THE CHAIRPERSON

EUROPEAN BANKING AUTHORITY

Floor 24-27, Europlaza,
20 avenue André Prothin, La Défense 4,
92400 Courbevoie, FRANCE

T: +33 186 526 832
E: JoseManuel.Campa@eba.europa.eu

https://eba.europa.eu

Andreas Barckow
Chairman
International Accounting Standards Board
Columbus Building, 7 Westferry Circus
Canary Wharf
London E14 4HD
United Kingdom

EBA-2022-D-3776

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Subject: IASB Request for Information – Post-implementation Review of IFRS 9 *Financial Instruments* – Classification and Measurement

Dear Mr Barckow,

The European Banking Authority (EBA) welcomes the opportunity to comment on the International Accounting Standards Board's (IASB's) Request for Information (RfI) as regards the IFRS 9 post-implementation review (PiR) on classification and measurement requirements. The EBA has a strong interest in promoting sound and high-quality accounting and disclosure standards for the banking and financial industry, as well as transparent and comparable financial statements that would strengthen market discipline.

The EBA strongly supports the IASB's efforts to develop clear and harmonised principles and believes that the current post-implementation review is of the utmost importance to continue developing high-quality international accounting standards.

The EBA comment letter is mainly focused on aspects that could represent an impact in prudential terms. While the EBA recognises the importance of all the topics included in the RfI from a pure accounting perspective, there are aspects that independently of the direction taken would not have a special relevance from a regulatory perspective. This is the case of the discussion around the presentation of the effects of own credit risk in other comprehensive income[1] that, under the Capital Requirements Regulation[2], are subject to the application of a prudential filter neutralising its effects in the computation of the CET1 ratio.

[1] Question 5 of the IASB's RfI ('Financial liabilities and own credit').

[2] Article 33 of Regulation (EU) No 575/2013 of the European Parliament and of the Council (Capital Requirements Regulation — CRR).

While the EBA believes that IFRS 9 reached the overall objective of aligning the measurement of financial assets with how financial institutions expect to manage them and also believes that the improvements over the previous standard on financial instruments are evident, there are some aspects that could benefit from further consideration from a standard-setting perspective.

This being said, the EBA's views on selected questions are expressed in detail in the annex to this letter. The EBA used this opportunity to share some detailed information on the observations as regards the practices implemented by the EU institutions to the extent that this information is deemed useful in the context of the current review. In this regard, several observations are drawn from a monitoring report on the implementation of IFRS 9 that the EBA published[3] on 24 November 2021 and where more details can be found, in particular, in sections '6. Classification and measurement' and '7. Recognition and derecognition'. If you have any questions regarding our comments, please do not hesitate to contact us.

Yours sincerely,

[signed]

Jose Manuel Campa

Chairperson, European Banking Authority (EBA)
On behalf of the EBA Board of Supervisors

[3] IFRS 9 monitoring report: Link

Annex: Detailed comments on the IASB's Request for Information: Post-implementation Review of IFRS 9 *Financial Instruments* – Classification and Measurement

Question 1 – Classification and measurement

Do the classification and measurement requirements in IFRS 9:

(a) enable an entity to align the measurement of financial assets with the cash flow characteristics of the assets and how the entity expects to manage them? Why or why not?

(b) result in an entity providing useful information to the users of the financial statements about the amount, timing and uncertainty of future cash flows? Why or why not?

1. In overall terms, the EBA believes that IFRS 9 reached the objective of aligning the measurement of financial assets with how financial institutions expect to manage them which is certainly useful information for the users of financial statements. The introduction of a single logic to classify financial instruments provides better clarity on the characteristics of instruments classified under each category.

2. The business model assessment leads to a classification and measurement of financial assets that provides useful information on the amounts, timing and uncertainty of an institution's future cash flows. Under this type of approach, it is now possible to have a good understanding of how an institution manages its financial assets to generate cash flows. Also the 'solely payments of principal and interest' (SPPI) criteria provide a sound set of aspects to be considered when determining whether a financial asset could be measured at amortised cost (AC) or at fair value through other comprehensive income (FVOCI). The EBA believes that the set of principles put in place on the classification and measurement requirements works well in general, having identified some concrete aspects that could eventually benefit from additional guidance or clarification. In the next sections, information on the EBA observations as regards the different topics assessed and respective conclusions under its monitoring activities is provided.

Question 2 – Business model for managing financial assets

(a) Is the business model assessment working as the Board intended? Why or why not?

(b) Can the business model assessment be applied consistently? Why or why not?

(c) Are there any unexpected effects arising from the business model assessment? How significant are these effects?

3. Following the monitoring activities conducted by the EBA on the implementation of IFRS 9, while it is perceived that the distinction between business models and consequent accounting classification and measurement is well understood by the EU institutions, some divergencies in practices were observed. In particular, as described in the EBA report published in November 2021, a multiplicity of approaches were implemented as regards the assessment of materiality and frequency of sales in order to be consistent with a held-to-collect (HTC) business model as, for instance, significantly different levels of quantitative thresholds when compared with an absence of quantitative threshold definition or the different qualitative methodologies followed. Independently of these observations, the EBA acknowledges that under the principles of IFRS 9 it does not necessarily mean an inconsistent application of the standard and respective principles that, in general, are deemed well designed and fit for the purpose especially when considering that these principles were developed to be applied to a wide range of entities operating in very different economic sectors. However, depending on how the principles are being applied by institutions, some overlapping might exist between what is considered 'held-to-collect' and 'held-to-collect and sell' when comparing different banks.

4. From a standard-setting perspective, it could be further explored whether the link between 'infrequent' and 'significant' works consistently well as, in practice, significant sales do not necessarily lead to the assessment on whether and how such sales are consistent with the objective of collecting contractual cash flows if those sales are considered infrequent (IFRS 9 paragraph B4.1.3B). Also from a banking regulatory/supervisory perspective, as it is well known, the need for specific supervisory expectations is assessed on a continuous basis in order to determine whether a more sectoral/targeted guidance would be needed. The EBA, together with the supervisory authorities, will give continuity to the regular monitoring activities having this aspect in consideration.

5. As regards the requirement to perform an assessment on whether and how sales are still consistent with the objective of collecting contractual cash flows when deemed frequent and/or significant, the EBA believes that, in some cases, internal transfers between different business lines might also provide evidence that changes in the business model have occurred. While IFRS 9 paragraph B4.1.2A explicitly mentions that when assessing business models for newly originated or newly purchased financial assets it must consider information about how cash flows were realised in the past, IFRS 9 paragraph B4.4.3 states that *'a transfer of financial assets between parts of the entity with different business models'* does not constitute a change in business model. The EBA would see some merits in considering internal transfers (e.g. a transfer of financial assets from the banking book to a trading desk or vice versa) as a potential indication of a change in the business model when assessing it for newly originated or acquired financial assets (i.e., no reclassification would be allowed for existing instruments in case of frequent and/or significant-in-value internal transfers).

6. One relevant point that would be of concern at this stage relates to the lack of criteria in the internal accounting policies to perform an adequate significance and frequency assessment. The EBA acknowledges, however, that this aspect might assume more relevance in the context of auditing and enforcement discussions than at standard-setting level.

7. As regards the sales that have occurred due to an increase in credit risk but which are still consistent with a HTC business model, in the same line as mentioned before, EU institutions have considered different types of indicators when performing such an assessment. Under IFRS 9 paragraph B4.1.3A, the following is stated 'irrespective of their frequency and value, sales due to an increase in the assets' credit risk are not inconsistent with a business model whose objective is to hold financial assets to collect contractual cash flows (…) Selling a financial asset because it no longer meets the credit criteria specified in the entity's documented investment policy is an example of a sale that has occurred due to an increase in credit risk. However, in the absence of such a policy, the entity may demonstrate in other ways that the sale occurred due to an increase in credit risk'. On this specific point, the EBA is of the opinion that more clarity on what should be understood as an increase in credit risk could be provided under IFRS 9 and/or related guidance as it seems that the current wording is too broad, and for this reason, it would hardly achieve a consistent implementation of the relevant principle. For instance, should the financial assets be credit-impaired or should these financial assets have experienced increases in credit risk without being credit-impaired?

8. Independently of the aspects listed in the previous paragraphs, it is worth noting that the measurement basis for financial assets and, therefore, the balance sheet structure of EU institutions remained broadly the same between 2018 and 2020. As of December 2020, similar to previous reference dates, the most common measurement basis was AC (around 80% of the financial assets, on average) followed by fair value through profit or loss (FVPL) and finally FVOCI measurement basis.

9. Under IFRS 9 requirements, events leading to changes in the business model are expected to be rare, occurring under very specific, limited and well-justified circumstances. In the context of the EBA's monitoring exercise, only a few reclassifications between accounting categories of financial assets were observed for some institutions. When analysing the information provided by a few of those institutions for the purpose of the monitoring exercise and under respective public disclosures, it was observed that the rationale behind those reclassifications is not always clearly explained. In this context, in the EBA monitoring report it was recalled that IFRS 9 reclassifications should be infrequent and reclassifications between the different accounting categories is not permitted unless it relates to a change in the business model. The EBA supports the restrictions imposed by IFRS 9 on this matter, as it is believed that they aim at avoiding opportunistic reclassifications that would also directly impact the application of regulatory capital requirements and computation of prudential ratios. For the few

reclassifications observed under the monitoring exercise, the Common Equity Tier 1 (CET 1) impact was not material. However, the EBA acknowledges that this is not always the case and should continue to be a relevant point for attention from a supervisory perspective well supported by the current principle under IFRS 9 that would not allow arbitrary decisions on the measurement basis to be considered for the different financial assets. Given the lack of evidence observed for some institutions as regards the change in the business model, the EBA believes that additional IASB guidance or illustrative examples on how to demonstrate to external parties a change in the business model would be beneficial to ensure that a proper level of disclosures on the rationale followed and internal changes performed are available to the users of financial statements.

10. As regards the accounting treatment of a reclassification from the FVOCI to the AC category, under IFRS 9 paragraph 5.6.5, at the reclassification date the financial asset is reclassified at its fair value. In practice, the cumulative gain or loss previously recognised in other comprehensive income (OCI) is removed from equity and adjusted against this fair value, not affecting profit or loss and allowing the financial asset to be measured at the reclassification date as if it was always measured at amortised cost. Given the immediate impact in equity to which a reclassification of financial assets would lead and the fact that this one-off impact does not necessarily provide useful insight on the financial situation to the readers of the financial statements, the EBA would suggest that the IASB review the potential merits of an approach more aligned with the one followed under IAS 39 when reclassifying financial assets from available-for-sale (measured at fair value through OCI) to held-to-maturity (measured at amortised cost) categories. To recall, under IAS 39 paragraph 54 'any previous gain or loss on that asset that has been recognised in other comprehensive income (…) shall be accounted as follows: (a) In case of a financial asset with a fixed maturity, the gain or loss shall be amortised to profit or loss over the remaining life of the held-to-maturity investment using the effective interest method.'

Question 3 – Contractual cash flow characteristics

(a) Is the cash flow characteristics assessment working as the Board intended? Why or why not?

(b) Can the cash flow characteristics assessment be applied consistently? Why or why not?

(c) Are there any unexpected effects arising from the cash flow characteristics assessment? How significant are these effects?

11. In the context of the EBA reviews, no particular issues were identified as regards the cash flows characteristics assessment and IFRS 9 principles are perceived to work as intended. Under the

first post-implementation report published by the EBA in December 2018[4], it was inferred from the available data that the SPPI test did not have a material influence on the classification of non-trading debt instruments as 96% of these instruments met SPPI criteria (paragraphs 42 and 43 of this report). In 2020, no evidence was collected that could indicate a different trend. On the practices implemented, some different approaches were observed but it is not seen as an inconsistent application of the principles under IFRS 9. For instance, one practical example relates to the different levels of thresholds and number of periods considered when assessing whether the cash flows are significantly different from the benchmark cash flows on each reporting date and cumulatively.

12. One aspect that would eventually benefit from additional guidance is the application of the SPPI criteria to contractually linked instruments (CLIs). In the context of the EBA monitoring activities, it was observed that very little information was provided for this particular type of instruments and some institutions have justified it with the fact that it was not possible to determine whether the SPPI criteria would be met or not given the lack of information to perform such an assessment or difficulties in applying the guidance implicit in the current IFRS 9 principles. While the EBA did not collect more detailed information on this aspect, it seems to be an item to which the IASB could dedicate some additional attention in the context of its review of the standard.

13. A relevant aspect related to the SPPI test that institutions are currently looking at is the application of the SPPI criteria to green or social bonds or loans, structured instruments linked to green or social indices and loans with environmental, social or governance (ESG) features. Having in mind the objective of the assessment of contractual cash flows characteristics, i.e., identification of financial assets with 'simple' contractual cash flows that represent solely payments of principal and interest, for some of these instruments the application does not seem particularly challenging. For instance, the assessment of contractual cash flows of green bonds with no sustainability-linked adjustment would not, in principle, create additional difficulties in this specific context. In the case of loans with interest rate linked to pre-determined ESG targets, this reflection assumes higher relevance and complexity. The EBA considers that the IASB guidance on the accounting treatment of instruments with ESG features and/or KPI targets would be useful, especially in the form of didactical material as it is not evident at this stage that particular amendments would be needed to existing principles.

14. In the context of the ESG instruments discussion, the EBA is also of the view that this topic deserves a broader discussion and should not be limited to the accounting classification of financial assets. ESG risks impact the measurement of financial assets via the computation of expected credit losses (ECL) and determination of fair value. As such, an overall assessment on how the classification criteria (and related measurement basis) would work in conjunction with

[4] EBA report: First observations on the impact and implementation of IFRS 9 by EU institutions

ECL and fair-value models seems to be needed which would justify, in the EBA's view, a separate initiative dedicated to this topic or inclusion in the next phases of the IFRS 9 PiR when covering ECL requirements as well.

Question 4 – Equity instruments and other comprehensive income

(a) Is the option to present fair value changes on investments in equity instruments in OCI working as the Board intended? Why or why not?

(b) For what equity instruments do entities elect to present fair value changes in OCI?

(c) Are there any unexpected effects arising from the option to present fair value changes on investments in equity instruments in OCI? How significant are these effects?

15. In the EBA public report on undue short-term pressures from the financial sector[5] concerns expressed by the industry on IFRS 9 were analysed, in particular, the one regarding the accounting treatment of equity and how it could negatively affect long-term investments due to equity instruments being accounted for at fair value through profit or loss (unless irrevocable election is made and instruments are measured at fair value through OCI). In this context, the following was mentioned: 'it should be noted that, from a broader financial market perspective, neither the public survey nor the collection of evidence from literature undertaken by ESMA has highlighted that fair value measurement results in distortions of the investment process that trigger undue short-term pressures in financial markets. Fair value is deemed to be a relevant measurement basis for both managers and investors, and there is no evidence yet on the consequences of the implementation of IFRS 9 on long-term investment practices'. Following the conclusion based on the available information at that time and the more recent investigations conducted by the EBA on the basis of the regulatory reporting data, it seems that there is no evidence (on an EU aggregated level) that new rules are negatively affecting the long-term investments held by the banking sector. The importance of a continuous monitoring and impact assessment is well acknowledged by the EBA and available data will continue to be scrutinised over time. From the EBA's perspective, the option to present fair value changes in OCI works as the Board intended and no unexpected effects were, so far, identified.

16. If the IASB considers revisiting the current accounting treatment under IFRS 9 in order to allow the recycling of gains and losses, i.e., the reclassification into profit or loss of income and expenses that have been previously included in OCI, the EBA shares the view expressed already by other EU authorities that a proper impairment model would need to be put in place. While

[5] EBA report on undue short-term pressure from the financial sector on corporations (December 2019)

this solution would potentially address specific concerns raised over time by some stakeholders, it might also increase the level of complexity of IFRS 9 application.

Question 6 – Modifications to contractual cash flows

(a) Are the requirements for modifications to contractual cash flows working as the Board intended? Why or why not?

(b) Can the requirements for modifications to contractual cash flows be applied consistently? Why or why not?

17. When assessing the criteria considered by institutions that would lead to the derecognition of a financial asset after a modification of contractual conditions, a multiplicity of approaches based on qualitative and quantitative factors are applied. The main qualitative criteria relate to a change of borrower and/or whether a change in the contractual terms is observed. It was also observed that, in some cases, modifications that lead to SPPI not being met are considered a substantial modification that leads to derecognition. In most of the cases, the established criteria in the internal policies are applied independently of the impairment 'stage' even if some institutions have adjusted their evaluation criteria depending on this allocation. In overall terms, the EBA observed that the criteria to assess derecognition seem to remain stable through the period under analysis and no material immediate changes were observed with the outbreak of the COVID-19 crisis.

18. Additionally, around half of the institutions included in the sample considered in the EBA monitoring exercise have mentioned the use of the 10% quantitative criterion, similar to the assessment conducted for liabilities. Practically all the institutions complement the use of this criterion with a qualitative assessment. From the EBA's perspective, this qualitative assessment is key especially having in mind the differences between the valuation of assets and liabilities. Given that the measurement of a financial asset already incorporates the effect from ECL and if this ECL amount is considered in the comparison performed, the pure consideration of a 10% threshold would not provide a meaningful outcome of the modification economic impact. For this reason, the EBA believes that this is an area where standard-setting activity would be needed, with the objective of providing more guidance under IFRS 9 on the qualitative characteristics that should actually trigger the derecognition of a financial asset.

19. Under IFRS 9 paragraph 5.4.4, an entity shall reduce the gross carrying amount of a financial asset in its entirety or a portion thereof if there are no reasonable expectations of recovery. A write-off constitutes a derecognition event. When assessing whether a total write-off would be appropriate, institutions mostly use criteria related to the likelihood of realising the collateral, ceasing to enforce the debt (e.g. further litigation actions to collect a claim are considered economically unprofitable, no legal basis for further handling the cases) and the debtor being

under liquidation proceedings. As regards the criteria considered for a potential partial write-off, the heterogeneity of practices is quite significant. While some institutions base their assessment on the application of forbearance measures, some others justify a partial write-off with the possible execution of the collateral. The case-by-case assessment based on expert judgement is the most common type of analysis.

20. IFRS 9 paragraph B5.4.9 provides a specific example on what a write-off would mean in practical terms. In order to understand whether the current level of guidance within the standard is leading to the implementation of robust internal policies, the percentage of recoveries after write-offs were assessed and it was observed that a significant number of institutions in the sample under consideration have recovered more than 10% of written-off amounts, with a few institutions indicating that this recovery corresponds to more than 30%. While this is a point-in-time observation, a high proportion of recoveries might indicate that internal policies would need some refinement in order to more accurately identify the amount that should, indeed, be derecognised. This is a matter of importance from a regulatory and supervisory perspective as low-quality practices in this field have a direct impact in key supervisory metrics. The EBA believes that this could also be relevant from a standard-setting perspective as the current guidance within the standard is proved to be too brief to guarantee a good level of efficacy and comparability of the implemented approaches. As such, the EBA would invite the IASB to explore the possible viable solutions on this topic.

Question 7 – Amortised cost and the effective interest method

(a) Is the effective interest method working as the Board intended? Why or why not?

(b) Can the effective interest method be applied consistently? Why or why not?

21. In the course of its monitoring activities, the EBA identified different approaches on the recognition and presentation of interest income. The EBA believes that the current PiR is a good opportunity to provide feedback on what was observed in order to provide the IASB with concrete material on the different practices currently being followed by the EU institutions on this matter. This information is deemed useful to feed the future standard-setting discussions at the IASB level. More detailed information can be found in the EBA monitoring report.

22. More than a half of the institutions assessed have presented the regular interest income for Stage 3 instruments in line with the conclusion of the ITG[6] December 2015, meaning that the amount of regular interest calculated on the basis of the carrying amount (non-impaired portion of the financial assets) is presented as interest income in the statement of profit or loss. However, some institutions are presenting the amount of regular interest calculated on the

[6] Transition Resource Group for Impairment of Financial Instruments

basis of the gross carrying amount, performing a separate adjustment to ensure that the amount of interest recognised in profit or loss corresponds to the net amount. This adjustment has been performed in different profit or loss lines, including interest income and impairment. From a balance sheet presentation perspective, different practices regarding gross or net presentation could be identified. Furthermore, some ambiguity has been observed regarding the accounting treatment for purchased or originated credit impaired (POCI) assets.

23. Also on the penalty interest income recognition[7], different practices were observed. While the large majority of institutions reflect these amounts in profit or loss only when the settlement occurs, a few institutions recognise the income from penalty interest prior to their collection. As regards the recognition and presentation of the accrued interest related to non-performing debt instruments measured at fair value through profit or loss, a significant heterogeneity in policies related to (i) the segregation from the changes in the fair value in terms of presentation and (i) the basis for calculation (principal amount outstanding vs carrying amount / fair value) was observed.

24. The existence of these different approaches will be taken into account when performing the regular supervisory activities/exercises as it is confirmed that there are comparability issues in these areas. The EBA would also invite the IASB to consider the divergencies identified when determining whether additional educational material / additional guidance could be useful to achieve a better consistency in the implementation of the relevant accounting principles.

25. The IASB is already aware of the existence of different views as regards the calculation of the effective interest rate at initial recognition of a financial instrument and how to account for subsequent changes in estimates of cash flows. A well-known example is on how a change in the estimates of amounts due is accounted for when those amounts are subject to a contingent event, as in the case of the ECB targeted longer-term refinancing operation (TLTRO III). Another question that is gaining higher relevance with the increased number of instruments with such links is how to calculate the effective interest rate in financial assets with ESG features given the conditions attached to the interest rate adjustments (whether and how an institution should take into account the probability of the borrower meeting the ESG targets specified in the loan determining the effective interest rate at initial recognition and whether the institutions apply paragraphs B5.4.5 / B5.4.6 of IFRS 9 when the interest rate is adjusted), in case those instruments would pass the SPPI assessment. The EBA recognises the importance of having clarity on these topics and would invite the IASB to consider the matter under its current PiR.

[7] i.e., interest payments for which the entity's rights to receive them only arise when there are past due amounts in the transaction.

Question 8 – Transition

(a) Did the transition requirements work as the Board intended? Why or why not?

(b) Were there any unexpected effects of, or challenges with, applying the transition requirements? Why or why not?

26. Under its report published in December 2018, the EBA observed that most of the changes in classification of financial assets when moving from IAS 39 to IFRS 9 have been observed from the AC to the FVPL measurement basis and from the FVOCI to the AC measurement basis. Additionally, it was concluded that, on average, new classification rules under IFRS 9 did not appear to have resulted in a material impact to institutions[8].

27. To recall, from a regulatory perspective, the impact from the change in the classification and measurement principles was fully reflected in CET 1. The IFRS 9 transitional arrangements under the Capital Requirements Regulation, applied by less than half of the EU institutions, solely covers the impact arising from the application of the new requirements on expected credit losses measurement and will phase in the recognition of this impact in CET 1 until the end of 2024.

[8] Please see paragraph 38 of the report (link).