EFRAG

European Financial Reporting Advisory Group

16 April 2013

International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

Dear Sir/Madam,

Re: Exposure Draft Classification and Measurement: Limited Amendments to IFRS 9

On behalf of the European Financial Reporting Advisory Group (EFRAG), I am writing to comment on the Exposure Draft *Classification and Measurement: Limited Amendments to IFRS 9 (proposed amendments to IFRS 9 (2010))* issued by the IASB on 28 November 2012 (the 'ED').

This letter is intended to contribute to the IASB's due process and does not necessarily indicate the conclusions that would be reached by EFRAG in its capacity as advisor to the European Commission on endorsement of definitive IFRS in the European Union and European Economic Area.

EFRAG welcomes the IASB's decision to consider making limited amendments to IFRS 9 *Financial Instruments* (2010). We note that changes to the original requirements have been proposed based on feedback received from constituents and also to consider the interaction with the future IFRS on insurance contracts and the differences with the FASB's tentative classification and measurement model. We appreciate the IASB's effort to consider our request to address accounting mismatches that may arise from the application of different measurement models to financial assets and insurance liabilities.

However, we have a number of concerns regarding the proposals, which are described in detail in our responses to the questions in the ED set out in the Appendix.

In our view, the IASB's proposals to modify the contractual cash flow characteristics assessment do not go far enough. EFRAG believes that there are still many financial assets that do not pass the contractual cash flow characteristics assessment, despite the fact that an amortised cost measurement – or fair value through other comprehensive income (FV-OCI) measurement – would provide more useful information than measurement at fair value through profit or loss (FV-PL) (see paragraphs 9 and 10 of the Appendix).

EFRAG believes that the IASB should clarify that the definition of interest in IFRS 9 (and the related application guidance) were not meant to be inconsistent with how entities determine interest of financial assets in practice, for example by including a reasonable profit margin and a premium for liquidity risk and considering other entity-specific factors such as the expected future behaviour of customers, provided that the resulting interest reflects market transactions.

Constituents reported that financial assets with regulated interest rates and those with early automatic redemption features would most likely fail the assessment. In both cases EFRAG believes that these instruments should be eligible for a measurement basis other than FV-PL. In this regard, we intend to share with the IASB the results arising from a fact finding exercise, which EFRAG is carrying out with its partners, that aims identifying the high level reasons for the changes from a current amortised cost measurement as foreseen currently by IAS 39 to a fair value basis under IFRS 9 (and the other way around) and to understand the accounting effects of the IASB's decision not to allow bifurcation for financial assets.

Constituents also identified a number of other instruments that are expected to fail the assessment, including financial assets that are currently measured at amortised cost under IAS 39 which are (at least partially) managed to collect the contractual cash flows. We recommend that the IASB introduces bifurcation into IFRS 9 for financial assets based on an approach consistent with the contractual cash flow characteristics assessment as described in paragraphs BC63-BC67 of the ED. In our view, entities should bifurcate financial assets that fail the contractual cash flow characteristics assessment, unless entities elect (either at the entity-level or on a portfolio-level) to measure these financial assets in their entirety at FV-PL due to the excessive cost of bifurcation. This would ensure measuring financial assets that fail the contractual cash flow characteristics assessment more consistently with how entities manage them.

With regards to the introduction of an additional measurement category in IFRS 9, EFRAG believes that the ED fails to clearly identify the business model underlying measurement at FV-OCI. In addition, the ED does not fully address the concerns raised by insurance companies, which was one of the reasons for reopening the classification and measurement requirements in IFRS 9.

EFRAG believes that measurement at FV-OCI is necessary as part of a solution to address insurers' concerns about accounting mismatches and performance reporting. Therefore, in the absence of a third business model being clearly identified, we recommend to the IASB introducing FV-OCI measurement as part of its project on insurance contracts rather than proceeding with the introduction of an additional measurement category in IFRS 9.

Finally, we note that the ED includes in its basis for conclusions the IASB's analysis of the likely effects that will result from the proposed amendments covering, among other aspects, the comparability and usefulness of the financial information that would result from the ED and the likely effect on costs for preparers and users of financial statements. In this respect, we appreciate the step forward that the IASB has taken by integrating an effect analysis into the standard setting process.

If you would like to discuss our comments further, please do not hesitate to contact Anna Vidal or me.

Yours sincerely,

Françoise Flores
EFRAG Chairman

APPENDIX

EFRAG's responses to the questions raised in the exposure draft

CONTRACTUAL CASH FLOW CHARACTERISTICS ASSESSMENT

Question 1

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

Question 2

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

Question 3

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

EFRAG's response

EFRAG welcomes the clarifications made in the contractual cash flow characteristics assessment; however we are concerned that there are still many financial assets that for different reasons do not pass the assessment, despite the fact that an amortised cost (or FV-OCI) measurement would provide more useful information than measuring them at FV-PL.

EFRAG believes that the IASB should clarify that the definition of interest in IFRS 9 (and the related application guidance) were not meant to be inconsistent with how entities determine interest of financial assets in practice, for example by including a reasonable profit margin and a premium for liquidity risk and considering other entity-specific factors such as the expected future behaviour of customers, provided that the resulting interest reflects market transactions.

In addition, EFRAG recommends that the IASB introduces bifurcation into IFRS 9 for financial assets based on an approach consistent with the contractual cash flow characteristics assessment as described in paragraphs BC63-BC67 of the ED.

In our view, entities should bifurcate financial assets that fail the contractual cash flow characteristics assessment, unless entities elect (either at the entity-level or on a portfolio-level) to measure these financial assets in their entirety at FV-PL due to the excessive cost of bifurcation. This would ensure measuring these financial assets more consistently with how entities manage them.

Clarification made in the contractual cash flow characteristics assessment

1 EFRAG agrees that a financial asset with a modified economic relationship could be considered an eligible financial asset to be measured at amortised cost – or fair value through other comprehensive income (FV-OCI) – under IFRS 9 when its contractual cash flows would not be more than insignificantly different from the benchmark cash flows of a regular financial asset. In those cases we believe that, as the contractual cash flows are economically almost indistinguishable, requiring the same treatment would be consistent with the underlying objective of existing IFRS 9, which was to identify simple financial assets that could be eligible for a measurement category other than fair value through profit or loss (FV-PL) as indicated in paragraph BC39 of the ED.

2 EFRAG is aware that many constituents welcome the clarifications made in the wording of the contractual cash flows characteristics assessment. These constituents have indicated that they expected some financial assets, which would not have met the original assessment, to qualify for amortised cost (or FV-OCI) measurement; in particular, those that contain interest rate mismatch features. In paragraphs 19 to 22 below, we include some comments on how the requirements regarding the use of benchmark instruments might be improved.

3 In EFRAG's view, however, the IASB's proposals to modify the contractual cash flow characteristics assessment do not go far enough. There exist financial assets other than those with a modified economic relationships that are expected to fail the assessment for different reasons, which are at least in part) held to collect contractual cash flows.

4 We provide below further explanations of our concerns and suggest our preferred approach.

Definition of interest

5 We believe that the definition of interest, for the purpose of the assessment, is too restrictive and somewhat unclear. While the ED does not propose any changes to the existing definition of interest in IFRS 9, paragraph B4.1.8A of the ED specifically states that if the contractual cash flows include payments that are unrelated to principal, the time value of money and the credit risk, the contractual cash flows do not represent solely payments of principal and interest. This paragraph further concludes that such financial assets must be measured at FV-PL.

6 EFRAG is concerned that if paragraph B4.1.8A of the ED was taken literally, it would require FV-PL measurement in almost all circumstances. Therefore, we believe that the IASB should clarify that the definition of interest in IFRS 9 (and the related application guidance) were not meant to be inconsistent with how entities determine interest of financial assets in practice, for example by including a reasonable profit margin and a premium for liquidity risk and considering other entity-specific factors such as the expected future behaviour of customers, provided that the resulting interest reflects market transactions.

Financial assets expected to fail the assessment

<u>Financial assets with regulated interest rates or early redemption features</u>

7 EFRAG is also concerned about a number of instances in which common simple financial instruments might not pass the contractual cash flow characteristics assessment despite the fact that measurement at amortised cost (or FV-OCI) provides more useful information. We note that users of financial statements have

indicated that amortised cost information is helpful when financial assets are held to collect the contractual cash flows.

8 In this context, financial assets that we believe could be inappropriately measured at FV-PL, as identified by our constituents, include:

(a) Financial assets with regulated interest rates which are common in many jurisdictions such as ‘Livret A’ receivables in France, mortgage loans at variable interest rates in Belgium, mortgage loans linked to the Bausparkassen system in Germany and Central Europe as part of the collective mechanism in place for financing homeownership, and constant maturity rate loans in China; and

(b) Financial assets with early automatic redemption features such contractual terms included in debt instruments issued by companies operating in the infrastructure sector that usually require an automatic early (partial) redemption of the principal if certain credit risk related performance milestones are not achieved.

9 EFRAG believes that the financial assets referred to in paragraph 8(a) should generally be considered eligible instruments provided that their interest rate represents the pricing basis that is compulsory in the jurisdiction for such type of transactions and is intended to provide a reasonable proxy for the time value of money.

10 We believe that fair value measurement of these assets would not result in better financial reporting, because a similar interest rate (or term structure) is applied to deposits received from customers that fund these loans. If these financial assets were to be measured at FV-PL, a significant accounting mismatch would arise because the corresponding deposits would most likely be measured at amortised cost as they meet the ‘double-double’ test included in IFRS 9 for bifurcation of financial liabilities. We further note that it may not be possible to determine reliably the fair value of financial assets whose interest is set by the Government or other authorities.

11 Regarding financial assets with early automatic redemption features referred to in paragraph 8(b), EFRAG believes that the accounting effects of prepayment options and automatic redemption features linked to the credit risk of the issuer are identical if not the same. However, the current guidance in paragraph B.4.1.12 regarding contractual terms that change the timing or amount of the payments of principal and interest only allows certain types of prepayment or extension options to be eligible for a measurement category other than FV-PL. We believe that the current guidance in IFRS 9 should be expanded to clarify that a financial asset with an automatic early (partial) redemption feature linked to credit risk deterioration of the issuer should not be excluded from measurement at amortised cost (or FV-OCI), provided that the financial asset prepays only principal and accrued interest.

<u>Other financial assets</u>

12 Notwithstanding the above, it should be noted that even if constituents had made significant progress in their assessments of the impact of IFRS 9, additional issues may arise and other financial instruments may exist for which the ‘principal and interest’ criterion as currently drafted might not work well in practice. In this respect, we note that EFRAG and its partners are carrying out a fact finding exercise that aims to identify how the classification and measurement requirements in IFRS 9, as modified by the ED, would affect the current classification and measurement of financial assets and to understand the

accounting effects of the IASB's decision to not allow bifurcation for financial assets. We intend to share with the IASB the findings arising from this study.

Bifurcation of financial assets

13 Constituents identified a number of hybrid instruments that are expected to fail the assessment, including financial assets that are currently measured at amortised cost under IAS 39 and that are (at least partially) managed to collect the contractual cash flows.

14 EFRAG is concerned that our previous recommendations to clarify the definition of interest and to deal with some specific assets would not address the various instruments that are expected to fail the assessment. In particular, we are concerned about the usefulness of information that would result from measuring financial assets in their entirety at FV-PL when (i) an entity manages the individual components of a financial asset separately (i.e. when the host contract is held to collect cash flows and the embedded derivative is managed on a fair value basis), and (ii) an entity holds a financial instrument to collect the cash flows but it contains features that could significantly impact the fair value of the instrument, for example when entities originate structured products to customers and acquire hybrid financial assets to match (replicate) the variable consideration provided. In this example, the hybrid financial assets are usually held to collect the cash flows. However, these hybrid financial assets are split into components for measurement purposes; for example the value of their embedded derivatives offsets the guaranteed component of the liabilities to customer.

15 EFRAG believes that bifurcation of the financial assets referred to above would be preferable and useful to users, as it would reflect the different nature and effect of each component of these instruments. In the absence of bifurcation, entities would be prevented from appropriately reflecting how they manage financial assets and their performance.

16 Accordingly, we recommend the IASB to introduce bifurcation into IFRS 9 for financial assets based on an approach consistent with the contractual cash flow characteristics assessment ('principal-and-interest' approach) as described in paragraphs BC63-BC67 of the ED.

17 In our view, entities should bifurcate financial assets that fail the contractual cash flow characteristics assessment, unless entities elect (either at the entity-level or on a portfolio-level) to measure these financial assets in their entirety at FV-PL due to the excessive cost of bifurcation. This would ensure measuring financial assets that fail the contractual cash flow characteristics assessment more consistently with how entities manage them.

18 EFRAG believes that such an approach would be consistent with the underlying requirements in IFRS 9 and also address constituents' concerns about traditional banking products that are expected to fail the assessment. Although we are aware that some constituents approved the IASB's decision to eliminate bifurcation of financial assets in IFRS 9 because of the complexity of the 'closely related' guidance in IAS 39, we believe that the benefits of a principle-basis for bifurcation and the possibility of opting for fair value through profit or loss for excessive cost should alleviate concerns.

Use of benchmark instruments

19 EFRAG is aware that many constituents have raised concerns about the lack of guidance in the ED regarding the use of benchmark instruments. In general terms, EFRAG believes that the ED proposes sufficient and operational guidance on

assessing a modified economic relationship. However, we note that some of those concerns could be addressed if the IASB were to clarify that the objective of using a benchmark instrument is to assess whether a financial asset yields an appropriate economic return at initial recognition considering the nature of the financial asset.

20 Having such an objective in IFRS 9 would help in clarifying (i) whether entities should look for global or local benchmark instruments, (ii) when the assessment should be performed (e.g. only at initial recognition or on a continuous basis), (iii) which cash flows should be considered and on which basis, and (iv) how hypothetical benchmarks should be constructed (e.g. for financial assets that have several underlying features like interest and inflation).

21 EFRAG is also aware that many constituents are concerned about performing detailed assessments for each individual financial asset, which would result in significant implementation costs. EFRAG understands that in many circumstances entities would not need to repeat such a detailed assessment or construct hypothetical instruments for each and every financial asset, as many will be very similar. Therefore, we would expect that regulators and standard setters, banking associations and auditors, would reach a common understanding about the classification of those financial assets that are most widespread in their jurisdictions.

22 To the extent that is not the case, we agree that assessing each financial asset individually would not be a straightforward exercise and would recommend the IASB to (i) clarify whether the assessment is always required, and (ii) indicate that actual benchmarks, where available, should be used in order to keep the assessment as simple as possible and to avoid possibilities of inconsistent application in practice.

BUSINESS MODEL ASSESSMENT

Question 4

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

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

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

Question 5

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

Question 6

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

EFRAG's response

EFRAG believes that the proposals in the ED fail to clearly identify an additional business model for accounting purposes and do not fully address the concerns raised by insurance companies, which was one of the reasons for reopening the classification and measurement requirements in IFRS 9.

EFRAG believes that measurement at FV-OCI is necessary as part of a solution to address insurers' concerns about accounting mismatches and performance reporting. Therefore, we recommend the IASB to introduce FV-OCI measurement (for financial assets) as part of its project on insurance contracts rather than proceeding with the introduction in IFRS 9 of a business model that is not well defined.

23 EFRAG believes that IFRS 9 should be based on a limited number of measurement categories and provide a clear rationale for each of those categories, as this would result in more useful reporting information while making IFRS 9 easier to apply by preparers by avoiding complexity. In our comment letter in response to the Discussion Paper *Reducing Complexity in Reporting Financial Instruments* issued by the IASB in March 2008, we noted that a fair amount of the complexity in financial instruments reporting under IAS 39 was caused by the many alternatives, bright lines and exceptions in that standard. EFRAG also believes that the absence of clear underlying principles resulted in complexity.

24 As part of its recommendations in that letter to simplify the classification requirements in IAS 39, EFRAG noted that any new approach should be based on facts – rather than allowing considerable choice and flexibility – and should represent the entity's activities.

25 The ED proposes to introduce FV-OCI measurement in IFRS 9 for financial assets that meet the contractual cash flow characteristics assessment, and are managed within a business model that has been defined as *'managing financial assets both to collect contractual cash flows and to sell'*.

26 EFRAG believes that the ED fails to clearly identify the business model underlying measurement at FV-OCI as no business model is characterised by a level of sales. In addition, the ED does not fully address the concerns raised by insurance companies, as described in paragraph BC11(b), which was one of the reasons for reopening the classification and measurement requirements in IFRS 9.

27 We provide below further explanations of our concerns and suggest our preferred approach to move forward.

A business model that is not well-defined

28 EFRAG believes that the definition of the additional business model proposed by the ED is not sufficiently clear so as to differentiate it from the existing business model in IFRS 9 to 'hold-to-collect' and the residual category of FV-PL (which includes assets that meet the definition of 'held for trading'). In particular, we note that assessing the financial assets that would meet the proposed definition has been assessed as difficult.

29 EFRAG notes that IFRS 9 uses the notion of 'business model' considering financial assets in isolation. We believe that introducing the additional business model, as defined by the ED, would put even more stress on the level of sales activity that it is allowed under each business model.

30 EFRAG believes that any additional business model that requires a different treatment for financial reporting purposes should be supported by a robust definition. Without such a robust definition, we note that FV-OCI measurement could only be introduced in IFRS 9 as a measurement category to eliminate or reduce an accounting mismatch that would otherwise arise from measuring assets or liabilities (or recognising the gains and losses on them) on different bases (e.g. such as mismatches arising in the accounting for some insurance contracts).

Insurance contracts accounting

31 EFRAG agrees with the rationale underlying paragraph BC17 of the ED that introducing FV-OCI measurement for certain financial assets is important to address the interaction between the classification and measurement of financial assets and the accounting for insurance contracts liabilities.

32 EFRAG notes that many insurers welcome the introduction of FV-OCI measurement because it might help them to reduce accounting mismatches arising from the use of different measurement basis for some insurance liabilities and the financial assets backing those liabilities; however, we believe that introducing measurement at FV-OCI as a mandatory category in IFRS 9 would not fully address their concerns.

33 The IASB is proposing a complex model for measuring insurance contracts, which is driven largely by the specific characteristics of the liabilities and reports performance in different ways. According to the IASB's tentative decisions, insurance contracts would be segregated into different components and the performance of each component would be reported either (i) in profit or loss, or (ii) in OCI and profit or loss. However, the insurance model contains two aspects that affect performance reporting:

(a) to the extent that (part of) the insurance liability depends contractually on an underlying asset, the presentation and measurement of the insurance liability would mirror that of the asset; and

(b) changes in the insurer's expectations about future coverage (or other future services) would not impact the performance of the period as they would adjust the unearned profit at a particular reporting date.

34 However, on the asset side, IFRS 9 is based on a completely different model that is driven largely by the characteristics of the financial assets and the business model, although it also allows for certain accounting designations such as the fair value option. The performance of financial assets would (partially) be reflected in (i) profit or loss, (ii) OCI or (iii) profit or loss and OCI.

35 Some insurers have 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. Other insurers have noted 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 and investments in property would not qualify for FV-OCI measurement.

36 Given that insurance liabilities can be 'backed' by different types of financial assets, the ED proposals are *not expected* to fully eliminate accounting mismatches for insurers. Indeed, the revised ED for insurance contracts has yet to be finalised and the future IFRS is unlikely to be issued before the end of 2014. Therefore, assessing the full impact of the proposals to amend IFRS 9 on

insurance companies is not yet possible, as the full interaction between the accounting requirements for financial assets and insurance liabilities is unclear.

37 Based on the above considerations, EFRAG believes that measurement at FV-OCI is necessary to address insurers' concerns about accounting mismatches and performance reporting. However, we note that :

(a) *if FV-OCI measurement were to be introduced as a mandatory measurement category*, it would not fully address the concerns raised by insurance companies, which was one of the main reasons to reopen the classification and measurement requirements in IFRS 9;

(b) *if FV-OCI measurement were to be introduced as an option to eliminate or reduce accounting mismatches*, it would require significant changes in the current approach in IFRS 9. For such an option to be operational and effective, it would be necessary to define explicitly the business model underlying FV-PL measurement. The IASB would have to assess whether the current definition of 'held for trading' in IAS 39 for this purpose (which was also carried forward in IFRS 9) has caused problems in practice; and

(c) *if FV-OCI measurement were to be introduced as an unrestricted option for all types of entities*, it would impair comparability.

38 Accordingly, we recommend that the IASB introduces FV-OCI measurement – for financial assets – as part of its project on insurance contracts rather than proceeding with the proposals of the ED based on the introduction of an additional business model that is not sufficiently clearly delineated. In particular, we believe that insurers should use FV-OCI measurement for financial assets in certain circumstances to be defined once the interaction between IFRS 9 and the future IFRS on insurance contracts is clear enough.

Other recommendations

Amortised cost measurement category

39 We provide below a number of other suggestions to make the clarifications on the amortised measurement category, as proposed by the ED, more operational:

(a) *Sales activity* – In general terms, we believe the ED puts too much emphasis on the volume of sales that are consistent with the 'hold-to-collect' business model, rather than on the reason for those sales and how they fit within the business model. We believe that it would be helpful to clarify that entities need to take into consideration the reasons why a sale occurred rather than simply the amount of sales and their frequency.

In particular, EFRAG believes that sales required by regulators, for example to demonstrate that financial assets are liquid in certain portfolios held by financial institutions, should not preclude entities from measuring financial assets at amortised cost. Sales required by regulators should not be considered to change by themselves the entity's business model to hold to collect contractual cash flows.

We also have concerns about how to assess the significance of sales and how the requirement 'infrequent (even if significant) or insignificant both individually and in aggregate (even if frequent)' should be implemented in practice (e.g. whether entities need to consider the amount of financial assets sold compared to the total financial assets held in that category or the total financial assets, or even in relation to the impact on profit or loss, and what happens in terms of reclassifications and measurement when significant sales occur but are executed over time).

(b) *Sales due to credit deterioration and other reasons in the amortised cost category* – The ED could be read to allow only for sales once a credit loss has been incurred. We believe that sales before an external downgrade should be allowed provided that these are in line with the entity's internal risk management and investment policy, since this would be consistent with the current proposals on impairment. It is also unclear whether sales due to deterioration in the credit quality can be assessed on a portfolio basis rather than on individual assets.

In addition, we believe that the link to the documented investment policy of the company should be expanded so that sales initiated by risk management in accordance with a documented investment policy for reasons other than credit deterioration are consistent with the 'hold-to-collect' business model (e.g. in the case of concentration risk).

(c) *Unit of account* – We believe that clarification would be helpful as to whether a securitisation portfolio could be split at inception, with part measured at amortised cost and part at FV-PL. In addition, the IASB should clarify whether the business model assessment can be applied to portions of financial instruments such to avoid classifying all loans originated in loan syndication businesses, where the originator intends to hold only a portion of each individual loan, at FV-PL.

<u>Dividing lines between business models</u>

40 If the IASB were to proceed with the proposal to introduce reference to an additional business model in IFRS 9, EFRAG believes that it should move away from the level of sales and characterise the various business models in a way that is relevant for financial reporting purposes. It should also make explicit the link between the characteristics of the business models and the differential financial reporting treatments adopted. The IASB should also further enhance the related application guidance, in particular the proposed examples, so as to ensure consistent application in practice and comparability between entities.

41 The ED is not clear whether a dual purpose exists when:

(a) an entity renegotiates a loan before its contractual maturity (i.e. they collect interest, but do not necessarily hold the instrument to maturity); and

(b) an entity expects that they may securitise part of a portfolio of financial assets at some future date (also it is unclear what the unit of account would be in such a case).

42 Also, the ED does not provide enough guidance on:

(a) how to differentiate between (i) managing financial assets with the objective to maximise return through selling and reinvesting when an opportunity arises and (ii) managing financial assets and evaluating their performance on a fair value basis with collection of contractual cash flows being only incidental; and

(b) whether managing financial assets on a fair value basis always leads to measurement at FV-PL, or this measurement basis could be overcome depending on facts and circumstances.

43 Furthermore, EFRAG is concerned about the fact that some changes proposed by the ED could lead to perceived inconsistencies. For example, the changes proposed on the existing Example 1 in paragraph B.4.1.4 of IFRS 9 could be read as not allowing sales in particular circumstances in the amortised cost measurement category. This would be inconsistent with the related application guidance in the ED that allows for sales for reasons other than credit deterioration, provided that they are infrequent or insignificant. The previous wording of the example indicated that if an entity held investments to collect the contractual cash flows but would sell an investment in particular circumstances, those investments met the amortised cost business model since some sales would not contradict the objective of hold to collect.

<u>Interaction with other phases of IFRS 9</u>

44 If the IASB were to proceed with the proposal to introduce reference to an additional business model in IFRS 9, EFRAG notes that the ED does not make any consequential amendments to paragraph 6.5.8 of the Review Draft *General Hedge Accounting,* which indicates that in fair value hedges the gain or loss on the hedging instrument should be recognised in profit or loss or OCI, if the hedging instrument hedges an equity instrument for which an entity has elected at inception to measure at FV-OCI. We understand that the gain or loss on the hedging instrument should be also recognised in OCI if the hedged item is an eligible debt instrument measured at FV-OCI.

45 EFRAG believes that the IASB should carefully consider this interaction with the general hedging proposals in the finalisation of the ED.

EARLY APPLICATION

Question 7

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

EFRAG's response

Considering the complexity arising from a phased application, EFRAG agrees with the proposal in the ED that after IFRS 9 is finalised, an entity early applying IFRS 9 should be required to apply IFRS 9 in its entirety.

However, we note that entities should be able to make this election irrespective of whether they choose to apply IAS 39 or IFRS 9 to their hedge relationships until the macro hedging project is completed.

We also agree with the six-month transition period.

46 EFRAG has noted in the past that phased introduction of IFRS 9 might reduce comparability between entities for some time. Although this is an important concern, we believe that preparers should not be prevented from applying improved new standards if this results in more useful and relevant information.

47 EFRAG believes in general that an appropriate balance of the benefits and related costs resulting from early application needs to be struck. In the particular case of

IFRS 9, we note that such a balance might be more difficult to achieve due to the complexity – in the transitional provisions and consequential amendments – arising from a phased introduction, this due to the number of possible permutations of adoption dates.

48 For example, we believe that paragraph 7.1.1A of the ED is a clear illustration of the complexity arising from a phased introduction. The application of this new paragraph might not be a straightforward exercise, since the affected preparers would need to carefully consider which paragraphs in IFRS 9 have been amended, added or deleted by the ED and which ones have not. If the IASB decides to proceed with the phased introduction of IFRS 9, we envisage further more complexity in the IASB's maintenance activity than at present. That might in turn undermine the easy understanding and application of the standard, and reduce the comparability of financial statements under IFRSs.

49 EFRAG, therefore, agrees with the proposal in the ED that after IFRS 9 is finalised, an entity early applying IFRS 9 should be required to apply IFRS 9 in its entirety. However, we note that entities should be able to make this election irrespective of whether they choose to apply IAS 39 or IFRS 9 to their hedge relationships until the macro hedging project is completed.

50 EFRAG understands that IFRS 9 will be finalised once the IASB issues the proposals in this ED, impairment and general hedge accounting; in other words, the final IFRS 9 would not include the requirements regarding macro hedge accounting. In this context, we refer to our letter of 22 March 2013, in which we recommend you to allow hedge accounting to comply with either IAS 39 or IFRS 9 until the macro hedging project is completed.

51 EFRAG also agrees with the six-month transition period proposed by the ED on the basis that is a practical expedient that provides relief to those constituents that have dedicated significant resources in preparation for the initial application of an individual phase of IFRS 9. In this context, we believe that there should be more clarity on the mandatory effective date of IFRS 9, since 1 January 2015 seems no longer realistic considering the current IASB's timetable for completing the remaining phases of IFRS 9 (i.e. impairment and hedge accounting). In order to assist constituents in their planning, it would be particularly helpful if the IASB confirmed as soon as possible any changes in the effective date of IFRS 9.

OWN CREDIT PROVISIONS

Question 8

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

EFRAG's response

EFRAG believes that entities should be permitted to early apply the 'own credit' provisions in IFRS 9. EFRAG reiterates its request to amend IAS 39 so as to not further delay the benefit of increase relevance in the presentation of the financial statements.

EFRAG is concerned that the relief being provided would only be available as an option once the remaining phases of IFRS 9 have been finalised.

52 EFRAG agrees that entities should be permitted to choose to early apply the 'own credit' provisions once IFRS 9 is finalised; however, EFRAG reiterates its request

to amend IAS 39 to align it to the requirement in IFRS 9 regarding the accounting for own credit risk on financial liabilities measured at fair value.

53 EFRAG is concerned that the relief being provided would only be available as an option once the remaining phases of IFRS 9 have been finalised and the final standard is published.

54 EFRAG has previously urged the IASB to consider incorporating the own credit risk requirements into IAS 39 so as not to delay the benefit of increased relevance in presentation while avoiding unnecessary lack of comparability.

55 Finally, we would like to repeat our request that the IASB amend IAS 39 to incorporate the provisions on 'own credit' as this would bring an immediate improvement in financial reporting.

FIRST-TIME ADOPTION

Question 9

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

EFRAG's response

EFRAG does not have any specific comments regarding first-time adopters.

56 EFRAG does not have any specific comments regarding first-time adopters.