European Financial Reporting Advisory Group

INVITATION TO COMMENT ON EFRAG'S ASSESSMENTS ON IFRS 9 *Financial Instruments*

Comments should be sent to commentletters@efrag.org by 30 June 2015

EFRAG has been asked by the European Commission to provide it with advice and supporting material on IFRS 9 *Financial Instruments* ('IFRS 9' or 'the Standard'). In order to do that, EFRAG has been carrying out an assessment of IFRS 9 against the technical criteria for endorsement set out in Regulation (EC) No 1606/2002 and has also been assessing impact of IFRS 9 on the European public good.

A summary of IFRS 9 is set out in Appendix 1 to the draft endorsement advice letter.

Before finalising its assessments, EFRAG would welcome your views on the issues set out below and any other matters that you wish to raise. Please note that all responses received will be placed on the public record, unless the respondent requests confidentiality. In the interest of transparency EFRAG will wish to discuss the responses it receives in a public meeting, so we would prefer to be able to publish all the responses received.

EFRAG initial assessments summarised in this questionnaire will be amended to reflect EFRAG's decisions in Appendices 2 and 3 of the draft endorsement advice.

Your details

1 Please provide the following details about yourself:

(a) Your name or, if you are responding on behalf of an organisation or company, its name:

Financial Reporting Council

(b) Are you a:

☐ Preparer ☐ User ☒ Other (please specify)

Regulator

(c) Please provide a short description of your activity:

Financial regulator and standard setter. The views expressed in this Invitation to Comment were developed by consultation with FRC constituents, including preparers, investors, auditors and academics. This included detailed discussions of the underlying issues at our Accounting Council, individual meetings with constituents as well as a specific constituent event to discuss this issue where the full spectrum of our constituents were present.

(d) Country where you are located:

United Kingdom

(e) Contact details including e-mail address:

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EFRAG's initial assessment with respect to the technical criteria for endorsement

2 EFRAG's initial assessment of IFRS 9 is that it meets the technical criteria for endorsement. In other words, it is not contrary to the principle of true and fair view and it meets meet the criteria of understandability, relevance, reliability and comparability and leads to prudent accounting. EFRAG's reasoning is set out in Appendix 2, paragraphs 2 to 197 of the draft endorsement advice.

(a) Do you agree with this assessment?

☒ Yes ☐ No

If you do not, please explain why you do not agree and what you believe the implications of this should be for EFRAG's endorsement advice.

3 EFRAG's initial assessment of IFRS 9 is that it leads to prudent accounting. EFRAG's reasoning is set out in Appendix 2 paragraphs 185 to 191 of the draft endorsement advice.

(a) Do you agree with this assessment?

☒ Yes ☐ No

If you do not, please explain why you do not agree and what you believe the implications of this should be for EFRAG's endorsement advice.

(b) Are there any issues relating to prudence that are not mentioned in Appendix 2 that you believe EFRAG should take into account in its technical evaluation of

IFRS 9? If there are, what are those issues and why do you believe they are relevant to the evaluation?

No

(c) Are there any other issues that are not mentioned in Appendix 2 of the draft endorsement advice that you believe EFRAG should take into account in its technical evaluation of IFRS 9? If there are, what are those issues and why do you believe they are relevant to the evaluation?

No

The European public good

4 In its assessment of the impact of IFRS 9 on the European public good, EFRAG has considered a number of issues that are addressed in Appendix 3 of the draft endorsement advice.

IFRS 9 compared to IAS 39

5 EFRAG's initial assessment of IFRS 9, and particularly with respect to the impairment and hedging requirements, is that it is an improvement over IAS 39 and will lead to higher quality financial reporting. The assessment is reflected in paragraphs 3 to 52 of Appendix 3 of the draft endorsement advice.

(a) Do you agree with this assessment?

☒ Yes ☐ No

If you do not, please explain why you do not agree and what you believe the implications of this should be for EFRAG's endorsement advice.

FRC agrees with EFRAG that the impairment and hedging requirements represent an improvement over IAS 39 and will lead to higher quality financial reporting. In particular, we understand that the hedge accounting requirements in IFRS 9 have been sufficiently simplified that non-financial companies, which were previously unable to take advantage of the IAS 39 requirements to their economic hedges, will now be able to use the IFRS 9 requirements to account for their hedging relationships. However, in contrast to EFRAG, we also believe that the classification and measurement requirements for financial assets in IFRS 9 represent an improvement on those requirements in IAS 39 for the following reasons:

- The requirements are principles based and take into account the entity's business model for holding the instrument as well as the characteristics of the cash flows from the instrument (and therefore the risks inherent).

- The majority of respondents to EFRAG's follow on field test on IFRS 9 reported that financial instruments currently held as measured at amortised cost or classified at AFS under IAS 39 would meet the SPPI test and as a result are unlikely to be reclassified. The main movement appears to be on AFS debt instruments, where some participants state that up to 20% of the debt at AFS will not meet the SPPI test and so would be reclassified as FVTPL.

- The field test results appear to provide evidence that the main impact of the implementation of IFRS 9 is to reclassify hybrid debt from AFS to FVTPL. In the aftermath of the credit crisis, accounting for such hybrid instruments (where the risks were not clearly signposted in the profit or loss) was one of the main areas of criticism of accounting for financial instruments. This indicates that IFRS 9 classification requirements represent an improvement over IAS 39 in this area and would lead to higher quality financial reporting.

(b) Are there any issues relating to IFRS 9 compared to IAS 39 that are not mentioned in Appendix 3 of the draft endorsement advice that you believe EFRAG should take into account in its technical evaluation of IFRS 9 when comparing to IAS 39? If there are, what are those issues and why do you believe they are relevant to the evaluation?

See answer to (a) above.

The lack of convergence with US GAAP

6 EFRAG's initial assessment is that IFRS 9 will lead to higher quality financial reporting when compared to current US GAAP and proposed changes to impairment requirements. The assessment is reflected in paragraphs 53 to 74 of Appendix 3 of the draft endorsement advice.

(a) Do you agree with this assessment?

☒ Yes ☐ No

If you do not, please explain why you do not agree and what you believe the implications of this should be for EFRAG's endorsement advice.

(b) Are there any issues related to the impact of the lack of convergence that are not mentioned in Appendix 3 of the draft endorsement advice that you believe EFRAG should take into account in its technical evaluation of IFRS 9 when comparing with US GAAP? If there are, what are those issues and why do you believe they are relevant to the evaluation?

No

Impact on investor and issuer behaviour

7 EFRAG's analysis in this area is based on our understanding of both changes in IFRS 9 and current practices of financial institutions and is not a full impact assessment. In its analysis EFRAG has tried to identify potential negative effects only, to contribute to identifying whether there would be any impediment to IFRS 9 being conducive to the European public good. The assessment is reflected in paragraphs 75 to 99 of Appendix 3 of the draft endorsement advice.

(a) Do you agree with this assessment?

☒ Yes ☐ No

If you do not, please explain why you do not agree and what you believe the implications of this should be for EFRAG's endorsement advice.

FRC has seen no evidence in the UK that the concerns raised by EFRAG in its assessment in this area will materialise. We believe that the EFRAG assessment should also highlight that:

- the concerns with the change in measurement and performance reporting for equity instruments are not noticeable in the EFRAG effects analysis even though 14 out of 23 participants were banking or insurance companies, the main investors in equity markets. We are not aware of this being a concern in the UK where most equity investments are already held at fair value through profit or loss.

- The valuation of the riskier lower ranking tranches of securitisations were heavily criticised during the credit crisis. Their measurement at FVTPL is consistent with the riskiness of the instrument although there is inevitably a clash with the investors' business intentions and time horizons. However, the credit crisis demonstrated that clear signposting of the riskiness of such instruments by reporting performance through the holding entity's profit or loss provides financial reporting that is understandable to investors.

- It is clear from EFRAG's field testing that most constituents are at the early stages of implementing their expected credit loss models. This is also the case in the UK and as such, there is little concrete evidence of the impact of the higher provision. Given that IFRS 9 introduces an entirely new stage of expected loss calculation, the requirement to recognise 12 month expected credit losses from day one, we would expect higher provisions for all lenders compared to those held under IAS 39. Furthermore, this was another one of the amendments to financial reporting for financial assets requested as a result of the credit crisis. A form of expected losses are already calculated for regulatory capital purposes for banks (the entities most affected by this change in requirements). We believe that the IFRS 9 expected credit loss model is consistent with that demanded as a result of the credit crisis and is likely to contribute to financial stability in Europe.

As a result, although we agree that the impact for issuer and investor behaviour in these instances is unclear, most of the changes brought about in IFRS 9 result from specific requests for improvements in accounting for financial instrument emanating from the likes of G20 as well as various Global and

European regulators. As such, we do not view these changes in requirements as impediments to IFRS 9 being conducive to the European public good.

(b) Are there any issues related to the impact of IFRS 9 on investor and issuer behaviour that are not mentioned in Appendix 3 of the draft endorsement advice that you believe EFRAG should take into account in its technical evaluation of IFRS 9? If there are, what are those issues and why do you believe they are relevant to the evaluation?

See response to (a) above.

Inter-relationship of IFRS 9 with the future insurance contracts standard

8 EFRAG has initially concluded that the mismatch in timing of the future insurance contracts standard and IFRS 9 will create disruptions in the financial reporting of insurance activities which may not be beneficial to investors and other primary users (see Appendix 3, paragraphs 100 to 110 of the draft endorsement advice). Hence EFRAG proposes to advise the European Commission to ask the IASB to defer the effective date of IFRS 9 for insurers and align it with the effective date of the future insurance contracts standard.

9 In reaching this preliminary position, EFRAG has relied on quantitative assessments prepared by the European insurance industry and released shortly before EFRAG concluded on its tentative advice to the European Commission. EFRAG intends to deepen its understanding of the effect on the reporting by insurance businesses by implementing IFRS 9 in advance of the forthcoming IFRS 4. EFRAG invites all quantitative evidence that can supplement the impact assessment received from the European insurance industry, including evidence gathered by those who oppose the deferral.

(a) Do you agree with this assessment and the subsequent advice to the European Commission?

☐ Yes ☐ No

If you do not, please explain why you do not agree and what you believe the implications of this should be for EFRAG's endorsement advice.

The FRC is aware of the concerns raised by insurance companies and believe that there is a need for a solution for insurance companies. We feel the answer to this concern must be a workable solution that can be delivered on a timely basis by the IASB to ensure clarity for insurance companies.

The FRC is neither able to agree nor disagree with the EFRAG proposal to advise the European Commission as we consider that standard setting should be evidence-based and we have not seen quantitative data reviewed by EFRAG on the potential scale of any accounting mismatches.

We note that there are a number of concerns with the EFRAG proposal to defer IFRS 9 for insurers, most of which have not been included in the EFRAG analysis. These include:

(a) *Unknown timeframe of IFRS 4 Phase II* – A comprehensive standard for insurance contracts has now been in development for over two decades. Even at the time of writing, it is difficult to state with any certainty when the standard may be issued. We understand that the IASB's current estimate is that the standard may be adopted for use in Europe in 2020-2021.

(b) *IASB resource and implications of deferral for finalisation of IFRS 4 Phase II* – If there is to be a deferral of IFRS 9 for insurance companies then the insurance expert staff and IASB Board time may have to be re-deployed to the IFRS 9 deferral project. This may further delay the completion of the insurance contracts standard.

(c) *Scope definition* – whilst this is mentioned in passing in the EFRAG analysis, it is a significant issue. IFRS 9 applies to financial instruments and IFRS 4 applies to insurance contracts. However, the request for deferral will refer to insurance business or companies. We are aware that some in Europe are proposing that the scope of the deferral can be defined on the basis of the regulatory definition of an insurance company, segmental reporting, or companies currently applying IFRS 4. It remains to be seen whether this can be achieved in practice, although UK insurance preparers have told us that they consider it to be achievable.

(d) *Scope of application of deferral* – Some UK companies have cited that they would apply this deferral to some group insurance companies but not others. For example, one UK headquartered global insurance company stated that it would only apply the exemption to one regional business whilst the rest of its world-wide and UK businesses would be adopting IFRS 9. If this approach is taken up more widely by other insurance companies, then within the insurance sector there could be some companies reporting financial assets in accordance with IFRS 9, others reporting on the basis of IAS 39 and others reporting on the basis of both IFRS 9 and IAS 39. As a consequence, comparability within the industry will be reduced and there will be need to develop fulsome disclosure and supervision.

(e) *Issues for conglomerates* – there are significant practical drawbacks for conglomerates, both financial and non-financial, with insurance business arms. The working assumption is that the insurance arm will apply IAS 39 and the non-insurance arm will apply IFRS 9. There is no consensus as yet on the extent of, and if so, how any intercompany loans, group-wide hedging, or intercompany transfers of financial assets would be dealt with in conglomerates. There are still outstanding questions about how the classification, measurement and any gains or losses on such intercompany transactions would be dealt with and how they will be reported at the group level. The additional complexity for conglomerates as well as the insurance companies identified in (d) above further diminishes comparability and will require significant disclosure and supervision.

(f) *Financial Instrument classifications* – conglomerates and other insurance companies applying both IAS 39 and IFRS 9 will be presenting seven different categories of financial assets on their balance sheets – IFRS 9 financial asset (at FVPL, at FVOCI, at Amortised cost) and IAS 39 financial assets (at FVPL, at AFS, at Held-to-maturity, and loans and receivables). In addition, insurance companies also currently present their Market Consistent Embedded Value (MCEV) or Embedded Value (EV) results to the markets as well.

As a result, the FRC believes that the additional complexities in reporting by insurance companies arising from a targeted deferral of IFRS 9 must be considered and addressed in developing a solution.

We understand that some in Europe have called for a liability based solution for insurance companies suggesting that it may be easier to devise, is likely to be consistent with current IFRS, and simpler for insurance companies to implement and users to understand. For example, the proposal by some to extend the shadow accounting requirements in the current IFRS 4 to economically matched assets and liabilities may help with the performance reporting mismatch identified by insurers whilst ensuring that the solution remains consistent with IFRS. When taken together with the IASB's current tentative decision to permit those applying IFRS 4 Phase II for the first time to reassess their IFRS 9 business models of the financial assets they hold, such a solution may limit accounting mismatches for insurance companies. We believe more should be done to determine if there is merit in providing a liability based solution as a potential alternative to a deferral of IFRS 9 for insurance companies.

We believe that any temporary solution for insurance companies should have a set expiry date.

(b) Do you think that EFRAG should recommend the EC to grant to insurance businesses a deferred mandatory date of application for the endorsed IFRS 9 if the IASB were not to defer the effective date of IFRS 9?

☐ Yes ☒ No

If you do not, please explain why you do not agree and what you believe the implications of this should be for EFRAG's endorsement advice.

A significant number of listed European insurance companies are global businesses with many subsidiaries around the world. A European deferral of IFRS 9 is subject to the same complexities as associated with the IASB based deferral but, in addition, it will not address the global nature of these businesses. For example, the deferral will not be applicable to European insurers with listings in the US who are required to comply with full IFRS as issued by the IASB.

(c) Are there any issues related to the inter-relationship of IFRS 9 with the future insurance contracts standard that are not mentioned in Appendix 3 of the draft endorsement advice that you believe EFRAG should take into account in its technical evaluation of IFRS 9 when assessing the inter-relationship between

IFRS 9 and the future insurance contracts standard? If there are, what are those issues and why do you believe they are relevant to the evaluation?

See our answers to (a) and (b) above.

European carve-out

10 EFRAG has initially concluded that the endorsement of IFRS 9 would not affect the ability of entities to rely on the European carve-out (see Appendix 3, paragraphs 111 to 117 of the draft endorsement advice).

(a) Do you agree with this assessment?

☒ Yes ☐ No

If you do not, please explain why you do not agree and what you believe the implications of this should be for EFRAG's endorsement advice.

(b) Are there any issues related to the European carve-out that are not mentioned in Appendix 3 of the draft endorsement advice that you believe EFRAG should take into account in its technical evaluation of IFRS 9 when assessing the EU carve out? If there are, what are those issues and why do you believe they are relevant to the evaluation?

No

Costs and benefits of IFRS 9

11 EFRAG is assessing the costs that are likely to arise for preparers and for users on implementation of IFRS 9 in the EU, both in year one and in subsequent years. Some initial work has been carried out, and the responses to this Invitation to Comment will be used to complete the assessment.

12 The results of the initial assessment of costs are set out in paragraphs 120 to 155 of Appendix 3 of the draft endorsement advice. To summarise, EFRAG's initial assessment is that overall, IFRS 9 is likely to result in significant costs for preparers related to implementation of and ongoing costs of complying with the standard. However, IFRS 9 is not likely to result in significant costs for users after the transition. At transition costs will be incurred in understanding the new financial reporting.

(a) Do you agree with this assessment?

☒ Yes ☐ No

If you do not, please explain why you do not and (if possible) explain broadly what you believe the costs involved will be.

In the UK we have heard concerns from banks about the initial systems development costs to implement the IFRS 9 expected loss model. We have also heard some of the insurance preparers' concerns, mainly related to the costs they may incur in the interim period between IFRS 9 and IFRS 4 Phase II implementation. However, we are not aware of any concerns about on-going costs of complying with the standard for financial preparers or any from non-financial companies.

We agree with EFRAG's assessment about the costs for users.

(b) In addition, EFRAG is assessing the benefits that are likely to be derived from the application of IFRS 9. The results of the initial assessment of benefits are set out in paragraphs 156 to 170 of Appendix 3. To summarise, EFRAG's initial assessment is that overall, users and preparers are both likely to benefit from IFRS 9, as the information resulting from it will be relevant and transparent and therefore will enhance the analysis of users.

Do you agree with this assessment?

☒ Yes ☐ No

If you do not agree with this assessment, please provide your arguments and indicate how this should affect EFRAG's endorsement advice.

13 EFRAG's initial assessment is that the benefits to be derived from implementing IFRS 9 in the EU as described in paragraph 12 (b) above are likely to outweigh the costs involved as described in paragraph 12 (a) above.

Do you agree with this assessment?

☒ Yes ☐ No

If you do not agree with this assessment, please provide your arguments and indicate how this should affect EFRAG's endorsement advice.

Overall assessment with respect to the European public good

14 EFRAG has initially concluded that endorsement of IFRS 9 would be conducive to the European public good (see Appendix 3, paragraphs 174 to 176 of the draft endorsement advice).

Do you agree with the assessment of these factors?

☒ Yes ☐ No

If you do not agree, please explain your reasons.

Other issues for consideration

Request to provide quantitative data on a confidential basis

15 EFRAG continues its search for quantitative data in the fields of impairment and the inter-relationship between IFRS 9 and the future insurance contracts standard. EFRAG calls upon constituents who have quantitative data available in these fields, to provide it to EFRAG on a confidential basis during the consultation period of the draft endorsement advice. Data provided will be used in finalising the endorsement advice but will not be made public.

The collection of these data is subject to EFRAG's field-work policy which is available on the EFRAG website.

Should endorsement be halted until quantitative data are available?

16 Based on the results of our questionnaire follow up to the field-tests, it can take up to 2017 to have quantitative impacts of the implementation of IFRS 9 available. It has been argued by some that the quantitative impacts of IFRS 9 should be known before endorsement of the standard is decided upon. EFRAG does not agree with this view and believes that the improvements brought to financial reporting by IFRS 9 should not be withheld from European companies for a period that long.

Do you agree with this assessment?

☒ Yes ☐ No

If you do not, please explain why you do not agree and what you believe the implications of this should be for EFRAG's endorsement advice.

In addition, we have been advised by constituents that no quantitative data is available until the systems are in place. However, the systems development work is extensive and needs the certainty of the standard being endorsed before it can be finalised.

Should early application of IFRS 9 be prohibited?

17 It has been argued by some that early application of IFRS 9 should not be allowed for specific regulated industries. EFRAG does not agree with this and is of the opinion that entities should be able to apply IFRS 9 early (see Appendix 2, paragraphs 192 to 195 of the draft endorsement advice).

Do you agree with this assessment?

☒ Yes ☐ No

If you do not, please explain why you do not agree and what you believe the implications of this should be for EFRAG's endorsement advice.

FRC view is that early adoption is permitted for all IFRSs adopted for use in Europe and should not be prohibited in this case. We understand that most banks are unlikely to be able to adopt the standard early due to the extensive systems development required. However, non-financial institutions applying the hedge accounting requirements to their economic hedges may be in a position to adopt the standard early and should not be prohibited from doing so. The request by certain regulators for this prohibition should be referred back to the regulators themselves who are able to require or prohibit early adoption for the entities they regulate. As such, we agree with EFRAG that all entities should have the opportunity to apply IFRS 9 early.