EUROPEAN COMMISSION
Directorate General Financial Stability, Financial Services and Capital Markets Union

INVESTMENT AND COMPANY REPORTING
Accounting and financial reporting

Brussels, 8 December 2014
FISMA B3/DR/av (2014) 4517716

Roger Marshall
President
EFRAG
Square de Meeûs 35
B-1000 Brussels

Subject: Endorsement advice on IFRS 9 Financial Instruments

Dear Roger,

Following the publication by the International Accounting Standard Board (IASB) of the IFRS 9, Financial Instruments, on 24 July 2014, the European Commission would like to request the European Financial Reporting Advisory Group (EFRAG) to deliver its opinion, on the new standard.

The opinion of EFRAG should be based upon the following conditions, against which endorsement is assessed in the Regulation (EC) No 1606/2002 of the European Parliament and of the Council on the application of International Accounting Standards, i.e. that the standard:

- is not contrary to the principle set out in Article 4(3) of Directive 2013/34/E and is conducive to the European public good, and
- meets the criteria of understandability, relevance, reliability and comparability required of financial information needed for making economic decisions and assessing the stewardship of management.

This advice should be supported by an effects analysis, which may include evidence already obtained by EFRAG during the course of the development of the standard or other available evidence as appropriate, in particular, on the effects of the new requirements in the area of impairment allowances.

As you are aware, members of the Accounting Regulatory Committee (ARC) vote on the adoption of each standard taking into consideration the endorsement advice provided by EFRAG to the European Commission. Accordingly, members of ARC have been asked to identify matters which they consider to be important in reaching their conclusions on whether to endorse IFRS 9. The appendix to this letter describes the matters raised by some ARC members together with other issues that have been brought to the attention of the Commission services by European stakeholders. I would like to request that EFRAG take these matters into consideration, as appropriate, in its reply to this letter.

Notwithstanding the matters set out in the appendix, many members of the ARC support a swift endorsement of this standard and, accordingly, I should be grateful if EFRAG would

provide its opinion within 6 months following receipt of this letter taking into account the need to address the matters raised and appropriate due process and consultation with European stakeholders.

We thank you in advance for your cooperation.

Should you have any questions, please contact Mr Piotr Swistun (Telephone: +32 2 29 55 6074).

Yours sincerely,

Didier MILLEROT
Head of Unit

cc.: Françoise Flores (EFRAG TEG Chairman), Piotr SWISTUN (MARKT)

Appendix

Endorsement Advice: IFRS 9, Financial Instruments – Matters for Consideration

1 Insurance accounting: Inter-relationship between IFRS 9 and IFRS 4 Revised (not yet finalised)

In general, insurance companies seek to match their financial assets to their insurance liabilities over the duration of those exposures. The accounting for financial assets will be subject to the principles in IFRS 9 whilst insurance liabilities will be subject to IFRS 4 Revised. The latter standard is not yet finalised nor has the IASB completed its deliberations on the standard, hence, it is not yet possible to understand what effects IFRS 9 and IFRS 4 would have when both applied. In particular, there is doubt whether the application of the two standards together would reflect matched positions appropriately or would give rise to some so-called artificial volatility meaning that variations in fair values of either the financial assets or insurance liabilities (or both) affect the primary statements in a way that makes them appear unmatched.

There is a further issue regarding the timing of the implementation of the two standards which both involve significant changes for the insurance industry and would ideally be introduced together.

2 Use of Fair Values

The application of fair values would be different under IFRS 9 as compared to IAS 39. Some question whether such changes could have a detrimental effect on financial stability as a result of greater volatility arising from increased use of fair values. Three examples have been given:

- IFRS 9 retains a third category of classification, fair value through other comprehensive income (FVOCI) but the scope of this category as compared to the available-for-sale category in IAS 39 is different. The effects of the differences should be understood.
- The principles for reclassification of financial assets are different under IFRS 9 as compared to IAS 39.
- IFRS 9 has no provision for bifurcating financial assets that contain embedded derivatives.

These matters may be of particular concern during a financial crisis or liquidity shortage.

There could be more clarity about the practical effects of the amendments that the IASB made in the final standard regarding the distinction between amortised cost, FVOCI and fair value through profit or loss. In particular, the effects of the changes relating to the application of the solely payments of principal and interest (SPPI) test and the distinction between business models should be assessed.

The valuation and accounting of investments in bonds and equities should be analysed. Some doubt exists whether the prohibition on recognition of profits or

losses in the income statement for equity classified at fair value through comprehensive income could be considered to be appropriate.

The appropriateness of the use of fair-values under IFRS 9 for the needs of long-term investors which may be corporates reporting under international accounting standards, for example, some insurance companies should be assessed.

3 Impairment

The IASB has established an Impairment Transition Resource Group (ITG) to provide support to stakeholders on the implementation of the impairment provisions of IFRS 9. It is not yet known what matters will be referred to this Group nor how the IASB will deal with them. The Basel Committee of Banking Supervisors (BCBS) also has a workstream setting out supervisory expectations regarding the implementation of an expected loss impairment model. These initiatives are being undertaken because the impairment model in IFRS 9 is very different to the existing model in IAS 39 and could be challenging to implement.

One area of uncertainty relates to how and to what extent banks will take into account forward-looking information including macro-economic indicators in their application of the standard. The way in which they do this may be influenced by the types of lending and the way in which lending is aggregated into portfolios. Furthermore, the standard requires entities to consider reasonable and supportable information that is available without undue cost or effort. It is unclear to what extent banks may seek to rely on this provision. For example, in cases where forward-looking information is not available without undue cost and effort, banks may rely on a 30 day past due status to indicate that credit risk on a loan has increased significantly since initial recognition although this is essentially a lagging indicator.

Other practical expedients in the standard may result in banks availing themselves of opportunities to avoid a more robust and costly implementation of the standard calling into doubt whether the standard will achieve its objectives.

The IFRS 9 model for loan allowances is predicated on the basis that loans are appropriately priced at origination; however, the financial crisis showed that credit bubbles can distort the interest rates charged by banks. Some doubt arises about whether IFRS 9 adequately addresses this issue. Another matter that should be addressed is the appropriateness of the model's distinction between a 12 month expected loss loan allowance and a full life-time loss for loans which have historical loss patterns that indicate the likelihood of losses occurring in early years but not within the 12 month period.

A final matter for consideration is whether the new impairment model would result in banks changing their lending practices to favour short-term loans over loans with a longer maturity.

4 Hedging

The continuity of the EU carve-out on macro-hedging within IAS 39 under IFRS 9 is important. The ability of banks to continue using this carve-out following an endorsement of IFRS 9 should be analysed for assurance on this matter.

5 Convergence

IFRS 9 is not converged with US GAAP, in particular in the accounting for impairment. The impact of this lack of convergence for globally active financial institutions, in particular, banks should be analysed.

6 Prudence

An assessment should be made of IFRS 9 in the light of the concept of prudence.