

27 March 2013

International Accounting Standards Board
30 Cannon Street
London
EC4M 6XH
United Kingdom

Submitted via the "Comment on a Proposal" Page at www.ifrs.org

Dear Sir / Madam,

The Association for Financial Markets in Europe (AFME) welcomes the opportunity to comment on the International Accounting Standards Board's (IASB) Exposure Draft ED/2012/4 Classification and Measurement: Limited Amendments to IFRS 9 ("the ED"). AFME represents a broad range of European and global participants in the wholesale financial markets. Its members comprise pan-EU and global banks as well as key regional banks and other financial institutions. AFME advocates stable, competitive and sustainable European financial markets, which support economic growth and benefit society.

Overall, we continue to support the classification of financial instruments on the basis of an entity's business model, which is incorporated in IFRS 9, and also support the IASB's efforts in the ED to extend the definition of contractual cash flows that are solely payments of principal and interest (SPPI). We also appreciate the IASB's attempts to enhance convergence with US GAAP and provide more flexibility to the classification and measurement of financial instruments by introducing the fair value through other comprehensive income (OCI) category.

However, we would like to express our concern that the introduction of an additional measurement category for financial assets and the associated quantitative tests (e.g. SPPI test) will add unnecessary complexity to the classification model and will accordingly detract from one of the original objectives of IFRS 9 to simplify existing classification and measurement.

Furthermore, we believe that the addition of the fair value through OCI category could significantly narrow the range of instruments that qualify for amortised cost measurement and will accordingly put considerable stress on a firm's ability to sell assets held under the amortised cost model. Consequently, we are concerned that the proposed introduction of the fair value through OCI category may lead to inappropriate measurement of such financial instruments.

Our detailed response to the ED is set out in Appendix.

We hope the above comments are helpful. We would of course, as always, be pleased to discuss any points which you may find unclear, or where you believe AFME members might be able to assist in other ways.

Yours faithfully,

A handwritten signature in black ink that reads "R Middleton". The signature is written in a cursive, slightly slanted style.

Richard Middleton
Managing Director, Tax & Accounting

APPENDIX

Background

The ED/2012/4 Classification and Measurement: Limited Amendments to IFRS 9 (Exposure Draft) has nine questions. The questions are repeated here for ease of reference.

Contractual cash flow characteristics assessment: a modified economic relationship between principal and consideration for the time value of money and the credit risk

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?

We welcome the objective of the ED, which clarifies the current guidance on the contractual cash flow characteristics assessment. We also agree that an instrument with a modified economic relationship between principal and consideration for the time value of money and credit risk can contain cash flows that are solely payments of principal and interest.

We note, however, that the amendment does add some complexity to IFRS 9, in that it introduces a quantitative test into the classification model.

Some members have further noted that the requirement that contractual and benchmark cash flows be not more than 'insignificantly different' is not clearly defined; furthermore, no explicit definition of benchmark instruments is provided. Those members therefore suggest that additional clarification of those concepts would facilitate a more consistent interpretation and application of them to the business models as proposed in IFRS 9.

Some AFME members also believe that application of the new model, even with the modified economic approach, could lead to fewer instruments qualifying to be held at amortised cost than is currently the case (e.g. the allowable leverage will be less than is currently permitted). Given that the ability to hold part of an instrument (i.e. the debt host) at cost via bifurcation no longer exists under IFRS 9, those members believe that the proposed amendment will lead to an inappropriate measurement basis for many instruments, such that instruments which are managed on an amortised basis can no longer be measured consistently. These members believe there is no convincing rationale that should prevent instruments currently accounted for at amortised cost from remaining in that measurement category under IFRS 9 if the business model is to collect contractual cash flows.

Therefore, those members believe that the “SPPI test” should take into account features currently permitted by the “closely related” notion (e.g. the “double-double” test for interest rate related features). In addition, this would provide a consistent approach for identifying leverage in both assets and liabilities given that the current (IAS 39) approach has been retained for the latter.

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?

Notwithstanding our reservations above regarding the added complexity that a quantitative test introduces, we support the IASB’s aim of providing broad guidance on both when such a test is necessary and what it should consist of. Further, as noted in our response to question 1, some members believe that the SPPI test should take into account the existing guidance on embedded derivatives. However, we do not believe that detailed rules should be given, but that the concepts should be clearly defined to enable reporting entities to apply their judgement to individual fact patterns.

Further, we believe that the assessment of a modified economic relationship is only applied at initial recognition and doesn’t need to be continuously assessed; it would be helpful to clarify this point in the final standard.

Finally, we note that some examples in the proposed amendment seem to imply that when assessing a modified economic relationship there would only be one benchmark instrument against which to make a comparison (e.g. B4.1.9B). Whilst we accept that in some cases this may be correct, we believe that it is possible for there to be more than one benchmark instrument in some instances. We therefore suggest that this possibility be reflected in the guidance.

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?

While the proposed amendments would be helpful in clarifying the application of the contractual cash flow characteristics assessment to financial assets that contain interest rate mismatch features as compared to the current version of IFRS 9, we believe that the IASB’s objective has not been completely achieved, given the concerns expressed above and the points noted below.

We are still concerned about the narrow definition of payments that can be included in an instrument that qualifies for amortised cost treatment. We note that:

- Many instruments include payments in respect of fees and expenses which should not disqualify them from this classification;
- The definition of interest is too narrow and should include other factors generally included in interest such as liquidity risk, etc.

In addition, some of our members have noted that certain rate regulated products (where, for instance, the rate is set at the discretion of the government), or other instruments (for example, instruments that have remote deferral features or small measures of mismatch (e.g. CMSs, etc)) that are managed on an amortised cost basis, might not meet the criteria in the proposed amendment for such treatment and will accordingly be forced into the fair value through profit and loss category. In these cases, it may not be possible to prove that the interest payment is set entirely as compensation for the time value of money, even though there is no evidence to the contrary or that any other risk or non-closely related derivative feature is embedded in the instrument. Consequently, these members believe that amortised cost is the most appropriate measurement basis for such instruments.

Business model assessment: the 'fair value through other comprehensive income' measurement category for financial assets that contain contractual cash flows that are solely payments of principal and interest

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?

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?

Overall, we are supportive of the approach in IFRS 9 and, in particular, the use of the business model as a criterion for classification; however we have some concerns over the definition of the business model.

In our view, the business model classifications as currently defined do not correspond to how entities manage their business. For example, entities would rarely define their business model as to “manage assets both in order to collect contractual cash flows and for sale”. This would tend to be an approach that is a result of another business model – for example to hold assets to match a liability portfolio or a required investment profile. Consequently, entities will need to consider whether their business model is likely to generate results that will allow the instruments held by those businesses to be appropriately classified in the fair value through OCI, amortised cost or fair value through profit and loss categories.

Some members are concerned that the addition of the fair value through OCI category will narrow the scope of the amortised cost category. They believe that the introduction of this third category will put considerable stress on an entity’s ability to sell assets held under the amortised cost model in any way that isn’t just deemed incidental to the model. Those members interpreted the amortised cost category in the original version of IFRS 9 as allowing a higher level of sales triggered by business model drivers, such as concentration risk, which they did not view as incompatible with the concept of holding assets in order to collect contractual cash flows; those members would therefore argue that the sales mentioned above are not significant as they do not detract from the business model.

Our members also believe that there is a clear distinction between:

- Sales at the request of regulators; and
- Sales at the discretion of the entity.

In our view, sales at the request of a regulator should not be determinative of an entity’s business model.

In addition, paragraph B4.1.3 proposes that an ‘entity may sell a financial asset if the credit quality of the financial asset has deteriorated such that it no longer meets the entity’s documented investment policy’ and notes that such sales are not inconsistent with a business model whose objective is to hold financial assets in order to collect contractual cash flows. Some of our members believe that this proposal should be extended to include sales due to **expected** credit deterioration without compromising the amortised cost classification. The current proposal appears to require assets to be held until a credit loss has been incurred, which is not consistent with either management practice or with the IASB’s new proposals for the impairment of assets.

Finally, some members are concerned that the interpretation of the ED could lead to requirement for a portfolio that a bank originated with the intention to hold, but with the possibility of a future sale (e.g. a possible securitisation), to be measured at fair value through OCI instead of measurement at amortised cost.

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?

We welcome the additional clarity that is provided in paragraph B4.1.6 of the ED on portfolios that would not meet the definition of fair value through OCI. We are still concerned, however, that some portfolios that are managed on a fair value basis might inadvertently meet the criteria for recognition at fair value through OCI.

It is not clear to our members whether being managed on a fair value basis would automatically lead to the assumption that collection of contractual cash flows is incidental, would create a rebuttable presumption that collection of contractual cash flows is incidental or requires the relevant criteria to be assessed independently on a case-by-case basis.

Our members in general believe that assets which are managed on a fair value basis should not meet the criteria for the fair value through OCI classification and should accordingly be measured at fair value through P&L without the need for a fair value option.

However, if being managed on a fair value basis does not mean that an asset fails the criteria for the fair value through OCI classification, then we believe that the fair value option needs to be restored for such items instead of this being restricted to accounting mismatch situations as is currently proposed.

In addition, our members also believe that the fair value option should be available for assets whose designation changes as a result of a business model change, which could occur at times other than on initial recognition, and that this should be clarified in the final standard.

Early application

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 (ie 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?

We agree that once the completed version of IFRS 9 is issued, entities that choose to early adopt IFRS 9 should be required to apply the completed version. We also believe that the six month period between the issuance of the completed version of IFRS 9 and the prohibition on newly applying previous versions of IFRS 9 becoming effective will be sufficient.

Notwithstanding the above, we note that many of our members are global firms and are accordingly required to apply other accounting standards in addition to IFRS. Therefore, we encourage the IASB to liaise with other standards setters and to coordinate the implementation of their respective accounting standards.

Presentation of 'own credit' gains or losses on financial liabilities

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?

As noted in our previous comments to the IASB, we strongly support the own credit provisions in IFRS 9. We note, however, that in practice the objective of those provisions might be achieved more easily and quickly if they were included in IAS 39.

We also believe that where profits and losses on an entity's issued debt instruments due to changes in its own credit are realised, then these should be recycled through the profit and loss account. Indeed we consider that the arguments set out in the Basis for Conclusions to the ED at BC24 and BC25 to support the recycling of gains or losses accumulated in other comprehensive income in respect of financial assets measured at fair value through OCI could equally be read as supporting the recycling of gains or losses recognised in OCI for financial liabilities designated under the fair value option. Furthermore, recycling of such gains and losses for financial liabilities would make their treatment consistent with that applied to realised gains and losses on similar liabilities measured at amortised cost.

First-time adoption

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?

Although we believe that many of the issues relating to adoption are covered in Questions 7 and 8 above, and are not unique to first-time adopters of IFRS, we agree with the IASB's comments in paragraph BC 113 of the ED that there are also some unique considerations for first-time adopters. Accordingly, we support the IASB's proposal to reconsider transition for first time adopters once re-deliberations on the ED are complete and the Impairment project has progressed sufficiently.