European Securities and Markets Authority

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Mr. Hans Hoogervorst
International Accounting Standards Board
30 Cannon Street
London
EC4M 6XH
United Kingdom

The IASB's Exposure Draft *Classification and Measurement: Limited Amendments to IFRS 9*

Dear Mr Hoogervorst,

The European Securities and Markets Authority (ESMA) thanks you for the opportunity to contribute to the IASB's due process. ESMA is pleased to provide you with the following comments aimed at improving the decision-usefulness of financial statements and the transparency and enforceability of IFRSs.

ESMA has considered the IASB's Exposure Draft (ED) *Classification and Measurement: Limited Amendments to IFRS 9*. ESMA does not support the introduction of a separate category for business models where assets are managed both in order to collect contractual cash flows and for sale and that would be required to be measured at fair value through OCI. Indeed, we believe that the two business models approach under the current IFRS 9 is more robust, resulting in more consistent application and enforcement and, as a consequence, in more transparency. Introducing a third category would make the accounting unnecessarily complex without leading to more decision-useful information. As the dividing line between the categories is not clear, because the third category is not defined in a rigorous manner, it might cause enforceability issues and thus hamper consistent application in practice and comparability between different issuers.

ESMA understands that there are cross-cutting issues between the IASB's projects on how to account for financial instruments and for insurance contracts. Having said this, we would strongly encourage the IASB to finalise a high quality standard on financial instruments accounting (IFRS 9) and not to link the finalisation of this standard to any other project.

We note that not supporting the proposed third category might result in divergence with US GAAP as developed by the US Financial Accounting Standards Board (FASB). Though we would encourage the FASB and IASB to converge US GAAP with IFRS, we believe that the IASB's primary objective should be to develop high quality accounting standards. We also think that, even if the proposed category would be introduced, convergence would not be fully achieved as other differences would remain.

As a final point we would like to mention that IFRS 9 has been developed to address concerns that IAS 39 – *Financial Instruments: Recognition and Measurement* is too complex, too rules based, contains too many exceptions to the underlying principles and is in some cases even internally inconsistent. Constituents urged the IASB to produce a principles based standard reducing complexity.

ESMA would urge the IASB, as many weaknesses have been identified in IAS 39, to complete a high quality standard on financial instruments accounting as soon as possible. As a consequence ESMA believes that there is no immediate need for the IASB to reopen debates, such as on voluntary bifurcation of financial assets and the definition of interest, that have already been closed. ESMA believes that voluntary application of bifurcation would harm comparability of financials statements and add complexity to IFRS 9.

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

Yours sincerely,

Steven Maijoor
Chair

European Securities and Markets Authority

Julie Galbo
Chair
Corporate Reporting Standing Committee
European Securities and Markets Authority

APPENDIX – ESMA's detailed answers to the questions in the IASB's *Classification and Measurement: Limited Amendments to IFRS 9*

Question 1 – Do you agree that a financial asset with a modified economic relationship between principal and consideration for the time value of money and the credit risk could be considered, for the purposes of IFRS 9, to contain cash flows that are solely payments of principal and interest? Do you agree that this should be the case if, and only if, the contractual cash flows could not be more than insignificantly different from the benchmark cash flows? If not, why and what would you propose instead?

Question 2 – Do you believe that this Exposure Draft proposes sufficient, operational application guidance on assessing a modified economic relationship? If not, why? What additional guidance would you propose and why?

Question 3 – Do you believe that this proposed amendment to IFRS 9 will achieve the IASB's objective of clarifying the application of the contractual cash flow characteristics assessment to financial assets that contain interest rate mismatch features? Will it result in more appropriate identification of financial assets with contractual cash flows that should be considered solely payments of principal and interest? If not, why and what would you propose instead?

1. ESMA agrees that a financial asset with a modified economic relationship between principal and consideration for the time value of money and the credit risk could be considered (for the purposes of IFRS 9) to contain cash flows that are solely payments of principal and interest. Nevertheless this should be the case if, and only if, the contractual cash flows could not be more than insignificantly different from the benchmark cash flows.

2. We are however concerned that the current drafting of the proposals could hamper their consistent application and effective enforcement in practice:

   — The ED states that "an entity may consider either an actual or a hypothetical financial asset as the basis for the assessment" (paragraph B4.1.9B). ESMA understands that the idea of the proposal is to compare the instrument with a "perfect" – and therefore potentially a hypothetical – instrument which would reflect only the time value of money and the credit risk, and ESMA supports this idea. The ED does however not say in which conditions a hypothetical financial asset should be used instead of an actual financial asset. It is our understanding that a

hypothetical instrument should be used if no actual financial asset with such characteristics exists on the market.

— Paragraph B4.1.9B of the ED states that the characteristics of the benchmark instrument need to be used to assess whether the economic relationship was modified. Though it could be read implicitly from this paragraph, ESMA would suggest to clearly state that the benchmark instrument should meet the condition set out in paragraph 4.1.2(b) of the ED. That is to say that the contractual terms of the financial asset should give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding.

— The Basis for Conclusions does not elaborate on the IASBs considerations on the benchmark instrument. ESMA believes that constituents might benefit from some further insights in the IASB's thinking to better understand how the benchmark instrument should be determined.

Question 4 – Do you agree that financial assets that are held within a business model in which assets are managed both in order to collect contractual cash flows and for sale should be required to be measured at fair value through OCI (subject to the contractual cash flow characteristics assessment) such that:
(a) interest revenue, credit impairment and any gain or loss on derecognition are recognised in profit or loss in the same manner as for financial assets measured at amortised cost; and
(b) all other gains and losses are recognised in OCI?
If not, why? What do you propose instead and why?

3. IFRS 9 has been developed to address concerns that IAS 39 – *Financial Instruments: Recognition and Measurement* is too complex, too rules based, contains too many exceptions to the underlying principles and is in some cases even internally inconsistent. Constituents urged the IASB to produce a principles based standard reducing complexity.

4. ESMA does not support the introduction of a separate category for business models where assets are managed both in order to collect contractual cash flows and for sale and that would be required to be measured at fair value through OCI. Indeed, we believe that introducing a third category would make the accounting unnecessarily complex without leading to more decision-useful information. As the dividing line between the categories is not clear, because the 3rd category is not defined in a rigorous manner it might cause enforceability issues and thus hamper consistent application in practice and comparability between different issuers.

5. ESMA is aware that the IASB's proposal to introduce such a new category could be linked to the tentative decision taken in the IFRS 4 – *Insurance Contracts* project, to allocate the movements in interest to OCI and to avoid an accounting mismatch. ESMA however believes that as long as the accounting of insurance contracts, and in particular how the changes in the fair value of the insurance contracts will be recognised, are not finalised it will remain difficult to decide on the introduction of a third category to ease the accounting of financial instruments by the issuers of those insurance contracts. Moreover, the accounting mismatches created by the tentative decision in IFRS 4 implying that variation in the value of insurance contracts caused by changes in interest rates will be accounted through OCI, will only be partially solved by the new category. Interest rate changes will influence not only assets eligible for this category but other items too, e.g. derivatives and investment properties, if the tentative decision in IFRS 4 is maintained.

6. We note that not supporting the proposed third category might result in divergence with US GAAP. Though we would encourage the FASB and IASB to further converge US GAAP with IFRS we believe that the IASB's primary objective should be to develop high quality accounting standards. We would like to highlight that even if the proposed category would be introduced convergence would not be fully achieved and differences would remain as (i) if the entity's business model changes, reclassification mechanics between categories are not fully converged, (ii) IFRS contains an option for equity investments (long-term strategic investments) to be accounted for fair value through OCI, whereas the US GAAP equivalent only contains such requirement for loans or debt securities and (iii) the conditions for applying a fair value options through P/L are different.

Question 5 – Do you believe that the Exposure Draft proposes sufficient, operational application guidance on how to distinguish between the three business models, including determining whether the business model is to manage assets both to collect contractual cash flows and to sell? Do you agree with the guidance provided to describe those business models? If not, why? What additional guidance would you propose and why?

7. As set out in our response to question 4, ESMA does not support the proposed third category. We believe that the dividing line between the categories is not clear and expect that it will cause enforceability issues and thus hamper consistent application in practice and comparability between different issuers.

   If the IASB would carry forward the proposed third category it should further clarify the distinction between the different business models, by defining the 3rd category in a rigorous manner and expand the guidance and examples currently provided in paragraphs B4.1.2A and B4.1.2B, which we believe that are currently not sufficient.

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8. In addition, we note that paragraph B4.1.3 of the ED states that, in order to qualify for the amortised category, sales should be "infrequent (even if significant) or insignificant both individually and in aggregate (even if frequent)". ESMA understand that these notions should be read differently to the ones in the prohibition for what is currently "Held to Maturity" (HTM) in IAS 39.

9. The difference is however not clear to us, except the removal of tainting rules. The notion of "insignificant sales" was already part of the requirements to use the HTM category. Even if the term "infrequent" was not used in IAS 39, exceptions to the tainting rules in paragraph AG22 of IAS 39 stated that sales could occur in a limited number of cases, amongst others in case of significant credit deterioration or the occurrence of changes in regulatory requirements. IFRS 9, in paragraph B4.1.3, states that "the entity need not hold all of those instruments until maturity" and provides one example: credit quality deterioration. Paragraph B4.1.3 is clear that "sales that occur for other reasons may also be consistent with a business model whose objective is to hold financial assets in order to collect contractual cash flows", but the nature of these "other reasons" is not clear. Example 4 in paragraph B4.1.4 gives "stress case" as a reason but does not provide further details.

10. ESMA is wondering what the "other reasons" for the "infrequent sales" are and if they really defer from the exceptions to tainting rules in paragraph AG22 of IAS 39. ESMA believes that the differences between the HTM category and the "collect contractual cash flows" model and the notion of 'infrequent' need further clarification.

11. As a last point, we note that prudential regulation makes use of the concept of "periodical sales" of assets from liquidity portfolios. We would encourage the IASB to consider whether the differences between the two concepts is entirely clear for constituents as well as whether additional clarification would be necessary. Consideration should also be given as to whether the amortised cost category could cater the liquidity portfolios of financial institutions when sales for market liquidity testing are not inconsistent with the business model objective.

Question 6 – Do you agree that the existing fair value option in IFRS 9 should be extended to financial assets that would otherwise be mandatorily measured at fair value through OCI? If not, why and what would you propose instead?

12. ESMA does not support the proposed 'fair value through OCI' category.

Question 7 – Do you agree that an entity that chooses to early apply IFRS 9 after the completed version of IFRS 9 is issued should be required to apply the completed version of IFRS 9 (i.e. including all chapters)? If not, why? Do you believe that the proposed six-month period between the issuance of the completed version of IFRS 9 and when the prohibition on newly applying previous versions of IFRS 9 becomes effective is sufficient? If not, what would be an appropriate period and why?

Question 8 – Do you agree that entities should be permitted to choose to early apply only the 'own credit' provisions in IFRS 9 once the completed version of IFRS 9 is issued? If not, why and what do you propose instead?

13. ESMA concurs with the IASB's proposal to permit early application of the 'IFRS 9 own credit' provisions once the completed version of IFRS 9 is issued.

Question 9 – Do you believe there are considerations unique to first-time adopters that the IASB should consider for the transition to IFRS 9? If so, what are those considerations?

14. ESMA does not have any consideration unique to first-time adopters in relation to the transition to IFRS 9.