

CLASSIFICATION AND MEASUREMENT OF FINANCIAL ASSETS

RESULTS OF THE FIELD TEST CONDUCTED BY EFRAG, ANC, ASCG, FRC AND OIC

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EXECUTIVE SUMMARY

- 1 EFRAG and National Standard Setters (ANC, ASCG, FRC and the OIC) have conducted a joint field test aimed to identify and describe how IFRS 9 (as modified by the ED on Limited Amendments to IFRS 9) would affect the current classification and measurement of financial assets.
- 2 Thirty-seven companies participated in field test, nearly half of which were from the banking industry and the remainder coming from the insurance and other industries. The majority of participants are European listed groups.
- 3 The field test intended to collect evidence, rather than views and opinions, and asked participants to provide information about the relative financial significance of the findings in terms of the total assets as of 31 December 2012.
- 4 The majority of participants provided a qualitative assessment based on their IFRS 9 implementation work; however, most participants did not provide quantitative information, or only some, on the financial significance of the changes expected to result from IFRS 9. As a result, it has not been possible to analyse the quantitative information on an aggregated basis or to extrapolate the data to draw broader conclusions.
- 5 The status of the internal assessments being conducted relating to IFRS 9 implementation varied significantly. The overall status and progress being made was generally impacted by the type of industry in which participants are based. Overall participants in the banking and insurance industries were more advanced with their internal impact assessments, due primarily to the significant impact that IFRS 9 will have on their particular industries, although significant work was still required to be done. This is explained in detail in the report.
- 6 Participants were fairly evenly divided on whether IFRS 9 would result in more financial assets being measured at fair value. Half of the participants (across the banking and other industries) expected no major changes in the accounting compared to IAS 39. The other half of participants (from all industries) expected more measurement at fair value, in particular, at FV-PL. A few participants reported more amortised cost measurement.
- 7 The main reason for changing the measurement from amortised cost and the classification in the available-for-sale (AFS) category (under IAS 39) to FV-PL (under IFRS 9) was the failure to meet the contractual cash flow characteristics test. This was particularly important in the banking and insurance industries.
- 8 Several banks identified a number of originated loan products with interest rate mismatch features or with regulated interest rates – currently measured at amortised cost – that would fail the assessment. The financial significance of these particular products varied across participants; the majority noted that they would represent 10% or less of the total assets with a participant reporting a much more significant impact.
- 9 The participants from the insurance industry reported that various debt-type instruments, currently most of them classified in the AFS category, would also fail the assessment. Three participants reported that the financial significance of these instruments ranged from 3% to 7% of the total financial investments or total assets, whereas one participant indicated that 5% of the total debt instruments (either classified in the AFS category or measured at amortised cost) would fail the assessment. Among these instruments, participants referred to financial assets with prepayment and extension options that are triggered by contingent events other than those allowed by IFRS 9 and financial assets with some type of equity feature.

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- 10 The findings indicate that the majority of financial assets that are expected to be measured at FV-OCI are currently classified in the AFS category. A large part of these assets form part of liquidity portfolios of banks, either required internally or by regulators, or back insurance contracts.
- 11 Six banks reported that the regulatory liquidity portfolio, currently classified in the AFS category, would most likely be measured at FV-OCI under the new requirements, with a small part of those portfolios measured at amortised cost or FV-PL. In contrast, four other banks would prefer measuring the entire liquidity portfolio at amortised cost. Some of these banks noted that creation of sub-portfolios may be a way to limit the amount of financial assets measured at FV-OCI, if necessary, so as to minimise any negative impact on the regulatory capital.
- 12 All participating insurance companies reported that a significant part of their portfolios may qualify for FV-OCI; however, they were concerned about (i) the financial assets that would not be eligible for this measurement basis (e.g. debt instruments that fail the contractual cash flow assessment, derivatives and debt instrument portfolios with a low expected turnover), (ii) the accounting mismatches that would arise considering the IASB's tentative decisions on the insurance contracts project, and (iii) the fact that the proposed accounting for financial assets would not reflect the linkage between assets and liabilities from an asset-liability management approach.
- 13 Most of the participants in the banking and insurance industries indicated that the final measurement at FV-OCI would depend on (i) an accurate assessment of the turnover and the reasons for sales, (ii) regulatory capital requirements, and (iii) the outcome of the insurance contracts project.
- 14 Regarding the option available in IFRS 9 to present changes in the fair value of equity instruments in OCI, nearly half of the participants (across the banking and other industries) intended to apply it to strategic holdings and other equity investments, either quoted and non-quoted. By doing this, participants expected to reduce volatility in profit or loss. The remainder participants from these industries had not yet decided on the use of the option.
- 15 The participants from the insurance industry were unable to conclude on the use of the option referred above. They reported that equities are usually market-quoted and held together with other investments as part of the asset-liability management. Measuring them either at FV-OCI (without recycling) or at FV-PL could give rise to accounting mismatches and/or volatility in profit or loss. Although these issues might be addressed by the IASB's tentative decisions on the mirroring approach, some participants stressed that the application of the principles underlying this approach was still unclear.
- 16 Participants expected to reclassify limited portfolios (or parts of these) that are currently classified in the AFS category to amortised cost. The main reason for this was that not all the portfolios in the AFS category would meet the business model underlying measurement at FV-OCI, as the turnover of certain portfolios was not expected to be significant enough. Some participants in the banking industry and the majority of participants in other industries expected to continue to measure these financial assets at amortised cost.
- 17 Participants also identified a range of other reasons that would lead to changes in the current measurement of financial assets, which are explained in this report.
- 18 More than half of the participants (across industries) indicated that the questions on bifurcation were not applicable or they did not use bifurcation. Of those participants, a large majority provided no information on whether they had financial assets eligible for

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bifurcation, whereas some of the other respondents indicated holding such financial assets and some indicated not holding such financial assets.

- 19 Of those participants who indicated using bifurcation, the majority reported an insignificant use of bifurcation. Several participants in the banking industry indicated that they currently use the fair value option instead of bifurcation because it is operationally easier and cheaper to apply and facilitates hedge management by avoiding hedge accounting.
- 20 As a consequence of the findings mentioned in the previous paragraphs, some participants (in various industries but including the majority of insurers) noted that accounting mismatches would increase. However, only a few participants from various industries expected more volatility in profit or loss.
- 21 Some participants in the banking and insurance industries expected a decrease in the reliability of financial information because the measurement of instruments that fail the contractual cash flow characteristics assessment and of non-quoted equities would be at Level 3 of the fair value hierarchy.
- 22 Twenty one participants (across industries) identified a range of implementation difficulties in the new requirements of IFRS 9, which they believed were important and that are explained in this report. Nineteen participants did not anticipate any practical difficulty.

INTRODUCTION

Background

- 1 In November 2012, the IASB issued the Exposure Draft *Classification and Measurement: Limited Amendments to IFRS 9* (proposed amendments to IFRS 9 (2010)) (the ED) to clarify and propose limited changes to the requirements for classifying and measuring financial instruments issued by the IASB in October 2010.
- 2 This paper refers to the classification and measurement requirements included in IFRS 9 *Financial Instruments* (2010), as modified by the ED, as ‘the new requirements’ for ease of reference.

Purpose of the field test

- 3 EFRAG and National Standard Setters (ANC, ASCG, FRC and the OIC) have performed a joint field test on how the new requirements would affect the current classification and measurement of financial assets. This exercise was focused on the practical application of the new requirements and was intended to gather solely facts and objective data rather than views and opinions.
- 4 The field test was intended to serve as input to the European Commission’s endorsement process and to EFRAG and National Standard Setters to help them formulate their views on the impacts of the application of the new classification and measurement requirements in IFRS 9.

Objective

- 5 The purpose of the field test was to identify in what circumstances the application of the new classification and measurement requirements in IFRS 9 would lead to changes in the current measurement of financial assets under IAS 39. In particular:
 - (a) to identify:
 - (i) in the group of financial assets that are currently measured in their entirety at FV-PL under IAS 39 (other than derivatives), those that would be no longer measured at FV-PL under IFRS 9;
 - (ii) in the group of financial assets that are currently classified in the available-for-sale category under IAS 39, those that would be measured at amortised cost, FV-OCI and FV-PL under IFRS 9,
 - (iii) in the group of financial assets that are currently measured in their entirety at amortised cost under IAS 39, those that would be measured at FV-OCI and FV-PL under IFRS 9;
 - (iv) in the group of financial assets that can be bifurcated under IAS 39, those for which bifurcation is no longer allowed under IFRS 9 and would be measured at FV-PL, and how they are currently measured under IAS 39;
 - (v) in the group of financial assets that contain a closely related embedded feature and are measured in their entirety at amortised cost under IAS 39, those that would be measured at FV-PL under IFRS 9; and
 - (b) to understand the relative importance of the groups identified above and the high level reasons for those changes.

- 6 EFRAG and National Standard Setters asked participants to provide information about the relative importance of the circumstances referred to above in terms of their total assets as of 31 December 2012.

Approach

- 7 Participants were requested to consider the new requirements (i.e. classification and measurement requirements set out in IFRS 9 (2010) as modified by the ED) assuming no changes in how financial assets are managed as of 31 December 2012. That is, participants were asked to consider the business model in place as at the date of reference.
- 8 Companies were asked to report on the tentative results and conclusions of their internal assessment regarding the implementation of the new requirements. In addition, participants in the field test that issue insurance contracts were requested to take into consideration the IASB's tentative decisions on the insurance contract project when answering the questions regarding accounting mismatches.
- 9 The purpose of this field test was to gain an understanding of the impact of IFRS 9 on the measurement of financial assets and related changes. In the conclusions drawn from this field test more weight was given to responses that were substantiated by facts and analysis.

Companies that participated in the field test

- 10 37 companies participated in the field test. Nearly half of the participants were from the banking industry, with the remainder coming from the insurance industry and other industries. For the purposes of the analysis the participants from the banking and insurance industries are treated separately as accounting for financial instruments is of particular concern to them. Participants from other industries are involved with smaller amount of financial instruments; they were grouped together in order to avoid identifying individual participants in the feedback report.
- 11 The table below summarises the number of participants by country and by industry.

Table 1: Total participants by country and by industry

<i>Participants by country:</i>		<i>Participants by industry:</i>	
France	5	Banking	17
Germany	16	Insurance	4
Italy	10	Other industries	16
Spain	1		
UK	5		
	<hr/>		<hr/>
	37		37

- 12 The list of participants is included in the Appendix A of this document.

FINDINGS

Financial significance of the findings

- 13 Most participants did not provide or only provided some information on the financial significance of their findings. As a result, it has not been possible to analyse the quantitative information on an aggregated basis or to extrapolate the data to draw broader conclusions. Therefore, this report reflects the financial significance of findings where provided, in an aggregated or individual (anonymous) basis.

Status of participants' internal assessments

- 14 In the banking industry (which includes banks with significant insurance activities) internal assessment projects have generally been completed for the initial impact assessments and some participants have commenced with the implementation of IFRS 9, however many participants indicated that this part of the project has been delayed until the proposed amendments to IFRS 9 are finalised. The participants described the state of their projects in the following terms:
- (a) High level impact assessment of the original IFRS 9 published in 2010 as well as ongoing assessment of the impact of the ED;
 - (b) An initial impact assessment documenting the composition, purpose and approach to the management of the financial asset portfolios;
 - (c) An assessment of the business model and a review to identify features that may impact the 'solely payment of principal and interest test'; and
 - (d) Interest modifications tests to gain an understanding of which products contain such features.
- 15 These examples highlight the work undertaken by the participants, but are by no means an exhaustive list. While participants' projects are at various stages, the majority of participants are making significant progress in their assessment of the new classification and measurement requirements. However, based on the responses received, very little has been done to address processes or systems which will be affected by the changes proposed in the ED.
- 16 Insurers participating in the field test have generally completed their initial impact assessments, with some participants having commenced the implementation phase of IFRS 9. Examples of projects underway are:
- (a) The analysis and classification of financial assets following the new requirements of the ED with this analysis being based on previous studies undertaken in 2009 when IFRS 9 was issued and a further deep analysis being performed prior to the commencement of the implementation project in the fourth quarter of 2013; and
 - (b) A high level impact assessment study of the new requirements based on the assessment of the terms and conditions of a sample of financial assets within different asset classes.

- 17 The individual projects of these insurance industry participants are at various stages, but the majority of participants are making progress in their assessment of the new classification and measurement requirements in the ED. However, very little has been done to address processes or systems that will be affected by the changes proposed in the ED. It should be noted that participants have indicated that this phase of the project is not progressing as quickly as hoped as the IFRS 4 phase II *Insurance Contracts* project has not been completed and they would want to run the project knowing what the impact will be on their financial assets and their insurance liabilities.
- 18 For the other industries the picture is more mixed. Most of the participants have not commenced their initial impact assessment projects. There are some exceptions, but on the whole most participants have only considered the impact of the new requirements at a very high level at this stage and many have commented that they are waiting for the final proposed amendments to IFRS 9 to be issued before commencing their initial impact assessment projects.

Detailed findings on the impact of IFRS 9 as modified by the ED on financial assets

Financial assets to be measured at FV-PL

General comments

- 19 The results of the field test show that one of the main reasons for changing the measurement of certain financial assets or portfolios to fair value through profit or loss (FV-PL) was that their cash flows do not solely represent payments of principal and interest (i.e. the cash flow characteristics assessment). Participants identified retail loan products originated in the banking industry and several types of investments that form part of portfolios backing insurance liabilities that would fail the cash flow characteristics assessment. While most of participants in the banking industry currently measure these loans at amortised cost, in the insurance industry it was more common to classify the financial assets backing insurance liabilities in the available-for sale category (AFS).
- 20 Nevertheless, some participants in the banking industry from various countries expected to continue to measure at amortised cost the majority of their retail and commercial loans, advances to customers, and receivables. One of these participants noted however that this conclusion depended on how the IASB would finally articulate the contractual cash flow characteristics assessment.
- 21 The majority of participants in other industries expected all of their financial assets, including trade and financial receivables and those held within liquidity portfolios, to meet the contractual cash flow characteristics assessment. Liquidity portfolios held by these companies differ from those held by banks, as they usually include cash and cash-equivalent investments with a term not exceeding three-months. The liquidity is often managed via group-wide cash pool systems with the objective of optimising the income earned from liquid funds at low risk.

Financial assets currently measured at FV-PL

- 22 The majority of participants did not identify any circumstances in which financial assets currently measured at FV-PL would be measured differently under the new requirements. Even if financial assets were to meet both the contractual cash flows characteristics

assessment and the business model assessment to be measured at amortised cost or FV-OCI; in any event, participants assumed that they would still be able to measure them at FV-PL by using the fair value option available in IFRS 9.

- 23 The ability to use the fair value option was particularly important for the unit-linked business. The financial assets held by insurers to back this business are currently measured at FV-PL. Participants in the insurance industry assumed that changes in the value of the liabilities related to unit-linked contracts (which are currently measured at FV-PL irrespective of whether the contracts transfer significant insurance risk) would be presented in profit or loss once the final standard on insurance contracts is finalised.

Explanation of changes in the measurement

Instruments not meeting the contractual cash flow characteristics assessment

- 24 Financial assets that are expected to fail the contractual cash flows characteristics assessment would trigger a transfer to FV-PL if they are currently either (i) measured at amortised cost, or (ii) classified in the AFS category.
- 25 Participants in the banking and insurance industry identified the following financial assets currently measured at *amortised cost* under IAS 39 that are expected to (or may) fail the contractual cash flow characteristics assessment, although they are held to collect contractual cash flows:

Table 2: Financial assets currently measured at amortised cost that do not meet the contractual cash flow characteristics assessment

-
- a) Financial assets with interest rate mismatch features
 - b) Financial assets with regulated interest rates:
 - Constant maturity loans in China
 - ‘Livret A’ receivables
 - Other loans originated in European jurisdictions
 - c) Securitisation vehicles (e.g. asset-backed securities and collateralised debt obligations)
 - d) Credit-linked products
 - e) Subordinated debt securities
 - f) Financial assets with prepayment and call options
 - g) Financial assets with automatic early redemption rights
 - h) Financial assets with prepayment above fair value
 - i) Debt instruments with non-vanilla features
 - j) Financial assets with participation features
 - k) Shared appreciation mortgages
 - l) Preference shares
 - m) Financial assets with derivatives bifurcated under IAS 39 (please see section on bifurcation).
- 26 Below we provide a summary of the descriptions provided by participants and information about their relative financial significance, if available:
- (a) Instruments with interest rate mismatch features – Five participants referred to financial assets which are market standard products in their relevant jurisdictions, but contain a modified economic relationship between principal and interest that could

be 'more than insignificant'. Appendix B to this report provides a detailed overview of the features as identified by participants.

Considering that these instruments are usually financed by liabilities measured at amortised cost, participants noted that accounting mismatches were expected to arise. They further indicated that the election of the fair value option for the related liabilities would not address these accounting mismatches because of differences in credit spreads and durations and the existence of a minimum floor on the deposits.

Two participants from France and UK indicated that these financial assets would represent approximately 5% of the total assets and 5% of the total loans and advances to costumers respectively. A participant from Italy noted that the financial assets would represent approximately 10% to 27% of the total loans to customers in the jurisdictions affected (considered together with certain financial assets with regulated interest rates); whereas another participant from the same country indicated that the impact would most likely be significant.

- (b) Financial assets with regulated interest rates – Four participants reported that these instruments are common in various jurisdictions, including constant maturity rate loans in China, 'Livret A' receivables in France and other financial assets with regulated interest rates in European jurisdictions. Appendix B to this report provides a detailed overview of the features as identified by participants.

Use of the fair value option for these financial assets would not address the accounting mismatches for the same reasons as explained in (a) above.

Two participants from France indicated that these financial assets would represent approximately 6% of the total assets. A participant from UK reported that they represented approximately 2% of the total loans and advances to customers, whereas a participant from Italy noted that these financial assets loans would represent approximately 10% to 27% of the total loans to customers in the jurisdictions where the participant operated (considered together with certain financial assets with interest rate mismatch features).

- (c) *Securitisation vehicles (e.g. asset-backed securities and collateralised debt obligations)* – Six participants from various countries noted that these financial assets would fail the specific requirements regarding contractually linked instruments because the underlying instruments generally give rise to payments other than principal and interest. In addition, the exposure to credit risk of the financial assets (tranches) may be higher than the exposure to credit risk of the underlying pool of financial instruments.

The amount of these financial assets was reported as insignificant by these participants. Although these financial assets would give rise to volatility in profit or loss, a participant noted that measurement at FV-PL would provide more relevant information due to the uncertain nature of the cash flows.

- (d) *Credit-linked products* – Three participants from various countries noted that some of these financial assets have limited synthetic exposures which may result in the underlying cash pool not meeting the requirements in IFRS 9. The amount of these financial assets was reported as insignificant by one of these participants.
- (e) *Subordinated debt securities* – Two participants from France and Italy referred to this type of financial assets. One of them indicated that they would fail the assessment

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because the debtor's non-payment would not constitute a breach of the contract and the participant did not have a contractual right to unpaid amounts of principal and interest even in the event of the debtor's bankruptcy. The amount of these financial assets would represent less than approximately 0.4% of the total assets.

- (f) *Financial assets with prepayment and call options* – Three participants from various countries noted that bonds may contain prepayment options such as covenants that are triggered by contingent events other than those allowed by the new requirements. Although these instruments may be held in portfolios whose objective is to collect cash flows or both to collect and sell, they would be measured at FV-PL.
- (g) *Financial assets with automatic early redemption rights* – A participant from Germany noted that such type of features, which are generally linked to the credit risk deterioration of the issuer, would not meet the contractual cash flows characteristics assessment under a strict reading of the new requirements as they do not represent (i) a change in a variable interest rate, (ii) a prepayment option, or (iii) an extension option.
- (h) *Financial assets with prepayment above fair value* – A participant from Germany indicated that certain debt instruments allow the issuer to prepay the instrument above its fair value, for example, when the prepayment amount is based on the outstanding coupons and principal and would be discounted using a non-current rate. Although these options are expected to be 'out of the money', they could lead to measurement at FV-PL.
- (i) *Debt instruments with non-vanilla features* – Particular examples provided by three participants were (i) deep out of the money convertible bonds, (ii) financial assets with a fixed annual interest payment and an insignificant expected annual dividend payment, and (iii) financial assets with 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).

Even if the non-vanilla features embedded in these financial assets were to be insignificant, the new requirements only provide relief for financial assets with modified economic relationships between their principal and interest that are 'no more than insignificant'.

- (j) *Financial assets with participation features* – A participant from UK reported that loan restructurings, as part of normal credit risk management strategies, may contain features that provide returns other than payments of principal and interest (e.g. profit or property participation rights). The amount of these financial assets was reported as insignificant.
- (k) *Shared appreciation mortgages* – A participant from UK reported that as part of their retail business certain loans could be issued with a low interest rate on the basis that the entity would participate in the appreciation of the property, reflecting returns that are not just payment of interest. The amount of these financial assets was reported as insignificant.
- (l) *Preference shares (regarded as debt instruments)* – A participant from Germany indicated that preference shares usually pay a fixed coupon for a fixed period of time. After that initial period, the issuer has the right to redeem the instrument. If the preference shares are not redeemed, a variable interest rate with a fixed step-up is

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paid annually for an unlimited period of time. After a certain time period, the issuer is obliged to pay all unpaid coupons.

The step-up feature may trigger FV-PL measurement if it does not only represent interest on the principal outstanding although it is an incentive for the issuer to exercise its redemption right. Similarly, the issuer's right to defer interest payments without being obligated to pay interest on the accrued interest would also trigger FV-PL measurement.

- (m) *Financial assets with bifurcated derivatives under IAS 39* – Please see the section 'Bifurcation'.
- 27 Some other participants in the banking and insurance industry only provided high level explanations and indications about the financial assets that are expected to fail the contractual cash flow characteristics assessment and their significance:
- (a) *Banking industry* – A participant from Italy reported that the financial assets currently measured at amortised cost that were expected to be measured either at FV-PL or FV-OCI could represent a significant proportion of the total assets. Another participant from the same country indicated that 10% of the financial assets currently measured at cost (excluding loans to costumers) would fail the assessment. These instruments were mainly structured instruments and collateralised debt obligations (CDO). A third participant indicated that less than 1% of their portfolio currently measured at amortised cost would probably fail the assessment.
- (b) *Insurance industry* – Two participants did not expect a significant amount of financial assets currently measured at amortised cost to fail the assessment. It should be noted however that the largest part of the portfolios that back insurance liabilities are currently classified in the AFS category.
- 28 A few participants in the banking industry also commented that IFRS 9 does not provide clear or enough specific guidance on how to apply the contractual cash flow characteristics assessment to (i) non-recourse financial assets, (ii) credit-linked instruments, and (iii) defaulted debt assets. These participants commented that paragraphs B.4.17 and B.4.21.c) about non-recourse financial assets and contractually linked instruments were difficult to understand and could lead to diversity in practice. Regarding defaulted debt assets, it was not clear whether these instruments should be treated in the same way as distressed debt for the purposes of assessing whether they give rise to payments of principal and interest.
- 29 The majority of participants in other industries expected that all their financial assets would meet the contractual cash flow characteristics assessment. A participant reported that a very limited number of financial assets, that are currently held to collect their cash flows, were expected to fail the assessment, including (i) project finance loans containing equity features, (ii) future project financing in the form of mezzanine capital, and (iii) investments with coupons that deviate more than insignificantly from the benchmark rate. The amount of these financial assets was however reported as insignificant.
- 30 Financial assets currently *classified in the AFS category* that are expected to fail the contractual cash flow characteristics assessment are very similar in nature to those currently measured at amortised cost, as shown in the table below:

Table 3: Financial assets currently classified in AFS category that do not meet the contractual cash flow characteristics assessment

<i>Financial assets involved</i>	<ul style="list-style-type: none"> • Financial assets with constant maturity variable interest rate • Plain-vanilla bonds with interest rate mismatch features • Securitisation vehicles (e.g. asset-backed securities and junior tranches) • Financial assets with prepayment and call options, including prepayment above fair value • Financial assets with automatic early redemption rights • Debt instruments and loans with non-vanilla features: <ul style="list-style-type: none"> – Structured bonds with a leveraged index – Convertible bonds with conversion options – Debt securities linked to inflation, equity, foreign currency, commodities, or indexes • Preference shares (regarded as debt instruments) • Non-cumulative perpetual bonds and other perpetual debt instruments Credit-linked notes and investments in mezzanine capital and in more subordinated tranches of structured debt • Certain receivables, including those which have payments depending on performance and legal factors other than credit risk • Money market funds and mutual funds
<i>Relative financial significance</i>	<ul style="list-style-type: none"> • Not all the participants that reported any of the instruments above provided information about their relative financial significance. • Four participants in the banking industry indicated that these financial assets represented less than 2% of the AFS category, whereas three participants indicated that they represented approximately 0.12% to 1.17% of the total assets. Three other participants indicated that these financial assets represented insignificant amounts in terms of total assets. • Participants in the insurance industry provided various indications: <ul style="list-style-type: none"> – A participant noted that 5% of the total debt instruments (either classified in AFS or measured at amortised cost) would fail the assessment; and – Three participants indicated that these financial assets would represent approximately 4% to 7% of the total financial investments, and 3% of the total assets, respectively. • The majority of participants in other industries expected insignificant amounts (or none) in terms of total assets. A participant noted that money market funds would represent approximately 5% of the total assets.

(i) This table does not include investments in equity-type instruments.

- 31 The financial assets included in Table 3 above were more widespread in the insurance industry than in other industries. The descriptions provided by participants were however very similar, if not the same, as those included in the previous section.
- 32 As part of the asset-liability management, participants in the insurance industry hold large portfolios of investments that are usually classified in the AFS category. Participants reported that the underlying objective of these portfolios was to collect the contractual cash flows, or both to collect and sell; however, some of the financial assets would fail the contractual cash flow characteristics assessment and lead to significant accounting mismatches. In this context, they considered the contractual cash flow characteristics assessment too restrictive.
- 33 Participants in the banking industry noted that these financial assets may form part of their liquidity portfolios. For example, a participant from UK noted that a number of financial

assets currently held in the liquidity portfolio were inverse floating Japanese government bonds indexed to the 10-years constant maturity swap rate and would fail the assessment. However, financial assets held in other portfolios could also fail the assessment such as receivables with payments that depend on the performance and legal factors rather than credit risk.

- 34 Participants in other industries were less involved with these financial assets. A few participants reported holdings in investment and mutual funds currently classified in the AFS category for cash management purposes. These participants had however different views on the classification of these funds. Some participants regarded them as debt instruments for classification purposes. In their view, if the cash flows arising from these mutual funds were based on equity investments, then the contractual cash flow characteristics assessment would not be met. Conversely, other participants considered that such type of funds would always fail the assessment if they were puttable at fair value.

Financial assets to be measured at FV-OCI

General comments

- 35 The majority of the financial assets that were expected to be measured at FV-OCI are currently classified in the AFS category; therefore, the new requirements would lead to a limited impact in terms of financial reporting (leaving aside the impact in profit or loss because of the new impairment proposals). However, the performance reported in profit or loss for equity instruments is expected to change and participants might need to measure at FV-OCI a number of other instruments that are currently classified as loans and receivables if the underlying business model is met.
- 36 Although this section focuses on financial assets that would meet the contractual cash flow characteristics assessment, as reported by participants, it also reports on the expected use of the FV-OCI option available in IFRS 9 for equity investments.

Financial assets to be transferred from AFS to FV-OCI

- 37 Participants in the banking and insurance industry identified the following financial assets currently classified in the *AFS category* that are expected to (or may) meet the business model underlying measurement at FV-OCI:

Table 4: Financial assets currently classified in AFS category that are held to collect contractual cash flows and sell

Financial assets involved

-
- Plain vanilla corporate bonds
 - Floating rate corporate notes
 - Government bonds and government agency securities with fixed and variable interest rates
 - Loans and traded loans in the form of promissory letters
 - Inflation-indexed bonds and rate structured (cap/floor) bonds
 - Asset-backed securities like notes collateralised by credit card receivables, residential mortgages, student loans and trade receivables
 - Discretionary portion of syndicated loans
 - Short-term securities, including cash at central banks and treasury bills
 - Money market funds
-

Field test – Classification and measurement of financial assets

Relative financial significance

- Not all participants that reported any of the instruments above provided information about their relative financial significance.
- Participants in the banking industry provided various indications:
 - Four participants indicated that between 80% and 100% of the total AFS debt instruments would be transferred to FV-OCI; and
 - Nine participants indicated that AFS debt instruments that would be transferred to FV-OCI represented approximately 2% to 18% of the total assets.
- Participants in the insurance industry provided various indications:
 - A participant indicated that approximately 75% to 85% of the total debt instruments (either classified in AFS or measured at amortised cost) were expected to be measured at FV-OCI;
 - A second participant indicated that financial assets transferred to FV-OCI would represent approximately 5% of the asset portfolio, but this could be as much as 63% depending on the final outcome on the insurance contracts standard;
 - A third participant indicated that FV-OCI measurement would contain the majority of investments; however, the breakdown between FV-OCI and amortised cost would depend on the final outcome on the insurance contracts standard. The potential financial assets to be reclassified represented approximately 54% of the total assets; and
 - A fourth participant indicated that financial assets in AFS to be transferred at FV-OCI represented approximately 36% of the total financial investments.
- The majority of participants in other industries expected to transfer insignificant amounts or less than 1% in terms of the total assets. Two participants indicated that the financial assets to be transferred would represent approximately 10% and 3% of the total assets.

(i) This table does not include investments in equity-type instruments, including share-based funds and trusts to fund benefit obligations.

38 Most of the financial assets included in Table 4 above were held within asset-liability management portfolios (including those backing insurance liabilities and pension obligations), liquidity portfolios in the banking and other industries, and portfolios representing non-core and discontinued businesses.

39 Participants provided the following descriptions on how the financial assets involved were managed within their companies:

- (a) *Banking industry* – Participants referred to liquidity portfolios where financial assets are usually managed for the combined purpose to collect contractual cash flows and to maximise the yields (minimising the cost of carry) of the portfolio. In order to maximise the yield, some selling activity takes place. These liquidity portfolios may encompass more financial assets than those held within regulatory liquidity portfolios. The specific comments reported by participants on the latter portfolios have been included in Appendix C ‘*Regulatory liquidity portfolios*’.

Participants also referred to broader portfolios that back centralised lending and deposit taking business for which they manage the interest rate and liquidity risks arising from the shorter duration of the financial liabilities. Depending on the legal and expected maturity of the deposits, it might be necessary to sell parts of the financial assets or invest in new ones. Although these instruments were part of their retail business and held to collect the contractual cash flows, they expected to measure them at FV-OCI.

- (b) *Insurance industry* – In general participants expected a large proportion of the financial assets currently classified in the AFS category to be measured at FV-OCI under the new requirements. However, they emphasised that the key issue was

Field test – Classification and measurement of financial assets

whether insurance companies would be able to use a consistent measurement approach for insurance liabilities and financial assets that reflects the asset-liability management.

Participants commented that their investment strategy is largely driven by asset-liability management. Debt instruments are mainly held to collect contractual cash flows; however, participants also manage them considering the market conditions and business objectives, the capital requirements and to match the expected cash flows arising from the insurance liabilities. This approach leads to a certain level of sales activity that is often not consistent with the hold to collect business model. The specific comments reported by participants on these portfolios have been included in Appendix D '*Portfolios backing insurance contracts*'.

- (c) *Other industries* – Participants often managed debt instruments together with equity-type instruments under a hold to collect and sell approach to achieve different objectives such as cash management, obtaining a yield or funding pension obligations. In some cases the amounts invested are externally managed based on an agreed investment policy.

40 Participants reported that sales may occur for various reasons such as:

- (a) Credit deterioration and to reduce concentrations of risk, including management decisions to change the focus of certain asset classes;
- (b) To demonstrate market-liquidity; or meet short-term liquidity needs, including payments of insurance claims;
- (c) To ensure maturity and interest rate profile of assets and liabilities, also to rebalance the portfolio to achieve economic hedging against certain capital and funding needs;
- (d) To manage the yield being earned from the portfolios and the overall interest rate margin;
- (e) To realise gains arising from changes in fair value, including sales to meet objectives of policyholder dividends; and
- (f) Other factors such as individual decisions of the fund manager to make particular investments within one asset class (e.g. exchanging debt assets), and securitization and syndication of the financial assets.

41 Regarding the expected level of sales activity, seven participants from various industries gave more consideration to the frequency and the reason for sales rather than to specific thresholds. Other factors considered were how the performance of the portfolios was reported to management and how fund managers and staff were compensated.

42 Conversely, a few other participants used such thresholds in their preliminary assessment. For example, a participant in the banking industry considered a yearly turnover of 10% of the portfolio as the level above which financial assets would be measured at FV-OCI, whereas another participant in other industries assumed that (i) infrequent was more than once a year and significant more than 5% of a portfolio, and (ii) FV-OCI measurement is required with more than infrequent significant sales and a portfolio turnover ratio below 100% per year.

43 Participants also reported a number of other considerations that are summarised below:

Field test – Classification and measurement of financial assets

- (a) *Banking industry* – Some participants indicated that the portfolios (or the portion of the portfolios) that would be measured at FV-OCI would depend on the final assessment of the turnover and whether they would be split for financial reporting purposes. Two participants commented that the clarifications introduced by the ED on the level of sales activity underlying the hold to collect business model had restricted the use of this category compared to their initial interpretation of IFRS 9.

Some participants expected to split their portfolios (including liquidity portfolios) into different sub-portfolios. A participant was however concerned about doing this, in particular when an entire portfolio is essentially managed for the same purpose.

A few participants from various countries found difficulties in articulating an expectation on the portfolios (or the portion of the portfolios) that would be measured at amortised cost, FV-OCI and FV-PL mainly because the dividing lines between measurement categories are not clear enough.

- (b) *Insurance industry* – Almost all participants noted that the final classification and measurement of financial assets could change significantly depending on the final outcome of the insurance contracts project.

For example, a participant noted that debt instruments would be measured at FV-OCI if the discount rate to be used for participating insurance contracts were a market rate with an illiquidity premium. Otherwise, all debt instruments would be measured at amortised cost. In the participant's view, the expected measurement of financial assets might differ because the new requirements do not reflect the linkage between financial assets and insurance liabilities.

A participant commented that IFRS 9 was unclear on how to perform the business model assessment on those financial assets that are held through consolidated investment funds. Two other participants indicated that the dividing lines between measurement categories are not clear enough.

Explanation of changes in the measurement

Instruments currently measured at amortised cost

- 44 Participants identified financial assets – identical in nature to those classified in the AFS category – that are currently measured at amortised cost and are expected to (or may) be measured at FV-OCI:

Table 5: Financial assets currently measured at amortised cost that are held to collect contractual cash flows and sell

Financial assets involved

- Vanilla loans including trade finance and corporate loans
- Certain securitisations including notes collateralised by residential mortgages, student loans, vehicle loans and other receivables
- Discretionary portion of syndicated loans
- Debt instruments classified in the loans category including (non-quoted) government or corporate bonds
- Credit linked products
- Trade accounts receivables

Relative financial

- Not all participants that reported any of the instruments above provided information about their relative financial significance.

Field test – Classification and measurement of financial assets

significance

-
- Participants in the banking industry provided various indications:
 - A participant reported significant impact regarding vanilla loans and certain securitisations to be measured at FV-OCI;
 - A second participant indicated that the collateralised notes and credit linked products to be measured at FV-OCI were not significant in relation to the total assets; however, the trade finance and corporate portfolio loans were significant as they represented approximately 5.5% of the total balance of loans and advances to customers; and
 - Seven participants noted that these financial assets to be measured at FV-OCI were expected to be insignificant.
 - Participants in the insurance industry provided the following indications:
 - A participant indicated that financial assets to be measured at FV-OCI represented approximately 11% of total financial investments;
 - A second participant indicated that approximately 75% to 85% of the total debt instruments (either classified in AFS or measured at amortised cost) were expected to be measured at FV-OCI; and
 - A third participant noted that these financial assets were insignificant.
 - The majority of participants in the other industries did not expect to reclassify any financial assets.
-

(i) This table does not include investments in equity-type instruments.

45 Most of the financial assets included in Table 5 were held within liquidity portfolios in the banking industry and, to a lesser extent, within portfolios of financial assets backing insurance liabilities.

46 Participants in the banking and insurance industries reported that these financial assets may no longer qualify for amortised cost measurement because they would meet the definition of the business model underlying FV-OCI measurement. These participants indicated that sales could be frequent or significant, and provided the following comments:

- (a) *Banking industry* – Participants could be involved with various activities that lead to FV-OCI measurement, for example, entering into asset-backed commercial paper or revolving sales programs or actively manage run-off businesses. In addition, sales may occur for reasons other than credit deterioration, for example, trade finance and corporate loans portfolios may be sold because of credit concentration or capital usage that is not consistent with the business model hold to collect.

Two participants provided different views on the classification of syndicated loans. One participant believed that the new requirements require both the portion to sell and retain to be measured at FV-OCI, whereas another participant expected to measure at amortised cost the mandatory portion of these loans (see also Tables 4 and 6).

- (b) *Insurance industry* – Participants noted that asset-liability management requires flexibility in the ability to sell financial assets that might easily be inconsistent with the business model of hold to collect. For example, two participants reported that certain loans and other debt assets would no longer be measured at amortised cost although they meet the contractual cash flow characteristics assessment. These instruments were acquired upon issue from the public industry, financial institutions and other industries; however, the expected level of sales activity would lead to measurement other than amortised cost.

- 47 Participants in the banking and insurance industry also noted other reasons for sales which were similar to those reported for financial assets currently classified in the AFS category (see paragraph 40).

Equity instruments measured at FV-OCI

- 48 Equity instruments should be measured at FV-PL under the new requirements; however, entities may make an irrevocable election at initial recognition to present in other comprehensive income (without recycling) subsequent changes in the fair value of these investments provided that they are not held for trading. Regarding the use of this option, participants noted the following:

- (a) *Banking industry* – Nine participants in the banking industry from various jurisdictions expected to apply the option to strategic participations that are not intended to be sold (e.g. investments held to operate on various exchanges and trading platforms and to achieve commercial synergies). Some of these instruments had quoted prices, whereas others were non-quoted equities. These participants expected to reduce the reported volatility in profit or loss by using the option. Six of these participants indicated that they intended to measure at FV-OCI (without recycling) equity securities representing less than 3% of the total financial assets in the AFS category or less than 1% of the total assets.

Conversely, three other participants did not expect to make significant use of this option mainly due to the prohibition of recycling or because strategic investments are usually consolidated within the groups. In this context, three participants noted that the final objective of holding some equity investments was to obtain a financial return; therefore, not allowing recycling was considered as a serious drawback that could lead to use non-GAAP measures for management and external reporting purposes.

- (b) *Insurance industry* – Participants indicated that equity securities are usually market-quoted instruments and held together with other investments as part of the asset-liability management. Measuring equity securities at FV-OCI (without recycling) could lead to accounting mismatches, because policyholders' participations often depend on realised gains and losses on those equities. On the other hand, measuring these equity securities at FV-PL would create volatility in profit or loss, thus not reflecting the long-term business model of insurers and distorting the performance reported.

Three participants indicated that holdings in equity securities represented approximately 4% to 10% of the total financial investments (or the total assets); however, none of them could indicate which part would be measured at FV-OCI (without recycling). In the view of one of these participants, the fair value option available in IFRS 9 could only be applied to strategic equity securities; therefore, portfolios of equities backing insurance liabilities could be out of its scope.

- (c) *Other industries* – Six participants expected to apply the option to all or part of their equity securities, including non-quoted equities. Most of these investments were not held for trading and measuring them at FV-PL would result in unjustified volatility in profit or loss. Two of these participants commented that they intended to use the cost as an approximation of fair value where this is appropriate. Four participants reported that these equities represented approximately 16% of the total assets in the AFS category or less than 1% of the total assets.

Two participants indicated that they did not intend to apply this option.

Financial assets to be measured at amortised cost

General comments

- 49 Participants identified a number of circumstances in which measurement at fair value would no longer be possible under the new requirements. Not all the instruments currently classified in the AFS category would meet the business model underlying measurement at FV-OCI, as the turnover of certain portfolios was not expected to be significant enough.
- 50 This section focuses on financial assets that would meet the contractual cash flow characteristics assessment, as reported by participants, and leaves aside the financial assets that are expected to continue to be measured at amortised cost.

Explanation of changes in the measurement

'Hold to collect' business model assessment

- 51 A participant in the banking industry from Germany identified a small population of trade receivables that are currently *measured at FV-PL* (because they were acquired with the intention to sell in the short-term) to be measured at amortised cost under the new requirements. The reason was that these financial assets are managed within larger portfolios together with other financial assets that are hold to collect the contractual cash flows.
- 52 Participants in various industries identified the following financial assets currently *classified in the AFS category* that are expected to (or may) meet the business model underlying amortised cost measurement:

Table 6: Financial assets currently classified in AFS category that are held to collect contractual cash flows

<i>Financial assets involved</i>	<ul style="list-style-type: none"> • Originated loans • Mandatory portion of syndicated loans • Plain vanilla corporate bonds • Fixed and floating rate government bonds and government agency securities, including UK Gilts • Inflation-indexed bonds and rate structured (cap/floor) bonds • Securitisation vehicles (e.g. asset-backed securities and senior tranches) • Credit-linked instruments (with insignificant credit exposure) • Money market funds • Financial assets that from part of a hedge relationship
<i>Relative financial significance</i>	<ul style="list-style-type: none"> • Not all participants that reported any of the instruments above provided information about their relative financial significance. • Participants in the banking industry provided various indications: <ul style="list-style-type: none"> – A participant expected significant amounts of these assets (including OCI accumulated balances) to be measured at amortised cost; – A second participant noted that approximately 20% of the debt instruments classified in AFS could be measured at amortised cost; however, 10% of these instruments (e.g. asset-backed securities) could end up being measured at FV-PL because they fail the contractual cash flow characteristics assessment; – A third participant reported that approximately 10% of the AFS assets would be measured at amortised cost with amounts recognised in OCI insignificant; and

Field test – Classification and measurement of financial assets

- Five participants expected to measure at amortised cost none of these financial assets or less than 1% of the total assets.
 - Participants in the insurance industry provided various indications:
 - A participant expected approximately 10% to 20% of the total debt assets (including those already measured at amortised cost) to be measured at amortised cost;
 - A second participant expected all instruments backing participant contracts to be measured at amortised cost if the rate to be used in the future for these contracts were to reflect the assets return rate; and
 - A third participant reported no significant amounts, both in terms of total assets and accumulated amounts in OCI.
 - Participants in other industries reported the following:
 - A participant reported that 32% of the AFS assets would be measured at amortised cost; however the amounts accumulated in OCI were not significant;
 - A second participant reported no significant amounts, both in terms of total assets and accumulated amounts in OCI;
 - Three participants indicated that none of the financial assets classified in AFS would be measured at amortised cost.
-

- 53 Most of the financial assets above were held within asset-liability management portfolios, liquidity portfolios of banks and other companies, and restricted cash portfolios. However, these financial assets may also back insurance liabilities, including insurance contracts with discretionary participation features.
- 54 Participants that identified any of the financial assets included in Table 6 noted that they were expecting low or minimal sales activity in the related portfolios (insignificant and infrequent). The majority of these participants considered quality criteria for the purposes of the assessment rather than any specific threshold.
- 55 Two participants in the insurance industry stressed that more financial assets could be measured at amortised cost depending on the final requirements for insurance contracts. Another participant commented that FV-OCI measurement should also be available as an option for those financial assets that would be otherwise measured at amortised cost. This participant noted that significant asset portfolios had a level of sales activity too low to be measured at FV-OCI (i.e. below a certain level of sales, the financial assets would have to be measured at amortised cost).
- 56 A few participants in other industries expected to measure at amortised cost the financial assets held to attend short-term liquidity needs and to comply with regulatory requirements to invest in restricted cash assets.

Use of fair value option

- 57 Almost no participants expected to apply at this stage the fair value option in the new requirements to avoid any new accounting mismatches arising from:
- (a) financial assets currently classified in the AFS category that:
 - (i) are expected to be measured at amortised cost (because they meet both the contractual cash flow characteristics assessment and the business model assessment) – Financial assets would be reclassified from the AFS category to amortised cost. The liability measurement will revert to a cost-based approach; therefore, no accounting mismatches were expected.

- (ii) would qualify for FV-OCI measurement under the new requirements – There would be no change to the current balance sheet measurement in the sense that financial assets would remain measured at FV-OCI, therefore, no new mismatches would be created.
 - (b) financial assets currently measured at amortised category that would qualify for FV-OCI measurement under the new requirements.
- 58 A participant commented that the fair value option did not provide the same reduction in accounting volatility compared to hedge accounting, whereas another participant reported that it intended to apply the fair value option to measure fixed interest rate bonds at FV-PL that would otherwise be measured at FV-OCI. This participant had entered into interest rate swaps (IRS) to change these bonds into floating instruments and was currently applying the fair value option in IFRS 9. These financial assets represented less than 5% in terms of the total assets.

Detailed findings on bifurcation

The use of bifurcation

- 59 Twenty participants from the banking, insurance and other industries indicated that the questions on bifurcation were not applicable or did not use bifurcation. Of those participants, three indicated not to have financial assets eligible for bifurcation. Four participants indicated to have financial assets eligible for bifurcation. Thirteen participants provided no information whether they had financial assets eligible for bifurcation or not.
- 60 Twelve participants from the banking, insurance and other industries reported an insignificant use of bifurcation. One participant from the banking industry had not yet completed its analysis.
- 61 Four participants – two from the banking industry, one from the insurance industry and one from the other industries – reported using bifurcation without providing information on the significance of the bifurcated financial assets. The participants were not concentrated in particular countries or industries.
- 62 Two participants from the banking and insurance industries indicated the IT cost as a reason not to use bifurcation. Another participant from the banking industry referred to the constraints related to bifurcation as a reason for not making use of it. Most participants did not indicate the relative financial significance of their bifurcated financial instruments. Of those participants that did provide an indication those described the significance as relatively low or insignificant. One participant from the other industries reported to use bifurcation for an amount of 5% of total financial assets; another one from the banking industry indicated an amount of 0.55% of the total balance sheet. One participant from the banking industry reported to use bifurcation for an amount of less than 1% of total debt securities.
- 63 Several participants from the banking industry indicated that they currently use the fair value option instead of bifurcation, because the fair value option is operationally easier to apply and it facilitates hedge management by avoiding hedge accounting.
- 64 Participants from the banking industry were using the fair value option for the following financial assets:

Table 7: Use of the fair value option instead of bifurcation

Financial assets involved

-
- Loans;
 - Real estate loans;
 - Bonds;
 - Reverse repurchase agreements;
 - Asset backed securities; and
 - Debt instruments with embedded derivatives which are characterised by an upfront payment to a party.
-

Financial instruments involved

- 65 The participants from the banking, insurance and other industries that applied bifurcation used it for the following financial assets while measuring hosts at amortised cost.

Table 8: Application of bifurcation with hosts at amortised cost

Financial assets involved

-
- Convertible bonds with an equity derivative;
 - Commodity linked coupons;
 - Fully funded total return swaps;
 - Credit linked notes;
 - Loans with an in the money interest rate floor;
 - Structured loans;
 - Investments in money market instruments;
 - Financial debt securities with leverage and constant maturity swap features; and
 - Structured debt securities with returns linked to interest rates.
-

- 66 The participants from the banking industry that applied bifurcation used it for the following financial assets while measuring hosts at fair value as part of the available-for-sale category.

Table 9: Application of bifurcation with hosts classified at available-for-sale

Financial assets involved

-
- Asset backed securities with embedded derivatives;
 - Convertible bonds with an equity derivative;
 - Government bonds with principal and interest tied to the rate of inflation of the issuing country but with no floor for the principal; and
 - Bonds with interest indexed in a way that the determination is not considered to be closely related to the host debt instrument.
-

- 67 One participant from the banking industry mentioned that measuring financial instruments belonging to this category at fair value through profit or loss would be acceptable. The participant did not provide examples of the financial instruments but indicated it rarely used bifurcation. One participant from the insurance industry reported to measure the financial instrument at fair value through profit or loss rather than bifurcating the embedded derivative.

Planned use of the fair value option to avoid an accounting mismatch

- 68 One participant from the banking industry indicated to have some structured loans, which were hedged into vanilla loans at variable rate, with bifurcation of the embedded derivative and amortised cost measurement for the host contract. The participant observed, at the moment credit spreads began to widen, that the use of the fair value option for the loan and trading for the bifurcated derivative would have generated a lot of volatility into profit or loss, thereby misrepresenting the business model. For this reason they have chosen for the future to bifurcate the embedded derivative of the loan and record it at fair value through profit or loss along with the economic hedging derivative. This accounting method reflects the business model better.
- 69 Two participants from the banking industry intended to make more use of the fair value option on the liability side due to the business model application. When assets would be measured at fair value through profit or loss because of the application of the business model then the fair value option would be used for the associated liabilities where the risks are managed together. Another participant from the banking industry mentioned that the absence of bifurcation would have no influence on their use of the fair value option on the liability side because the fair value risk of the host instrument is rarely economically hedged via funded liabilities.

General findings

Fair value or amortised cost measurement

- 70 Fourteen participants from the banking and other industries expected no major changes in the accounting compared to IAS 39. Of those who responded five were banks, and nine came from other industries. The only exception would be the requirement to measure equity instruments at fair value through profit or loss.
- 71 Fifteen participants from the banking, insurance and other industries indicated that they expected more measurement at fair value. Of those who responded seven were banks, one was an insurer and seven participants came from other industries. The following reasons were provided for this.

Table 10: Reasons why more measurement at fair value was expected

-
- The 'solely payment of principal and interest test' was considered stricter than the current closely related notion;
 - The absence of bifurcation on the asset side;
 - The restrictions on sales for the amortised cost category. Participants indicated that it would become uneconomical to hold some portfolios of financial assets due to stricter prudential rules (due to increased capital requirements or stricter concentration risk rules). These portfolios would gradually be sold. As a consequence the sales criterion would be breached. The restriction on sales was also mentioned in relation to the financial assets part of the liquidity portfolio;
 - The requirement to measure equity instruments at fair value through profit or loss;
 - The application of the business model; and
 - The use of the FV-OCI category.
-

- 72 One participant from the insurance industry noted that the outcome would depend on the final requirements under IFRS 4 for participating contracts and the discount rate used for this category of contracts.

- 73 Four participants noted they would have more amortised cost measurement. The following reasons were provided for this:

Table 11: Reasons why more amortised cost was expected

-
- Participants did not use the held to maturity category under IAS 39 because of the tainting rules;
 - The possibility to hedge items at amortised cost under IFRS 9 compared to not being able to designate financial assets for hedging purposes categorised in the held to maturity category under IAS 39 for a number of risks; and
 - The possibility to qualify a part of the liquidity portfolio at amortised cost.
-

Measurement at fair value through profit or loss

- 74 Ten participants from the banking industry and other industries did not expect more measurement at fair value through profit or loss to a significant effect.
- 75 Twenty participants from the banking, insurance and other industries expected more measurement at fair value through profit or loss.
- 76 One participant from the banking industry saw no impact in the short term. However, as a result of changes in the banking regulatory environment, it was noted that many financial instruments would fail the ‘solely payment of principal and interest test’, leading to a fair value through profit or loss measurement.
- 77 One participant from the banking industry indicated he would be willing to use the fair value through profit or loss category in order to avoid using the ‘solely payment of principal and interest test’.

Impact on profit or loss or other comprehensive income

- 78 Eighteen participants from the banking industry and other industries did not expect a significant impact on profit or loss or other comprehensive income. However, eleven participants from the banking, insurance and other industries expected a significant impact on profit or loss or other comprehensive income.
- 79 One participant from the banking industry expected a significant impact on profit or loss as a result of the Livret A issue. One participant from the insurance industry expected a significant impact on profit or loss and other comprehensive income because the increased measurement at fair value through profit or loss compared to IAS 39 and a possible increase in accounting mismatches as result of the final IFRS 4 standard. The nature of these accounting mismatches is discussed in more detail in Appendix D ‘*Portfolios backing insurance contracts*’.

Accounting mismatches

- 80 Seventeen participants from the banking industry and other industries did not expect to be impacted, or at least not to a significant extent. Of those participants five were banks and twelve came from other industries.
- 81 Of the participants which did not expect to be impacted by a change in accounting mismatches, twelve did not expect a significant impact on profit or loss or other comprehensive income. One participant did expect a significant impact on profit or loss.

Field test – Classification and measurement of financial assets

- 82 Ten participants from the banking, insurance and other industries expected more accounting mismatches. Of those participants two were insurers, seven were from the banking industry and one was from other industries. One participant from the banking industry expected less accounting mismatches. Of those participants three expected more volatility in profit or loss. For insurance activities it was observed that an accounting mismatch may be reduced by the introduction of the FV-OCI category provided that IFRS 4 allows for changes in insurance liabilities due to market risk to be at FV-OCI. Additional mismatches may be created by the narrow definition of the FV-OCI category and the exclusion of equities that will be at fair value through profit or loss.
- 83 One participant from the banking industry expected less accounting mismatches provided the amortised cost category could be applied widely enough.

Reliability of financial information

- 84 Twenty participants from the banking, insurance and other industries did not expect the reliability of financial information to be greatly impacted. One participant from the banking industry noted that reliability would increase as the available-for-sale category was a residual category but a lot of financial instruments ended up in it. One participant from the insurance industry mentioned that it was not the reliability of information that was impacted, but rather the volatility of net income.
- 85 Two participants from the banking and other industries expected more reliability of financial information. Conversely, nine participants from the banking and insurance industry expected less reliability of financial information mainly because the measurement of instruments that fail the contractual cash flow characteristics assessment and of non-quoted equities would be within Level 3 of the fair value hierarchy. However, these participants also referred to (i) the volatility arising from measuring at FV-PL certain instruments that are held to collect contractual cash flows and (ii) the elimination of bifurcation for financial assets as reasons for a decrease in the reliability of financial information.

Difficulties in implementing the standard

- 86 Nineteen participants from the banking, insurance industry and other industries did not anticipate any practical difficulty. Twenty-one participants from the insurance, banking and other industries did identify difficulties. Ten participants from the banking and other industries noted difficulties in obtaining input to assess the fair value of financial assets.
- 87 The participants that *did not* and those that *did* anticipate any practical difficulty described the status of their internal assessments as ‘analysis not completed’, ‘analysis deferred’, ‘analysis based on a high level basis only’, ‘currently analysing’ or ‘analysis still in progress’. In other words, there was no clear relationship between the status of a participant’s IFRS 9 implementation project and the issues identified.
- 88 The following tables describe the operational difficulties reported by participants, distinguishing between those difficulties noted by more than one participant and those reported by only one participant.

Table 12: Operational difficulties noted by more than one participant

-
- Verification of the cash-flow characteristics, to be effected at the date of first time adoption on existing stock and at the date of issuing new products, could be extremely time consuming. While it was not believed the test should be effected also during the life of an asset, after initial entry, that aspect was not particularly clear in the ED (two
-

participants provided this comment);

- Many of the theoretical aspects of the 'solely payment of principal and interest test' (SPPI test) were found to be unclear (five participants provided this general comment):
 - It was unclear how a benchmark instrument should be defined. Was it necessary to refer to an existing asset or construct a hypothetical one? (four participants provided this comment);
 - It was unclear what the unit of account for performing the SPPI test should be: some indicators when to measure at amortised cost seemed to be at portfolio level while others seemed to be focused on single instrument (two participants provided this comment);
 - Test methods could lead to passing or failing the SPPI test depending on when they were carried out. For example, the date of issuance could affect the cash flow resulting from the mismatch feature and could therefore change the result of the test. (three participants provided this general comment);
 - The lack of observable market data on rates and credit spreads for determining the fair value of loans. For many contract clauses in loans participants reported no common revaluation models existed (six participants provided this comment);
 - The lack of observable market data in the measurement of non-quoted equity instruments (three participants provided this comment);
 - The fair value measurement of the Livret A and retail loans with small mismatches would cause high volatility and this was seen as misrepresenting the business model (two participants provided this comment);
 - The definitions of the measurement categories are unclear for example in order to classify bonds, money market funds, debt assets which are insignificantly different from simple debt instruments, credit linked products, products with repayment clauses and securitised assets not previously assessed under the new criteria for concentration risk. In order to clarify the boundaries for the amortised cost category clarification is needed about what are permitted sales and when a credit deterioration has been deemed to occur (ten participants provided this comment); and
 - The impact of other phases of IFRS 9 on the classification and measurement standard (three participants provided this comment).
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Table 13: Operational difficulties identified noted by single participants

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- Theoretical aspects of the 'solely payment of principal and interest test' (SPPI test):
 - It was not clear whether the quantitative test should be effected on the basis of curves existing at the time of measurement or if different scenarios were to be foreseen for the simulation;
 - It was unclear whether the test should be conducted based on the effective interest rate of the instrument;
 - It was unclear whether market practice be taken into account;
 - It was unclear what 'more than insignificant' did meant. It was unclear what the limit of materiality was;
 - It was mentioned that a certain degree of judgement existed about the possibility of doing only a qualitative assessment instead of a quantitative one;
 - It was mentioned that the phrase 'more than insignificant' could be extremely penalising; it was suggested using a different term such as 'not significant' as well as clarifying the nature of the assessment. It was suggested clarifying the terms with reference to materiality, without introducing a single bright line definition;
 - It was noted that failing of the SPPI test, especially based on a restrictive
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interpretation of levels of materiality, might not be in line with the business model of holding the asset;

- The alignment between the effective date of IFRS 4 and IFRS 9;
 - The measurement of financial assets with embedded derivatives that did not require bifurcation but which would fail the SPPI test;
 - The application of the business model test would require clarification of the terms 'frequent' and 'significant'. The business model test should also be defined to reflect asset liability strategies;
 - Areas where additional guidance may be useful are the treatment of syndicated loans and the interaction with IFRS 5. It was unclear whether the accounting classification would change if a business with amortised cost loans was being sold as a going concern, whereby the vendor would sell the assets and not collect the contractual cash flows, but where the buyer retains the portfolio and operates a hold to collect model. If reclassification would be required, IFRS 9 requires that this was made prospectively at the start of the first reporting period following the change in the business model. The remainder of the disposal group would be reclassified when the IFRS 5 criteria was met. This could result in different dates of reclassification for the financial assets and the other items in the disposal group. Also IFRS 9 would require re-measurement of the financial assets at fair value, but IFRS 5 requires re-measurement at the lower of fair value less costs to sell and carrying amount for other assets;
 - Discrepancy between the application of the business model test (at portfolio level) and the cash flow characteristics test at individual level;
 - When subsidiaries securitise assets and sell to another group entity thereby achieving de-recognition, then a different model would be required for the assets in the subsidiary and at group level which increased the complexity of the consolidation; and
 - If the final standard on impairment would result in an excessively low level of credit risk to be adopted for measuring lifetime expected losses, the resulting profit or loss and equity volatility related to credit risk measurement would be similar to a fair value through profit or loss measurement, requiring strategies for mitigation of this new source of volatility, such as anticipated disposal of loans when approaching measurement lifetime expected losses.
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APPENDIX A – LIST OF PARTICIPANTS IN THE FIELD TEST

Participant	Industry
Barclays	Banking
Bayerische Landesbank	Banking
BBVA	Banking
BNP Paribas	Banking
BPCE	Banking
Deutsche Bank	Banking
Federkasse	Banking
Gruppo Iccrea	Banking
Helaba (Landesbank Hessen-Thüringen)	Banking
HSBC	Banking
Intesa Sanpaolo	Banking
LBBW (Landesbank Baden-Württemberg)	Banking
Lloyds TSB	Banking
Mediobanca	Banking
Standard Chartered	Banking
UBI Banca	Banking
Unicredit	Banking
Allianz	Insurance
AXA	Insurance
CNP Assurances	Insurance
Generali	Insurance
Alcatel Lucent	Other industries (Technology)
Continental	Other industries (Consumer Goods)
ENI	Other industries (Utilities)
Henkel	Other industries (Consumer Goods)
Infineon	Other industries (Technology)
K+S	Other industries (Chemistry)
Lanxess	Other industries (Chemistry)
Linde	Other industries (Chemistry)
Siemens	Other industries (Industrials)
Telecom Italia	Other industries (Technology)
ThyssenKrupp	Other industries (Industrials)
Undisclosed	Other industries (Utilities)
Unilever	Other industries (Food and Beverage)
Volkswagen	Other industries (Consumer Goods)
EnBW (Energie Baden-Württemberg)	Other industries (Utility)
RWE	Other industries (Utility)

APPENDIX B – FEATURES OF PARTICULAR INSTRUMENTS

This appendix provides a description of the features identified in instruments with interest rate mismatches and those with regulated interest rates that would (may) trigger measurement at FV-PL as described by participants in the fact-finding study.

Financial assets with interest rate mismatch features

Retail mortgages

- 1 Two participants noted that common retail mortgages in France are based on three-month Euribor with yearly resetting. The reason why these instruments are reset only once per year is operational, since customers may choose at each period of revision either to modify the amount of their monthly payment or the duration of the loan.
- 2 A participant noted that certain mortgages in various European jurisdictions (including Italy, Spain and Portugal) may fail the assessment because they have 'lagged' interest rate features. The interest rate of these mortgages is calculated based on the average rate of a preceding period (e.g. the rate may be calculated by averaging 12-month Euribor for every working day in the month preceding the reset). The payments arising from some of these mortgages are monthly; however, the tenor of the rate is longer.
- 3 A second participant expected various loans with interest rate mismatches in Italy to fail the assessment. For example, loans with variable interest rate reset quarterly to one-month interest rate and those which are reset semi-annually to a three-month interest rate would fail the assessment when the principal represents more than 100,000 EUR and the original maturity is more than 20 years. This participant considered differences between the loans and the benchmark instrument to be significant when they exceeded a 3% threshold.
- 4 A third participant indicated that common financial products in Austria are based on an interest rate based on the Austrian average secondary market rate for an indefinite period. The main reason for using this reference is to protect costumers from significant changes in interest rates.

Other financial assets

- 5 A participant also identified perpetual debt instruments with indexed interest rate that is not connected to a specific period of time as a class of financial assets with interest rate mismatch features.

Financial assets with regulated interest rates

Constant maturity loans in China

- 6 One participant referred to constant maturity loans in China, where the central bank dictates the interest rates on loans (and deposits) set by banks by way of banking regulations. In this jurisdiction, financial assets are re-priced according to their original tenor; therefore, instruments with the same remaining maturity could have different interest rates set according to their original maturity for any given level of credit risk. As a result, there is no available benchmark instrument within the jurisdiction and it is difficult to determine what would be the appropriate interest rate to use in the benchmark instrument.

Field test – Classification and measurement of financial assets

The only alternatives would be to compare these constant maturity loans with instruments that do not exist in China or to instruments of a different nature; however, in either case the hypothetical benchmark would not resemble the financial assets to be assessed.

- 7 These instruments are measured at amortised cost under IAS 39, as the interest rate mismatch feature is not considered to be an embedded derivative.

Livret A receivables in France

- 8 Three participants referred to loans to public bodies that are funded by Livret A deposits for which similar issues as above arise. Banks take deposits from costumers and provide these to the government to fund the French social residential industry, thereby creating both an asset and a liability for banks. All aspects of these deposits, including the interest rate, is defined and regulated by French law. The liability side is not considered to require bifurcation under IFRS 9 and would be measured at amortised cost. However, the related assets are unlikely to remain measured at cost under the new requirements.
- 9 The interest rate is rest semi-annually considering an average of monthly EONIA, Euribor three-month and inflation. However, the French government has discretion on the final interest rate set within a certain range and makes public any revisions.
- 10 These participants indicated that these instruments were expected to be measured at FV-PL.

Commercial loans in Austria

- 11 One participant noted that the interest rate for a large part of loans in Austria is fixed and subsidised by the Government. Banks are allowed to provide these loans for the construction of buildings or in support of the manufacturing industry through which they only earn a margin. The participant indicated that these instruments were expected to be measured at FV-PL.

APPENDIX C – REGULATORY LIQUIDITY PORTFOLIOS

This appendix summarises the specific comments provided by participants in the banking industry regarding regulatory liquidity portfolios. It should be noted that some participants referred to financial assets held within larger internal liquidity portfolios. The comments provided by these participants have been included in the various sections of the document based on the expected changes, if any, in their measurement.

- 1 Banks will be required to prove the liquidity of the assets held within regulatory liquidity portfolios. Although the specific requirements have not yet been articulated, including the periodicity and the portion of financial assets that would be affected, it is expected that banks would be able to prove liquidity executing repos or through sales. In addition, it should also be noted that the new capital requirements are expected to phase out the filter on prudential capital of unrealised gains and losses arising from financial assets measured at FV-OCI.
- 2 Two participants from UK and four participants from Italy reported that the regulatory liquidity portfolio, generally classified in the AFS category, would most likely be measured at FV-OCI under the new requirements. In addition, a small part of financial assets could be measured at amortised cost or FV-PL, the latter when they fail the contractual cash flows characteristics assessment. One of these participants noted that this measurement represented a change from its initial impact assessment of IFRS 9, as they would have split the portfolio between amortised cost and FV-PL.
- 3 Conversely, four participants from various countries indicated their preference to measure the entire liquidity portfolio at amortised cost. Measurement at FV-OCI would only be used for a small part of assets to optimise the cost of the portfolio. Some of these participants intended to test the liquidity of the portfolio via repo transactions instead of sales, whereas others intended to create sub-portfolios to limit the amount of financial assets measured at FV-OCI, if necessary, so as to minimise any negative impact on the regulatory capital.
- 4 A participant from France reported that it was extremely difficult to articulate an expectation on the portion of the regulatory liquidity portfolio that would be measured at amortised cost, FV-OCI and FV-PL. This participant intended to minimise the amount of financial assets measured at FV-OCI by investing only in short-term liquid assets or hedging certain components of the financial assets held in the liquidity portfolios.
- 5 A participant from Italy did not expect significant changes in the measurement of the financial assets held within the liquidity portfolio that are currently measured at amortised cost and FV-PL and classified in the AFS category. This participant stressed that the elimination of the prudential filters for sovereign bonds could trigger different business and investment decisions, such as shortening the average maturity and changing the investment strategy.

APPENDIX D – PORTFOLIOS BACKING INSURANCE CONTRACTS

This appendix summarises the specific comments provided by participants in the insurance industry regarding portfolios backing insurance contracts

- 1 The composition of the portfolios backing insurance liabilities varied by insurer and by class of insurance business written. Participants noted that in some countries like France the majority of the life business written had discretionary participation features and was primarily backed by debt securities, with some exposure to equities, equity funds and properties. In other countries like UK the business was primarily unit-linked, and was backed primarily by equities, equity funds and other funds which are measured at FV-PL to match the guaranteed amount to policyholders (i.e. the fair value of the underlying assets). It should be noted however that the unit-linked business it was also common among other countries.
- 2 Accordingly, the portfolio management is often driven by the class of business written. For example, portfolios backing non-linked insurance contracts are structured to match the expected contractual outflows, whereas portfolios backing unit-linked products are managed in order to maximise return to policyholders within a set of risk limits. Products with discretionary participation features combine both types of management. These contracts typically provide a capital guarantee or guaranteed returns, which are primarily backed by debt securities held to collect contractual cash flows, and provide some type of supplement benefits by way of holding investments in equities or in other assets riskier than debt instruments. The latter assets may be realised more regularly in order to achieve enhanced returns.
- 3 The financial assets underlying the portfolios described above are classified under IAS 39 according to the management intent. Although most participants reported significant amounts of financial assets classified in the AFS category, with financial assets backing unit-linked and index-linked portfolios measured at FV-PL, differences were observed across countries. For example, a participant from UK with insurance activities reported that the financial assets held to back insurance liabilities were designated at FV-PL and represented approximately 80% of the total assets balance measured at FV-PL. These financial assets backed insurance liabilities comprising with-profit, unit-linked and non-profit business.
- 4 The majority of participants indicated that classification of financial assets depended on the final requirements and the timing of the IASB's project on insurance contracts. Although participants could expect financial assets to be in the three classification categories under the new requirements, a significant part of their portfolios may qualify for FV-OCI. This not only because the instruments would meet both the contractual cash flow characteristics and the business model assessment, but also because participants could change their investment strategies to align with the measurement approach that would be applied to insurance liabilities so as to reduce reporting accounting mismatches.
- 5 Some participants noted that portfolios held with the intention of meeting liabilities as they arise may not have sufficient portfolio turnover to meet the criteria for the FV-OCI measurement category (e.g. portfolios backing annuity business). Other insurers reported that derivatives used to manage interest, credit or other risks would not meet the criteria for the FV-OCI category either. Similarly, portfolios of financial assets that do not meet the contractual cash flow characteristics assessment would not qualify for FV-OCI measurement. Each of these situations would lead to potential accounting mismatches

and volatility in profit or loss considering the IASB's current decisions on the insurance contracts project. For example, a participant reported that a change of 10% on the fair value of the debt instruments that are expected to fail the contractual cash flow characteristics assessment could lead to an effect in profit or loss of around half of the annual net income.

- 6 Two participants commented that the IASB's tentative decisions on the mirroring approach for participating contracts might address some of the issues mentioned above; however, the application of the principles underlying this approach was still unclear.
- 7 All participants indicated that the proposed accounting for financial assets would not reflect the linkage between assets and liabilities from an asset-liability management approach. This may result in financial statements that do not reflect the business model or performance of the companies. Although these participants were not able to assess this inter-linkage yet, they believed that further work is needed to ensure that the financial statements of insurers provide relevant and appropriate information.
- 8 A participant from UK with insurance activities commented that it would be better to wait until these proposals on insurance contracts are finalised before changing the accounting of the financial assets. In its view, the proposed OCI approach for insurance liabilities may lead to unnecessary complexity. In particular the participant was concerned that reporting separately fair value movements in the income statement and OCI would have little or no relevance to users of financial statements unless they are considered in aggregate.