Basel Committee
on Banking Supervision

Centralbahnplatz 2
CH-4002 Basel, Switzerland
Tel: +41 61 280 8080
email@bis.org · www.bis.org

Via email: commentletters@ifrs.org

28 January 2022

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

Subject: IASB Request for Information on the Post-implementation Review of IFRS 9 – Classification and Measurement

Dear Mr Barckow

The Basel Committee on Banking Supervision (the Committee) welcomes the opportunity to comment on the International Accounting Standards Board's (IASB's) request for information on the Post-implementation Review of IFRS 9 *Financial Instruments – Classification and Measurement*.

The Committee has a strong interest in promoting high quality financial reporting by banks and strongly believes that the IASB's review of IFRS 9 is an important step to support the further development of high-quality accounting standards. Financial information that is relevant and faithfully represents the substance of transactions or other events helps to promote the safety and soundness of the financial system.

The Committee considers that, by and large, the classification and measurement requirements in IFRS 9 allow banking transactions to be accounted for in a robust manner, consistent with user information needs. The application of the "solely payments of principal and interest on the principal amount outstanding" (SPPI) criteria provides useful information about the amount, timing and uncertainty of future cash flows, and represents a sound basis for the classification assessment. However, challenges in applying some requirements on how to assess the business model give rise to unwarranted diversity in practice in some jurisdictions. This letter sets out those challenges and some points the IASB might consider. The Committee will assess future IASB proposals in response to this consultation, including how any proposed changes may interact with the regulatory framework. Our comments are explained in more detail in the Annex.

We provide detailed technical comments in relation to changes in business model, however this does not imply that the topic should necessarily be prioritised over those identified in our response[1]

[1] www.bis.org/bcbs/commentletters/iasb55.pdf

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to the IASB's Third Agenda Consultation, including in regard to the treatment of climate-related financial risks.

This letter has been prepared by the Committee's Accounting and Audit Expert Group, chaired by Katherine Tilghman Hill, Vice President, Federal Reserve Bank of New York. If you have any questions regarding these comments, please contact Joanne Marsden at the Basel Committee Secretariat (+41 76 350 8541).

Yours sincerely

Pablo Hernández de Cos

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Annex: Comments on the IASB's Request for Information – Post-implementation Review of IFRS 9 – Classification and Measurement

Question 2 - business model for managing financial assets

1. The Committee finds that the principles defined for the classification of financial assets are clear and allow for a sound differentiation of whether financial assets should be measured at amortised cost, fair value through other comprehensive income or at fair value through profit or loss. While the principles are sound, some jurisdictions reported difficulties in the application that arise from some parts of the more prescriptive guidance provided by IFRS 9. Therefore, the Committee invites the IASB to consider if some existing guidance may lead to outcomes that are not consistent with the underlying principles. We believe that the underlying principles should be maintained.
2. In particular, a partially ambiguous differentiation between the "held to collect" and the "held to collect and sell" business models can lead to inconsistent outcomes. The assessment of sales out of the held to collect business model that are "*infrequent*" or "*insignificant in value*" requires a high degree of judgment. These criteria are most adequate to differentiate the "held to collect" from the "held to sell" business model, but some jurisdictions have observed that these are less appropriate to differentiate the "held to collect" from the "held to collect and sell" model. It is noted that IFRS 9.B4.1.4B speaks of a "*greater frequency and value of sales*", but the objectives of collecting cashflows and selling are both considered integral to the business model. This overlap and ambiguity makes it difficult to assess whether there was a change in the business model justifying the need for an accounting reclassification.
3. In the development of IFRS 9, the IASB did not define the terms "infrequent" and "insignificant", but given that the principles delineating "held to collect" and "held to collect and sell" are not mutually exclusive, the outcome critically depends on how entities define "infrequent" or "insignificant" in their accounting policies.
4. Some entities may not establish robust internal criteria, and define their accounting policies whenever sales occur. Other entities use widely varying quantitative criteria leading to hardly comparable outcomes or apply definitions of "infrequent" and "insignificant" broad enough to allow for a volume of sales in the "held to collect" model which other entities apply for the "held to collect and sell" model.
5. Given the risk of opportunistic sales or reclassifications, the Committee believes that the following could be considered by the IASB:
   (a) While IFRS 9.B4.1.3B clarifies that several sales transactions need to be considered in aggregate to determine insignificance, a single sale is admissible irrespective of its size, as the standard speaks of infrequent sales "even if significant in value". This appears to be in conflict with the underlying principle as a single transaction is enough to dispose of a whole portfolio. It could be clarified that a holistic assessment of both insignificant and infrequent sales is warranted.
   (b) IFRS 9.B4.1.3B is unclear about the time horizon of the assessment, eg whether the assessment should also include sales in previous periods or sales expected in the future. While a bright line like the three-year horizon previously used by IAS 39 may be too

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prescriptive, a clarification that a (holistic) assessment of significance and frequency should consider sales along the average duration of the instruments in a portfolio may be considered by the IASB.

(c) It may also be useful to add indicators for sales that are not in line with the held to collect objective, in particular sales with the objective of meeting earnings expectations or capital targets. This could complement the indicators in B4.1.3B and B4.1.4 on circumstances which are in line with the collection objective, for example sales close to maturity or sales motivated by credit risk.

6. Some jurisdictions observed difficulties resulting from the way the criteria *infrequent* or *insignificant* are embedded in the standard. These criteria are backward-looking by nature (sales already occurred), while the business model assessment is forward-looking (information about past sales and expectations about future sales provide evidence related to how the entity's stated objective for managing the financial assets is achieved). The accounting consequences of the occurrence of more than infrequent or insignificant sales within the collection model remain ambiguous. The standard is clear that an entity needs to consider how cash flows were realised in the past when it assesses the business model for newly originated or acquired assets. It is also clear that an entity does not have an error in its past accounting simply because actual realisations were different from expectations. However, it is less clear on the extent to which transactions that contradicted previous intentions shall be considered in relation to the prospective assessment of the business model of the remaining assets.

7. The IASB might consider providing more principle-based guidance on how to incorporate past sales in the assessment of the held to collect business model for the remaining assets. The guidance could stress the quality of evidence that results from actual sales and the quality of evidence that speaks for the collection objective. As actual sales usually constitute robust and objective evidence for changed intentions, the IASB could consider whether an entity must produce equally robust and objective counterevidence to maintain the collection objective. When the actual behaviour was different in the past, merely subjective intentions laid down in a management memorandum with little other convincing evidence should not be sufficiently credible to support a collection model.

8. Some entities transfer individual instruments or portfolios between different business lines that pertain to different accounting models, not least for the purpose of saving costs that would arise from external transactions. IFRS 9 B4.4.3 is clear that such transfers do not necessarily change the business model – and therefore do not trigger reclassification in accordance with paragraph 4.4.1. However, following a more principle-based approach, a significant number of transfers to business lines with inconsistent objectives should also prompt reconsideration of the business model for newly originated or acquired financial assets. This is because such transfers may provide similarly objective evidence to that provided by a sale transaction.

9. The IASB should consider providing more guidance or illustrative examples regarding the level of evidence expected to document a change in business models, with particular attention to financial institutions. Such evidence could include objective indicators like changes in the risk management systems, changes in a formally approved risk appetite framework and changes in remuneration policies (eg changes from rewarding fixed income and credit risk towards rewarding total return). For regulated financial institutions, such objective evidence could include examples such as an active deliberation in supervisory reviews or legal updates of the required authorisations. Consistent application might be further improved by adding a

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counter-indicator. Reactive strategies like refraining from sales when market activity drops may speak against a change in the business model.

10. While the Committee does not intend that banks classify more instruments at fair value in general, it would welcome more comparability as a prerequisite to effective prudential supervision. In addition, it is important that the understanding of financial institutions' business models is consistent and robust for both prudential supervision and financial reporting.

Question 3 – contractual cash flow characteristics

11. The Committee believes the SPPI assessment provides a sound basis to identify financial assets that should be measured at amortised cost or fair value through other comprehensive income (OCI). This concept should be maintained with, at best, only minor clarifications.
12. A potentially important issue that banks may be actively considering is the treatment of "green loans" with variable payments linked to specific climate-related targets. The IASB may wish to clarify the application of the standard to ensure that issuers of such instruments have adequate principles and/or guidance to apply the requirements given these new features. Such clarification may be by means of interpretations or educational material, after further elaboration. IFRS 9.B4.1.18, among other paragraphs, already provides some criteria for variable cash flows which are consistent with the SPPI notion.
13. The Committee believes that the IASB should not consider climate-related financial risks in the area of classification in isolation, given these risks could impact the measurement of assets and liabilities, for example the determination of expected credit losses when the SPPI test is satisfied, or the application of fair value models. The Committee invites the IASB to consider the issue in a holistic way, including considering information needs related to measurement. Isolated and far-reaching changes limited to the classification framework may have unexpected impacts on the measurement.
14. The Committee is generally satisfied with the consistency of application of the SPPI assessment. However, a specific area that might benefit from further clarifications is the guidance on contractually linked instruments; these are characterised by tranches resulting from a prioritisation of contractual payments (IFRS 9.B4.1.20). Further guidance or illustrative examples on what constitutes a tranche when assessing SPPI for contractually linked instruments with more complex structures could increase consistency of practices among preparers.
15. The Committee is not aware of unexpected effects arising from the SPPI assessment.

Question 5 – financial liabilities and own credit

16. The Committee supports the current model to recognise profits or losses induced by an issuer's own credit risk in OCI. However, limiting this treatment to liabilities that are voluntarily carried at fair value, excluding instruments that must be carried at fair value, is conceptually inconsistent. Financial institutions have implemented system solutions to measure debit valuation adjustments for all fair valued instruments, so separating own credit risk components would not create undue operational burdens.

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17. The Committee recommends that the IASB considers extending the application of the guidance on changes in the credit risk to all liabilities measured at fair value on a recurring basis.

Question 6 – modifications to contractual cash flows

18. The absence of a definition of "substantial modification" and of derecognition thresholds for financial assets in IFRS 9 may result in different applications of the modification and derecognition requirements for financial assets, particularly in case of forbearance measures implemented to maximise expected cash flows.

19. To determine whether a modification of an asset results in derecognition, entities following IAS 8.11 may use the indicator defined for financial liabilities by analogy, namely whether the modification reduces the present value of the cashflows by at least 10%. However, the valuation of financial assets already incorporates expected credit losses, which is different to liabilities. If an expected loss has already been captured in the loan loss allowance, a forbearance measure that reduces the debt burden for expected losses would not be substantial enough to justify a derecognition, especially if the risk profile of the instrument has not been changed.

20. There may be other entities that do not rely on the 10% reduction of the present value, but assess whether the modification has commercial substance, ie it is granted in order to retain the customer (as opposed to a modification granted for credit reasons, namely to provide financial relief to the borrower). These entities look mainly at qualitative characteristics. Such an approach provides more useful information as it focuses on the economic characteristics beyond reduced present values. Therefore, IFRS 9 may benefit from more guidance on when a modification of a financial asset results in its derecognition based on qualitative characteristics, notably the liquidity and market risk and return profile. At the same time, the standard should clearly specify that the application of the modification rather than the derecognition regime disregards the reasons for which changes to contractual terms have been granted (see BC5.231–BC5.235). Regarding financial liabilities, paragraph B3.3.6 establishes a quantitative test of 10% in order to assess whether terms are substantially different. Consistent with our suggestion for financial assets, the derecognition assessment may benefit from the inclusion of qualitative analysis.

21. The Committee also observed some diversity in practice on how modification gains and losses are presented in the statement of comprehensive income, including the treatment as positive or negative components of impairment expense, and as components of interest income and other income. The Committee would welcome a clarification and prefers a presentation outside both impairment expense and interest income for better transparency.