European Banking Federation

Chief Executive

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Email

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Mr Hans HOOGERVORST
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Dear Mr Hoogervorst,

The European Banking Federation (EBF)[1] would like to express its views on a number of issues that its members consider of great importance to the development of IFRS 9.

Request for amendment of IAS 39 to address the own credit risk in financial liabilities

First of all, there are concerns from both users and preparers about the accounting for own credit risk on financial liabilities designated at Fair Value (FV) through profit and loss. The effects are counter-intuitive in times of crisis and therefore misleading for users of financial statements. Investors are increasingly questioning the credibility of financial statements, since profits are recognized as credit spreads widen and the volatility in reported results increases as credit spreads fluctuate. Stock market analysts typically adjust reported results to remove the effects of own credit and financial institutions present non-GAAP measures on this basis in order to provide more relevant information to markets.

This concern is being addressed by IFRS 9, which requires fair value movements due to own credit risk to be recognised in Other Comprehensive Income (OCI) rather than Profit and Loss (P&L). **Given the urgency of the issue, the EBF would urge the IASB to make this change available immediately for early adoption under current IAS 39, without linking it to the adoption of other IFRS 9 provisions**. There is widespread consensus on this topic from a broad cross section of stakeholders and the issue can be easily resolved by making relatively minor amendments to IAS 39 on a timely basis.

[1] *Launched in 1960, the European Banking Federation is the voice of the European banking sector from the European Union and European Free Trade Association countries. The EBF represents the interests of almost 5000 banks, large and small, wholesale and retail, local and cross-border financial institutions. Together, these banks account for over 80% of the total assets and deposits and some 80% of all bank loans in the EU only.*
The EBF is committed to supporting EU policies to promote the single market in financial services in general and in banking activities in particular. It advocates free and fair competition in the EU and world markets and supports the banks' efforts to increase their efficiency and competitiveness.

<u>The introduction of a third measurement category (Fair Value through Other Comprehensive Income)</u>

The members of the EBF are of the view that the introduction of a third category must not undermine the business model principle of IFRS 9 or the objective of the IASB to improve financial reporting and reduce the complexity of IAS 39.

Members of the Federation are not convinced that introducing a third category without other significant changes to both IFRS and US GAAP would result in meaningful convergence. For example, without changes to the treatment of foreign exchange gains and losses on Fair Value through OCI financial assets, the most significant measurement difference between IFRS and US GAAP would remain. Indeed a similar looking presentation with unresolved technical differences will result in more confusion than clear, easily understandable differences. The banking industry does not support the development of a standard that would represent little improvement on IAS 39 for the sake of convergence.

The EBF believes that the use of the third category should be limited. Its members do not believe that the third category is necessary to accommodate liquidity and balance sheet management portfolios in most circumstances. Such portfolios can be appropriately classified using the two category model in IFRS 9 as issued, perhaps with additional guidance if this is considered necessary to clarify the requirements as banks understand them. The objective of the underlying business model will need to be analysed in detail, which was not necessary under IAS 39 when the ‘Available For Sale’ category was effectively the default classification. The introduction of a third category must not invalidate the basic principle introduced by IFRS 9 in assessing the business model objective.

The banking industry believes that the introduction of a third category would require careful articulation to avoid changing the underlying principles of IFRS 9.

In many cases, the EBF believes that the objective of business models that underlie liquidity portfolios and many balance sheet management portfolios, is to hold financial instruments to collect cash flows. Any sales or purchase transactions are driven by the need to rebalance the portfolio due to changes in expected cash flows, regulatory requirements, or to protect against actual or expected credit deterioration. Transactions resulting from regulatory requirements, notwithstanding the more than infrequent purchase and sale activity in such portfolios, would not contradict the intent to collect contractual cash flows.

While the frequency and value of sales (and whether they generate gains or losses) are relevant to the analysis, the key point is an assessment of whether and how such sales are consistent with the objective of collecting contractual cash flows as set out in the documented business model and risk management objectives. The banking industry believes it is necessary to understand the objective of the business model in qualitative terms rather than inadvertently creating bright lines or re-introducing the concept of tainting concentrating quantitative thresholds.

Examples where banks believe portfolios should qualify for amortised cost measurement include:

Liquidity portfolios required by regulators

The narrowly defined liquidity portfolio mandated by regulators should always qualify for amortised cost treatment where the portfolio meets the principle of being held to collect contractual cash flows. Assets held in such portfolios comprise high grade plain vanilla securities and are used to fund unexpected cash outflows arising from stressed scenarios and the requirement to maintain a buffer, generally means that the size of the liquidity portfolio is stable and disposals are matched with purchases of similar duration and currency. Management's monitoring of such portfolios is driven by the need to meet regulatory guidelines, and critically, such portfolio are not managed to maximize fair value gains.

Putting aside sales required by the regulator to demonstrate liquidity, disposals are only to be expected in the extreme situations of a liquidity crisis. Even in extreme situations, banks are more likely to use these high quality liquid assets as collateral in repo transactions rather than sell them outright to raise liquidity. Regulatory turnover requirements should not disqualify such portfolios from amortized cost measurement.

The standard should therefore clarify that any mandatory regulatory requirement to demonstrate the liquidity of instruments through actual sales does not trigger a change in the business model.

Liquidity portfolio held for business needs of the 'held to collect' business model

Surplus funds from 'hold to collect' lending and deposit taking activities are typically placed with a central treasury function, which invests in a portfolio of securities. The holdings would include liquid assets held to meet the liquidity requirements as well as those required by regulation. Sales activity may be necessary to meet the cash requirements generated by deposit withdrawals and/or lending activity in the hold to collect business models.

Sales may also be made to avoid expected credit deterioration, or ensure that liquid asset characteristics are maintained. Typically such activity would be managed within defined risk limits and would not involve additional sales and purchases to generate total returns. While such portfolios are managed as efficiently as possible, in most circumstances, the entity should be able to demonstrate that any sales are consistent with the objectives of collecting contractual cash flows as set out in the existing paragraph B4.1.3 of IFRS 9.

The example in the recent staff papers of a deposit held to meet a requirement for funds in five years being part of held to collect business model only if its duration is five years or less, even if better interest rates are available on deposits of a longer duration, may be relevant for a single funding requirement being met by a single deposit. However, banks' business models will make assessments on a portfolio basis to meet many different and varying funding requirements; banks do not manage liquidity on an instrument by instrument basis. Portfolios should not be disqualified from the amortised cost measurement in circumstances where instruments in the portfolio are sold prior to maturity to meet unanticipated funding requirements; when the instrument was purchased, the bank could not have anticipated its disposal prior to maturity. Otherwise, banks could be obliged to incur unnecessary losses, simply to meet a prescriptive and artificial requirement to qualify for amortised cost accounting.

Asset Liability Management (ALM) portfolios that support amortised cost business which are managed in terms of responding to internal and external changes rather than to changes in the market value of the instruments should qualify for amortised cost.

An ALM strategy aimed at managing interest rate risk by matching assets and liabilities durations with a portfolio of debt securities can be adopted by banks that have structural funding in excess of their loan book. Under this strategy, banks buy and sell securities according to the change in asset/liability gap to reflect the change in expected duration. While the application of IFRS 9 is no doubt less straight-forward in this situation, nevertheless, EBF members believe that appropriate judgments can still be made. Amortised cost would apply where sales are to manage liquidity and interest rate risk in accordance with the documented business model and risk management objectives (including limits) consistent with an amortised cost business model. If there are more than infrequent sales, such sales will result from managing risk in response to internal and external factors such as customer behaviour rather than in response to changes in the market value of the instruments themselves.

In summary, there is a range of different business activities adopted by different banks in practice, so it is necessary to look qualitatively at the business model to understand the business objective and how this is achieved. It is right that there is no quantitative bright line for sales in IFRS 9, as it is not possible to predict sales levels in such a business model as conditions can change. Nevertheless, one would expect that sales volumes would be modest over periods of time and that any 'spikes' could be explained by underlying movements in the hold to collect business models, or disposals for credit purposes. Therefore, the EBF believes that the current wording in IFRS 9 is operational. The introduction of a third category to IFRS 9 must not lead to the narrowing of the scope of items measured at amortised cost in the banking sector.

Use of a benchmark to assess SPPI

The EBF supports the IASB in attempting to clarify the requirements for SPPI (solely payments of principal and interest on the principal amount test) by eliminating the problematic example of instrument B. In many European markets, the amendment of the standard to include the concept of comparing an instrument with a benchmark that does not have the feature of concern would appear to be of assistance. However, comparison with a benchmark as the comparable perfect instrument is less helpful in jurisdictions where there are no instruments in the market that do not contain the feature of concern.

For example, the interest rates in China for certain mortgages are mandated by the central bank. A five-year floating rate loan with annual re-pricing will be priced at prevailing five-year regulated central bank rate and the loan will reference the prevailing five-year regulated rate at the annual re-pricing dates.

Comparison with a “perfect” instrument will lead to a result that is artificial, unless the actual rates available in the market can be considered the benchmark. For example, rates used in some segment of retail banking could not be considered the benchmark for interbank market rates that are determined on another segment of financial markets.

The banking industry would suggest that the benchmark instrument should be reasonably available on that market. If there were no reasonable benchmark instrument alternative for reasons outside the control of the entity, e.g. as a result of regulatory or legislative requirements or the features of a less developed market, then the instrument with modified relationship between the principal and interest could be considered as providing an appropriate economic return consistent with amortised cost accounting.

Regulatory change and capital instruments

There is a great deal of regulatory change in process, which is focused on bank's debt securities to ensure that they are effective in bearing losses in crisis situations, for example, bail in bonds. Some of this regulation may result in changes to the law that affect all capital instruments directly and some may result in changes to the terms of individual capital instruments. At this stage it is too early to determine whether accounting issues will arise in assessing SPPI for these new instruments. However, EBF members would like to make the IASB aware of one consequence which they believe may be unintended.

Where subsidiaries of banking groups require additional capital to take the form of debt securities with these loss bearing features included in the terms of the instrument, there is concern that the parent company that holds the security will have to measure the security at fair value through profit or loss. The parent will generally measure the share capital it holds in its subsidiary at cost in accordance with IAS 27 'Separate Financial Statements'. It seems questionable that the debt security, which is in substance part of the investment in the subsidiary, should be measured differently from the equity investment. It may be helpful to make a consequential amendment to IAS 27 to include debt securities within its scope or otherwise clarify the treatment for holdings of such subsidiary debt securities.

Impact of IFRS 9 on existing hedging practices

It is the understanding of the EBF that the IASB intends to issue a version of IFRS 9 which includes only the revised general hedge accounting requirements without addressing macro-hedging which will still be under consideration. Banks understand the constraints the Board is facing with the timeline for adopting IFRS 9. However, they do not consider this approach as the best way to address the need for a high quality and timely revision of financial instrument accounting. If pursued, it must be clear that the current practices for macro-hedging can be carried on until a new standard on macro-hedging is put in place.

Under this approach for hedge accounting, IFRS 9 will only cover general hedges, without addressing macro-hedging, which will only be dealt with at the end of a transitional period on the adoption and implementation of a standard specifically dedicated to portfolio hedges. In the meantime, the current macro hedge accounting practices including the EU carve-out would be maintained and banks would be able to continue their current macro hedge accounting.

The EBF questions how such an approach will be able to work in practice. Although the banks have yet to study the final hedge accounting text, it is unclear to them whether the existing IAS 39 implementation guidance, which supports current portfolio-hedge accounting practices, would still be considered valid if there are actual or perceived conflicts with the new principles under IFRS 9. Issues of concern include the ability to model core deposits, the de-designation/re-designation process and the treatment of prepayments and several of the general hedging criterion and implementation guidance that may be used both for single hedges as well as for portfolio hedges today. This list is, however, not exhaustive and will need to be checked against the final text of the standard on general hedges. In addition, should IG F 6.2/3 be eliminated, EBF members are concerned that there will be no longer any guidance to support the practices of banks applying macro cash flow hedge accounting. Therefore, F6.2/3 should be grandfathered until macro hedge accounting is fully addressed. Finally, it is not clear to the EBF how banks will determine whether a hedge strategy involving multiple hedged items and hedging instruments will be in the scope of the existing IAS 39 portfolio hedge accounting provisions or in the revised hedge accounting requirements.

The EBF is concerned that it may be more complicated than first envisaged to ensure that existing macro hedge accounting practices can continue to apply during the period between the implementation of IFRS 9 and the finalisation of the revised macro hedge accounting requirements. Since it is crucial for the phased approach to work, the banking industry suggests that the IASB give this issue sufficient priority and would be pleased to assist in identifying issues to be resolved when the staff draft of the revised hedge accounting standard is available.

Further delay of IFRS 9 implementation

Banks prefer a single mandatory implementation date for IFRS 9 (excluding own credit risk issues, as mentioned above) and the IASB recognised that further delay might become necessary when the mandatory effective date for IFRS 9 was moved to 2015. **Considering the delay in finalising Phase II of the financial instruments project and the reopening of Phase I, the EBF would suggest further postponement to the mandatory implementation date of IFRS 9**. It would be helpful if the IASB provided more clarity on this as soon as practicable. Such clarity will not reduce implementation effort, but will allow it to be directed efficiently. This is particularly important given the volume of regulatory change and the risk for banks with a US listing of having to apply the existing IFRS 9 before it is finalised or endorsed.

The EBF believes that banks should be given sufficient time for implementation. Its members have particular concerns with the time it may take to implement impairment, for which the requirements have yet to be finalised. In the past, the EBF has estimated that it would require three years for implementation from the time of the issuance of the final standard; and this estimate may need to be revised in light of the final impairment requirements.

The European Banking Federation thanks you in advance for your consideration. Should you require any further information the EBF would be glad to provide it.

Yours sincerely,

Guido Ravoet

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