esma European Securities and Markets Authority

The Chair

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Mr Roger Marshall
European Financial Reporting
Advisory Group (EFRAG)
35 Square de Meeûs
1000 Brussels
Belgium

Ref: EFRAG Draft endorsement advice on Adoption of IFRS 9 *Financial Instruments*

Dear Mr Marshall,

The European Securities and Markets Authority (ESMA) thanks you for the opportunity to contribute to the EFRAG's draft endorsement advice on adoption of IFRS 9 *Financial Instruments*. On 4 May 2015 EFRAG published its draft endorsement advice, concluding that IFRS 9 complies with requirements of Article 3 of the IAS Regulation.[1] In particular, EFRAG concluded that IFRS 9 meets the technical endorsement criteria of understandability, relevance, reliability and comparability required of the financial information needed for making economic decisions and assessing the stewardship of management, is not contrary to the true and fair view principle of Article 4(3) of the Accounting Directive[2] and is conducive to the European public good.

ESMA concurs with EFRAG's conclusion that IFRS 9 meets all the technical endorsement criteria and is not contrary to the true and fair view principle as defined in the Accounting Directive. ESMA strongly believes that IFRS 9 as issued by the IASB should be endorsed for use in the European Union (EU) on a timely basis, inter alia, in order to respond to the concerns raised during the financial crisis. Furthermore, ESMA is of the view, that in order to maintain comparability between companies listed in the EU using IFRS as endorsed by the EU and those using IFRS globally, the mandatory adoption date in the EU should be aligned with the IFRS 9 as issued by the IASB (annual periods starting on or after 1 January 2018) and that early application of IFRS 9 should be permitted.

ESMA also concurs with EFRAG that adoption of IFRS 9 is conducive to the European public good. ESMA believes that IFRS 9 brings improvements to the financial reporting in response

[1] Regulation (EC) No 1606/2002 of the European Parliament and of the Council of 19 July 2002 on the application of international accounting standards
[2] Directive 2013/34/EU of the European Parliament and of the Council of 26 June 2013 on the annual financial statements, consolidated financial statements and related reports of certain types of undertakings

to the financial crisis as requested by G20. In order to contribute to the assessment of impact of adoption of IFRS 9 on European public good, following the request for assistance from EFRAG, ESMA analysed the relevant aspects, in particular, impact on investor protection and financial stability that are in the scope of ESMA Regulation.[3] In ESMA's view, the adoption and implementation of IFRS 9 are expected to have a positive impact on investor protection and financial stability in comparison with the current financial reporting requirements in IAS 39 *Financial Instruments: Recognition and Measurement*. Our detailed assessment of these aspects is set out in the Appendix I to this letter.

When assessing the European public good, EFRAG concluded that there is a strong case for deferral of IFRS 9 for insurance businesses to be analysed and promulgated by the IASB. ESMA is of the view that in light of significant uncertainty about the timing of finalisation of the new standard on insurance contracts, there should be no delay in the application of IFRS 9 for insurance industry. Furthermore, ESMA is of the view that EFRAG should explicitly acknowledge that the IASB already considered and tentatively rejected deferring the mandatory effective date of IFRS 9 for entities that issue insurance contracts in January 2015.[4]

IASB reached this tentative conclusion because IFRS 9 provides more relevant information about financial instruments in comparison with IAS 39 and in light of practical difficulties in defining the scope of the deferral, impact on financial conglomerates as well as considering the lack of convincing evidence that adoption of IFRS 9 could not be dealt with in the current framework of IFRS 4 *Insurance Contracts*.

ESMA agrees with the IASB's arguments and also believes that deferral of IFRS 9 for insurance entities might create a separate set of requirements for a single industry which would be inconsistent with the generic nature of IFRS that are applicable to all industries. That would lead to inconsistent accounting between banking and insurance industries and cause confusion to users of financial statements. In particular, ESMA has serious concerns that deferral of all provisions of IFRS 9, notably for insurance parts of financial conglomerates,[5] might create scope for earnings management and thus could undermine the credibility of financial reporting in Europe. Furthermore, allowing application of different requirements for identical financial assets in banking and insurance parts of a financial conglomerate within a single set of IFRS consolidated financial statements can have wide conceptual repercussions and unintended consequences.

While ESMA does not disagree that EFRAG asks the IASB to re-assess the deferral of the IFRS 9 for certain assets that back insurance contracts, in our view, any temporary deferral of IFRS 9 requirements could be considered only if the IASB concludes after its re-

[3] Regulation (EU) No 1095/2010 of the European Parliament and of the Council of 24 November 2010 establishing European Securities and Markets Authority
[4] IASB Update January 2015, IFRS Foundation, London, January 2015
[5] Groups with licences in both the banking and the insurance sector as defined in the Financial Conglomerates Directive (Directive 2002/87/EC European Parliament and Council Directive of 16 December 2002 on the supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate)

assessment that deferral of any provisions of IFRS 9 is necessary to address objectively identified artificial volatility stemming from different implementation dates of IFRS 9 and the future insurance standard. However, even in such case, it should be strictly limited only to assets backing insurance contracts, where rigorous quantitative analysis provides sufficient convincing evidence that adoption of IFRS 9 would create incremental accounting mismatches that:

(i) could not be addressed in the current framework of IFRS 4, i.e. would not prevent timely implementation of improvement to financial reporting, such as the expected loss model; and

(ii) could be addressed by future insurance standard, i.e. would not defer IFRS 9 requirements which might create or increase accounting mismatches that cannot be addressed by the future insurance standards, such as the requirement to measure all equity instruments at fair value.

Finally, ESMA does not believe that a European carve-out is a feasible solution in this area. We have reached this conclusion in light of the global nature of the European insurance industry activities (e.g. measured by the number of listed subsidiaries of European insurance companies) and the need of extensive additional guidance for any deferral (i.e. additional presentation and disclosure requirements) that is not possible to be added to a standard according to the existing European legal framework.

Please do not hesitate to contact us should you wish to discuss all or any of the issues we have raised.

Yours sincerely,

Steven Maijoor

CC: Francoise Flores, EFRAG TEG Chair

Valerie Ledure, Acting Head of Unit B3 FISMA, European Commission

Appendix I – Impact of adoption of IFRS 9 on Investor Protection and Financial Stability

When assessing the expected impact of IFRS 9 on investor protection and on financial stability, ESMA believes that the assessment needs to be done on a relative basis, comparing the current requirements of IAS 39 with the requirements of IFRS 9.

a. Impact of IFRS 9 on Investor Protection

When assessing the impact of introduction of IFRS 9 on investor protection, evaluation needs to be made whether the requirements of IFRS 9 enable investors (primarily investors in issuer's equity and debt instruments) to make better and (more) adequately informed investment choices than what would have been the case under the current requirements of IAS 39. In this respect, assessment needs to be made whether sufficient transparency is provided to existing and potential (debt and equity) investors on the financial position, performance and cash flow in order to make better-informed investment. The IFRS 9 requirements[6] shall enable to better reflect the business model in the classification of financial assets as well as contribute to additional transparency in providing financial information in comparison with those required under IAS 39, notably in the areas of impairment of financial assets, and reflection of risk management and hedging activities in the financial statements.

In this regard, financial information presented in the IFRS financial statements can be assessed from the perspective of fundamental qualitative characteristics of relevance and faithful representation, and enhancing qualitative characteristics of comparability, verifiability, timeliness and understandability as defined by the IASB Conceptual Framework.

Furthermore, the enforceability of the standard is important in order to enable consistent application of IFRS 9 and therefore a more level playing field in this area. The new classification model that bases classification on the objectively observable business model as well as additional disclosure requirements in the area of impairment of financial assets and hedge accounting can contribute to consistent application and enforceability of IFRS 9.

While all three parts of IFRS 9 are equally important for the assessment of investor protection, this note discusses the classification and measurement model in a greater detail as the nature of changes between IAS 39 and IFRS 9 makes assessment of their impact on investor protection more pertinent.

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[6] Disclosure requirements resulting from changes of classification and measurement requirements of IFRS 9 are included in consequential amendments to IFRS 7 *Financial Instruments: Disclosure*. However, these are considered in this note as a single package impact of which is assessed at the same time.

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Classification and measurement of financial instruments:

The approach to classification and measurement of financial assets in IFRS 9 is based on the principles of '*assessment of the issuer's business model*' and the evaluation of the '*nature of cash flows of individual financial assets*'. ESMA believes that the IFRS 9 classification model renders financial information more relevant as it enables to better reflect the underlying economics of the financial assets when compared to IAS 39 and thus enhance understanding of the financial information.

Furthermore, not separating embedded derivatives from the financial asset hosts means that complex financial instruments will need to be classified at fair value in their entirety. This might lead to simplification of some financial instruments as some issuers might be reluctant to purchase complex financial instruments (e.g. by purchasing the plain vanilla financial assets and derivative financial instruments products separately from different providers/market makers). This simplification might increase understandability of financial instruments by investors and facilitate their valuation, thus indirectly contributing to enhancement of investor protection.

ESMA acknowledges that each accounting standard inevitably leads to structuring of financial instruments. This was the case under IAS 39 and is expected to be the case for IFRS 9. The changes to product characteristics that have already happened or might happen in the future should align the types of products with the business model of the banks and/or lead to simplification of their features in order to meet the solely payment of principal and interest (SPPI) test. Indeed, the circumstantial evidence showing that some complex features are already being streamlined for new products (e.g. elimination or reduction of significant mismatches between the period for which floating interest rate is set and the interest rate benchmark). While some products regulated by national legislation/practices might be impacted, further changes to the practice/national legislation will follow changes in IFRS (as national practices were often based on prior national GAAP or on IAS 39). ESMA believes that the SPPI criteria are appropriate and thus should not have negative impact on investor protection.

The ability of issuers to sell financial assets classified in the amortised cost portfolio(s) upon identification of **any** credit risk deterioration without impacting their classification in IFRS 9 allows timelier sale of relevant assets when compared to requirements of IAS 39 that allowed (untainted) sales out of held-to-maturity portfolio only upon significant deterioration in the issuer's creditworthiness. Hence, investor's in issuers' equity or debt instruments can be shielded from potential losses if the issuer timely identifies and manages the credit risk inherent in the portfolio of financial assets held.

The requirement to measure all investments in equity instruments at fair value will lead to removal of the separate impairment test for equity instruments currently required for investment classified as available-for-sale category. This will increase the comparability. As indicated in the ESMA report on the comparability of financial statements of financial institutions, there is a significant diversity in practice regarding the application of the

'significant or prolonged' criteria when assessing impairment of investments in equity instruments classified as available-for-sale and lack of transparency regarding application of these criteria. Therefore, in this respect, IFRS 9 will lead to more comparable information, thus contributing to investor protection.

During the development of IFRS 9, ESMA, in its comment letters to the IASB, disagreed with the introduction of the third business model for debt instruments held. At that point, ESMA noted that introduction of the Fair Value through Other Comprehensive Income category (FVOCI) will increase the complexity of IFRS 9, notably in light of the IASB's objective to reduce complexity of accounting requirements in IAS 39 and thus might make enforceability of IFRS 9 more difficult. ESMA notes that further reduction of complexity of the accounting requirements would have contributed to increased investor protection. While ESMA acknowledges that the objective of reducing complexity of classification requirements was not fully achieved, we do believe that, taking all requirements into account, the classification model of IFRS 9 is superior to IAS 39 in terms of enhancing investor protection.

The classification model of financial liabilities has not changed apart from financial liabilities to which fair value option is applied. For these instruments, the portion of the changes in fair value resulting from changes of the own credit risk is presented in other comprehensive income (OCI). From the investor protection perspective, this is positive change because it prevents the presentation of gains in profit or loss in situations when there is in fact a deterioration of the economic situation (and creditworthiness) of the reporting entity. Furthermore, separate presentation of these changes in primary financial statements increases transparency for investors.

Overall, as the basis of the classification of financial assets changes from management intent in IAS 39 to business model in IFRS 9, linking changes in classification to objectively observable changes in the business model, the new classification model can contribute to consistent application and enforceability of IFRS 9.

Impairment of financial assets:

Earlier recognition of credit losses due to the move from the incurred loss model in IAS 39 to the expected loss model in IFRS 9 will increase the relevance of the information provided as credit losses are not delayed until there is objective evidence of a loss event. Earlier recognition of credit losses contributes to investor protection as it avoids the 'cliff effect' when previously unrecognised credit losses are recognised in full upon identification of loss event and enables to inform investors earlier about the deterioration of the credit risk of financial assets held in the portfolio of the issuer.

Additional disclosures in the financial statements might enhance the understanding of the credit risk of the financial assets held by the issuer and thus enable more informed investment decisions.

Due to the information asymmetry between management of the issuer and users of financial information, it can be expected that management should be able to estimate the expected credit losses for the financial instruments better than investors. While reflection of these expectations increases the relevance of financial statements, from the perspective of investor protection, adequate disclosure requirements on the assumptions made when estimating expected losses are required. By requiring such disclosures on a granular level, IFRS 9 contributes to transparency of financial information and enhances the investor protection.

Hedge Accounting:

While the new general hedge accounting model is based on improved reflection of risk management activities in the financial statements, thus improving relevance of financial information provided, it also relies on significant management judgements. By requiring disclosure of the risk management strategy and providing sufficient level of transparency of hedging decisions, new disclosure requirements[7] could significantly contribute to quality and provide additional transparency in financial information to users of financial statements in comparison with those required under IAS 39.

b. Impact of IFRS 9 of Financial Stability

In ESMA's view, transparency in providing financial information to the market participants contributes to financial stability and orderly functioning of financial markets. Insufficient transparency was one of the shortcomings that financial markets showed in the midst of the financial crisis as lack of information might have contributed to mispricing of risk. The additional disclosure requirements that accompany IFRS 9 should contribute to additional transparency in providing financial information in comparison with those required under IAS 39. Better reflection of the business model in the classification of financial assets and additional disclosures might help to better ascertain risk appetite of different institutions (notably from the financial sector) and thus enable regulators and market participants better appraise their riskiness.

While acknowledging possible impact of accounting principles on financial stability, ESMA notes that other changes in business environment, notably the level of competition, changes in tax legislation and banking regulation (e.g. prudential requirements on own funds, or liquidity of regulated entities) might have a bigger impact on changes in issuer's behaviour and on financial stability.

Classification and measurement of financial instruments:

ESMA is of the view that the use of amortised cost category seems to be appropriately circumscribed to 'basic lending instruments' using the combination of the business model test and the SPPI criteria. Appropriate use of fair value and amortised cost as measurement basis will contribute to the financial stability.

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[7] In IFRS 7, through consequential amendments.

While ESMA notes that the classification model in IFRS 9 might lead to the situation whereby some financial assets that could have been measured at amortised cost under IAS 39 will need to be measured at fair value, we believe that appropriate trade-off have been reached on which financial assets are mandatorily measured at fair value. While mandatory classification of some financial assets at fair value through profit or loss (FVTPL) might increase the volatility in the reported profit or loss, ESMA believes that appropriate trade-off between reporting the underlying economic volatility of financial instruments and transparency of economic performance have been reached. Proper disclosure of this volatility in the financial statements increases transparency of financial information and thus assists financial stability.

In addition, ESMA notes that many financial instruments that have been measured at fair value under IAS 39 (as they were classified as available-for-sale) will qualify for amortised cost treatment in IFRS 9.

Impairment of financial assets:

A single model for impairment of debt instruments based on **expected loss model** should lead to earlier recognition of credit losses addressing the 'too little too late problem' associated with the IAS 39 incurred loss model by lessening the cliff effect of a sudden full recognition of previously unrecognised credit losses upon identification of a loss event.

The 'expected loss' model together with improved transparency on credit risk quality contributes to financial stability. Consequently, the new impairment model might reduce certain pro-cyclical effects resulting from the existence of incurred loss recognition threshold in the IAS 39 model.[8] While not all drivers of volatility could be addressed in accounting standards, ESMA is of the view that by requiring the issuers to base their credit risk expectations on granular information/evidence, the accounting standards could contribute to reduction of volatility. Furthermore, ESMA believes that such reported earnings volatility would faithfully represent the underlying economic performance of the issuers.

ESMA noted that ensuring that loan loss provisions of banks appropriately reflect loan losses is crucial for assessing their underlying ability to generate earnings on loans and absorb losses in the future. Information on provisioning is more relevant when it reflects expected losses in a systematic and credible way over the life of the financial instrument rather than incurred losses as was the case under the IAS 39 model. Such earlier recognition of expected losses contributes to financial stability.

[8] However, while incorporation of all available information (e.g. macro-economic information) and their immediate incorporation in the measurement of credit losses enables earlier recognition of credit losses, it might exacerbate the creation of credit risk provision in economic downturn.

Hedge Accounting:

Regarding the general hedge accounting model, while hedge accounting remains largely optional, additional disclosure requirements that accompany the new hedging model should provide more transparent and insightful information on the risk management strategies the issuer applies and thus enables regulators and market participants to better understand the risk appetite of a particular entity.

By placing a greater emphasis on providing insights on how an entity manages risks rather than how it uses specific accounting rules (application of the hedge accounting rules of IAS 39) should improve the understanding of riskiness of the entity's business model and operations, and thus contribute to orderly functioning of financial markets (e.g. by less market surprises).