Post-implementation Review IFRS 9 *Financial Instruments* Update on Working Group Consultations

Objective

1 The objective of this session is to:

(a) provide EFRAG TEG-CFSS members with an update on the IASB work with regard to the Post-Implementation Review (PIR) of IFRS 9 *Financial Instruments;*

(b) discus the initial feedback received from working groups; and

(c) prepare the messages that EFRAG can bring at the upcoming ASAF meeting.

Background

2 The effective date of IFRS 9 was set as annual reporting periods beginning on or after 1 January 2018. Insurers and EU financial conglomerates have the possibility to defer the application date of IFRS 9 till 1 January 2023 (subject to fulfilling particular conditions).

3 In October 2020 the IASB decided to begin the PIR of the IFRS 9 classification and measurement requirements, but not to begin the PIR of the Standard's impairment and hedge accounting requirements.

4 The objective of the PIR of IFRS 9 - Classification and Measurement is to:

(a) assess whether the requirements introduced by IFRS 9 have improved financial reporting (without disproportionate cost); and

(b) identify lessons learned that will help the IASB in its efforts to continuously improve its standard-setting.

5 In assessing whether the requirements have improved financial reporting, the IASB will consider the following questions:

(a) are the requirements working as intended?

(b) are the requirements capable of being applied consistently? and

(c) are there any significant unexpected effects, either positive or negative?

Preparatory Activities of EFRAG Secretariat

6 The EFRAG Secretariat has consulted the following working groups in order to collect information on issues that are to be considered by the IASB during the post-implementation review of IFRS 9. In addition, the EFRAG Secretariat had a meeting with the IFRS 9 Task Force of Accountancy Europe.

ACE IFRS 9 Task Force	10 February 2021
EFRAG Academic Panel	11 February 2021
EFRAG User Panel	16 February 2021
EFRAG FIWG	24 February 2021
EFRAG IAWG[1]	2 March 2021

7 The scope of the PIR is limited to the Classification and Measurement requirements of IFRS 9. However, at the request of EFRAG TEG in its 19 January 2021 meeting, the EFRAG outreach is expanded to cover the hedge accounting requirements. This to provide input into the Dynamic Risk Management (DRM) project.

Further work on prevalence

8 At the EFRAG FIWG meeting it was suggested to support the qualitative inputs with material on the prevalence of issues by consulting a database. The EFRAG Secretariat welcomes this suggestion. Although it may be difficult to organise in sufficient time for the March ASAF meeting, the quantitative update could be submitted to the IASB after that.

IFRS 9 is a complex standard

9 Both from users and academics the message was provided that IFRS 9 is very complex to understand as well as to compare the financial statements of entities that report under IFRS 9. Some consider therefore that the aim of increased transparency has not been fulfilled.

List of issues identified

10 The working groups have identified the following issues on classification, measurement, and hedging requirements of IFRS 9 for the post-implementation review of IFRS 9 and the DRM project. A short description of the issues can be found in Appendix I. Appendix 2 contains a list of academic literature provided by the Academic Panel.

	Issue identified	***Working group***	***Working group opposing view***
1	***Classification and measurement***		
1	*Equity instruments measured at FVOCI without impairment and recycling – long term financing*	*Academic Panel* *FIWG*	*User Panel*
2	*Sustainable finance – SPPI test*	*FIWG, ACE*	

[1] The inputs from EFRAG IAWG will be provided orally during the meeting as the IAWG meeting takes place the day before the EFRAG TEG-CFSS meeting.

	Issue identified	***Working group***	***Working group opposing view***
3	*SPPI – use of administrative rates – using rates other than benchmark rates*	*FIWG, Written input*	
4	*Business model – boundary HTC /HTCS (liquidity buffers banks – loan syndicates)*	*FIWG, ACE, written input*	
5	*Business model – sales - COVID*	*ACE, FIWG*	
6	*Contractually linked instruments – non-recourse*	*FIWG, ACE*	
7	*Reclassification and IFRS 5 – scope of IFRS 9*	*FIWG, ACE*	
8	*Credit risk*	*FIWG*	
9	*Variable rates*	*FIWG*	
10	*Comparatives – financial instruments derecognised at initial application*	*FIWG*	
11	*Prepayments*	*FIWG*	
12	*Modifications of cash flows*	*FIWG*	
13	*Treatment of equity instruments*	*Written input*	
14	*Embedded derivatives*	*Written input*	
15	*Reporting gains on gross basis*	*Written input*	
16	*Benchmark test for last-reset rates due to IBOR reform*	*Written input*	
17	*Measurement of derivatives to meet obligations to policyholders*	*Written input*	
18	*Varia: dealing with COVID moratoria - accounting for TLTRO III – issues related to BMR*	*Written input*	
2	***Hedge accounting***		
20	*Use of carve-out*	*FIWG*	*User Panel* *Academic Panel*
21	*Use of fair value option when hedging credit risk*	*ACE*	
22	*Treatment of credit risk*	*ACE*	
23	*Cash flow hedge – highly probable test*	*ACE*	
24	*Cash flow hedge in currency other than functional currency*	*Written input*	

	Issue identified	***Working group***	***Working group opposing view***
25	*Fair value hedge on a subsidiary classified as non-current assets held for sale*	*Written input*	

Questions for EFRAG TEG-CFSS

11 Do EFRAG TEG-CFSS members have comments on the points raised by the different working groups?

12 Do EFRAG TEG-CFSS members agree to submit the issues and academic research identified to the IASB at the upcoming ASAF meeting?

13 Do EFRAG TEG-CFSS members agree to provide a quantitative update to the IASB subsequent to the ASAF meeting?

14 Of the issues received only through written input, do EFRAG TEG-CFSS members agree to assess these first before submitting to the IASB?

Appendix I: Description of the issues

Issue 1 - Equity instruments measured at FVOCI

15 In accordance with IFRS 9, entities can measure equity instruments at FVOCI. Gains and losses on these instruments cannot be recycled to P&L which does not permit to show the performance achieved in line with the long-term business model. The use of the FVOCI without recycling for equity instruments is seen by users as bringing useful information.

16 In contrast, preparers have a different view and note that the prohibition of recycling gains and losses on disposals into P&L may have detrimental effects on long-term investments. Moreover, a FVOCI measurement with no recycling is not relevant to measure performance of such instruments regards to their business model.

Issue 2 – Sustainable finance – SPPI test

17 IFRS 9 does not currently specify if sustainable products[2] should be account at fair value even when they fail the SPPI test as it may trigger additional regulatory capital considerations. Banks might be indirectly discouraged from mainstreaming this type of lending.

18 Incorporating ESG[3] factors and risks into the business model analysis and definition could improve the long-term business strategies to mitigate and reduce environmental harmful activities and promote environmentally sustainable activities. Preparers noted that the alignment of the accounting to the business model may have positive effects on long-term sustainable investments.

Issue 3 - SPPI test – use of administrative rates

19 It was noted that more and more financial instruments with so called administrated rates are being issued on the market. Due to the absence of term structure in such rates problems arise in coping with the SPPI test, triggering a need for further guidance (in addition to IFRS 9.B.41.9E).

20 In addition, some note the SPPI test receives too much focus in the standard: many loans to corporates and SME's and retail loans are priced using a mechanism other than relying on benchmark rates.

Issue 4 – Business model – boundary HTC/HTCS (held to collect/held to collect and sell)

Liquidity buffers of banks

<u>Transfer between banking departments (written input)</u>

21 In the context of liquidity management, an Investment Banking department may purchase on the wholesale market securities that are resold to the Group's Retail entities for liquidity portfolio management. The limitation of circumstances that are considered as reclassifications of financial assets generates mismatches between the valuation of securities purchased on the wholesale market and these same securities resold within the group. Securities that are valued at fair value in respect of the Investment Banking activity, can no longer be valued at amortised cost when they are transferred to Group entities or departments that intend to hold them for the purpose of a "hold to collect" business model. To be eligible for amortised cost, these securities would have to be purchased by the entities or departments directly on the market, in most cases at a higher cost. The fact not to recognise

[2] Green bonds, green loans, green deposit products etc.

[3] Environmental, Social or Governance characteristics that may have a positive or negative impact on the financial performance or solvency of an entity, sovereign or individual.

reclassifications of financial assets between departments or entities within a group does not accurately reflect the economic purpose of the transactions.

Reclassification in periods of stress

22 In cases of market stress the classification of these bonds can vary significantly depending on the business model chosen. It was noted that for financial assets – part of a liquidity buffer of a bank – the reclassification requirements in these circumstances are a too high hurdle and the change is very difficult to demonstrate to external parties.

23 It was suggested to identify the HTC business model as a default category, while FVPL would be redefined as trading.

Loan syndications (written input)

24 Concerning loan syndications, the objective for the bank is to define, prior to the syndication, the portion of the loans retained, and the portion of the loans sold, in order to apply to the former a “hold to collect” business model and to the latter a “collect and sell” or “hold to sell” business model. However, it is not uncommon that some of the loans that were initially to be sold are not sold and that, as a result, the bank decides to retain them and allocate them to “hold to collect” portfolio. In this case, these loans will have to be valued at fair value over their entire life excluding amortized cost measurement because of the initial intent. This does not correspond to the management objective of a “hold to collect” business model that will prevail until the end of the life of these outstanding loans.

Issue 5 – Business model – sales - COVID

25 Diversity in practice occurs on how to assess “frequent and significant sales” of financial assets under the business model held to collect.

26 In the context of COVID, more guidance is sought on how to assess changes in business models (whether sales of financial assets under the business model held to collect are permitted sales).

Issue 6 – Contractually linked instruments – non-recourse

27 IFRS 9 contains requirements (paragraph B.4.1.20 and following) for debt instruments issued in tranches whose terms create concentrations of credit risk and a special exception for loans that pay a negative interest rate. The payments on these financial assets are contractually linked to payments received on a pool of other instruments.

28 Diversity in practice is noted with application of the non-recourse guidance and contractually linked instruments. More detailed guidance is needed to resolve these inconsistencies in particular with regard to the scope of applying the “look through to” approach.

(a) Non-recourse vs contractually linked:

The contractually linked definition could be seen as very broad with no explicit guidance on what constitutes a tranche. In order to distinguish between non-recourse financing and contractually linked, some believe it is necessary to consider the nature and substance of an arrangement.

(b) Interpretation of contractually linked guidance:

The contractually linked guidance requires the underlying pool to ‘contain one or more instruments that give rise to cash flows that are solely payments of principal and interest on the principal amount outstanding’. The key question to some is what constitutes an ‘instrument’ for the purposes of contractually linked guidance guidance.

29 The issue reported is also related with the reclassification requirements as it is argued by some that a change in processes would also qualify as a change in business model.

30 Also the look-through approach is considered difficult in some cases, as the required details are not available for every line of underlying investments.

Issue 7 – Reclassification and IFRS 5 – scope of IFRS 9

31 The measurement provisions of IFRS 5 scope out financial assets within the scope of IFRS 9. It is noted that the interaction between the strict reclassification requirements under IFRS 9 and the scope of IFRS 5 create issues in case where there is a restructuring. In such situations, losses are sometimes not recognised early enough.

Issue 8 – Credit risk

32 Diversity in practice is noted how entities disclose their credit risk exposure between financial assets measured at FVPL and those measured at FVOCI.

Issue 9 – Variable rates

33 It was noted that the IFRS 9 paragraphs B.4.5.5. and B.4.5.6 provide insufficient guidance to assess variables rates in some circumstances.

Issue 10 - Comparatives – financial instruments derecognised at initial application

34 At transition, IFRS 9 cannot be applied to items that have already been derecognised at the date of initial application. Insurance entities applying IFRS 9 and IFRS 17 together as from 2023 would prefer to provide full comparative information on IFRS 9 requirements.

Issue 11 - Prepayments

35 Diversity in practice was noted in how entities apply the guidance on prepayment features with negative compensation.

Issue 12 – Modifications of cash flows

36 The guidance on modification of cash flows for financial assets is considered to be insufficient.

Issue 12 – Treatment of equity instruments

37 It was noted by some that the FVPL measurement of equity-type instruments such as funds introduces volatility that cannot be hedged. In addition, fair valuing certain untraded equities is considered difficult (companies whose value of shareholder equity is not equivalent to its liquidation value as a consequence of contractual agreements with shareholders or due to state regulations such as Mutual Guarantee Companies).

Issue 13 – Embedded derivatives

38 The lack of bifurcation of embedded derivatives on financial assets is noted to limit the possibility as a bank to act as a liquidity agent in issuances of own structured notes (as repurchasing the portfolio from clients does not pass the SPPI-test and hence leads to a FVPL measurement).

Issue 14 – Reporting gains on gross basis

39 The performance of the banks is not reflected when there is an obligation of the banks to allocate gains on gross basis to certain beneficiaries. In addition, those gains on debt instruments sold should be reported on a gross basis in the PL when such gains are not distributable to banks' shareholders.

40 According to some, this information is not useful enough mainly related to insurance activities.

Issue 15 – Benchmark test for last-reset rates due to IBOR reform (written input)[4]

41 Entities may identify the need to perform the SPPI benchmark test for significance of interest mismatches between:

(a) the last reset rates containing a time lag feature due to being calculated and known in advance at the start of the current interest period as averages of risk-free overnight rates over the previous interest period; and

(b) rates representing time value of money due to being calculated based on the risk-free rates development in the current interest period (known at the end of the period).

42 The issue would arise separately for:

(a) legacy portfolios which are subject to the IBOR rates replacements falling back to the last rest rates; and

(b) new portfolios where entities decide to use the last reset rates.

43 The issue raised is:

(a) whether and to what extent the need to perform the quantitative benchmark test arises and whether this brings any inappropriate burden to entities;

(b) whether there are any failures in the SPPI benchmark test resulting in non-SPPI financial assets measured at FVPL to the extent which entities would not consider as appropriate since they deem them as basic lending agreements from business perspective

Issue 16 - Measurement of derivatives to meet obligations to policyholders (written input)

44 As an alternative to the application of hedge accounting, the current classification and measurement requirements in IFRS 9 for derivatives could be reviewed to better reflect the risk management, in particular of the interest rate risk, that insurance companies have had in place for a very long time. Measuring all derivatives at FV-PL leads to volatility and is difficult to explain the performance when all the remaining investment portfolios of insurers will be measured at FV-OCI. As an alternative treatment, a specific scope of derivatives could be measured at FV-OCI if certain conditions are met.

Issue 17: Varia: dealing with COVID moratoria - accounting for TLTRO[5] *III – issues related to BMR*[6]

45 No further information provided.

Hedge accounting

Issue 20 – Use of carve out

46 Most of European banks are currently applying the carve-out of IAS 39 for macro hedge account, for that reason is difficult to assess whether the current IFRS 9 requirements have improved financial reporting. The use of the carve out is seen by preparers as bringing useful information (under IAS 39). However, those corporates

[4] The issue of application of the SPPI test to particular rates has been discussed at EFRAG TEG and FIWG in the course of drafting the comment letter on the Phase 2 exposure draft (ED/2020/1). EFRAG concluded that an assessment of such rates would go beyond the scope of the IBOR project and is rather a general issue in the context of SPPI assessment.

[5] TLTRO : Targeted longer-term refinancing operations

[6] BMR : Benchmark Regulation

that are applying IFRS 9 hedge accounting, experience an improvement in regards with IAS 39 hedge accounting.

47 In contrast, users and academics have a different view and note that insufficient information is provided about the current hedge accounting practices. Some users were seeking a qualitative description of the risks, how the entity is dealing with those risks and how the results of the hedging strategy is reflected in the accounts. In addition, some users are looking for a sensitivity analysis in terms of "what would have been the result/balance sheet without hedging and with hedging".

Issue 21 – Use of fair value option when hedging credit risk

48 In case an entity uses a credit derivative to manage credit risk of underlying bonds, the underlying bonds are measured at FVPL. In practice, some choose bonds with important unrealised gains or losses resulting in earnings steering (all unrealised gains or losses are considered, not only the ones since designation of the credit derivative).

Issue 22 – Treatment of credit risk

49 Some argue that -because of the progress that has made in measuring credit risk – the treatment of credit risk in the hedge accounting requirements should be re-assessed.

50 In addition, it is noted that for entities with listed CDS it is reasonable to consider the credit risk to be identifiable and hence the possibility of the credit risk associated to the debt issued by such entities being an eligible hedged item.

Issue 23 – Cash flow hedge – highly probable test

51 Reference is made to the IFRIC agenda decision relating to "Application of the Highly Probable Requirement when a Specific Derivative is Designated as a Hedging Instrument" March 2019

52 It is noted by some that the highly probable criterion in this situation (forecast energy sales) is irrelevant. Hence, specific guidance is asked for to deal with such situations.

Issue 24 – Cash flow hedge in currency other than functional currency

53 Currently it is possible to establish an accounting hedge of currency (such as currency swaps) other than in the functional currency of the entity in a net position. When an entity issues a debt in a currency other than the functional it would be more convenient to hedge directly in the currency other than the functional rather than hedge the exchange risk.

Issue 25 - Fair value hedge on a subsidiary classified as non-current assets held for sale

54 The possibility of establishing a fair value hedge on an investment in a subsidiary when it fulfils the requirements to be classified as Non-Current Assets Held for Sale should be considered, as in this case variations in the investment's fair value can affect the year's statement of profit or loss. In cases in which the subsidiary is classified as a Non-Current Assets Held for Sale, the Cash Flow hedges can generate an accounting imbalance until the highly probable operation is carried out.

Appendix II: List of Academic Literature identified by Academic Panel

Transition to IFRS 9 / general impact on value relevance

55 ElKelish, W.W. (2021) The International Financial Reporting Standards 9 financial instruments, information quality and stock returns in the modern technology era, Journal of Applied Accounting Research

56 Huttenhuis J, ter Hoeven R (2017) Gevolgen van invoering IFRS 9: Europese banken onder de loep. Maandblad Voor Accountancy en Bedrijfseconomie 91: pag. 29-28.

57 Huttenhuis J, ter Hoeven R (2018) De invoering van IFRS 9 bij Europese banken; Een vervolgstudie. Maandblad Voor Accountancy en Bedrijfseconomie 92(11/12): pag. 329-344.

58 Huttenhuis J, Bout B-J, ter Hoeven R (2019) IFRS 9 en Europese banken; het eerste toepassingsjaar verslagen. Maandblad Voor Accountancy en Bedrijfseconomie 93(11/12): pag. 343-359.

59 Loew, Edgar and Schmidt, Lisa E. and Thiel, Lars F, (2019) Accounting for Financial Instruments under IFRS 9 – First-Time Application Effects on European Banks' Balance Sheets. European Banking Institute Working Paper Series 2019 – no. 48.

60 Mechelli, A., & Cimini, R. (2020). The effect of corporate governance and investor protection environments on the value relevance of new accounting standards: the case of IFRS 9 and IAS 39. Journal of Management and Governance, pag. 1-26.

61 Mechelli, A., Sforza, V., & Cimini, R. (2020). Is IFRS 9 better than IAS 39 for investors' decisions? Evidence from the European context at the beginning of the transition year. *Financial Reporting¸*2020 (1), pag. 125-148.

62 Novotny-Farkas, Z. (2016) The Interaction of the IFRS 9 Expected Loss Approach with Supervisory Rules and Implications for Financial Stability, Volume 13, 2016 – Issue 2

63 Onali, E., & Ginesti, G. (2014). Pre-adoption market reaction to IFRS 9: A cross-country event-study. Journal of Accounting and Public Policy, 33(6), pag. 628-637.

Classification and measurement

64 Albrahimi, A. (2020) Loan loss provisioning and market discipline: Evidence from IFRS 9 adoption

65 Bischof, J., Brüggemann, U., & Daske, H. (2014). Fair value reclassifications of financial assets during the financial crisis. SSRN Working Paper Series.

66 Bratten, B., Causholli, M., & Khan, U. (2016). Usefulness of fair values for predicting banks' future earnings: evidence from other comprehensive income and its components. Review of Accounting Studies, 21(1), pag. 280-315.

67 Fiechter, P. (2011). Reclassification of financial assets under IAS 39: impact on European banks' financial statements. Accounting in Europe, 8(1), pag. 49-67.

68 Fiechter, P., & Novotny-Farkas, Z. (2017). The impact of the institutional environment on the value relevance of fair values. Review of accounting studies, 22(1), pag. 392-429.

69 Paananen, M., Renders, A., & Shima, K. M. (2012). The amendment of IAS 39: determinants of reclassification behavior and capital market consequences. Journal of Accounting, Auditing & Finance, 27(2), pag. 208-235.

70 Thinggaard, Wagenhofer, Araceli, DiPietra & others (2006) Performance Reporting – The IASBs proposed formats for financial statements in the exposure draft of IAS, Accounting in Europe, vol. 3, 2006

Hedge accounting

71 Glaum, M., & Klöcker, A. (2011). Hedge accounting and its influence on financial hedging: when the tail wags the dog. *Accounting and Business Research,* 41(5), pag. 459-489.

72 Hartmann, Marton & Söderström (2018) The improbability of fraud in accounting for derivatives: a case study on the boundaries of financial reporting compliance. 27(5) pag. 845-873.

73 Muller, V., (2020) Hedge Accounting and its Consequences on Portfolio Earnings. A simulation study, Accounting in Europe, 2020 Vol. 17, No. 2, pag. 204-237.