RE: Exposure Draft Classification and Measurement: Limited Amendments to IFRS 9

Dear Sir / Madam,

We are pleased to comment on the Exposure Draft *Classification and Measurement: Limited Amendments to IFRS 9*, published by the IASB in November 2012.

We welcome the IASB’s efforts in clarifying the SPPI (solely payments of principal and interest) criterion for instruments with a modified economic relationship. However we have concerns when it comes to the practical implementation of the SPPI test for instruments with modified economic relationship, especially in two areas:

- Debt instruments with limited leverage: We recommend the Board to consider, as a practical expedient, reintroducing the double-double test of IAS 39. This would permit to address situations where the instrument should be classified in accordance with the business model to which it belongs rather than be automatically classified in the FV-P&L category because of a cash flow characteristic that provides only a limited leverage.

- Benchmark instruments in a regulated environment: The final text of the amendment should specify in our opinion that when interest rates are imposed by a regulator or a state authority and no legal alternative exists as to the choice of the interest rate, the characteristics of the benchmark instrument used for the SPPI Test shall comply with this regulated environment (i.e. the benchmark instrument should be legally permissible).
We also welcome the re-opening of the FV-OCI category to financial assets meeting the SPPI criterion. However, we consider that this category should not be attached to a specific business model but rather defined as a residual category. The proposed boundary between the amortised cost and the FV-OCI categories will most likely be difficult to establish in practice. The "Held to collect and sell" definition seems too broad to us to be really operational. We are convinced that the classification model should be based on a positive definition of business models attached to the amortised cost category (held to collect) and FV-P&L category (trading and short term profit taking) and that defining the FV-OCI category as the residual category would be more appropriate. The duality of the FV-OCI measurement (fair value on the statement of financial position and amortised cost in P&L) allows it to provide the best information to users of financial statements for financial assets meeting the SPPI criterion but managed neither in a held to collect nor in a trading - short term profit taking business model.

We also strongly recommend the Board to reconsider the accounting treatment of gains and losses on equity instruments voluntarily designated in the FV-OCI category under IFRS 9. We are convinced that gains (or losses) realised either through dividends or upon the sale of the instrument should be reflected in the same way in P&L. We are aware of the complexity of developing an alternative impairment model for equity instruments, but we encourage the Board to address this issue properly. In the meantime, we suggest that the Board retain current IAS 39 impairment approach which is obviously not flawless and should be replaced, but which is currently implemented in existing accounting systems.

Our detailed answers to the questions raised in the Exposure Draft and some additional comments are provided in the appendices attached to this letter.

Do not hesitate to contact us should you want to discuss any aspect of our comments.

Yours sincerely,

Michel Barbet-Massin
Head of Financial Reporting Technical Support
Appendix 1: Detailed answers to questions raised in the Exposure Draft Classification and Measurement: Limited Amendments to IFRS 9

**Contractual cash flow characteristics assessment: a modified economic relationship between principal and consideration for the time value of money and the credit risk**

**Question 1**

Do you agree that a financial asset with a modified economic relationship between principal and consideration for the time value of money and the credit risk could be considered, for the purposes of IFRS 9, to contain cash flows that are solely payments of principal and interest? Do you agree that this should be the case if, and only if, the contractual cash flows could not be more than insignificantly different from the benchmark cash flows? If not, why and what would you propose instead?

**Question 2**

Do you believe that this Exposure Draft proposes sufficient, operational application guidance on assessing a modified economic relationship? If not, why? What additional guidance would you propose and why?

**Question 3**

Do you believe that this proposed amendment to IFRS 9 will achieve the IASB’s objective of clarifying the application of the contractual cash flow characteristics assessment to financial assets that contain interest rate mismatch features? Will it result in more appropriate identification of financial assets with contractual cash flows that should be considered solely payments of principal and interest? If not, why and what would you propose instead?

We appreciate and support the Board’s efforts made in developing a principles-based approach to classifying instruments with a modified economic relationship. We consider that the additional guidance provided by the exposure draft will be useful in order to reduce the number of situations where an instrument would fail the “solely payments of principal and interest” (SPPI) test whereas it obviously meets the “consideration for time value of money and credit risk” principle.

However we would like to draw the attention of the Board to the following situations:

**Debt instruments with limited leverage:** Under IAS 39, interest rate leverage issue is addressed by the provisions of paragraph IAS 39 AG33a which prescribe a test often called “double-double test”. The purpose of this double-double test is to provide a relief from separating derivatives embedded in hybrid instruments with limited leverage. For such instruments, the SPPI (solely payments of principal and interest) criterion is likely not to be met under IFRS 9, even taking into account the Exposure Draft’s proposals on instruments containing a modified relationship. As a result, such instruments will be accounted for at FV-P&L in their entirety under IFRS 9 without an opportunity to classify them in a category consistent with the way they are managed.
Characteristics of the benchmark instrument in a regulated or legally defined environment: As we mentioned above, we support the Board’s proposal to introduce an approach consisting in comparing the cash flows of the actual instrument with those of a benchmark instrument in order to implement the SPPI test. The exposure draft proposes to define the benchmark instrument in paragraph IFRS 9.B4.1.9B as “a contract of the same credit quality and with the same contractual terms [...] except for the contractual term under evaluation”. We recommend the Board to amend this definition in order to ensure that the benchmark instrument is legally permissible. Indeed, we consider that the SPPI test should not be failed when the assessed contractual term is imposed by law or by an authority/ regulator rather than intentionally chosen by the parties to the contract. In this case, and assuming that the instrument has no other modified features, the business model assessment should prevail in order to provide the best information to users of financial statements.

Definition of the benchmark instrument, illustrative examples: We welcome the Board’s intention to provide some examples in order to illustrate the SPPI criterion. However, we consider that the wording of the examples should be clarified to avoid misinterpretations. To illustrate, we consider that the definition of the benchmark instrument could be amended. Currently, the paragraph B4.1.9B of the proposed application guidance states that (emphasis added):

‘The appropriate comparable financial asset is a contract of the same credit quality and with the same contractual terms (including, when relevant, the same reset periods), except for the contractual term under evaluation.

If the financial asset under assessment contains a variable interest rate that is reset monthly to a three-month interest rate, the appropriate benchmark would be a financial asset with the identical contractual terms and the identical credit quality except that the variable interest rate is reset monthly to a monthly interest rate.’

Such wording would seem to suggest that in the example above an instrument resetting quarterly to a 3-month interest rate index would not be an eligible benchmark instrument when assessing whether an instrument with an interest rate mismatch feature meets the SPPI criterion. Was this the Board’s intention?

Although we agree that the benchmark test would in practice be easier to implement using a benchmark instrument having the same reset frequency (i.e. since the benchmark instrument would have the same number of cash flows as the actual instrument, the cash flows of the two instruments would be easier to compare), we see no conceptual reason for prohibiting an alternative benchmark instrument having the same index but different reset frequency than the actual instrument.

We therefore strongly encourage the Board to clarify this point in order to prevent misinterpretation of the approach.
Re-assessment of the SPPI Test: IFRS 9 paragraph 4.4.1 states clearly that reclassification should only occur upon a change in business model. Our understanding is that, without any change in the business model, the SPPI test shall not be re-assessed even if the economic environment changes. However, it is unclear whether the test should be carried out once again upon a reclassification triggered by a change in the business model. Therefore we recommend the Board to clarify that the SPPI Test shall only be performed:
- upon the initial recognition of the asset, or
- upon a reclassification out of the FV-P&L category triggered by a change in the business model in which the asset is managed. In this situation, the SPPI Test shall be performed based on the economic environment prevailing on the reclassification date.

Business model assessment: the ‘fair value through other comprehensive income’ measurement category for financial assets that contain contractual cash flows that are solely payments of principal and interest

Question 4

Do you agree that financial assets that are held within a business model in which assets are managed both in order to collect contractual cash flows and for sale should be required to be measured at fair value through OCI (subject to the contractual cash flow characteristics assessment) such that:
(a) interest revenue, credit impairment and any gain or loss on derecognition are recognised in profit or loss in the same manner as for financial assets measured at amortised cost; and
(b) all other gains and losses are recognised in OCI?

If not, why? What do you propose instead and why?

Question 5

Do you believe that the Exposure Draft proposes sufficient, operational application guidance on how to distinguish between the three business models, including determining whether the business model is to manage assets both to collect contractual cash flows and to sell? Do you agree with the guidance provided to describe those business models? If not, why? What additional guidance would you propose and why?

We welcome the re-introduction of the FV-OCI category for assets which are debt instruments since presenting fair value in the balance sheet and amortised cost related impacts in profit or loss provides the best information for certain business models.

We also appreciate the harmonisation of impairment rules for this category with those applicable to assets in the Amortized Cost category. This will help ensure that the credit risk on identical assets is reflected in profit or loss identically, whatever the measurement basis applied to these assets (i.e. FV-OCI or amortized cost).
FV-OCI should be a residual category for financial asset meeting the SPPI criterion. We do not agree that the FV-OCI category should be defined positively, i.e. with a specific business model condition attached to it.

Indeed, the business model for FV-OCI measurement is defined in the Exposure Draft in such an unrestricted manner (held to collect and sell) that a very large part of debt instruments meeting the SPPI criterion are likely to be classified in this category. Besides, the boundary between Amortized cost and FV-OCI categories will most likely be difficult to establish in practice. We consider that the mix between fair value on the balance sheet and amortised cost related impacts for the profit or loss provides balanced information if compared with the two other categories which should therefore be the ones with business model conditions attached.

For all these reasons, we believe that for instruments meeting the SPPI Test (please refer to our comments to questions 1-3 above), Amortized Cost and FV-P&L should be the only two categories defined in a positive manner, whereas the FV-OCI category should be the residual category.

Should the Board nevertheless proceed with a positive definition of the business models attached to the FV-OCI category as proposed in the Exposure Draft, we would recommend the Board to clarify the boundary between the situations and activities in line with the Held-to-Collect business model and those meeting the Held-to-Collect-and-Sell model’s criteria, and especially when it comes to financial assets held by financial institutions. Indeed, it is not clear whether high-quality liquid assets held by banks in their liquidity portfolios in order, for example, to meet the forthcoming Liquidity Coverage Ratio requirement will meet the held-to-collect business model criterion for Amortized Cost measurement.

We also have some wording concerns concerning the Example 4 in § B4.1.4 of the proposed application guidance. We suggest splitting this example into two, with the end of the example (p. 21) being presented as a separate example. For this example, we suggest clearly stating that the situation corresponds to the definition of the held-to-collect-and-sell model, instead of simply saying that this activity does not meet the held-to-collect definition.

Specificities relating to Insurance activity: Insurance companies (as defined by IFRS 4 Insurance Contracts) are also facing specific difficulties in reflecting their asset and liability management. Indeed, they are managing their assets in relation with their insurance liabilities. Therefore, their performance can only be appropriately reflected if the measurement of assets and related liabilities is consistent. IFRS 4 phase 2 being still under development, it is difficult to determine whether the proposed limited amendments to IFRS 9 will permit an appropriate performance reporting for this kind of activity. In this regard, we nevertheless welcome the introduction of the FV-OCI category which will be a useful tool for financial assets managed in order to meet payment commitments stemming from insurance liabilities.

But this new category will not allow addressing all situations. For example, derivatives instruments commonly used in insurance ALM will fail the SPPI test and be measured under IFRS 9 at FV-P&L whereas the related financial assets (and probably insurance liabilities) will most likely be measured at FV-OCI. Therefore we recommend the Board to consider this issue in the macro-hedge accounting project.
Another possibility that the Board could consider in order to help Insurers better reflect their actual ALM practices could be the introduction of a FV-OCI option to reduce accounting mismatches in certain situations. We are convinced that the business model should remain the primary driver for classifying financial assets and therefore we do not want to encourage the multiplication of alternative optional classifications. However, in the specific case of Insurance activity where the business model approach is difficult to implement as the accounting treatment of assets and liabilities is not governed by the same standard, this FV-OCI option – which would be limited to accounting mismatch situations – could be a way considered by the Board to reflect the actual performance of Insurers ALM if IFRS 9 and IFRS 4 fail to do so.

Please refer also to our answer to question 7 regarding the impact of the first application of IFRS 4 on IFRS 9 fair value option.

Question 6
Do you agree that the existing fair value option in IFRS 9 should be extended to financial assets that would otherwise be mandatorily measured at fair value through OCI? If not, why and what would you propose instead?

Yes, we agree with extending the existing fair value option in IFRS 9 to financial assets measured at FV-OCI.

Early application & transition

Question 7
Do you agree that an entity that chooses to early apply IFRS 9 after the completed version of IFRS 9 is issued should be required to apply the completed version of IFRS 9 (i.e. including all chapters)? If not, why? Do you believe that the proposed six-month period between the issuance of the completed version of IFRS 9 and when the prohibition on newly applying previous versions of IFRS 9 becomes effective is sufficient? If not, what would be an appropriate period and why?

We agree with the proposal of the IASB, since it will simplify the transition to IFRS 9 compared to a phased approach.

We also agree with providing a six-month relief before withdrawing the previous versions of IFRS 9 as this will constitute a practical expedient for entities having already made progress towards adopting an existing version of IFRS 9.
Nevertheless, we are of the opinion that the application of the fair value option (either through P&L or OCI\(^1\)) proposed by IFRS 9 should, to a certain extent, be linked to the IFRS 4 project on insurance contracts. Should IFRS 9 be finalized before IFRS 4 project on insurance contracts and be applicable before this standard, entities should be given the opportunity to revise – when applying IFRS 4 (Phase 2) for the first time – the choices made as to the application of the fair value option upon transition to IFRS 9. For example, if a previous accounting mismatch no longer exists due to new requirements on accounting for insurance liabilities, preparers should be allowed to revoke the fair value designations made when first applying IFRS 9. Similarly, if new mismatches arise, preparers should be allowed to apply the fair value option upon transition to IFRS 4 (Phase 2) for instruments to which this option could not be applied when first applying IFRS 9.

Presentation of ‘own credit’ gains or losses on financial liabilities

**Question 8**

Do you agree that entities should be permitted to choose to early apply only the ‘own credit’ provisions in IFRS 9 once the completed version of IFRS 9 is issued? If not, why and what do you propose instead?

Yes, we agree with this proposal as it will help achieve without further delay a more relevant presentation of the financial performance of financial liabilities designated at fair value through profit or loss.

However, we would recommend the Board to amend IAS 39 so as to introduce this provision without having to wait for the finalisation of IFRS 9 project. In this regard, we recommend the Board adopting the same process as the one recently implemented for the ED Novation of derivative and continuation of hedging relationship.

First-time adoption

**Question 9**

Do you believe there are considerations unique to first-time adopters that the IASB should consider for the transition to IFRS 9? If so, what are those considerations?

We are not aware of any considerations specific to first-time adopters.

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\(^1\) please refer to our answer to questions 4-5
Appendix 2: Other comments

Equity instruments accounted for at FV-OCI

As already explained in our Comment Letter on the exposure draft IFRS 9 ‘Financial instruments: Classification and measurement’ dated September 14th 2009, we reiterate our opinion that recycling to profit or loss of fair value changes of equity instruments accounted for in OCI should be required upon derecognition of the financial asset. Since there are no economic grounds to make a distinction between a dividend received and a realised gain or loss on sale, we are convinced that both impacts should be accounted for in the same way.

In our view, this accounting treatment, already existing under IAS 39, is the only one permitting to properly reflect in the financial statements the performance generated by the entity upon the sale of an equity instrument.

We do not underestimate the complexity of developing an alternative impairment model for equity instruments. However, we recommend the Board to address this issue properly as current IAS 39 provisions in this regard are not flawless and should be replaced. In the meantime, we would nevertheless favour retaining the existing provisions of IAS 39 rather than proceeding with the accounting treatment currently proposed by IFRS 9 for equity instruments classified in the FV-OCI category. Should the Board consider this alternative, we would further recommend amending current IAS 39 provisions to require the reversal of impairment for equity instrument.

Interest rates in regulated environments (Question raised in BC 44)

Please see our related comment in the answer to Question 1-3 above.

Definition of interest in light of the SPPI criterion

We believe that the definition of interest should be revised to clarify that it includes other components which are inherent in any theoretical definition of interest (e.g. liquidity risk). This should be done in light of the recent tentative decisions on the insurance contracts project.

Interaction with other phases of the IFRS 9 project

The IASB should carefully consider the interaction of the final limited amendments to IFRS 9 Phase 1 with the general hedge accounting model, e.g. by specifying the accounting treatment for a Fair Value Hedge-type hedging relationship whereby the hedged item is a financial asset accounted for at FV-OCI.