EFRAG

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** |
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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.** |
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## 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:

| Austrian Federal Economic Chamber<br>Division Bank and Insurance |
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(b) Are you a:

☐ Preparer ☐ User ☐ Other (please specify)

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

| The division Bank and Insurance represents the entire Austrian banking, insurance and pension fund industry. |
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(d) Country where you are located:

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(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.

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| N/A, *) For the insurance industry see the comments of the CFO Forum on EFRAG`s draft endorsement advice and the cover letter on it signed by the CFO Forum and Insurance Europe. |

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.

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| N/A |

(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?

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| 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?

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| Entity-to-entity and period-on-period comparability/consistency of classification and measurement (for the same lending product managed under the same business model) may be affected due to the outcome of assessing the SPPI criterion (by quantitative benchmark testing as prescribed under IFRS9.B4.1.9C-D for debt instruments with modifications of the time-value element) being simultaneously impacted by a wide variety of input variables into the benchmark test modelling, such as assessed instrument's:<br>• Principal amount (higher the principal, higher the chance for quantitative benchmarking to "pass"),<br>• Principal repayment schedule (more evenly spread the principal repayment schedule, higher the chance for quantitative benchmarking to "pass"),<br>• Values of any interest rate caps/floors embedded (wider the gap between any embedded interest rate caps/floors, higher the chance for quantitative benchmarking to "pass"),<br>• Value of (fixed) credit spread/margin charged to the customer (paradoxically: higher the credit spread/margin, higher the chance for quantitative benchmarking to "pass"),<br>• Date of origination. |

**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.

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| The proposed standards for expected lifetime losses rely on internal risk evaluation models which will impact the determination of the so-called 'staging criteria' leading to the need for calculation of either 12-month expected losses on lifetime-expected losses. Thus the comparability of financial statements between financial institutions will be jeopardized.<br>The IFRS 9 impairment model is complex and as of writing (mid-2015) there is no common understanding between preparers, auditors and investors about what constitutes best practice implementation. This is likely to lead, at least at the beginning, to a heterogeneous approach being applied by preparers which is unlikely to lead in any way to higher quality financial |

reporting. Furthermore, the added constraints which are currently being suggested by the BCBS mean that rather than being able to rely solely on IFRS 9 it is necessary to second guess what aspects of the BCBS guidance will inform the supervisory authorities. The resources of the BCBS would be better used to tackle the implications of IFRS 9 for regulatory capital requirements and provide comfort that the accounting department isn't going to eliminate precious capital with assumptions about credit risk in 30 years time.

(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?

No

*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.

In our view IFRS 9 with its forward-looking provisioning concept has some drawbacks, because financial statements become far more complex and judgemental insofar as judgements on forward-looking input factors will impact the applied risk models and timing and certainty of future cash flows (lifetime) is not fully predictable. When pushing accounting into a direction which requires financial statements to a large extend to make predictions on future cash flows' this might be a direction far beyond the basic aim of accounting to "provide information about financial position, financial performance and cash flows of an entity that is useful to a wide range of users in making economic decisions". Therefore keeping in mind the increase in volatility and pro-cyclicality of financial statements due to sophisticated models which are currently being developed raises the question if this really can be concluded as 'higher quality' of financial statements'? We are sceptical about this conclusion and do not share it because in our view complexity does not automatically lead to higher quality.

(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?

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| 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.

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| 'The proposed new standards may have regulatory implications. We deem that such regulatory implications and the resulting impact on providing lending to the economy have not (sufficiently) been analyzed.'<br><br>Currently banks are in a position that in parallel to the EFRAG DEA which asks for input, there is available a BCBS-paper 'Guidance on accounting for expected credit losses' which to some extent includes elements which are far beyond pure IFRS 9 – requirements (e.g. BCBS critical view on the 'low credit risk' exemption). This presumably implies duplication of efforts because IFRS-reporting may deviate from regulatory reporting needs and this impacts implementation costs and at the moment in addition does not allow simulation of potential impact on regulatory capital.<br><br>It is questionable if a full application of IFRS9 in regulatory capital calculation leads to a kind of double-counting effect insofar as the cyclical effects are already included in PD calculation and in the buffers of minimum capital requirements. |

(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?

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| No |

*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.

(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.

N/A

(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?

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*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.

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| N/A |

(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?

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| 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.

As 'users' of the standard are not only analysts and peers, but also the customers of banks and therefore this conclusion is broadly defined.

The proposed standards require massive investments by financial institutions into IT systems. Naturally, the cost of implementing and operating such IT systems will need to be included in one way or the other into the conditions offered to bank customers. Furthermore, the proposed standards may cause the regulatory capital requirements of financial institutions (i) to increase and (ii) to become more volatile. Both such effects will also need to be reflected in the calculation basis for banking products thus making such products to become more expensive.'

Based on current experience the costs in terms of time and resources needed to define "significant deterioration in credit risk" are significant. More guidance, or at least hints at the bright lines, on this aspect of the standard would be help to avoid theorizing that many banks have to undertake on their own.

(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.

The proposed standards rely on internal risk systems. This will jeopardize the comparability of financial statements and thus will significantly undermine the benefits stemming from the increased information.'

Also for preparers it is at the moment not appropriate to raise such conclusion; because they will be faced with complexity, significant implementation costs and ongoing incremental costs, increased P&L volatility and pro-cycliclity which is significantly related solely to external influences outside our control (more than it currently does) and need to consider accounting impacts of product lines with regards to Business Models behind and existence of 'SPPI features'.

Based on our initial experience of calculating lifetime expected losses it is difficult to see the benefits due to the fact that for time horizons over 1 year there is very little new information to be found in data.

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.

Our reserve in fully agreeing with this assessment refers to the potentially high on-going cost/benefit ratio (both for preparers and for users) in respect of Classification & Measurement (namely: the assessment of the fulfilment of the SPPI condition for debt instruments subject to "benchmark testing" due to "imperfections" of the time-value-of-money element of interest).

For both preparers and users, we think that on-going costs might outweigh on-going benefits, especially from the perspective of potentially reduced comparability/inconsistencies in classification and measurement (as further referred to in our answer to the Question 3c above.

We have in the same time positively received EFRAG's assessment that "*in many cases, especially for loans, qualitative testing should be sufficient to assess whether the interest mismatch features are solely payments of principal and interest. Such a test is focused on whether the contract terms have been designed to provide compensation only for the time value of money and other basic lending risks or whether the contract contains some structuring elements. Quantitative testing would in most cases only be required where qualitative testing does not provide a conclusion. EFRAG assesses that in many cases this should remove the concerns raised for loans having interest rate mismatched features. In those cases they should result in amortised cost measurement if held in the appropriate business model*". (DEA, Appendix 2, paragraph 14a).

However, at this stage, we are unable to assess how this expectation of EFRAG would translate in the on-going practice of performing this test (both in terms of (a) setting the borderline between qualitative assessment being sufficient and quantitative benchmarking being necessary, and (b) modelling the quantitative assessment and interpreting its results in a defendable and consistent manner).

*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.

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| See comments provided under 13/ |

**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.

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| Agreed. |

*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.

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| Keeping in mind that IFRS 9 fundamentally will impact financial statements due to the fact that it includes revised guidance on the classification and measurement of financial instruments as well as a new expected credit loss model for calculating impairment (i.e. replacing the 'incurred loss model' included in IAS 39) a quantification of impact should be known before endorsement. |

*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.

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| N/A |