not, why? What do you propose instead and why?

Yes, we strongly support the introduction of the FV-OCI category in IFRS 9. This category is essential to appropriately reflect an insurer's business model in the income statement and to better reflect the tentative approach in IFRS 4 to present the effect of changes in the discount rate in OCI. Additionally, we agree with the accounting mechanics for the category FV-OCI as outlined in Question 4 (a) and (b) above.

Please see also our comments provided on page two of the cover letter and further below regarding the definition of the FV-OCI category.

<u>Question 5</u>
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?

We believe the additional application guidance that has been included in the standard on the three business models is useful, but will not solve the problems in differentiating between them completely. To avoid the difficulty to distinguish between the three business models, in particular between amortized cost and FV-OCI, we believe, an alternative and better solution is to provide an unconditional option for OCI for all debt assets which are not part of a trading portfolio and eligible for a measurement other than FV-PL under the cash flow characteristic test.

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?

Yes, we agree that the fair value option in IFRS should be extended to financial assets which are classified as FV-OCI. The fair value option is essential to avoid accounting mismatches and to avoid circumstances where the FV-OCI business model test is met but the more appropriate measurement is FV-PL. For example, for debt instruments backing unit-linked contracts, the use of the fair value option is essential to avoid an accounting mismatch.

The final standard needs to ensure that the FV-PL option is available for such situations. As the IFRS 4 Exposure Draft is not yet available, our assessment on the fair value option cannot be finalised until the point in time both (draft) standards have been released.

Questions to EFRAG's constituents

80 Do you support View 1 or View 2 above? Please explain why.

81 The basis for conclusions in the ED (paragraph BC30) indicate that interested parties have raised concerns that the introduction of the FV-OCI measurement category would increase the use of fair value relative to IFRS 9 (2010) and that the IASB did not seek however to increase or reduce the use of fair value measurement. In addition, the IASB notes that in some cases financial assets that would have been measured at FV-PL could be measured at FV-OCI as a result of the proposals.
Do you believe that the introduction of the FV-OCI measurement category would increase the use of fair value relative to IFRS 9 (2010)? Please explain why.

82 Are there any additional arguments that have not been identified above?

Allianz strongly supports the introduction of a FV-OCI category. This category is essential in its interaction with the decision in the insurance contracts project to present interest rate driven changes of the insurance liability in OCI. This enables insurers to present a current balance sheet, reflecting fair value information of investments and the current fulfillment value of insurance liabilities, as well as presenting an income statement which reflects the long term nature of the business.

To meet the needs of the insurance industry and ensure a consistent accounting approach, we think that an unconditional option to either select amortized cost or FV-OCI treatment for all assets which (a) meet the cash flows characteristics test as simple debt instruments and (b) are not hold in a trading portfolio (as defined in IAS 39) would be the most convincing approach (please see our arguments on page two of the cover letter). An option conditional on the existence of an accounting mismatch (view 2) is problematic due to the interaction with the insurance contracts project: For participating contracts, to avoid an accounting mismatch, the IASB proposes that the measurement basis of insurance liabilities is mirrored to the treatment of the asset side (-> “mirroring” decision). Therefore, a circularity occurs when the FV-OCI option on the asset side is also conditional on an accounting mismatch.

In case the OCI-option will not be established on an unconditional basis we prefer the proposal of the ED that debt assets are classified as FV-OCI if they are held within a business model whose objective is both to collect contractual cash flows and to sell (view 1). However, in this case an option to use FV-OCI needs to be established for assets which fall in the “hold to collect” amortized cost category to avoid an accounting mismatch.

<u>Question 7</u>
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?

We are not considering to early apply IFRS 9 before the effective date. Nonetheless given the complexity arising from a phased application we conceptually agree that an entity early applying IFRS 9 should be required to apply IFRS 9 in its entirety. The same statement applies to the six-month transition period.

However, we are generally concerned about the interactions of the IFRS 9 project with Phase 2 of IFRS 4 for the following reasons:

- As the IFRS 4 Exposure Draft is not yet available, our assessment of IFRS 9 cannot be finalised until the point in time both (draft) standards have been released.
- Moreover, insurers would have to undertake two significant conversion exercises within a short period of time. This staggered approach regarding the implementation of two fundamental accounting standards will give rise to complexity and significant operational costs for the insurance industry.
- Additionally, it may also put into question the usefulness of financial reporting for users during this period, as users will experience two major changes in an insurer’s financial statements in very short succession.

As such the mandatory effective date for IFRS 9 should be aligned with the expected adoption date for IFRS 4 in 2018, so that insurers would not be required to adopt these two significant changes on a piecemeal basis, whereas voluntarily early adoption should still be possible to address the needs of other reporting entities.

<u>Question 8</u>
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?

Yes, we agree.

<u>Question 9</u>
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?

We do not have any specific comments regarding this question.