



Jeroen Hooijer  
Head of Unit Accounting  
European Commission  
DG Internal Market  
Rue de la Loi, 200  
B-1049 Brussels  
[Jeroen.Hooijer@ec.europa.eu](mailto:Jeroen.Hooijer@ec.europa.eu)

CC : Mr. Nicolas Bernier Abad  
[Nicolas.bernier-abad@ec.europa.eu](mailto:Nicolas.bernier-abad@ec.europa.eu)

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Dear Mr. Hooijer,

Thank you for the invitation to the Industry Technical Assessment Meeting of 22 April 2010 concerning IFRS 9 “Financial instruments: Classification and Measurement”. We would like to take this opportunity to give further input to the European Commission. Overall, ESBG fully supports a mixed measurement model, which is widely understood to result in more effective financial reporting.

In our view, accounting rules need to be revised in light of the lessons of the financial crisis. The main issue is therefore to set the right balance between amortised cost and fair value. The mixed measurement model should follow a principles-based approach by acknowledging the fact that different entities may follow different business models. The aim should be for the accounting standards to accommodate the various business models and circumstances in which financial instruments are used.

Overall, ESBG considers that IFRS 9, as proposed by the IASB, offers some improvement to IAS 39 but defines the amortised cost category too narrowly. As a result many instruments managed on a long term basis - more particularly illiquid instruments – will be recorded at fair value through profit and loss. Such an increase of fair value will not only mislead investors and stakeholders but may also affect financial stability.

We would like to divide our letter in two parts: first we will explain why the classification criteria of IFRS 9 are not satisfactory. Secondly we will provide you with details on technical aspects.





## ESBG suggestions on the classification criteria in IFRS 9

ESBG agrees with the G-20 conclusions as well as with the messages conveyed in the European Commission's letters of 16 September and 4 November 2009 to the IASB.

IFRS 9 considers both the characteristics of the instrument (contractual cash-flows) and the business model at equal level and therefore sets fair value as the default category<sup>1</sup>. In other words, the reality for retail banks will be that in the majority of cases the characteristics of the instrument will be the prevailing criterion. ESBG does not support this approach.

We believe that the proposed standard will lead to more instruments being classified at fair value through profit and loss compared to the existing IAS 39, thus potentially exacerbating volatility and creating undue competitive distortions for retail banks. In fact, we find that IFRS 9 does not completely take the consequences of the crisis into account. In this context, we recall the Basel Committee on Banking Supervision high level guiding principles on IAS 39 on 27 August 2009 stressing that *“the two category approach should not result in an expansion of fair value accounting”*<sup>2</sup>.

Accordingly, we agree with your letter of 16 September 2009, which stressed that the classification criterion *“should be based primarily on the business model and that only then should the characteristics of the financial instruments be taken into account”*<sup>3</sup>. Our understanding is that the Commission proposal would reverse the line drawn between the amortised cost and fair value categories for retail banks, while not impacting on other financial institutions which follow different business models. Furthermore this solution would be in accordance with the Basel Committee Guiding principles on IAS 39 stating that : *“there should be a strong overlay reflecting the entity's underlying business model as adopted by the Board of Directors and senior management, consistent with the entity's documented risk management strategy and its practices, while considering the characteristics of the instruments”*<sup>4</sup>.

In fact, ESBG foresees that IFRS 9 as proposed by the IASB will affect differently one entity to another, depending on their business model. We consider that it is not acceptable that accounting rules have an impact on any business model, as; on the contrary, accounting rules should be neutral and reflect the economic model underpinning the respective entities. We highlight that the IASB current proposals could hamper retail banks with respect to all other financial companies.

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<sup>1</sup> IFRS 9 paragraph 4.2 : *a financial asset shall be measured at amortised costs if both the following conditions are met: (1) the objective of the entity' business model is to hold the financial asset in order to collect the contractual cash flows; and (2) the contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal outstanding.*

<sup>2</sup> <http://www.bis.org/publ/bcbs161.pdf?noframes=1>

<sup>3</sup> [http://ec.europa.eu/internal\\_market/accounting/docs/ias/20090916-ias39-comment\\_en.pdf](http://ec.europa.eu/internal_market/accounting/docs/ias/20090916-ias39-comment_en.pdf)

<sup>4</sup> <http://www.bis.org/publ/bcbs161.pdf?noframes=1>



ESBG would like to stress the importance of this issue not only for retail banks but also for the wider European economy. Already under the present accounting rules, ESBG members proved robust lenders during the financial crisis. We have to prevent any change in accounting rules which would either create competitive distortions to the disadvantage of retail banks or impede their ability to provide credit to the real economy. We consider that in order to avoid competition distortions a greater emphasis should be given to the business model as the primary classification criterion.

We also reiterate our concern regarding the piecemeal approach adopted by the IASB. In order to fully assess the impact of a mixed measurement accounting model, it is necessary to form a view of the entire situation, including:

- the classification and measurement of liabilities (the current proposal only concerns the asset side but leaves the other half of the balance sheet – liabilities – aside, therefore asymmetrical rules for assets and liabilities are possible);
- impairment rules (Phase 2 is only at the consultation stage, the exposure draft on the expected cash flow approach to impairment might be amended); and
- hedge accounting principles (Phase 3, on which we are still expecting a draft proposal).

In addition, a possible “Phase 4” may be developed: the project to converge IFRS with US GAAP entails high uncertainty. IFRS 9 could later be completely re-assessed in the light of US GAAP.

We also stress that transitional arrangements should not be overly burdensome. Every effort should be made to facilitate a coherent and smooth implementation of the three (or four) IAS 39 revision phases. In this regard, we consider that the proposed changes to the measurement of financial instruments have to be synchronized. Therefore, a separate endorsement of the different phases is not acceptable. Furthermore, endorsing IFRS 9 - Phase 1 as such will not necessarily promote increased transparency. The endorsement will enable some banks to freely apply the new standard, while others will decide not to apply it. As a consequence, comparability between different banks will become more difficult as they may apply different accounting standards.

## **Specific comments**

### ***1. Reclassification***

Most of the reclassification performed in 2008 would also have to be reversed. Taking into account the lessons of the financial crisis, we believe in the superiority of the rules introduced in October 2008 which allowed reclassification of illiquid instruments out of fair value. For instance, tranches of securitization currently recognised at cost as a consequence of reclassification made in 2008 would be recognised at fair value through profit and loss. Moreover, banks would have to fair value tranches of securitization that they could not sell and that will have to be maintained in the balance sheet in accordance with prudential rules.

### ***2. The prohibition of bifurcation for embedded derivatives***

Regarding embedded derivatives, we believe that the bifurcation of these instruments should be allowed as it is currently in IAS 39. Banks have many structured financial assets and liabilities where



embedded derivatives are clearly identifiable, measurable and separable. The abolition of bifurcation will result in a considerable extension of the scope of the fair value without any consideration of the business model of the entity.

For example, convertible debt would be fair valued as well as an important amount of hybrid contracts. Some loans might be valued differently depending on whether they are incorporated in a structured product or if they are considered individually. Furthermore this would increase volatility as for instance some hybrid Tier 1 would be at fair value. Tier 1 represents a significant source of funding for some banks' capital, particularly in Europe. In our view it is relevant to separate the embedded derivatives that are clearly identifiable, separable and measurable.

### ***3. The prohibition of recycling of gains and losses for equity instruments at fair value through Other Comprehensive Income (OCI)***

Under IFRS 9, equity instruments not held for trading can be measured at fair value through profit and loss or at fair value through Other Comprehensive Income (OCI) (where fair value changes are recognized in OCI without recycling of gains and losses into profit and loss) The option of measurement at fair value through OCI is irrevocable. Under IAS 39 recycling from OCI to profit and loss is required.

We do not consider that the concept of fair value through OCI, with no recycling of gains or loss when the asset is sold, is adapted for equity investments. We recall Basel Committee Guiding principles for the replacement of IAS 39 which specifically asked the IASB to avoid arbitrary rules, namely to prohibit recycling. ESBG emphasizes that this proposal will discourage investment and could mean important funding problems for the European industry (equity investments that cannot be consolidated because the proportion does not reach the minimum legal).

In addition, if the equity instrument is sold, revenue or loss will be found in OCI while cash flows should normally appear in profit and loss. In general, this prohibition results in a lack of transparency. We do not believe the proposal will provide useful information to investors as the realised gains and losses should be shown in profit and loss and not in OCI.

### ***4. The prohibition to measure at cost unquoted equity instruments***

While IAS 39 allows measurement at cost for unquoted equity instruments if the fair value is not reliably measurable, IFRS 9 requires all equity instruments - including unquoted equities - to be measured at fair value.

Finding a "fair value" for those instruments will not only be an artificial task and an unreliable task (i.e. difficult and costly to assess because of the lack of reliable inputs) but will increase volatility in the balance sheet. The current financial crisis has highlighted the weakness of fair value for such instruments.

### ***5. The exclusion of non-recourse loans from amortised cost measurement***

The IASB explains that it excludes from amortised cost measurement an instrument where "the creditor's claim is limited to specified assets of the debtor or the cash flows from specified assets (for example, a non-recourse financial asset)" (IFRS 9. B4.16).

Fair value would be inappropriate to measure these financial assets as it would not correspond to the business model commonly used for these types of loans. These loans are originated and



managed under a contractual cash-flow business model through the collection of those cash flows. Fair value measurement would lead to recognize non realised gains that could be reversed due to the decrease of the value of the underlying asset and would introduce fluctuation in the performance of the instrument. Measuring at amortised cost with an impairment test would better portray the business model used to manage these specialized activities and be less procyclical.

**6. *Variable rate instruments with interest rate term different from the reset frequency***

IFRS 9 – “paragraph B4.13 - example for instrument B” considers that a variable rate instrument with interest rate term which is different to the reset frequency have to be measured at fair value in its entirety. Some ESBG members have loans of this kind (for example with a resetting frequency of the variable rates each 12 months but with a rate fixed at a different term e.g. 3-month Euribor).

Such loans do not contain any leverage features and are customary loan products which are in line with the national customer protection legislation. Most of these loans products are retail loans and are thus very numerous. It is impossible to measure them at fair value from practical point of view.

Fair value changes of such loans are usually not significant. These loans do not bring higher income volatility than with normal variable loans. Therefore fair value measurement is likely be also economically irrelevant.

**Conclusion**

ESBG is opposed to an endorsement of IFRS 9 step I as it stands, regardless of whether IFRS 9 is considered on a standalone basis or as part of a package. We believe the Commission should ask the IASB to change some of its proposal regarding IFRS 9 - phase 1 especially regarding the predominance of the Business Model criterion as well as on the specific comments we listed above. It is also for us of utmost importance that the measurement of financial assets and liabilities is analysed in context with revised hedge accounting rules. Finally, we think it is very important that banks have sufficient time to implement the new accounting rules of IFRS 9.

Yours sincerely,

A handwritten signature in blue ink, appearing to read 'Chris DE NOOSE'.

Chris DE NOOSE  
Managing Director