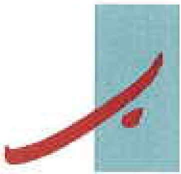

FEDERATION
BANCAIRE
FRANCAISE

Banking supervision
And Accounting issues Unit

The Director

Paris, June 30th 2015

FBF comments on EFRAG's assessments on adoption of IFRS 9 Financial instruments.

Dear Mr Marshall,

The French Banking Federation welcomes the opportunity to comment on the EFRAG Draft Endorsement advice.

We appreciate the comprehensive analysis conducted by the EFRAG regarding IFRS 9 in order to consider technical criteria for endorsement and whether IFRS 9 could be conducive to European public good.

Considerable efforts had been expended to date on the project. IFRS 9 has achieved some improvements over the existing requirements in IAS 39, i.e. more focusing on business model for classifying and measuring financial assets, defining a new provisioning model that addresses the criticism of "too little too late" of IAS 39 in response to the G20 orientations, better aligning the general hedge accounting model with the risk management practices and hedging strategies. IFRS 9 has also addressed the issue of **own credit spread** and has allowed changes in fair value related to changes in own credit risk to be presented separately in OCI. We regret that the IASB has not issued an amendment to IAS 39 instead of delaying the benefit of changes in own credit provisions in the presentation of financial statements until completion of the IFRS 9 standard. We believe that EFRAG should have mentioned the point.

However, as already expressed in our letter of March the 13th, while remaining favourable towards the endorsement of IFRS 9, we are convinced that a **quantitative impact assessment of the IFRS 9 expected loss provisioning model should be conducted at the European level as necessary prerequisites**.

Mr Roger MARSHALL
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For banks and other financial institutions, the new expected loss impairment model will undoubtedly imply higher and more volatile allowances. It will be important to measure the practical implications of these on European economic growth.

The aim of such QIS at the European level is to duly inform European authorities so that the European Commission will be in a position to take a decision about IFRS 9 endorsement with full knowledge of the facts. Indeed, the expected loss provisioning model will imply a greater overall level of collective allowances than under the IAS 39 allowances for the European banks, affecting the banks ' Common Equity Tier 1, thereby weakening banks 'solvency and threatening ongoing European initiatives in favor of growth and employment. Moreover, the potential impacts may be huger if during implementation phase, external parties or regulators were to impose more stringent condition in regards to credit deterioration criteria when using this standard.

We acknowledge that the EFRAG has undertaken work to collect data on some quantitative assessments related to the effects of the expected loss model, but with less success as quantifications of the impacts are not expected to be available until 2017.

We believe that a Quantitative Impact Study could be conducted at the European Banking Authority level. The intended benefits of tests conduct at such level are the definition of common scenarios, a broader application of the scope and the understanding of how the new expected loss model is perceived by the supervising authorities.

Besides, we have some remaining issues on the conclusions reached or the demonstration provided by the EFRAG when assessing specific issues towards endorsement criteria as we mention below.

Impairment

We welcome the IFRS 9 model based on expected credit losses in response to the weaknesses of the IAS 39 incurred loss model.

From a conceptual point of view, for basic loans, the interest rate and thus the interest revenues include a premium representing a credit risk component that should be deferred in order to cover losses when they occur since the pattern for the perception of the risk premium and the pattern for the effective occurrence of losses differ by construction. Conceptually, this risk premium model should compensate at all reporting dates the mismatch between the above two patterns.

We acknowledge that recognising a loss allowance at an amount equal to 12-month expected credit losses is a pragmatic solution and not a conceptual one. Nevertheless, it achieves an appropriate balance between the faithful representation of the underlying economics of an expected loss model and the costs of implementation of a risk premium model approach. It is a proxy for recognising the initial expected credit losses under a reasonable and pragmatic horizon. As it would allow a timely recognition of the credit risk premium, 12-month expected credit losses can be viewed as a trade-off between the non-recognition of losses at the instrument's inception, which might be conceptually sound and application of prudence to provide timely recognition of impairment losses.

Business combination.

When an entity acquires a business, the loans that have been purchased are required to be measured at fair value at the date of acquisition under IFRS 3. Then, under IFRS 9, a separate loan loss provisioning needs to be recognised after the acquisition. Thus, the entity will recognize a Day-one-loss the day after the acquisition, so as to account for expected credit losses on the acquired loans.
Therefore, understandability of the performance of the entity is questioned when significant business combination are acquired as a D1 loss should be recognised. Non gaap information will be needed in order to explain the potential benefits of the acquisition of the business.

We would have welcomed that the issue would have been raised in the EFRAG endorsement advice paper as regards to the relevance.

Reclassification

IFRS 9 permits reclassification of financial assets when an entity changes its business model for managing the financial assets. But IFRS 9 considers that "A temporary disappearance of a particular market for financial assets" is not to be changes in the business model.

EFRAG raises fairly the point that "these restrictions are taken at the expense of relevance of the information provided (appendix 2 §33; appendix 3 §13).
However we believe that the EFRAG misses its reasoning when concluding that these restrictions ""can be considered suitable in normal times".

Reclassification amendments to IAS 39 were the results of the European Commission commitment to address accounting and valuation issues highlighted by the financial crisis. Reclassifications from the trading category to a hold to collect business model when markets become suddenly illiquid were a consequence of the financial crisis. During that period, financial assets were transferred out of the trading category because it was no longer possible to sell them on the market due to the illiquidity of the market and the measurement of their fair value was therefore highly judgmental and involved a change in management of the assets.

As far as the classification and measurement of financial instruments are determined on the primary basis of business model, we find appropriate and fully consistent to require reclassification under rare circumstances or changes in the business model particularly as a result of external factors. Although such changes to entities' business model should be rather rare, the experience of the past years tells us that such event is possible notably in times that are not "normal".

Therefore, we believe that the EFRAG should have taken into account the point of financial turmoil times before concluding about the relevance of such restrictions to reclassification of financial assets.

European carve-out from IAS 39 for macro hedging

We agree with the EFRAG's conclusions that, under IFRS 9, the EU carve-out from IAS 39 for macro hedging will continue to be available in accordance with the purpose for which it was intended until the macro hedging project will be finalized.

However, we would like to put attention on the need to maintain unchanged the paragraphs of IAS 39 that deals with hedge accounting and those that were carved-out in order to maintain unchanged all current hedge accounting for open portfolios and thus to avoid unintended consequences on macro hedge relationships until the completion of the macro hedging project.

Inter-relationship between IFRS 9 and the future insurance contracts standard.

We fully support the conclusion of EFRAG to advise the European Commission to ask the IASB to defer the application date of IFRS 9 for insurance entities on an optional basis until IFRS 4 phase 2 is adopted.

Accounting requirements applied to financial asset instruments and insurance liabilities should be applied together as far as insurance entities are concerned. Indeed, most of financial assets held by insurance companies will be required to be measured under IFRS 9 at fair value through P&L as it is anticipated that these assets will not meet the SPPI test and will not be eligible to the amortised cost, whereas insurance liabilities measurement will be remain unchanged until the implementation of IFRS 4 phase 2.

As a consequence, this will lead to undue accounting mismatches and significant level of volatility in the income statement of insurance entities with no useful information to users. Additional non-gaap information related to the accounting mismatches may not facilitate the understandability of insurance entities performance and assets and liabilities measurements.

The scope of the deferral should apply to insurance entities instead of insurance activities. Insurance activities are held in specific legal entities which are subject to the supervision of an independent authority due to their main activities related to insurance. Such definition of scope will be less burdensome and less costly to implement from an operational point of view for preparers, but also, information will be more readable to users.

Should the IASB fail follow the deferral proposal, we believe that a European solution should be found. It should be assessed how the Commission regulation could include a temporary exclusion clause of IFRS 9 adoption for insurance entities until IFRS 4 phase 2 will be adopted.

As a last resort, should the deferral of IRS 9 for insurance entities not be adopted, we advocate that transition measures allow an unrestricted reclassification of the financial assets when IFRS 4 phase 2 will come into force.

Equity

We welcome the creation of the third category of fair value through OCI and the overall approach for equity instruments held with the objective of medium or long term horizon detention. However, we question on the effect of the prohibition of recycling gains and losses into the profit and loss account. This may limit the relevance of the information of performance of the entity, as mentioned by the EFRAG (appendix 2 §36).

We do not believe that potential difficulties to define an appropriate impairment approach could be retained as an argument to prevent from allowing recycling of unrealized gains and losses in profit and loss account. As highlighted by the EFRAG, "a less conceptually sound model is better than no model". Impairment losses should be taken when necessary and reverse when the impairment is no longer met. Such impairment model could be based on the EFRAG suggestion of the lower of cost or market or it could be based on the investor's holding horizon.

To simply refer to disclosures or non-gaap measures to provide relevant information about the performance of the entity could not be a mean to mitigate the drawbacks of the prohibition of recycling.

Besides, we disagree with the EFRAG conclusion that it is unlikely that investors "would change their investment strategy as a result of the implementation of IFRS 9" (appendix 3 §83). Constraints resulting from non-recycling may have detrimental effects on long-term investments as investors may hesitate to take investment decisions, whereas banks will need to issue new securities to meet the new binding regulatory requirements notably regarding liquidity buffer portfolios or regulatory solvency ratios or covering own funds. This could be crucial to maintain competitive advantages in the European market union.

Modifications or renegotiations of contractual cash flows.

Under IFRS 9, the modification requirements apply to all modifications or renegotiations of contractual cash flows, regardless of the reason the modification. As a result, losses will be recognized even when contractual terms of the loan are modified due to commercial reasons rather than credit deterioration reasons. The consequences are clearly highlighted by the EFRAG (appendix 2 §16 & § 17).

However, the EFRAG accepts that no distinction could be made and, thus, the relevance of the information may be limited only because of the "difficulty to distinguish between the two types of modifications" (appendix 2 §19).
We strongly oppose this conclusion. Banks are entirely in the capacity of distinguishing between the two of modifications. They are required to develop a good knowledge of the financial situation of their customers in order to manage any credit risk deterioration for accounting purposes to be able to recognize appropriate loan loss allowances and for prudential purposes. Besides, since 2014, banks are required to report forborne exposures under the regulatory reporting. Therefore banks are able to make clear distinction between modifications of contractual terms of loans due to commercial renegotiations and restructurings of loans due to credit risk purposes.

We hope you find these comments useful and would be pleased to provide any further information you might require. We would therefore appreciate if the EFRAG could consider our concerns related to, notably, quantitative impact study on impairment and the deferral of IFRS 9 on an optional basis until the new IFRS 4 phase 2 becomes mandatory.

We agree with EFRAG that IFRS 9 effects would need close monitoring to "identify any unforeseen or unanticipated consequences". We believe that such monitoring should be envisaged at the Commission level.

Yours sincerely,

Bertrand Lussigny