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EFRAG Draft Comment Letter on the IASB's Request for Information *Post-implementation Review IFRS 9 Financial Instruments – Classification and Measurement*

Dear Jean-Paul,

Thank you for sharing with us EFRAG's draft comment letter on the IASB's Request for Information *Post-implementation Review IFRS 9 Financial Instruments – Classification and Measurement*.

In summary, we believe that the issues raised and views taken in your draft comment letter are in full alignment with our perception of the key issues for the post-implementation review. For your reference, please find attached our comment letter that we have submitted to the IASB today on behalf of Allianz Group.

If you have any questions or if you would like to discuss our comment letter in further detail, please feel free to contact Job Schöningh (job.schoeningh@allianz.com) or us.

Yours sincerely,

Dr. Roman Sauer
Head of Group Accounting & Reporting

Andreas Thiele
Head of Group Accounting Policy Department

Attachment: Allianz Group's Comment Letter on the IASB's Request for Information *Post-implementation Review IFRS 9 Financial Instruments – Classification and Measurement*

Chairman of the Supervisory Board: Michael Diekmann.
Board of Management: Oliver Bäte, Chairman;
Sergio Balbinot, Sirma Boshnakova, Dr. Barbara Karuth-Zelle, Dr. Klaus-Peter Röhler, Ivan de la Sota,
Giulio Terzariol, Dr. Günther Thallinger, Christopher Townsend, Renate Wagner, Dr. Andreas Wimmer.
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Invitation to comment on the IASB's Request for Information *Post-implementation Review IFRS 9 Financial Instruments – Classification and Measurement*

Dear Andreas,

We appreciate the opportunity to comment on the IASB's Request for Information *Post-implementation Review IFRS 9 Financial Instruments – Classification and Measurement* (herein referred to as 'RfI'). This comment letter summarizes the Allianz Group's key positions on the questions addressed in the RfI.

Overall, the classification and measurement requirements in IFRS 9 are suitable to align the measurement of financial instruments with their contractual cash flow characteristics and the way the entity manages them. As such, IFRS 9 generally provides users of financial statements with useful information about the amount, timing and uncertainty of the entity's future cash flows.

Notwithstanding this, it is our perception that the current IFRS 9 measurement rules for equity and equity-type financial instruments do not always adequately reflect the holders' applicable business model, especially if the holders are long-term investors such as insurance entities.

In particular, the existing prohibition to reclassify gains or losses that arise upon disposal of an investment in an equity financial instrument into P&L adversely affects the faithful representation of the long-term investors' financial performance. Therefore, we strongly support overcoming the current prohibition of OCI recycling for equity financial instruments and replace the existing model with

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a FVOCI option that entails OCI recycling. In the light of this, we agree that a FVOCI with recycling solution should be accompanied by a robust impairment model.

We have provided more detailed considerations with regards to the proposed FVOCI with recycling approach in our answer to question 4, including our suggestions for the establishment of a robust impairment model.

In this context, we would also like to point out that we support the idea that investments in equity instruments should generally be treated alike, regardless of whether they are held directly by an entity or indirectly, e.g. via an investment fund. Therefore, we conclude that the mentioned proposals with regards to the FVOCI accounting treatment should also apply accordingly to units of funds and puttable instruments that invest in equity instruments, associated derivatives and necessary cash holdings.

Moreover, we acknowledge that the application of the SPPI cash flow criterion to new types of investments such as sustainability-linked bonds may be challenging. Although Big4 audit firms have published interpretative guidance with regards to these instruments, the application of this guidance requires considerable judgement by the entity, which may lead to diversity in practice. As a consequence, we propose to enhance the current IFRS 9 rules with specific classification guidance for these types of investments but abstain from fundamental changes to the overall SPPI concept of IFRS 9.

Under the presumption that ESG linked interest rate adjustments become a more and more customary feature of debt financial instruments whose cash flows are otherwise solely payments of principal and interest, this feature could be viewed as a common element of a basic lending arrangement which, as such, does not violate the SPPI criterion. Please refer to our answer with regards to question 3 for further details.

As indicated, the appendix to this letter sets out our view and detailed comments on the specific questions posed in the RfI, with a focus on the issues which are of particular relevance for us.

We hope that our feedback is helpful for your further deliberations. Please feel free to contact Job Schöningh (job.schoeningh@allianz.com) or us to discuss any matters raised in this letter.

Yours sincerely,

Dr. Roman Sauer
Head of Group Accounting & Reporting

Andreas Thiele
Head of Group Accounting Policy Department

Appendix: IASB RfI – Consultation Questions

Question 1 – Classification and measurement

Do the classification and measurement requirements in IFRS 9:

(a) enable an entity to align the measurement of financial assets with the cash flow characteristics of the assets and how the entity expects to manage them? Why or why not?
(b) result in an entity providing useful information to the users of the financial statements about the amount, timing and uncertainty of future cash flows? Why or why not?

Overall, the classification and measurement requirements in IFRS 9 are suitable to align the measurement of financial instruments with their contractual cash flow characteristics and the way the entity manages them. In this context, we concur with the view that by aligning measurement to both of these factors, IFRS 9 generally provides users of financial statements with useful information about the amount, timing and uncertainty of the entity's future cash flows

Notwithstanding this, the current IFRS 9 measurement rules for equity and equity-type financial instruments do not always adequately reflect the holders' applicable business model. This observation is of particular relevance for long-term investors such as insurance entities. Furthermore, the application of the SPPI cash flow criterion to new types of investments may be challenging, specifically in case of financial instruments whose contractual cash flows are linked to ESG target achievements. Therefore, we will focus our feedback on these aspects which are addressed in questions 3 and 4.

Question 2 – Business model for managing financial assets

(a) Is the business model assessment working as the Board intended? Why or why not?
(b) Can the business model assessment be applied consistently? Why or why not?
(c) Are there any unexpected effects arising from the business model

In our opinion, the business model assessment works as the Board intended. IFRS 9 provides sufficient guidance to conduct a consistent and sustainable business model assessment. We have not encountered any noticeable unexpected effects arising in this regard. Consequently, we share the Board's expectation that reclassifications of financial assets triggered by a change in the underlying business model will only occur in rare cases.

Question 3 – Contractual cash flow characteristics

(a) *Is the cash flow characteristics assessment working as the Board intended?* Why or why not?
(b) Can the cash flow characteristics assessment be applied consistently? Why or why not?
(c) Are there any unexpected effects arising from the cash flow characteristics assessment? How significant are these effects?

In general, we conclude that the cash flow characteristics assessment works as the Board intended and that it can be applied consistently. However, as indicated in the RfI, the surge of new types of financial instruments with sustainability-linked features poses new challenges to the cash flow characteristics assessment.

As outlined in the RfI, there are different types of financial instruments with sustainability-linked features. These may include so called "green bonds" that are characterized by using the principal exclusively for "green" projects but for which the achievement of ESG targets does not give rise to variabilities in the contractual cash flows.

Conversely, some instruments may be linked to green indices that are not specific to a contractual party whereas others have interest rates that change based on whether the borrower meets pre-determined ESG-targets, such as a specified level of CO_2 reduction, etc.

While we expect that the cash flow characteristics assessment of “green loans or bonds” as well as “structured instruments linked to green indices” mentioned in the RfI is rather straight-forward and can be applied consistently, the main uncertainties arise in the case of debt instruments with contractual cash flows (e.g. interest payments) linked to the fulfillment of certain, pre-determined ESG targets.

As ESG-linked investments have emerged to a noticeable extent after the publication of IFRS 9, Big4 audit firms have recently published dedicated accounting guidance to support entities in applying the general IFRS 9 principles to these types of investments. Basically, an ESG-linked debt financial asset would pass the SPPI test if the holder can demonstrate that the change in interest rate upon fulfilment or non-fulfilment of the ESG targets, as the case may be, is commensurate with the change in credit risk that is entailed with the target achievement. From a conceptual point of view, this approach is comprehensible to us and reflects the idea of a “basic lending arrangement”.

However, considerable judgement is required to make this determination. This may lead to diversity in practice. Moreover, we assume that it might often be difficult for an entity to demonstrate that the relationship between ESG target fulfilment and the change in interest rate is given. Unless the ESG-linked feature is de minimis, the instrument would fail the SPPI test in this situation, even if it is deemed to represent a basic lending arrangement in all other respects.

We believe that, on the one hand, the application of the prevailing interpretive guidance alone is not sufficient to overcome the above mentioned uncertainties and related application issues with regards to ESG-linked debt instruments. On the other hand, a fundamental change of the current IFRS 9 SPPI concept does not appear reasonable to us either. In our opinion, the potential benefits would presumably be outweighed by the costs of other knock-on effects that would be associated with such a change.

Hence, we conclude that the best approach to resolve this apparent conflict of objectives would be to enhance the current IFRS 9 classification rules by purposive guidance that specifically addresses the classification of debt instruments with contractual cash flows that are linked to the fulfilment of pre-determined ESG targets by the issuer.

Under the presumption that ESG linked interest rate adjustments become a more and more customary feature of debt financial instruments whose cash flows are otherwise solely payments of principal and interest, this feature could be viewed as a common element of a basic lending arrangement which, as such, does not violate the SPPI criterion.

Question 4 – Equity instruments and other comprehensive income

(a) Is the option to present fair value changes on investments in equity instruments in OCI working as the Board intended? Why or why not?
(b) For what equity instruments do entities elect to present fair value changes in OCI?
(c) Are there any unexpected effects arising from the option to present fair value changes on investments in equity instruments in OCI? How significant are these effects?

From the perspective of a long-term investor, like an insurance company, the option to present unrealized fair value changes on investments in equity instruments that are not held for trading in OCI rather than immediately recognizing a gain or loss in the P&L generally contributes to the decision usefulness of its financial statements. As a consequence, Allianz Group has decided to elect the FVOCI option per default, provided that the requirements according to paragraph 5.7.5 of IFRS 9 are met. Classification as measured at FVPL is only foreseen in exceptional circumstances under specified conditions (e.g. if this would eliminate or reduce an accounting mismatch).

Notwithstanding the above, the existing prohibition to reclassify gains or losses that arise upon disposal of an investment in an equity financial instrument into P&L has adverse implications on the objective of faithful representation.

Most insurers generally manage their investments either in a hold-to-collect or hold-and-sell business model. This implies (infrequent) sales of investments that are triggered by the underlying strategic asset allocation and asset-liability management decisions. From an economic perspective, the overall return profile of equity investments encompasses both, the stream of revenues from dividends as well as realized gains and losses upon disposal.

In addition, the fact that the current accounting rules for investments in equity financial instruments do not foresee any impairments, implies that the adverse impact from underperforming investments is not reflected in the income statement of a long-term investor either.

In our view, this leads to a misrepresentation of the long-term investor's asset management performance.

The OCI recycling ban on equity financial instruments is also inconsistent to the accounting treatment of investments in other asset classes. In the case of debt financial instruments as well as joint, ventures, associates, or investment property, the investor realizes gains or losses upon disposal. Therefore, it is not comprehensible for us that one asset class is treated differently from the others.

Taking this into consideration, we strongly support overcoming the current prohibition of OCI recycling for equity financial instruments.

In this context, we agree that if OCI recycling were introduced for equity instruments, it would impose the need to establish an impairment model for these instruments, as well. We noted that the RfI refers to the current IAS 39 approach for AfS financial assets and raises concerns that the impairment assessment would create "significant application problems". This perception does not coincide with our experience in applying the IAS 39 impairment rules for AfS equity investments. Over the years, preparers and auditors have developed well-established concepts on how to determine whether there is objective evidence of impairment, taking into consideration IAS 39.61 which points out that a "significant or prolonged decline in fair value of an investment in an equity instrument below its cost is also objective evidence of impairment".

We acknowledge that the Standard does not provide specific quantitative thresholds to determine what is "significant" and what is "prolonged". As a consequence, an entity needs to establish an accounting policy that defines such thresholds and to apply them consistently. In our opinion, these quantitative thresholds usually represent significant accounting policies that have to be disclosed in the notes and, as such, are suitable to provide relevant information to users of financial statements and assure faithful representation of the entity's performance.

In the RfI, the IASB expresses its concerns that the recycling of gains and losses from OCI to profit or loss on the disposal of investments in equity instruments would create opportunities for earnings management. In our view, the combination of OCI recycling with an established impairment model that needs to be applied consistently restricts the possibility to create such opportunities. Furthermore, the above mentioned accounting and disclosure requirements would make an entity's (potential) earnings management activities fully transparent to the users of the financial statements.

Currently, we are noticing discussions as to whether IFRS 9 should specify thresholds that need to be adhered to by the preparers. In our view, this would mean a deviation from the general principles-based approach of IFRS 9 by introducing a rules-based element. At Allianz Group, we strongly support the principles-based approach, but we would also not object to including specific thresholds into the Standard if this is helpful to avoid diversity in practice and to further reduce the concerns related to earnings management opportunities.

In this context, we would like to mention that the relevant accounting literature has already developed a set of quantitative criteria that may be used as points of reference for the determination of such thresholds (if considered useful). For example,

- a decline in fair value in excess of 20 percent below cost should generally be regarded as significant.
- a decline in fair value below cost that persists for nine months or more should generally be considered to be prolonged.

There could be different ways to introduce these thresholds into IFRS 9, either directly as a specified threshold or via examples in the application guidance. For instance, instead of specifying explicit bright lines, we could imagine that the Standard may provide examples of thresholds that represent clear indicators for a significant or prolonged decline in fair value (e.g. more than 25%; more than 12 months) and those that do not (e.g. less than 15%; less than 6 months). These examples could help to define a bandwidth of applicable quantitative thresholds while narrowing down the room for judgment. In this context, we would like to refer to the application examples in IFRS 10.B72, that, in our opinion, could serve as a good example case for such kind of guidance.

Another issue that arises in this regard is the treatment of equity-type financial instruments, such as certain units of funds and puttable instruments. If the holder does not have control, joint control or significant influence in these investments, the current IFRS 9 rules foresee a classification as debt financial instruments that generally fail the SPPI test, even if these funds predominantly invest in equity financial instruments and therefore respond to movements in market variables in a similar way to equity instruments held directly by the entity.

We support the idea that investments in equity instruments should generally be treated alike, regardless of whether they are held directly by an entity or indirectly via an investment fund. Therefore, we conclude that the above mentioned proposals with regards to the FVOCI accounting treatment should apply analogically in these cases. In that sense, we also support limiting this guidance to units of funds and puttable instruments that invest in equity instruments, associated derivatives and necessary cash holdings.

Question 5 – Financial liabilities and own credit

(a) Are the requirements for presenting the effects of own credit in OCI working as the Board intended? Why or why not?

(b) Are there any other matters relating to financial liabilities that you think the Board should consider as part of this post-implementation review (apart from modifications, which are discussed in Section 6)?

From our perspective, the requirements for presenting the effects of own credit in OCI work as the Board intended and we do not see the need to change the current IFRS 9 rules.

Question 6 – Modifications to contractual cash flows

(a) Are the requirements for modifications to contractual cash flows working as the Board intended? Why or why not?

(b) Can the requirements for modifications to contractual cash flows be applied consistently? Why or why not?

In our opinion the requirements for modification to contractual cash flows work as the Board intended and they can be applied consistently. Nevertheless, we support the Board's considerations to make a possible narrow-scope amendment to IFRS 9 to introduce consistent wording for the description of a modification of a financial asset and a financial liability in order to clarify the requirements for modifications.

Question 7 – Amortised cost and the effective interest method

(a) Is the effective interest method working as the Board intended? Why or why not?
(b) Can the effective interest method be applied consistently? Why or why not?

The effective interest method is an established method that has been adopted from IAS 39 without any relevant changes. As such, we have not encountered any issues when applying this method. Hence, we conclude that it works as the Board intended and can be applied consistently.

Question 8 – Transition

(a) Did the transition requirements work as the Board intended? Why or why not?
(b) Were there any unexpected effects of, or challenges with, applying the transition requirements? Why or why not?

We highly appreciate that the Board has made a narrow scope amendment to IFRS 17 to allow for a classification overlay. The classification overlay is capable of eliminating unexpected effects or challenges upon transition to IFRS 9 and 17. Taking this into consideration, we expect the transition requirements to work as the Board intended.

Question 9—Other matters

(a) Are there any further matters that you think the Board should examine as part of the post-implementation review of the classification and measurement requirements in IFRS 9? If yes, what are those matters and why should they be examined?
(b) Considering the Board's approach to developing IFRS 9 in general, do you have any views on lessons learned that could provide helpful input to the Board's future standard-setting projects and why should they be examined?

From our perspective, there are no further matters that the Board should examine as part of this post-implementation review.