



Basel Committee on Banking Supervision

BANK FOR INTERNATIONAL SETTLEMENTS

Chairman

Via email: hhoogervorst@ifrs.org

Mr Hans Hoogervorst
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***Exposure draft (ED/2012/14) Classification and Measurement Limited
Amendments to IFRS 9 (proposed amendments to IFRS 9 (2010))***

Dear Hans

The Basel Committee on Banking Supervision appreciates the opportunity to provide comments to the International Accounting Standards Board's proposed amendments to IFRS 9 on the classification and measurement of financial assets (the Proposal or Exposure Draft). The Committee strongly supports high quality financial reporting by banking organisations. Its interest in this topic is consistent with the April 2009 call by the G20 Leaders for "*accounting standard setters to work urgently with supervisors to ... achieve a single set of high quality global accounting standards*" as an action to strengthen financial supervision and regulation. The Proposal is of particular importance to the Committee as a number of key regulatory ratios and measures are based on the accounting measure of an asset. For example, under Basel III, changes in fair value of all financial assets in the FV-OCI category would be included in Common Equity Tier One (CET1) – the highest quality form of regulatory capital. Therefore, unrealised gains and losses, as per the Proposal, would affect CET1.

The Committee has concluded that, at this point in time, it will not express a view on the merits of the Board's proposal to incorporate the FV-OCI classification and measurement category into IFRS 9 for eligible debt instruments. However, consistent with the Committee's *Guiding principles for the replacement of IAS 39*,¹ we believe the final version of the IFRS 9 classification and measurement guidance should not expand the use of fair value, especially for traditional lending instruments such as loans. It is unclear to us whether the proposed incorporation of the FV-OCI category into IFRS 9 would be consistent with our guiding principles because the definitions require additional clarity.

If the FV-OCI category were to be incorporated into the final version of IFRS 9, the Committee believes that several key clarifications and/or revisions to the principles that underscore the FV-OCI category (and the related implementation guidance) are necessary. Such would serve to limit the expansion of the use of fair value,

¹ www.bis.org/publ/bcbs161.pdf

reduce complexity in financial reporting and to foster consistency in the implementation of the final standard across entities and jurisdictions. Further, we encourage the Board to continue working mutually with the United States Financial Accounting Standards Board (FASB) on principles and implementation guidance in order to minimise differences in the accounting classification and measurement of financial assets among institutions in different jurisdictions around the world.

The Committee supports the IASB's decision to expand the principles and implementation guidance regarding the business model assessment to determine whether a financial asset is eligible for classification and measurement at amortised cost. However, additional clarification of the proposed new guidance pertaining to the hold-to-collect business model is required in order to limit the expansion of the use of fair value and maximise the consistency in implementation of the final standard.

While the Committee acknowledges that the proposed clarifications to the cash flow characteristics criterion are intended to provide practical relief, we continue to be concerned that this aspect of the classification and measurement model is overly complex. We are of the view that it will result in certain traditional lending instruments being measured at fair value with changes in profit and loss (FV-P&L).

Finally, consistent with the Committee's guiding principles note above, and with other stakeholders' interest in transparency and enhanced disclosures, we encourage the IASB to continue working with the FASB to establish converged disclosure requirements for the classification and measurement of financial instruments. Disclosures for financial instruments should be timely and comparable across financial institutions in order to provide meaningful information to users, reduce public uncertainty and contribute to financial stability.

These comments, along with our detailed observations and recommendations included in the attached appendix, have been prepared by the Committee's Accounting Task Force, which is chaired by Mr René van Wyk, Registrar of Banks, South African Reserve Bank. If you have any questions regarding our comments, please feel free to contact Mr van Wyk (+27 12 313 3601) or Xavier-Yves Zanota at the Basel Committee Secretariat (+41 61 280 8613).

Yours sincerely



Stefan Ingves

Appendix: Detailed Comments

Business Model Assessment – Distinction between FV-OCI and FV-P&L Categories

The way the proposed FV-OCI category and related business models is described in the Exposure Draft raises questions as to what the practical line of demarcation is between the FV-OCI and FV-P&L categories. The principle underpinning the FV-P&L category and the related business model requires financial assets held for trading or managed on a fair value basis to be measured at FV-P&L. The Proposal would require financial assets managed to achieve value realisation through sales and through collection to be classified and measured at FV-OCI. The fact that sales are integral to both business models blurs the distinction between these two categories and unduly increases the complexity associated with classifying financial assets. Therefore, if the FV-OCI category is included in the final version of IFRS 9, further clarification of the dividing line between the FV-OCI and FV-P&L categories is required to reduce complexity in financial reporting and to maximise consistency in the implementation of the final standard.

We recommend that the principles underscoring the FV-OCI category more clearly articulate that a business model in which financial assets are managed for both the collection of contractual cash flows and sale involves a combination of investment activities primarily carried out to manage usual liquidity needs, interest rate risk, and portfolio returns. Additionally, the implementation guidance for the FV-OCI category could include examples of financial assets that meet the cash flow characteristics criterion but, due to the way in which they are managed, do not qualify for classification and measurement at amortised cost such as origination of loans or trade receivables for sale into the securitisation market, and origination of loans intended to be syndicated or participated.

Business Model Assessment – FV-OCI – Implementation Guidance

If the FV-OCI category is incorporated into the final version of IFRS 9, the implementation guidance for the hold to collect and sell business model introduced by the Exposure Draft needs to be clarified. In Example 1 (B4.1.4B) the Exposure Draft provides that managing financial assets by, among other things, “*making decisions on an ongoing basis about whether collecting contractual cash flows or selling financial assets will maximise the return on the financial assets*” is consistent with a business model in which an entity holds financial assets to both collect the contractual cash flows and sell. The example also provides that, “*managers responsible for the portfolio are compensated based on the return generated by the financial assets.*” We question how such business decisions and compensation structure differ from a held for trading business model.

Therefore, if the FV-OCI category is included in the final version of IFRS 9, we recommend eliminating the phrase “*maximise return*” from the aforesaid example and making it clear that sales of financial assets under this category are aligned with the business model of managing an entity’s usual liquidity needs, interest rate risk, and portfolio returns.

Finally, if the FV-OCI category is incorporated into the final version of IFRS 9, the implementation guidance on the reclassification due to a change in business model in B4.4.1 should be amended to include examples of the hold to collect and

sell business model. In the same context, paragraph B4.1.6 should be modified so that the business model where a portfolio is managed and its performance is evaluated on a fair value basis does include the business model to which FV-OCI category can be applied.

Interaction between the FV-OCI Category and Credit Impairment

If the FV-OCI category is incorporated into the final version of IFRS 9, the Board should evaluate the interaction between debt instruments that would be measured at FV-OCI under the Proposal and how credit losses would be measured and recognised on such instruments under its proposed credit impairment standard. The application of the IASB's proposed credit impairment standard, which is intended to capture expected cash shortfalls inherent in an instrument's amortised cost, to debt instruments that are measured at fair value on the balance sheet raises some conceptual and operational questions. The fair value measurement invariably reflects market participants' views of credit risk (including expected cash shortfalls) while the impairment treatment reflects management's views of credit risk. Differences between those views on credit risk would affect the amount of any unrealised gain or loss remaining in accumulated OCI so interpreting the amount remaining in accumulated OCI could be challenging.

Business Model Assessment – Amortised Cost

The Exposure Draft provides that certain types of sales would not be inconsistent with a hold to collect business model as long as such sales are either infrequent (even if significant) or insignificant, both individually and in the aggregate (even if frequent). Without further clarification, the Proposal could lead to diversity in application of the standard and hamper efforts by financial statement users, auditors, and regulators to objectively evaluate the hold to collect business model, including sales that are individually insignificant but that occur frequently. The final standard should therefore clarify what measure of time and level of significance should be used to assess whether sales are consistent with a hold to collect business model.

Business Model Assessment – Amortised Cost – Implementation Guidance

Example 4 in B4.1.4 introduces the concept of sales prompted by a *stress case scenario* and/or an entity's regulator. The Exposure Draft suggests that significant sales of financial assets to meet liquidity needs that result from a *stress case scenario* (for example, run on a bank's deposits) are not inconsistent with a hold to collect business model if the entity did not intend to sell such assets outside of that scenario. As there is no principle underpinning the term *stress case scenario*, and what may constitute a stress case scenario for one entity may not for another entity, there may be inconsistent or incorrect application of the standard in practice.

We recommend that the IASB incorporate aspects of the existing guidance in IAS 39 for the types of sales permitted from the held to maturity category such as isolated/rare, nonrecurring, and unusual events into the discussion of the types of sales permitted within a hold to collect business model, an example of which could be a run on a bank's deposits triggered by a systemic event.

In addition, the frequency and magnitude of sales prompted by regulatory requirements are of keen interest to the international banking industry. Therefore,

we recommend that the IASB modify Example 4 in B4.1.4 so it is more consistent with the “access to market” test in the Committee’s revised international liquidity standard issued in January 2013.² This will be critical so institutions can appropriately draw the distinction between “*frequent*” and “*insignificant*” sales permitted under the Proposal (as described in B4.1.3) and the requirement in the Committee’s liquidity standard to “*periodically monetise a representative proportion of the assets*” in the liquidity buffer.

Where securities are available for liquidity needs, the final standard should illustrate whether and how an entity would be permitted to segregate portions of its investment portfolio held for liquidity purposes between assets held for usual liquidity management (for example, satisfying periodic/ongoing cash flow needs), which assets would not qualify for amortised cost, and assets held solely for liquidity that is needed to sustain rare, infrequent, and unusual circumstances (for example, a regional or global financial crisis), which assets could qualify for amortised cost.

Further clarification is needed regarding the monetisation of financial assets through outright sales versus securities financing transactions. The final standard should explicitly clarify that a financial asset that meets the cash flow characteristics criterion and that is subject to a transfer/repurchase transaction accounted for as a secured borrowing (versus a sale) could be classified and measured at amortised cost. The final standard also, should clarify whether the duration of the repurchase transaction is relevant to a financial asset’s classification and measurement.

Cash Flow Characteristics Assessment – Overall

We support the Board’s proposal to clarify the cash flow characteristics criterion in a way that does not automatically disqualify instruments with insignificant leverage from being measured outside of FV-P&L without interfering with the IASB’s original intent of the criterion. However, a grey area still exists between the ultimate objective of the Board (to preclude financial assets with one or more leverage features to be measured outside of FV-P&L) and the cash flow characteristics assessment as it is currently drafted. In particular, the proposed revisions to the cash flow characteristics assessment do not address concerns that certain traditional lending instruments appear to fail the solely principal and interest criteria (which the Committee raised when IFRS 9 was originally proposed) as well as complexity concerns.

Accordingly, we urge the Board to conduct further field-testing of the cash flow characteristics assessment prior to finalising IFRS 9 to ensure that the model is faithful to the overall economics of a debt instrument and operational in order to minimise the effect of unintended consequences. Additionally, there are implementation issues that we foresee with the proposed cash flow characteristics guidance, which are discussed in more detail below. These matters should be addressed prior to the issuance of the final standard.

² www.bis.org/publ/bcbs238.pdf

Cash Flow Characteristics Assessment – Frequency

The Proposal still leaves it unclear as to whether the cash flow characteristics assessment is only performed at initial recognition or whether a continuous assessment is required to determine the appropriate classification of a financial asset. The final standard should explicitly state that this assessment is only performed at inception.

Cash Flow Characteristics Assessment – Benchmark Instrument

The introduction of the concept of a benchmark instrument for purposes of evaluating modified economic relationships creates additional complexity, which is counter to the Committee's guiding principles for replacing IAS 39, and therefore, warrants clarification. First, the definition of a *benchmark instrument* is not defined clearly within the principles or the implementation guidance. Since the term *benchmark instrument* is being created for accounting purposes to determine the classification and measurement of a financial asset it should be defined so that it can be implemented consistently by entities within various jurisdictions around the world. The lack of clarity in the Proposal arises from the fact that variability in the cash flows associated with financial assets that involve a modified economic relationship arises from both the interest index and its interest rate reset frequency. The Committee believes that the IASB's intent for how a *benchmark instrument* should be defined is that it is a financial asset that has (or would have) all of the same terms of the financial asset being evaluated except that the tenor of the interest rate index of the benchmark instrument would match the reset frequency of the actual instrument's interest rate. For example, if the actual instrument resets monthly to three-month LIBOR the benchmark instrument would reset monthly to one-month LIBOR. The final standard should clarify that this is the case.

Second, it's not clear how a benchmark instrument would be defined for markets in which the interest rate terms (including formula-based interest rates) of all interest-bearing debt instruments of a certain type (e.g., floating-rate bank loans, time deposits, etc.) are established by regulation. For instance, a regulated interest rate may be based on the mean between 3-month LIBOR and the inflation rate in a particular jurisdiction. The Committee believes that, in this case, because all of the instruments' interest rate terms are uniform across issuers, the actual instrument would be eligible as a benchmark on the basis that the interest rate yields the time value of money and the credit risk that would be considered by all market participants in the specific market.

Third, it is unclear whether the significance of leverage terms associated with a financial asset, as described in B4.1.9, should be evaluated relative to the instrument or the reporting entity's financial condition or performance. If the evaluation of significance is to be performed based on the instrument, it is unclear whether this should be done based on the instrument's carrying amount or its yield. This should be clarified in the final standard with conforming changes to the Basis for Conclusions. Also, it is unclear whether the assessment of modified economic relationships between principal and interest using a *benchmark instrument* must be quantitative or qualitative, and if quantitative, how that assessment would be done. The Exposure Draft requires an entity to consider reasonably possible scenarios in conducting the assessment, which suggests a quantitative assessment would always be required.

Lastly, the Exposure Draft does not address application of the cash flow characteristics assessment to perpetual debt instruments whose terms require or permit deferral of the contractual interest payments upon certain contingent credit-related events such as a downgrade in the issuer's credit rating and where deferred interest payments do not accrue interest during the deferral period. As perpetual debt instruments are increasingly more common for regulated financial institutions in some jurisdictions, this issue should be addressed in the final standard with an example that indicates whether they are eligible for measurement either at FV-OCI or amortised cost.

Fair Value Option

If the FV-OCI category is incorporated into the final version of IFRS 9, we agree with the Board's decision to permit entities to apply the fair value option to debt instruments that otherwise would be classified and measured at FV-OCI if doing so would significantly reduce or eliminate an accounting mismatch. In addition we support the requirement for entities to revoke fair value option elections made under previous versions of IFRS 9 if an accounting mismatch no longer exists as a result of adopting the new guidance.

Changes in Own Credit

We agree with the Board's decision to present in OCI fair value gains/losses attributable to changes in the credit risk of financial liabilities that are designated as measured at FV-P&L without otherwise changing the classification and measurement of financial instruments. This approach addresses the counterintuitive income statement results from measuring an entity's own issued liabilities at fair value on a recurring basis in a pragmatic and decision useful manner. We also recommend that the IASB explicitly clarify in the final standard that entities are permitted to early adopt this aspect of IFRS 9 even if they continue to apply IAS 39 to all other aspects of the accounting for financial instruments prior to the mandatory transition period for IFRS 9. It may be appropriate, for practical reasons, for the IASB to include an option for entities to recognise changes in the credit risk associated with liabilities for which the fair value option was elected as a limited amendment to IAS 39 prior to finalising IFRS 9.

Additionally, the Committee urges the IASB to consider extending the application of the guidance on changes in the credit risk of all other liabilities measured at fair value on a recurring basis (e.g., derivatives, short sales, and trading liabilities). Applying this guidance to other liabilities would improve financial reporting because it would result in consistent recognition of changes in own credit risk associated with all liabilities measured at fair value on a recurring basis. Also, this recognition approach would improve the relevance of an entity's financial performance as it would eliminate volatility in earnings associated with changes in an entity's own credit risk (which rarely is realised).