EFRAG
European Financial Reporting Advisory Group

Jonathan Faull
Director General, Financial Stability, Financial Services and Capital Markets Union
European Commission
1049 Brussels

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Dear Mr Faull

Adoption of 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 considered 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?

The assessment of IFRS 9 has led us to identify areas in which IFRS 9 could have been a better standard. These include, inter alia, restrictions on an entity's ability to reclassify financial assets and the accounting for equity instruments that impedes the reporting of performance by insurers and other long-term investors. None of these limitations however precludes, in our view, IFRS 9 from providing 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 was 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. 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 to allow 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 costs[1]. 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 considered 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, that we have assessed IFRS 9 to be an improvement over IAS 39 and that we regard the proposed US GAAP impairment model to provide less relevant information than the IFRS 9 impairment model, we conclude that IFRS 9 will compare 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 applying 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

[1] This assessment was reached independently from the analysis of the inter-relationship between IFRS 9 and the future insurance contracts standard for insurance businesses.

impact on the pricing and maturity of lending instruments in the EU, in order to identify any potential adverse effect on economic growth. Our conclusions have not been substantiated by quantitative analysis as we do not expect quantifications to be available on a broad basis 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 absorbed by equity, going forward changes in provisions will be recognised in profit or loss. Such changes in profit or loss will generally be less pronounced for stable portfolios although 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 need to be assessed further. Furthermore we have received advice 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 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 insurers 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. This might have some impact on the extent of their equity investments.

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 considered 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 contacts standard and IFRS 9 may create disruptions in the financial reporting of 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 is of the 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, make a strong case for deferral of IFRS 9, albeit for insurance businesses only. We recommend a global solution promulgated by the IASB. Consequently, we advise the European Commission to ask the IASB to defer the effective date of IFRS 9 for insurance businesses and align it with the effective date of the future insurance contracts standard. We believe the deferral should be available for all insurance businesses, however we acknowledge that a deferral is most likely to be used by those entities that currently apply cost models to their insurance liabilities. EFRAG can assist the IASB in defining the scope of entities that the deferral option could apply to. 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 without unnecessary delay to all activities other than insurance businesses.

Note to constituents

EFRAG has reached its preliminary position on the effective date of IFRS 9 for insurance businesses on the basis of all of the above and a first set of quantitative data received from the European insurance industry shortly before the draft endorsement advice was approved. EFRAG considers that a more in-depth understanding of the magnitude of the potential effects of IFRS 9 being implemented in advance of the future insurance contract standard is critical to the finalisation of its endorsement advice to the European Commission. EFRAG is therefore calling on constituents to provide more evidence and insights on this issue.

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 IFRS 9 is conducive to the European public good. It is indeed expected that IFRS 9 supports an improved efficiency of capital markets[2]. 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 able to early adopt the standard because of the implementation time and effort that may be 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 the standard and benefit sooner from improvements of the standard in general and, in particular, 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 practical expedients provided in IFRS 9 and 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 considered 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 the standard 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

[2] This assessment was reached independently from the analysis of the inter-relationship between IFRS 9 and the future insurance contracts standard for insurance businesses.

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 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. Although our conclusions have been reached on the basis of very limited quantitative assessments, we recommend IFRS 9 for endorsement without further delay, as we have learnt that data 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 lending[3] 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

[3] EFRAG notes that the concept of basic lending is not directly defined in IFRS 9. However, the standard says 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 the basic lending does not need to be in a form of a loan.

repayments of that principal. Interest is described broadly as including consideration 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 the standard 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

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 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. No other reclassification is permitted. In comparison to IAS 39, IFRS 9's requirements are more restrictive. 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 calculations and how they measure expected credit losses and 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 the three hedge accounting models from IAS 39 but with some 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.

C.3.1. MACRO-HEDGING PRACTICES

31 IFRS 9 does not address specific accounting for open portfolios of hedged items or macro hedging: 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

Note to constituents

This appendix sets out the basis for the conclusions reached in the technical assessment made, by EFRAG on IFRS 9.

In its comment letters to the IASB, EFRAG points out that such letters are submitted in EFRAG's capacity of contributing to the IASB's due process. They do not necessarily indicate the conclusions that would be reached by EFRAG in its capacity of advising the European Commission on endorsement of the definitive IFRS in the European Union and European Economic Area.

In the latter capacity, EFRAG's role is to make a recommendation about endorsement based on its assessment on the final IFRS or Interpretation against the technical criteria for the European endorsement, as currently defined. These are explicit criteria which have been designed specifically for application in the endorsement process, and therefore the conclusions reached on endorsement may be different from those arrived at by EFRAG in developing its comments on proposed IFRSs or Interpretations. Another reason for a difference is that EFRAG's thinking may evolve.

Summary

1 Appendix 2 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 the main areas of the standard: 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 the Appendix 2 EFRAG also concludes that early application of IFRS 9 should be permitted.

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 -117;

(b) reliability: paragraphs 118 -136;

(c) comparability: paragraphs 137 -170;

(d) understandability: paragraphs 171 -184; and

(e) whether overall it leads to prudent accounting: paragraphs 185 - 191.

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 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); and

(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 - Classification and Measurement

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

A.1 Classification and measurement of financial assets;

A.2 Classification of financial liabilities: own credit risk; and

A.3 Use of fair value.

10 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.

A.1. CLASSIFICATION AND MEASUREMENT OF FINANCIAL ASSETS

A.1.1. TAKING INTO ACCOUNT CONTRACTUAL CASH FLOW CHARACTERISTICS

11 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.

12 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.

13 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.

14 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.

15 Overall EFRAG assesses that, except for a few specific cases for example the one described in paragraph 14(b), the application of the contractual cash flow test will increase the relevance of the resulting information. In accordance with the late adjustments to the solely payment of principal and interest test made by the IASB, instruments which are basic lending instruments in the market in which they are contracted 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.

A.1.2. ACCOUNTING FOR MODIFICATIONS OF CONTRACTUAL CASH FLOWS

16 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 from the EFRAG field-test on the 2013 ED *Financial instruments: Expected Credit Losses* raised concerns about this requirement as it leads to the recognition of losses even when the terms of financial assets are modified due to commercial reasons rather than credit deterioration reasons.

17 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. A change in the contractual terms of a loan may not lead to the same accounting as if the prepayment option had been exercised and a new loan entered into with the bank, although the substance of the two transactions may be the same. The issue is exacerbated by the fact that, in presence

of a prepayment right, it is unclear whether the modification of the contractual cash flows due could result in derecognition. For instance, if a loan included a prepayment option at par and the client were to renegotiate the loan on market terms, the situation would be in substance the same as if the prepayment option had been exercised and a new loan had been entered into at market conditions (the bank may actually 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). In such a case, some may consider that the modification of the contractual terms lead to derecognition leading to no modification gain or loss recognised in profit or loss. However, if this view is not taken, it would be considered that the bank has no unconditional right to receive all initially scheduled cash flows throughout the contractual life of the loan and a change in the contractual cash flows would result in a modification gain or loss. However, when 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.

18 EFRAG understands that, in some jurisdictions, derecognition of the original loan is applied in cases of modifications, while there might be a gain or loss, if any, on disposal, IFRS 9 does not require specific disclosure of a modification gain or loss when the modification results in derecognition. However, when the entity changes commercial terms under the existing contract so that the customer enjoys more favourable conditions (e.g. decrease of interest rate to the current market level) and does not derecognise the asset, IFRS 9 requires a modification gain or loss to be recognised in profit or loss even though the two situations are economically the same.

19 EFRAG assesses that reporting a modification gain or loss for commercial renegotiations 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. The limitation in the relevance of the information may however be the price to pay for reliability of the information given the difficulty to distinguish between the two types of modifications.

A.1.3. Reflecting different business models

20 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.

21 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.

22 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.

23 Although EFRAG considers that financial reporting should generally reflect the business model, 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 that 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.

24 We assess below the measurement of basic lending instruments for each business model.

A.1.3.1. BUSINESS MODEL: HOLD TO COLLECT

25 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.

26 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.

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

27 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.

28 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.

29 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.

A.1.3.3. OTHER BUSINESS MODELS

30 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.

31 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.

A.1.4. RECLASSIFICATIONS

32 IFRS 9 requires financial assets to be reclassified between measurement categories when, and only when, the entity's business model for managing them changes.

33 In the view of EFRAG, reclassifications when the business model changes provide useful information. IFRS 9 restricts the circumstances in which a change in the business model arises. For example, reclassifications would not be allowed if a market temporarily disappears for a particular financial asset (i.e. when liquidity disappears) and the entity may not have the practical ability to operate in accordance with the desired business model (at least in the short term) and might decide to transfer portfolios of assets that were actively traded to its banking book. These restrictions are taken at the expense of relevance; however they strike a balance with reliability that can be considered suitable in normal times.

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

34 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.

A.1.6. Investments in equity instruments

35 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.

36 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.

37 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 79 - 83.

38 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. This implies that 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. Notwithstanding this, EFRAG assesses that any limitation in relevance of the information 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.

A.2. Classification of financial liabilities: own credit risk

39 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.

40 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.

41 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.

42 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.

43 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.

A.3. USE OF FAIR VALUE

44 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).

45 EFRAG assesses that 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) amortised 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 15.

46 As explained in paragraphs 27 - 30, 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.

47 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.

48 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 34, 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 39 to 43 further contributes to the relevance of the information.

49 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.

50 Overall, EFRAG assesses that in those cases where IFRS 9 relies on fair value measurement this leads to relevant information.

B - Impairment

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

B.1. A general approach;

B.2. 12-month and lifetime expected credit losses;

B.3. Determining significant increases in credit risk;

B.4. Addressing mispricing at inception

B.5. Simplified approach for trade receivables, contract assets and lease receivables;

B.6. Measurement of expected credit losses; and

B.7. Purchased or originated credit-impaired assets.

B.1. A GENERAL APPROACH

52 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.

53 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.

54 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.

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

55 The expected credit losses model in IFRS 9 distinguishes between recognition of 12-month and lifetime expected credit losses.

56 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 recognition[4] 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) a comparison of such a conceptual impairment approach with the IFRS 9 impairment model from the perspective of operationality, amount of expected credit losses recognised and application in all circumstances.

57 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 in the pricing of the instrument's cash flows and generally increases the market return of the instrument, mainly the interest rate. Loss allowance equal to the initial expected losses is accrued in proportion to the interest revenue and is 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.

58 When comparing the IFRS 9 expected credit loss impairment model with this conceptual approach the following can be observed:

(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

[4] 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.

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 56 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 64).

(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 67.

(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 64 and 65). 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.

59 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 effect of the compromise 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.

60 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.

61 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 58 and 59.

62 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.

63 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.

64 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 higher interest rate, increase the 12 months expected credit loss recognised.

65 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 58(e).

66 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.

67 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.

68 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.

69 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.

70 EFRAG also assesses that the forward-looking impairment model responds to the G20's request to accounting standard setters '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.

B.3. DETERMINING SIGNIFICANT INCREASES IN CREDIT RISK

71 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.

72 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 on 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.

73 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.

74 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, the practical expedient does not impair the relevance of the information provided.

B.4. ADDRESSING MISPRICING AT INCEPTION

75 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.

76 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.

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

77 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, the simplified approach provides users with relevant information.

78 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.

B.6. MEASUREMENT OF EXPECTED CREDIT LOSSES

79 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.

80 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 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.

81 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.

B.7. PURCHASED OR ORIGINATED CREDIT-IMPAIRED ASSETS

82 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.

83 EFRAG considers 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 - Hedging

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

C.1. Objective of hedge accounting;

C.2. Qualifying hedging instruments;

C.3. Qualifying hedged items;

C.4. Hedge effectiveness requirements;

C.5. Accounting for the time value of options;

C.6. Accounting for currency basis spreads;

C.7. Designation of a component of a nominal amount; and

C.8. Macro hedging.

C.1. OBJECTIVE OF HEDGE ACCOUNTING

85 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.

86 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.

87 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.

88 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.

89 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.

90 In addition, IFRS 9 does not limit hedge accounting to risks that affect profit or loss, but also 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.

C.2. QUALIFYING HEDGING INSTRUMENTS

91 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 2012 field-test on general hedge accounting did not indicate that designation of a separated embedded derivative as a hedging instrument was a common practice. In addition, the results from the 2013 field-test on classification and measurement 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.

92 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.

93 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.

C.3. QUALIFYING HEDGED ITEMS

C.3.1. NON-FINANCIAL RISK COMPONENTS

94 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.

C.3.2. SUB-LIBOR ISSUE

95 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.

96 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).

97 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 Standard is not currently fully meeting its objective.

98 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.

99 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.

C.3.3. CREDIT RISK

100 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.

101 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.

102 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.

103 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.

104 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.

C.4. Hedge effectiveness requirements

105 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).

106 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.

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

107 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).

108 EFRAG notes that the disclosures require 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.

C.4.2. REBALANCING

109 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.

110 As argued in paragraph 89 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.

C.5. ACCOUNTING FOR THE TIME VALUE OF OPTIONS

111 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. This treatment is considered to provide 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.

C.6. ACCOUNTING FOR CURRENCY BASIS SPREADS

112 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.

113 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.

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

114 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.

115 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.

C.8. MACRO HEDGING

116 IFRS 9 does not address hedge accounting for open portfolios, i.e. macro hedging. It could be argued that because of this the standard 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 86 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.

D - Overall conclusion on relevance

117 EFRAG's overall assessment is that IFRS 9 could have been a better standard if some limitations on relevance had been avoided. However, when considering significance of these issues as explained above they do not override the overall positive conclusion reached that the standard leads to provision of relevant information.

Reliability

118 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.

119 There are a number of aspects to the notion of reliability: freedom from material error and bias, faithful representation, and completeness.

A - Classification and Measurement

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

A.1. The business model and the contractual cash flow characteristics; and

A.2. Investments in unquoted equity instruments.

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

121 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.

122 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 indicate in which cases the cash flow characteristics test is expected to be met and thus are expected to result in reliable classification.

123 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. 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.

A.2. INVESTMENTS IN UNQUOTED EQUITY INSTRUMENTS

124 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 rare circumstances where cost may be an appropriate estimate of fair value.

125 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.

B - Impairment

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

B.1. Assessment of significant increase in credit risk and calculation of expected credit losses; and

B.2. Practical expedients.

B.1. Assessment of significant increase in credit risk and calculation of expected credit losses

127 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.

128 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.

129 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.

130 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 135.

131 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.

B.2. PRACTICAL EXPEDIENTS

132 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 155 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 73 and 74 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.

133 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.

134 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.

135 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.

C - Overall conclusion on reliability

136 EFRAG's overall assessment is that IFRS 9 could have been a better standard if some limitations on reliability had been avoided. However, as explained above these limitations do not override the overall positive conclusion that the standard leads to the provision of reliable information.

Comparability

137 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.

138 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 - __Classification and Measurement__

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

A.1. Classification and measurement of financial assets;

A.2. Measurement options; and

A.3. Modifications of financial assets.

A.1. CLASSIFICATION AND MEASUREMENT OF FINANCIAL ASSETS

140 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.

141 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.

142 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. The restriction around reclassifications as noted in paragraph 33 limits comparability as it limits relevance. However, it is assessed as the price to pay for reliability.

143 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.

144 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, 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 reasons, frequency, timing and significance of sales activity, 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.

A.2. MEASUREMENT OPTIONS

145 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 excessive fluctuations in profit or loss in cases when they do not consider it to be economically substantiated or to show the effects of their risk management practices.

A.3. MODIFICATIONS OF FINANCIAL ASSETS

146 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.

147 For example, entities may conclude that changes in the terms of an original loan that includes a prepayment option is economically the same as if the customer had exercised its prepayment option and entered into a new loan reflecting current market conditions. Accordingly, they would adopt similar accounting as if the prepayment option had been exercised (derecognition) and avoid recognition of modification losses although there may be an economic loss if the new terms do not benefit the issuer. 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 the asset is derecognised or not may also occur in the area of modifications due to financial difficulties of debtors.

148 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.

B - Impairment

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

B.1. A uniform approach;

B.2. Recognition of expected credit losses;

B.3. More than 30 days past due rebuttable presumption;

B.4. Financial instruments that have low credit risk at reporting date;

B.5. Definition of default; and

B.6. Transition.

B.1. A UNIFORM APPROACH

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

B.2. RECOGNITION OF EXPECTED CREDIT LOSSES

151 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.

152 Practical expedients in the assessment of significant increases in credit risk and measurement of expected credit losses are discussed in paragraphs 132 to 135 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.

153 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.

154 As discussed in paragraph 60 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.

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

155 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 considers as leading to information that can be deemed comparable.

B.4. Financial instruments that have low credit risk at reporting date

156 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.

157 On the other hand, this addresses some of the concerns raised by participants in the EFRAG field-test on the 2013 ED *Financial instruments: Expected Credit Losses* 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 considers that the operational benefits provide an adequate offset to the limitations in comparability in applying the practical expedient of low credit risk.

B.5. Definition of default

158 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.

B.6. Transition

159 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.

160 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.

161 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 operationality of the model upon transition which EFRAG assesses provides adequate compensation.

C - Hedging

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

C.1. Objective and scope of hedge accounting;

C.2. Application of IAS 39; and

C.3. Accounting for time value of options.

C.1. OBJECTIVE AND SCOPE OF HEDGE ACCOUNTING

163 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.

C.2. APPLICATION OF IAS 39

164 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 reflecting the effect of an entity's risk management activities.

165 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.

C.3. ACCOUNTING FOR TIME VALUE OF OPTIONS

166 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.

167 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.

D - Transition

168 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.

169 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, albeit with compensating disclosures, provides significant operational relief in transition to IFRS 9 and EFRAG considers under the circumstances that less comparability is justified in terms of the relief.

E - Overall conclusion on comparability

170 EFRAG's overall assessment is that IFRS 9 could have been a better standard if some limitations on comparability had been avoided. However, as explained above these limitations do not override the overall positive conclusion that the standard leads to the provision of comparable information.

Understandability

171 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.

172 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.

173 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 - Classification and Measurement

174 With regards to classification and measurement, and taking into account the comment made in paragraph 172, EFRAG considers that the information resulting from IFRS 9 is not unduly complex, as the requirements in IFRS 9 are generally built upon clear principles.

B - Impairment

B.1. PRINCIPLES FOR IMPAIRMENT RECOGNITION

175 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.

176 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.

B.2. EXCEPTIONS AND PRACTICAL EXPEDIENTS

177 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 considers that they are not expected to generate concerns over understandability.

C - Hedging

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

C.1. Accounting for qualifying hedging relationships; and

C.2. Amendments to IFRS 7.

C.1. ACCOUNTING FOR QUALIFYING HEDGING RELATIONSHIPS

179 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.

180 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.

C.2. AMENDMENTS TO IFRS 7

181 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.

182 It could be argued that, by collecting the disclosures of those risks 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.

183 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.

D - __Conclusion on understandability__

184 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

185 For the purpose of this draft endorsement advice, prudence is defined as caution in conditions of uncertainty.

A - Classification and measurement

186 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 is a less relevant representation of what they might be. For this reason, EFRAG considers such a fair value measurement basis prudent for both these types of financial instruments, even when financial instruments with contractual features that do not reflect solely payment of principal and interest are being held in the banking book. EFRAG notes that where material the resulting short term fair value changes would be expected to be presented or disclosed separately.

187 IFRS 9 contains an option to designate a financial asset as 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.

188 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 over-stated.

B - Impairment

189 EFRAG assesses that the impairment model using comprehensive credit risk and forward-looking information is a prudent approach as it recognises expected credit losses as soon as they are foreseeable during the life of a financial asset.

C - Hedging

190 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

191 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

192 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.

193 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.

194 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 156 to 170 of Appendix 3; and

(b) Based on the assessment explained in paragraphs 3 to 52 of Appendix 3 EFRAG believes that IFRS 9 is an improvement over IAS 39 and will lead to higher quality financial reporting.

195 Consequently EFRAG believes that early application of IFRS 9, as permitted by the IASB, should be permitted in Europe.

True and Fair

196 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 tentatively concludes that the application of IFRS 9 would not be contrary to the true and fair view principle.

197 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 has concluded that there are reasonable grounds to believe that a deferral of the effective date of IFRS 9 for insurers until the future insurance contracts standard is effective would be conducive to the European public good. Therefore, EFRAG advises the European Commission to ask the IASB to defer IFRS 9 for insurers until the future insurance contracts standard is completed. EFRAG can assist the IASB in identifying the scope of insurance entities to which such a deferral could apply.

(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 insurers if the effective dates of both IFRS 9 and the forthcoming insurance contracts standards are not aligned [Note to constituents; gathering more quantitative evidence is critical to EFRAG's final assessment on this issue]. 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 to all activities other than insurance businesses without unnecessary delay.

2 Overall, EFRAG concludes that the adoption of IFRS 9 is conducive to European public good. EFRAG also highlights the linkages between IFRS 9 and the future insurance contracts standard and believes that alignment of the mandatory effective dates would avoid a breach of consistency and understandability in the information provided to users without proportionate benefit in transparency and reduce the costs for preparers and users of the financial statements of insurance entities.

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:

A Classification and measurement of financial assets;

B Impairment of financial assets;

C Hedge accounting; and

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

A - Classification and measurement of financial assets

4 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.

5 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

6 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 considered:

(a) accounting designations based on intent are constrained by rules such as tainting in order to provide consistency over time in the measurement;

(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.

7 The classification and measurement requirements of IFRS 9, and a description of the changes from IAS 39, are set out in Appendix 1.

8 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

9 An exception to this positive assessment could be made in relation to embedded derivatives as IFRS 9 is based on the financial asset in its entirety, even though some

entities may manage cash flows of an embedded derivative separately from a host contrast. However, evidence from EFRAG's field-testing of the IFRS 9 requirements 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.

10 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.

11 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.

12 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 14 of Appendix 2.

A.2. RECLASSIFICATIONS

13 EFRAG assesses that the reclassification requirements under IFRS 9 are more restrictive than those in IAS 39 and do not allow entities to address particular situations. This may reduce the relevance of the resulting information. For example, if an active market vanishes, an entity's existing business model, including how the assets are managed and performance assessed, may not have changed. However, because the entity may not have the practical ability to operate in accordance with the existing business model, it may need to change its business model. The restrictions on reclassification under IFRS 9 in such circumstances may reduce the relevance of the information provided. However the requirements strike a balance with reliability that can be considered suitable in normal times.

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

14 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.

15 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

16 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; and

B.4. Measurement of impairment for FVOCI category

B.1. THE SCOPE OF THE IMPAIRMENT MODEL

17 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.

18 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.

19 EFRAG believes that having a single impairment model will reduce complexity and potentially more closely align impairment requirements with credit risk management practices.

20 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.

21 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

22 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.

23 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.

24 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

25 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.

26 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.

27 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.

28 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

29 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.

30 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

31 EFRAG assesses that IFRS 9 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 results in transparency which in turn will enhance investors' confidence. More importantly, the use of the expected credit loss model will reduce the current potential for overstatement of profit or loss. This is caused by reporting interest revenue in advance of recognition of the credit losses that is compensated for by interest revenue.

C - Hedge accounting

32 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; and

C.5. Treatment of credit risk.

C.1. Reflecting risk management

33 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.

34 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

35 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.

36 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

37 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.

38 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.

39 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.

40 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.

41 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.

42 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

43 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.

44 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.

45 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 consistent with risk management practices.

C.5. TREATMENT OF CREDIT RISK

46 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.

47 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

48 Overall, EFRAG assesses that the hedging requirements in IFRS 9 provide more relevant information than those in IAS 39 because they permit a better reflection of an entity's hedging practices.

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

49 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 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).

50 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.

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

52 For the reasons given above, and particularly with respect to the impairment and hedging requirements, 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

53 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.'

54 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; and

C Hedging.

A - Classification and measurement

55 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 52 above. The analysis with respect to classification and measurement is also valid in respect of a comparison with US GAAP.

56 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.

57 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.

58 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 believes that an approach based on economic substance is superior to one based on legal form and that therefore IFRS 9 is more appropriate in this regard.

B - Impairment

59 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.

60 EFRAG has also considered what it believes to be the quality of the resulting financial information for users.

61 The proposed US GAAP guidance has not yet been finalised and EFRAG's analysis is based on its understanding of the tentative decisions to date. The proposed US GAAP requirements differ depending both upon the legal form of the instrument (whether the legal form of the instrument meets the definition of a debt security) and the measurement basis applied to it with significant differences between:

(a) Financial assets (including debt securities[5]) measured on an amortised cost basis; and

(b) Financial assets other than debt securities which are classified as held for sale (and measured at the lower of cost and fair value) and debt securities classified as available for sale (measured at fair value with qualifying changes presented in other comprehensive income).

62 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.

63 However, there is a key difference between proposed US GAAP requirements and IFRS 9 in 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. It does not distinguish, as IFRS 9 does, between financial assets based on whether there has been a significant deterioration in credit quality since initial recognition.

64 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 the 12-months expected credit losses. When there is a significant deterioration in a financial instrument's credit quality IFRS 9 requires the loss allowance to be measured at lifetime expected credit losses.

65 IFRS 9 therefore requires a loss allowance following deterioration of approximately the same as the proposed US GAAP requirements do from day-one.

66 In analysing these different requirements, EFRAG has considered the business model of lending, in which financial institutions, especially banks, are compensated for expected credit losses through the interest rate charged to borrowers. 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 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.

67 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. In addition, IFRS 9 provides significantly more information to users of financial

[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.

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.

68 For financial assets (other than debt securities) 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.

69 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. The proposed US GAAP current expected credit loss impairment model does not apply to financial assets classified as available for sale. The existing impairment requirements, which are similar to those for amortised cost financial assets in IAS 39 - and have equally raised reliability issues in practice - would materially remain. Although fair value changes would be recognised in other comprehensive income, delayed recognition in profit or loss of such impairment would remain an issue.

70 Consequently, EFRAG concludes that the overall IFRS 9 impairment model with its emphasis on credit deterioration and scope encompassing both loans and debt securities provides more relevant and more comparable information for investors than the US GAAP approach.

C - Hedging

71 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.

72 Given the improvements for hedge accounting in IFRS 9 over IAS 39, as identified in paragraphs 32 to 48 above, EFRAG believes that IFRS 9 can be assessed as leading to significantly improved financial reporting when compared to US GAAP.

73 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 superior to US GAAP in this regard.

D - Conclusion – Impact of lack of convergence

74 For the reasons explained above, and more particularly the differences in the impairment model and hedge accounting, EFRAG believes 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

75 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).

76 This analysis is based on what was reported by constituents in the field-tests as potential issues, and input from other stakeholders. EFRAG highlights certain requirements of IFRS 9 which it considers may have potential negative or positive impacts on investor or issuer behaviour that are worthy of consideration.

77 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.

78 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; and

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

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

79 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.

80 For life insurers, 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 insurers 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.

81 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 insurers 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 insurers argue that the lack

of reclassification makes it more difficult to portray the performance of their investment activities.

82 EFRAG believes that broader economic considerations such as the need for insurers 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.

83 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. EFRAG thinks it is unlikely that these entities would change their investment strategy as a result of the implementation of IFRS 9, but will gather further information on this during the consultation period of the draft endorsement advice.

B - Expected credit loss model for basic lending instruments

84 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.

85 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 undertaken, which in turn may increase the cost of lending on consumers.

86 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.

87 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.

88 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.

89 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.

90 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.

91 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.

92 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.

93 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.

C - Financial assets other than basic lending instruments

94 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.

95 EFRAG's field-testing 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, due to financial reporting changes in the availability of financial assets other than basic lending instruments.

96 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. 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

97 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.

98 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, recognition through other comprehensive income provides a solution.

E - Conclusion on impact on investor and issuer behaviour

99 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. In this analysis EFRAG has tried to identify potential negative effects only, to contribute to identifying whether there would be any impediment to IFRS 9 being conducive to the European public good. The capacity of IFRS 9 to improve the quality of financial reporting, and hence contribute to the efficiency of capital markets supporting economic growth in the EU, has been assessed in paragraphs 3 to 52.

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

100 The business model of some insurers[6] 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 an insurer's financial position and performance.

101 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. Although the future insurance contracts standard is expected to be issued before IFRS 9 becomes effective, it would be extremely difficult for an insurer 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.

102 Requiring an insurer to apply IFRS 9 before the future insurance contracts standard has the potential to significantly reduce the quality of information available to users. Any accounting mismatches between IAS 39 and existing IFRS 4 have been addressed by insurers. However, the adoption of IFRS 9 before the adoption of the future insurance contracts standard is expected to lead to accounting mismatches that would be difficult, or even impossible, to address until both standards are applied.

103 The IASB has so far tentatively decided not to consider deferring the mandatory effective date of IFRS 9 for insurers[7] in order to align it with the application date of the future insurance contracts standard. This may be because IFRS 9 provides more relevant information about financial instruments compared to IAS 39; it is difficult to identify the scope of the insurance entities that might be eligible for such a deferral; and the technical hurdles to be overcome in drafting such a deferral.

104 In the event there is no deferral of IFRS 9, the IASB is considering additional transitional reliefs, including fresh start accounting for applying the IFRS 9 business model assessment to reduce accounting mismatches at the time the future insurance contracts standard is applied. However, such reliefs will not have any impact during the period between adopting IFRS 9 and subsequently the future insurance contracts standard as they will only be effective from the date the future insurance contracts standard is applied.

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

A.1. Potential benefits of a deferral

105 EFRAG considers that the benefits of deferring the application of IFRS 9 for insurance entities that apply cost models to their insurance liabilities include:

[6] For the purpose of this draft letter, an insurer 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).

[7] See IASB Update at: http://media.ifrs.org/2015/IASB/January/IASB-Update-January-2015.pdf

(a) *Information needs of users.* Users will find difficulties in understanding the financial performance and position of insurers during the period between the adoption of IFRS 9 and the future insurance contracts standard. Insurance entities 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 insurer's results by linking non-GAAP measures to the financial statements.

(b) *Costs for preparers.* In the event IFRS 9 is implemented before the future insurance contracts standard, insurers would incur additional costs for having to first implement IFRS 9 and then reassess that implementation when implementing the new insurance contracts standard. Reassessment would however be limited to possible changes in conditions having occurred since IFRS 9 was first implemented.

(c) *Accounting mismatches.* If insurers 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 insurers applying the cost model under the existing IFRS 4 *Insurance Contracts*. 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.

A.2. POTENTIAL DRAWBACKS OF A DEFERRAL

106 While there are benefits for insurers 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, particularly the improved impairment model, for an unknown number of years is an issue of concern. Allowing insurers 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. However, given that many financial assets held by insurers are investment grade assets, the application of the IFRS 9 impairment model is not expected to result in significantly higher provisions than the IAS 39 incurred loss model. This is because the 12-month expected credit loss allowances for those investment grade assets are not expected to be material in absolute terms.

(b) *Reduction in comparability.* Some argue that a deferral of IFRS 9 would reduce comparability in the treatment of financial assets between insurance and banking entities. EFRAG considers that this is not a major drawback because the measurement of insurance liabilities currently differs between insurers because of the provisions of IFRS 4 and consequently the impact of the different business models between insurers and other financial institutions impacts the measurement of financial assets.

(c) *Impact on conglomerates*. It has been suggested that allowing a deferral of IFRS 9 would be difficult for conglomerates if recognising in the consolidated financial statements some financial assets using IFRS 9 and other financial assets using IAS 39 results in the conglomerate applying non-uniform accounting policies which is not in accordance with IFRS 10 *Consolidated Financial Statements*. In EFRAG's view, this concern may be addressed by acknowledging the dissimilar circumstances through presenting and disclosing financial instruments recognised and measured in accordance with IAS 39 separately from those recognised and measured in accordance with IFRS 9.

A.3. Conclusion on potential benefits and drawbacks

107 Having duly considered the possible drawbacks and assessed their significance, EFRAG is of the view that the benefits to users of consistent and understandable financial reporting until IFRS 9 and the future insurance contracts standard are applied at the same time, together with the cost savings for preparers and users, make a strong case for the deferral of IFRS 9 for insurers. However, EFRAG considers that any deferral of IFRS 9 should be optional as some insurers, such as conglomerates, may take the view that, in their circumstances, the drawbacks of a deferral outweigh the benefits.

B - Quantitative assessment

Note to constituents

EFRAG has reached its preliminary position on the basis of all of the above and a first set of quantitative data received from the European insurance industry shortly before the draft endorsement advice was approved. EFRAG considers that a more in-depth understanding of the magnitude of the potential effects of IFRS 9 being implemented in advance of the future insurance contracts standard is critical to the finalisation of its endorsement advice to the European Commission. EFRAG is therefore calling on constituents to provide more evidence and insights on this issue.

108 EFRAG has reached out to the insurance industry in order to understand the likely effect of adopting IFRS 9 before the adoption of the future insurance contracts standard.

109 In this regard, EFRAG received a joint preliminary high level quantitative assessment from the European insurance industry showing an initial review of the balance sheets of some of the largest and most affected continental European insurers. 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 insurers for the years 2011 to 2014 there would have been fluctuation in profit or loss of up to 20 per cent.

C - Conclusion

110 Based on the above analysis and quantitative assessment, EFRAG thinks that there are reasonable grounds to believe that a deferral of IFRS 9 for insurers would be conducive to the European public good. EFRAG therefore advises the European Commission to request the IASB to open an option to defer the application date of IFRS 9 for insurance businesses. EFRAG is ready to assist the IASB in designing the scope of such an option.

European carve-out

111 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.

112 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

113 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.

114 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

115 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.

116 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

117 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 for a legal expert to assess whether an update of the relevant paragraph is needed.

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

118 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.

119 EFRAG's evaluation is based upon the results of its field-tests 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

120 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.

121 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.

122 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.

123 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 105 to 110.

A.1.2. IMPAIRMENT

124 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.

125 Participants in the EFRAG field-test on the 2013 ED *Financial instruments: Expected Credit Losses* 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.

126 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.

127 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.

128 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

129 The implementation costs to comply with the disclosure requirements will impose a significant burden on preparers. As identified in EFRAG's field-tests*,* disclosure requirements are comprehensive and are frequently prescriptive rather than principle-based.

130 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

131 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

132 As highlighted in the field-test, 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

133 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.

134 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.

135 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

136 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.

137 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.

138 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.

139 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

140 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.

141 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.

142 As indicated in EFRAG's field test on general hedge accounting, 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.

143 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.

144 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.

145 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.

146 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

147 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

148 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 the standard.

B - Costs for users

B.1. One-off costs for users

149 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.

150 EFRAG assesses that users will have to organise special meetings with preparers in order to understand how they have implemented the standard and the implications for their organisation. EFRAG assesses that these one-off costs will be significant.

151 Users will incur particularly high costs for understanding the financial statements of entities that issue contracts within the scope of IFRS 4 *Insurance Contracts.* 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

152 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

153 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

154 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 – COST FOR USERS

155 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

156 The extent of the benefit for preparers will depend on existing practices and the industry within which the preparer operates.

157 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, but identifying and documenting business models will result in costs being incurred.

158 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).

159 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 insurers may face two significant changes within a relatively short period of time.

C.2. Impairment

160 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.

161 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 75 to 76 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.

162 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.

163 Preparers will benefit from the fact that existing credit risk management processes are capable of being leveraged to fulfil the IFRS 9 requirements.

C.3. Hedging

164 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.

165 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 the standard allows for hedge accounting of non-financial risk components which will better reflect commercial reality.

166 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.

167 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.

168 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

169 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.

170 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

171 EFRAG's assessment that is based on all practical expedients being available to preparers is that the overall benefits for preparers and users in implementing IFRS 9 are likely to outweigh costs for both preparers and users associated in implementing those requirements.

172 EFRAG acknowledges that this may not be the case for insurers, unless the effective date of IFRS 9 and the forthcoming insurance contracts standard are aligned. Insurers' business model rely on an asset and liability management whereby financial assets are used to cover the obligations resulting from insurance liabilities. Consequently, a consecutive change in the accounting for the financial assets due to IFRS 9 and the insurance liabilities due to a future insurance contracts standard would possibly lead to reassessments of the business model, reclassifications between financial asset categories and increased efforts in explaining the resulting information to users of financial statements.

173 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 believes that the benefits of IFRS 9 outweigh the associated costs.

Overall assessment with respect to the European public good

174 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 lowers the cost of capital and assists in the assessment of management stewardship.

175 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.

176 In assessing these issues, EFRAG has identified some areas where it is possible that adoption of IFRS 9 may not be conducive to the European public good. However, taking into account the improved financial reporting brought about by IFRS 9, EFRAG, on balance, believes adoption of IFRS 9 is conducive to the European public good[8].

[8] This conclusion is subject to EFRAG's final conclusion on the inter-relationship between IFRS 9 and the future insurance contracts standard.

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 field-test was to gain an understanding of the impact of IFRS 9 and any implementation challenges. The relevant results of this field-test have been included in Appendix 2 and 3.

B - Surveys considered

5 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*; and

(f) 2014 Deloitte, IFRS 9 *Impairment Umfrage zur EL-Wertminderung*.

6 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 standard.

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

7 Twenty-three entities participated in the field test. 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.

8 The table below summarises the total number of participants by country and by industry.

Participants by country:		**Participants by industry:**	
Germany	8	Banking	11
Sweden	1	Insurance	3
France	10	Other industries	9
UK	4		
	23		23

9 In describing the findings the following denominations 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 23 participants.

C.1. QUANTITATIVE DATA ON CLASSIFICATION AND MEASUREMENT

10 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:

	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%

11 One participant from the insurance industry provided quantitative input with regard to the above assessment with results which did not contradict the above trends.

12 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

13 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	6	23

14 Some participants from the banking, insurance and other industries provided quantitative data to the question concerning initial modelling of the effect on provisions according to specific portfolios. The answers are summarised in the following table.

	Lower		**Higher**				
Type of portfolio	>25%	0-25%	0-25%	25-50%	50-75%	75-100%	>100%
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