AUTORITÉ DES NORMES COMPTABLES
5, PLACE DES VINS DE FRANCE
75573 PARIS CÉDEX 12
Phone 33 1 53 44 28 53
Internet http://www.autoritecomptable.fr/
Mel jerome.haas@anc.gouv.fr

Chairman

JH
n°46

Paris, the 5th March 2013

Monsieur Hans HOOGERVORST
Chairman
IASB

30 Cannon Street
LONDON EC4M 6XH
UNITED KINGDOM

Re: IASB ED 2012/4 Classification and measurement : limited amendments to IFRS 9

Dear Mr Hoogervorst,

I am writing on behalf of the Autorité des Normes Comptables (ANC) to express our views on the Exposure Draft (ED) Classification and measurement : limited amendments to IFRS 9 released by the IASB in November 2012.

The ANC welcomes the IASB's decision to re-open the phase I of IFRS 9 on classification and measurement. We consider that the proposed clarifications regarding the application guidance on the "solely payment of principal and interest" (SPPI) test may ease the classification of some instruments into the amortised cost category and that the introduction of a third category at fair value through OCI is a step towards a better depiction of the performance of financial assets in the income statement, notably for insurance companies.

However, the ANC considers that the classification of financial assets must be primarily based on the business model of the entity and regrets that the IASB does not draw all the consequences of this notion which is only partially used in IFRS 9. As a result, we disagree with the limited scope of the proposed amendments. Currently, the use of the business model in IFRS 9 is limited to the amortised cost category and also constrained by the criterion on the characteristics of the instrument, thereby designating the fair value through profit or loss (FVTPL) category as the default category. The FVTPL category as currently defined in IFRS 9 does not appropriately reflect the performance of all financial assets that are not eligible to the amortised cost category, thus impairing the relevance of the accounting for such instruments, as the IASB acknowledges in the basis of conclusion of the ED. Therefore, a third category is needed in order for the FVTPL measurement basis to apply only to the appropriate business model. Namely, FVTPL is obviously relevant notably for instruments effectively held for trading. Financial instruments that relate to a business model which is neither based on the recovery of cash flows nor on short-term profit taking should naturally fall into this third category.

As regards the IASB's limited proposals, the SPPI test limiting the financial assets eligible to both the amortised cost and FV through OCI categories in the ED is still too restrictive. It does not allow entities to appropriately classify at amortised cost or at FV through OCI many financial assets which do not exactly have basic loan features whereas this would be consistent with their business model.

Taking into account the business model as the main classification criterion also involves the extension of the third category to financial assets with non contractual cash flows such as equity instruments. For instance, this extension is fundamental to insurance companies as they invest in different types of financial instruments which are managed globally in relation with the time horizon of their obligations towards policyholders so as to appropriately reflect their asset liability management business model and their long term performance. Furthermore, the current prohibition of recycling between OCI and profit & loss for equity instrument under IFRS 9 still prevents long term investors from using this option since it would result in a misrepresentation of their performance in the income statement.

The ANC also disagrees with the Board's decision not to reintroduce bifurcation for financial assets (contrary to financial liabilities and non financial host contracts) since bifurcation may allow entities to properly reflect two different business models at an appropriate level of unit of account. Maintaining bifurcation provisions may also resolve the concern above regarding financial assets with limited leverage that do not exactly meet the SPPI test.

The ANC still believes that the IASB failed to address the main accounting issues raised by the financial crisis and the requests made by the G20 in April 2009 to "improve standards for the valuation of financial instruments based on their liquidity and investors' holding horizons". For example, requiring the market valuation through P&L of illiquid instruments with no relevant price is one of the major problems raised during the crisis which have still not been solved as requested by all relevant authorities. Our proposal to define a business model for the FVTPL category consisting in effectively traded financial instruments may solve this issue.

Our detailled comments have been included in the Appendix attached to this letter.

We hope you find these comments useful and would be pleased to provide any further information you might require.

Yours sincerely,

Jérôme HAAS

Appendix

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?

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?

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?

SPPI test
We agree that the proposed amendment to IFRS 9 regarding the application guidance on the "solely payment of principal and interest" (SPPI) test may ease the classification of instruments, that may not fit perfectly the strict conditions as currently written in IFRS 9 but obviously meet the "consideration for time value of money and credit risk" principle, into the amortised cost category.

However, we have the following comments on the application of the revised SPPI test:

a) In order to assess whether the contractual cash flow characteristics meet the SPPI test the notion of benchmark instrument is critical. We wonder how this benchmark instrument will be built for financial instruments based on several underlying features (such as an interest rate and inflation for example). In addition, the example in paragraph B.4.1.9B which states that "if a financial asset that contains a variable rate reset monthly to a three-month interest rate, the appropriate benchmark would be [...] a variable interest that reset monthly to a monthly rate" seems questionable. The standard floating rate in the market may be considered to be a three-month interest rate in certain circumstances which could hence represent a more relevant benchmark rate. The benchmark rate should not systematically depend on the contractual reset date of the actual instrument but should depend on facts and circumstances.

We therefore consider that more flexibility should be given on the determination of an appropriate benchmark instrument by allowing entities to consider which contractual feature of the actual instrument should be considered in order to define what the appropriate reference instrument is. The example in paragraph B.4.1.9B should allow entities to consider the appropriate benchmark between a variable interest rate that resets monthly to a monthly rate or a variable interest rate that resets quarterly to a three-month rate.

b) Moreover, we are concerned about interest rates in regulated environments (mentioned in BC44) that do not perfectly fit the notion of SPPI and for which, by nature, no benchmark instrument exists. We therefore welcome the staff proposal (AP6B October 2012) to deal with legally based interest rates, which is relevant for highly regulated products in many jurisdictions. A measurement other than

amortised cost would not appropriately reflect the economics of these products, when entities hold them to collect the contractual cash-flows.

Additionally, the ANC considers that these marginal improvements to the SPPI test are far from being sufficient to properly deal with several financial instruments with non basic loan features currently recognised under IAS 39 at amortised cost whereas they would not pass the SPPI test of IFRS 9. We believe that amortised cost remains relevant if this is consistent with the holder's business model. This concern was already raised in our comment letter to the first ED in 2009. Financial assets that may be inappropriately measured at fair value through P&L include for instance:

- Some perpetual debt instruments (not qualified as equity instruments according to IAS 32) with contingent coupons (e.g. distributable profit, change in control, ...) or that may have a deferred coupon (which does not accrue) may no longer be measured at amortised cost only due to particular (but usual) provisions that nevertheless have small (if any) effects on their fair values compared to basic instruments. For instance, if an interest payment may be deferred but does not accrue because of solvency constraints, this feature is more a matter of credit risk than consideration for time value of money.

- Contractually linked instruments : mezzanine and senior debt (but not the most senior one) (e.g. full-funded CDOs) currently classified as loans & receivables in the absence of an active market. Preventing such subordinated debt from being classified at amortised cost only because of the level of credit risk compared to the underlying is not consistent with the "consideration for time value of money and credit risk" principle. Credit risk (including concentration of credit risk) is an integral part of loan features. Uncertainty related to credit risk related to loans at amortised cost is managed by the way of impairment. Hence, similarly to any loan, credit risks related to subordinated interest could be appropriately represented through an amortised cost (+ impairment) measurement model.
- Debt instruments with limited leverage

One way to cope with the issue would be to introduce, as a proxy for the SPPI criterion, the well-known "double-double" test that is maintained in IFRS 9 for financial liabilities.

Bifurcation

The ANC disagrees with the Board's decision not to reintroduce bifurcation for financial assets since it is preferable and useful to users to reflect the different nature and effect of each component of hybrid instruments that have significant different features (e.g. hybrid instruments with a loan component and a commodity index component). The recognition of some hybrid assets in their entirety at fair value through profit and loss will prevent some entities to properly reflect their business model, i.e. the host contract is usually held on a cash flow basis whereas the embedded derivative is usually managed within trading activities on a fair value basis. It has not been demonstrated by the Board that a contract is the relevant unit of account on which the business model should apply. Some different components of the same contract may be managed through two different business models.

Moreover, beyond the inconsistency resulting from a difference in the accounting treatment of assets and liabilities, whereas these instruments may be linked or managed together, the simplification principle used by the Board to justify the prohibition of bifurcation on the asset side (perceived as complex) has not been applied throughout the standard since this complexity will remain in IFRS 9 for hybrid contracts with non financial hosts and financial liabilities. For the latter, the Board states in the basis for conclusion that "the bifurcation methodology in IAS 39 is generally working well". We do not see clearly the rationale according to which a requirement that is working well for financial liabilities would not work as well for financial assets. There is consequently no reason to retain this requirement only for financial liabilities and non financial host contracts.

We therefore ask the Board to re-examine the reintroduction of the current IAS 39 bifurcation requirements for embedded derivatives to financial assets in order to better reflect the business model of entities. We note that it would not be harmful for either those entities that do not currently bifurcate their hybrid instruments or those which actually bifurcate their hybrid financial instruments.
Moreover, maintaining bifurcation on the asset side would also resolve the concern above regarding financial assets that may inappropriately classified at FVTPL under IFRS 9 (even after this limited amendment), such as instruments with limited leverage or economically closely related indexes.

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?

In our comment letter to the ED *financial instruments: classification and measurement* in 2009, the ANC requested the introduction of a third category. Therefore, we welcome the creation of a third category by the IASB with the following objectives:

- "*address the feedback from those who have questioned the appropriate classification for those financial assets under IFRS 9*" (BC17a), i.e. "*whether measurement at FVTPL appropriately reflects the performance of financial assets that are managed so as to maximise return from a combination of contractual cash flows and fair value gains*" and those who "*believed that the business model assessment results in classification outcomes that are too limited*" because all assets that are not held to collect contractual cash flows are measured at FVTPL (BC11a)

- "*address the interaction between the classification and measurement of financial assets and the accounting for insurance liabilties*" (BC17b)

We agree with these objectives which would avoid measuring some activities at fair value through profit or loss when it is not consistent with the business model of the entity. However, we consider that the proposed ED does not fully achieved these objectives. We also understand that, according to the new example added in IFRS 9 (example 4), if there are infrequent or insignificant sales, a liquidity buffer when held by a financial institution to meet liquidity needs in a stress case scenario should be classified at amortised cost.

Better take into account the business model

The FVTPL category as currently defined in IFRS 9 does not appropriately reflect the performance of all financial assets that are not eligible to the amortised cost category, thus impairing the relevance of

the accounting for such instruments, as the IASB acknowledges in the basis of conclusion of the ED. Therefore, a third category is needed in order for the FVTPL measurement basis to apply only to the appropriate business model. As a consequence, we are concerned that the fair value through P&L category is the default category. The business model is not used to define the "fair value through profit and loss" category, thus the held for trading business model under current IAS 39 disappears, whereas the G20 at the London meeting on 2 April 2009 required to "improve standards for the valuation of financial instruments based on their liquidity and investors' holding horizons". As expressed in our comment letter to the first ED in 2009, we consider that fair value through profit and loss is an adequate measurement attribute only for instruments effectively held for trading and assets contractually linked to liabilities at fair value through profit and loss (for futher details see hereafter point b). This proposal would resolve one of the major problems raised during the crisis by preventing the recognition in P&L of the market valuation of illiquid instruments with no relevant price that cannot be effectively traded.

We still believe that it is more robust and easier to clearly define the business model that suits to amortised cost or fair value through P&L and leave the third category as the default one.

We remind the IASB that, in our comment letter in 2009, we proposed "*that classification must be primarily based on the business model which leads to the following categories :*
a) Amortised cost category: financial instruments that the entity holds (or issued) for the purpose of collecting (settling) contractual cash-flows.
b) Fair value through P&L category: effectively actively traded financial instruments which are held for trading purposes by the entity – such as trading activities in the banking industry - or financial instruments compulsorily held by the entity in order to comply with contractual or regulatory commitments which are required to be settled and measured in the balance sheet (liabilities) at the fair value of these underlying financial assets – such as unit linked contracts in the insurance industry.
c) A third category (for which an appropriate measurement attribute should be determined): financial instruments that are held as investments in a medium or long term perspective or that do not meet the definition of either the amortised cost category or of the fair value through P&L category.
As this last category would not be measured at fair value through P&L, it implies that an impairment model, which should take into account investors' holding horizons, should be determined. Moreover, it should require recognition in profit or loss of impairment on debt instruments relating to credit risk and should allow for reversal (for all instruments) in case of a change in the circumstances leading to impairment."

Extend the type of instruments eligible to the third category

Last but not least, we consider that the third category at fair value through OCI (recyclable in P&L) proposed by the IASB should not be limited only to basic debt instruments. Equity instruments that are not held for trading should also be eligible to this category instead of maintaining a separate option for equity instruments at FV through OCI prohibiting recycling. We note that the IASB has acknowledged the interactions between assets hold by insurers and insurance liabilities by introducing the FVOCI category. However, it is not sufficient at this stage as it covers only simple debt instruments. The extension of this category to all financial instruments is fundamental to insurance companies as they invest in different types of financial instruments which are managed globally in relation with the time horizon of their obligations towards policyholders so as to appropriately reflect their asset liability management business model and their long term performance.

Moreover such an extended third category would also fit with the business model of other long term equity investors.
Furthermore, we still believe that the prohibition of recycling between OCI and profit & loss for equity instruments will result in a misrepresentation of the performance of entities in the income statement. For instance, an entity holding only equity instruments on a medium or long term horizon will not be able to presents in the income statement one of its main source of profit (capital gains upon sales of its investments). As already expressed in several previous letters, the ANC strongly believes that the income statement (instead of comprehensive income) is the most relevant indicator of performance.

We acknowledge that extending the third category to equity instruments raises the issue of impairment. We recommend that the Board deals with impairment principles for equity instruments with the following leading guidance :

- take into account investors' holding horizon in the assessment of impairment as requested by the G20, especially for long term investors
- permit the reversal of impairment: the ANC considers that there is no justification for not allowing the reversal of impairment on equity instruments as it is currently the case under IAS 39. Moreover, it would enhance consistency with the treatment of impairment on debt instruments.

However, if the Board were unable to find a majority approval among constituents on a new impairment approach, we would recommend at a minimum that the current principles in IAS 39 remain but that reversal of impairment be allowed.

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 Board's decision to extend the fair value option to assets at fair value through OCI in order to eliminate or significantly reduce an accounting mismatch.

Consistent with our proposal to re-introduce the bifurcation of embedded derivatives on the asset side (see our answer to Q1-3), we believe that a fair value option should be allowed for hybrid instruments that contain one or more embedded derivatives that should be separated if the bifurcation raises operational difficulties or significant costs.

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 IFRS 9 should be applied at a single date on a whole basis once completed rather than on a phase by phase basis which would undermine the comparability among IFRS reporting entities.

In addition, we still believe that IFRS 9 and IFRS 4 phase 2 should be applied at the same date; however would IFRS 9 be mandatory in 2015 and IFRS 4 later, entities should be able to revisit the accounting choices made while applying IFRS 9 for the first time when implementing later IFRS 4 phase 2 standard.

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?

The ANC has consistently asked, for all liabilities designated under the fair value option, that changes in the credit risk of the liability should not affect profit or loss. This delimited topic raises major concerns due to its counter-intuitive effects. Therefore, we are in favor of allowing an early application of only "own credit" provisions in IFRS 9.

Furthermore, we would also recommend that the Board amends IAS 39 in the short term. We note that the IASB rightfully proposes a short term amendment of IAS 39 on the novation of OTC derivatives, which demonstrates the Board's capability to deal with urgent matters.

The ANC also considers that the IASB should further look into the accounting treatment of own credit risk for financial liabilities held for trading (derivative and non derivative instruments), since they raise similar counter-intuitive outcomes. We note that the Basel committee decided in July 2012 to extend the prudential filter regarding own credit risk to debit valuation adjustment (DVA) on derivative liabilities.

Other comments

The ANC still considers that the following issue raised by IFRS 9 should be addressed by the Board: cost exception for non quoted equity instruments. IFRS 9 removes the cost exception in IAS 39 for unquoted equity instruments whose fair value is not reliable. Moreover, circumstances (given in the application guidance) under which cost can be representative of fair value will be rare in practice. Thus, the reliability of the information resulting from the fair valuation of such equity instruments may be questionable. We also note that the FASB tentatively decided to provide a practicability exception to fair value for equity securities without a readily determinable fair value