Comments
on
the Exposure Draft ED/2012/4
Classification and Measurement:
Limited Amendments to IFRS 9
(Proposed amendments to IFRS 9 (2010))

Positions of the German Insurance Association

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General Comments:

We appreciate the opportunity to comment on the proposed limited amendments to IFRS 9 Phase I 'Classification and Measurement' as issued by IASB on 28th November 2012 as Exposure Draft ED/2012/4. The German Insurance Association (GDV) represents the common view of 470 insurers. With this response the GDV would like to underline the importance of the proposals and reconfirm its fundamental positions and expectations with regard to the accounting of financial instruments. Furthermore, we will focus on main issues which are especially important for German insurers. These issues are also highly relevant for successfully completing the insurance contracts project, where the design of the accounting principles for financial instruments is inherently of utmost importance.

In advance of our detailed comments the GDV would like to express explicitly its full support for the intensive efforts undertaken by the Chairman, the other members of the Board and the staff of the IASB to finalise the projects 'IFRS 9 Financial Instruments (*replacing IAS 39*)' and 'IFRS 4 Insurance Contracts (Phase II)' in the near future. We strongly believe that the final principle-based standards will be sufficiently robust to deliver appropriate solutions to transparently reflect the business model of long-term oriented insurers and their performance.

The re-opening of IFRS 9 Phase I 'Classification and Measurement' was a right decision and a necessary step.

The GDV has supported from the very beginning the limited reconsideration of IFRS 9 Phase I 'Classification and Measurement'. We highly appreciate that the IASB has decided to explicitly address the concerns expressed by the insurance industry and restarted the targeted consultations and deliberations on a more suitable approach for accounting of financial instruments. In particular, we recognise that the Board acknowledged that IFRS 9 is not only tailored to the specific needs of the banking industry. Likewise, an appropriate design of classification and measurement provisions for financial instruments is fundamentally relevant for insurance industry.

The GDV highly appreciates and strongly supports the introduction of the FV/OCI measurement and presentation category.

In general, we express our full support for the proposed limited amendments to IFRS 9 Phase I 'Classification and Measurement'. The introduction of the fair value through other comprehensive income (FV/OCI) measurement and presentation category is an important and necessary step on the way towards a robust holistic solution with regard to an appropriate accounting framework for financial instruments. It is also an essential element with regard to the insurance contracts project. The inherent interconnection between insurance liabilities and covering financial assets is explicitly acknowledged by the Board (IN1, BC11). It clearly demonstrates that an item-by-item-approach might not always be suitable in the process of developing international financial reporting standards. In our strong view, the **FV/OCI measurement and presentation category** for financial assets in IFRS 9 **is an indispensable part of the holistic solution** within an appropriate accounting framework for insurers to achieve a fair presentation of a financial position and a meaningful income statement in a current measurement environment. Thus, the Board's proposal to reintroduce the FV/OCI category in IFRS 9 is a highly appreciated step.

Nevertheless, a final assessment of IFRS 9 'Financial Instruments' will not be possible before the international financial reporting standard for insurance contracts (IFRS 4 Phase II) is completed. *For this reason we would currently like to reserve the right to assess the principles and provisions of IFRS 9 again once the final IFRS 4 is released*.

A level playing field for the insurance industry has to be ensured.

IFRS 9 is not supposed to be a sole banking standard; other industries also hold a significant amount of financial assets (e.g. simple debt instruments, conventional equity instruments). Likewise, IFRS 4 is not a standard being solely developed for insurers. However, the banking industry is able to consistently apply 'at amortized cost' measurement approach on both sides of the balance sheet since 'financial liabilities' and 'loans and receivables' are generally measured 'at amortised cost' under the current IFRS 9. We strongly advocate that the similar conceptually consistent approach should apply to insurers. A **consistent two-sided FV/OCI measurement and presentation approach** would be most appropriate for the insurance industry as it would reflect the current decisions on the insurance contracts project (e.g. regarding the current balance sheet). A proper and transparent reflection of the business model of insurers and a level playing field with other industries is vitally important and should be ensured by the IASB.

A consistent accounting approach for insures might require a broader scope of FV/OCI measurement and presentation category.

We would like to highlight that not only simple debt instruments (e.g. bonds or loans) are used by German insurers to back their insurance liabilities, although these debt instruments play currently the most important rule. Being aware of that, we would like to state that a broader scope for the FV/OCI category might be needed to eliminate or at least significantly reduce possible accounting mismatches.

Especially, we are afraid that the cash flow criterion might be in many cases too restrictive as a constraint provided that the business model test ('hold to collect contractual cash flows and for sell') has been successfully passed. We are convinced that not only conventional simple debt instruments should be eligible for the FV/OCI category. In many other cases, when debt instruments are insignificantly different from simple debt instruments, the use of the OCI presentation should also be ensured (e.g. originated infrastructure debt instruments, subordinated loans or certain mortgages). In such cases the mandatory classification as fair value through net income would inevitably lead to an accounting mismatch in the insurer's net income. We encourage the Board to address our concerns by an explicit clarification (within Application Guidance or Business for Conclusions) that such debt instruments are available for OCI presentation.

Furthermore, we kindly suggest to the Board that the contractual cash flow characteristics assessment should not prevent **equity instruments** from being designated to the FV/OCI presentation. A similar treatment of debt and equity instruments within one business model should be a feasible objective for further considerations.

A consistent accounting approach for insurers might require an introduction of an explicit FV/OCI option for 'at amortized cost' category.

We are aware of the limited scope of the ED/2012/4 and political constraints and expectations after the financial crises with regard to strict accounting rules for financial assets. This is the main rationale and driver for replacing of IAS 39 by IFRS 9. Nevertheless, we believe that there is a necessity to accept an option to apply the FV/OCI measurement and presentation category for simple debt instruments not passing the business model assessment if (significant) accounting mismatch would occur. In our view, the business model assessment might lead to misleading results if being conducted on the portfolio level. Furthermore, we are afraid that in the case of investment strategy being very conservative (e.g. holding all the simple debt instruments always until maturity) even conducting the business model assessment on the entity level would not lead to an expected use of the OCI measurement and presentation category. Thus, in our view only an **explicit FV/OCI option for 'at amortised cost' category** might address the identified 'assessment gap'.

Considering the existence of fair value through profit or loss option in IFRS 9 the **GDV suggests introducing an equivalent fair value through other comprehensive income option**. Both alternatives should be equivalently available for financial assets that would otherwise be mandatorily measured at amortised cost.

Many German insurers are following very conservative investment strategies. Taking into consideration the current stage of discussions on the insurance contracts project we have the strong view that only an explicit FV/OCI option can remove the significant accounting mismatches and the resulting volatility in equity which would otherwise arise. Thus, we suggest to the Board that an entity should be permitted to designate financial assets as measured at fair value through other comprehensive income if, and only if, such a designation **eliminates or significantly reduces a measurement or recognition inconsistency ('accounting mismatch')**. In accordance with the existing fair value through profit or loss option in IFRS 9 such designation would be performed at initial recognition and would be irrevocable.

In addition, in case of participating contracts (IFRS 4 Insurance Contracts (Phase II)), an explicit clarification might be needed to ensure that the application of the proposed mirroring approach (means: reflection of the financial asset measurement basis on the liability side) does not exclude the use of the suggested FV/OCI option, and thus a holistic and consistent use of FV/OCI measurement category on the asset side is guaranteed and not restricted by the accounting mismatch constraint (‘**circularity problem**’). A fragmented measurement approach for financial assets backing insurance liabilities which share the same cash flow characteristics is not desirable. The required clarification should be included in the Application Guidance for IFRS 9 and/or in the standard text of the final IFRS 4.

Recycling for equity instruments is necessary and conceptually consistent.

Last but not least we would like to emphasise the need for recycling of amounts accumulated in other comprehensive income with regard to equity instruments at the moment of sale or derecognition. We do not understand why realized gains or losses should not be recognised in the income statement. We are in favour of a simple principle to be applied: ‘**recycle when derecognized**’. Furthermore, we do not agree with the view that recycling necessarily requires impairment rules (in opposition to BC24 (a)). The tentative decision to reject the need for the Loss Recognition Test (LRT) within the insurance contract project demonstrates that impairment rules are not necessary to allow for recycling when recycling is only allowed at derecognition or occurs automatically. However, if the Board should again come to the conclusion that introduction of a recycling mechanism would require impairment rules, we suggest a simplified one: ‘lower of cost or market’. This simple rule would completely eliminate a storage of a negative other comprehensive income.

The mandatory effective dates of final IFRS 9 and IFRS 4 (Phase II) should stay aligned.

The finalized IFRS 9 is currently planned to become effective on the 1th January 2015. The finalised IFRS 4 should possibly be enacted on the 1th January 2018. Considering the systematic interconnection of the financial instruments project and insurance contracts project we would like to reiterate our fundamental position on the general need for the alignment of the effective dates of both standards (as recently expressed in the joint letter of Insurance Europe and European Insurance CFO Forum of 14th December 2012). The new accounting principles for financial instruments and for insurance contracts should be implemented and applied at the same time, also at the group level. However, the possibility of early application should be permitted for both standards. We believe that a pragmatic solution for a question of such importance for insurance industry should be feasible. Especially, a pragmatic approach defined by the IASB on a global basis is more suitable than any potential deferral of endorsement at the European level.

Final remarks

Although we fully acknowledge the narrow scope of the Exposure Draft ED/2012/4 we would like to encourage the Board to seize the opportunity and reconsider the critical issues for insurers as set out above. The introduction of the FV/OCI measurement and presentation category is a decisive und indispensable element of a final robust two-sided solution for insurers' accounting, especially with respect to the long-term horizon of the insurance industry and its investment decisions, where short-term movements of interest rates introduce otherwise a 'market noise' and as such an artificial volatility to income statement.

Thus, to consistently tackle the issue of a transparent fair presentation of insurers' business model the GDV advocates a wider scope of the FV/OCI category. Its introduction in IFRS 9 is an important step in the right direction. We suggest an explicit FV/OCI option for financial instruments being otherwise measured 'at amortised cost' to enable conservative insurers to avoid or significantly reduce accounting mismatches.

For our arguments and further detailed comments on the Exposure Draft ED/2012/4, please consider our positions enclosed.

We hope that our comment letter provide a useful contribution to the future discussions on the final standard for financial instruments.

Contractual cash flow characteristics assessment: a modified economic relationship between principal and consideration for the time value of money and the credit risk

The IASB has received questions about the application of the contractual cash flow characteristics assessment to some financial assets. In particular, questions have been raised about financial assets that contain interest rate mismatch features (ie the interest rate is reset but the frequency of the reset does not match the tenor of the interest rate).

Accordingly, this Exposure Draft proposes an amendment to the application guidance in IFRS 9 to clarify that if contractual cash flows on a financial asset include only payments related to principal and consideration for the time value of money and the credit risk, but the economic relationship between those components is modified due to an interest rate mismatch feature or leverage ('a modified economic relationship'), an entity shall assess that modification to determine whether the contractual cash flows represent solely payments of principal and interest. In assessing a modified economic relationship, an entity considers the cash flows of a financial asset that is identical in all respects (including reset dates) other than not containing the modification in the economic relationship ('benchmark cash flows'). If the modification could result in contractual cash flows that are more than insignificantly different from the benchmark cash flows, the contractual cash flows are not solely payments of principal and interest.

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?

In general, we 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 to contain cash flows that are solely payments of principal and interest on the principle amount outstanding and thus be available for the ‘at amortized cost’ or ‘fair value through other comprehensive income’ category. Furthermore, we agree that this should only be the case when the differences to the benchmark instrument are not more than insignificant with regard to the contractual cash flows.

The optional use of the actual or hypothetical financial asset as the basis for the assessment is a pragmatic approach (B4.1.9B). We acknowledge that the judgmental use of this option will rely on the related search costs for such real ‘benchmark instrument’ which should not exceed a reasonable level. The presumption in B4.1.9E that a performance of a detailed assessment is **not needed** if it is clear that cash flow test would be passed positively is much appreciated.

In general, we consider the suggested ‘benchmark solution’ as an appropriate and robust one. Further specifications might not be necessary in a principle-based standard. They even would be not suitable regarding the diversity of available debt products in the market and across the countries.

Furthermore, we welcome the clarification that the interest rate reset feature does not necessarily lead to a failure of the cash flow test (B4.1.9B - B4.1.9D). The same applies to the amendment to the example on ‘Instrument A’ (B4.1.13), where the Board states that in the case of indexing to the debtor’s performance resulting in an adjustment that only compensates for changes in credit quality of the instrument, the contractual cash flows still only represent payments for principal and interest.

We fully acknowledge that the application of the defined conditions of the cash flow criteria will remain a matter of judgment. Thus, more detailed specifications might be more contradictive rather than helpful.

Nevertheless, we strongly encourage the Board to reconsider a broadening of the scope of the financial instruments which are available for the fair value through other comprehensive income (OCI) measurement and presentation. In many cases, where debt instruments are insignificantly different from simple debt instruments, the use of the OCI presentation should also be accepted. For detailed explanation of our positions we refer to our comments on questions 4 and 5.

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?

In our assessment the proposed Exposure Draft sufficiently provides the needed guidance on how to apply the proposed ‘benchmark approach’. We understand that the entity’s assessment whether the modifications of the economic relationship are more than insignificant relies on the changes in cash flow patterns and their relation between the principle and interest payments and does not relate to the relative or absolute present value differences between the debt instrument under consideration and the benchmark’s cash flows.

Thus, in general, we do not see a need for further specification as the assessment of the modified economic relationship (if needed) should remain a matter of judgment on entity level and on instrument-by-instrument basis. The principle-based IFRS 9 can hardly cover the whole variety of debt instruments being often individually contracted and issued in practise. Furthermore, the individual design of a single debt instrument may vary over time, thus a principle-based approach is more robust and flexible.

Finally, we would expect that in many common cases the presumption of B4.1.9E can be referred to, thus a performance of a detailed assessment might not be necessary. In this respect we would also consider a reference to the general principle of materiality as useful.

Nevertheless, the proposed amendments are solely addressing the question of modified economic relationship between two components: contractual cash flow payments related to principal (principal payments) and consideration for the time value of money and the credit risk (interest payments). In our understanding any additional feature will lead to the consequence that the financial debt instrument under consideration is mandatorily measured at fair value through net income (FV/PL). **We do not consider this result as appropriate**. We suggest an explicit clarification that debt assets which are insignificantly different from simple debt instruments are not mandatorily classified for fair value through net income (FV/PL) measurement.

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?

Yes, we believe that the proposed amendment to IFRS 9 will contribute to a more appropriate application of the contractual cash flow characteristics assessment in intended cases.

We are aware and appreciate that the Board tries to implement reasonable safeguards to ensure a proper application of the cash flow criterion in the accounting practice on a global level. In addition, we do believe that the suggested additional disclosure requirements (IAS 1 paragraph 123 (d)) will ensure the needed transparency on the management's use of judgment with regard to assessment whether contractual cash flows of a financial asset are solely payments of principal and interest (SPPI). Thus, we support the proposed amendment.

We are also referring and relying on the statutory auditors' responsibility which will, in our view, ensure the consistent application of the proposed principle-based provisions for conducting of the contractual cash flow characteristics assessment. At this stage it is important to emphasise the Board's decision to reject the strict/narrow interpretation approach that any modification in the economic relationship between the principle and the consideration for the time value of money and the credit risk (interest) would automatically result in the financial asset being mandatorily measured at fair value through profit or loss (BC42 - BC44). We explicitly support this Board's decision as a guideline for interpretation.

Particularly, in a case of a conventional simple variable-rate loan the contractual cash flows are economically principal payments and interest (B4.1.12 (a)). Therefore, the financial debt instrument under consideration can be classified and measured as 'at amortised cost' or as 'at fair value through other comprehensive income', depending on the underlying business model.

Business model assessment: the ‘fair value through other comprehensive income’ measurement category for financial assets that contain contractual cash flows that are solely payments of principal and interest

The Exposure Draft proposes that some financial assets should be mandatorily measured at fair value through OCI, specifically, financial assets held within a business model in which assets are managed both in order to collect contractual cash flows and for sale (subject to the contractual cash flow characteristics assessment; ie these are debt instruments). Under the proposals, interest revenue, credit impairment and any gain or loss on derecognition would be recognised in profit or loss; all other gains or losses (ie the difference between these items and the total change in fair value) would be recognised in OCI.

Interest income and credit impairment would be computed and recognised in the same manner as for financial assets measured at amortised cost. Cumulative gain or loss recognised in OCI would be reclassified to profit or loss when the financial asset is derecognised. That would result in amortised cost information being provided in profit or loss and fair value information being provided in the statement of financial position.

The Exposure Draft proposes application guidance on how to determine whether the business model is to manage assets both to collect contractual cash flows and to sell.

In addition, the Exposure Draft proposes clarifications to the application guidance in IFRS 9 on what is a ‘hold to collect’ business model.

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 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 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 other comprehensive income (OCI). However, we understand that the mandatory use of the OCI measurement is effectively not required when the so called fair value option can be exercised (Question 6).

The proposed introduction of the FV/OCI measurement and presentation category (fair value measurement with presentation for the fair value changes in OCI) **is highly appreciated and supported by the German insurance industry**.

In our assessment the proposed amendments to IFRS 9 paragraph 4.1.2A and paragraph 5.7.1 (d) are essential and indispensable given the inherent interaction between the classification and measurement of financial assets and the accounting of insurance contracts liabilities. As tentatively decided by the Board in May 2012 for the insurance contracts project, the use of OCI will allow for a proper and transparent presentation of interest rate driven changes of the insurance liability (‘market noise’). We strongly support this tentative decision. The artificial volatility should not distort the adequate reflection of the long-term oriented insurance business and the related performance in the income statement.

Consequently, the corresponding financial assets backing insurance liabilities should also be eligible for OCI presentation. The introduction of the FV/OCI measurement and presentation category in IFRS 9 will result in current information being provided in the statement of financial position (‘current balance sheet’) and amortised cost information being provided in profit or loss (as if the financial assets were measured at amortised cost). Both are very useful as they help to present / interpret the financial position of entities in an appropriate and transparent way. In our strong view, only a **holistic**, **two-sided OCI-solution** would enable insurers to present a fair value of investments and the current fulfilment value of insurance liabilities (current balance sheet), as well as presenting an income statement which reflects the long term horizon of the insurance business. The OCI presentation ensures that the short term artificial volatility, driven especially und mostly by market interest rates movements, does not distort the income statement of insurers.

The existing two measurement categories in IFRS 9 (‘at amortised cost’ and ‘at fair value through profit or loss’) do not allow for an appropriate reflection of long-term oriented insurance business model, especially taking into consideration the current state of the IASB’s insurance contracts project decisions which require a current measurement of the insurance liabilities and mandatory use of the OCI for changes in insurance liabilities arising from changes in discount rates.

It is highly appreciated that the Board acknowledged the urgent need for making a distinction between influence of artificial volatility (‘market noise’) and other effects on the profitability of insurers within the insurance contracts project (IFRS 4 Phase II). The tentative Board’s decision from May 2012 to introduce the OCI presentation will contribute significantly to a more appropriate performance measurement of insurers. The proposed introduction of the **FV/OCI measurement and presentation category in IFRS 9 is a necessary subsequent step** which amends the decision on insurance contracts project in a consistent way and makes the statement of comprehensive income of insurers more transparent and the income statement more adequate. Accepting the current balance sheet on the asset side on the fair value through profit or loss (FV/PL) basis would lead to a distorted income statement and profit number being driven mostly by the market interest rate volatility. That outcome would *not* be a fair presentation at all. The use of FV/OCI category will not only contribute to meaningful income statement reducing the accounting mismatch but also allow for offsetting effects within the other comprehensive income as part of the statement of the comprehensive income. These effects will especially significantly reduce the volatility of the net income in an effective way.

In addition, the GDV strongly supports the proposed rules for recycling at derecognition (as defined in paragraph 5.7.1A). The amount of cumulative gains or losses previously recognised and accumulated in OCI should become effective in profit or loss when the gains/losses are realised or financial assets are derecognised. This is in our view a conceptually consistent approach.

Finally, we do not have any detailed critical comments on the added reclassifications rules (paragraphs 5.6.4-5.6.7) which are related to the new FV/OCI measurement and presentation category; they are necessary. In our assessment the proposed rules are conceptually sound and operationally feasible.

Technical and structural remarks on the approach of IFRS 9 and the ED:

The application of IFRS 9 is conceptually based on the **business model assumption**. The contractual cash flow criteria imply further constraints. Thus, the current IASB's proposal suggests two conditions which both need to be met.

The GDV agrees that the application of IFRS 9 requires the assessment of the entity's business model for managing its financial assets. **We support the business model approach** as generally reconfirmed by the IASB (BC36). It is also consistent with recent decisions of the IASB (e.g. on the 'Investment Entities project'). Especially, the suggested introduction of the 'third business model' reflects the fact that **insurers have a unique long-term oriented business model**. And it is much appreciated that the Board acknowledged and addressed it explicitly in the ED/2012/4. If financial assets are managed within a 'defined business model', they can be measured and presented as **FV/OCI category**. This decision will help to better reflect the way how insurers manage their (financial) assets portfolios and satisfy the management approach.

The entity's '**defined business model**' on the asset side **is to manage financial assets both in order to collect contractual cash flows and for** sale (paragraph 4.1.2A). In our view, the FV/OCI measurement and presentation category reflects the nature of the insurers' business in a **more suitable** way than the existing categories in IFRS 9. We agree with the assessment of the Board that the added complexity to IFRS 9 is '*justified by the usefulness of the information provided*' (BC21) and '*may improve consistency between the classification and measurement of financial assets and insurance contracts liabilities*' (BC29). A complex economic environment requires a sophisticated accounting treatment. An Item-by-item approach is not suitable for addressing the interaction between insurance liabilities and related assets as the fundamental core of insurer's approach to manage its business. Therefore, the Board's decision on a more holistic consideration of insurers' asset/liability management strategies is much appreciated.

We strongly believe that the final principle-based standard IFRS 9 will have a high quality. However, in our assessment there are still some **important technical fine-tuning adjustments** to the classification and measurement provisions for financial instruments **necessary**, especially to achieve **more consistency with the insurance contracts project**. We fully acknowledge the need to make appropriate constraints on the 'defined business model' criteria or on the 'contractual cash flows characteristics assessment'. Nevertheless, we have the strong view that the scope and the availability of the FV/OCI measurement and presentation category in IFRS 9 should be broader.

To illustrate our rationale, and the related expectations in more detail we have developed the following suggestions:

<u>Suggestion 1:</u>

The proposed restrictions in ED/2012/4 with regard to the use of the FV/OCI category in IFRS 9 might be too extensive.

The requirement that all financial assets have to pass the narrow contractual cash flow characteristics assessment might not always be suitable. We understand the rationale for the original introduction of this cash flow oriented constraint within the business model "hold to collect". But it might not be always necessary or even distracting in the case of insurers' business model and for the classification of financial assets backing insurance liabilities.

The main reason for our first suggestion is that not only simple debt instruments (e.g. bonds or loans) are used by German insurers to back their insurance liabilities. Therefore, we suggest further extending of the scope of the proposed FV/OCI category to achieve a more robust and compatible accounting treatment, especially with regard to the insurance contracts project. In our assessment, it should be explicitly considered that mandating the use of the OCI presentation for discount rate changes in insurance contracts project does require extension of the FV/OCI category within IFRS 9 and for other related standards (e.g. IAS 40 *Investment Property*). A consistent measurement of economically related assets and insurance liabilities should remain feasible. Any other approach will be not broad or holistic enough and remain as such only a fragmentary solution.

In our **General Comments** we have expressed the strong view that the **FV/OCI category should be extended at least to a broader scope of debt instruments**. The contractual cash flow characteristics test is too restrictive to identify all instruments that should be available for the FV/OCI measurement. In particular, we are advocating for a broadening of the simple debt definition as it too often triggers fair value through net income measurement. We believe that debt instruments which are insignificantly different from simple debt instruments should be eligible for the OCI presentation (e.g. originated infrastructure debt instruments, subordinated loans or certain mortgages).

Suggestion 2:

The eligible OCI presentation for equity instruments should include recycling.

We have the view that the contractual cash flow characteristics assessment should not prevent equity instruments from being designed to the OCI presentation. A similar treatment of debt and equity instruments within one business model should be envisaged.

Thus, although strongly supporting the business model oriented basis for the introduction of the FV/OCI category we recommend a deliberate reconsideration of the accounting mismatch issue for insurers. In other words, all random changes of fair values should be all kept in the OCI before **recycling at derecognition** (being usually the moment of realisation/sale). The short-term volatility should be better presented in the OCI and not distort the net income of long-term oriented insurers.

For further explanations and the possible design of the recycling principle for equity instruments we kindly refer to our additional remarks in this comment letter.

Suggestion 3:

We favour a FV/OCI option for financial assets being classified and measured 'at amortized cost' to ensure for the insurance industry a level playing field with other industries.

We are aware of the limited scope of the ED/2012/4 and political constraints and expectations after the financial crises with regard to strict rules on accounting for financial assets. Nevertheless, we believe that there is an **justified necessity to introduce an explicit option to use the FV/OCI** measurement and presentation category for (simple) debt instruments, when the business model assessment (depending on its final design) is not fulfilled (e.g., in the case of very conservative investing insurers) and significant accounting mismatch might occur. For the rationale and further details with regard to the design of the FV/OCI option we refer to our **General Comments**. Especially the '**circularity problem'** in the case of participating contracts (IFRS 4 Phase II) should be addressed by the Board. In our view, the application of mirroring approach for participating contracts should *not* exclude the possibility of a consistent use of the **two-sided OCI presentation**. Thus, the suggested FV/OCI option should also remain available in case of participating contracts; a holistic use of the FV/OCI category on the asset side should not be restricted by the accounting mismatch constraint. Split in measurement basis, e.g. a fragmented measurement approach for financial assets is not desirable when the financial assets (backing insurance liabilities) share the same cash flow characteristics. In our view, the suggested clarification should be included in the Application Guidance for IFRS 9 and/or to the standard text of the final IFRS 4 Insurance Contract (Phase II.

The banking industry is able to consistently apply 'at amortized cost' measurement approach on both sides of statement of financial position as the financial liabilities under IFRS 9 are measured mostly 'at amortised cost'. A similar approach should also apply to other industries, e.g. insurers. The decision of the IASB to enforce a current measurement of insurance liabilities (IFRS 4 Phase II) requires appropriate adjustments for insurers for the asset side measurement.

Thus, for consistency purposes a two-sided use of the FV/OCI measurement and presentation category should be feasible. A proper reflection of the long-term oriented business model of insurers and level playing field has to be ensured.

Suggestion 4:

Alternatively, we suggest structural redefinition of the relationships between the three categories within IFRS 9 and to explicitly define only the categories '*at amortized cost*' (hold to collect the contractual cash flows) and '*at fair value through profit or loss*' (frequent trading activities) with the '*fair value through other comprehensive income*' as a residual one, which would be available for any financial asset.

The current classification and measurement rules in IFRS 9 rely on the conceptual assumption that the category 'fair value through profit or loss' is a residual one. We understand and fully support the intention of the Board to get a conceptually well founded basis for the proposed third category (as stated in BC31 - BC33). However, if the Board would decide to redesign the definition of the third category, we would suggest considering the **FV/OCI category as a default category**. It would imply that 'trading category' would be mandatorily and explicitly defined, as previously in IAS 39 *Financial Instruments: Recognition and Measurement*.

Thus, the reversed ordering approach would contribute to persistence of the measurement provisions for financial assets and ensure a better comparability of financial statements over time. In our strong view, the measurement categories FV/PL and FV/OCI are on the same level of importance and relevance; the FV/OCI is however a more transparent category with regard to transparency of result presentation. Especially, the OCI presentation would isolate random fair value movements and treat them separately from realised gains or losses at derecognition.

Nevertheless, our suggestion 4 does not replace the need for introduction of the FV/OCI option for 'at amortised cost' category. Therefore, our suggestion 3 is still valid.

Summing up the structural remarks and our four suggestions how to improve and fine-tune the ED/2012/4 we strongly insist to **introduce an explicit FV/OCI option for 'at amortised cost' category to avoid or significantly reduce an accounting mismatch**. This amendment would complete the proposed FV/OCI category in an appropriate way, especially for insurers following very conservative investment strategies with the consequence that OCI business model test fails and an assessment gap occurs. Finally, we advocate for a broader scope of debt assets for the OCI presentation.

<u>An additional re-assessment of IFRS 9 in future unavoidable:</u>

A proper interaction between IFRS 9 and IFRS 4 is crucial for insurers. Thus, the final holistic assessment of the interaction between the completed IFRS 9 and the final future standard for insurance contracts (IFRS 4 Phase II) will be feasible only after both standards are finalised.

For this reason we would like to reserve our right to comment again on the final IFRS 9 *Financial Instruments* after its completion and after the final standard on insurance contracts will be available.

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?

As stated in paragraph 4.1.1 (a), the entities are required to classify financial assets on the basis of the entity's business model for managing the financial assets. An assessment is needed whether the financial assets meet the conditions in paragraph 4.1.2 (a) or in paragraph 4.1.2A (a) on the basis of the objective of the business model as determined by the entity's key management personal (as defined in IAS 24 *Related Party Disclosures*). Paragraphs B4.1.1 - B.4.1.26 provide application guidance on how to apply these provisions.

We support this robust principle-based approach, and the focus on the business model of an entity and its core activities in a holistic assessment. **Insurers have a unique business model** and it is much appreciated that the Board acknowledged that and chose it as a basis for their conceptual decision to introduce the so called third business model within IFRS 9. **The business model definition 'to hold to collect and to sell' can be considered to be an appropriate one.**

Especially, the clarification that the entity's business model for managing the financial assets is a matter of fact is an important one (B4.1.2A). Fundamentally important is that the entity's business model does not depend on the management's intention for an individual financial instrument (B.4.1.2). We also welcome the statement in B4.1.2B, that all objective evidence is relevant to assessing the entity's business model. Thus, the frequency, timing and volume of sales in prior periods are indeed only one of the factors which have to be considered by the assessment.

The ED/2012/4 provides sufficient application guidance on how to distinguish the defined business models. The 'defined business model' for the FV/OCI category, to manage assets both to collect contractual cash flows and to sell, is sufficiently defined with regard to the indented objective within a principle-based standard as IFRS 9 should remain to be. The suggested business model definition ‘to collect contractual cash flows and to sell’ reflects this ‘something between’ business model based mostly on trading activities and the business model where solely the holding of financial assets for collection of contractual cash flows is the aim. Insurers’ business model has indeed inherently elements both of ‘holding to collect’ and ‘for sale’.

Thus, in our current assessment **the definition and the guidance on the three business models are sufficient and will allow for operational application**. The initial implementation will require a degree of judgment, but this flexibility is necessary to reflect the diversity on the global basis within one principle-based-standard. We also do not believe that there is a need for further clarification at which level the judgment about the existence of business model has to be exercised. It is a matter of fact; there are differences between entities if they have structured their businesses and management control in a different way. As stated in Application Guidance in B4.1.2, a single entity may have more than one business model for managing its financial instruments.

The GDV is aware that some interested parties are fundamentally questioning the need for the FV/OCI category and deny the existence of the related business model. We strongly encourage the Board to reconfirm the decision that only two business models - as previously defined within IFRS 9 - do not allow for an appropriate reflection of the complex economic realities in a current measurement approach. Especially, we fully share the Board’s view that the decision to allow for the use of FV/OCI category does not limit the scope or the relevance of the ‘at amortised cost’ category. The decision to allow for the FV/OCI category also does not indicate an advanced relevance of the fair value measurement (BC30), especially where only the presentation is affected. We strongly support the Board’s view that the **decision on FV/OCI category solely improves the relevance of the financial information provided**. The fair presentation is indeed the generally shared and main objective of financial reporting (IAS 1 paragraph 15).

We encourage the Board to carefully consider whether further clarification would be suitable to address the arguments that a clear cut between FV/OCI category and FV/PL category is not possible. In our view, the contrary is right. And we support explicitly the *Example 3* (related to B4.1.4B). We also refer to our **Suggestion 4** (as part of our response to

Question 4) to reconsider the possible treatment of FV/OCI category as a default category. The reversed ordering approach might be politically helpful to address the scepticism of the critics of the clear definition of the FV/OCI category as it would be then the residual one.

The Exposure Draft proposes that the existing fair value option in IFRS 9 should be available for financial assets that would otherwise be mandatorily measured at fair value through OCI. That is, the Exposure Draft proposes that an entity would be permitted to designate such a financial asset as measured at fair value through profit or loss if, and only if, such a designation eliminates or significantly reduces a measurement or recognition inconsistency (sometimes referred to as an ‘accounting mismatch’). In accordance with the existing fair value option in IFRS 9 such designation would be performed at initial recognition and would be irrevocable.

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 support the proposed extension of the existing fair value option. The same treatment of the measurement categories ‘at amortised cost’ and ‘fair value through other comprehensive income’ is conceptually consistent as also the other measurement provisions (e.g. effective interest rate being determined at initial recognition, impairment rules, provision for application of the foreign exchange rules under IAS 21 *The effects of changes in foreign exchange rates*) are proposed to be aligned.

Effectively the Board is suggesting a strict **conditional mandatory** use of the FV/OCI measurement and presentation category. The use of the OCI is effectively not required when the fair value option (fair value through net income) can be exercised. The GDV supports such a design of the new category. The same should apply to the suggested FV/OCI option (**Suggestion 3** in Question 4).

However, we question the rationale behind the example in B4.1.30 point a) as it does not reflect the very appropriate decision of the Board to introduce the OCI presentation within IFRS 4 Phase II for changes in insurance liabilities arising from changes in discount rates. Thus, the contrary is true: the mandatory use of the OCI presentation in IFRS 4 Phase II for some changes in insurance liabilities requires the use of the OCI presentation in IFRS 9 for financial assets backing insurance liabilities. Otherwise measurement inconsistency (‘accounting mismatch’) would arise. We suggest not changing the example and keeping the reference to ‘at amortised cost’ as the appropriate one. Under the current decisions and the proposed ED/2012/4 we do not expect all financial assets to be available for FV/OCI category as the example would suggest. Again, we would like to refer to our **Suggestion 3** (Question 4).

Early application

At present, more than one version of IFRS 9 can be applied early: that is, an entity is permitted to apply either the classification and measurement requirements for financial assets only (ie IFRS 9 issued in 2009) or to apply the classification and measurement requirements for both financial liabilities and financial assets (ie IFRS 9 issued in 2010). The Exposure Draft proposes that only the completed version of IFRS 9 (ie including Classification and Measurement, Impairment and General Hedge Accounting chapters) can be newly applied prior to the mandatory effective date (except as described in question 8 below). This proposed amendment would become effective six months after the completed version of IFRS 9 is issued.

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?

The GDV is not supportive of phased application of IFRS 9 as it causes needless additional operational efforts for entities and reduces comparability for users. Thus, we encourage the Board to reconfirm that only the finalised version of IFRS 9 can be applied prior to the mandatory effective date after the completed version of IFRS 9 is finalised. We understand that standard IFRS 9 *Financial Instruments* is completed once the Board publishes the final amendments after deliberations of this ED, impairment rules and general hedge accounting. We remind the Board to guarantee that sufficient time is available after the final publication of the whole package (including all chapters) to ensure an effective and appropriate implementation of the complete IFRS 9.

However, we also understand the need for a suitable transition period once some entities might have invested significant resources in application of phased IFRS 9 and some more time delay might still occur before finalisation. Nevertheless, they should be obliged to use the last available version of IFRS 9 and not allowed to use the previous ones.

Further analysis is still needed on how to achieve suitable interaction between the mandatory application of final IFRS 9 and the mandatory use of IFRS 4 Phase II. For this point we refer to our additional remarks at the very end of our response and to our **General Comments**. We believe that it is crucial that the effective dates of the insurance contracts standard and IFRS 9 are aligned for insurers, also on the group level.

Presentation of ‘own credit’ gains or losses on financial liabilities

Notwithstanding the proposed transition requirement above, once IFRS 9 is completed, an entity will be permitted to early apply only the ‘own credit’ provisions in IFRS 9, which require an entity to present in other comprehensive income fair value gains or losses attributable to changes in the credit risk of financial liabilities designated as measured at fair value through profit or loss, without otherwise changing the classification and measurement of financial instruments.

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?

We do not have any specific concerns or comments with regard to this point.

Nevertheless, as insurers are also major institutional investors, we would like to emphasise that an appropriate disclosure in the notes to the financial statement about the annual and cumulative amount of the fair value changes which are related to own credit risk change should be required. And we would like note that such requirement already exists in IFRS 7 *Financial Instruments: Disclosures* in paragraph 10.

First-time adoption

This Exposure Draft does not propose any specific changes to IFRS 1 *First-time Adoption of International Financial Reporting Standards* for first-time adopters of IFRS. However, to make sure that first-time adopters are given sufficient lead time to apply IFRS 9 and are not at a disadvantage in comparison to existing preparers, the IASB intends to consider the transition to IFRS 9 for first-time adopters when these proposals are redeliberated.

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?

We do not have any specific concerns or comments with regard to this point. The general rules of IFRS 1 *First-time Adoption of International Financial Reporting Standards* might be sufficient.

In general, the GDV is always in favour of appropriate and pragmatic transitional provisions (e.g., transitional periods) for new released international financial reporting standards or their amendments, especially when local (e.g., European) endorsement procedures introduce an additional uncertainty with regard to the mandatory effective date. Thus, we strongly advocate for considering this while reconsidering the mandatory effective date of the final and complete IFRS 9. Not only first-time adopters should be given sufficient time to implement the standard.

Additional remarks:

The Exposure Draft ED/2012/4 does not explicitly ask for further comments. Nevertheless, the GDV would like to share its additional remarks with regard to two important aspects of the financial instrument project.

a) Recycling for equity instruments

The GDV would like to share its additional remarks on such an important aspect as recycling for equity instruments. This issue has been already discussed by the Board in the past, but it has been evaluated negatively. The Board referred mainly to the limited scope of this ED. However, the question 8 demonstrates that some additional issues are treated within this ED. They have also not been intended or mentioned in the decision on the limited re-opening of the deliberations on the Phase I of IFRS 9.

Therefore, we refer hereafter to our fundamental position on treatment of equity instruments within IFRS 9.

b) Mandatory effective date for IFRS 9 for insurers

Of utmost importance for insurers is the question if they will be forced to readjust their accounting systems for financial instruments twice within a short period of time or not.

a) Recycling for equity instruments

We strongly agree that equity instruments should be available for the FV/OCI category when they are not hold for trading purposes. But we continue to fundamentally disagree that profit or loss recycling is completely not allowed in such cases. In our assessment the final recycling for equity instruments is indispensable to ensure that realised profits or losses are at least once (and only once) presented in the entity's income statement. From the point of view of empirical research recycling is also conceptually needed to ensure that the 'clean surplus concept' (so called congruency principle) is valid: the sum of the periodically realized profits is equal to the total profit of an entity.

Therefore, the GDV strongly believes that a transfer of the accumulated amounts from other comprehensive income to profit or loss in income statement ("recycling") should be required or at least allowed if a sale/derecognition of equity instruments, which are classified and measured as FV/OCI category, occurs. '**Recycling on derecognition**' could be the simplest underlying principle.

In addition, we do not agree with the conclusion of the IASB that 'recycling accumulated gains or losses would require an [equity] instrument to be assessed for impairment' (as stated in BC24 (a)). In our assessment impairment rules on equity instruments might not be necessary to reintroduce recycling mechanism for them when classified for FV/OCI category.

The Board's tentative decision to reject the need for the Loss Recognition Test (LRT) within the insurance contract project (IASB Update May 2012) demonstrates well that impairment rules might not be necessary to allow for recycling when recycling is only allowed at derecognition (or takes place automatically as for insurance contract positions). However, if the Board should again come to the conclusion that introduction of recycling mechanism would necessarily require impairment rules, we suggest a simplified one: 'lower of cost or market'. This simple rule would completely eliminate a storage of a negative other comprehensive income.

We fully acknowledge the narrow scope of the ED/2012/4. Nevertheless we encourage the Board to seize the opportunity and to reconsider the recycling decision as discussed above. Especially, we do not believe that the introduction of the proposed recycling mechanism for equity instruments (being optional measured at FV/OCI) would extend the project in time in an inappropriate way. Therefore it would be in line with BC7 (a).

Thus, we strongly encourage the Board to reconsider the decision and to allow recycling for equity instruments at derecognition.

b) Mandatory effective date for IFRS 9 for insurers

The completed standard IFRS 9 *Financial Instruments* is currently planned to become effective on the 1th January 2015. The finalised IFRS 4 *Insurance Contracts* (Phase II) should possibly become mandatory on the 1th January 2018. Having in mind the systematic interconnection of the financial instruments project and insurance contracts project we would like to reiterate our strong fundamental position regarding the need for the alignment of the mandatory effective dates of both standards (as express last in the joint letter of Insurance Europe and European Insurance CFO of 14th December 2012).

The potential feasibility of implementation of new rules on accounting for financial instruments and for insurance contracts at the same time (also at the group level) is of crucial importance for all insurers. Thus, we encourage and kindly ask the Board to ensure that insurers will not be required to apply the final IFRS 9 before the mandatory effective date of the new insurance contract standard (IFRS 4 Phase II).

We highly appreciate the fact that the IASB acknowledged that an extended transition period for insurance contracts project of at least three years after publication of the final standard is very necessary. Nevertheless, we also believe that a postponement of the *mandatory* application of IFRS 9 for insurers is the most suitable way of how to achieve a pragmatic solution, reduce operational cost and ensure or even increase the fair presentation of financial statements of insurers, so they are better understood by users.

When the effective dates of the insurance contracts standard and IFRS 9 are not aligned, insurers would be forced to significantly adjust their accounting treatment of financial instruments twice within a short period of time. We doubt if related additional operational cost and invested time for this exercise are necessary and/or helpful for users as they reduce the comparability of information provided (as stated by the Accounting Standards Committee of Germany in its comment letter of the 3th December 2010 on ED/2010/8 Insurance Contracts, page 36).

In addition, we do not believe that any additional reclassification rules and redesignation criteria for financial assets required for transition period can replace the need for aligned mandatory effective dates of IFRS 4 Phase II and IFRS 9 for insurers. We are fully convinced that a pragmatic solution approach defined by the IASB on a global basis is more suitable than a potential deferral of endorsement at European level. However, the GDV does not oppose an optional early application of both standards.

Berlin, 19th March 2013