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European Commission
1049 Brussels

15 September 2015

Dear Mr Guersent,

Endorsement Advice on IFRS 9 *Financial Instruments*

Based on the requirements of the Regulation (EC) No 1606/2002 of the European Parliament and of the Council on the application of international accounting standards we are pleased to provide our opinion on IFRS 9 *Financial Instruments*, which was issued by the IASB in July 2014.

The objective of issuing IFRS 9 is to replace IAS 39 *Financial Instruments: Recognition and Measurement* with a principle-based and less complex standard. IFRS 9 becomes effective for annual periods beginning on or after 1 January 2018, with earlier application permitted. Appendix 1 to this letter provides a summary of the changes introduced by IFRS 9.

In order to provide our endorsement advice as you have requested, we have first assessed whether IFRS 9 would meet the technical criteria for endorsement, i.e. whether IFRS 9 would provide relevant, reliable, comparable, understandable information and would not be contrary to the true and fair view principle. We have then assessed whether IFRS 9 would be conducive to the European public good. We provide our conclusions below. We also have assessed whether entities should be allowed to apply IFRS 9 early in accordance with the IASB's transition arrangements in IFRS 9. Finally we report on the results of our efforts to obtain quantitative assessments of the effects of IFRS 9.

Does IFRS 9 meet the IAS Regulation technical endorsement criteria?

In our view, IFRS 9 will provide relevant, reliable, comparable and understandable financial information needed for making economic decisions and assessing the stewardship of management. We have considered and assessed that the use of fair value in IFRS 9 is appropriate and that IFRS 9 would lead to prudent accounting. EFRAG has therefore concluded that IFRS 9 would not be contrary to the true and fair view principle. This assessment has been carried out considering IFRS 9 on a stand-alone basis. The basis for our conclusions is provided as Appendix 2 to this letter.

Is IFRS 9 conducive to the European public good?

In our assessment of whether IFRS 9 would be conducive to the European public good, we have assessed whether IFRS 9 would improve financial reporting, would reach an acceptable cost-benefit trade-off, whether the lack of convergence with US GAAP could be detrimental to European entities, and whether IFRS 9 might have an impact on issuer and investor behaviours that could affect economic growth. We have also considered the inter-relationship of IFRS 9 with the future insurance contracts standard and if the IAS 39 carve-out would remain available. We provide insights into those assessments below.

Improvement to financial reporting

We have assessed whether IFRS 9 would contribute to improving financial reporting. We have identified that IFRS 9 would bring a distinct improvement over the existing requirements in IAS 39 in the accounting for basic lending instruments, in the impairment of financial assets and hedge accounting, whilst bringing different but still relevant accounting for financial instruments other than basic lending instruments.

Further, the improvements in accounting for the impairment of financial assets meet the G20 request in the wake of the financial crisis to implement a forward-looking impairment model that leads to more timely recognition of expected credit losses. In doing so, the impairment requirements are expected to contribute to financial stability. Furthermore, users will be able to distinguish between instruments for which the credit risk has increased significantly and those for which it has not.

Finally, the changes brought to hedge accounting remedy the long-standing criticism that IAS 39 was excessively restrictive and did not allow a proper reflection of risk management practices, as the new general hedge accounting broadly meets this objective.

Costs and benefits

The implementation of IFRS 9 will undoubtedly trigger significant implementation costs. We have however concluded that the benefits derived from the improvements summarised above would outweigh the costs¹. We have reached this conclusion taking into account that IFRS 9 allows for a proportionate approach to the implementation of IFRS 9 in providing practical expedients.

Lack of convergence with US GAAP

We have assessed and concluded, taking into account current US GAAP requirements for classification, measurement and hedge accounting and the expected changes to US GAAP impairment requirements, that IFRS 9 would not put European entities at a competitive disadvantage compared to entities applying US GAAP. Indeed, given that US GAAP and IAS 39 requirements hold a lot of similarities, we have assessed IFRS 9 to be an improvement over IAS 39 and we regard the proposed US GAAP impairment model to provide less relevant information than the IFRS 9 impairment model, we conclude that IFRS 9 compares favourably overall to US GAAP.

In particular, we have concluded that the IFRS 9 impairment model brings more relevant information than the proposed US GAAP impairment model. The proposed US GAAP impairment model makes no allowance for the fact that financial institutions are compensated for expected credit losses through the interest rate that they charge to borrowers and therefore recognising lifetime credit losses for all instruments in its scope distorts the reporting of the entity's performance. Whilst the 12-month expected loss allowance required by IFRS 9 has the limitations of a practical expedient, it has the merit of more closely reflecting economic reality. Furthermore the proposed US GAAP impairment model is not expected to apply to debt securities classified as available for sale, whereas the IFRS 9 impairment model will apply to debt instruments measured at fair value through other comprehensive income. As a result IFRS 9 leads to recognition of expected losses in profit or loss in a more timely fashion than US GAAP for debt instruments at fair value through other comprehensive income and brings more comparability in the impairment of all forms of debt instruments. Consequently, we conclude that the overall IFRS 9 impairment model with its emphasis on credit deterioration and scope encompassing both loans and debt securities provides more relevant information for investors.

Effects on economic growth

We have also considered, on the assumption of normal business behaviour, whether the changes triggered by IFRS 9, especially through the impairment model, could have an impact on the pricing and maturity of lending instruments in the EU, in order to identify any

¹ This assessment was reached independently from the analysis of the inter-relationship between IFRS 9 and the future insurance contracts standard for insurers where it might depend on whether a solution is identified to remedy the effects of the non-alignment of the effective dates for IFRS 9 and the new insurance contracts standard, and on what that solution is.

potential adverse effect on economic growth. Our conclusions have not been substantiated by quantitative analysis as we do not expect quantifications to be widely available before 2017. We note that the expected credit loss impairment model will lead to higher credit risk provisions than is currently the case. While the effect upon transition will be deducted from equity, going forward changes in provisions will be recognised in profit or loss. Although changes in profit or loss will generally be less pronounced for stable portfolios, they are likely to be higher in the early phase of a credit deterioration.

Higher credit loss provisions are also expected to affect the regulatory capital of banks. EFRAG understands that the interactions of IFRS 9 with the existing prudential requirements will be considered on a timely basis by the relevant regulators. Based on the results from the 2015 follow-up questionnaire on IFRS 9, EFRAG expects many banks to leverage on their existing credit risk systems developed for regulatory purposes in implementing the impairment requirements.

Furthermore we have received advice that changes in capital requirements, the state of the economy and market competition are expected to impact issuers' behaviours more than changes in accounting. As a result we are not able to assess whether an increase in credit loss provisions would have a significant impact on lending activities.

The default requirement to measure all equity investments at fair value through profit or loss may not reflect the business model of long-term investors, including entities undertaking insurance activities and entities in the energy and mining industries. EFRAG observes that IFRS 9 provides an option to measure some equity instruments at fair value through other comprehensive income. However, it is not likely to be attractive to long-term investors because the prohibition on recycling gains and losses may not properly reflect their performance.

Some lenders may face fluctuations in profit or loss because of the requirement to measure financial assets which do not meet the cash flow characteristics test at fair value through profit or loss. This requirement may have an impact on their decisions about which financial instruments to offer to borrowers. However, EFRAG's field-test has shown that only a small portion of financial assets that are currently measured at amortised cost will have to be measured at fair value through profit or loss.

Inter-relationship with the future insurance contracts standard

We have also assessed at your request the interrelationship between the future requirements for the accounting for insurance contracts and IFRS 9. We observe that the mismatch in timing of the future insurance contracts standard and IFRS 9 would create disruptions in the financial reporting by many entities undertaking insurance activities during the period until the future insurance contracts standard is applied, which will make financial reporting less understandable for users while increasing costs for preparers.

EFRAG has confirmed its preliminary view that the benefits to users of consistent financial reporting until IFRS 9 and the future insurance contracts standard are both applied, together with the cost savings for preparers and users, made a strong case for having the IASB defer the effective date of IFRS 9, so as to align it with the effective date of the future insurance contracts standard, albeit only for entities undertaking insurance activities and as an option. We are pleased to note that the IASB has started exploring how best they could respond to the concerns that have been expressed, by investigating various approaches that would address those concerns, including approaches based on a deferral of the IFRS 9 effective date for entities undertaking insurance activities. The purpose of searching for alternatives is to eventually mitigate some negative effects of the deferral alternative. Those alternatives could have indeed the potential to bring a different, albeit satisfactory or even better, trade-off of costs and benefits. However, the IASB is at the early stages of its work and therefore we are not in a position today to assess whether their initiative will remove the concerns created by the non-alignment of the effective dates of IFRS 9 and the future insurance contracts standard.

Furthermore, in the absence of uniform accounting policies for insurance liabilities, and considering that some insurance activities are conducted in the context of conglomerates, the impact of the non-alignment of the effective dates of IFRS 9 and the future insurance contracts standard varies from one company to the other. Therefore any remedy provided to mitigate the negative impact of the non-alignment of effective dates should be granted on an optional basis.

We further note that it is critical that the whole standard-setting process is as expeditious as possible so that all companies have, as early as feasible, clarity in the conditions of implementation of IFRS 9 that apply to them. Consequently, we advise the European Commission to request the IASB to proceed with the necessary IFRS amendments, on the basis of the use of an option, as expeditiously as possible. EFRAG acknowledges that any solution (deferral or other) remains sub-optimal and therefore, in addition to being optional, should be of a very temporary nature. For this reason, we also advise the European Commission to request the IASB to make their best efforts to finalise the future insurance contracts standard, as early as possible, so that the endorsement process of this new insurance contracts standard can start in Europe in 2016.

Availability of the IAS 39 carve-out

We have also concluded that the EU carve-out from IAS 39 for macro hedging will continue to be available in accordance with the purpose for which it was intended until the IASB addresses macro hedging.

Conclusion on European public good

Based on all of the above we have concluded that overall IFRS 9 is conducive to the European public good, except for the impact on the insurance industry of applying IFRS 9 before the finalisation of the forthcoming insurance contracts standard. The IASB is working on one or more solutions for the insurance industry and is expected to make tentative decisions in the next two months. We will advise you on our views as the IASB's work develops and on that basis will provide further advice relevant for the insurance industry. In any event we recommend that all businesses other than those carrying out insurance activities are required to account for their financial instruments in compliance with IFRS 9 in 2018 and businesses carrying out insurance activities are permitted to do so in compliance with IFRS 9 from the same date. The detailed basis for our conclusions is provided as Appendix 3.

Should European entities be allowed to apply IFRS 9 early?

As explained in Appendix 2, we believe that the early application option contained in IFRS 9 should be retained. While many financial institutions may not be ready to adopt IFRS 9 early because of the implementation time and effort needed given their extensive use of financial instruments, EFRAG notes that for many corporates the implementation of IFRS 9 will be less burdensome. Consequently, many corporates will be able to early adopt IFRS 9 and benefit sooner from improvements it brings, especially the improved general hedge accounting guidance.

Should our endorsement advice rely on more extensive assessments?

We have to report that our efforts to gather information, in particular about the use of IFRS 9 impairment model, and to obtain some quantitative analysis of the effects of the impairment model on the level of allowances for credit losses, had limited success. The various surveys on the implementation of IFRS 9 are based on previous versions of IFRS 9 or based on the text of Exposure Drafts and thus not fully representative of the effects of implementing the final version of IFRS 9 being assessed for endorsement. The follow up to earlier EFRAG field-tests has produced limited quantitative data; the available data is included in Appendix 4. EFRAG notes that, based on the results of the follow up to its field-tests, entities are still in the early stages of implementing IFRS 9 and consequently these data can be seen as indicative only.

Our attempts have convinced us that waiting for comprehensive information about implementation decisions by individual entities and a quantitative analysis would delay the endorsement advice from EFRAG significantly, because entities generally state that they need IFRS 9 to be endorsed before they can implement it and provide quantitative data. This could take up to 2017, as demonstrated by the results of our recent outreach. We do not think that the improvements brought to financial reporting by IFRS 9 summarised above should be withheld from European entities for such a long period. Also decisions on endorsement of IFRS 9 would take away the uncertainty entities are facing in deciding whether to invest the necessary resources to change their systems and reporting frameworks.

Given the call by many for a swift endorsement process, we have concluded that delaying the endorsement advice from EFRAG would be detrimental to Europe, considering the above mentioned uncertainty for financial institutions and the possible knock-on effect on investors.

Our endorsement advice to the European Commission

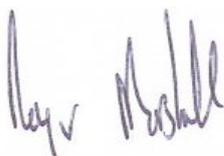
As explained above we have concluded that IFRS 9 meets the qualitative characteristics of relevance, reliability, comparability and understandability required to support economic decisions and the assessment of stewardship, leads to prudent accounting, and therefore is not contrary to the true and fair view principle. We have also concluded that IFRS 9 is conducive to the European public good, except for its impact on the insurance industry. We therefore recommend that all businesses other than those carrying out insurance activities are required to account for their financial instruments in compliance with IFRS 9 in 2018 and that businesses carrying out insurance activities are permitted to do so in compliance with IFRS 9 from the same date.

Any optional remedy by the IASB is expected to result in changes to current IFRS, which will require due process. As a result, a final optional remedy by the IASB can be expected to be finalised only in the course of 2016. However we expect that the IASB will make its overall decisions on optional remedies within the next 2 months, subject to due process. EFRAG remains at the Commission's disposal to assist in assessing the adequacy of any proposed remedies by the IASB, and on that basis to supplement our current assessment in relation to the insurance industry.

Although our conclusions have been reached on the basis of very limited quantitative assessments, we have decided to provide you with our endorsement advice without waiting for the availability of data that we have learnt would not be available on a broad basis before 2017 when IFRS 9 implementation efforts are advanced. We therefore also recommend that the implementation of IFRS 9 is closely monitored to identify any unforeseen or unanticipated consequences that would need to be remedied. EFRAG stands ready to assist in this effort.

On behalf of EFRAG, I would be happy to discuss our advice with you, other officials of the European Commission or the Accounting Regulatory Committee as you may wish.

Yours sincerely



Roger Marshall
Acting President of the EFRAG Board

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Appendix 1: Understanding the main changes brought by IFRS 9

A - Background of the Standard

- 1 IFRS 9 replaces most of the requirements of IAS 39 *Financial Instruments: Recognition and Measurement*. Work on replacing IAS 39 was accelerated following the financial crisis when interested parties, including the G20, the Financial Crisis Advisory Group and the Financial Stability Board highlighted a number of areas in financial instruments accounting that needed to change. These included, inter alia, the timeliness of recognition of credit losses, the complexity of multiple impairment models and the reporting in profit or loss of changes in own creditworthiness.
- 2 The overall scope and recognition/derecognition model of IFRS 9 *Financial Instruments* are materially the same as IAS 39, but there are significant changes to:
 - (a) Classification and Measurement;
 - (b) Impairment; and
 - (c) Hedge Accounting.

B - How the issues have been addressed

- 3 IFRS 9 changes the classification requirements for financial assets, using a single approach for all types of financial assets. Only basic lending² instruments are potentially eligible for measurement at amortised cost and all other financial assets are measured at fair value. Measuring all non-basic lending instruments at fair value has led to the elimination of the multiple impairment models in IAS 39 and the design of a single model based on the principle of expected, rather than incurred, credit losses results in earlier recognition of credit losses. The hedge accounting requirements more closely align hedge accounting with risk management practices.

C - What has changed?

C.1. CLASSIFICATION AND MEASUREMENT

C.1.1. FINANCIAL ASSETS

- 4 The classification and measurement approach for financial assets in IFRS 9 is based upon the:
 - (a) contractual cash flow characteristics of the financial asset; and
 - (b) for financial assets that are assessed to be 'basic lending instruments', the entity's business model for managing the financial assets.
- 5 IFRS 9 distinguishes basic lending instruments from other financial assets as having contractual cash flows that are assessed as being solely payments of principal and interest ('SPPI') on the principal amount outstanding.
- 6 Within the assessment of payments being SPPI, 'principal' is the fair value of the financial asset at initial recognition, which changes over time to reflect any repayments of that principal. Interest is described broadly as including consideration

² EFRAG notes that the concept of basic lending is not directly defined in IFRS 9. However, IFRS 9 states that contractual cash flows that are solely payments of principal and interest on the principal amount outstanding are consistent with basic lending arrangements. It also clarifies that basic lending does not need to be in a form of a loan.

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for the time value of money, credit risk, other basic lending risks (such as liquidity risk), costs (such as administrative costs) and a profit margin consistent with a basic lending arrangement.

- 7 All financial assets that have contractual cash flows that are not assessed as being SPPI are measured at fair value, with changes in the fair value presented in profit or loss. The IASB decided that fair value is the best predictor of future net cash inflows for these assets. Moreover for equity instruments, other than those held for trading and contingent consideration recognised in a business combination, the IASB has introduced an irrevocable option at inception on an instrument-by-instrument basis that permits those instruments to be accounted for at fair value through other comprehensive income, with no impairment losses recognised in profit or loss and no reclassification in profit or loss of gains or losses upon derecognition.

C.1.1.1. THE BUSINESS MODEL WITHIN WHICH FINANCIAL ASSETS ARE MANAGED

- 8 For basic lending instruments, the financial reporting depends upon the business model the entity uses to manage the assets in order to generate cash flows - by collecting contractual cash flows, selling financial assets or both. The business model is assessed on a level that reflects how basic lending instruments are managed to achieve a particular business objective. The business model does not depend upon management's intentions for an individual instrument, and is therefore determined on a higher level of aggregation. IFRS 9 acknowledges that a single reporting entity may have more than one business model for managing its financial assets and therefore classification need not be determined at the reporting entity level.
- 9 The business model for managing basic lending instruments is a matter of fact rather than an assertion, and IFRS 9 states that it is typically observable through the activities that the entity undertakes to achieve the objectives of the business model. Evidence of the nature of the business model includes:
- (a) How the performance of the business model and the financial assets held within that business model are evaluated and reported to the entity's key management personnel;
 - (b) The risks that affect the performance of the business model and the way in which those risks are managed; and
 - (c) How managers of the business are compensated.
- 10 Basic lending instruments that are managed within a business model whose objective is to hold assets in order to collect contractual cash flows are measured at amortised cost, with interest revenue and impairment losses presented in profit or loss.
- 11 Basic lending instruments that are managed within a business model whose objective is achieved by both collecting contractual cash flows and selling financial assets have the same presentation in profit or loss as basic lending instruments that are managed within a business model whose objective is to hold assets in order to collect contractual cash flows. However, for the balance sheet, such financial assets are measured at fair value. The difference between an instrument's amortised cost measurement (which is the basis for calculating the amounts presented in profit or loss) and its fair value is presented in other comprehensive income, with reclassification into profit or loss upon derecognition.
- 12 Basic lending instruments that are managed within any other business model are measured at fair value through profit or loss.
- 13 There is an irrevocable option at initial recognition to designate basic lending instruments at fair value through profit or loss if such designation eliminates or

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significantly reduces a measurement or recognition inconsistency (sometimes referred to as an 'accounting mismatch').

C.1.1.2. DETERMINING WHETHER CASH FLOWS ARE SOLELY PAYMENTS OF PRINCIPAL AND INTEREST

- 14 IFRS 9 provides extensive guidance to assist in determining whether contractual cash flows are SPPI. For contractual cash flows to be SPPI they must include returns consistent with a basic lending arrangement (e.g. fixed interest rates). For example, if the contractual cash flows include a return for equity price risk then that would not be consistent with the contractual cash flows being SPPI.

C.1.1.3. WHEN A BUSINESS MODEL CHANGES

- 15 Because the classification model for basic lending instruments is based upon the business model within which those financial instruments are managed, IFRS 9 requires reclassification if and only if that business model changes. Such changes are expected to be very infrequent, and must be significant to the entity's operations and demonstrable to external parties, for example when the entity acquires, disposes of or terminates a business line. In comparison to IAS 39, IFRS 9's requirements are better ring-fenced, with reclassifications only being allowed if there is evidence of change in business model. Consequential amendments to IFRS 7 *Financial Instruments: Disclosures* require detailed disclosures about such reclassifications (including the amount of financial assets moved into and out of different measurement categories and a detailed explanation of the change in business model and its effect).

C.1.1.4. EQUITY INSTRUMENTS

- 16 IFRS 9 applies the definition of equity instruments as contained in IAS 32 *Financial Instruments: Presentation*. Financial instruments are therefore not classified as equity instruments if they include a contractual obligation for the issuer to transfer cash or another financial asset (for example shares in open ended investment funds or shares puttable to the issuer at fair value). As a result, entities investing in such instruments cannot make use of the fair value through other comprehensive income option available to equity instruments.

C.1.2. FINANCIAL LIABILITIES

- 17 Except for the accounting for changes in own credit risk described below, all IFRS 9 requirements for financial liabilities are carried forward from IAS 39, including the bifurcation of particular embedded derivatives. As a result, many financial liabilities, apart from derivatives, non-derivative financial liabilities held for trading or financial liabilities that an entity designates under the fair value option, will continue to be measured at amortised cost.

C.1.2.1. CHANGES IN OWN CREDIT RISK

- 18 IFRS 9 introduces new requirements for the accounting and presentation of changes in the fair value of a financial liability when the entity has chosen at inception to measure that financial liability at fair value under the fair value option. This responds to criticism that it was counterintuitive for an entity to recognise a gain in profit or loss due to a deterioration of its own credit standing. Under IFRS 9, a change in fair value due to the change in the credit risk of the liability is reported in other comprehensive income unless such presentation would create or enlarge an accounting mismatch in profit or loss. The accumulated amounts presented in other comprehensive income are not reclassified to profit or loss, which might give rise to realised gains or losses not being recognised in profit or loss in the limited circumstances in which the liability is derecognised before maturity (e.g. repaid early).

C.2. IMPAIRMENT

- 19 The impairment section of IFRS 9 reflects a fundamentally different approach to that of IAS 39 in that the loss recognition model is based on 'expected' rather than 'incurred' losses. This change was designed to address concerns raised during the financial crisis that IAS 39, as it was implemented, recognised impairment losses on financial assets too late. The model in IFRS 9 is conceptually a 'loss allowance' model, recognising a provision for expected credit losses on financial assets before any losses have been incurred and updating the amount of expected credit losses recognised at each reporting date to reflect changes in the credit risk of financial instruments. Credit losses are the value of the difference between the contractual cash flows that are contractually due to the entity and the cash flows that the entity actually expects to receive discounted at the original effective interest rate.
- 20 The expected credit losses model applies to financial assets measured at amortised cost, debt instruments measured at fair value through other comprehensive income, loan commitments and financial guarantee contracts that are not measured at fair value through profit or loss, lease receivables that are within the scope of IAS 17 *Leases* and trade receivables or contract assets within the scope of IFRS 15 *Revenue from Contracts with Customers*.
- 21 The loss allowance model requires an entity to base its measurement of expected credit losses on reasonable and supportable information, including historical, current and forward-looking information, which is available without undue cost or effort. It has three stages:
- (a) Stage 1: At the reporting date, if credit risk on a financial instrument has not increased significantly since initial recognition, an entity shall measure the loss allowance for that financial instrument at an amount equal to 12-month expected credit losses.
- 12-month expected credit losses are the portion of lifetime expected credit losses that represents the expected credit losses that could result from default events that are possible within 12 months from the reporting date. The 12-month expected credit losses loss allowance amount is intended to be a proxy for the amount of credit losses expected to be covered by interest margin over the next 12 months.
- (b) Stage 2: At each reporting date, if the credit risk increases significantly from initial recognition, full lifetime expected credit losses are recognised. As a practical expedient, entities may assume that the credit risk has not increased significantly if the financial instrument is determined to have low credit risk at the reporting date.
- (c) Stage 3: A financial asset reaches stage 3 if it is specifically identified as credit-impaired. At this stage, recognition of interest revenue changes as described below whereas expected credit losses continue to be recognised on a lifetime losses basis.
- 22 In stages 1 and 2, interest revenue as recognised in profit or loss is calculated on the gross carrying amount of the financial asset. However, in stage 3, interest revenue is calculated based on the gross carrying amount less the loss allowance.
- 23 For purchased or originated credit-impaired financial assets the cumulative changes in lifetime expected credit losses since initial recognition are recognised as impairment gain or loss.
- 24 The new model is accompanied by enhanced disclosures about expected credit losses and credit risk. For example, entities are required to provide information that

explains the basis for their expected credit loss measurement and how they assess changes in credit risk.

C.3. HEDGE ACCOUNTING

- 25 The requirements in IAS 39 for hedge accounting were widely regarded as rule-based, difficult to implement and inconsistent with risk management practices. The main changes to the hedge accounting requirements in IAS 39 have been made to meet the objective of reflecting risk management practices. IFRS 9 retains accounting mechanics of the three hedge accounting models from IAS 39 but with some minor changes to the fair value and cash flow hedge accounting models.
- 26 IFRS 9 expands the range of hedged items to include items such as risk components of non-financial items, aggregated exposures, net positions and layer components of items. The range of hedging instruments is also expanded: for example non-derivative financial instruments measured at fair value through profit or loss can be used to hedge risks other than foreign exchange risk. IFRS 9 provides greater incentives to designate options as hedging instruments since the fluctuation of the time value is presented through other comprehensive income rather than profit or loss.
- 27 The hedge effectiveness requirements needed to qualify for hedge accounting have changed so they are less rules-based. Hedged items and hedging instruments need to be connected through an economic relationship that leads to offsetting changes in value, provided those value changes are not dominated by credit risk. A designated hedging relationship is required to reflect what is actually being hedged. The entity is required to document the arrangement in advance and identify how hedge effectiveness will be assessed and the sources of hedge ineffectiveness. Any hedge ineffectiveness is recognised in profit or loss.
- 28 IFRS 9 introduces the concept of 'rebalancing'. Rebalancing refers to adjustments to the designated quantities of either the hedged item or the hedging instrument of an existing hedging relationship for the purpose of maintaining a hedge ratio. This allows entities to respond to changes that arise from the underlying instrument or risk variables. However, entities may not voluntarily de-designate the hedge accounting relationship when the hedge accounting relationship continues to reflect the risk management objective.
- 29 Credit risk is not a hedgeable risk. However, IFRS 9 permits an entity to designate a financial instrument at fair value through profit or loss when its credit risk is managed by using a credit derivative.
- 30 As an alternative to hedge accounting, the use of the fair value option is extended for own-use contracts with non-financial items.

C.3.1. MACRO-HEDGING PRACTICES

- 31 IFRS 9 does not address specific accounting for open portfolios of hedged items (referred to as macro hedging) since this is part of a separate IASB project. Consequently, entities can elect to apply IAS 39 to account for the portfolio fair value hedge of interest rate risk.
- 32 IFRS 9 also provides entities with an accounting policy choice between applying the hedge accounting requirements of IFRS 9 and continuing to apply the existing hedge accounting requirements in IAS 39 for all hedge accounting. This accounting policy choice is intended to remain available until the work on macro hedge accounting has been finalised.

D - When does the Standard become effective?

- 33 The Standard has a mandatory effective date of annual periods beginning on or after 1 January 2018 with early application permitted. The section of IFRS 9 on the presentation of changes in own credit risk in other comprehensive income can be applied prior to adopting the rest of IFRS 9.

Appendix 2: EFRAG's technical assessment on IFRS 9 against the endorsement criteria

Summary

1 This appendix assesses how IFRS 9 *Financial instruments* satisfies the technical criteria set out in the Regulation (EC) No 1606/2002 for the adoption of the international accounting standards. It provides detailed evaluation for the criteria of relevance, reliability, comparability and understandability, so that financial information is appropriate for economic decisions and the assessment of stewardship. It evaluates separately whether IFRS 9 leads to prudent accounting. When assessing these criteria specific IFRS 9 requirements are analysed through its main areas: classification and measurement, impairment and hedge accounting. EFRAG has identified areas in which IFRS 9 could have been a better standard, however none of the limitations identified impedes IFRS 9 from meeting each of the criteria and from delivering prudent accounting. As a result EFRAG assesses that IFRS 9 is not contrary to the true and fair view principle. At the end of this appendix EFRAG also concludes that early application of IFRS 9 should be permitted. This assessment has been carried out considering IFRS 9 on a stand-alone basis.

Does the accounting that results from the application of IFRS 9 meet the technical criteria for EU endorsement?

- 2 EFRAG has considered whether IFRS 9 meets the technical requirements of the European Parliament and of the Council on the application of international accounting standards, as set out in Regulation (EC) No 1606/2002, in other words that IFRS 9:
- (a) is not contrary to the principle of 'true and fair view' set out in Article 4(3) of Council Directive 2013/34/EU; and
 - (b) meets the criteria of understandability, relevance, reliability, and comparability required of the financial information needed for making economic decisions and assessing the stewardship of management.
- 3 In the following analyses, EFRAG has considered each issue from the perspective of both usefulness for decision-making and for assessing the stewardship of management. In all cases, EFRAG has concluded that, for financial instruments, the information resulting from the application of IFRS 9 is appropriate both for making economic decisions and assessing the stewardship of management.
- 4 EFRAG's assessment on whether IFRS 9 is not contrary to the true and fair view set out in Article 4(3) of Council Directive 2013/34/EU is based on the assessment of whether it meets all other technical criteria and whether it leads to prudent accounting. Detailed assessments are included in this appendix in the following paragraphs:
- (a) relevance: paragraphs 7 - 127;
 - (b) reliability: paragraphs 128 - 151;
 - (c) comparability: paragraphs 152 - 190;
 - (d) understandability: paragraphs 191 - 208; and
 - (e) whether overall it leads to prudent accounting: paragraphs 209 - 218.
- 5 In providing its assessment on whether IFRS 9 results in relevant, reliable, understandable and comparable information, EFRAG has considered all the requirements of IFRS 9. EFRAG has, however, focused its assessment on the

Endorsement Advice on IFRS 9 Financial Instruments
Appendix 2: EFRAG's technical assessment on IFRS 9 against the endorsement criteria

requirements it considered most significant in relation to each of the criteria. EFRAG has accordingly focused on guidance that:

- (a) is fundamental to the accounting for financial instruments and/or to IFRS 9;
 - (b) has been subject to substantial debate (evidenced by the comments EFRAG has received from constituents including participants in EFRAG's field-tests of the Exposure Drafts);
 - (c) may be problematic to apply (evidenced by the results of EFRAG's field-tests);
or
 - (d) relates to the issues raised by the European Commission in its request for endorsement advice dated 8 December 2014.
- 6 EFRAG has assessed IFRS 9 requirements against each of the technical criteria for each of the following:
- (a) Classification and Measurement;
 - (b) Impairment; and
 - (c) Hedging.

Relevance

- 7 Information is relevant when it influences the economic decisions of users by helping them evaluate past, present or future events or by confirming or correcting their past evaluations.
- 8 EFRAG considered whether IFRS 9 would result in the provision of relevant information – in other words, information that has predictive value, confirmatory value or both – or whether it would result in the omission of relevant information.

A - Summary

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| <ol style="list-style-type: none">9 IFRS 9 classification and measurement principles will bring relevant information. On the asset side, the application of the contractual cash flow test is assessed to increase the relevance of the resulting information, as it provides a sound basis to distinguish in an entity's financial position between financial instruments that should be measured at amortised cost from those that are measured at fair value. Furthermore the combination of the criteria of contractual cash flows and the business model for basic lending instruments is assessed as providing relevant information on an entity's performance. Although EFRAG has identified some areas in which IFRS 9 could have been a better standard for the reporting of an entity's performance. EFRAG has nevertheless assessed that these do not prevent IFRS 9 from providing overall relevant information. IFRS 9 could have been a better standard if fair value through profit or loss had not been the measurement attribute by default for a few types of basic lending instruments which fail the contractual cash flow test and if recycling of profits or losses arising on investments in equity instruments measured at fair value through other comprehensive income had not been prohibited. On the liability side, IFRS 9 does not bring any change except for greater relevance brought by the requirement to account for the own credit risk component in other comprehensive income, as well as by the exception to do so in profit or loss.10 The impairment model combining recognition of 12-month and lifetime expected credit losses will result in providing timely information on the extent of expected credit losses while remaining consistent with the economics of lending transactions. While acknowledging that 12-months expected credit losses are a pragmatic rather than a fully conceptual model, EFRAG expects that the IFRS 9 impairment model will bring relevant information.11 The hedge accounting model brings relevant information as it has been designed to represent in the financial statements the effect of an entity's risk management activities and broadly achieves that objective. When assessing the eligibility of the hedged risks, the eligibility of hedging instruments including treatment of time value of the options, the hedge effectiveness requirements, the discontinuations of hedges and the rebalancing requirement, EFRAG overall concluded that the relevance of the resulting information would be enhanced. This assessment has given due consideration to a few restrictions such as the non-eligibility as hedging instruments on a stand-alone basis of derivatives embedded in financial assets or sub-LIBOR exposures not being eligible for hedge accounting. However, these issues do not prevent IFRS 9 hedge accounting requirements from providing relevant information.12 EFRAG's overall assessment is that IFRS 9 could have been a better standard if some limitations on relevance had been avoided. However, these issues do not prevent IFRS 9 requirements from providing relevant information. |
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B - Classification and Measurement

- 13 Following the criteria set out in paragraph 5 above, EFRAG has focused its assessment on requirements related to:
- B.1 Classification and measurement of financial assets;
 - B.2 Classification of financial liabilities: own credit risk; and
 - B.3 Use of fair value.
- 14 The classification and measurement approach for financial assets in IFRS 9 is based upon the contractual cash flow characteristics of the financial assets, and for financial assets that are assessed to be basic lending instruments, the determination of the entity's business model for managing the financial assets.

B.1. CLASSIFICATION AND MEASUREMENT OF FINANCIAL ASSETS

B.1.1. TAKING INTO ACCOUNT CONTRACTUAL CASH FLOW CHARACTERISTICS

- 15 Amortised cost is a relatively simple measurement technique using the effective interest rate to allocate interest over the relevant periods. It is only applied to financial assets with contractual cash flows that are solely payments of principal and interest and should be consistent with a basic lending arrangement.
- 16 EFRAG notes that amortised cost generally provides relevant information in relation to financial assets that have solely payments of principal and interest. The contractual cash flow test excludes instruments with contractual features giving rise to exposure to risks or fluctuations unrelated to a basic lending arrangement, such as leverage or changes in equity prices or commodity prices.
- 17 EFRAG also notes that even when components of the contractual cash flows could not be considered as being solely payments of principal and interest they are ignored if:
- (a) those components are 'non-genuine', i.e. they affect cash flows only on the occurrence of an event that is extremely rare, highly abnormal, and very unlikely; or
 - (b) possible impacts of those components are 'de minimis', i.e. in EFRAG's understanding, in all scenarios the magnitude of the impact on contractual cash flows is trivial or minor.
- 18 EFRAG notes that it may be argued that certain types of financial instruments might be viewed as being basic lending agreements but IFRS 9 does not consider their contractual cash flows as being solely payments of principal and interest. These financial instruments include:
- (a) Financial assets with interest mismatch features: these are generally variable rate instruments whose interest rate is periodically reset but the frequency of the reset does not match the tenor of the interest rate. Such mismatches may also be implicitly present in instruments with managed interest rates where the variable rate is set at the bank's discretion and may not fully track the current market rate. Interest mismatches also arise with 'lagged rates' such as 12-month Euribor as fixed one month ago reset every 12 months.

In many cases, especially for loans, qualitative testing should be sufficient to assess whether the interest mismatch features are solely payments of principal and interest. Such a test is focused on whether the contract terms have been designed to provide compensation only for the time value of money and other basic lending risks or whether the contract contains some structuring elements.

Quantitative testing would in most cases only be required where qualitative testing does not provide a conclusion.

EFRAG assesses that in many cases this should remove the concerns raised for loans having interest rate mismatched features. In those cases they should result in amortised cost measurement if held in the appropriate business model.

- (b) Instruments for which under certain conditions (such as insolvency of the debtor) payments do not have to be made and no interest accrues on the deferred amounts are not considered as having solely payments of principal and interest. This may be the case for certain types of subordinated debt instruments. EFRAG notes however that subordination in itself does not preclude amortised cost measurement and the issue only arises due to the additional feature.

EFRAG assesses that for those instruments described in the previous paragraph fair value through profit or loss would bring less relevant information than amortised cost as such instruments are generally viewed as basic lending instruments. However, when it becomes likely that the conditions referred to above would occur, a fair value measurement provides more relevant information than amortised cost.

- 19 Overall EFRAG assesses that, except for a few specific cases for example the one described in paragraph 18(b), the application of the contractual cash flow test will result in relevant information. In accordance with the last minute adjustments to the solely payment of principal and interest test made by the IASB, instruments which are considered to be basic lending instruments in the markets in which they are issued are expected to pass the cash flow characteristics test and (subject to additionally fulfilling the business model criterion) qualify for amortised cost. EFRAG therefore believes that the application of the solely payment of principal and interest test provides a sound basis to aggregate financial instruments into those that qualify for amortised cost and those that qualify for fair value in the balance sheet.

B.1.2. ACCOUNTING FOR MODIFICATIONS OF CONTRACTUAL CASH FLOWS

- 20 For financial assets, a modification gain or loss is recognised in profit or loss whenever there is a modification in contractual cash flows that does not result in derecognition. Some constituents raised concerns about this requirements in their responses to the EFRAG 2013 field-test on the proposed impairment requirements (see Appendix 4, paragraph 2) r as it leads to the recognition of losses even when the terms of financial assets are modified due to commercial rather than credit deterioration reasons. EFRAG notes that in this part relevance of the requirements for the recognition of modification gains or losses is discussed for modifications which do not lead to derecognition. Additional issues surrounding uncertainties whether modifications lead to derecognition are assessed in paragraphs 166 to 168 of the section on comparability.
- 21 EFRAG assesses that in some cases relevance would not be optimised by recognising all modifications gains and losses in profit or loss, particularly when clients have a prepayment right on loans. When a prepayment occurs, there is no real economic loss, rather an opportunity cost. Upon prepayment, debtors may get another loan with the same bank or another bank enjoying lower interest rate if the rates have declined in the meantime. The above analysis does not change even when a bank has economically hedged its interest position resulting from the loans as such economic hedges are mostly performed at a portfolio level taking into account the risk of prepayments.
- 22 EFRAG assesses that reporting a modification gain or loss for commercial renegotiations of assets with prepayment options limits the relevance of information

as this could be considered as accounting for an opportunity loss. In contrast, EFRAG assesses that reporting a modification loss due to a deterioration of credit risk would result in relevant information as it would provide information about the extent of losses resulting from renegotiations as a result of credit rather than market events. As a result of recent regulatory measures in the area of forbearance introduced by the European Banking Authority, banks will distinguish between commercial and non-commercial renegotiations and therefore banks could show the resulting losses separately. However, there may be borderline cases where such a distinction cannot be made in a reliable manner and the limitation in the relevance of the information for assets with prepayment options may be the price to pay for reliability of the information.

B.1.3. REFLECTING DIFFERENT BUSINESS MODELS

- 23 Taking into account the business model in determining the accounting for financial assets provides a basis for increased relevance. However, the application of the business model test in IFRS 9 is limited to the accounting for basic lending instruments. Only assets which have cash flows which are solely payments of principal and interest can subsequently result in amortised cost or fair value through other comprehensive income or fair value through profit or loss measurement based on the business model in which they are managed. Assets not having solely payments of principal and interest are automatically measured at fair value and the business model does not play a role in their classification. EFRAG assesses the combination of the criteria of contractual cash flows and business model for basic lending instruments as providing relevant information.
- 24 EFRAG assesses that this is the case for both debt securities and originated loans. While EFRAG acknowledges that debt securities and originated loans can be managed and priced differently, both categories have cash flow characteristics and are managed according to a particular business model which is determinable. Consequently, they can be categorised based upon these criteria which faithfully represent the instrument's characteristics. EFRAG notes that requiring a specific treatment for originated loans would lead to a rules-based approach with additional requirements such as how to deal with embedded derivatives.
- 25 Some constituents have argued that financial assets should be subject to a business model assessment regardless of the outcome of the contractual cash flow test. One might also propose as a solution the possibility to bifurcate the instrument in which case only the 'basic lending' host component would be subject to the business model assessment. EFRAG itself held the view that this would contribute to making financial reporting more relevant.
- 26 EFRAG can accept the trade-off made by the IASB between relevance and simplicity in this case even though this limits how business models are reflected. For example, EFRAG notes that financial instruments other than basic lending instruments would require a specific impairment model if they were not measured at fair value through profit or loss. Further, the impairment models have shown their limits in providing relevant information and no fully satisfactory alternative has been identified. EFRAG therefore considers that arguments for having the business model play a role for financial instruments other than basic lending instruments have to be balanced against those observations.
- 27 We assess below the measurement of basic lending instruments for each business model.

B.1.3.1. BUSINESS MODEL: HOLD TO COLLECT

- 28 Provided an entity's business model is to collect contractual cash flows and the cash flow characteristics represent solely payments of principal and interest then

amortised cost measurement provides in the view of EFRAG, the most useful information about future cash flows both in the statement of financial position and in profit or loss. It provides information about the asset's performance through the generation of interest revenue and helps in predictions of future interest streams.

- 29 An entity's business model can be to hold basic lending instruments to collect contractual cash flows even where sales of those financial assets occur or are expected to occur in the future because sales are incidental to the objective of holding to collect contractual cash flows. Issues do not arise when a sale is made because of a credit deterioration of a counterparty or when a financial asset is sold close to its maturity and the proceeds from the sale approximate to the collection of the remaining contractual cash flows. Under IFRS 9, sales are not inconsistent with the hold to collect business model if they are infrequent (even if significant in value) or insignificant in value either individually or in aggregate (even if frequent). EFRAG assesses that this additional guidance on sales avoids unnecessary restrictive rules and strengthens the relevance of the business model.

B.1.3.2. BUSINESS MODEL: HOLD TO COLLECT AND SELL

- 30 If the objective of an entity's business model is achieved by both collecting contractual cash flows and selling financial assets, the measurement related to this business model is based upon fair value in the statement of financial position, while the effect on profit or loss would be the same as if the basic lending instruments were measured at amortised cost, i.e. including impairment. The difference between the fair value and amortised cost is presented in other comprehensive income.
- 31 EFRAG notes that entities might invest in debt instruments to generate yield but with an intention to sell if the price is advantageous or if it is necessary to periodically adjust or rebalance the entity's net risk, duration or liquidity position. In those instances both fair value and amortised cost information is relevant in helping financial statement users to understand performance and to predict future cash flows because of the two potential value realisation paths that can be taken.
- 32 Unlike the hold to collect business model, selling assets is integral to achieving the objective of the hold to collect and sell business model. In addition, there is no threshold for the frequency or the value of sales that must occur in this business model. Therefore, EFRAG assesses that reasons, the frequency, timing and value of sales constitute relevant distinguishing factors between the hold to collect and the hold to collect and sell business models.

B.1.3.3. OTHER BUSINESS MODELS

- 33 Where entities manage basic lending instruments primarily with the objective of realising cash flows through the sale of the assets, fair value provides useful information about future cash flows in both the statement of financial position and profit or loss because it reflects the return that could have been achieved at reporting date and is the best available estimate of future cash flows. Consequently, EFRAG assesses that fair value through profit or loss measurement provides relevant information for those financial assets.
- 34 The measurement category at fair value through profit or loss includes both financial assets managed in relevant business models and those that fail the contractual cash flows test because of not having solely payments of principal and interest. Some constituents have argued that this might obscure the reported results of trading portfolios because of mixing them with gains and losses from other assets and thus impair the relevance of the fair value information provided. EFRAG understands these concerns. However EFRAG notes that entities are required to present separate line items in the income statement when this is useful to an understanding of financial performance. On this basis entities could present or disclose results from trading

portfolios separately from other instruments in fair value through profit or loss if they consider such information relevant.

B.1.4. RECLASSIFICATIONS

- 35 IFRS 9 requires financial assets to be reclassified between measurement categories when, and only when, the entity's business model for managing them changes. IFRS 9 ring-fences the circumstances in which a change in the business model has occurred. For example, reclassifications would not be allowed by the mere fact that a market temporarily disappears or when the intention related to a particular financial asset changes in response to market conditions, if there is no evidence that the business model has changed.
- 36 EFRAG assesses that reclassifications triggered solely based on a change in intentions due to market conditions would create tension in terms of reliability of the information. EFRAG is satisfied that IFRS 9 requires an entity to reclassify financial instruments if a change in business model has been decided in response to a change in market conditions. As a result EFRAG assesses the requirements for reclassification of financial assets as leading to relevant information.

B.1.5. OPTION TO DESIGNATE A FINANCIAL ASSET AT FAIR VALUE THROUGH PROFIT OR LOSS

- 37 IFRS 9 contains an option to designate a financial asset as at fair value through profit or loss if it eliminates or significantly reduces accounting mismatches that would otherwise result from measuring economically matched assets or liabilities on different bases. Without the use of the option, economically matched assets and liabilities could generate gains or losses in profit or loss which would not be a proper reflection of economic reality. EFRAG therefore assesses that this option results in relevant information. One may argue that irrevocable designation at inception may bring some limitation to the relevance of the information because if the reason for choosing the fair value option disappears the ongoing fair value measurement may give rise to an accounting mismatch. However EFRAG believes that the trade-off struck by the IASB between relevance and reliability is acceptable.

B.1.6. INVESTMENTS IN EQUITY INSTRUMENTS

- 38 The option to present changes in the fair value of equity instruments in other comprehensive income unless the equity instrument is held for trading (or is not contingent consideration in a business combination under IFRS 3 *Business Combinations*) ensures that entities do not have to recognise short term changes in fair value in profit or loss.
- 39 However, gains and losses on investments in equity instruments remeasured through other comprehensive income will never impact profit or loss even when the investment is sold (although dividends impact profit or loss immediately). Further, no impairment loss will ever be recognised in profit or loss, and EFRAG notes that this introduces a unique accounting treatment in IFRS. This may be considered as limiting the relevance of the information, especially if such gains or losses upon sale, or impairment losses, would be viewed as indicative of the performance of the investor and useful for assessing stewardship.
- 40 It has been brought to the attention of EFRAG that this issue would be particularly relevant for long-term investors. While EFRAG acknowledges the difficulties that the IASB had to find a conceptually sound impairment model for equity instruments, we believe that a less conceptually sound model is better than no model. EFRAG also notes that, in commenting to the IASB, we suggested the lower of cost or market model be considered for the impairment of equity instruments held for the long term to enable users to distinguish those holdings from equity instruments held for trading. However, the IASB did not follow that suggestion. Accounting aspects of investments

in equity instruments held by these entities are also discussed in Appendix 3, paragraphs 84 - 88.

- 41 Certain types of assets (such as investments in funds) expose investors to equity risk without meeting the definition of equity instruments because they are puttable. The option to present the fair value changes through other comprehensive income is not available for such assets and, because they do not meet the contractual cash flow test, they have to be measured at fair value through profit or loss. This measurement basis may not reflect the way the assets are managed in a long-term investment business model, which may limit the relevance of the information. EFRAG assesses that such funds may have different underlying instruments bearing different risks which would require a look through approach to identify the proper measurement method complying with the riskiness of the underlying instruments. Such an approach would increase complexity. Hence, EFRAG assesses that if there is a limitation in the relevance of the information for puttable instruments, this is balanced by the fact that the approach is principle-based and avoids complexities which would otherwise result from overriding the definition of equity instruments.

B.2. CLASSIFICATION OF FINANCIAL LIABILITIES: OWN CREDIT RISK

- 42 When an entity designates a financial liability to be measured at fair value through profit or loss in its entirety, IFRS 9 requires that the changes in the fair value due to changes in the credit risk of that liability (own credit risk) are presented in other comprehensive income. However, if doing so would create or enlarge an accounting mismatch in profit or loss, or when the liability is held for trading, an entity presents all gains or losses on that liability (including the effects of changes in the credit risk of that liability) in profit or loss.
- 43 This requirement significantly improves the relevance of reported profit or loss. The reason is that it avoids counterintuitive reporting of gains in profit or loss when the own credit standing of entity deteriorates and the reporting of losses when the credit standing improves.
- 44 The requirement that presentation in other comprehensive income does not apply if such presentation would create or enlarge an accounting mismatch in profit or loss further contributes to relevance.
- 45 The option to early apply the provisions for own credit risk separately from other parts of IFRS 9 will increase the relevance of the financial information for those entities that use the fair value option for financial liabilities.
- 46 The accumulated change in fair value due to the entity's own credit risk on financial liabilities for which the fair value option has been taken is never reclassified to profit or loss. IFRS 9 argues that, when an entity repays the contractual amount, the cumulative effect of changes in the liability's credit risk over its life will net to zero because the liability's fair value will ultimately equal the contractual amount due. EFRAG recognises that this may be often the case. However, in situations where the repayment differs from the contractual amount (for example, due to early repurchase at fair value), the lack of reclassification may limit the relevance of the information especially if gains resulting from the repurchase of liabilities are perceived as part of the performance of the entity. EFRAG understands these views but also notes that these concerns are mitigated to some extent because the amount of such gains or losses has to be disclosed.

B.3. USE OF FAIR VALUE

- 47 The following assets and liabilities are measured at fair value under IFRS 9:

- (a) Financial assets that do not meet the contractual cash flow characteristics test including:
 - (i) all equity instruments;
 - (ii) all derivatives; and
 - (iii) debt instruments not meeting the test.
 - (b) Investments in debt instruments (financial assets) that meet the contractual cash flows characteristics test but are held within the business models where selling the assets is the main objective or an integral part of achieving the business model objective;
 - (c) Financial liabilities held for trading;
 - (d) Financial assets and financial liabilities designated at fair value through profit or loss (fair value option); and
 - (e) Hedged item designated in fair value hedges (if the hedged item is designated in respect of risk components, only the revaluation resulting from those risk component is recognised).
- 48 EFRAG assesses that the principle of measuring financial assets that do not meet the contractual cash flow characteristics test at fair value leads to relevant information for the following reasons:
- (a) equity investments and derivatives have no contractual cash flows which can be used as a basis for amortised cost;
 - (b) cost provides little information with predictive value about timing, amount and uncertainty of cash flows relating to these instruments; and
 - (c) for debt instruments not passing the cash flow characteristics test EFRAG assesses that fair value is a better predictor of future net cash inflows for these assets than amortised cost as discussed in paragraph 18(b).
- 49 As explained in paragraphs 30 - 33, fair value is one of the measurement methods leading to relevant information for investments in debt instruments held in a business model to sell or collect and sell. Having said that, EFRAG acknowledges that the distinction between the two business models is complex and requires significant judgement while leading to different presentation of changes in the value of the assets.
- 50 Generally, EFRAG assesses that amortised cost provides the most relevant information for measuring many financial liabilities as it reflects the issuer's legal obligation to pay the contractual amounts. However, when financial liabilities are held for trading, the entity's short term objective is not to repay the contractual amount due but rather to achieve a trading result from repurchasing it. In such cases EFRAG assesses that fair value provides relevant information.
- 51 When an entity elects to measure a financial asset or a financial liability at fair value through profit or loss, EFRAG assesses that fair value leads to relevant information. This is because the option is available if it eliminates or significantly reduces an accounting mismatch, as assessed in paragraph 37, or in addition, for financial liabilities, performance of these is evaluated on a fair value basis or when embedded derivatives cannot be measured separately. The fact that IFRS 9 requires that the changes in fair value due to changes in the entity's own credit risk are presented in other comprehensive income as discussed in paragraphs 42 to 46 further contributes to the relevance of the information.

- 52 Finally EFRAG assesses that measuring the hedged item in a fair value hedge at fair value leads to relevant information as it ensures that offsetting changes in the value of the hedging instrument and the hedged item are recognised in profit or loss.
- 53 EFRAG has heard from constituents that there are a number of consequences that may arise from the use of fair values, especially in stressed conditions:
- (a) Under IFRS 13 *Fair Value Measurement*, fair value is measured based on market information or by using models that either use data observable in the markets or through valuation models using best estimates. The use of models in normal conditions is not insignificant, and in times of stress, fair value may not be available through normal market mechanisms and entities may have to resort to using models to estimate fair value, in very high conditions of uncertainty, eventually stretching the reliability of estimates to their limits.
 - (b) Fair value is dependent on actual or estimated market values at reporting date and is impacted by conditions at that date. Especially in stressed conditions, such point in time values may not be representative of the long-term trends and may provide less relevant information for long term investors.
 - (c) Fair value measurements, reflecting by definition both upswings and downswings in markets, are considered by some as pro-cyclical. EFRAG notes that empirical evidence of this is inconclusive.
- 54 In the instances identified above, entities may need to supplement their normal level of disclosures to explain the significance of financial instruments for their financial position and performance as is required by IFRS 7 *Financial Instruments: Disclosures*.
- 55 EFRAG wishes to emphasise that these aspects are not generated by IFRS 9; rather they may arise in all circumstances where IFRS require or allow fair value measurement.
- 56 The above consequences do not prevent EFRAG from assessing that, overall, IFRS 9 leads to relevant information in those cases where it relies on fair value measurement.

C - Impairment

- 57 Following the criteria set out in paragraph 5 above, EFRAG has focused its assessment on requirements related to:
- C.1. A general approach;
 - C.2. 12-month and lifetime expected credit losses;
 - C.3. Determining significant increases in credit risk;
 - C.4. Addressing mispricing at inception;
 - C.5. Simplified approach for trade receivables, contract assets and lease receivables;
 - C.6. Measurement of expected credit losses;
 - C.7. Purchased or originated credit-impaired assets; and
 - C.8. Business combinations.

C.1. A GENERAL APPROACH

- 58 The expected credit loss impairment model is based on a forward-looking approach that takes into account internal information, such as internal default rates and

delinquencies, and external information, such as borrower-specific, market and macro-economic indicators, in estimating the credit loss allowance.

- 59 The size of the loss allowance is determined by the credit risk status of the financial instruments and in particular as to whether the financial instruments have suffered credit deterioration since initial recognition or not. It therefore ensures that full economic losses, i.e. those which are not reflected in initial pricing of the instruments, are recognised on a timely basis. This provides useful information to users of financial statements.
- 60 EFRAG assesses that the model using comprehensive credit risk and forward-looking information provides an appropriate basis for users to understand the extent of expected credit losses resulting from credit risk of financial instruments. As a result, EFRAG considers that the approach brings relevant information for assessing the likelihood of collecting future contractual cash flows.

C.2. 12-MONTH AND LIFETIME EXPECTED CREDIT LOSSES

- 61 The expected credit losses model in IFRS 9 distinguishes between recognition of 12-month and lifetime expected credit losses.
- 62 12-month expected credit losses are recognised as a loss allowance at each reporting date as long as there is no significant deterioration in the credit risk since initial recognition of the instrument. The relevance of recognition of 12-month expected credit losses may be questioned as it is an arbitrary measure of credit losses which lacks a conceptual basis. It can be deemed to overstate losses at initial recognition³ as there is no economic loss if credit risk is reflected in the initial price of the instrument. In assessing the relevance of the information provided by 12-month and lifetime expected credit loss allowances EFRAG has looked at:
- (a) how a more conceptual impairment approach would address impairment of financial assets; and
 - (b) how such a conceptual impairment approach compares with the IFRS 9 impairment model as to implementation difficulties and amounts of expected credit losses recognised.
- 63 Under such conceptual impairment approach, for a financial instrument measured at amortised cost, interest revenue is accrued over the life of the financial instrument. The cost of credit risk, reflecting the initial expected credit losses, is factored initially into the pricing of the instrument's cash flows and generally increases the market return of the instrument, mainly through the interest rate. Conceptually the cost of credit risk incorporated in the interest rate should be deferred and used to offset credit losses when they occur. This approach results in an interest revenue pattern which is net of risk and reflects the expected economics of lending transactions. Unlike IFRS 9, no loss is recognised initially. If the expected credit losses subsequently increase an economic loss arises and an allowance reflecting the impairment loss would be recognised.
- 64 When comparing the IFRS 9 expected credit loss impairment model with this conceptual approach the following can be observed:

³ The document refers to *losses at initial recognition* or *day-one loss* as a shortcut. The exact requirement of IFRS 9 is that the 12-month expected credit losses are recognised at each reporting date unless the credit risk has increased significantly since initial recognition.

- (a) This conceptual approach has been explored and exposed to comments as part of the IFRS 9 impairment model development but abandoned by the IASB as it was deemed not to be operational based on comments from constituents.
 - (b) The 12-month expected credit loss is designed to make the requirements in IFRS 9 operational:
 - (i) Many of the inputs used for the calculation of 12-month probabilities of default are already tracked by most financial institutions to meet prudential regulatory requirements.
 - (ii) Even though the recognition of 12-month expected credit losses overstates losses at initial recognition it addresses the criticism that current accounting models do not provide for timely recognition of impairment losses. From this perspective, 12-month expected credit losses can be viewed as a compromise between the non-recognition of losses at the instrument's inception, which might be conceptually sound, and timely recognition of impairment losses in line with fact that the interest revenue which includes the compensation for credit risk is accrued from initial recognition.
 - (c) The 12-month expected credit losses lead to an overstatement of losses at initial recognition as discussed in paragraph 62 and in (b)(ii) above. However, there might also be exceptional circumstances when recognition of 12-month expected losses may understate the losses compared to this conceptual approach. It would be the case in particular for portfolios with losses occurring at a later stage of the financial instruments' lives so that the 12-month probability of default is low relative to the overall risk (so called late loss patterns as opposed to early loss patterns which are discussed below in (e) and paragraph 70).
 - (d) The IFRS 9 impairment model provides an outcome which is similar to the conceptual approach when recognising subsequent increases in credit risk. However it tends, to a certain extent, to overstate the amount of lifetime expected losses compared with this conceptual approach. This issue is addressed in paragraph 73.
 - (e) There are significant differences in how the losses in portfolios with early loss patterns are captured (the early loss patterns are defined and further discussed in paragraphs 70 and 71). This conceptual approach does not recognise losses for portfolios with early loss patterns at the time when they actually occur. As long as the overall risk of the portfolio does not change the losses will be offset by future interest cash flows from non-defaulting assets which carry the compensation for the original credit risk. IFRS 9 does not take such future compensation into consideration and recognises the early losses when they actually occur at individual instrument level.
- 65 As a result EFRAG assesses that the IFRS 9 impairment model achieves an appropriate balance between the benefits of a conceptual presentation of expected credit losses and the operational costs and complexity. The impact of achieving this balance is a trend towards over-impairment in most circumstances, which can be analysed as a limitation in relevance. EFRAG supports this outcome nevertheless as it thinks that it will overall bring information that is relevant to users.
- 66 It can also be argued there is an inconsistency in measuring expected credit losses at initial recognition between financial assets measured at amortised cost on the one hand and financial assets measured at fair value on the other hand. In the former case, equity is reduced by the amount of expected credit losses. In the latter case, the offsetting effect between the interest cash flows, including the cost of risk, and

- expected losses is reflected in fair value measurement and equity is not reduced specifically for calculated impairment losses. If financial assets are measured at fair value through other comprehensive income the neutral impact on equity is achieved by the requirement that the impairment loss is offset by an entry in other comprehensive income.
- 67 EFRAG acknowledges this difference but notes that this is outweighed by the advantage of having a dual measurement model where financial assets can be measured at amortised cost or at fair value depending on their contractual cash flow characteristics and the business model under which they are held. The neutral impact on equity for financial assets measured at fair value is inherent in fair value measurement and results from the offsetting effect between the interest cash flows and the expected credit losses. Thus the fair value recognised in the balance sheet is an unadjusted amount and its subsequent changes impact equity which contributes to relevance of the information. The reduction in equity for financial assets measured at amortised cost at initial recognition results from recognition of the 12-month expected credit losses, whose relevance is discussed in paragraph 64 and 65.
- 68 Some have claimed that, in all cases, recognition of full lifetime expected credit losses at inception would provide more relevant information. This is a key feature of the forthcoming FASB model. EFRAG disagrees with this view, as such an approach would lead to recognising losses on creditworthy financial assets significantly in advance of:
- (a) any economic losses; and
 - (b) the compensation for credit risk, i.e. the interest margin that is expected to accrue throughout the life of the instrument.
- 69 Concerns have been raised in respect of how the distinction between a 12-month expected losses and full lifetime expected losses addresses loans which have historical loss patterns indicating the likelihood of losses occurring in early years however not within the 12-month period.
- 70 Early loss patterns relate to higher than average default rates in a specific period for a particular portfolio. Expected early credit losses patterns are included in the price charged to debtors and consequently, due to the higher interest rate, increase the 12-months expected credit loss recognised.
- 71 In the cases of instruments which are expected to have an early loss pattern and the early losses are expected to occur (fully or proportionally) within the next 12 months, the effect would be captured by the 12-month expected credit losses being higher than for instruments without such a loss pattern. Early loss patterns expected to occur beyond the 12-month period would be reflected in the price charged. The impact on the allowance would depend on the expected timing of the early loss. EFRAG also notes that the requirements for recognition of lifetime expected losses ensure that the early losses are recognised in full when the credit quality falls and refers to the discussion in paragraph 64(e).
- 72 IFRS 9 requires recognition of full lifetime expected credit losses when the credit risk of the instrument increases significantly. The assessment is required to be made on the basis of all reasonable and supportable forward-looking information that is available, i.e. having full lifetime credit losses recognised in advance of any default. Users of financial statements will be able to clearly distinguish between financial assets for which credit risk has increased significantly since initial recognition and those for which credit risk has not, and have indicated that this information is useful to them. Significant increases in credit risk will affect profit or loss through the recognition of lifetime expected credit losses, and disclosures will provide information about the volume of exposures subject to significant credit deterioration.

- 73 Lifetime expected credit losses are calculated by comparing contractual cash flows with expected cash flows. As a result, their volume reflects cash flows resulting from the credit margin which are designed to absorb the losses. There is no economic loss connected with this portion of cash flows and ideally, in order to provide relevant information, credit losses should be calculated by considering cash flows net of the original asset's credit spread. However, EFRAG notes that such a treatment was part of the impairment approaches that were explored and abandoned as they were deemed not to be operational.
- 74 Contractual terms of some instruments provide for repricing of the interest rate to reflect increases in credit risk. No economic loss arises upon such repricing if it adequately compensates for the increase in credit risk. However, IFRS 9 requires that the general principle is applied and lifetime expected losses are recognised in such cases. EFRAG assesses this treatment as relevant since it supports the objective of recognising lifetime expected credit losses for any significant increases in credit risk and avoids operational difficulties connected with assessing whether the increase in credit risk is adequately compensated.
- 75 Consequently, EFRAG assesses that the impairment model, including the 12-month approach for all instruments for which credit risk is appropriately priced and requiring recognition of lifetime expected credit losses when credit risk is assessed as increasing significantly, provides relevant and timely information on expected credit losses to users of the financial statements.
- 76 EFRAG also assesses that the forward-looking impairment model responds to the G20's request 'to strengthen accounting recognition of loan-loss provisions by incorporating a broader range of credit information' since it:
- (a) considers all relevant credit information, including macroeconomic factors, and
 - (b) provides for timely recognition of credit losses as result of:
 - (i) a minimum of 12-month expected credit losses recognised for all credit exposures; and
 - (ii) more timely recognition of economic losses upon significant credit deterioration when full lifetime expected losses have to be recognised. This also ensures that the losses will react to deteriorating economic conditions in a timely manner.

C.3. DETERMINING SIGNIFICANT INCREASES IN CREDIT RISK

- 77 The assessment of the change in credit risk since inception avoids absolute thresholds that could lead to a misalignment of the recognition of credit losses and the compensation charged for assuming the credit risk involved. This factor contributes to the relevance of the information.
- 78 EFRAG notes that a relative assessment on credit risk deterioration may lead to different loss allowances on financial assets with the same counterparty depending on when such financial assets were contracted. However, EFRAG considers that an economic assessment of initial credit loss expectations and subsequent changes in expectations provide more relevant information than an absolute assessment based on the counterparty's credit risk level because credit risk at inception is assumed to be included in the pricing of the instrument and it is therefore the effect of the change that will result in economic losses.
- 79 IFRS 9 permits 12-month expected credit losses to be recognised irrespective of the change in credit risk from initial recognition provided that the financial asset's credit risk is assessed as low at the reporting date. For this purpose, entities may use internal systems that are consistent with globally understood definitions of low credit

risk. An external rating of 'investment grade' may be an example of a financial instrument considered as having low credit risk.

- 80 Based on publically available long-term global default rates for investment grade investments, EFRAG does not expect the effect of the 'low credit risk' simplification on the timing of recognition of lifetime expected credit losses, and the amount of expected credit losses to be significant. This confirms the IASB's observation. Therefore EFRAG assesses that the practical expedient does not impair the relevance of the information provided.

C.4. ADDRESSING MISPRICING AT INCEPTION

- 81 Credit risk at inception would normally be included in the initial pricing of a financial asset, while full economic losses above initial expectations that emerge later are not. Significant increases in credit risk since inception lead to the recognition of lifetime expected credit losses.

- 82 If a financial asset is under-priced at inception, IFRS 9 would address the mispricing as follows:

(a) In the case that the mispricing becomes apparent only after initial recognition:

- (i) *Financial assets measured at amortised cost:* Mispricing because the credit risk was under-estimated would be addressed when subsequent reassessment of the credit risk leads to the recognition of lifetime expected credit losses. If the credit risk of the asset has not increased significantly but the mispricing element has been identified it would be addressed by the increase in the 12-month expected credit losses. Mispricing, other than mispricing related to credit risk (i.e. underestimation of non-credit pricing margins) would not be recognised as an impairment and the effect of mispricing would be reflected in profit or loss over the life of the asset through a reduced interest margin.
- (ii) *Financial assets measured at fair value through other comprehensive income:* The impact on profit or loss would be the same as described in (i). In addition, once the mispricing is identified it would be fully reflected in the reduction of fair value in the balance sheet. The decrease in value not already captured in profit or loss through the recognition of an impairment loss would be recognised through other comprehensive income.

(b) If the mispricing was evident at initial recognition it would be captured through the requirement that a financial instrument has to be initially measured at fair value. The best evidence of fair value of a financial instrument at initial recognition is normally the transaction price. However, if this is not the case, the accounting treatment would be:

- (i) If the part of the transaction price (e.g. the amount lent) is for something other than the financial instrument (e.g. is effectively a prepayment for services received from the borrower or related to a campaign for getting new customers) the difference between the transaction price and the fair value is recognised as an expense unless it qualifies for recognition as asset.
- (ii) If initial differences between the transaction price and the fair value arose due to other reasons they would be recognised immediately in profit or loss. However, if the fair value was not determined either based on quoted prices in active markets or by a model which uses only observable market data, the difference would be deferred and subsequently amortised into profit or loss over the life of the asset.

- 83 EFRAG assesses that the IFRS 9 requirements provide relevant information in capturing the effects of potential initial mispricing of credit risk.

C.5. SIMPLIFIED APPROACH FOR TRADE RECEIVABLES, CONTRACT ASSETS AND LEASE RECEIVABLES

- 84 The simplified approach consists in recognising the loss allowance for full lifetime expected credit losses on those trade receivables and contract assets without a significant financing component. This is because such assets generally have a maturity that is less than one year, so the lifetime expected credit losses and the 12-month expected credit losses would generally be equal. Further, EFRAG notes that interest to allow for credit losses is not normally charged on short-term trade receivables. Therefore, a credit deterioration event would not have an effect on the basis for calculating the loss allowance. As a result, EFRAG assesses that the simplified approach provides users with relevant information.
- 85 The simplified approach is extended, as an accounting policy choice, to trade receivables and contract assets with a significant financing component and lease receivables. EFRAG notes that using the lifetime expected credit loss approach for these assets may reduce relevance of the information due to the absence of distinction between 12-month and lifetime expected credit losses, given that trade receivable and contract assets with a significant financing component and lease receivables would generally mature after more than 12 months. EFRAG observes that the accounting policy choice was introduced in order to provide operational relief to preparers in specific business areas. EFRAG assesses that the benefits of this simplification outweigh the limited relevance.

C.6. MEASUREMENT OF EXPECTED CREDIT LOSSES

- 86 IFRS 9 defines expected credit losses as the expected present value of all cash shortfalls over the remaining life of the financial instrument. The term 'expected value' implies that the measurement is based on a probability weighted outcome determined by evaluating a range of possible loss scenarios and using probabilities of default as weights. EFRAG assesses that the expected value approach provides an appropriate basis to inform users about the current likely effect of credit risk.
- 87 The measurement of expected credit losses reflects all contractual terms (e.g. prepayment, extension, call and similar options) and considers the maximum contractual period over which the entity is exposed to credit risk, thus aligning the model with the definitions of assets, liabilities and expenses in the Conceptual Framework. An exception from focusing on contractual terms is applicable to revolving credit facilities such as credit cards and overdrafts. EFRAG notes that, in these cases, the consideration of the time beyond the contractual period provides relevant information because it aligns accounting with risk management practices and captures the actual extent of expected credit losses. For such facilities, the contractual cancellation period is usually very short and is not actively enforced as a part of the lenders' day-to-day credit risk management process. Entities generally continue to extend the credit and cancel the facilities only when an observable negative credit event occurs. As a result, the expected credit losses are estimated over the expected period of the exposure to credit risk. EFRAG assesses that such an approach is fully consistent with a forward-looking expected credit loss model and therefore will bring relevant information.
- 88 EFRAG notes that reflecting the economic life might also be relevant in specific cases of short-term facilities which are generally rolled-over and effectively provide longer-term lending. It is common for lenders to assess the credit quality of the facility and decide whether to renew it, possibly with an adjusted interest rate. However, if the

contractual roll-over period is very short lenders may not be able to effectively identify increases in the credit risk and react. Thus the facilities might be economically similar to the revolving facilities discussed in the paragraph above in a sense that they expose the lender to credit risk beyond the contractual period. However, such roll-over facilities do not include an undrawn commitment component which is a qualifying condition in IFRS 9 to consider expected exposure to credit risk rather than the contractual terms. EFRAG assesses that in the specific circumstances described above the relevance of the information in respect of real exposure to credit risk may be limited. The limitation of the relevance can be considered as a price to pay for reliability of the resulting expected credit loss allowance as lenders of such short-term facilities may not always succeed in timely recognising increases in credit risk.

C.7. PURCHASED OR ORIGINATED CREDIT-IMPAIRED ASSETS

- 89 In the case of financial assets which are purchased or originated at a deep discount that reflects the expected credit loss (credit-impaired at initial recognition), initial lifetime expected credit losses are included in the estimated cash flows at inception when calculating the credit-adjusted effective interest rate of the asset. As a result, initial expected credit losses decrease the interest revenue over the life of the asset and there is no loss allowance at initial recognition. Subsequent changes in cash flow estimates result in impairment gains or losses.
- 90 EFRAG assesses that this approach properly captures the specifics of financial assets which are credit-impaired at initial recognition. Recognition of interest revenue reflects the initial expectation of credit losses. If, due to changes in cash flows estimates, the economic value changes the asset holder incurs economic gains or losses which are accounted for as impairment allowances. Such measurement provides relevant information about the amount, timing and uncertainties of future cash flows from purchased or originated credit impaired assets.

C.8. BUSINESS COMBINATIONS

- 91 When financial assets are acquired in business combinations they are initially recognised at fair value. Subsequently, impairment loss equal to 12-month expected losses will be recognised at the reporting date (unless credit risk has increased significantly in the meantime). It has been brought to the attention of EFRAG that for significant business combinations which involve large volume of financial assets such impairment losses arising shortly after the combination may impact understandability of the performance of the acquirer, raise questions about the merits of business combinations and lead to non-GAAP disclosures. In opinion of some constituents, the initial impairment allowances should be recognised as an identifiable item when allocating the acquisition price under IFRS 3 *Business Combinations*.
- 92 EFRAG assesses that acquisitions of financial assets are economically similar transactions no matter if they arise from business combinations or separate transactions, i.e. the requirements of the impairment model are the same in both cases. In both cases the assets would be initially measured at fair value. Large amounts of 12-month expected credit losses which may be recognised shortly after some business combinations is commensurate with the volume of the financial assets acquired. It serves the purposes that the recognition of allowances was designed for, mainly it brings a balancing effect against the interest revenue which is accrued from initial recognition and also includes the compensation for credit risk. As a result, EFRAG assesses that application of the requirements of the impairment model to business combinations does not limit relevance.

D - Hedging

- 93 Following the criteria set out in paragraph 5 above, EFRAG has focused its assessment on requirements related to:
- D.1. Objective of hedge accounting;
 - D.2. Qualifying hedging instruments;
 - D.3. Qualifying hedged items;
 - D.4. Hedge effectiveness requirements;
 - D.5. Accounting for the time value of options;
 - D.6. Accounting for currency basis spreads;
 - D.7. Designation of a component of a nominal amount; and
 - D.8. Macro hedging.

D.1. OBJECTIVE OF HEDGE ACCOUNTING

- 94 IFRS 9 describes the objective of hedge accounting as to represent, in the financial statements, the effect of an entity's risk management activities that use financial instruments to manage exposures arising from particular risks that could affect profit or loss or in particular cases other comprehensive income.
- 95 However, under IFRS 9, hedge accounting is not mandatory. Entities can choose not to apply hedge accounting even when applying economic hedging for different reasons. EFRAG assesses that such a voluntary decision to apply hedge accounting is useful as risk management may include a large variety of strategies and actions that do not involve the use of financial instruments, for example, when insuring risks or in the case of supply management. In such cases, the information provided by the general accounting is sufficiently relevant without the need to supplement it with information added by specific hedge accounting requirements.
- 96 However, there may be cases – other than where the accounting mismatch is immaterial or when the entity elects to use the fair value option – where economic hedges are applied and hedge accounting could be used. In these cases, entities that elect not to apply the hedge accounting provisions of IFRS 9 are not providing all the relevant information that could be made available, i.e. they would not reflect their economic hedging in the financial statements.
- 97 Once initiated, a hedging relationship cannot be discontinued unless the risk management objective for that relationship changes. Instead, the hedging relationship is rebalanced in order to continue to meet the qualifying criteria. IFRS 9 distinguishes between an entity's risk management strategy and the risk management objective for a particular hedging relationship. The risk management strategy is established at the highest level at which an entity determines how it manages its risk. A risk management strategy is typically in place for a longer period, whereas a risk management objective applies at the level of a particular hedging relationship. It relates to how the particular hedging instrument that has been designated is used to hedge the particular exposure that has been designated as the hedged item.
- 98 EFRAG assesses that the inability to discontinue a hedging relationship unless the risk management objective for that relationship has changed provides useful information. This is because by initiating hedge accounting the entity has decided that doing so would recognise the offsetting effects in profit or loss from using hedging instruments for mitigating risks. The relevant nature of the resulting information does not disappear when market circumstances change. Only when the risk management

objective for the hedging relationship changes, is a re-assessment of the resulting information and thus potentially a discontinuation of the hedge relationship required.

- 99 In addition, IFRS 9 does not limit hedge accounting to risks that affect profit or loss. It also includes risks that affect other comprehensive income in the case of investments in equity instruments for which an entity has elected to present changes in fair value in other comprehensive income. EFRAG assesses that this results in relevant information as it aligns hedge accounting with the accounting for investments in equity instruments for which an entity has elected to present changes in fair value in other comprehensive income.

D.2. QUALIFYING HEDGING INSTRUMENTS

- 100 IFRS 9 requires that qualifying hedging instruments must be generally designated in their entirety. Hence derivatives embedded in financial assets are not eligible as hedging instruments on a stand-alone basis. Except for some embedded derivatives in own use contracts, participants in the EFRAG 2012 field-test on general hedge accounting (see Appendix 4, paragraph 3) did not indicate that designation of a separated embedded derivative as a hedging instrument was a common practice. In addition, the results from the EFRAG 2013 field-test on classification and measurement (see Appendix 4, paragraph 1) showed that bifurcation for measurement purposes was rarely used. Instead the fair value option was used because it was operationally easier and cheaper to apply.
- 101 EFRAG notes that a few constituents raised concerns that relevance would be impaired if embedded derivatives could not be used as hedging instruments as regards:
- (a) asymmetry in using embedded derivatives as hedging instruments resulting from applying bifurcation only for financial liabilities and non-financial items and not for financial assets; and
 - (b) entities which have been applying bifurcation of financial assets under IAS 39 and relied on the bifurcated embedded derivatives as hedging instruments would no longer be able to do so.
- 102 EFRAG notes that due to their contractual cash flow characteristics, financial assets with embedded derivatives are likely to be measured at fair value through profit or loss. IFRS 9 allows the designation of such financial instruments as hedging instruments. This in effect could lead to similar outcome as if the financial asset was subject to bifurcation and the embedded derivative designated separately as a hedging instrument. However, EFRAG also notes that the need to designate the hedging instrument in its entirety may limit the situations in which the hedge effectiveness requirements for such hedges would be met.

D.3. QUALIFYING HEDGED ITEMS

D.3.1. NON-FINANCIAL RISK COMPONENTS

- 103 EFRAG notes that IFRS 9 allows entities to designate financial and non-financial risk components as eligible hedged items as well as aggregated exposures. EFRAG assesses that in particular the eligibility of non-financial risk components (for example commodity price risk and some risk components of insurance liabilities) will improve the relevance of hedge accounting relationships of entities. This because it may permit corporates to reflect risk management of their business by relying on risk components which are directly related to their business.

D.3.2. SUB-LIBOR ISSUE

- 104 EFRAG observes that financial institutions often include core demand deposits with a low or zero interest in their hedging strategies. The interest rate risk being hedged is not the low or zero interest cash flows but rather the benchmark market interest rate (e.g. LIBOR), hence the nomenclature 'sub-LIBOR issue'. A sub-LIBOR-related issue is also found in certain cash flow hedging strategies of some utility entities where the designated hedged item can be higher than the actual cash flow risk exposure due to dynamic changes subsequent to the designation of the actual cash flow exposures being hedged.
- 105 EFRAG additionally observes that such hedging strategies are not aimed at hedging the interest rate risk of core demand deposits in isolation, but rather a net position of assets and liabilities in portfolios whereby hedged items can be added and/or removed continuously (i.e. open portfolios of hedged items).
- 106 EFRAG acknowledges that such hedging strategies pose challenges for hedge accounting other than those which are addressed by IFRS 9 and may be developed further as part of any future macro hedging proposals. Nevertheless, this omission means that the objective of aligning the hedge accounting with risk management practices is not currently fully met.
- 107 Also EFRAG notes that the argument for prohibiting the designation of a component of a cash flow that is higher than the total cash flows of the entire item as the hedged item was based on an assumption that interest rates have a natural floor of zero. In the light of current market circumstances, this has proven not to be correct in all circumstances.
- 108 Hence, EFRAG assesses that the absence of a solution for the sub-LIBOR issue may limit the relevance of the information for hedging strategies relying on sub-LIBOR hedging. EFRAG assesses that the limitation in the relevance of the information should be considered as temporary in nature given the work of the IASB in the field of macro hedge accounting.
- 109 The outcome of the IASB work in the field of macro hedge accounting may also be relevant for economic micro hedging strategies. The macro-hedge accounting project is to identify if such strategies require specific presentation requirements compared to other interest rate risk hedging strategies.

D.3.3. CREDIT RISK

- 110 IFRS 9 considers that credit risk is not a separately identifiable risk component and hence does not qualify for designation as a hedged item on risk component basis. However, EFRAG notes that economic hedges of credit risk using credit derivatives are used by some entities. It could therefore be argued that a standard on hedge accounting ought to address these practices.
- 111 EFRAG notes that the pricing of credit risk in credit derivative markets and debt instrument markets are not always strongly correlated because of:
- (a) possible uncertainties about what measures may be considered as a credit event triggering a pay-out on the credit derivatives;
 - (b) cheapest-to-deliver options (i.e. at the moment a credit event occurs, the credit risk protection buyer can choose to deliver the cheapest financial instrument issued by the entity) affects the price of credit derivatives; or
 - (c) liquidity and speculative factors in the credit derivative markets generally leading to a higher fluctuations in credit spreads in credit derivative markets than in the related debt instruments.

- 112 EFRAG generally assesses that the degree of the lack of correlation goes beyond what can be considered as an economic relationship between the hedged item and the hedging instruments. This holds for credit risk positions for which no credit event has occurred when all of the factors (a) to (c) mentioned above play a role.
- 113 Where a credit event has occurred, EFRAG assesses that effective protection against impairment would be provided in case of bankruptcy when factors (a) to (c) tend to have a minor effect. However, for other credit events, such as restructuring, there are factors other than credit risk which influence the value of the asset and the hedge may not be effective.
- 114 Although there are cases when entities use credit derivatives for protection against credit risk as part of their risk management strategies, EFRAG assesses that the economic relationship between the hedged item and the hedging credit derivative is not always present to the extent that it can be assessed as a systematic offset. Consequently, the prohibition of designation of credit risk on risk component basis might limit the relevance of the information to a certain extent, however this may be considered as a trade-off between relevance and reliability. EFRAG also notes that IFRS 9 introduces a special type of fair value option applicable for financial instruments whose credit risk is managed by credit derivatives which might provide a solution for entities using credit derivatives for risk protection.

D.4. HEDGE EFFECTIVENESS REQUIREMENTS

- 115 EFRAG notes that the hedge accounting model is based on a general notion of offset between gains and losses on the hedging instrument and the hedged item. EFRAG assesses that the hedge effectiveness requirements put reasonable boundaries on effective economic relationships and provide relevant information because:
- (a) There must be an economic relationship between the hedging instrument and the hedged item which means that their values generally move in the opposite direction with respect to the same risk, which is the hedged risk;
 - (b) Even when there is an economic relationship between the hedging instrument and the hedged item the effect of different credit risks inherent in the two instruments may result in the offset becoming erratic: as a result, IFRS 9 requires that that effect is not dominant; and
 - (c) The hedge ratio must be the same as the entity actually uses in their economic hedges, i.e. based on the quantities of the hedging instruments and hedged items used to manage the risk. This requirement limits the space for designating hedge relationships in an inappropriate way to achieve a particular accounting outcome (such as cash flow hedges designated in an 'underhedge' position leading to recognition of ineffectiveness in the cash flow hedge reserve rather than in profit or loss).
- 116 IFRS 9 allows the application of 'proxy hedging' which means that hedging instruments need not be directly designated in respect of items to which they economically relate. Such economically hedged items may not meet criteria for qualifying hedged items, e.g. they are net positions in interest rate risk or they are core deposits. Instead, a hedged item meeting the qualifying criteria is designated, e.g. variable-rate financial assets serving as a proxy for hedges of core deposits. Such designations are permitted as long as they reflect the risk management objective in relation to the hedging instrument. EFRAG assesses that proxy hedges are an important element which enables the reflection of the risk management practices in hedge accounting and thus results in relevant information.

D.4.1. HEDGING STRATEGIES NOT MEETING THE QUALIFYING CRITERIA FOR HEDGE ACCOUNTING

- 117 Not all hedging strategies meet the qualifying criteria for hedge accounting. In addition some risk management hedging strategies do not fit the accounting techniques of a fair value or a cash flow hedge (e.g. hedges of basis risk of variable rate instruments).
- 118 EFRAG notes that the relevance of the financial statement information is improved by the disclosures requiring a description of how dynamic risk management strategies are reflected by using the static hedge accounting techniques permitted by IFRS 9. Further, the disclosures prescribe a tabular format that separates information by type of hedge risk, the risk category and risk management strategy.

D.4.2. REBALANCING

- 119 If a hedging relationship ceases to meet the hedge effectiveness requirement relating to the hedge ratio but the risk management objective for that hedge relationship remains unchanged, an entity shall adjust the hedge ratio (i.e. rebalance) so that it meets the qualifying criteria again.
- 120 As argued in paragraph 98 above, EFRAG assesses that by initiating hedge accounting an entity is aware that doing so would require recognising the offsetting effects in profit or loss from using hedging instruments for mitigating risks. The relevant nature of the resulting information does not disappear when market circumstances change. Consequently, it is logical to rebalance the hedge relationship in such circumstances and the resulting information has the same relevant quality as the information before rebalancing the hedge relationship.

D.5. ACCOUNTING FOR THE TIME VALUE OF OPTIONS

- 121 When an entity separates the intrinsic value and time value of an option contract and designates as the hedging instrument only the change in intrinsic value of the option, the change in fair value of the time value is recognised in other comprehensive income. EFRAG considered that this approach provides relevant information as the intrinsic value of the option gives rise to offsetting changes in relation to the hedged risk. The time value of the option, paid at inception as an option premium and economically considered as a cost of hedging, is outside the hedging relationship and its fair value fluctuation does not affect profit or loss.

D.6. ACCOUNTING FOR CURRENCY BASIS SPREADS

- 122 IFRS 9 includes foreign currency basis spreads which are inherent in foreign currency derivatives in the 'costs of hedging'. Foreign currency basis spreads are considered as a charge to exchange one currency into another in a forward market. They are an economic phenomenon that exists because of a number of factors such as the credit risk embedded in the underlying reference rates of the currencies or the demand and supply for a particular financial product. Their importance as a valuation component became obvious during the financial crisis and has been relevant since.
- 123 The fair value of a cross-currency interest rate swap used as a hedging instrument will include a pricing element that reflects the foreign currency basis spread. In contrast, the spread is not a characteristic of the hedged item because it is expressed in a single currency and does not include the exchange of currencies. Consequently, EFRAG assesses that considering foreign currency basis spreads as costs of hedging rather than as ineffectiveness provides relevant information.

D.7. DESIGNATION OF A COMPONENT OF A NOMINAL AMOUNT

- 124 A layer component that includes a prepayment option is not eligible to be designated as a hedged item in a fair value hedge if the prepayment option's fair value is affected by changes in the hedged risk, unless the designated layer includes the effect of the related prepayment option when determining the change in the fair value of the hedged item.
- 125 EFRAG notes that, in their risk management, entities may assume that prepayments are not part of the layer being hedged, for example when hedging a bottom layer. Not allowing this possibility when hedging a (bottom) layer limits the relevance of the resulting information as it is not in line with risk management practice. EFRAG assesses that the limitation in the relevance of the information can be considered as a price to pay for the reliability of the information.

D.8. MACRO HEDGING

- 126 IFRS 9 does not address hedge accounting for open portfolios, i.e. macro hedging. It could be argued that, because of this, IFRS 9 is internally inconsistent as for some hedge accounting relationships an alignment with risk management is permitted while portfolio hedging continues to be a documentation exercise. EFRAG disagrees with this view because these two models are applied to different hedging strategies and hedge accounting is optional. As argued in paragraph 95 above, the fact that the general hedge accounting requirements are applied to some economic hedges and not to others does not make the resulting information less relevant.

E - Overall conclusion on relevance

- 127 EFRAG's overall assessment is that IFRS 9 could have been a better standard if some limitations on relevance had been avoided. However, EFRAG concludes that this does not prevent IFRS 9 from providing relevant information.

Reliability

- 128 EFRAG also considered the reliability of the information that will be provided by applying IFRS 9. Information has the quality of reliability when it is free from material error and bias and can be depended upon by users to represent faithfully what it either purports to represent or could reasonably be expected to represent, and is complete within the bounds of materiality and cost.
- 129 There are a number of aspects to the notion of reliability: freedom from material error and bias, faithful representation, and completeness.

A - Summary

- 130 In the area of classification and measurement EFRAG expects that the application of both the contractual cash flow characteristics and the business model will not trigger reliability issues. EFRAG assesses that a business model is a matter of fact which supports the verifiability of the resulting information. The assessment of the contractual cash flows will in many cases be unambiguous and substantial guidance is provided in IFRS 9 to assist in assessing the cases where the outcome is not straightforward.
- 131 Except in rare cases, EFRAG expects entities to have reliable data to measure the fair value of equity instruments as it is relevant to their decisions to hold or sell. EFRAG notes further that to assess whether an equity instrument is impaired the determination of the recoverable amount would imply the use of a valuation methodology that is not very different from a fair value assessment. Furthermore in those rare cases where the fair value of non-quoted equity instruments cannot be measured reliably, disclosures are required to make the limitations in measurement transparent.
- 132 The forward looking approach in the expected credit losses model requires the application of judgement, based on multiple sources of information combining both internal and external sources. Reliability of the resulting information is expected to benefit from the extensive disclosures related to the inputs, assumptions and estimation techniques. IFRS 9 also includes practical expedients for implementing the impairment model which are considered not to impair reliability as they can be applied only in line with the overarching principles in IFRS 9.
- 133 Where hedge accounting is concerned, EFRAG has not identified any reliability concern.
- 134 EFRAG's overall assessment is that IFRS 9 leads to the provision of reliable information. Limitations to reliability which have been identified are balanced against operationality or relate to cases which are rare.

B - Classification and Measurement

- 135 Following the criteria set out in paragraph 5 above, EFRAG has focused its assessment on the requirements related to:
- B.1. The business model and the contractual cash flow characteristics; and
 - B.2. Investments in unquoted equity instruments.

B.1. THE BUSINESS MODEL AND THE CONTRACTUAL CASH FLOW CHARACTERISTICS

- 136 Assessment of the business model within which basic lending instruments are managed should consider all relevant available evidence (e.g. objective information,

such as business plans, how managers of the business are compensated and the amount and frequency of sales activity). IFRS 9 also provides application guidance and examples related to the activities that are commonly associated with each of the three business models. In addition, the business model is assessed at a level that reflects the way groups of basic lending instruments are managed together to achieve a particular business objective and is observable through the particular activities that the entity undertakes to achieve the particular business objective. As such, a business model is a matter of fact rather than an assertion, which helps produce information which is verifiable. As a result, EFRAG assesses that the business model criterion result in providing an information which is reliable.

- 137 The assessment of the contractual cash flow characteristics will often be unambiguous. However, in some cases, deciding whether the cash flow characteristics criterion is met will require assessment of contractual provisions that do or may change the timing and/or amount of the contractual cash flows. Thus the implementation of the cash flow characteristics criterion requires judgement to ensure that financial assets are classified into the appropriate category. IFRS 9 includes substantial guidance on specific contractual features and terms, which indicates in which cases the cash flow characteristics test is expected to be met and thus EFRAG assesses that the criterion is expected to result in reliable classification.
- 138 EFRAG notes that having the hold to collect and the hold to collect and sell as two separate business models might increase complexity for preparers and create tensions in the reliability of the information. This is because preparers will have to separate similar solely payment of principal and interest compliant financial assets between the amortised cost category and the fair value through other comprehensive income category, requiring judgement to evaluate the distinguishing factors for each portfolio.

B.2. INVESTMENTS IN UNQUOTED EQUITY INSTRUMENTS

- 139 IFRS 9 requires all investments in equity instruments, and derivatives over them, to be measured at fair value. This includes investments in, and derivatives over, unquoted equity instruments that cannot be measured reliably. When acquiring equity investments EFRAG expects entities mostly to have reliable data to assess fair value of such instruments as otherwise they would refrain from acquiring them at the fair value used in the transaction. In cases where such data are based upon unobservable inputs disclosures are able to provide the essential information to users. Consequently, EFRAG assesses that the cases where it would not be possible to measure reliably non-quoted equity instruments seem to be rare. However, EFRAG notes that IFRS 9 acknowledges the existence of limited circumstances where cost may be an appropriate estimate of fair value.
- 140 In those rare cases, measuring unquoted equity investments at fair value may result in gains being recognised beyond what the exercise of caution in conditions of uncertainty would command. However, the use of cost (other than as estimate of fair value) may delay the recognition of losses, as evidence of decrease in value for unquoted equity investments could be untimely or unclear. Moreover, if these were carried at cost, the holder would still need to determine a recoverable amount; for an equity investment, this would imply the use of a valuation methodology that is not very different from a fair value assessment.

C - Impairment

- 141 Following the criteria set out in paragraph 5 above, EFRAG has focused its assessment on requirements related to:

- C.1. Assessment of significant increase in credit risk and calculation of expected credit losses; and
- C.2. Practical expedients.

C.1. ASSESSMENT OF SIGNIFICANT INCREASE IN CREDIT RISK AND CALCULATION OF EXPECTED CREDIT LOSSES

- 142 An assessment of the significant increase in credit risk takes into consideration only the changes in the risk of a default occurring rather than changes in the amount of expected credit losses. This aligns the assessment of changes in credit risk with the way probabilities of default are generally tracked in practice and provides reliable information about the practices of the holders of the financial asset. EFRAG also notes that further alignment with credit risk management practices is achieved because risk management generally focuses on those instruments with credit deterioration in assessing appropriate actions to be taken to mitigate credit losses arising.
- 143 Entities will need to exercise judgement when assessing the existence of a significant increase in credit risk to determine whether 12-month or lifetime expected credit losses are recognised. Entities will also need to decide the most appropriate techniques for measuring expected credit losses in accordance with the measurement principles using information about past events, current conditions and forecasts of future conditions. The judgements and estimates will be based on multiple sources of information combining internal and external data including forward-looking and macroeconomic information which is available on a reasonable and supportable basis. An exhaustive search for the information is not required if it entails undue cost or effort. The subjective nature of these factors impacts the reliability of the information being provided.
- 144 The level of judgement required by IFRS 9 for recognition of expected credit losses is substantial as the financial information is being prepared taking into account high levels of uncertainty. On the other hand, extensive information related to the inputs, assumptions and estimation techniques used will be disclosed. This contributes to the reliability of the information.
- 145 Some believe that the limitation put to the search for information on the basis of undue cost or effort would trigger a lack of reliability. EFRAG does not share this view as IFRS 9 requires that all information that is available without undue cost or effort on a reasonable and supportable basis should be used. Going beyond what is available to the entity would not increase reliability as it could lead to spurious estimates and would raise the question whether the impairment model would be operational. Entities are required to use their best efforts to calculate the expected credit losses but the extent to which the information is available to individual entities differs and IFRS 9 acknowledges this. EFRAG notes that proportionality would apply in accordance with the sophistication of entities' systems. The draft guidelines on expected credit losses issued by the Basel Committee contain their view of proportionality and are further discussed in paragraph 150.
- 146 The forward-looking approach in IFRS 9 using unbiased information about past events, current conditions and forecast economic conditions supported by disclosure requirements is designed to faithfully represent the current financial position rather than smoothing performance over the expected economic cycle. This enhances the reliability of the information.

C.2. PRACTICAL EXPEDIENTS

- 147 IFRS 9 includes the following practical expedients:
- (a) When assessing significant increases in credit risk:
 - (i) more than 30 days past due rebuttable presumption (assessed in paragraph 175 of the section on comparability);
 - (ii) the assessment can be based on 12-month rather than lifetime probabilities of default;
 - (iii) entities can compare current credit risk with threshold for credit risk at origination; and
 - (iv) entities can perform the assessment at counterparty rather than at individual instrument level.
 - (b) IFRS 9 permits 12-month expected credit losses to be recognised irrespective of the change in credit risk from initial recognition provided that the financial asset's credit risk is assessed as low at the reporting date. This practical expedient is assessed in paragraphs 79 and 80 of the section for relevance.
 - (c) When calculating expected credit losses entities can apply practical expedients which are compliant with the general requirements for measurement of expected credit losses. An example would be a provision matrix used for trade receivables. This is to address practical approaches which use loss rates mainly based on delinquency status usually applied to trade receivables but they can also be found in the area of retail exposures.
- 148 The practical expedients listed in (a) and (c) are in line with current credit risk management approaches. All of these practical expedients can be applied only if doing so is consistent with the underlying principles. IFRS 9 brings additional safeguards which illustrate and should ensure their proper application. Therefore, EFRAG considers that practical expedients do not impair the reliability of the information.
- 149 In developing the practical expedients, the IASB paid attention to bringing costs of implementation proportional to the expected benefits considering the size of the entities and their respective involvement with financial instruments.
- 150 In February 2015 the Basel Committee on Banking Supervision published a consultative document *Guidance on accounting for expected credit losses*. The Basel standards are generally designed for internationally active banks with a potentially wide scope of application across banks in Europe. The draft guidelines discuss supervisory requirements for sound credit risk practices that interact with expected credit risk loss measurement and contain some explanations on how they should be applied in a proportionate manner. In doing this the draft guidelines intend to limit the use of practical expedients. The draft guidelines also discuss how the loss allowance based on 12-month expected credit losses are to be measured and how significant increases in credit risk are to be determined. EFRAG has not assessed the impact on the cost-benefit analysis if the draft Basel guidelines are applied.

D - Overall conclusion on reliability

- 151 EFRAG's overall assessment is that IFRS 9 leads to the provision of reliable information. Limitations to reliability which have been identified are balanced against operability or relate to cases which are rare.

Comparability

- 152 The notion of comparability requires that like items and events are accounted for in a consistent way through time and by different entities, and that unlike items and events should be accounted for differently.
- 153 EFRAG has considered whether IFRS 9 results in transactions that are:
- (a) economically similar being accounted for differently; or
 - (b) transactions that are economically different being accounted for as if they are similar.

A - Summary

- 154 As IFRS 9 provides a logical structure and a clear rationale for the classification and measurement of financial assets with only a few accounting choices, and since application guidance is provided to exercise judgement in applying the of the characteristics of the instrument test and the determination of the business model, EFRAG has overall concluded that the IFRS 9 classification and measurement requirements would lead to the provision of comparable information. This is despite the limitation brought by the absence of bifurcation for hybrid assets that EFRAG has accepted, first as a simplification, second as the application of bifurcation requirements were not without comparability concerns in practice. This is also despite the measurement options in IFRS 9 for which EFRAG assesses that the right balance between relevance and comparability has been struck. Indeed such options are useful because they help avoid accounting mismatches that would otherwise distort economic reality.
- 155 The impairment requirements bring a uniform basis applicable to all financial instruments in scope of IFRS 9 which leads to comparable information. Some limitations to comparability can be found in how the 12-month expected credit losses impact equity at initial recognition between the different measurement classes. Also, at the date of initial application of IFRS 9, comparability may be limited as not all entities will be able to assess the changes in credit risk since origination of all instruments. In case entities cannot do so without relying on information that requires undue cost or effort, and the level of credit risk at initial application is not considered to be low, lifetime expected credit losses are to be recognised. The latter limitation is to be balanced against the operability of the impairment model. The more than 30 days past due presumption can be rebutted so it is assessed not to lead to spurious uniformity. Although IFRS 9 does not provide a definition of default, rather, there is a rebuttable presumption that default does not occur later than 90 days past due. EFRAG assesses that rebuttal of the presumption will occur in different economic contexts. Reflecting such different economic contexts leads to comparable information.
- 156 As hedge accounting is not mandatory, the comparability between entities applying hedge accounting and those that do not could be limited. However, the non-mandatory application of hedge accounting ensures that it is applied only where it leads to relevant information. IFRS 9 includes accounting policy options to apply either the IAS 39 or IFRS 9 requirements to its hedging relationships. This limits comparability but is balanced by the fact that it addresses the lack of a comprehensive hedge accounting solution.
- 157 IFRS 9 distinguishes between transaction related and time-period related hedged items and accounts for them differently. EFRAG assesses this as appropriate as it leads to comparable information for each specific type of hedged item.

158 EFRAG's overall assessment is that IFRS 9 leads to the provision of comparable information. Limitations to comparability which have been identified are balanced against the relevance of the resulting information or are considered necessary to avoid accounting mismatches or to show the effects of risk management practices.

B - Classification and Measurement

159 Following the criteria set out in paragraph 5 above, EFRAG has focused its assessment on the requirements related to:

B.1. Classification and measurement of financial assets;

B.2. Measurement options; and

B.3. Modifications of financial assets.

B.1. CLASSIFICATION AND MEASUREMENT OF FINANCIAL ASSETS

160 IFRS 9 provides a logical structure and a clear rationale for the classification and measurement of financial assets by providing a space for only a few accounting choices. Under IFRS 9 basic lending instruments which are managed in a similar way are classified in the same way for accounting purposes. Consequently, differences in financial reporting between reporting periods for an individual entity, and between different entities in a particular reporting period, will reflect the differences in the underlying economics.

161 IFRS 9 provides application guidance, including examples, about the activities that are commonly associated with the three business models, which will enhance the consistency in how the business model criterion is applied and hence enhance the comparability of the information provided.

162 IFRS 9 makes reclassifications between measurement categories mandatory when, and only when, there has been a change in the entity's business model. Those reclassification requirements will enhance comparability because an entity will generally account for its financial instruments consistently over time and only reclassify when the entity's business model changes.

163 IFRS 9 requires hybrid contracts with financial asset hosts to be classified in their entirety as a single instrument. However, if cash flows similar to those resulting from a hybrid contract are replicated through two separate contracts, each contract will be classified separately which may result in a different financial reporting treatment and hence limits the comparability of the information. EFRAG assesses that this limitation in comparability is balanced by the simplicity of the approach in not requiring bifurcation of hybrid contracts.

164 Although IFRS 9 states that the business model is a matter of fact, it also acknowledges that judgement is needed to assess the business model for managing particular financial assets. For example, IFRS 9 does not include 'bright lines' for assessing the impact of sales of financial assets. Instead, it requires that entities consider the reasons for and timing, significance and frequency of sales activity and whether the sales activity and the collection of the contractual cash flows are each integral or incidental to the business model. Because judgement is needed to assess the impact of sales activity on the business model, economically similar portfolios might result in different classification and measurement categories (e.g. portfolios of instruments that are held for liquidity management), thus limiting the comparability of the information in respect of how the financial assets are managed. These limitations are the price to pay for enhanced relevance.

B.2. MEASUREMENT OPTIONS

165 The option in IFRS 9 for changes in the fair value of equity instruments that are not held for trading (or are not contingent consideration in a business combination under IFRS 3) to be presented in other comprehensive income may reduce comparability. However this option opens the ability to reflect the different business models that can be applied to such investments. Similar limitations in comparability can also be identified for financial instruments designated at fair value through profit or loss. However, EFRAG assesses that there are valid reasons for existence of these options because they enable entities to avoid accounting mismatches that lead to excessive fluctuations in profit or loss which do not reflect economic reality or to show the effects of their risk management practices.

B.3. MODIFICATIONS OF FINANCIAL ASSETS

166 IFRS 9 does not change existing derecognition requirements for financial assets. As a result there remains in IFRS 9 a lack of clarity on whether a modification in contractual cash flows would result in derecognition of the financial asset. Entities could apply different interpretations with different accounting impacts for gains and losses upon modification and subsequent measurement.

167 For example, entities may conclude that changes in the terms of an original loan that includes a prepayment option is in substance the same as if the customer had exercised its prepayment option at par and entered into a new loan at current market conditions (the bank may prefer changing the loan's terms rather than going through the extinguishment of the original loan and the issuance of a new loan, to avoid an administrative burden). Accordingly, they would adopt similar accounting as if the prepayment option had been exercised (i.e. derecognition) and avoid recognition of modification losses. Other entities may conclude that it is not appropriate to treat the two transactions similarly and derecognise the modified assets based on an argument that the contract still exists and was only subject to decrease in interest rate. This view would lead to recognition of modification losses. Different accounting outcomes, depending on whether or not the asset is derecognised, may also occur in the area of modifications due to financial difficulties of debtors.

168 EFRAG assesses that judgement will be required in particular cases to decide whether derecognition will be required or not. Also, additional disclosures according to IAS 1 *Presentation of Financial Statements* would help provide comparable information to users.

C - Impairment

169 Following the criteria set out in paragraph 5 above, EFRAG has focused its assessment on requirements related to:

- C.1. A uniform approach;
- C.2. Recognition of expected credit losses;
- C.3. More than 30 days past due rebuttable presumption;
- C.4. Financial instruments that have low credit risk at reporting date;
- C.5. Definition of default; and
- C.6. Transition.

C.1. A UNIFORM APPROACH

170 The approach brings a uniform calculation basis for impairment applicable to all financial instruments in its scope. EFRAG assesses this leads to comparable information.

C.2. RECOGNITION OF EXPECTED CREDIT LOSSES

171 The expected credit loss model is based on principles and, except for a few practical expedients, avoids bright lines and thresholds. Application of the principles will inevitably lead to subjective judgements, assessments and estimates. Subjectivity is also introduced by the requirement to use reasonable and supportable information available without undue cost or effort. Varying levels of sophistication in the models that entities have developed to support these assessments and estimates could be considered as obstacles to comparability. Disclosures that accompany those estimates are however expected to provide users with sufficient insight into the bases for the judgements and estimates used and would therefore support overall an appropriate level of comparability.

172 Practical expedients in the assessment of significant increases in credit risk and measurement of expected credit losses are discussed in paragraphs 147 to 150 of the section for reliability. EFRAG assesses that they should not hinder comparability as they have to be applied consistently with the general recognition principles.

173 Further, EFRAG notes that the issue of consistent application is likely to be most prominent upon initial application as entities are developing their understanding of the assessments that they are required to make. To support initial application, IASB has set up an Impairment Transition Resource Group to help preparers interpret and apply IFRS 9 consistently.

174 As discussed in paragraph 66 there are differences in how the recognition of 12-month expected credit losses impacts equity at initial recognition. In case of financial assets measured at amortised cost equity is reduced. For financial assets measured at fair value, there is no immediate impact on equity. Subsequently, there are further differences in how this outcome is achieved for assets remeasured through profit or loss and through other comprehensive income. EFRAG assesses that these requirements, to certain extent, limit comparability. However the balancing effect is relevance of the information brought by each of the measurement approaches. Furthermore EFRAG notes that, under IFRS 9, the assignment of measurement approaches to debt instruments, based on cash flow characteristics and business model criteria and fair value option election conditional on removing accounting mismatches, is a matter of fact rather than of an entity's choice. Therefore different information will be presented for instruments with different characteristics which makes it difficult for entities to opt for a particular measurement to achieve a desired outcome.

C.3. MORE THAN 30 DAYS PAST DUE REBUTTABLE PRESUMPTION

175 The more than 30 days past due threshold serves as a backstop to determine significant increase in credit risk. IFRS 9 states that it is not an absolute indicator and an entity can rebut the presumption. As a consequence, IFRS 9 will not lead to spurious uniformity that will hinder comparability. IFRS 9 also requires disclosures on whether and how the presumption has been rebutted which EFRAG assesses as leading to information that can be deemed comparable.

C.4. FINANCIAL INSTRUMENTS THAT HAVE LOW CREDIT RISK AT REPORTING DATE

- 176 An entity may assume that the credit risk on a financial instrument has not increased significantly since initial recognition if the financial instrument is determined to have low credit risk at the reporting date. That is, an entity has an instrument-by-instrument choice whether to apply the low credit risk simplification or not. Furthermore, an entity may assess low credit risk using internal ratings based on globally understood definitions of low credit risk. This brings limitations in comparability between entities due to the instrument-by-instrument choice and the different internal rating grades which is the price to pay for enhanced relevance.
- 177 On the other hand, this addresses some of the concerns raised by participants in the 2013 field-test on proposed impairment requirements (see Appendix 4, paragraph 2) relating to the interpretation of the threshold as a bright line and the difficulty of mapping internal ratings to external ratings. Furthermore, disclosures are required with respect to if and how financial instruments are considered to have low credit risk including respective classes of financial instruments. As a result, EFRAG assesses that the operational benefits provide an adequate offset to the limitations in comparability in applying the practical expedient of low credit risk.

C.5. DEFINITION OF DEFAULT

- 178 IFRS 9 does not provide a definition of default. However, it includes a rebuttable presumption that default does not occur later than 90 days past due unless an entity has reasonable and supportable information to use a more lagging default criterion. As a consequence, some entities may rebut the 90 days past due presumption and some may not; this will be based on different economic contexts and the ability to reflect those different economic contexts is expected to lead to comparable information. Also, disclosure requirements relating to an entity's definitions of default, including the reasons for selecting those definitions are required. EFRAG assesses that enhancing the relevance of financial information in bringing operational benefits for entities and insights into the entity's risk management will not negatively affect comparability.

C.6. TRANSITION

- 179 At the date of initial application, an entity shall use reasonable and supportable information to determine whether there has been a significant increase in credit risk since initial recognition. However, if such a determination would require undue cost or effort, lifetime expected credit loss is recognised for each exposure unless the credit risk is low in which case 12-month expected credit loss is recognised. As a result, comparability of the information may not be fully optimised.
- 180 Entities that can determine the credit risk of instruments at initial recognition will apply the relative assessment. It means that they will track the changes in the credit risk in compliance with the standard impairment model. On the other hand, entities that cannot assess the significant increase in credit risk for particular instruments upon transition will use an absolute assessment as permitted by the transition provisions and will determine whether the current level of the credit risk is low or not and recognise 12-month or lifetime expected credit losses accordingly. Such assessment will be applicable until derecognition of the instruments.
- 181 The loss of comparability upon transition may be significant as potentially a large proportion of financial instruments may end up with an absolute rather than relative assessment. Such a situation will persist until derecognition of those instruments. However, the balancing effect is the provision of operability of the model upon transition which EFRAG assesses provides adequate compensation.

D - Hedging

182 Following the criteria set out in paragraph 5 above, EFRAG has focused its assessment on the requirements related to:

D.1. Objective and scope of hedge accounting;

D.2. Application of IAS 39; and

D.3. Accounting for time value of options.

D.1. OBJECTIVE AND SCOPE OF HEDGE ACCOUNTING

183 Hedge accounting is not mandatory. Hence because entities are able to choose whether to use hedge accounting or not, EFRAG assesses that this limits the comparability of financial statements. In addition in certain cases, depending on the risk position entities can choose to apply a fair value hedge or a cash flow hedge. EFRAG assesses that the possibility to use one hedge accounting mechanism or another limits the comparability of the financial statements. All the limitations are the price to pay to enhance relevance.

D.2. APPLICATION OF IAS 39

184 IFRS 9 describes the objective of hedge accounting as to represent, in the financial statements, the effect of an entity's risk management activities that use financial instruments to manage exposures arising from particular risks that could affect profit or loss or in particular cases other comprehensive income. IAS 39 hedge accounting does not require that the financial statements reflect the effect of an entity's risk management activities.

185 IFRS 9 permits an entity to apply the hedge accounting requirements in IAS 39 instead of those in IFRS 9 for the all of its hedging relationships. This choice may be considered to limit comparability between entities. However, the accounting policy choice between IFRS 9 and IAS 39 is a response to the lack of a comprehensive hedge accounting solution (including macro hedging) in IFRS 9. EFRAG assesses that the choice for preparers to apply the requirements of IAS 39 and continue existing practices was the price to pay to achieve a reasonable cost / benefit trade-off.

D.3. ACCOUNTING FOR TIME VALUE OF OPTIONS

186 IFRS 9 requires separating the intrinsic value and the time value of an option contract and to designate only the change in the intrinsic value as the hedging instrument. IFRS 9 further prescribes two methods to account for the time value of an option contract depending on whether the hedged item is a transaction related item or a time-period related hedged item.

187 Accounting the same way for transaction related and time-period related hedged items would be accounting alike for unlike items. EFRAG assesses that the different accounting provides comparable information.

E - Transition

188 IFRS 9 can be applied before its effective date 1 January 2018. As a result, users may not obtain comparable information if some entities decide to adopt IFRS 9 before it becomes mandatory. However, considering the challenges in implementing the new requirements, EFRAG generally does not expect early application by entities with extensive use of financial instruments in their business. The early application option is likely to be used primarily by non-financial entities which will have the possibility to

simplify their hedge accounting practices and hence the relevance of their financial reporting significantly. Therefore, EFRAG assesses that the limitations in comparability resulting from the possibility of early adoption should not be a concern.

- 189 IFRS 9 permits, but does not require the restatement of prior periods upon transition, if the necessary information is available without the use of hindsight. Not restating comparative periods will result in information which, at the entity level, is not comparable between the periods at the time of transition. With regards to the prior period, information will not be comparable between those entities that decide to restate the prior period and those that do not. However, the possibility not to restate prior periods provides significant operational relief in transition to IFRS 9 and EFRAG assesses under the circumstances that less comparability is justified in terms of the relief.

F - Overall conclusion on comparability

- 190 EFRAG's overall assessment is that IFRS 9 leads to the provision of comparable information. Limitations to comparability which have been identified are balanced against the relevance of the resulting information or are assessed to be necessary to show the effects of risk management practices.

Understandability

- 191 The notion of understandability requires that the financial information provided should be readily understandable by users with a reasonable knowledge of business and economic activity and accounting and the willingness to study the information with reasonable diligence.
- 192 Although there are a number of aspects to the notion of 'understandability', EFRAG believes that most of the aspects are covered by the discussion above about relevance, reliability and comparability.
- 193 As a result, EFRAG believes that the main additional issue it needs to consider, in assessing whether the information resulting from the application of IFRS 9 is understandable, is whether that information will be unduly complex.

A - Summary

- 194 In the area of classification and measurement EFRAG assessed that the information resulting from IFRS 9 is not unduly complex. The same is valid for the impairment requirements where extensive disclosures can be used to help users understand the practical application of the principles relating to the impairment model.
- 195 IFRS 9 also retains the three types of hedge accounting relationships in IAS 39, which are well understood. Also, the requirement that all disclosures on hedge accounting are concentrated in one place through IFRS 7 increases the understandability of the information to users.
- 196 In EFRAG's view IFRS 9 does not contain any complexity that may impair understandability. Therefore, EFRAG's overall assessment is that IFRS 9 satisfies the understandability criterion in all material respects.

B - Classification and Measurement

- 197 With regards to classification and measurement, and taking into account the comment made in paragraph 192, EFRAG assesses that the information resulting from IFRS 9 is not unduly complex, as the requirements in IFRS 9 are generally built upon clear principles.

C - Impairment

- 198 Following the criteria set out in paragraph 5 above, EFRAG has focused its assessment on the requirements related to:
- C.1 Principles for impairment recognition; and
 - C.2. Exceptions and practical expedients.

C.1. PRINCIPLES FOR IMPAIRMENT RECOGNITION

- 199 The general applicability of the model to credit risk bearing exposures other than those measured at fair value through profit or loss significantly increases its understandability to the users. The expected credit loss model is built on clear principles which further contributes to the understandability.
- 200 Practical application of the principles for assessment on increases in credit risk and calculation of expected credit losses may require complex approaches. However, there are extensive disclosure requirements included in the consequential amendments to IFRS 7 which are focused on providing information that help users in understanding how an entity has assessed credit risk and measured its expected

credit losses including information about an entity's credit risk management practices. Considering that the assessment on understandability assumes knowledgeable users, EFRAG assesses that the principles of impairment recognition result in information that is understandable.

C.2. EXCEPTIONS AND PRACTICAL EXPEDIENTS

- 201 IFRS 9 brings a number of exceptions and practical expedients which have been deemed acceptable in terms of relevance, in that they help provide a meaningful and consistent outcome at reduced cost. They are discussed together with reasons for their existence in the sections for relevance, reliability and comparability. EFRAG therefore assesses that they are not expected to generate concerns over understandability.

D - Hedging

- 202 Following the criteria set out in paragraph 5 above, EFRAG has focused its assessment on the requirements related to:

- D.1. Accounting for qualifying hedging relationships; and
- D.2. Amendments to IFRS 7 *Financial Instruments: Disclosures*.

D.1. ACCOUNTING FOR QUALIFYING HEDGING RELATIONSHIPS

- 203 IFRS 9 retains the three types of hedge accounting relationships in IAS 39:

- (a) Fair value hedges;
- (b) Cash flow hedges; and
- (c) Hedge of a net investment.

- 204 Although some small changes are made to the accounting for these hedge relationships, the mechanics of these three types of hedging relationships are well understood and, consequently, no issues are expected on understandability of their application.

D.2. AMENDMENTS TO IFRS 7 FINANCIAL INSTRUMENTS: DISCLOSURES

- 205 IFRS 7 requires an entity to present the disclosures on hedge accounting in a single note or separate section in its financial statements. These disclosures encompass information on:

- (a) The risk management strategy for each risk category that an entity decides to hedge;
- (b) The amount, timing and uncertainty of future cash flows; and
- (c) The effects of hedge accounting on the financial position and performance.

- 206 It could be argued that, by collecting the disclosures of those risks that an entity decides to hedge account for in one place without requiring the same for those risk exposures which an entity decides not to hedge account for, it would be difficult for users to understand the risk management of an entity. However, IFRS 9 only deals with hedge accounting (in addition to classification and measurement and impairment). In addition, hedge accounting is optional, not mandatory so while all entities will have risk exposures, only some of them will be hedge accounted for.

- 207 Consequently, EFRAG agrees that the disclosures on hedge accounting do not allow a full understandability of the risk management of an entity by users. However, this is not the objective of IFRS 9. EFRAG assesses that by requiring all disclosures on

hedge accounting in one place through IFRS 7, IFRS 9 increases the understandability of the information for users.

E - Conclusion on understandability

208 In EFRAG's view, due to the above reasons, IFRS 9 does not contain any complexity that may impair understandability. Therefore, EFRAG's overall assessment is that IFRS 9 satisfies the understandability criterion in all material respects.

Prudence

- 209 For the purpose of this final endorsement advice, prudence is defined as caution in conditions of uncertainty. In some circumstances, prudence requires to have asymmetry in recognition such that assets or income are not overstated and liabilities or expenses are not understated.
- 210 Prudence is different from and unrelated to prudential reporting. The former is a qualitative characteristic used in accounting standard setting and is applicable to the financial statements of all companies. The latter refers to the reporting by individual financial institutions to regulators in order to meet the regulator's objectives (such as capital adequacy and liquidity).

A - Classification and measurement

- 211 Financial assets which meet the cash flow characteristics test can be measured at amortised cost subject to the business model in which they are held. The contractual cash flow test excludes financial instruments with contractual features that give rise to exposure to risks or changes in value unrelated to a basic lending instrument from this measurement basis. Financial instruments with such contractual features would be measured at fair value through profit or loss. Their cash flows are generally less predictable and thus amortised cost provides a less relevant representation of future cash flows. For this reason, EFRAG assesses such a fair value measurement basis to be prudent for both these types of financial instruments. EFRAG notes that where material the resulting short term fair value changes would be expected to be presented or disclosed separately.
- 212 IFRS 9 contains an option to designate a financial asset at fair value through profit or loss if it eliminates or significantly reduces an accounting mismatch. The use of this option results in more prudent information because it prevents a gain being recognised without the corresponding effect from the other components of the accounting mismatch by ensuring that all components of the accounting mismatch are offset in profit or loss.
- 213 The option to present changes in the fair value of equity instruments in other comprehensive income unless the equity instrument is held for trading (or are contingent consideration in a business combination under IFRS 3) ensures that entities do not have to recognise fair value movements in profit or loss. If investments are held as a strategic holding or as part of a long-term investment business model, information about fair value changes in profit or loss leads to less relevant information. This option however results in both unrealised and realised losses never being reflected in profit or loss. EFRAG has considered this and concluded that IFRS 9 leads to prudent accounting as the entity's net assets are never stated above recoverable amount.
- 214 EFRAG's assessment of the use of fair value in the Standard can be found in paragraphs 47 to 56 of Appendix 2.

B - Impairment

- 215 EFRAG assesses that the impairment model using comprehensive credit risk and forward-looking information is a prudent approach. Recognition of 12-month expected losses from an instrument's inception brings an element of prudence. Furthermore it recognises lifetime expected credit losses during the life of a financial asset as soon as significant credit deterioration occurs.

- 216 EFRAG's assessment in comparing the expected credit loss model with a conceptual impairment model can be found in paragraphs 63 to 65 of Appendix 2.

C - Hedging

- 217 EFRAG assesses that hedge accounting provides prudent information in that both the hedged item and the hedging instrument are, within reasonable boundaries set for reliability purposes, measured on the same basis in respect of impact on profit or loss, thus ensuring that offsetting gains and losses are recognised in the same period rather than permitting the early recognition of gains.

D - Conclusion on prudence

- 218 Based on all of the above, EFRAG has concluded that the application of IFRS 9 would lead to prudent accounting.

Early application of IFRS 9

- 219 Entities must apply IFRS 9 for annual periods beginning on or after 1 January 2018, with earlier application permitted. When doing so, an entity should apply all of the requirements of the Standard at the same time. Despite this, an entity may elect to early apply only the requirements for the presentation of gains and losses on financial liabilities designated as at fair value through profit or loss (the own credit risk provisions) without applying the other requirements in the Standard.
- 220 One may argue that earlier application of the IFRS 9 requirements, with exception of the own credit risk provisions, should not be allowed for the following reasons:
- (a) A sufficiently long preparatory period is required to assure a high quality implementation of IFRS 9; and
 - (b) Implementation of IFRS 9 at different moments in time may temporarily lead to less comparability of the financial position between regulated entities within the same sector.
- 221 EFRAG disagrees with this view and believes that these drawbacks do not outweigh the benefits of earlier application for the following reasons:
- (a) The information provided by an implementation of IFRS 9 will provide benefits for preparers and users as explained in paragraphs 174 to 188 of Appendix 3; and
 - (b) Based on the assessment explained in paragraphs 3 to 57 of Appendix 3 EFRAG believes that IFRS 9 is an improvement over IAS 39 and will lead to higher quality financial reporting.
- 222 Consequently EFRAG believes that early application of IFRS 9, as permitted by the IASB, should be permitted in Europe.

True and Fair

- 223 Information can be relied on to meet the true and fair view principle when it faithfully represents the financial performance and position of an entity. To do so accounting requirements should help provide information that is relevant, reliable, comparable and understandable and lead to prudent accounting. EFRAG's assessment on all of the above criteria is positive. It therefore concludes that the application of IFRS 9 would not be contrary to the true and fair view principle.
- 224 Accordingly, for the reasons set out above, EFRAG's assessment is that IFRS 9 satisfies the technical criteria for EU endorsement.

Appendix 3: Assessing whether IFRS 9 is conducive to the European public good

Summary

- 1 Appendix 3 assesses whether IFRS 9 *Financial instruments* is conducive to the European public good. In doing this:
 - (a) EFRAG assesses whether IFRS 9 is an improvement over its predecessor IAS 39 *Financial Instruments: Recognition and Measurement* across the areas which have been subject to changes: classification and measurement of financial assets, impairment of financial assets, hedge accounting, classification of financial liabilities in respect of own credit risk presentation for fair value option liabilities. EFRAG's conclusion is that, except for classification and measurement of financial assets where a clear conclusion cannot be made, IFRS 9 is an improvement over IAS 39 for all other areas.
 - (b) In the area of convergence with US GAAP which has not been achieved, EFRAG concludes that IFRS 9 will lead to higher quality financial reporting than the equivalent US GAAP standards.
 - (c) Regarding the impact of IFRS 9 on investor and issuer and behaviour, EFRAG highlights certain requirements of IFRS 9 which it considers may have potential impacts. However, we are not able to analyse whether any potential impacts would actually materialise.
 - (d) EFRAG has assessed the inter-relationship of IFRS 9 and the future insurance contracts standard and considers that an optional remedy for entities undertaking insurance activities is required to address the period after the effective date of IFRS 9 until the future insurance contracts standard is effective, in order to conclude that IFRS 9 is conducive to the European public good for the insurance industry. EFRAG notes that the IASB has started exploring various approaches to address the existing concerns. Therefore, EFRAG will advise the European Commission on our views as the IASB's work develops, and, on that basis, will provide further advice where the insurance industry is concerned. As any solution will however remain sub-optimal, it should be temporary and be applied for as short a period as feasible. For this reason, EFRAG recommends the European Commission request the IASB to finalise the future insurance contracts standard as early as possible so that the endorsement of the future standard can start in Europe in 2016.
 - (e) EFRAG has assessed the 'EU carve-out for macro hedging' from IAS 39 and has concluded it will continue to be available for the purposes it was intended.
 - (f) EFRAG has evaluated the costs and benefits of IFRS 9. One-off costs connected with IFRS 9 implementation are likely to be significant both for preparers and users whereas only preparers are likely to incur significant ongoing costs. Both users and preparers are likely to benefit from IFRS 9. Overall, the benefits are likely to outweigh the costs. This, however, may not hold for entities undertaking insurance activities if the effective dates of both IFRS 9 and the forthcoming insurance contracts standards are not aligned. Having said that, EFRAG wishes to emphasise that in its view IFRS 9 should not be stopped from being endorsed so as to be applicable in 2018 to all businesses other than those carrying out insurance activities and, on an optional basis, to businesses carrying out insurance activities without unnecessary delay.

Endorsement Advice on IFRS 9 Financial Instruments
Appendix 3: Assessing whether IFRS 9 is conducive to the European public good

- 2 Overall, EFRAG concludes that the adoption of IFRS 9 will be conducive to the European public good, except for the impact on the insurance industry. The IASB is working on one or more solutions for the insurance industry and is expected to make tentative decisions in the next two months. We will advise the European Commission on our views as the IASB's work develops, and on that basis will provide further advice where the insurance industry is concerned. In any event we recommend that all businesses other than those carrying out insurance activities are required to account for their financial instruments in compliance with IFRS 9 in 2018 and businesses carrying out insurance activities are permitted to do so in compliance with IFRS 9 from the same date.

Is the financial reporting required by IFRS 9 an improvement over the financial reporting required by IAS 39?

- 3 EFRAG has focused its assessment on the areas it considers most significant in the change from IAS 39 to IFRS 9. EFRAG's assessment also considers how the changes from IAS 39 to IFRS 9 affect different industries. Therefore the assessments of certain areas distinguish an industry-specific assessment. The structure is as follows:
- A Classification and measurement of financial assets;
 - B Impairment of financial assets;
 - C Hedge accounting;
 - D Classification and measurement of financial liabilities: own credit risk;
 - E Improvement by industry; and
 - F Conclusion.

A - Classification and measurement of financial assets

- 4 In assessing whether the classification and measurement requirements of IFRS 9 constitute an improvement over those of IAS 39, EFRAG has focused on:
- A.1 Classification and measurement;
 - A.2. Reclassifications; and
 - A.3. Conclusion on classification and measurement of financial assets.
- 5 IFRS 9 introduces significant changes to the accounting for financial assets, using a different model from that in IAS 39 and with different restrictions on when financial assets can be reclassified.
- 6 Under IAS 39, financial assets are classified into four categories, which determine subsequent measurement, presentation of changes and reclassification requirements:
- (a) Fair value through profit or loss;
 - (b) Held-to-maturity;
 - (c) Loans and receivables; and
 - (d) Available for sale.

A.1. CLASSIFICATION AND MEASUREMENT

- 7 In considering how the classification and measurement approach of IFRS 9 compares to the IAS 39 approach, EFRAG believes the following aspects of IAS 39 need to be assessed:
- (a) accounting designations based on intent are constrained by rules such as tainting in order to provide consistency over time in the measurement; and
 - (b) bifurcation of embedded derivatives require the separation of complex or fluctuating cash flows from a 'simple' host instrument, unless those complex or fluctuating cash flows were assessed as being 'closely related' to the host.
- 8 The classification and measurement requirements of IFRS 9, and a description of the changes from IAS 39, are set out in Appendix 1.

Endorsement Advice on IFRS 9 Financial Instruments
Appendix 3: Assessing whether IFRS 9 is conducive to the European public good

- 9 A classification approach based on the entity's business model increases the relevance of the resulting information, as it reflects an entity's purpose in respect of that asset. IFRS 9 introduces reliance on the business model in the accounting for basic lending instruments. EFRAG assesses this as providing more relevant information compared with the accounting for basic lending instruments in IAS 39. The business model is based on factual information rather than on an accounting designation as required under IAS 39. The business model test also allows the provision of information on a higher level of aggregation than an instrument-by-instrument basis and consequently simplifies the accounting. EFRAG assesses that for these reasons users will be provided with more understandable and reliable information on all basic lending instruments.
- 10 An exception to this positive assessment could be made in relation to embedded derivatives as IFRS 9 is based on classifying the financial asset in its entirety, even though some entities may manage cash flows of an embedded derivative separately from a host contract. However, evidence from the EFRAG 2013 field-test on classification and measurement (see Appendix 4, paragraph 1) is that the IAS 39 bifurcation model was very rarely applied in practice. Instead, entities found it operationally easier to designate entire instruments at fair value through profit or loss.
- 11 Under IFRS 9 all debt instruments other than certain basic lending instruments are measured at fair value through profit or loss, regardless of the business model that applies to them. Whilst IAS 39 categories were not specifically reliant on an entity's business model, the various categories of measurement, together with the ability to bifurcate embedded derivatives and instrument-by-instrument designation, allowed an entity to reflect, to a large extent, their business intent in the accounting for financial assets.
- 12 For this reason, some think that IAS 39 provided more relevant information when debt instruments other than basic lending instruments were held to collect contractual cash flows. This criticism that IFRS 9 does not allow the business model to influence the measurement of financial assets other than basic lending instruments is partly mitigated by the option included in IFRS 9 to account for equity instruments at fair value through other comprehensive income which opens the possibility of distinguishing between equity instruments held for trading and equity instruments that are invested for the longer term. When this option is taken only dividends are presented in profit or loss. Fair value gains and losses are not reclassified into profit or loss upon derecognition and no impairment loss is recognised in profit or loss, potentially reducing the understandability of the returns on such equity instruments.
- 13 In summary, EFRAG believes that:
 - (a) The IFRS 9 'whole of asset' classification model that takes account of the business model provides more comparable information and is less operationally complex than the model in IAS 39 that relies on management intent and discretion as to identification of cash flows that represent embedded derivatives.
 - (b) The level of aggregation in IFRS 9 is more appropriate than the instrument-by-instrument approach of IAS 39.
 - (c) IFRS 9 may result in a less relevant depiction of performance with relation to investments in equity instruments if they are held in a long-term business model. Revaluation through profit or loss may not provide useful information for them. Under the IFRS 9 alternative of revaluing them through other comprehensive income, gains or losses are not recycled into profit or loss and, consequently, any impairment losses are never recognised in profit or loss. This impairs the ability of users to easily assess the performance of the entity's investment activities by relying on profit or loss. On the other hand, this

treatment avoids the complexity of an additional impairment model for equity investments and addresses the identified problems with the IAS 39 model.

- (d) Accounting for financial instruments which are non-basic lending instruments at fair value through profit or loss will generally provide relevant information under IFRS 9. This also holds for instruments which might be viewed as basic lending instruments but their cash flow characteristics lead to uncertain or fluctuating cash flows and measuring them at fair value through profit or loss. The fair value measurement capturing changes of the cash flows brings relevant information in a different manner than the relevance of the information provided under IAS 39 which used the approach of bifurcation of embedded derivatives.
- (e) EFRAG has identified specific cases of assets which may be viewed as basic lending instruments where the relevance of the fair value measurement might be limited. These are some instruments with interest mismatches features and subordinated debts with payments holiday where no interest accrues on outstanding amounts and are discussed in paragraph 18 of Appendix 2.

A.2. RECLASSIFICATIONS

- 14 EFRAG assesses that the reclassification requirements under IFRS 9 are better ring-fenced than those in IAS 39, as reclassification is required, if and only if, a change in business model has occurred.

A.3. CONCLUSION ON CLASSIFICATION AND MEASUREMENT OF FINANCIAL ASSETS

- 15 The overall comparison of the IFRS 9 classification and measurement requirements with those of IAS 39 does not lead to a conclusion that IFRS 9 is superior in all respects. Whilst the accounting for basic lending instruments will improve financial reporting, it is not possible to reach the same conclusion for all financial assets. EFRAG has identified issues for investments in equity instruments and certain types of assets which may be viewed as basic lending instruments but the contractual cash flows test in IFRS 9 results in measuring them at fair value through profit or loss.
- 16 EFRAG has received no quantitative data that might indicate that the changes brought by IFRS 9 will have a detrimental effect on financial stability as a result of greater fluctuations in profit or loss arising from any inappropriate use of fair value.

B - Impairment of financial assets

- 17 In assessing whether the impairment requirements of IFRS 9 constitute an improvement to those of IAS 39, EFRAG has focused on:
 - B.1. The scope of the impairment model;
 - B.2. The expected credit loss model;
 - B.3. The use of judgement and the role of probability-weighting;
 - B.4. Measurement of impairment for FVOCI category; and
 - B.5. Conclusion with respect to impairment.

B.1. THE SCOPE OF THE IMPAIRMENT MODEL

- 18 Under IAS 39, different impairment requirements apply depending on the nature and categories of the financial assets, with different guidance for assets at amortised cost, available for sale debt instruments, available for sale equity instruments and

- investments in equity instruments measured at cost when the reliability exception applies.
- 19 In contrast to the above-mentioned IAS 39 requirements, the use of fair value through profit or loss (or the other comprehensive income presentation option for equity instruments) for all instruments other than basic lending instruments results in the need in IFRS 9 for one single impairment model only that applies to all basic lending instruments that are managed in hold to collect and hold to collect and sell business models.
- 20 EFRAG believes that having a single impairment model will reduce complexity and potentially more closely align impairment requirements with credit risk management practices.
- 21 EFRAG also notes that the introduction of a single model is achieved at the cost of introducing the option for the accounting for equity instruments at fair value through other comprehensive income without recycling because of the lack of an appropriate impairment model for equity instruments. The recognition of losses on equity instruments in other comprehensive income without any recognition in profit or loss even when the instrument can be deemed impaired may not appropriately reflect an entity's performance in the view of those investors who expect to have all impairment losses included in profit or loss.
- 22 Therefore EFRAG believes that the benefits of a single impairment model are reduced by the lack of recognition of losses in profit or loss on equity instruments that are measured at fair value through other comprehensive income. EFRAG also notes that the IAS 39 impairment guidance for equity instruments, which requires an impaired loss to be recognised where there was significant or prolonged decline in their fair value below cost, has been difficult to apply and resulted in diversity in practice.

B.2. THE EXPECTED CREDIT LOSS MODEL

- 23 Under IAS 39, no impairment is recognised unless and until a loss event occurs after the initial recognition of a financial asset. During the recent financial crisis, this 'incurred loss' approach was criticised for resulting in delayed recognition of losses and for being difficult to understand and apply.
- 24 The IFRS 9 expected credit losses model is a forward looking model aimed at addressing this criticism of 'too little, too late' by requiring the recognition of a day-one loss representing 12-month expected credit losses for all financial assets that are not measured at fair value through profit or loss (but with operational simplifications for lease receivables, trade receivables and contract assets). Full lifetime expected credit losses are recognised where there has been a significant deterioration in creditworthiness. The size and moment of transition from 12-month expected credit losses to lifetime expected credit losses provides clear information to users of financial statements on changes in the credit quality of the underlying portfolios.
- 25 EFRAG notes that while the IFRS 9 impairment model will result in the accounting for expected credit losses at initial recognition even though those losses are also reflected within the carrying amount of the financial asset which is initially at fair value, the timely recognition of expected credit losses is likely to improve investors' confidence in the reporting of financial instruments. However, the increased reliance on judgements may limit the reliability of the impairment measures.

B.3. THE USE OF JUDGEMENT AND THE ROLE OF PROBABILITY-WEIGHTING

- 26 Under IAS 39, entities are allowed to estimate, based on management judgement, impairment losses as either a single amount or as a best estimate from a range of possible amounts. This is sometimes criticised as lacking sufficient reliability as it is not clear why an entity would pick one number from a range of possible outcomes as its best estimate of the impairment loss.
- 27 In contrast, IFRS 9 does not allow expected credit losses to be measured using the most likely outcome or the entity's best estimate of the ultimate amount because the expected credit losses model requires the measurement to reflect the probability-weighted amounts.
- 28 While IFRS 9 also requires judgement in evaluating a range of possible outcomes, EFRAG believes that the use of unbiased and probability-weighted estimates provides a higher level of confidence than the IAS 39 most likely outcome and improves the reliability of the impairment amount calculated. However, the benefits of probability-weighting may be outweighed by the amount of judgement required under IFRS 9 when compared with IAS 39.
- 29 IAS 39 requires less judgement in that impairment is recognised only when a credit loss event occurs. In addition, the IFRS 9 expected credit loss model requires significant judgement in assessing significant credit deterioration for all applicable financial assets and the forward-looking aspect in the assessment of credit risk and estimates of expected credit losses. It is expected however that such estimates are already at least partly available to support entities' credit risk management. Where IFRS 9 would require that they are further enhanced, this development could be deemed beneficial to the entity as a whole, for example through bringing more robust credit pricing methodologies.

B.4. MEASUREMENT OF IMPAIRMENT FOR FVOCI CATEGORY

- 30 Under IAS 39, the impairment of debt instruments that are classified as available for sale is calculated based on changes in fair value. This approach has been criticised because factors unrelated to credit risk, such as interest rates, are a key driver of fair value changes. Under IFRS 9, the impairment loss is measured as the present value of contractual cash shortfalls discounted using an effective interest rate. The impairment loss is recognised in profit or loss and the fair value adjustment that is not attributable to credit risk is recognised in other comprehensive income.
- 31 EFRAG assesses that the requirements of IFRS 9 will address the criticisms of IAS 39 and improve the relevance of financial information: performance reported in profit or loss is based on amortised cost while fair value is presented in the balance sheet.

B.5. CONCLUSION WITH RESPECT TO IMPAIRMENT

- 32 EFRAG assesses that the IFRS 9 impairment model, when compared to the IAS 39 incurred loss model, reflects the economics of lending transactions in a more appropriate way and is better aligned to credit risk management processes. Moreover, the use of the expected credit loss model will reduce the current potential for overstatement of profit or loss. This is caused by IAS 39 reporting interest revenue designed to compensate for credit losses in advance of the recognition of the associated credit losses. IFRS 9 also significantly improves the disclosures about the way impairment losses are calculated and recognised, including how significant changes in credit quality are taken into account. This enhances transparency which in turn will enhance investors' confidence.

C - Hedge accounting

33 The hedge accounting categories are substantially unchanged and access to the EU carve-out remains. EFRAG has focused its assessment on the areas which it considered the most affected by the change from IAS 39 to IFRS 9. Hence, this chapter addresses the following topics:

- C.1. Reflecting risk management;
- C.2. Eligible hedged items;
- C.3. Eligible hedging instruments;
- C.4. Effectiveness testing and rebalancing;
- C.5. Treatment of credit risk; and
- C.6. Conclusion with respect to hedge accounting.

C.1. REFLECTING RISK MANAGEMENT

34 In contrast to IAS 39, the objective of hedge accounting under IFRS 9 has been clearly defined and is to represent in the financial statements the effect of an entity's risk management activities that use financial instruments to manage exposures arising from particular risks that could affect profit or loss or in particular cases other comprehensive income.

35 EFRAG assesses that putting the risk management strategy of an entity central to the objective of hedge accounting enhances the relevant nature of the resulting information. Reflecting in the financial statements how an entity manages its risks provides more information to users than hedge accounting information under IAS 39, where that link is not necessarily clear.

C.2. ELIGIBLE HEDGED ITEMS

36 IFRS 9 allows a broader category of hedged items, including risk components of non-financial items, net positions (in particular circumstances), portfolio layers for both cash flow hedges and fair value hedges (in particular circumstances) and aggregated exposures.

37 EFRAG assesses that IFRS 9 provides more possibilities for designation of hedged items than IAS 39. Consequently, IFRS 9 provides better opportunities for designating hedge accounting relationships that reflect risk management strategies.

C.3. ELIGIBLE HEDGING INSTRUMENTS

38 IFRS 9 provides a wider range of possible hedging instruments than IAS 39 and notably allows non-derivative financial instruments to be designated as hedging instruments for all hedgeable risks if these non-derivative financial instruments are measured at fair value through profit or loss.

39 In contrast to IAS 39, embedded derivatives bifurcated from financial assets are no longer eligible as hedging instruments. However, under IFRS 9 financial assets including such embedded derivatives are likely to be measured at fair value through profit or loss, and thus be eligible hedging instruments.

40 New requirements relating to using options as hedging instruments allow the deferral of changes in the time value of options through other comprehensive income. The timing of reclassification to profit or loss depends on the nature of the underlying hedged item (i.e. whether it is transaction-related or time-period related). This change improves the financial reporting of hedge-accounted risk management strategies that

use options since it reflects the fact that the option premium represents the cost of hedging and avoids profit or loss fluctuations which would otherwise arise.

- 41 When hedging foreign currency risk, entities can designate either the spot rate or the forward rate under both IAS 39 and IFRS 9. However, IFRS 9 permits an entity that designates only the change in the spot element as the hedging instrument to recognise the forward element of a forward contract in other comprehensive income. This is achieved by using the accounting treatment applicable to the time value of the option.
- 42 Unlike IAS 39, under IFRS 9 foreign currency basis spreads are considered as costs of the hedge relationship and, similar to the treatment of forward element, changes can be recognised through other comprehensive income.
- 43 EFRAG assesses that, with the exception of embedded derivatives bifurcated from financial assets, IFRS 9 provides a wider range of possible hedging instruments than IAS 39. Consequently, IFRS 9 provides entities with a greater possibility in designating hedge accounting relationships in order to reflect their risk management strategy.

C.4. EFFECTIVENESS TESTING AND REBALANCING

- 44 Under IAS 39, the effectiveness of the hedge accounting relationship has to be able to be reliably measured and is expected to be highly effective both retrospectively and prospectively. It is also subject to ongoing stringent quantitative tests. In contrast, under IFRS 9 hedge effectiveness is measured on a more principled basis.
- 45 EFRAG assesses that the removal of the stringent quantitative test in IAS 39 increases the availability of hedge accounting for many risk management strategies and also removes a 'bright-line' rule.
- 46 In contrast to IAS 39, IFRS 9 does not permit voluntary de-designation of hedge accounting relationships if the risk management objective remains the same. However, it requires rebalancing of the hedge relationship. EFRAG assesses that the need to rebalance a hedge accounting relationship improves the reflection of hedge accounting relationships in the financial statements consistently with risk management practices.

C.5. TREATMENT OF CREDIT RISK

- 47 IAS 39 does not prescribe a specific approach to dealing with credit risk. IFRS 9 states that the credit risk of a debt instrument cannot be isolated and thus does not meet the eligibility criteria to be designated as a hedged item. However, IFRS 9 provides an option to designate a financial instrument at fair value through profit or loss when specific conditions are fulfilled such as when a credit default swap is used to manage the credit risk.
- 48 EFRAG notes that economic hedges of credit risk using credit derivatives are a common practice. It could therefore be argued that a standard on hedge accounting should address these practices. The limitation on qualifying credit risk as a hedged item may be seen as diminishing the relevance of reported results when management has actually hedged that credit risk. However EFRAG also acknowledges that the pricing in credit derivative markets and cash markets are not always strongly correlated, supporting the IASB's assertion that credit risk of a debt instrument cannot be isolated. The prohibition will also increase comparability.

C.6. CONCLUSION WITH RESPECT TO HEDGE ACCOUNTING

- 49 Overall, EFRAG assesses that the hedging requirements in IFRS 9 provide more relevant information with respect to general hedge accounting model than those in IAS 39 because they permit a better reflection of an entity's hedging practices. EFRAG also notes that IFRS 9 brings no changes to macro-hedging requirements and entities will have to make use of IAS 39 requirements until a separate project in this area has been finalised.

D - Classification and measurement of financial liabilities: own credit risk

- 50 If an entity measures a financial liability at fair value under the fair value option, IAS 39 requires the entire fair value change to be presented in profit or loss. This means that the effect of changes in the credit risk of a financial liability (own credit risk) affect the primary measure of performance even when the liability is not held for trading. This led to a counterintuitive result whereby the issuer would recognise a gain (loss) in profit or loss when its own credit standing deteriorates (improves).
- 51 When an entity elects to measure a financial liability at fair value through profit or loss in its entirety, IFRS 9 requires that the changes in fair value due to changes in the entity's own credit risk are presented in other comprehensive income. An exception to this requirement is if doing so would create or enlarge an accounting mismatch in profit or loss, in which case an entity shall present all gains or losses on that liability (including the effects of changes in the credit risk of that liability) in profit or loss.
- 52 EFRAG assesses that this requirement improves the relevance of reported profit or loss by removing the counterintuitive impact of the IAS 39 requirement as an entity will generally not realise the effects of changes in the liability's credit risk unless that liability is held for trading.

E - Improvement by industry

- 53 After providing its assessment for the different areas of IFRS 9, EFRAG also provides its assessment for key industries affected, namely banks, entities undertaking insurance activities, and corporates. This is to underline whether, and to what extent, IFRS 9 is considered an improvement over IAS 39 for these industries. This would also allow for an assessment of the costs and benefits by industry.
- 54 As far as the banking sector is concerned, EFRAG concludes that, in respect of classification and measurement and in line with our general comments above, IFRS 9 is not regarded as necessarily leading to superior, but simply different information compared to the classification model in IAS 39. As regards the new impairment requirements, moving from an incurred loss to an expected loss model for the banking book does appropriately address the 'too little too late' concern and is, thus, assessed to leading to a superior solution. Lastly, whilst IFRS 9 does provide some relief compared to the hedge accounting requirements in IAS 39, it equally does not allow banks to faithfully portray their risk management activities as long as macro hedge accounting is not part of the solution. We have learned from initial outreach that the majority of the banks will, hence, exercise the accounting policy option and continue applying IAS 39 for purposes of hedge accounting. To sum up, the key area where IFRS 9 is deemed superior for banks is impairment.
- 55 With regard to entities undertaking insurance activities, EFRAG's conclusions with regard to the classification and measurement requirements are the same as before – the information derived under the new model is different to that generated by IAS 39 but not necessarily superior. As far as the new impairment model is concerned, EFRAG has been advised that the vast weighted majority of assets backing

insurance liabilities is classified as available-for-sale today and is, hence, already presented on a fair value basis in the statement of financial position. The additional 12-month expected loss allowance under IFRS 9 will only lead to an appropriation between net income and OCI. Thus, whilst EFRAG cannot deny that entities undertaking insurance activities will generally build up an additional allowance compared to IAS 39 (except for entities undertaking insurance activities whose assets are already and continue to be classified as fair value through profit or loss), the impact of any 12-month allowance is far more limited than for banks. Lastly, EFRAG has learned from entities undertaking insurance activities that they will not start implementing any new hedge accounting solution before the future insurance contracts standard is published, so it is difficult to assess the superiority of IFRS 9 over IAS 39 in this regard. Overall, the superiority of IFRS 9 over IAS 39 is less evident for entities undertaking insurance activities.

- 56 With regard to all other corporates, EFRAG concludes that, overall, IFRS 9 is likely to represent an improvement over IAS 39. The changes brought about by the new classification and measurement and the impairment requirements are of lesser importance given that their primary financial instruments are trade receivables meeting the SPPI test and the majority of companies will likely be (continuing) using the simplified approach. Nonetheless, the non-recycling of equity investments accounted for at fair value through other comprehensive income may limit the benefits of applying IFRS 9 for corporates. In contrast, the key benefit provided by IFRS 9 is hedge accounting due to less restrictions and extended eligibility criteria (such as hedging identifiable risk factors). For corporates, IFRS 9 therefore clearly represents a superior standard in comparison to IAS 39 as regards hedge accounting.

F - Conclusion with respect to whether IFRS 9 is an improvement over IAS 39

- 57 For the reasons given above, and particularly with respect to the impairment, hedging requirements and the treatment of own credit risk for financial liabilities under the fair value option, EFRAG believes that IFRS 9 is an improvement over IAS 39 and will lead to higher quality financial reporting.

The lack of convergence with US GAAP

- 58 In the letter requesting advice on endorsement, it was noted that ‘IFRS 9 is not converged with US GAAP, in particular in the accounting for impairment. The impact of this lack of convergence for globally active financial institutions, in particular, banks should be analysed.’
- 59 IAS 39 was substantially converged with US GAAP, but subsequent changes to US GAAP and the publication of IFRS 9 changed the situation. EFRAG’s analysis on the lack of convergence follows the three main areas of IFRS 9:
- A Classification and measurement;
 - B Impairment;
 - C Hedging; and
 - D. Conclusion – Impact of the lack of convergence.

A - Classification and measurement

- 60 The classification and measurement requirements of US GAAP have not materially changed and are substantially the same as IAS 39. An analysis of whether financial reporting under IFRS 9 is an improvement over financial reporting under IAS 39 is included in paragraphs 3 to 57 above. The analysis with respect to classification and measurement is also valid in respect of a comparison with US GAAP.
- 61 EFRAG has identified one potentially significant change to the US GAAP classification and measurement requirements, which is in relation to equity instruments. US GAAP currently requires ‘non-marketable’ equity instruments to be held at cost less impairment and ‘marketable’ equity instruments (other than equity-method investments where the investor has significant influence over the investee) to be classified as either held for trading (at fair value through profit or loss) or available for sale (at fair value through other comprehensive income and with recycling on disposal). It is proposed that this requirement in US GAAP be changed to require all equity instruments to be held at fair value with changes presented in profit or loss. Certain entities may take a proposed election in relation to some investments without a readily determinable fair value, and measure them based on cost, less impairment, plus or minus observable price changes of an identical or similar investment of the same issuer.
- 62 Given that there is no proposal to allow fair value changes to be presented in other comprehensive income (as in IFRS 9) EFRAG assesses that impact of lack of convergence in this regard is that entities reporting under US GAAP will potentially have significantly higher fluctuations in reported profit or loss.
- 63 In addition, it should be noted that for some US GAAP requirements, classification and measurement is driven by legal form (for example whether the financial instrument meets the definition of a ‘debt security’ or is a mortgage loan) rather than by economic substance. EFRAG assesses that an approach based on economic substance is more principles-based compared to one based on legal form and that therefore IFRS 9 is more appropriate in this regard.

B - Impairment

- 64 In analysing the impact of lack of convergence in impairment requirements, EFRAG has considered:
- (a) the proposed US GAAP requirements; and

- (b) whether IFRS 9 or the proposed US GAAP requirements more appropriately reflect the economics of credit losses on financial instruments.
- 65 EFRAG has also considered what it believes to be the quality of the resulting financial information for users.
- 66 The proposed US GAAP guidance has not yet been finalised and EFRAG's analysis is based on its understanding of the tentative decisions to date⁴. The proposed US GAAP requirements differ depending both upon the legal form of the instrument (whether the instrument meets the legal definition of a debt security) and the measurement basis applied to it, with significant differences between:
- (a) Financial assets (including debt securities⁵) measured on an amortised cost basis;
 - (b) Financial assets other than debt securities (e.g. loans) which are classified as held for sale (and measured at the lower of cost and fair value); and
 - (c) Debt securities classified as available for sale (measured at fair value with qualifying changes presented in other comprehensive income).

B.1. FINANCIAL ASSETS (INCLUDING DEBT SECURITIES) MEASURED ON AN AMORTISED COST BASIS

- 67 For financial assets (including debt securities) measured on an amortised cost basis, similar to IFRS 9 the proposed US GAAP model takes a loss allowance approach based on expected credit losses.
- 68 However, the key difference between the proposed US GAAP requirements and IFRS 9 is that the proposed US GAAP model uses a single basis for measuring the loss allowance. This basis (known as 'current expected credit losses') is based on expectations, as at the reporting date, of credit losses for the lifetime of the financial instrument.
- 69 Under the proposed US GAAP model, a day-one loss allowance is recognised in profit or loss for an entity's expectations of credit losses for the lifetime of the financial instrument. In contrast, IFRS 9 requires a day-one loss allowance equivalent to a portion of lifetime credit losses expected as a result of default events in the 12 months after the reporting date. Only when there is a significant deterioration in a financial instrument's credit quality, does IFRS 9 require the loss allowance to reflect the entity's expectations of credit losses for the lifetime of the financial instrument. Consequently, on day one, IFRS 9 does not require entities to hold allowances as large as the proposed US GAAP requirements do. In assessing this difference EFRAG has made the following considerations as explained in paragraphs 70 to 74 below.
- 70 In analysing these different requirements, EFRAG has considered the business model of lending. In setting a market price for loans, financial institutions, especially banks, are compensated for expected credit losses through the interest rate charged to borrowers. It follows that, at any time, the expected credit loss is reflected in the current market interest rate. Therefore, IFRS 9 requires the recognition of expected credit losses for all financial instruments that are not measured at fair value as

⁴ Based on the FASB's project update covering the FASB meetings up to 22 April 2015 which notes that deliberations are finished unless any sweep issues arise in drafting the final guidance.

⁵ For financial asset debt securities to be measured at amortised cost the entity must have chosen to classify them as held to maturity. Due to associated tainting requirements, very few entities make material use of the held to maturity classification.

measurement on a cost basis needs to be updated for changes in credit risk since origination or acquisition.

- 71 EFRAG does not believe the proposed US GAAP model appropriately reflects the economics of lending, because using a lifetime expected credit losses model in all circumstances does not reflect the fact that expected credit losses are compensated for through the interest charged to borrowers and distorts the reporting of an entity's performance: at day-one no economic loss has been suffered, but one is reported.
- 72 Although the 12-month expected credit losses allowance in IFRS 9 has the limitations of a practical expedient, EFRAG believes that it has the significant merit of being closer to an appropriate depiction of economic reality than the proposed US GAAP model. Especially in the case of high quality financial assets where there is no evidence of credit deterioration, IFRS 9 requires the provision of a lower (and more closely related to reality) allowance for expected credit losses. In addition, IFRS 9 provides significantly more information to users of financial statement, because a significant deterioration in credit quality results in a transition from 12-month to lifetime expected credit losses, highlighting to users how the credit quality of an entity's financial assets has changed.

B.2. FINANCIAL ASSETS OTHER THAN DEBT SECURITIES WHICH ARE CLASSIFIED AS HELD FOR SALE

- 73 For financial assets other than debt securities (e.g. loans) that are classified as held for sale, US GAAP would continue to require such financial assets to be held at the lower of [amortised] cost (without impairment) and market (fair value). This includes financial assets which are reclassified from held for investment to held for sale, in which case any existing loss allowance in excess of the difference between amortised cost and fair value is reversed.

B.3. DEBT SECURITIES CLASSIFIED AS AVAILABLE FOR SALE

- 74 The proposed US GAAP current expected credit loss impairment model does not apply to debt securities classified as available for sale.⁶ In this area modified requirements of the existing other-than-temporary impairment model will be applied. The approach uses a threshold for when impairment is to be recognised and therefore belongs to the category of 'incurred loss' models.

B.4. CONCLUSION

- 75 EFRAG concludes that overall the IFRS 9 expected loss impairment model with its emphasis on credit deterioration and full scope encompassing both loans and debt securities provides more relevant and more comparable information for investors than the US GAAP approach. EFRAG notes that the US GAAP approach has been assessed based on the tentative decisions made by the FASB up to this date.

C - Hedging

- 76 No material changes have been made to US GAAP with relation to hedging requirements, which remain substantially the same as IAS 39. A project to revise hedging requirements has started, but it is at its initial stages.

⁶ For financial assets that meet the definition of 'debt securities', US GAAP requires them to be classified as available for sale unless they are held for trading or designated as held to maturity.

- 77 Given the improvements for hedge accounting in IFRS 9 over IAS 39, as identified in paragraphs 33 to 49 above, EFRAG believes that IFRS 9 can be assessed as leading to significantly improved financial reporting when compared to US GAAP.
- 78 Furthermore, portfolio fair value hedge accounting of interest rate risk, which was included in IAS 39 at the request of European banks, does not exist in US GAAP. Although these requirements have not yet been revised to benefit from the other changes in IFRS 9 that hedge accounting must reflect the economic effects of hedging strategies, their inclusion nevertheless ensures that IFRS 9 is more appropriate to European preparers compared to US GAAP in this regard.

D - Conclusion – Impact of lack of convergence

- 79 For the reasons explained above, and more particularly the differences in the impairment model and hedge accounting, EFRAG assesses that the divergence between IFRS 9 and equivalent current or proposed US GAAP does not raise any level playing field issue that could be detrimental to European companies.

Impact on investor and issuer behaviour

- 80 In assessing the impact on issuer and investor behaviour EFRAG has considered any potential changes made by entities which report under IFRS, such as financial institutions, on their issuing or own investment decision making (for example due to a desire to avoid certain financial reporting consequences).
- 81 This analysis is based on what was reported by constituents in the EFRAG field-tests as potential issues, and input from other stakeholders. EFRAG highlights certain requirements of IFRS 9 which it assesses may have potential negative or positive impacts on investor or issuer behaviour that are worthy of consideration.
- 82 However, EFRAG is not able to assess whether any potential impact on investor and issuer behaviour would materialise. Furthermore, EFRAG is not able to quantify the magnitude of any impact or to distinguish between any impact of IFRS 9 and other factors affecting financial institutions and other entities including the impact of economic conditions at any stage of the economic cycle and regulatory developments including regulators' attitude to the accounting model and its application. Therefore, this analysis should not be construed as representing any form of impact assessment on investor and issuer behaviour. The assessment of the potential effect on the European economy is assessed below under a separate heading.
- 83 This analysis considers the following topics:
- A Equity investments at fair value and long-term investments;
 - B Expected credit loss model for basic lending instruments;
 - C Financial assets other than basic lending instruments;
 - D Presentation of changes in own credit risk on financial liabilities under the fair value option; and
 - E Conclusion on impact on investor and issuer behaviour.

A - Equity investments at fair value and long-term investments

- 84 Some constituents have argued that the default requirement to measure all equity instruments, including unquoted ones for which a fair value is not reliably determinable, at fair value through profit or loss may negatively impact the investment appetite for equity instruments of long-term investors.
- 85 For life entities undertaking insurance activities, measuring equity instruments at fair value through profit or loss may result in fluctuations in profit or loss that may not reflect the economics of their business, because the insurance liabilities which are backed by these assets are measured either at cost (based on existing IFRS 4 *Insurance Contracts* that allows the use of local GAAP) or at current value through other comprehensive income (based on a future insurance contracts standard). EFRAG notes that those entities undertaking insurance activities that already measure their insurance liabilities at current value through profit or loss (on the basis of the existing insurance contracts standard) do not have this issue.
- 86 IFRS 9 provides an option to measure equity instruments that are not held for trading (or are not contingent consideration in a business combination under IFRS 3) at fair value through other comprehensive income which could reduce accounting mismatches, however some entities undertaking insurance activities are unlikely to avail themselves of this option. This is because any gains or losses in those equity instruments are never reclassified from other comprehensive income to profit or loss

even when the equity investments are sold, while changes in the insurance liabilities due to changes in the current rate are recognised in or reclassified to profit or loss. Those entities undertaking insurance activities argue that the lack of reclassification makes it more difficult to portray the performance of their investment activities.

- 87 EFRAG believes that broader economic considerations such as the need for entities undertaking insurance activities to obtain a yield on their asset portfolio sufficient to meet their obligations to policy holders are likely to outweigh any accounting concerns in deciding whether or not to invest in equity investments.
- 88 It has been brought to the attention of EFRAG that other long-term investors, in certain European jurisdictions may face undesirable effects of measuring equity investments at fair value through profit or loss. These entities argue that they invest in equity investments with a long-term horizon and the fair value movements recognised in profit or loss on period-by-period basis does not reflect the economic reality of their business since any gains or losses on their equity investments will only be realised at expiry of their investment horizon. For these long-term investors, EFRAG believes that the option to recognise fair value changes in other comprehensive income is not a preferred solution. While it would remove the fluctuations resulting from unrealised gains or losses from profit or loss and recognise it in other comprehensive income, the prohibition on reclassification of accumulated gains or losses from other comprehensive income to profit or loss is regarded as distorting the performance of these entities given that these equity investments are held primarily for capital appreciation in the long run. EFRAG also believes that, as a consequence, this may lead to non-GAAP measures being developed by such entities to provide relevant information about their performance by removing the fluctuations caused by unrealised gains or losses from profit or loss. However, based on limited evidence, EFRAG assesses it is unlikely that these entities would change their investment strategy as a result of the implementation of IFRS 9.

B - Expected credit loss model for basic lending instruments

- 89 EFRAG has identified some potential negative effects of both 12-month and lifetime expected losses. However, it should be noted that these generally will be less pronounced for stable portfolios. As a result, the effects would be observable only to the extent that portfolios:
- (a) are growing in volume or their average lifetime extends; or
 - (b) the credit quality of the portfolio deteriorates.
- 90 The recognition from day-one of 12-month expected losses may lead to higher provisions for lenders expanding their portfolios (including new entrants to a market) or lenders originating or investing in assets with higher credit risk. This may lead to lenders changing their pricing strategies in order to compensate for the credit risk being accepted, which in turn may increase the cost of lending on consumers.
- 91 However, EFRAG notes that immediate recognition of credit losses is already required for regulatory purposes. Regulatory capital is an important consideration by banks in making business decisions and in most cases banks would include that impact in their pricing and appetite for new lending. Therefore, EFRAG assesses that the new financial reporting requirements should have a limited impact of their own, if any, on banks' pricing strategies or lending appetite.
- 92 To the extent that the day-one provision will result in additional consideration of credit risk in lending decisions and credit pricing, EFRAG believes that this is a positive economic effect due to reduction in credit mispricing because lenders will be more mindful of the actual credit risk being undertaken.

- 93 EFRAG acknowledges that the day-one provision will result in accounting for a loss even when lifetime expected credit losses are priced in the loan. This timing mismatch in the recognition of credit losses from an accounting point of view needs to be balanced against using more conceptual accounting approaches which have been explored and abandoned as they were deemed not to be operational.
- 94 Estimates of lifetime expected credit losses at initial recognition are generally reflected in the pricing of assets for credit risk from a business perspective. From an accounting perspective there is a timing mismatch resulting from an earlier recognition of losses. The lifetime expected losses on instruments with significant increases in credit risk are recognised immediately. The positive effects of assets without significant credit deterioration are recognised on an accruals basis over the life of the instruments as entities account for the interest revenue.
- 95 As lifetime expected losses will generally be higher for exposures with longer maturities there might be incentives to shorten the maturities of the instruments by loan providers or as a result of a demand from investors. Banks might be averse to providing new loans with longer maturities in times of financial crisis when they face losses on their portfolios. However, assuming the demand for loans with longer maturities continues, EFRAG notes that while competitive forces will not prevent banks from implementing such a short-term strategy, they might constrain it. This is because failing to satisfy the demand for loans with longer maturities would adversely reflect on the bank's market share as well as the ability to build a long-term relationship with clients.
- 96 EFRAG's constituents drew attention to the fact that the higher level of loss allowances confronted with the current regulatory environment will affect the capital of banks. In its comment letter on EFRAG's draft endorsement advice on IFRS 9, the European Banking Authority (EBA) acknowledged this issue. They mentioned several areas where the replacement of IAS 39 with IFRS 9 may interact with prudential requirements (e.g. capital treatment of provisioning; prudential filters on the previous Available-for-Sale category and non-existence of filters for IFRS 9 environment; classification under IFRS 9 for regulatory liquidity portfolios; prudent valuation requirements). In the EBA's opinion these possible interactions will have to be analysed further during the implementation period in particular when quantitative impacts of the Standard become available.
- 97 The EBA conducted a preliminary qualitative assessment of the impact of IFRS 9 on investor and issuer behaviours including the impact on lending practices. The EBA found that whilst accounting may be one of the drivers of changes in these behaviours and practices, there are other aspects that have an influence on them (such as regulation, state of the economy and market competition) and therefore it is not possible at this stage to isolate the impact of the application of IFRS 9 on existing investor and issuer behaviour and lending practices.
- 98 In certain cases the requirement to recognise lifetime expected credit losses might create incentives to securitise financial instruments just before significant credit deterioration occurs, in order to avoid recognition of lifetime expected losses. This is because the selling price includes offsetting effects between the expected credit losses and the seller's share in the future interest margin.
- 99 The approach in IFRS 9 is a point-in-time approach rather than through-the-cycle. As a result, it leads to forecasts of future economic conditions that react to the current stage of an economic cycle but are also more variable than a through-the-cycle approach. The variability will be greater for entities with longer-term portfolios because of higher lifetime expected losses which will be recognised in an economic downturn or reversed in times of an economic upturn. If such increased variability is not accepted by market participants evaluating the performance of lenders and

investors, it might trigger a tendency to prefer instruments with shorter maturities or have some minor consequences for pricing.

- 100 EFRAG notes that the variability results from a timely recognition of losses at the time when they are expected due to significant changes in original credit losses expectations. Therefore it reflects the economics of the lending business.
- 101 Finally, in assessing the expected credit losses model and its impact on lending behaviour EFRAG has taken into account the literature review of the Basel Committee on Banking Supervision *The interplay of accounting and regulation and its impact on bank behaviour, Working Paper 28*.

C - Financial assets other than basic lending instruments

- 102 Lenders may face fluctuations in profit or loss due to financial assets that are assessed as not being basic lending instruments due to their cash flow characteristics (i.e. they are assessed as not being solely payments of principal and interest). This may have an impact on their behaviour. On the other hand, the demand of investors for complex and leveraged returns may influence the issuers of such instruments.
- 103 Follow-up to the EFRAG field-tests on the classification and measurement, impairment and general hedging requirements of IFRS 9 carried out in 2015 by EFRAG and the National Standard Setters (ANC, ASCG, FRC and the OIC) has shown that only a small portion of financial assets that are presently measured at amortised cost have cash flows that are assessed as not being solely payments of principal and interest. EFRAG therefore does not believe there will be significant changes arising from financial reporting changes in the availability of financial assets other than basic lending instruments.
- 104 IFRS 9 may lead to securitisation tranches being measured at fair value through profit or loss to a larger extent than under IAS 39. This is especially relevant for lower ranking tranches which are likely to fail the solely payments of principal and interest test due to their riskiness or because they are synthetic securitisations. EFRAG notes that measuring lower ranking tranches at fair value through profit or loss is consistent with their riskiness. Nevertheless, longer-term investors may not find the fair value through profit or loss measurement consistent with their business intentions. As a result, all other things being equal, the demand for higher risk tranches or in the markets for synthetic securitisations may be dampened.

D - Presentation of changes in own credit risk on financial liabilities under the fair value option

- 105 As a result of the IFRS 9 requirement to recognise in other comprehensive income the changes in the fair value of financial liabilities designated at fair value through profit or loss (fair value option) due to changes in the issuer's own credit risk, entities may have better incentives to issue certain types of structured debt instruments.
- 106 Prior to IFRS 9, the entire fair value changes, including changes due to own credit risk, of such liabilities would have been recognised in profit or loss which resulted in fluctuations because own credit risk was not hedged. Furthermore, there was a counterintuitive result whereby the issuer would recognise a gain (loss) in profit or loss when its own credit standing deteriorates (improves). These factors required reliance on non-GAAP measures to explain the effects to users and, under IFRS 9, EFRAG assesses that recognition through other comprehensive income provides a solution.

E - Conclusion on impact on investor and issuer behaviour

- 107 This analysis is based on EFRAG's understanding of both changes in IFRS 9 and current practices of financial institutions and is not a full impact assessment. The conclusions as described in paragraphs 108 to 110 have not been substantiated by quantitative analysis as EFRAG does not expect quantifications to be available on a broad basis before 2017.
- 108 EFRAG notes that the expected credit loss impairment model will lead to higher credit risk provisions than is currently the case and will also affect the regulatory capital of banks. EFRAG has received advice from constituents that changes in capital requirements, state of the economy and market competition are expected to impact issuers' behaviours more than changes in accounting. As a result, EFRAG is not able to assess whether an increase in credit loss provisions would have a significant impact on lending activities.
- 109 In respect of investments in equity instruments EFRAG assesses that the measurement requirements, namely the prohibition of recycling the gains or losses on investments measured at fair value through other comprehensive income, might have limitations for the reporting of performance by some long-term investors. However EFRAG does not expect their investment strategies to be significantly affected.
- 110 The requirement to measure financial assets which do not meet the cash flow characteristics test at fair value through profit or loss may have an impact on the decisions of some lenders and investors. However, EFRAG's follow-up to field-test has shown that only a small portion of financial assets that are currently measured at amortised cost will have to be measured at fair value through profit or loss. As a result EFRAG does not expect significant impacts in this area.

Inter-relationship between IFRS 9 and the future insurance contracts standard

- 111 The business model of some entities undertaking insurance activities⁷ is based on asset/liability management, with the objective of investing in assets in order to generate income and capital appreciation to cover insurance liabilities and provide profit for shareholders. It follows that both IFRS 9 and the future insurance contracts standard will play a very interactive and pervasive role in presenting such entities' financial position and performance.
- 112 IFRS 9 is to be applied for annual periods beginning on or after 1 January 2018. In contrast, the IASB is currently deliberating the future insurance contracts standard and its effective date is unknown (although certainly later than 1 January 2018). Although the future insurance contracts standard is expected to be issued before IFRS 9 becomes effective, it would be extremely difficult for an entity undertaking insurance activities to apply IFRS 9 and early adopt the future insurance contracts standard at the same time. Recognising the extent of the changes for some entities that are brought by the future insurance contracts standard, the IASB has decided that it will allow approximately three years between finalising the future insurance contracts standard and its mandatory effective date.
- 113 Requiring an entity undertaking insurance activities to apply IFRS 9 before the future insurance contracts standard has the potential to significantly reduce the quality of information available to users for many companies undertaking insurance activities. Most accounting mismatches between IAS 39 and existing IFRS 4 *Insurance Contracts* have been addressed by entities undertaking insurance activities. However, the adoption of IFRS 9 before the adoption of the future insurance contracts standard is expected to lead to further accounting mismatches that would be difficult, or even impossible, to address within the remit of the current IFRS until both standards are applied.
- 114 The extent of the difficulties created by the non-alignment of the effective dates of IFRS 9 and the future insurance contracts standard varies from one company to the next. This is due to the diversity that currently exists in the accounting policies for insurance liabilities, the current IFRS 4 having grand-fathered the former national GAAP that prevailed before IFRS were adopted in Europe. Accounting mismatches arise when changes in economic conditions that affect both assets and liabilities are recognised for assets and not for liabilities or vice versa. The more the economic matching of assets and liabilities is critical to an activity's financial position as is the case for entities undertaking insurance activities, the more accounting mismatches are likely to arise and obscure their economic performance. The more diverse the accounting for liabilities, the more the accounting mismatches that arise from the implementation of IFRS 9 vary in significance from one company to the other. Also it is not uncommon for insurance activities to be carried out by conglomerates, the significance thereof within the group varying from one conglomerate to another. As a result of this diversity across the insurance industry, the cost-benefit trade-off that is assessed as negative for many entities carrying out insurance activities, may prove positive for some of them. For this reason any remedy to the overall negative impact for the insurance industry should be brought on an optional basis.

⁷ For the purpose of this letter, an entity undertaking insurance activities is an entity (or a component of an entity such as an operating segment) whose principal activity is to issue insurance contracts (as defined in IFRS 4).

- 115 In its July 2015 meeting, the IASB has considered how to address the issue identified by EFRAG in the development of its endorsement advice to the European Commission. The IASB explored alternative solutions, including using the flexibility currently included in IFRS 4 and the possibility of increasing this flexibility. It decided to explore the new profit or loss overlay approach. This approach would require an entity undertaking insurance activities to apply IFRS 9 in full but permit the insurer to remove from profit or loss and recognise in other comprehensive income the difference between (i) the amounts that would be recognised in profit or loss in accordance with IFRS 9 and (ii) the amounts recognised in profit or loss in accordance with IAS 39 for specified assets. Consequently, the net effect on profit or loss would reflect the IAS 39 accounting for those specified assets. The IASB will consider at a future meeting how to identify these assets, any additional disclosures and the requirements that would need to apply when those assets are transferred within a group.
- 116 The IASB also decided to explore approaches including an optional deferral of IFRS 9 for entities undertaking insurance activities.
- 117 EFRAG welcomes the IASB's efforts to find an acceptable optional remedy. However, the IASB is at the early stages of its deliberations and therefore we are not in a position as of today to assess whether their efforts will result in the amendments necessary to remove the impediments created by the non-alignment of the effective dates of IFRS 9 and of the future insurance contracts standard.
- 118 We assess below the benefits and drawbacks of an optional deferral of the effective date of IFRS 9 for entities undertaking insurance activities, which is the remedy that EFRAG had envisaged in its draft endorsement advice. As indicated above, it is too early for us to compare those with the benefits and drawbacks of the alternative solution that the IASB tentatively decided on 20 July 2015 to develop further. EFRAG will continue to actively monitor and contribute to the IASB standard-setting efforts and will keep the European Commission informed of those developments and of its assessment of the IASB's proposals.

A - Potential benefits and drawbacks of deferring IFRS 9 for entities undertaking insurance activities

A.1. POTENTIAL BENEFITS OF A DEFERRAL

- 119 EFRAG assesses that the benefits of deferring the application of IFRS 9 for entities undertaking insurance activities that apply cost models to their insurance liabilities include:
- (a) *Accounting mismatches.* If entities undertaking insurance activities were required to change the accounting for financial assets by applying IFRS 9 without a corresponding change in the accounting for insurance liabilities backed by those financial assets, it would result in accounting mismatches for those entities undertaking insurance activities applying the cost model under the existing IFRS 4. This is because some debt instruments currently accounted for at amortised cost or at fair value through other comprehensive income and most equity instruments currently accounted for at fair value through other comprehensive income with recycling are likely to be accounted for at fair value through profit or loss. Fair value movements on these assets would be recognised in profit or loss, while insurance liabilities backed by those assets remain measured at cost, resulting in accounting mismatches in profit or loss even where the insurance liabilities are perfectly matched by financial assets. A deferral of IFRS 9 until the future insurance contracts standard is implemented would allow changes in the accounting requirements for financial

instruments and insurance liabilities to be applied at the same time, thereby avoiding expensive (and not necessarily effective) adjustments or accounting mismatches during the interim period.

- (b) *Information needs of users.* Users will find difficulties in understanding the financial performance and position of entities undertaking insurance activities during the period between the adoption of IFRS 9 and the future insurance contracts standard. Entities undertaking insurance activities are likely to provide non-GAAP measures to explain the impact of accounting mismatches caused by a change in the measurement of financial assets that is not accompanied by a change in the measurement of the insurance liability. This is likely to require users to perform complex analyses to understand the results of an entity undertaking insurance activities by linking non-GAAP measures to the financial statements. EFRAG has conducted a range of interviews with users specialised in insurance businesses. A significant majority thereof indicate that they would favour considering accounting changes arising from IFRS 9 and the future insurance contracts standard at the same time. A deferral of IFRS 9 effective date would satisfy them.
- (c) *Costs for preparers.* In the event IFRS 9 is implemented before the future insurance contracts standard, entities undertaking insurance activities would incur additional costs for having to first implement IFRS 9 and then reassess that implementation when implementing the new insurance contracts standard.

A.2. POTENTIAL DRAWBACKS OF A DEFERRAL

120 While there are benefits for entities undertaking insurance activities of aligning the effective dates of IFRS 9 and the future insurance contracts standard, EFRAG notes that a deferral of IFRS 9 is not without drawbacks, including:

- (a) *Delaying the provision of improved financial information.* IFRS 9 is generally considered an improvement over IAS 39. Delaying the application of IFRS 9, above all the improved impairment model, particularly if it is for an unknown number of years, is an issue of concern. Allowing entities undertaking insurance activities to continue applying the IAS 39 incurred loss model, which has been criticised as providing for 'too little, too late' loss allowances, instead of the IFRS 9 forward-looking expected credit losses model, might be seen as a significant drawback in light of the G20 recommendation at first glance.
- (b) *Reduction in comparability.* A deferral of IFRS 9 would reduce comparability in the treatment of financial assets between entities undertaking insurance activities and banks or other entities, and also within the insurance industry. To be satisfactory, it would have to be granted as an option.
- (c) *Impact on conglomerates.* Allowing a deferral of IFRS 9 could lead to recognition, in the consolidated financial statements of conglomerates, of financial assets accounted for in accordance with either IFRS 9 or IAS 39 and hence result in conglomerates applying non-uniform accounting policies. This would increase complexity and reduce understandability. When, in a conglomerate, banking activities are dominant, selecting the option may not be considered as the most effective basis for financial communication and this can be perceived as a competitive disadvantage among entities undertaking insurance activities.

A.3. CONCLUSION ON POTENTIAL BENEFITS AND DRAWBACKS

121 EFRAG has carefully considered the benefits and drawbacks identified above and reached the following conclusions:

- (a) Whilst limitations in the application of the IFRS 9 impairment model are not desirable, EFRAG has been informed by constituents that those limitations are said not to be expected to have very material effects for entities undertaking insurance activities. As demonstrated by the results of the 2015 follow-up to the EFRAG field-tests on IFRS 9 (see Appendix 4, paragraphs 4, 16 – 20), moving from an incurred loss model to the IFRS 9 expected loss model is said to generate significant increases in credit loss allowances; however these increases would apply to low amounts because most of these assets are reported to be investment grade assets.
- (b) The loss of comparability between entities undertaking insurance activities and other entities, banking entities in particular, relating to financial instruments amounts, cannot be denied; however it is to be put in the perspective of the currently low level of comparability of the financial statements of entities undertaking insurance activities – among each other or with others – that results from the current situation under IFRS 4. The measurement of insurance liabilities currently differs between entities undertaking insurance activities because the current IFRS 4 has grandfathered previous national GAAP to the point that different GAAPs may be used in a same set of financial statements for the accounting of various insurance liabilities. Therefore, with or without a deferral option, the financial statements of insurance businesses will not reach any acceptable level of comparability before the new insurance contracts standard is introduced. As a result, the effects of the loss of comparability between companies and entities undertaking insurance activities on financial instruments amounts are not, in EFRAG's view, commensurate with the disruptive effects on financial statements as a whole that successive changes and accounting mismatches could have on users.
- (c) EFRAG draws similar conclusions on the breach of uniform accounting policies that a deferral option may bring in the financial statements of financial conglomerates. Whilst the breach in uniform policies on the asset side within the group is indeed a factor of increased complexity, EFRAG believes that separate presentation and disclosure of financial assets measured in accordance with IAS 39 and IFRS 9 may mitigate the negative effects. Segment reporting can also help mitigate the negative effects on understanding and EFRAG has heard from users that they relied primarily on segment reporting to carry their analyses.
- (d) EFRAG has carefully considered the argument that entities undertaking insurance activities included in a banking dominant conglomerate could be put at a disadvantage if the group would decide not to benefit from the option of the deferral for its insurance activities. EFRAG notes that any option creates comparability issues and is therefore undesirable. EFRAG concludes however that it would be for each conglomerate to weigh the advantages and disadvantages of applying any option granted. EFRAG does not expect a conglomerate to adopt the option if using it would create significant competitive disadvantages. And, more importantly, EFRAG believes that this potential negative outcome is in no way proportionate with the disruptions in the financial reporting for a significant part of the entities undertaking insurance activities that would be generated by the non-alignment of the effective dates of IFRS 9 and the future insurance contracts standard.

122 In its conclusions above, EFRAG is comforted by the additional and specific outreach it carried out, with the IASB as observer, to users directly involved in entities undertaking insurance activities. As mentioned earlier, a significant majority of users

interviewed⁸ express a strong preference for having IFRS 9 and the future insurance contracts standard implemented at the same time.

B - Other approaches

- 123 The recent decision by the IASB to consider how to remedy the non-alignment of the effective dates of IFRS 9 and the future insurance contracts standard for entities undertaking insurance activities shows that the IASB has acknowledged that taking action to address the issues of the non-alignment is justified. In addition to exploring the deferral of the effective date of IFRS 9 for entities undertaking insurance activities as a potential remedy, the IASB is also investigating other remedies that would provide similar or better outcomes, while mitigating some of the potential negative effects of the deferral option.
- 124 EFRAG stands ready to actively consider and contribute to the IASB standard-setting process in this area. Whatever the outcome of the IASB's work, EFRAG believes that an acceptable solution must be brought to the difficulties that the non-alignment of the effective dates of IFRS 9 and the future insurance contracts standard would create for many entities undertaking insurance activities and users of their financial statements.

C - Quantitative assessment

- 125 EFRAG has reached out to the entities undertaking insurance activities in order to understand the likely effect of adopting IFRS 9 before the adoption of the future insurance contracts standard.
- 126 In this regard, EFRAG received a joint preliminary high level quantitative assessment from the European entities undertaking insurance activities showing an initial review of the balance sheets of some of the largest and most affected continental European entities undertaking insurance activities. This suggests that between 8 and 20 per cent of the assets currently accounted for at amortised cost or on an available-for-sale basis, with a value of more than € 250 billion, will be accounted for at fair value through profit or loss on adoption of IFRS 9. Fair value movements on these assets would be recognised in profit or loss. With the measurement methodology for insurance liabilities remaining unaltered until the future insurance contracts standard is implemented this will give rise to significant accounting mismatches resulting in fluctuations in reported net income unrelated to changes in the entity's performance. For example, based on an analysis by some of the larger continental European entities undertaking insurance activities for the years 2011 to 2014 there would have been fluctuation in profit or loss of in one case up to 20 per cent. It should be noted however that some of these assets are held in the non-life and other non-insurance activities of these entities undertaking insurance activities, where there is less or no economic linkage between assets and liabilities.

D - Conclusion

- 127 Based on its analysis EFRAG concludes that IFRS 9 would not be conducive to the European public good where the insurance industry is concerned unless a mitigating remedy to the problems noted above is found.

⁸ Many of these interviews occurred before the IASB's meeting in July 2015. It was at that meeting that significant alternatives to deferral were considered.

128 EFRAG further notes that:

- (a) as explained in other sections of our endorsement advice, significant benefits are expected from the application of IFRS 9 to the other sectors, in particular the banking industry; EFRAG therefore recommends that application of IFRS 9 be required for all businesses other than those carrying out insurance activities in 2018 and businesses carrying out insurance activities be permitted to apply IFRS 9 from the same date;
- (b) all businesses carrying out insurance activities should have clarity as soon as feasible in the conditions and timeframe in, and the extent of, they will have to implement IFRS 9; the European Commission should hence request the IASB to proceed with the necessary amendments as expeditiously as possible; and
- (c) any solution (deferral or other) remains sub-optimal and therefore should be of a very temporary nature; EFRAG therefore urges the IASB to make their best efforts to finalise the future insurance contracts standard as early as possible, so that the endorsement process of the future insurance contracts standard can start in Europe in 2016.

European carve-out

- 129 The European carve-out permits entities to continue to access the carve-out in IAS 39 *Financial Instruments: Recognition and Measurement* because the relevant paragraphs have been retained in revised IAS 39.
- 130 Entities applying IFRS 9 can access the European carve-out in one of two ways:
- (a) An entity may elect to continue to apply all of the hedge accounting requirements in IAS 39, rather than applying the hedge accounting requirements in IFRS 9 (Scope 1); or
 - (b) An entity that elects to apply the IFRS 9 hedge accounting requirements may elect to apply the IAS 39 requirements for fair value hedge accounting of the interest rate exposure of a portfolio (Scope 2).

A - Scope 1: Apply the hedge accounting requirements of either IAS 39 or IFRS 9

- 131 The transition provisions of IFRS 9 include an accounting policy choice allowing entities to continue to apply the hedge accounting requirements of IAS 39 instead of the requirements of IFRS 9 for all of their hedge accounting. This accounting policy choice is made when an entity first applies the Standard.
- 132 In order for this accounting policy choice to be effective for entities which rely on the carve-out, the paragraphs of IAS 39 which relate to the carve-out need to remain in existence. This is the case with the amendments that IFRS 9 makes to IAS 39.

B - Scope 2: Application of IFRS 9 and IAS 39 to portfolio fair value hedge

- 133 IFRS 9 permits that for a fair value hedge of the interest rate exposure of a portfolio of financial assets or liabilities (and only for such a hedge), an entity may apply the hedge accounting requirements in IAS 39 instead of those in IFRS 9. In that case, the entity must also apply the specific requirements for the fair value hedge accounting for a portfolio hedge of interest rate risk and designate as the hedged item a portion that is a currency amount.
- 134 This means that an entity would be able to apply the carve-out to a portfolio fair value hedge of interest rate risk (and only for such a hedge), while applying IFRS 9 to all its other hedges.

C - Update of the European carve-out necessary for editorial reasons

- 135 IFRS 9 slightly changes one of the carved-out paragraphs of IAS 39, without affecting the substance of the carve-out. As a consequence, it may be necessary that a legal expert assess whether an update of the relevant paragraph is needed.

EFRAG's evaluation of the costs and benefits of IFRS 9

- 136 EFRAG has considered whether, and if so to what extent, implementing IFRS 9 in the EU might result in incremental costs for preparers and/or users, and whether those costs are likely to be exceeded by the benefits to be derived from its adoption. EFRAG has also considered whether, and how, these costs and benefits are likely to depend on the industry that a preparer belongs to.
- 137 EFRAG's evaluation is based upon the results of its field-tests (see Appendix 4, paragraphs 1 - 4) of the various parts of IFRS 9 and additional input from constituents, including in EFRAG working groups.

A - Costs for preparers

A.1. ONE-OFF COSTS FOR PREPARERS

A.1.1. CLASSIFICATION AND MEASUREMENT

- 138 The one-off costs will depend on the individual circumstances of the entity, i.e. the type (and diversity of) business models for its financial assets as well as the contractual cash flow characteristics of the instruments.
- 139 Preparers are expected to incur significant one-off costs to undertake the initial analysis of business models and contractual cash flows on transition; to develop new processes, systems and controls; to develop valuation systems for specific financial assets which were previously measured at amortised cost; to prepare disclosures related to transition; to obtain expert advice for compliance and explaining to users of financial statements the differences between the information produced under IAS 39 and IFRS 9.
- 140 The fact that upon transition to IFRS 9 there is no requirement to restate the financial information for previous periods will help contain the costs for preparers in implementing IFRS 9.
- 141 Entities that issue contracts that are within the scope of IFRS 4 *Insurance Contracts* will need to consider the possibility of accounting mismatches between IFRS 9 and their current accounting for insurance contracts when implementing IFRS 9. They will then need to reassess the application of IFRS 9 when the new insurance contracts standard becomes effective in order to reflect their asset-liability management appropriately. Even though this may not result in doubling the costs of implementing IFRS 9, some doubt the benefits of the first implementation effort. This is further discussed in paragraphs 119 to 128.

A.1.2. IMPAIRMENT

- 142 The costs of applying the expected credit loss model will vary depending on the diversity of investment strategies and the sophistication of existing credit risk management systems.
- 143 Participants in the 2013 field-test on proposed impairment requirements (see Appendix 4, paragraph 2) identified that there would be further significant cost including costs for development and roll-out of systems, tools and processes for collecting data, tracking credit risk and calculating expected credit losses. New systems and controls will also be required in order to integrate information produced for credit risk management or other business purposes into their financial reporting process.
- 144 In determining significant increases in credit risk, entities will need to develop systems for tracking the credit risk at initial recognition, identifying increases in credit

risk on a timely basis at the level of both individual instrument and collectively. The transitional relief may reduce the costs with respect to instruments recognised before the application of IFRS 9 because the lifetime expected credit losses can be recognised with respect to the current level of credit risk or the past due status.

- 145 Calculation of expected credit losses will require development of systems for collecting historical information about defaults, loss rates, and behavioural aspects of exposures. At the time of transition to IFRS 9, many entities will lack sufficient historical data and the entities will have to find reliable methods for extrapolating the short-term observations over the period of the life of their exposures. Measurement of expected credit losses will require systems for projection of future conditions affecting the exposure and for their extrapolation beyond the horizon of reasonable forecasts. This may include adjustments of through-the-cycle parameters calculated by financial institutions for prudential regulatory purposes. Calculations are based on present values and the introduction of discounting at the instrument's effective interest rate to the reporting date will bring additional challenges.
- 146 EFRAG also expects that additional costs will be incurred by preparers to explain to users specific aspects of applying the new impairment model to support the users' understanding of the information presented.

A.1.3. DISCLOSURES FOR IMPAIRMENT

- 147 The implementation costs to comply with the disclosure requirements will impose a significant burden on preparers. As identified in EFRAG's 2013 field-test on the proposed impairment requirements (see Appendix 4, paragraph 2) and the 2015 follow-up to the field-tests on IFRS 9 (see Appendix 4, paragraph 4), disclosure requirements are comprehensive and are frequently prescriptive rather than principle-based.
- 148 With respect to specific disclosure requirements, participants in the field-test highlighted the costs of reconciliations between opening and closing balances for the gross carrying amount of financial assets and loss allowances because the data in the accounting and risk systems have to be combined and other information may need to be collected.

A.1.4. HEDGING

- 149 Because IFRS 9 requires prospective application of the hedging requirements, EFRAG assesses that the main one-off costs are expected to be:
- (a) educating staff and preparing new reporting systems and procedures for the disclosure requirements;
 - (b) costs of collecting information about hedge of risk components of non-financial items (i.e. commodity risk); and
 - (c) updating of the documentation for existing hedging relationships.

A.1.5. OTHER COSTS

- 150 As highlighted in the EFRAG 2013 field-test on the proposed impairment requirements (see Appendix 4, paragraph 2), entities will incur high one-off costs to:
- (a) educate and train personnel;
 - (b) define roles and responsibilities and new procedures and workflows; and
 - (c) update the accounting system, including the disclosures for the annual report.

A.2. ONGOING COSTS FOR PREPARERS

A.2.1. CLASSIFICATION AND MEASUREMENT

- 151 One of the main ongoing costs of applying IFRS 9 will be the need for entities to monitor the frequency and magnitude of sales in order to decide whether there is an impact on the classification of financial assets. Entities will also incur costs in classifying new financial assets with respect to meeting the solely payments of principal and interest criteria.
- 152 IFRS 9 requires some financial assets to be measured at fair value on an ongoing basis. IFRS 7 already requires disclosure of the fair value of financial instruments. However, calculation of fair value for inclusion in the primary statements rather than disclosure may result in additional cost.
- 153 There will also be new disclosure requirements which will result in the need to capture more data than under the current disclosure requirements in IFRS 7 (e.g. additional disclosures about investments in equity instruments measured at fair value through other comprehensive income, disclosures for reclassifications).

A.2.2. IMPAIRMENT

- 154 The principle of using reasonable and supportable information available without undue cost or effort allows the entities to consider the level of sophistication of their credit risk management systems and thus alleviates the cost burden. However, this also implies that the availability of information will improve and the threshold for undue costs will lower over time. Entities are likely to further develop their impairment systems which will bring some costs on an ongoing basis.
- 155 The ongoing cost of measuring a loss allowance at an amount equal to 12-month expected credit losses will be higher for financial institutions that do not use an internal-ratings based approach for regulatory purposes.
- 156 For non-financial institutions, the calculations of 12-month and lifetime expected credit losses are a new concept that would not normally be required for other management purposes. As a result, they are unlikely to have applied such a calculation in the past. This will require ongoing monitoring of systems and processes.
- 157 For both financial and non-financial institutions, ongoing costs will be incurred in connection with obtaining calculation inputs and improving their quality over time.

A.2.3. HEDGING

- 158 The ongoing costs will be different from entity to entity and depend on an entity's facts and circumstances so it is difficult to provide a general assessment of the impact. The size of the ongoing costs will be influenced by the type of hedging instruments and hedged items each individual entity uses, as well as their implementation of hedge accounting in terms of processes and systems.
- 159 IFRS 9 generally keeps the mechanics of hedge accounting for fair value, cash flow and net investment hedges the same, which will reduce the costs of transition to IFRS 9. Further, IFRS 9 permits entities to apply the IAS 39 requirements for the portfolio fair value hedge of interest rate risk while accounting for all other hedge relationships according to IFRS 9. Consequently, the introduction of IFRS 9 would not adversely affect the ability and costs for portfolio fair value hedge activities. In addition, the migration from macro cash flow hedge requirements under IAS 39 to the hedge accounting requirements of IFRS 9 should not lead to extra costs for preparers as the new requirements do not change how risk components of financial items can be designated as hedged items.

- 160 As indicated in EFRAG's 2012 field-test on general hedge accounting (see Appendix 4, paragraph 3), ongoing costs may relate to application of the hedge ratio and rebalancing. However, as these requirements have been further clarified in the finalisation process of IFRS 9, these costs may be lower than initially assessed.
- 161 In determining hedge effectiveness, entities need to assess the effect of credit risk on the hedge relationship. This may bring some operational complexities, although the application of the hedge effectiveness requirements has been simplified compared to the ones required under IAS 39. However, as the assessment is to be done on a 'should not dominate' basis, the costs related to this assessment are not expected to be extremely high.
- 162 Although used for an economic hedge IFRS 9 does not consider the hypothetical derivative as a method in its own right for assessing hedge effectiveness. It is one possible way of determining an input for other methods. One may argue that this could increase the operational cost of preparers, however EFRAG notes that other methods exist to demonstrate hedge effectiveness. Consequently, EFRAG believes that the impact on operational cost for preparers may be minimal.
- 163 IFRS 9 expands the notion of 'costs of hedging' so as to include foreign currency basis spreads, the reason for this being that foreign currency basis spreads are considered as a charge of forward exchanging one currency into another. Such an approach is a practical expedient and thus cost-reducing.
- 164 When an entity separates the intrinsic value and time value of an option contract and designates as the hedging instrument only the change in intrinsic value of the option, the change in fair value of the time value is recognised in other comprehensive income. However the accounting treatment differs depending on whether the option hedges a transaction related hedged item or a time-period related hedged item. This may lead to an increase in operational costs for applying the hedge accounting requirements.

A.2.4. OTHER ONGOING COSTS

- 165 Other ongoing costs are expected to be:
- (a) Collecting the relevant disclosures;
 - (b) Ongoing system development and training;
 - (c) Maintenance of systems and management of data, models and processes;
 - (d) Complex ongoing processes and procedures; and
 - (e) Audit costs.

A.3. CONCLUSION – COSTS FOR PREPARERS

- 166 Overall, EFRAG's assessment is that IFRS 9 is likely to result in significant costs for preparers related to implementation of IFRS 9 and ongoing costs of complying with IFRS 9. These costs are expected to be significantly higher for financial institutions than for the non-financial sector.

B - Costs for users

B.1. ONE-OFF COSTS FOR USERS

- 167 EFRAG's assessment is that users may have to incur one-off costs to read and understand IFRS 9 and the impact on the classification of financial instruments, including the available options, and the immediate impact of the impairment requirements. The mechanics of hedge accounting for fair value, cash flow and net

investment hedges are already well known by users, which will not lead to any additional cost.

- 168 EFRAG assesses that users will have to organise special meetings with preparers in order to understand how they have implemented IFRS 9 and the implications for their organisation. EFRAG assesses that these one-off costs will be significant.
- 169 Users will incur particularly high costs for understanding the financial statements of entities that issue contracts within the scope of IFRS 4. This is because the effective dates for IFRS 9 and the forthcoming insurance contracts standard are not aligned. Classification and measurement of financial assets following IFRS 9 may have to be reassessed at the moment of implementing the forthcoming insurance contracts standard.

B.2. ONGOING COSTS FOR USERS

B.2.1. CLASSIFICATION AND MEASUREMENT

- 170 The ongoing costs for users are generally unlikely to be significant since the requirements will lead to relevant, understandable and comparable information and it is not expected that users will have to restate financial statements. Changes in an entity's business model and consequential costs of analysis are expected to be rare.

B.2.2. IMPAIRMENT

- 171 The assessment of changes in credit risk since initial recognition and calculation of expected credit losses inherently involves a significant amount of subjectivity and therefore reduces the verifiability and comparability of reported amounts. On the other hand, disclosures help in improving the verifiability and comparability. Analyses of all the information available are likely to result in ongoing costs for users of financial statements.

B.2.3. HEDGING

- 172 The hedge accounting requirements have the objective to represent in the financial statements the effect of entities' risk management. While this provides users an opportunity to analyse entities' risk management it also requires the cost of performing these analyses.

B.3. CONCLUSION – COSTS FOR USERS

- 173 Overall, EFRAG's assessment is that, based on the above analysis, IFRS 9 is not likely to result in significant costs for users after the transition. However, at transition costs will be incurred in understanding the new financial reporting.

C - Benefits for preparers and users

C.1. CLASSIFICATION AND MEASUREMENT

- 174 The extent of the benefit for preparers will depend on existing practices and the industry within which they operate.
- 175 For financial assets that are assessed as having contractual cash flows that are solely payments of principal and interest, classification and measurement aligned with the entity's business model would mean that the entity's internal management and financial reporting would also be better aligned. This is expected to result in lower ongoing costs for preparers.
- 176 For financial assets that are assessed as having cash flows that are not solely payments of principal and interest, the removal of the complex rules regarding

bifurcation of embedded derivatives means that it is simpler to identify the cash flows that are measured at fair value (i.e. it is all of the contractual cash flows of the financial asset, not just some).

- 177 Users will benefit from relevant and transparent information because the classification and measurement requirements in IFRS 9 will reflect how the cash flows of financial assets are expected to be realised given the entity's business model and the nature of the contractual cash flows. However, if the effective date of IFRS 9 is not aligned with a new insurance contracts standard, users of financial statements of entities undertaking insurance activities may face two significant changes within a relatively short period of time.

C.2. IMPAIRMENT

- 178 Preparers will benefit from the fact that existing credit risk management processes are capable of being leveraged to fulfil the IFRS 9 requirements.
- 179 Users of financial statements will benefit from the information about expected credit losses being provided on a timely basis. This will help them to predict future cash flows on financial instruments.
- 180 Furthermore, the model provides information about credit quality upon initial recognition and the deterioration in credit quality over time. In doing so, the model indirectly relates the measurement of the credit quality with how the credit risk was reflected in the original pricing of the financial instrument as explained in paragraphs 81 to 82 of Appendix 2. As a result, users will be able to distinguish between instruments for which the credit risk increased significantly and resulted in economic losses and instruments with no significant credit deterioration for which the credit losses are largely absorbed by the interest cash flows.
- 181 Users will be assisted by comprehensive disclosures that will help them understand the models, assumptions and inputs used to recognise expected credit losses. They will also find information about the absolute level of credit risk of financial instruments.

C.3. HEDGING

- 182 The hedging requirements of IFRS 9 are expected to bring the following benefits for preparers and users:
- (a) Better consistency between accounting and risk management;
 - (b) Less need for non-GAAP information to explain hedge accounting to users; and
 - (c) Availability of standardised and more transparent information resulting in a better understanding of an entity's performance.
- 183 Given that risk management strategies for each risk category are to be disclosed, hedge accounting requirements will be more closely aligned with risk management making for preparers easier to explain how their risk management functions and providing to users the opportunity to better understand these activities. This should contribute to better economic decision making through improved financial reporting. This is especially the case for corporates as IFRS 9 allows for hedge accounting of non-financial risk components which will better reflect commercial reality.
- 184 The new hedge effectiveness requirements, including the possibility to rebalance a hedge accounting relationship, will benefit users and preparers as effectiveness will be assessed based on the (continuing) existence of an economic relationship between hedged item and hedging instrument and not based on bright line limits.
- 185 IFRS 9 considers the time value of an option as a premium paid for protection against risk and, consequently, aligns the accounting for the time value with the risk

management perspective. This will be beneficial for users and preparers as the time value paid is treated as a cost of hedging with the resulting fluctuations recognised in other comprehensive income instead of as held for trading.

- 186 IFRS 9 requires comprehensive information to be disclosed in a single note to allow users to understand the effects of hedge accounting on the financial statements. In addition, the disclosures provide a higher level of transparency on hedge accounting activities which would permit users to more readily develop their view of an entity's risks and how they are hedge accounted for.

C.4. CONCLUSION – BENEFITS FOR PREPARERS AND USERS

- 187 Overall, EFRAG's assessment is that users are likely to benefit from IFRS 9, as the information resulting from it will be relevant and transparent and therefore will enhance their analysis. However, these benefits are expected to vary significantly from entity to entity and depending on the industry.
- 188 Also, EFRAG's assessment is that preparers are likely to benefit from IFRS 9 due to the reasons stated above.

D - Overall conclusion regarding costs and benefits

- 189 EFRAG's assessment is based on all practical expedients being available to preparers. EFRAG notes that, in this context, availability of all practical expedients shall be understood in the context of materiality. Materiality is an entity-specific aspect of relevance based on the nature or magnitude, or both, of the items to which the information relates in the context of an individual entity's financial report.
- 190 When taking into account the benefits of a simpler classification and measurement model and the production of information that is easier to understand, the impairment model resulting in timelier recognition of credit losses and comprehensive disclosures, better possibilities for hedge accounting reflecting risk management practices, EFRAG assesses that the benefits of IFRS 9 outweigh the associated costs. EFRAG acknowledges that its conclusion is a general conclusion that does not differentiate between different industries. EFRAG further acknowledges that this positive assessment might depend on how the non-alignment of the effective dates for IFRS 9 and the new insurance contracts standard is dealt with.

Overall assessment with respect to the European public good

- 191 EFRAG believes that IFRS 9 will generally bring improved financial reporting when compared to IAS 39. As such, its adoption is conducive to the European public good in that improved financial reporting improves transparency and assists in the assessment of management stewardship.
- 192 EFRAG has considered whether there are any other factors that would mean adoption is not conducive to the public good. The other factors considered were:
- (a) The impact of the lack of convergence with US GAAP;
 - (b) The impact on investor and issuer behaviour;
 - (c) The interrelationship between IFRS 9 and the future insurance contracts standard;
 - (d) The continuing availability of the European carve-out; and
 - (e) The costs and benefits of adoption.
- 193 After having assessed these issues, EFRAG has concluded that IFRS 9 is conducive to the European public good, except for the impact on the insurance industry. The IASB is working on one or more solutions for the insurance industry and is expected to make tentative decisions in the next two months. We will advise the European Commission on our views as the IASB's work develops, and on that basis will provide further advice where the insurance industry is concerned. In any event we recommend that all businesses other than those carrying out insurance activities are required to account for their financial instruments in compliance with IFRS 9 in 2018 and businesses carrying out insurance activities are permitted to do so in compliance with IFRS 9 from the same date.

Appendix 4: Extent of quantitative assessment available

A - Work undertaken to collect quantitative data

A.1. INITIAL FIELD-TESTS

- 1 In 2013 EFRAG and the National Standard Setters (ANC, ASCG, FRC and the OIC) carried out a field-test on the proposed classification and measurement requirements for financial assets contained within IFRS 9, as amended by the Exposure Draft *Classification and Measurement (Limited Amendments to IFRS 9)*. The field-test report was published on 17 June 2013 and is available on EFRAG's [website](#).
- 2 In 2013 EFRAG and the National Standard Setters (ANC, ASCG, FRC and the OIC) carried out a field-test on the proposed impairment requirements in the IASB Exposure Draft *Expected Credit Losses*. The field-test report was published on 19 July 2013 and is available on EFRAG's [website](#).
- 3 In 2012, EFRAG and the National Standard Setters (ANC, ASCG, FRC and the OIC) carried out a field-test on the Review Draft *Hedge Accounting*. In addition a consultation was held on the transition from IAS 39 *Financial Instruments: Recognition and Measurement* to IFRS 9 for macro-hedging practices. The field-test report was published on 24 July 2013 and is available on EFRAG's [website](#).

A.2. FOLLOW-UP TO FIELD-TESTS

- 4 In 2015, EFRAG and the National Standard Setters (ANC, ASCG, FRC and the OIC) carried out a follow-up to the field-tests on the classification and measurement, impairment and general hedging requirements of IFRS 9. The purpose of this pre-endorsement questionnaire was to gain an understanding of the impact of IFRS 9 and any implementation challenges. The relevant results of this pre-endorsement questionnaire have been included in Appendix 2 and 3. The feedback report on the results of the pre-endorsement questionnaire was published on 4 August 2015 and is available on EFRAG's [website](#).

A.3. FINANCIAL REPORTS OF EARLY ADOPTERS

- 5 EFRAG has attempted to obtain data from financial statement of early adopters of IFRS 9 outside the EU with focus on financial institutions. EFRAG observes that currently little data is available internationally as early adopters seem to be rare.

B - Surveys considered

- 6 EFRAG has also looked at the following IFRS 9 surveys from audit firms to collect quantitative data:
 - (a) 2009 CFA Institute Financial Instrument Accounting Survey;
 - (b) 2010 PWC survey What investors think of FI reporting;
 - (c) 2012 EY survey Reflecting credit and funding adjustments in fair value;
 - (d) 2013 Survey on classification of financial instruments of the Japanese Analysts Association;
 - (e) 2014 Deloitte Fourth global IFRS banking survey;
 - (f) 2014 Deloitte, IFRS 9 Impairment Umfrage zur EL-Wertminderung; and
 - (g) 2015 Deloitte Fifth Global IFRS Banking Survey.

- 7 EFRAG has found these surveys useful in identifying general challenges in the implementation of IFRS 9 but has not relied on the quantitative data which are presented in those surveys because:
- (a) some of these surveys are outdated;
 - (b) even the most recent surveys were based on Exposure Drafts of IFRS 9, completed with tentative decisions of the IASB Board as well as using a specific IFRS 9 simulation tool; and
 - (c) no survey is available which has been solely based on the final IFRS 9.
- 8 In May 2015, Deloitte published its 5th Global IFRS Banking Survey. The Survey provides a view on how impairment provisions would be affected under the new accounting requirements, but in doing so makes no difference between IFRS 9 and the new Current Expected Credit Losses model under US GAAP. The participants in this Survey were not only European but came from all over the world.

C - Results from the 2015 follow-up to field-tests on IFRS 9

- 9 Twenty-three entities participated in the pre-endorsement questionnaire. Eleven of the participants were from the banking industry, nine of the participants came from other industries and three participants came from the insurance industry. For the purposes of the analysis the participants from the banking and insurance industries were treated separately as accounting for financial instruments is of particular concern to them.
- 10 The table below summarises the total number of participants by country and by industry.

Participants by country:	8	Participants by industry:	11
Germany	8	Banking	11
Sweden	1	Insurers	4
France	10	Other industries	9
UK	4		
Italy	1		
	24		24

- 11 In describing the findings the following descriptors were used in this report:
- (a) Few: 1 to 4 participants;
 - (b) Some: 5 to 11 participants;
 - (c) Majority: 12 to 18 participants;
 - (d) A large majority: 19 to 24 participants.

C.1. QUANTITATIVE DATA ON CLASSIFICATION AND MEASUREMENT

- 12 A majority of participants from the banking, insurance and other industries estimated the number of financial instruments currently measured at amortised cost or classified at available for sale under IAS 39 as meeting the solely payments of principal and interest (SPPI) test to be within the following ranges:

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	Expected to be assessed as		
	Currently	SPPI	Not SPPI
Loans and receivables		Between 95% and 100%	Between 0% and 5%
Held to Maturity		Majority if not all or 100%	0%
AFS debt instruments		Between 80% and 100%	Between 20% and 0%

- 13 One participant from the insurance industry provided quantitative input with regard to the above assessment with results which did not contradict the above trends.
- 14 Some participants from the banking, insurance and other industries noted that they were not able to make the above assessment, did not reply or were still doing the assessment.

C.2. QUANTITATIVE DATA ON IMPAIRMENT

- 15 Participants from the banking, insurance and other industries expected to have a materially complete understanding of the impairment as follows:

Ready now	2015	2016	2017	No answer	Total
2	10	3	2	7	24

- 16 Some participants from the banking, insurance and other industries provided quantitative data to the question concerning initial modelling of the effect on provisions as compared to the IAS 39 requirements according to specific portfolios. The answers are summarised in the following table. The figures in the table show number of entities which reported percentage changes in respective ranges.

	Provisioning under IFRS 9 compared to IAS 39						
	Lower			Higher			
	>25%	0-25%	0-25%	25-50%	50-75%	75-100%	>100%
Type of portfolio							
Loans to local, regional and central governments			1	1			
Loans to corporates			1	2		1	
Loans secured on real estate property				3			1
Retail loans				2	1		
Loans to credit institutions and investment firms			1	1			
Other loans			2	1			
Total loans			1	2			1
Debt securities (making use of external ratings)			1	1			2
Debt securities (making use of internal ratings)				1			2
Purchased or originated credit impaired assets			2				1
Lease receivables			3				1
Trade receivables			4				1
Financial guarantees and loan commitments			1	1			1

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- 17 The expected impacts on loans portfolios were, in most cases, an increase between 25% and 50% of impairment allowances. For debt securities portfolios the estimates ranged from minimal change to a more than 100% increase. Estimates for other financial instruments were mainly in the range 0 to 25%.
- 18 The estimates on increase in the loss allowances for loans were mainly submitted by participants from the banking industry, while the estimates for debt securities, trade receivables, lease receivables, purchased or originated credit impaired receivables came from the banking, insurance and other industries.
- 19 One participant from the insurance industry provided estimates of increases of more than 100% for all items (with loans restricted only to total loans) with a note that the IAS 39 loss allowances were very low (e.g. no provisions for bonds) and the IFRS 9 allowance for expected credit losses would be around one to two percent of the net equity, using parameters applied for regulatory purposes. Other estimates of increases of more than 100%, i.e. for loans secured on real estate property and debt securities, came from participants from the banking industry.
- 20 In assessing the importance of the percentages above it is to be kept in mind that the participants from the banking and insurance industry who provided input to the above table currently held relatively low allowances for their financial assets. Few of the participants from other industries who provided input to the above table currently held allowances with a percentage impact higher than the ones held by the participants from the banking and insurance industries and consequently expected lower increases than the participants from the banking and insurance industry.