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E-MAIL

EACB Comments on IFRS 9

Dear Mr. Dekker,

The European Association of Co-operative Banks (EACB) appreciates the cooperation with EFRAG and in particular the dialogue we had on IFRS 9 during the EACB WG Audit and Accounting Meetings on 5 June and on 18 October 2012. We would like to reiterate the main concerns of cooperative banks with regards to IFRS 9:

- While we consider the introduction of a new third financial instrument category for debt instruments measured at fair value through other comprehensive income (FVOCI) as an improvement, we would like to make sure it will not reduce the scope of the category amortised cost. We think that the category amortised cost is for instance an appropriate category for the "stable" part of the liquidity reserve, i.e. assets which are held to collect cash flows but are eligible to repurchase agreement in case of liquidity stress. The third category should be an option rather than being compulsory.

- It would be important to take into account prudential impacts of the category FVOCI in IFRS 9. We support the amendments of the European Parliament to the CRR regarding the filtering of OCI for sovereign debt instruments (Art 30 CRR, ANNEX I), that would permit that unrealized gains and losses shall remain under provisions at least in the period between the implementation of the CRR and IFRS 9. Therefore unrealized gains and losses on debt instruments classified in the category FVOCI would not be included in own funds.

- Under the amendment to IFRS 9 with regard to the contractual cash flow characteristics it is required that an entity needs to consider, if the cash flows on the financial assets are consistent with the principal and interest, only criterion in case of modifications of the relation between interest and credit risk. As long as such modifications reflect changes in the time value of money and the credit risk of the instrument which lead to insignificant changes this would not preclude an amortised cost categorisation. This needs to be assessed by comparing the modified instrument with a benchmark instrument. It seems to be unreasonable to carry out such a test for each individual loan. Furthermore the insignificance criterion must not be understood in a narrow sense in order not to force such instruments to be measured at fair value. The construction of benchmark instruments will in most cases create significant operational efforts. It should be clarified that some modifications (e.g. tenor of the interest rate mismatches, retail loans,...) meet the principal and interest criterion.

- In addition our French members are still concerned about the definition of contractual cash flow characteristics allowing amortised cost accounting according to Paragraph 4.1.2.b of IFRS 9:

    - For a variable interest rate loan with a fixing different than the maturity of the index, the solution to compare with a benchmark instrument as proposed by the board is cumbersome and it will be quite difficult to implement. The market practice on variable mortgage loans in some Member States uses a very common type of mismatch (mismatch inferior to 1 year ; the most common is a 3 months rate with a yearly fixing) and we would find completely inappropriate to account these type of loans at fair value.

  - We also have an issue with the accounting treatment of some instruments with state-regulated interest rates (Livret A in France) that could not be classified as „basic loan" and measured at amortised cost due to the cash flow characteristics which are considered as basic regarding the restrictive definition of IFRS 9. Fair value option would not be a solution. We consider that the IASB should create a narrow scope exception for instruments with state-regulated loans, whenever these instruments are held in order to collect their cash flows and with a scope not limited to regulated jurisdictions. Please see ANNEX II for further explanation.

  - Lastly, we are also concerned about the accounting of bonds denominated in euro including a remuneration for the inflation of a specific country and not for the euro zone. A lot a government bonds include this feature in France (indexed on the French inflation for bonds denominated in euros). We would like to make sure that they are eligible to amortised cost under IFRS 9.

- From our point of view it is important to develop principle based accounting standards. Having said that we want to stress that we do not support any bright lines regarding the transfer of instruments from bucket 1 to bucket 2 in the context of impairment. We understand that the FASB is in favour of including bright lines, and therefore we do not support any convergence on this basis.

- Regarding the impairment model, simplified solution such as practical expedient should be developed for smaller banks which apply the standardized approach for credit risk and aren't likely to have developed internal credit risk assessment systems based on an expected loss concept.

- When taking into account the accounting treatment of instruments with "bail-in" clauses from an investors perspective we fear that the scope of the category amortised cost could have unintended consequences on the funding capability of banks. The accounting options for an investor can only be either Fair value through profit or loss or Fair value through OCI without recycling.

- Furthermore, we have the following comments on paragraph B6.5.5 of the Draft of the forthcoming IFRS on IFRS 9 Phase 3 General Hedge Accounting:

- The last sentence which prevents from imputing "*a charge for exchanging different currencies for a cross-currency interest rate swap*" in the hypothetical derivative is not consistent with valuation methodologies. The concept of "hypothetical derivative" should refer to a derivative contract that exist or could exist on capital markets providing it perfectly matches the characteristics of the hedged item. It does not seem economically sound to prohibit the incorporation of key valuation inputs from the modelling (such as the effect of a basis swap for a cross currency interest rate swap). This provision may cause ineffectiveness and significant volatility of the profit or loss resulting from economically perfect hedge relationships.

  Moreover, the last sentence implies (taking into account the foregoing text) that a charge for exchanging different currencies for a cross-currency interest rate swap (i.e. cross currency basis spread) is a feature that does not exist in the item

hedged by this swap. This is more than questionable considering the fact that the charge for exchanging different currencies is usually being taken into account by the banks when setting the interest rates for foreign currency denominated loans whose risks are hedged using the cross currency swaps. Consequently, the purchaser and the seller of the loans on the secondary market will include the cross currency basis spread in loan pricing.
In order to avoid unintended consequences or over-interpretation, we recommend that the Board removes this example from the application guidance B.6.5.5.

- We also recommend to delete the sentence *"Consequently, a 'hypothetical derivative' cannot be used to include features in the value of the hedged item that only exist in the hedging instrument (but not in the hedged item)"*. Indeed, it could lead to :

  - Modifications on the way classical Cash Flow Hedge (CFH) effectiveness tests are set up (using hypothetical derivatives). Modifying all the CFH relations already implemented will create costs and take time.

  - Unintended consequences on partial term hedging: indeed, a lot of entities apply IG F.2.17 of IAS 39 "partial term hedging": in order to do so, the effectiveness test is often done using a "hypothetical" bond with a principal payment due at year 5. If we "cannot include features in the value of the hedged item that only exist in the hedging instrument", we cannot consider the principal payment to be due at year 5, but only to be due at year 10…which will create huge ineffectiveness.

- It is important to us, that the current practice of macro hedging can be maintained on the long run. In particular, the choice of endorsement will not have to influence on our risk and accounting practices.

- Finally, we reckon that the on going macro hedging discussions relating to open portfolios should not only be focused on the macro fair value hedge but should also deal with macro cash flow hedge as hedges of open portfolios introduce complexity to the accounting for such hedges whatever the types of hedging relationship.

Should you have any questions, we would be happy to clarify the issues more precisely.

Yours sincerely,

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ANNEX I

Amendment to Article 30 of CRR voted on 14th May by the European Parliament Economic and Monetary Affairs Committee

Article 30
Cash flow hedges and changes in the value of own liabilities

Institutions shall not include the following items in any element of own funds:

(a) the fair value reserves related to gains or losses on cash flow hedges of financial instruments that are not valued at fair value, including projected cash flows;

(b) gains or losses on liabilities of the institution that are valued at fair value that result from changes in the own credit standing of the institution.

(ba) unrealised gains or losses on asset items constituting claims on Zone A central governments measured at fair value.

Until the review of the IFRS due to eliminate the available for sale category, EBA shall draft technical standards to specify the conditions according to which point (ba) shall apply.

EBA shall develop draft regulatory technical standards to specify the conditions according to which letter ba) shall apply.

EBA shall submit those draft regulatory technical standards to the Commission by 1 January 2013.

Power is delegated to the Commission to adopt the regulatory technical standards referred to in the first subparagraph in accordance with the procedure laid down in Articles 10 to 14 of Regulation (EU) No 1093/2010.

ANNEX II

To put the issue "accounting treatment of some instruments with state-regulated interest rates" expressed above into context, we need to explain the origin of **Livret A**. The French Government needed funds to finance the social sector of the economy. The Government organised the funding through deposits collected by banks networks, and retroceded to "Caisse des depots et Consignation" (CDC), in charge of managing the money for the Government. All the conditions related to those deposits (maximum amount, rate, interest calculation..) is regulated by Law. The Banks receive a commission for their role as intermediary.

In substance, the 'Livret A' package consists in medium or long term resources that are collected by French banks on behalf the French Government in order to fund social housing. The related remuneration is managed at the French Government discretion so that it remains attractive for the saver, considering the passage of time and the inflation index over the period (reflecting the time value of money in a manner consistent with the concept in IFRS 9), but also other arbitrary parameters, including tax incentives.

The rate formula of the "livret A" is fixed twice a year, and refers to Eonia, 3 months Euribor and inflation, but results in a rate which is then:

- Rounded to the nearest figure "0.25" (this means that we can only have a rate x,00%, x,25%, x,50% or x,75%);
- Capped and floored so that the variation between the current rate and the previous rate reset cannot be more than 1.5 point.
- Finally, the French State can modify the rate obtained through the above formula, if it considers it necessary.

Even if this rate formula does not meet all IFRS 9 requirements for the purpose of classification and measurement at amortised cost, it would not make sense to recognize the "Livret A" package at fair value:

- Actually, the financial assets are held in order to collect contractual cash flows ;
- The contractual terms of the financial asset give rise on specified dates to cash flows that are […] payments of principal and interest on the principal amount outstanding.
- Furthermore, the "Livret A" package cannot be traded ; there is not any *"price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants"* according to IFRS 13. Therefore, fair value cannot be reliably measured and amortised cost is the sole valuation technique that could be retained.

We consider, as mentioned in the staff paper *"Agenda paper 6B – 15 October 2012 Sweep issue – regulated interest rates",* **that the IASB should create a narrow scope exception for instruments with state-regulated loans**, **whenever** these instruments are **held** in order **to collect** their cash flows (held to collect business model).

However, the scope exception should not be limited to regulated jurisdictions, as it seems to be recommended by the staff in paragraph 14 of the staff paper, **to instruments having a "*base interest rate*** *[…] consistent with and required by a stated interest rate structure that is set by the government or central bank* ***and that***

represents the legal pricing basis for domestic currency transactions available in the jurisdiction", **and excluding therefore instruments existing in *"jurisdictions,*** *[where]* ***other products and a broader market is available in the relevant currency that is based on interest rates that reflect the time value of money in a manner consistent with the concept in IFRS 9".***

Indeed, in our view, whatever the rest of the market in the jurisdiction**, state-regulated instruments are always marketed in separate / special status / subcategory of general markets.**