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Comments on "Post-Implementation Review of IFRS 9 – Classification and Measurement"

Dear Sir/Madam,

On behalf of the Austrian Financial Reporting and Auditing Committee (AFRAC), the privately organised standard-setting body for financial reporting and auditing standards in Austria, we appreciate the opportunity to comment on the request for information "*Post-Implementation Review of IFRS 9 – Classification and Measurement*" (September 2021).

Principal authors of this comment letter were Gerhard Margetich, Michael Bergthaler, Peter Bitzyk, Iryna Bura, Michael Hammer, Philip Kudrna, Julia Newertal, Elisabeth Renner, Katharina Wagner and Sabine Weintögl. In order to ensure a balanced Austrian view on the request for information, the professional background of these authors is diverse and includes preparers, auditors and academics.

General Remarks

In general, we think that the requirements in IFRS 9 regarding the classification and measurement of financial instruments address the problems and criticism which were discussed in connection with IAS 39. We think that the concept of combining the cash flow characteristics of assets with an entity's business model introduces a less rule-based but rather fundamental approach and forms a good basis for aligning the measurement of financial instruments with the way the entity manages them. However, we identified a number of areas which require attention.

The classification requirements are being applied rather static, as subsequent changes to management's intentions are not reflected sufficiently in the business model concept. This leads to difficulties in applying this concept consistently over time in accordance with management's intentions.

We think that the IASB should evaluate whether the classification and measurement principles are robust and clear enough in order to keep up with recent and future market developments. In particular, the evolving market of sustainable finance indicates difficulties for the application of the concept of IFRS 9 in accordance with current and developing market practices.

More detailed remarks can be found in the specific remarks section below.

SPECIFIC REMARKS

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?

(a) AFRAC believes that the classification and measurement requirements in IFRS 9 partially enable an entity to align the measurement of financial assets with the cash flow characteristics of the assets and with the way the entity expects to manage them. However, there are several aspects of the classification and measurement requirements – including unexpected effects arising from the application of the rules – that, in our view, need further discussions. For more details, please refer to our answers to the following questions.

(b) Overall, the classification and measurement requirements result in an entity providing useful information. Nevertheless, in certain areas, such as reclassification, the requirements do not always result in useful information for the users of financial statements. For further details, please refer to our answers to the following questions.

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 assessment? How significant are these effects?

(a) The business model assessment is only partially working as the Board intended. On the one hand, classifying financial assets based on the business model assessment achieves the Board's objective of providing users of financial statements with useful information at the initial classification according to IFRS 9.4.1. However, on the other hand, this is not always the case at later dates.

While management's intention of managing financial instruments may change over time, a reclassification is only possible under restrictive circumstances, for instance, when an entity either begins or ceases to perform an activity that is significant to its operations. According to IFRS 9.B4.4.1, reclassifications are expected to be very infrequent. In our view, the need for reclassification arises more frequently than the Board expected. A reassessment of the business model, i.e. a reclassification, is only allowed when there is a change in the objective of the entity's business model for managing those financial assets at company level. This causes inconsistency because the business model assessment for the initial classification is carried out on portfolio or on subportfolio level. IFRS 9.4.4.1 requires that "When, and only when, an entity changes its business model for managing financial assets it shall reclassify all affected financial assets". In addition, IFRS 9.B4.4.3(a) clearly states that a change in intention related to particular financial assets should not be considered as a change in business model. Moreover, IFRS 9.B4.4.3(c) states that a transfer of financial assets between parts of the entity with different business models does not constitute changes in the business model itself. Consequently, it is not permitted to apply a change of business model and a reclassification to only a subset of assets within a business model. Thus, applying the standard does not always result in useful information for users of financial statements. AFRAC believes that the requirements for a reclassification of particular financial assets should be reassessed by the IASB in order to determine whether there is a need for amendment of the existing accounting requirements according to IFRS 9. Moreover, AFRAC believes that the IASB should provide more examples and guidance regarding the assessment of demonstrability of a change in the objective of the entity's business model to external parties and its significance for the entity's operations.

Hence, after initial recognition, due to the strict reclassification requirements, it is not always possible to provide users of financial statements with the most useful information about the way an entity manages its financial assets to generate cash flows.

However, the prospective reclassification of only the affected financial assets according to IFRS 9.5.6 – albeit only under the very restrictive prerequisites mentioned in IFRS 9.4.1.1 – reflects the economic reality better than the tainting rules under IAS 39, where the business model for managing financial assets changes in the course of a financial asset's useful life. In this respect, we identified a significant improvement which resulted in more useful information to the users of financial statements. Nevertheless, this improvement is hampered by the fact that the accounting measures for reclassification can only be applied in very limited and rare circumstances.

(b) Please refer to Question 2.(a).

(c) Yes. The business model assessment according to IFRS 9 triggered a change in real business models. Overall, we observe an increase in diversity in practice. Banks have to assess and manage their financial position in a very dynamic environment which is increasingly influenced by regulatory requirements. Although the business model may be applied in consistency with management's initial intention at inception and over the useful life, changes in regulatory requirements may force management to adopt new regulations and, hence, change the business model accordingly. We observe that this resulted in either an inconsistent presentation in the financial statements or in a change in the way banks manage their portfolio.

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?

(a) Not entirely. In this regard, the accounting for ESG bonds should be discussed. The aim should be to allow consistent application of the assessment of cash flow characteristics in the ESG context. In particular, ESG loans, which would otherwise constitute basic lending agreements, shall not fail the SPPI test due to ESG components. There are two different lines of argument why certain ESG components may be part of basic lending risks according to IFRS 9.4.1.3(b). First, it can be argued that ESG instruments are part of a new market segment where compliance with certain ESG clauses reduces credit risk. While this applies to long-term financing, ESG compliance might probably not affect the credit risk of short-term financing to the same extent. Second, according to IFRS 9.4.1.3(b) interest includes – among other components – a profit margin. Therefore, it can be argued that lower interest rates due to ESG compliance are SPPI compliant as banks reduce their profit margin. The reduction of the profit margin may be economically feasible as banks can improve their green asset ratio and reputation. Furthermore, green loans may not only improve a bank's reputation, but might also serve as the basis for the issuance of green notes and, thus, more attractive and cheaper funding. This means that liquidity/funding costs are another argument, why (certain) ESG clauses should be considered as being compliant with the definition of basic loan features.

However, we have noted that there is an increasing number of investment products, where the terms and conditions depend on KPIs related to ESG indices or other indicators that are not specific to either party of the contract. AFRAC believes that such products should be treated in a different way as those which are described in the previous paragraph.

(b) Please refer to Question 3.(a) and the first paragraph of Question 3.(c).

(c) Yes. First, according to IFRS 9.4.1.3(b) interest includes consideration of the time value of money. Terms such as smoothed variable interest rates (e.g. by smoothing the variability of the interest rate by applying an average method) modify the time value of money and are, therefore, not “SPPI compliant”. Thus, the implementation of the cash flow characteristics assessment can lead to basic lending agreements being classified as 'measured at FVtPL'. However, the smoothing of interest rates actually reduces volatility (instead of increasing it), so that – in our view – the classification as 'measured at FVtPL' is hard to justify. (A fixed rate loan is SPPI compliant, as is a variable rate loan. It is, therefore, hard to understand, why something in between these two characteristics should not fulfil the definition of a basic loan feature.) Currently, banks have the option to perform a benchmark test, which, however, causes additional costs and an increase in complexity (including interpretation problems). In contrast to the application of the time value of money concept, as mentioned above, last reset rates due to the IBOR reform, which are also based on averages, do not lead to a modification of the time value of money. Hence, the cash flow characteristics assessment is not applied consistently in this context.

Second, in order to avoid classifying financial assets as 'measured at FVtPL', banks tend to generally avoid certain lending conditions, such as interest smoothing clauses, even if they are/were intended to protect customers. Thus, in certain cases the economic behaviour of banks is influenced by IFRS 9, leading to a change in the pricing (simplification) of lending products.

It is hard to assess the significance of these effects on banks’ fair value portfolios and financial statements respectively, as banks have taken measures to minimise fair value classification (refer to the two paragraphs above).

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?

(a) Yes, the option is working as the Board intended. However, the Board could increase the usefulness of the information provided if recycling was possible again.

In addition, AFRAC noted that the current classification requirements may not result in the most useful information in the context of insurance businesses and, therefore, a sector-specific solution could be considered by the Board.

(b) In our opinion, entities elect to present fair value changes of almost all equity instruments, but particularly of strategic/long-term instruments, in OCI.

(c) The option to present changes in the fair value of investments in equity instruments in OCI results in an increased amount of Level 3 disclosures, where under IAS 39 the paragraphs AG80 and AG81 would have been applied.

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)?

(a) Yes. The requirements for presenting the effects of own credit in OCI were adopted and applied accordingly. However, it is difficult to measure the own credit spread as well as to audit the calculations of the own credit spread as it involves a significant amount of management's estimate and judgement. Depending on the use of management's judgement, effects are either classified in OCI or in P&L. In any case, IFRS 7.10 does not require entities to disclose details about the calculation of the own credit risk or about the sensitivity of the amounts presented in OCI to that calculation. Thus, it might be difficult for users of financial statements to understand the rationale underlying the effects of the own credit risk presented in OCI.

(b) No, there are no other matters to report.

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?

(a) No, we do not believe that the requirements for modifications work as intended. On one hand the requirements for modifications for liabilities according to IFRS 9.3.3.1 to 3.3.4 have not changed as compared to IAS 39 and are sufficiently clear. We do not observe significant diversity in practice.

On the other hand, the requirements of IFRS 9.5.4.2 for financial assets are unclear. Therefore, we observe diversity in practice regarding whether companies apply the requirements for a modification, for a derecognition or for a change in estimate to changes in the terms and conditions of a contract. For details, please refer to Question 6 (b).

(b) No. In our view, the standard is lacking systematic guidance on modifications, including where to report modification gains or losses in the P&L statement. The absence of a clear guidance causes practical issues that ultimately lead to diversity in practice regarding the application of the modification requirements. First, it can be difficult to identify whether an interest rate change is within the contractual terms or results in a modification. For example, it could be argued that an implicit right to prepayment without a significant penalty implies an option to reduce the spread without modifying the original contract terms. Second, it requires management's judgement to differentiate between substantial modifications according to IFRS 9.B5.5.25 that lead to the derecognition of a financial asset, modifications according to IFRS 9.B5.5.27 that do not lead to the derecognition of a financial asset and (partial) write-offs according to IFRS 9.5.4.4. (Is the reduction of a spread of an interest rate a partial waiver of cash-flows falling under IFRS 9.5.4.4. or a non-substantive modification leading to a modification loss? What is the relationship between the two? Is there a hierarchy?) Third, the disclosure requirements relating to modifications are hard to understand and to provide for.

In addition, AFRAC notes that in the context of the COVID-19 pandemic there might be situations where, after the modification of the contractual cash flows of a financial instrument, the resulting contractual cash flows may no longer be considered as "solely payments of principal and interest" (SPPI), e.g. because the loan contract contains a modified repayment schedule or there is a modified interest component. This raises the question how the features that are not SPPI-compliant after modification measures (e.g. government measures, like public debt moratoria, concessions granted by banks to their customers or a combination of both) should be treated. Do these features trigger a "substantial modification" and, therefore, a "derecognition"?

Since restructuring/forbearance measures lead to a change in the contractual cash flows, there is a modification according to paragraph IFRS 9.5.4.3 or IFRS 9.B5.5.25. IFRS 9 does not define the terms "modified" and "imperfect". However, the underlying principle of IFRS 9.B4.1.7A is that, if the financial instruments contain contractual terms that introduce exposure to risks or volatility in the contractual cash flows that is unrelated to a basic lending arrangement (e.g. equity prices or commodity prices), the SPPI-test is considered as failed without performing a benchmark test. In cases, where the resulting contractual cash flows may no longer be considered as SPPI-compliant, amortised cost measurement of the restructured loans is not appropriate because this measurement method does not reflect the new risks introduced by the restructuring measures (IFRS 9.BC4.23). Therefore, AFRAC believes that the IASB should provide further explanations when a modified financial asset shall be derecognised, including criteria for derecognition and practical examples illustrating the application of those criteria.

However, it shall also be noted that the application of the modification rules required banks to develop and implement entirely new systems, which needed substantial efforts and investments. Hence, an amendment or specification of the requirements might lead to further technical complexity and additional/higher costs for banks. Therefore, we would support outreach activities in order to gain a better understanding about the way preparers apply the modification requirements and how users understand the related disclosures.

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?

(a) Yes. However, we have identified some issues which need the attention of the Board. For further details, please refer to Question 7. (b).

(b) Not entirely. The guidance regarding certain issues is not clear, which causes diversity in practice. Some examples are:
- Where in the P&L should the NPV effect of a modification be shown and does the reporting depend on the underlying reason of the modification?
- What is the relationship between derecognition and modification result?
- How should margin grid loans be accounted for, according to IFRS 9.B5.4.5 or IFRS 9.B5.4.6?

Furthermore, it is not clear how certain fees paid or received should be included in the effective interest rate calculation and how the probability of cash flows should be factored concerning the estimation of future contractual cash flows. For example, it may be questionable whether the term "*expected*" refers to a minimum probability threshold that cash flows must have, so that they can be considered for estimating the effective interest rate or whether this threshold should be set to a "virtually certain" level. A recent example, where this issue played a role, is the TLTRO III programme.

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?

(a) Yes, we believe that the transition requirements worked well.

(b) Yes, one issue that we observed was that upon transition some banks reset the OCI movement of FVtOCI portfolios to zero.

<u>Question 9 – Other matters</u>

(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?

(a) No. In our opinion, the request for information covers all relevant matters and the main issues are addressed in the questions above.

(b) No. There are no further matters to report.

If you would like to further discuss our comments, please do not hesitate to contact us.

Best regards,

Romuald Bertl
Chairman of AFRAC