



David Schraa
Regulatory Counsel

May 15, 2013

Ms. Leslie Seidman
Chairman
File Reference No. 2012-260
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

1333 H Street, NW, Suite 800E
Washington, DC 20005-4770

TELEPHONE 202.857.3600
FAX 202.775.1430
WEB iif.com

Dear Ms. Seidman:

The IIF Senior Accounting Group (SAG) welcomes the opportunity to comment on the FASB *Exposure Draft (ED) Financial instruments – Overall (Subtopic 825-10)*. We commented on the IASB *Exposure Draft 2012/4: Financial Instruments: Classification and Measurement; Limited Amendments to IFRS 9* on April 3, 2013. We attach to the present letter the comment letter we submitted to the IASB as Appendix A, and the IASB is being sent a copy of this letter. We request that the FASB and the IASB read both letters together, targeting convergence as a priority.

Our responses to questions requiring specific comments on the FASB ED are included in Appendix B; below we highlight central concerns.

The IIF SAG considers the ED as a constructive proposal, potentially furthering convergence with IFRS and providing better alignment with the direction of the Insurance Contracts joint project. We believe that the proposal is a step forward toward convergence on classification and measurement of financial instruments; however, despite good intentions and directional orientation, there remain serious reservations that need to be overcome.

We are concerned that the new proposal would force portfolios that, as a business matter, are traditional banking portfolios and not trading portfolios to be accounted at Fair Value through Profit and Loss (FVPL). This change, which would not reflect business reality, may arise either because of the Solely Payment of Principal and Interest (SPPI) test, which on its face appears to allow substantially fewer instruments to be accounted for at amortized cost than the bifurcation criteria under current U.S. GAAP, or because the definition of business models is not always aligned with the way assets and liabilities are managed.

In addition, we urge both Boards to reconsider the proposed use of business models in the standards to improve the translation into accounting of business realities and to avoid creation of an “accounting concept” that would not be consistent with economic business models or business models as understood intuitively or for other purposes. We therefore suggest additional consideration of the classification attributes of financial assets and the articulation of the concept of business models.

Furthermore, there is substantial concern that “Hold-To-Collect” (HTC) would not be available for many positions that historically would have been held on such a basis. A requirement to account for any loans at fair value in the balance sheet only because there is a small chance of selling them at some point would not reflect an economic HTC business model. In an economic HTC business model, assets are occasionally sold for reasons of risk management policy, and not because the entity manages the portfolio to optimize its position; the question is not the sales or the frequency of sales but the *reason* for the sales. The reasons for sales are not explicitly referenced in either proposal. It should be relatively straightforward to permit possible occasional sales for risk management or other reasons characteristic of accrual portfolios, which will contrast clearly with the sales patterns in non-HTC portfolios.

In practice, the HTC category seems likely to be narrower than expected. For example, if a bank intends to securitize loans, keeping some and selling some after an accumulation period, then according to our understanding, the entire portfolio would quite likely have to be classified in Fair Value through Other Comprehensive Income (FVOCI) category, although the retained loans would be intended to be held on a HTC basis. This result is particularly concerning given that post-crisis regulatory requirements to retain “skin in the game” will require retaining some portion of most securitization transactions. At a time when many in the public sector are looking for ways to facilitate securitization because of the substantial increase of financing capacity that it can represent, it would be paradoxical if a technical accounting requirement should cut against this need by not permitting HTC treatment for retained positions that are clearly intended to be “held to collect” as a business matter.

The industry’s analysis of the present portfolios is that the characteristics of financial instruments predominate in the decision criteria for classification and measurement instead of how assets, often together with liabilities, are managed to derive value. The SPPI test, as it is presented, is too restrictive compared to the existing bifurcation criteria.

The conditions of the proposed test, requiring both similar reset date and interest rate for the benchmark, would disqualify loans without any leverage but which are designed either to meet public policy requirements, protect consumers, or to facilitate banks’ processes. As a result, many “vanilla” assets would end up being required to be carried at FVPL, despite the business model they are managed within, which would not maximize decision-useful information to investors. This is, for example, true for certain resettable loans on a quarterly basis using a one-month LIBOR rate. Furthermore, any product with any contingent feature would be disqualified however remote the contingency. This is especially important for new capital instruments (cocos) that have conversion features that would be triggered only in the contingency of a firm’s sharp deterioration in solvency, which by definition would be highly unlikely at the time of issuance of such instruments. Although the pricing reflects the contingency, the instruments are intended to be available to buy-and hold investors that may be discouraged if held-to-collect treatment is not permissible.

The IIF therefore urges both Boards to reconsider the SPPI criteria as applied to such instruments (because of the effects of contingency or because of mismatch of rates) and whether the criteria can be applied without such instruments’ ending up systematically in FVPL, contrary to their appropriate business treatment and understanding.

Furthermore, the complexity and interpretative challenges of the SPPI proposal raise a more fundamental question of whether SPPI is an appropriate solution. There is substantial concern that

the proposal may be more complex, more difficult to interpret and apply, and yield less accurate presentation of business realities than the present approach. Moreover, the SPPI test is likely either to require guidance that will quickly become quite complex, or, if such guidance is not supplied officially, will lead to auditors' guidelines of equal complexity and perhaps even more rigidity. The flexibility behind the original, judgment-based concepts that led to development of SPPI seem to have been lost, with the results that the benefits it seemed to promise are in danger of being lost as well.

A further problem is that members are concerned that the relatively minor embedded features that would cause an asset to fail the SPPI test are much less likely to be caught (or are more likely to be the subject of a dispute) than the analysis of more significant embedded derivatives for the bifurcation test. Thus the proposal, if implemented as it now stands, threatens much greater restatement risk (if whole classes of loans had to be restated from amortized cost to FVPL) than the risk of reclassification of specific instruments under the current rules if any misstatement occurs. Moreover as the fair value of the entire asset is obviously more substantial than the fair value of the embedded feature, the amount of the restatement would be significantly material and so would the transitional effect. Given the arbitrary nature of the classifications that would likely result from SPPI as it now stands, such reclassifications would serve no purpose of improving investors' understanding but would, of course, cause needless cost, and would serve to undermine the credibility of financial reporting.

If the two Boards are not able to devise criteria (whether in revision of SPPI or otherwise) that are easier to understand and to implement than the current bifurcation criteria and, as a consequence, reduce complexity, then the Industry would rather ask that both Boards simply revert to the bifurcation approach. We understand that such might not be a satisfactory result given the efforts made in this area. But the industry is rapidly coming to the conclusion that the bifurcation approach may be the more pragmatic solution. Similarly, the proposal's approach to business model has become complex to implement and distanced from an intuitive understanding of the business model concept. It appears increasingly likely that a cost-benefit would lead to the conclusion that the proposal will pose both transitional and ongoing challenges of interpretation and implementation and would not appreciably increase benefits to users, especially if the problem of undue exclusion of many instruments is not resolved.

Convergence.

Whatever the decision might be, we do want to reiterate that we urge both Boards to agree on a single proposal: the worst scenario for the industry would be to have to cope with two different worlds and to implement two different sets of rules that will only share complexity but not principles.¹

While much can be said about convergence, it is important to focus on the divergence that will remain if both proposals (including IFRS 9 -2010) are not reconsidered. Two types of concerns emerge from the discussion:

¹ We further note that the EFRAG comment letter to the IASB on the Limited Amendments to IFRS9, which would envision use of SPPI with a fallback to bifurcation, is even less appropriate and could only lead to further complexity and danger of confusion.

- a) differences of language not reflecting differences of high level accounting principles;
and
- b) divergence in principle or in substance.

Differences of language not reflecting differences of high level accounting principles

A number of relatively minor wording differences are noticeable. Some do not call into question high level accounting standards but are troubling because they add unnecessary complexity or obscurity. Differences of language or articulation add confusion because all respondents try first to assess if the language betrays any difference in principles or required application (preparers inevitably must question why differences in language exist). If there are differences, international groups that prepare accounts under U.S. GAAP and under IFRS (or are required to do so for certain operations) would be obliged to follow two separate processes despite similar principles. More broadly, differences in language are of concern because they could lead to different assumptions and different accounting treatments of similar assets or transactions across jurisdictions. We urge the Boards when reviewing both standards to eliminate whenever possible non-essential divergences in order to avoid confusion and additional complexity for users and preparers alike.

Divergence in principle or in substance

Three issues require particular attention:

- a) Fair Value Option (FVO) for liabilities
- b) Equity investments
- c) Disclosure on fair value

Fair Value Option for liabilities

The unconditional FVO (for financial instruments within the scope of the proposed guidance) in existing U.S. GAAP is proposed to be eliminated. Instead, in the future, the option would be allowed to be applied for two reasons (a) because of an embedded derivative under certain conditions, and (b) where assets and liabilities are managed together in a trading portfolio². These requirements are similar to IFRS 9 4.2.2 (b) and IFRS 9 4.3.5. Furthermore, characteristics of financial instruments that are allowed to use the FVO are similar. However IFRS 9³ also allows the FVO to eliminate any significant mismatch between assets and liabilities. The FVO is applied for

² **825-30-15-2**All entities may apply the **fair value** option to a group of financial assets and financial liabilities for which both of the following conditions are met:

- a. The entity manages the net exposure relating to the financial assets and financial liabilities (which may be **derivative instruments** subject to Topic 815) on a fair value basis.
- b. The entity provides information on a net exposure basis to its management.

825-30-15-3All entities may apply the fair value option to a hybrid financial liability provided that neither of the following conditions exists:

- a. The embedded derivative or derivatives do not significantly modify the cash flows that otherwise would be required by the contract.
- b. It is clear with little or no analysis when a similar hybrid instrument is first considered that separation of the embedded derivative or derivatives is prohibited.

³**4.2.2 (a)** eliminates or significantly reduces a measurement or recognition inconsistency (sometimes referred to as “an accounting mismatch” that would otherwise arise from measuring assets or liabilities or recognizing the gains and losses on them on different bases.

structured debt when bifurcation is either complex or not permitted under IAS 39, or hedge accounting is difficult to achieve because the embedded derivatives are multiple or complex. Furthermore, because of the accounting mismatch criteria in current IFRSs and the unrestricted FVO in U.S. GAAP, some use the FVO to avoid the complexity of hedge accounting for non-structured own debt issued.

It is clear that full convergence on the FVO would be in the interest of all concerned. We urge the FASB to add the third reason allowed by the IASB i.e. to allow the use of the FVO to eliminate any significant mismatch between assets and liabilities. If not, convergence on acceptable reasons for use of FVO should be achieved at the very least, and the Boards should clearly state the reasons for any differences in their final rules and explain whether and to what extent practice is intended to be different between the two standards.

We support the Boards' decision to account for the own credit risk element of the fair value movement for liabilities using FVO in OCI as we think that it is a significant improvement to current accounting.

We also support allowing own credit risk to be recycled in income upon settlement of the liability instead of being transferred within equity. We have urged the IASB to follow the FASB on this topic.

Equity investments

Both Boards require equity investments to be accounted for at fair value. However, the FASB Proposal provides a practical exception **for measuring equity investments without readily determinable fair values** that do not qualify for the practical expedient in paragraph 820-10-35-59 of the FASB Proposal (that is, the net asset value per share expedient) and a one-step impairment model for all equity investments, subject to the practicability exception. Despite the hope that the final result will be similar to the IASB proposal⁴, we urge both Boards to align their final standards to the FASB position with the practical expedient.

In addition, the IASB offers an option for particular equity investments to be classified at FVOCI. We generally support the IASB proposal that entities should be permitted to present in OCI changes in fair value of particular investments in equity instruments.

However, we also think that an entity should be required to recognize in earnings any realized gains or losses upon derecognition of equity investments even if the entity elected the FVOCI option, and to account for any impairment in earnings.

We would like to highlight the important issue that the proposals may result in unintended consequences from the proposed accounting treatment for equity investments, both in the FASB's proposal (because it only authorizes FVPL) and in the IASB's proposal (because realized gains or losses are not accounted for in Profit and Loss). Both may lead to changes in business investment

⁴ IFRS 9- B5.4.14 - All investments in equity instruments and contracts on those instruments must be measured at fair value. However, in limited circumstances, cost may be an appropriate estimate of fair value. That may be the case if insufficient more recent information is available to determine fair value or if there is a wide range of possible fair value measurements and cost represents the best estimate within that range.

IFRS 9- B5.4.15 defines the conditions where cost is not appropriate.

behavior for participants in the equity markets; that is, the accounting treatment could drive investment behavior for firms that are significant long-term investors in the equity markets.

In short, we urge the Boards to align their proposals.


Disclosure on fair value

The FASB proposal requires fair value disclosure to be presented parenthetically for items measured at amortized cost on the face of the statement of financial position. We do not think that such presentation would be more useful than the footnotes that are already published in the financial statements. On the contrary, parenthetical presentation will clutter the primary statement and is likely to cause confusion as to what is the most relevant and important disclosure, raise needless issues of comparisons across firms (given HTC business models) if fair-value parenthetical information varies from firm to firm for similar assets, and increase equally needless debate about level 2 and level 3 valuations, which will inevitably constitute the bulk of the parenthetical valuations in most cases.

Given existing fair value disclosure requirements, there is already information available about the hierarchy of fair values used and the proposed parenthetical disclosure would add nothing to that disclosure. If the aim is more timely reporting of fair values of amortized cost categories, this can better be addressed through interim reporting requirements. Beyond that, and more basically, there are extensive changes of disclosure coming up, including the conceptual framework projects of both boards and, for banks, extensive new disclosures that are likely to be adopted at the behest of the FSB in most major markets pursuant to the recommendations of the Enhanced Disclosure Task Force, and specific disclosures to be promulgated by the Basel Committee with respect to issues such as liquidity, risk weights (probably including extensive valuation information that will overlap with the valuation information contemplated by the proposal), and other matters, not to mention a comprehensive review of Pillar III of the Basel Accord. IOSCO is reviewing a number of disclosure issues as well.

Given all these potential disclosures, and the need to keep them reasonably aligned in order to avoid conflicts, superfluities, and duplications, we suggest the Board reserve the disclosure point until a comprehensive review is possible. At that point, consistency with IFRS disclosures as well as all the other bodies of disclosure will be of primary importance in order to avoid confusion and information overload in the market.

Very truly yours,



CC: Mr. Hans Hoogervorst, Chairman, IASB

Appendix A

IIF Letter to the IASB on *Exposure Draft 2012/4 (ED): Financial Instruments: Classification and Measurement; Limited Amendments to IFRS 9*, April 3, 2013. (Attached.)

Appendix B

Questions posed in FASB *Exposure Draft Financial instruments – Overall (Subtopic 825-10)*.

Only questions that are subject to a response are listed below.

Question 1: *Do you agree with the scope of financial instruments included in this proposed Update? If not, which other financial instruments should be included or excluded from the guidance in this proposed Update and why?*

Yes, we agree with the scope of financial instruments covered by the Exposure Draft.

Question 2: *Do you agree with the industry-specific specialized guidance scope exceptions in paragraph 825-10-15-9? If not, why? What would you propose instead?*

We note that certain specialized industry guidance would be retained including, for example, guidance for brokers and dealers where proprietary trading securities would continue to be measured at fair value. We agree with this; however we are also of the view that the proposals, would result in the same recognition and measurement conclusions and there may be opportunities further to simplify the codification.

Question 4: *Do the proposed amendments appropriately convey the principle associated with the contractual cash flow characteristics assessment? If not, why? What would you propose instead?*

Certain vanilla products appear to be excluded by the mechanics of the current proposal. The “vanilla products” we have in mind include instruments such as adjustable rate mortgages (ARMs), pre-payable securities purchased at a discount, and credit card receivables; other examples are likely to exist or in the future and similar issues have been identified in other countries. See the IIF SAG’s letter to the IASB on its parallel proposal, attached as Appendix A.

For example, ARMs reset to a variable rate that often may be based on an index that does not have an associated tenor (e.g., a bank’s Prime Rate), or a rate that resets on a different frequency than the index. In that case, the SPPI test criteria would not be satisfied because it requires a benchmark with an existing tenor and a perfect matching of reset date. We do not think that such differences should disqualify such products. Such differences do not create leverage to the extent that FVPL would become the most appropriate category to measure such loans.

As another example, pre-payable securities purchased at a discount may fail to pass the prepayment guidance if the discount is considered more than reasonable additional compensation for the early termination of the contract. The notion of “reasonable additional compensation” should be evaluated in a more flexible and qualitative way to avoid penalizing transactions in such securities arbitrarily.

Certain credit card receivables have features related to airline points or similar bonus inducements for the underlying obligors. Such features do not change the character of the underlying assets, but could, if an excessively literal reading is taken, raise issues under the SPPI test.

In each of these cases, the resulting exclusion from HTC or FVOCI would not reflect either the characteristics of the instruments or the way they are in fact managed; thus, the arbitrary line-drawing would detract from, rather than enhance, accurate understanding by users. If the two Boards are not able to devise criteria (whether in revision of SPPI or otherwise) that are easier to understand and to implement than the current bifurcation criteria and, as a consequence, reduce complexity, then the Industry would rather ask that both Boards simply revert to the bifurcation approach. The industry is rapidly coming to the conclusion that the bifurcation approach may be the more pragmatic solution. It appears increasingly likely that a cost-benefit would lead to the conclusion that the proposal will pose both transitional and ongoing challenges of interpretation and implementation and would not appreciably increase benefits to users, especially if the problem of undue exclusion of many instruments is not resolved.

Question 5: *The proposed amendments **define principal as the amount transferred by the holder at initial recognition.** Should the definition of principal be expanded to include repayment of the principal amount at maturity or other settlement? If so, what instruments would fail (or pass) the contractual cash flow characteristics criterion as a result of this change?*

IFRS 9 does not define “principal.” For securities that are bought with a premium or debt issued under nominal value, we are concerned that the definition of principal should clearly not exclude them from the amortized cost category. The definition should at least allow including such customary market transactions in amortized cost. We are not sure how BC101⁵ of the FASB proposal should be read.

Furthermore it is unclear whether the definition might exclude credit cards, because the definition does not reflect how credit-card cash flows work.

As a matter of convergence, we do not think that a definition is needed and we urge the FASB to follow the IASB and to avoid imposing a definition of principal. It will be difficult for accountants to communicate with business and operations people, as well as financial statement users, if they are required to employ this commonly used term differently than would normally be understood by these constituencies.

Question 6: *Do the proposed amendments contain sufficient application guidance and illustrations on implementing the cash flow characteristics assessment? If not, why?*

⁵ BC101. A principal amount is a critical distinguishing characteristic of a debt instrument. Thus, to satisfy the characteristics of the instrument criterion, the FASB had decided that an amount must be transferred to the debtor (issuer) at inception that will be returned to the creditor (investor) at maturity or other settlement. That amount adjusted by any discount or premium at acquisition would be the principal amount of the contract.

The requirement of assessment of cash-flow characteristics would be necessary for instruments with any degree of complexity, possibly on an instrument by instrument basis. This assessment would need to identify a reliable (or determine a hypothetical) benchmark. The practicability of such assessment is highly questionable, especially in certain markets, where the hypothetical instrument could not legally exist, and would have to be constructed with reference to existing instruments, adjusted such that credit quality was aligned. A reason why multiple assessments may be required is that, even if loans with the same terms can be assessed together, their date of issuance could affect the cash flows resulting from a mismatch feature and could therefore change the result of the test, so monthly or even daily testing could be required in some cases.

The test would be more operational if only a qualitative assessment were required, such as describing the features of an asset and documenting the lack of leverage.

A somewhat related issue concerns instruments that are subject to possible but remote or unlikely conditions of conversion or suspension of payment of interest. Under FASB proposal, the *probability* of such an event's occurring, and consequent possible economic effects are not considered in applying the solely payments of principal and interest (SPPI) test, assuming the contractual term constitutes a cash-flow characteristic that is very unlikely to occur. This is an excessively stringent test in light of the practical concerns set out below, or one that could be interpreted so narrowly as to make it almost irrelevant.

We believe that the SPPI test should be amended to require or permit additional consideration of whether terms of conversion or suspension of payment are materially likely to affect the actual receipt of interest that is to be expected to be received. If an instrument that otherwise has the basic principal and interest characteristics of debt includes involuntary conversion or suspension provisions that are highly unlikely to be triggered at the time of recognition, then the inclusion of such conditions in the terms of the instrument should not disqualify it under the SPPI test. (This issue is extensively discussed in our parallel letter to the IASB.)

Question 7: Should a financial asset with a contractual term that modifies the economic relationship (see paragraphs 825-10-55-17 through 55-20) between principal and interest be considered to contain cash flows that are solely payments of principal and interest? Should this be the case if, and only if, the contractual cash flows could or could not be more than insignificantly different from the benchmark cash flows as discussed in paragraph 825-10-55-19? If not, why? What would you propose instead?

The Board should consider modifying the definition of interest to ensure classification that provides decision-useful information by facilitating inclusion in a HTC business model, hence reflecting the characteristics of the way that such assets are managed and funded. The benchmark, if needed, could refer to the market where such products are widely sold. Such an approach is likely to be more efficient than making product-specific exceptions. Furthermore, the Board should also consider how the significant operational and audit burdens for preparers that would arise from the proposals as currently drafted might be alleviated.

For example, the Board could consider amending the proposed approach to capture:

- Products that are widely offered in a particular market and compensated by interest but for which it is not possible to construct a meaningful hypothetical benchmark, because of the structure of the market.
- Products of which essential characteristics are defined by law or regulation rather than market forces. This is particularly an issue for consumer products with regulation for consumer protection or market regulation. Such protection would not be expected to introduce leverage.
- Products with no additional leverage linked to specific non-principal and interest features.

Question 8: *Do the proposed amendments contain sufficient application guidance in paragraphs 825-10-55-17 through 55-20 on assessing a modified economic relationship? If not, why?*

See answer to question 7.

Question 9: *For beneficial interests in securitized financial assets, the proposed amendments would require an entity to look through to the underlying pool of instruments in determining whether the tranche contains payments of solely principal and interest. Do you agree with this look-through approach? If not, why? What would you propose instead?*

We are however concerned about the complexity of the requirements and think that most securitized financial assets will end up at FVPL because of the cost of such a requirement. Moreover, provision of information on underlying assets is or will soon be subject to new prudential and market regulatory requirements that will determine the extent to which look-through is available. Such requirements are expected to recognize limitations on look-through that are expected to be maintained for third-party transactions, where specific information may be proprietary or sensitive for the original issuer. For many transactions, due diligence on a portfolio basis, including for underwriting and servicing procedures, will be sufficient. Given the extensive regulation of this field being imposed by other authorities, there is little reason for accounting standards to duplicate such requirements, perhaps on an inconsistent basis. In any case, the due diligence procedures required for collecting assets for a given type of securitization are likely under all foreseeable circumstances to indicate whether a tranche contains payments solely of principal and interest, rendering the proposal both out of phase with other requirements and unnecessarily complex and detailed.

Question 10: *Do the proposed amendments appropriately convey the principle associated with the business model assessment? If not, why? What would you propose instead?*

Definition of the business-model concept is especially important in light of other disclosure mandates that firms encounter. While the business-model concept could contribute to the overall quality of financial reporting and related disclosures if appropriately defined, the present proposal may actually detract from the ability to present and disclose decision useful information to investors in the context of the actual economic business models that firms have (as opposed to accounting constructs). A business model definition should include, pursuant to Enhanced Disclosure Task Force (EDTF) recommendations (five to eight) on ***Risk governance and risk management strategies/business model***, “***a clear and explicit account of how value is created by firms***”.

We believe that a firm should be able to translate that concept into its financial reporting. Business models should be articulated in such a way as to be clearly understood by users and therefore need to be translated consistently in accounting, regulatory and financial reporting as a whole. Certainly a narrow “business-model” concept used essentially in a technical sense relating only to accounting for financial assets and not to the actual conduct of business would not help overall understanding and clarity. Therefore, attention needs to be given to making the concept more reflective of actual economic business models. If this is not possible, then, consideration should be given to using another term for accounting purposes, such as “measurement model”, if the accounting definition of the concept remains at odds with the more intuitive concept of “economic business models” used in broader disclosures.

Question 11: *Do the proposed amendments provide sufficient application guidance and illustrations on how to distinguish among the three business models, including determining whether the business model is to manage assets both to collect contractual cash flows and to sell? Do you agree with the proposed guidance provided to describe those business models? If not, why?*

There is a serious concern that the proposal results in a HTC category that is essentially limited for practical reasons to loans and receivables held to maturity, while nevertheless requiring a relatively complex business-model analysis. This does not correspond to the business reality of business lines conducted on what can be called a “hold-to-collect” basis, which in actual fact needs to meet various management and risk-management imperatives, while still conforming to an overall HTC objective. Furthermore, as noted at the beginning of this letter, there is an issue of how to relate what, without significant clarification, would be a very technical, accounting-specific concept of “business model” to the broader business-model disclosures firms need to do for other purposes. Thus, the business-model criterion needs to be very clear and representative of how business is expected to operate in practice. Otherwise a business-model analysis would be unnecessary, and in some ways result in misleading or confusing information for investors. In addition, if the practical effect is that only loans and receivables are captured in the HTC category, then this could be more easily achieved by amending the classification criteria of existing U.S. GAAP.

In many cases, the allocation of assets held vs. assets to be securitized takes place only sometime after the origination of specific assets, as adequate pools must be built up before the decision to package or retain them can be made. In addition, recent regulatory “skin in the game” requirements will often require firms to retain a portion of securitized instruments. Therefore, it would be reasonable to interpret section 4.1 of the ED to allow the amortized cost classification for holdings of assets where portions may be retained or securitized after origination; any subsequent sale that achieves derecognition would be expected to be “infrequent”. This is notwithstanding Example 3 in IFRS 9 B4.1.4, which assumes that the entire portfolio is sold, albeit within the group. The deviation between the IASB proposal and the FASB proposal on this point is troubling because FASB paragraph 825-10-25-25 seems to require placing assets as to which a hold-or-securitize determination has not been made in FVOCI. This does not provide decision-useful information because, once the allocation is made, the assets retained are clearly held on a hold-to-collect basis.

We urge the FASB to amend its proposal to ensure amortized cost is required for loans which are retained. We do of course urge the IASB to take the same position. If the final standards

remain divergent, then it will be incumbent upon both Boards to explain clearly the points of difference and the reasons therefore.

Although both Boards make it clear that the tainting rules are no longer relevant, the IIF SAG is concerned that the guidance in both proposals describing the conditions as to when sales are allowed in the amortized cost category may be read as if those rules continue to exist, de facto if not de jure, unless there is further explanation.⁶

We note that sales are permitted if the credit quality of an individual financial asset has deteriorated such that it no longer meets the entity's documented investment policy (paragraph 825-10-55-32⁷). Furthermore according to paragraph 825-10-55-31⁸, it appears that managing credit concentration would not be consistent with a HTC business model. We do think that firms should be permitted to act on their own credit determinations (including risk concentrations), subject to documentation of their strategy. Classification in the HTC category should not be at the expense of being able to operate effective risk management. Analysis for this purpose would be akin to, but not necessarily the same as, analysis of credit deterioration for expected-loss determinations for provisioning purposes.

In many cases, assets are not managed instrument by instrument but on a portfolio basis. Specific portfolios often match assets and liabilities by maturity and interest rate at a defined level of interest margin. Under such conditions, changes in the liability structure of a given portfolio – caused, for example, by customer withdrawals – have to be replicated on the asset side to maintain the balance. Though this may predictably require assets to be sold, the original objective – namely to generate contractual cash flows – remains the same. Sales are not a way to optimize the earnings but just a way to maintain a stable interest rate margin. This is in no way at odds with the objectives of an amortised cost business model, because the firm's intention in holding the portfolio continues to be to collect contractual cash flows, not to realise fair value changes in the near term.

⁶IFRS 9 - B4.1.3: *In determining whether cash flows are expected to be collected from contractual cash flows, the level of sales activity, as well as the reason for any sales, must be considered. Although the objective of an entity's business model may be to hold financial assets in order to collect contractual cash flows, the entity need not hold all of those instruments until maturity.*

⁷ **825-10-55-32** Sales that result from reasons other than managing credit exposure should be very infrequent. For example, sales that result from the following events or circumstances would not be inconsistent with the objective of amortized cost classification (because the events would occur very infrequently):

- a. A change in tax law that eliminates or reduces the tax-exempt status of interest on debt instruments
- b. A major business combination or major disposition that results in an entity's reassessment of its business model and subsequent realignment of the assets managed within that business model
- c. A change in statutory or regulatory requirements that significantly modifies either what constitutes a permissible investment or the maximum level of investments in certain kinds of debt instruments
- d. A significant increase by a regulator in the industry's capital requirements that causes the entity to sell financial assets to meet regulatory requirements
- e. A significant increase in the risk weights of debt instruments used for regulatory risk-based capital purposes.

Sales that result from events other than a significant deterioration in the issuer's creditworthiness that are isolated, nonrecurring, unusual for the entity, and result from events that could not have been reasonably anticipated would not be inconsistent with the objective of amortized cost classification. Similarly, sales of financial assets that occur close to the maturity of the financial assets and the proceeds from those sales that approximate the collection of the remaining contractual cash flows would not be inconsistent with the objective of amortized cost classification.

⁸ **825-10-55-31** As part of the business activity for managing financial assets for collection of contractual cash flows, an entity would focus on managing the credit risk of the assets to maximize the collection of contractual cash flows. Sales of financial assets as a result of a significant deterioration in the issuer's creditworthiness would not be inconsistent with the objective of amortized cost classification if the purpose of those sales is to maximize the collection of contractual cash flows through sales rather than through cash collection. However, sales of financial assets that result from managing the credit exposure because of concentrations of credit risk would not be consistent with the objective of amortized cost classification.

Clarity is also required in situations where sales (or repos) may take place only or principally to meet regulators' requirements. Given the impact and significance of the Basel III liquidity rules, compliance with such requirements does not reflect business decisions that should affect an economic business-model analysis. Therefore the final standard should be revised in such a way as to make it clear that the criteria on frequency and the like do not exclude financial instruments that would otherwise qualify for amortized cost by reason of transactions mandated by regulators, for example, to prove that certain assets are capable of being sold if needed and are therefore appropriate for use in liquidity portfolios

Some are concerned that the upshot of the present proposal – with a narrow interpretation of permissible sales⁹ as described in Example 4 in paragraphs B4.1.4 and paragraph 825-10-55-32 to paragraph 825-10-55-34¹⁰ would be that the Industry would need to separate portfolios of similar instruments that would normally as a business matter be managed together for liquidity purposes, in order to meet accounting requirements. Dividing liquidity portfolios in order to meet both regulatory and accounting requirements would mean creating an artificial pool of instruments to be used for regulatory-mandated sales and another pool of the same instruments held for essentially the same business and regulatory purposes. This artificial separation would of course not reflect the business model, and would result in unnecessary administrative and systems complexity. Such an approach to achieve a particular accounting result is not consistent with high quality accounting standards.

Question 12: *Should the classification and measurement model for financial instruments contain an explicit tainting notion or should it rely on the principle and exercise of professional judgment? Why?*

The tainting notion does not reflect any economic business model. As explained in answer to question 11, there are many circumstances under which sales are not inconsistent with a HTC business model. Therefore, if the business-model concept is to have any relationship to the actual economics of the business or to the business models of firms as they are understood for other purposes, it will be necessary to rely on the principle and the exercise of professional judgment by preparers and auditors.

Question 13: *The proposed amendments would require loan commitments, a revolving line of credit, or a commercial letter of credit (the potential creditor) to be measured on the basis of the **likelihood of exercise of the commitment and the classification of the underlying loan that would be made upon exercise of the commitment**. Do you agree with the proposed classification of loan commitments? If not, why? What would you propose instead?*

⁹IFRS 9 - B4.1.4 - Example 4: ...In contrast, if an entity holds financial assets to meet its everyday liquidity needs and that involves recurring and significant sales activity, the objective of the entity's business model is not to hold the financial assets to collect contractual cash flows. Similarly, if the entity is required by its regulator to routinely sell significant volumes of financial assets to demonstrate that the assets are liquid, the entity's business model is not to hold financial assets to collect contractual cash flows. The fact that the requirement to sell the financial assets is imposed by a third party rather than being at the discretion of the entity is not relevant to the analysis.

¹⁰FASB - 825-10-55-34: Certain regulatory requirements for managing some types of exposures would only entail sales of financial assets in accordance with paragraph 825-10-55-32(c) through (e). Those business activities may entail holding portfolios of highly liquid securities (that are held for collection of contractual cash flows) that are only used to comply with regulatory requirements that affect the Industry (rather than the entity). That business activity would be consistent with the primary objective of a held-to-collect business model. For example, if a regulator directs a particular financial institution (rather than all institutions supervised by the regulator) to sell or transfer debt instruments classified at amortized cost, those sales and transfers are inconsistent with paragraph 825-10-55-32(c), which describes a change in regulations applicable to all entities that are affected by the legislation or regulator enacting the change. However, circumstances that cause a regulator to direct an institution to sell securities possibly could be considered an event that is isolated, nonrecurring, and unusual such that it could not have been reasonably anticipated at acquisition of the assets and would not be inconsistent with the primary objective of a held-to-collect business model.

We support the notion that the measurement of a loan commitment should follow the accounting for the funded loan. We believe this requirement would result in classification of a loan commitment according to the way the loan commitment is managed and will generally reduce complexity. However, we remain concerned about the implications of the Proposed Update to loan commitments that are remote of funding held in a business model that is other than a hold-to-collect strategy.

Question 15: *The proposed amendments would eliminate the unconditional fair value option (for financial instruments within the scope of this proposed guidance) in existing U.S. GAAP and, instead, permit an entity to elect to measure at fair value, with all changes in fair value recognized in net income, all of the following:*

a. A group of financial assets and financial liabilities if the entity both:

1. Manages the net exposure relating to those financial assets and financial liabilities (which may be derivative instruments) on a fair value basis

2. Provides information on that basis to the reporting entity's management.

b. Hybrid financial liabilities that meet certain prescribed criteria.

c. Financial assets that meet the contractual cash flow characteristics criterion and are managed within a business model that has the objective of both holding financial assets to collect contractual cash flows and selling financial assets (in accordance with paragraph 825-10-25-25(b)).

Do these options provide decision-useful information? If not, why?

We agree that the Fair Value Option should be available for financial assets that would otherwise be measured at fair value through OCI. We urge both Boards to align their final decisions on the Fair Value Option.

Question 16: *Should financial liabilities subsequently be measured at amortized cost, unless certain exceptions are met? If not, why?*

Yes. However, we believe that a Fair Value Option should be retained.

Question 17: *The proposed amendments would require a nonrecourse financial liability that is settled with only the cash flows from the related financial assets (see paragraph 825-10-35-11) to be measured on the same basis as those assets. Do you agree with the proposed amendments? If not, why? What would you propose instead?*

In this particular case, IFRS and U.S. GAAP will yield similar outcomes. However because the rule will be mandatory under the FASB proposal while preparers would have the right to use the FVO under IFRS, the disclosure would differ because of the obligation to disclose the reason for the use of the FVO. It is such divergences that we urge the two Boards to avoid even if the outcome is similar because divergence of language or explanation is likely to add unnecessary confusion and complexity.

We would prefer that the FASB introduce the same mismatch criterion as IASB for using the FVO and delete these requirements. The outcome would be similar but comparability across entities would be facilitated.

If the FASB decides to retain the requirement, it would be essential for it to clarify the circumstances in which the requirement would arise and to explain to the market the reasons for differing disclosure requirements.

Question 18: *The proposed amendments would require financial assets measured at amortized cost that are subsequently identified for sale to continue to be classified and measured at amortized cost less impairment and would prohibit recognition of the gain, until the sale is complete. Do you agree with the proposed classification and measurement requirements? If not, why?*

We do not understand the need for such a requirement nor do we understand how such a case would work without undermining the classification of the portfolio to which the asset belongs. If necessary, a footnote indicating the fair value of the asset would be more helpful than a separate line.

If the FASB decides to retain the requirement, it would be essential for it to clarify the circumstances in which the requirement would arise. A fully converged, common answer with the IASB to the problem would be highly desirable.

Question 19: *The proposed amendments would provide a **practicability exception for measuring equity investments without readily determinable fair values** that do not qualify for the practical expedient in paragraph 820-10-35-59 (that is, the net asset value per share expedient) and a one-step impairment model for all equity investments subject to the practicability exception. Do you agree with the proposed amendments? If not, why?*

Both Boards require equity investments to be accounted for at fair value. However, the FASB Proposal provides a practical exception **for measuring equity investments without readily determinable fair values** that do not qualify for the practical expedient in paragraph 820-10-35-59 of the FASB Proposal (that is, the net asset value per share expedient) and a one-step impairment model for all equity investments, subject to the practicability exception. Despite the hope that the final result will be similar to the IASB proposal¹¹, we urge both Boards to align their final standards to the FASB position with the practical expedient.

Question 20: *Should an entity evaluate the need for a valuation allowance on a deferred tax asset related to a debt instrument measured at fair value with qualifying changes in fair value recognized in other comprehensive income separately from the other deferred tax assets of the entity (rather than combined and analyzed together)? If not, why?*

No. We believe that an entity should not separately evaluate the need for a valuation allowance on a deferred tax asset related to a debt instrument measured at FVOCI from the other deferred tax assets of the entity because it should be determined on the same basis (or method) as the way the entity determines its valuation allowance when determining its tax obligations in each relevant jurisdiction it files its tax returns. Banks determine their deferred tax valuation allowances at the tax jurisdictional level, which we believe best reflects the tax consequences.

¹¹ IFRS 9- B5.4.14 - All investments in equity instruments and contracts on those instruments must be measured at fair value. However, in limited circumstances, cost may be an appropriate estimate of fair value. That may be the case if insufficient more recent information is available to determine fair value or if there is a wide range of possible fair value measurements and cost represents the best estimate within that range.

IFRS 9- B5.4.15 defines the conditions where cost is not appropriate.

Question 21: *Under the amendments in this proposed Update, hybrid financial assets would not be required to be analyzed for bifurcation under Subtopic 815-15 and would be assessed in their entirety on the basis of the proposed classification requirements. In contrast, hybrid financial liabilities would be assessed for bifurcation and separate accounting under Subtopic 815-15, and the financial liability host contract would be subject to the proposed amendments. Do you agree with this proposal? If not, why? What would you propose instead?*

On the asset side. The conditions of the proposed test requiring both similar reset date and interest rate for the benchmark would disqualify loans without any leverage but which are designed either to further public policy, protect consumers or to facilitate banks processes. As a result, many “vanilla” assets would end up being at FVPL despite the business model they are managed within, which would not maximize decision useful information to investors. This is, for example, true for certain resettable loans on a quarterly basis using a one month LIBOR rate: typically, those instruments would never have been bifurcated under current standards.

If the two Boards are not able to devise criteria (whether in revision of SPPI or otherwise) that are easier to understand and to implement than the current bifurcation criteria and, as a consequence, reduce complexity, then, as stated above, the Industry would rather ask that both Boards simply revert to the bifurcation approach. The industry is rapidly coming to the conclusion that the bifurcation approach may be the more pragmatic solution. It appears increasingly likely that a cost-benefit would lead to the conclusion that the proposal will pose both transitional and ongoing challenges of interpretation and implementation and would not appreciably increase benefits to users.

On the liability side. We agree generally with the proposal. However, we think that full convergence on the FVO should be sought. The unconditional FVO (for financial instruments within the scope of the proposed guidance) in existing U.S. GAAP is proposed to be eliminated. Instead, in the future, the option would be allowed to be applied for two reasons (a) because of an embedded derivative under certain conditions, and (b) where assets and liabilities are managed together in a trading portfolio¹². These requirements are similar to IFRS 9 4.2.2 (b) and IFRS 9 4.3.5. Furthermore, characteristics of financial instruments that are allowed to use the FVO are similar. However IFRS 9¹³ also allows the FVO to eliminate any significant mismatch between assets and liabilities. The FVO is applied for structured debt when bifurcation is either complex or not permitted under IAS 39, or hedge accounting is difficult to achieve because the embedded derivatives are multiple or complex. Furthermore, because of the accounting mismatch criteria in current IFRSs and the unrestricted FVO in U.S. GAAP, some use the FVO to avoid the complexity of hedge accounting for non-structured own debt issued.

¹² **825-30-15-2**All entities may apply the **fair value** option to a group of financial assets and financial liabilities for which both of the following conditions are met:

- a. The entity manages the net exposure relating to the financial assets and financial liabilities (which may be **derivative instruments** subject to Topic 815) on a fair value basis.
- b. The entity provides information on a net exposure basis to its management.

825-30-15-3All entities may apply the fair value option to a hybrid financial liability provided that neither of the following conditions exists:

- a. The embedded derivative or derivatives do not significantly modify the cash flows that otherwise would be required by the contract.
- b. It is clear with little or no analysis when a similar hybrid instrument is first considered that separation of the embedded derivative or derivatives is prohibited.

¹³ **4.2.2 (a)** eliminates or significantly reduces a measurement or recognition inconsistency (sometimes referred to as “an accounting mismatch” that would otherwise arise from measuring assets or liabilities or recognizing the gains and losses on them on different bases.

It is clear that full convergence on the FVO would be in the interest of all concerned. We urge the FASB to add the third reason allowed by the IASB i.e. to allow the use of the FVO to eliminate any significant mismatch between assets and liabilities. If not, convergence on acceptable reasons for use of FVO should be achieved at the very least, and the Boards should clearly state the reasons for any differences in their final rules and explain whether and to what extent practice is intended to be different between the two standards.

Question 22: *The proposed amendments would require reclassification of financial assets when a change in business model occurs and prescribes how those changes should be subsequently accounted for. Do you agree with the proposed amendment on reclassifications? If not, why?*

We are concerned with the use of the business model concept in the proposal. It is unclear what a reclassification means and on what level should a change of business model be assessed. As explained extensively in this comment letter, depending on the reasons for sales, the mere possibility of eventual sales should not call into question the classification and measurement of a portfolio. If the intent is a true change of business model in the intuitive sense (e.g. a firm decides to discontinue a line of business or enters a new asset class on a new basis), then the proposal makes sense, but this needs to be clarified if such is the intent.

Question 23: *The proposed amendments would require public entities to **parenthetically present fair value for items measured at amortized cost on the face of the statement of financial position**. Does that presentation requirement provide decision-useful information? If not, why? What would you propose instead?*

The FASB proposal requires the fair value disclosure to be presented parenthetically for items measured at amortized cost on the face of the statement of financial position. We do not think that such presentations would be more useful than the footnotes that are already published in the financial statement. On the contrary, parenthetical presentation is likely to cause confusion as to what is the most relevant and important disclosure.

For additional discussion of this topic, see the main text.

Question 25: *The proposed amendments would require an entity to separately present changes in fair value attributable to changes in instrument-specific credit risk in other comprehensive income for financial liabilities for which that entity has elected the fair value option. Would the proposed presentation requirement provide decision-useful information? If not, why? What would you propose instead?*

We support the Boards' decision to account for the own credit risk part of liabilities using Fair Value Option in OCI as we think that it is a significant improvement to current accounting. We also support that the decision that own credit risk would be recycled in Profit and Loss upon settlement of the liability instead of being transferred within equity. We have urged the IASB to follow the FASB on this topic.

Question 26: *The proposed amendments would require an entity to separately recognize in net income changes in fair value attributable to foreign currency gain or loss on foreign-currency-denominated debt securities measured at fair value through other comprehensive income (see paragraphs 825-10-45-14 through 45-15). Is the proposed fair-value-based method provided for computing the foreign currency gain or loss component operable? If not, why? What would you propose instead?*

We are concerned that the FASB methodology would not be equivalent to the IASB methodology. Requirements affecting foreign currency are always significant for general ledger implementations. It is of high importance to follow one single process to avoid reconciliation processes for internationally active entities that would otherwise have to operate on a confusing and inefficient double-GAAP basis.

The Boards' agreement on a single methodology would be highly beneficial to preparers and users alike.

Question 27: *The proposed amendments would require a public entity to provide **disclosure of the core deposit liability balance, implied weighted-average maturity period, and the estimated all-in-cost-to-service rate by significant type of core deposit liability.** Do you agree with the proposed disclosure requirement and, if so, how would you use that information? If not, what information should be provided and why? Is it appropriate not to require this information for nonpublic entities?*

The IIF Working Group on Liquidity is concerned about such a requirement for many reasons. First the definition of core deposits as described in the proposal is not in line with Basel III proposal which has a broader view of core deposit. Second, disclosure in footnotes isolated from other liquidity requirements and not in line with Basel III will add confusion and will not provide useful information for users. The Group is also concerned that these disclosure will interfere with other disclosure on liquidity risk and be misinterpreted by users.

The Group urges the FASB to postpone its proposal until regulatory disclosure on liquidity are implemented.

Question 31: *Should the effective date be the same for both public entities and nonpublic entities?*

Yes

Question 32: *How much time is needed to implement the proposed guidance?*

We believe at least two years and more likely three years would be required.

Question 33: *Are the transition provisions in this proposed Update operable? If not, why?*

The provisions will need to be readdressed once the proposal has been deliberated and the impact of the impairment proposal considered.

Question 34: *The proposed amendments would require investments that qualify for the equity method of accounting in Subtopic 323-10, Investments—Equity Method and Joint Ventures—Overall, to be subsequently measured at fair value with changes in fair value recognized in net income if the investment is held for sale at initial recognition. Are the proposed indicators/conditions operable? If not, why? What would you propose instead?*

No. We believe that this method of measurement should only be applied to equity method investments for which it is the entity's intent to sell the investment; i.e., considered to be "Held For Sale". We do not agree with the proposed language "available for exit" as this would capture many investments for which fair value through net income accounting would not be representative of the long term nature of many equity method investments.

Question 35: *The proposed amendments would change the current two-step impairment model for equity method investments to a one-step impairment model for all equity investments. Do you agree with the proposed one-step equity impairment model? If not, why? What would you propose instead?*

Once again, it is important for both Boards to review their positions on equity investments to reassure the industry that they will come up with common principles either on impairment or classification and measurement. Consequently we ask the Boards to align their positions. We believe that the existing guidance at ASC 323-10-35-31-32A should be retained. A loss in value of an investment that is other than a temporary decline should be required to be recognized. A current fair value of an investment that is less than its carrying amount may be the first indicator (step one) that an equity method investment has a loss in value of the investment, however we believe that all factors should be evaluated in determining the second step as to whether the loss is other than temporary before any write down is required.

David Schraa
Regulatory Counsel



April 3, 2013

Mr. Hans Hoogervorst
Chairman
International Accounting Standards Board
30 Cannon Street
EC4M 6XH London
United Kingdom

1333 H Street, NW, Suite 800E
Washington, DC 20005-4770

TELEPHONE 202.857.3600
FAX 202.775.1430
WEB iif.com

ED/2012/4

RE: Classification and measurement: Limited Amendments to IFRS 9

Dear Mr. Hoogervorst:

The Institute of International Finance Senior Accounting Group (SAG) appreciates the opportunity to comment on the IASB *Exposure Draft 2012/4 (ED): Financial Instruments: Classification and Measurement; Limited Amendments to IFRS 9*. We will comment separately on the FASB *Exposure Draft Financial instruments – Overall (Subtopic 825-10)*. However, the IASB and FASB proposals will inevitably be read together now, and once finalized and implemented; it is therefore important to consider the implications of the one for the other and to identify any conflicts or ambiguities that might arise from perceived or actual differences. We also note that, as we undertake further analysis of the FASB proposal, we may wish to make additional comments on the IASB proposals.

Our responses to questions requiring specific comments are included in Appendix C; below we highlight central concerns.

The IIF SAG considers the ED as a constructive proposal, potentially furthering convergence with U.S. GAAP and providing better alignment with the direction of proposed accounting for insurance liabilities in the revised IFRS 4 *Insurance Contracts*. Furthermore, we believe that the ED would resolve certain important issues on the boundary between amortized cost and fair value through profit and loss that have arisen under the existing IFRS 9. However, further clarification is still required, with regard to both the attributes of those financial assets that are required to be measured at amortized cost or Fair Value through OCI (FVOCI) and the articulation of business models, to ensure that the requirements are operational, reflect a firm's actual business models and result in decision-useful information for investors, so that the standard would therefore pass a cost/benefit test.

The lines drawn in the proposal appear to be generally operational; however, some specific issues would arise from them. We therefore suggest additional consideration of

some of the classification attributes of financial assets and the articulation of business models. We believe there to be significant risk that, particularly in the FASB proposal but also with respect to how the IASB version will be interpreted in the light of the FASB proposal, a firm's business model becomes almost irrelevant as classification is mainly driven by the cash-flow characteristics and the nature of the instrument; that is, in practice, application of the proposed standard might result in only loans and receivables that are held to maturity being categorized as held-to collect, which would not be a faithful representation of the way that many other assets are managed.

Definition of the business-model concept is especially important in light of other disclosure mandates that firms encounter. While the business-model concept could contribute to the overall quality of financial reporting and related disclosures if appropriately defined, the present proposal may actually detract from the ability to present and disclose decision useful information to investors in the context of the actual economic business models that firms have (as opposed to accounting constructs). A business model definition should include, pursuant to Enhanced Disclosure Task Force (EDTF) recommendations (five to eight) on ***Risk governance and risk management strategies/business model, "a clear and explicit account of how value is created by firms"***. We believe that a firm should be able to translate that concept into its financial reporting. Business models should be articulated in such a way as to be clearly understood by users and therefore need to be translated consistently in accounting, regulatory and financial reporting as a whole. Certainly a narrow "business-model" concept used essentially in a technical sense relating only to accounting for financial instruments and not to the actual conduct of business would not help overall understanding and clarity. Therefore, attention needs to be given to making the concept more reflective of actual economic business models. If this is not possible, then, consideration should be given to using another term for accounting purposes, such as "measurement model", if the accounting definition of the concept remains at odds with the more intuitive concept of "economic business models" used in broader disclosures.

Characteristics of financial assets

In paragraphs 4.1.2 and 4.1.2 A of the ED, one of the attributes that requires or allows a financial asset to be measured either at amortized cost or at FVOCI is its cash-flow characteristics. Such cash flows need to be solely payments of principal and interest (SPPI) on the principal amount outstanding.

Vanilla Products with Non-Market-Driven Characteristics. Certain vanilla products appear to be excluded by the mechanics of the current proposal. Such outcomes do not result in appropriate reflection of the operation of held-to-collect business models for such products. To illustrate these concerns, we focus in this letter on three examples of what are essentially vanilla products that are managed, and should be included, within the held-to-collect business model:

- (a) Chinese loans
- (b) Regulated saving products in Europe: "Livret A" receivables
- (c) Variable rate mortgages with specific reset conditions

There are several ways to look at this issue, but they all lead to the conclusion that a more flexible definition of the SPPI test is required (if extensive and instrument-specific guidance or exemptions are to be avoided).

As the detailed discussions in Appendix A illustrate, there are products – and there are likely to be many others over time – that include specific features as a result of the characteristics of their marketplaces (often as a result of legal requirements or other regulatory policy decisions). These products form part of the most basic business of banking. However, if they are not capable of meeting the benchmark test designed, they will be classified as Fair value through Profit or Loss (FVPL) which will not give investors an appropriate understanding of such products or the business models under which they are held. As a consequence, liabilities may be classified differently than the assets being funded; creating accounting volatility that is not useful to investors’ understanding of the business performance of an entity.

An additional consideration is the significant complexity and operational problems regarding such instruments.

An assessment of cash-flow characteristics could be necessary for instruments with even a very slight degree of complexity, possibly on an instrument by instrument basis. This assessment would include identification of a reliable (or determination of a hypothetical) benchmark. The practicability of such assessment is highly questionable, especially in particular market places. Multiple assessments may be also required; even if loans with the same terms can be assessed together, their date of issuance could affect the cash flows resulting from a mismatch feature and could therefore change the result of the test, so monthly or even daily testing could be required in some cases.

The test would be more operational if only a qualitative assessment were required, such as describing the features of an asset and documenting the lack of leverage.

The examples described in Appendix A are not exhaustive but aim to demonstrate concerns with the SPPI test as drafted. The Board should consider modifying the definition of interest to ensure classification that provides decision-useful information by facilitating inclusion in a held-to-collect business model, hence reflecting the characteristics of the marketplace and the way that such assets are managed and funded. The benchmark, if needed, could refer to the market where such products are widely sold. Such an approach is likely to be more efficient than making product-specific exceptions. Furthermore, the Board should also consider the significant operational and audit burdens for preparers that would arise from the proposals as currently drafted might be alleviated.

For example, the Board could consider amending the proposed approach to capture:

- Products that are widely offered in a particular market and compensated by interest, but for which it is not possible to construct a meaningful hypothetical benchmark because of the structure of the market.
- Products of which essential characteristics are defined by law or regulation rather than market forces. This is particularly an issue for consumer products with

regulation for consumer protection or market regulation. Such protection would not be expected to introduce leverage.

- Products with no additional leverage linked to specific non-principal and interest features.

Having such products in mind, the Group is convinced that the guidance in paragraphs B4.1.9B to B4.1.9E would not result in decision-useful classifications in some situations, and could be operationally complex and potentially burdensome.

Instruments Subject to Remote Contingencies. A somewhat related issue concerns instruments that are subject to possible but remote or unlikely conditions of conversion or suspension of payment of interest. Under IFRS 9 the *probability* of such an event's occurring, and consequent possible economic effects are not considered in applying the SPPI test, assuming the contractual term is considered to constitute a cash-flow characteristic that is "genuine"¹. This is an excessively stringent test in light of the practical concerns set out below, or one that could be interpreted so narrowly as to make it almost irrelevant.

We believe that the SPPI test should be amended to require or permit additional consideration of whether terms of conversion or suspension of payment are materially likely to affect the actual receipt of interest that is to be expected. If an instrument that otherwise has the basic principal and interest characteristics of debt includes involuntary conversion or suspension provisions that are highly unlikely to be triggered at the time of recognition, then the inclusion of such conditions in the terms of the instrument should not disqualify it under the SPPI test.

An example is "Instrument G", where payment of interest cannot be made unless the issuer is able to remain solvent immediately after payment. According to IFRS 9 paragraph B4.1.14, instrument G does not meet the SPPI test because "*the issuer may be required to defer interest payments and additional interest does not accrue on those deferred interest amounts*". Application of the proposed "highly unlikely" threshold would resolve the narrow SPPI test for such instruments. As it stands, the stated explanation of paragraph B4.1.14 is itself an excessively narrow interpretation that is likely to be applied by analogy to other instruments.

Another example of particular current concern to the Industry is conditionally convertible bonds (CoCos), which are debt instruments that are subject to being converted to equity or written down partially or entirely upon the issuer's breaching a solvency threshold. Appropriate treatment of CoCos is particularly important because CoCos and similar instruments are a significant feature of many regulatory and Industry considerations in improving the capital positions and resilience of financial service firms. Such instruments are, under all foreseeable circumstances, intended to act as subordinated bonds, paying interest to the holder. Their conversion or suspension features only apply under adverse

¹"... A cash-flow characteristic is not genuine if it affects the instrument's contractual cash flows only on the occurrence of an event that is extremely rare, highly abnormal and very unlikely to occur." IFRS 9 – B4.1.18. The proposed FASB test is similar, and poses similar problems: "...Although an entity must not consider the probability of occurrence of the contingent event that would affect the instrument's contractual cash flows, the entity must disregard the contingent term if it would affect the instrument's contractual cash flows only on the occurrence of an event that is extremely rare, highly abnormal, and very unlikely to occur." FASB – 825 -10-55-24.

circumstances that both issuers and holders would expect not to occur at inception of the instrument. The example of CoCos is set out in detail in Appendix B.

In addition there is considerable regulatory uncertainty about what range of other unsecured debt instruments are likely to be subject to “bail-in”. “Bail-in” would involve the write-down or conversion of a financial institution’s unsecured debt instruments (both subordinated and senior), with narrow exceptions, upon a firm’s entering into resolution proceedings.² A number of credible regulatory proposals in the U.S., E.U., and other jurisdictions would require firms to issue a significant amount of debt subject to “bail-in”. While under some versions of the “bail-in” idea,³ instruments would be subject to “bail-in” as a matter of law in the event of a firm’s entering into resolution, there are also proposals being considered that would require specific contractual “bail-in” provisions.

Therefore, while it is the IIF’s interpretation that instruments that might “bailed-in” solely by operation of law should not be affected by this analysis (given that all debt is subject to haircut or modification in traditional bankruptcy), there is concern that a substantial portion of the debt of banks, bank holding companies, and some other financial institutions, may be subject to “bail-in” under specific contractual provisions or disclosures.

The proposals, as drafted, could result in significant amount of core debt used for funding being classified as FVPL for investors. There is hence a significant danger that institutional investors that might otherwise form a ready market for Co-Cos and debt subject to “bail-in” on a buy-and-hold basis would be dissuaded if they were forced into FVPL treatment.

Definitions of Business models

Not all members are convinced that the third category is an improvement, although we welcome both Boards’ efforts on convergence. However, based on an assumption that there will be a third category, for the purposes of this letter we have focused on the difference between the Held-To-Collect (HTC) category and the FVOCI category.

There is a serious concern that the proposal results in a HTC category that is essentially limited for practical reasons to loans and receivables held to maturity, while nevertheless requiring a relatively complex business-model analysis. This does not correspond to the business reality of business lines conducted on what can be called a “hold-to-collect” basis, which in actual fact need to meet various management and risk-management imperatives, while still conforming to an overall HTC objective. Furthermore, as noted at the beginning of this letter, there is an issue of how to relate what, without significant clarification, would be a very technical, accounting-specific concept of “business model” to the broader business-model disclosures firms need to do for other purposes. Thus, the business-model criterion needs to be very clear and representative of how business is expected to operate in

² It may be noted that debt of financial institutions has always been subject as a legal matter to risk of partial or complete loss in event of their insolvency; however, (a) in the post-crisis environment the argument is frequently made that the exposure of debt holders to loss needs to be made more explicit and (b) the new resolution proceedings being put in place in major countries make possible “bail-in” with write-down or conversion features to allow firms to be recapitalized without recourse to public funds.

³ See FSB, *Key Attributes Effective Resolution Regimes for Financial Institutions*, October, 2011, paragraphs 3.5 and 3.6.

practice. Otherwise a business-model analysis would be unnecessary, and in some ways result in misleading or confusing information for investors. In addition, if the practical effect is that only loans and receivables are captured in the HTC category, then this could be more easily achieved by amending the classification criteria of IAS 39 *Financial Instruments: Recognition and Measurement*.

The business-model criterion is furthermore a point on which convergence between IFRS and U.S. GAAP is especially important. If, as is currently the case, there are differences in wording between the two, confusion could result and also divergence of interpretation among preparers, auditors and users alike.

Among the problems of the differences between the IASB proposal and the FASB proposal is the interpretation of what to do about assets that are originated either to hold or to distribute through securitization. In many cases, the allocation of assets held vs. assets to be securitized takes place only some time after the origination of specific assets, as adequate pools must be built up before the decision to package or retain them can be made. In addition, recent regulatory “skin in the game” requirements will often require firms to retain a portion of securitized instruments. Therefore, it would be reasonable to interpret section 4.1 of the ED to allow the amortized cost classification for holdings of assets where portions may be retained or securitized after origination; any subsequent sale that achieves derecognition would be expected to be “infrequent”. This is notwithstanding Example 3 in IFRS 9 B4.1.4, which assumes that the entire portfolio is sold, albeit within the group. The deviation between the IASB proposal and the FASB proposal on this point is troubling because FASB paragraph 825-10-25-25 seems to require placing assets as to which a hold-or-securitize determination has not been made in FVOCI. This does not provide decision-useful information because, once the allocation is made, the assets retained are clearly held on a hold-to-collect basis. We urge the IASB not to follow the FASB on this point (and will urge the FASB to amend its proposal). If the final standards remain divergent, then it will be incumbent upon both Boards to explain clearly the points of difference and the reasons therefore.

Although both Boards make it clear that the tainting effects are no longer intended, the IIF SAG is concerned that the guidance in both proposals describing the conditions as to when sales are allowed in the amortized cost category may be read as if tainting rules continue to exist, de facto if not de jure, unless there is further explanation.⁴

We note that sales are permitted if the credit quality of an individual financial asset has deteriorated such that it no longer meets the entity’s documented investment policy (paragraph B4.1.3). The use of past tense raises concerns about whether sales are permitted in advance of value’s being lost and whether firms are permitted to act on their own credit determinations (including risk concentrations), subject to documentation of their strategy. Classification in the HTC category should not be at the expense of being able to operate

⁴IFRS 9 - B4.1.3: *In determining whether cash flows are expected to be collected from contractual cash flows, the level of sales activity, as well as the reason for any sales, must be considered. Although the objective of an entity’s business model may be to hold financial assets in order to collect contractual cash flows, the entity need not hold all of those instruments until maturity.*

effective risk management. Analysis for this purpose would be akin to, but not necessarily the same as, analysis of credit deterioration for expected-loss determinations for provisioning purposes.

In many cases, assets are not managed instrument by instrument but on a portfolio basis. Specific portfolios often match assets and liabilities by maturity and interest rate at a defined level of interest margin. Under such conditions, changes in the liability structure of a given portfolio – caused, for example, by customer withdrawals – have to be replicated on the asset side to maintain the balance. Though this may predictably require assets to be sold, the original objective – namely to generate contractual cash flows – remains the same. Sales are not a way to optimize the earnings but just a way to maintain a stable interest rate margin. This is in no way at odds with the objectives of an amortised cost business model, because the firm’s intention in holding the portfolio continues to be to collect contractual cash flows, not to realise fair value changes in the near term.

Clarity is also required in situations where sales (or repos) may take place only or principally to meet regulators’ requirements. Given the impact and significance of the Basel III liquidity rules, compliance with such requirements does not constitute business decisions that should affect the business-model analysis.

Some are concerned that the upshot of the present proposal – with a narrow interpretation of permissible sales⁵ as described in Example 4 in paragraphs B4.1.4 and paragraph 825-10-55-32 to paragraph 825-10-55-34⁶ would be that the Industry would need to separate portfolios of similar instruments that would normally as a business matter be managed together for liquidity purposes, in order to meet accounting requirements. Dividing liquidity portfolios in order to meet both regulatory and accounting requirements would mean creating an artificial pool of instruments to be used for regulatory-mandated sales and another pool of the same instruments held for essentially the same business and regulatory purposes. This artificial separation would of course not reflect the actual business model, and would result in unnecessary administrative and systems complexity. Such an approach to achieve a particular accounting result is not consistent with high quality accounting standards.

⁵IFRS 9 - B4.1.4 - Example 4: *...In contrast, if an entity holds financial assets to meet its everyday liquidity needs and that involves recurring and significant sales activity, the objective of the entity’s business model is not to hold the financial assets to collect contractual cash flows. Similarly, if the entity is required by its regulator to routinely sell significant volumes of financial assets to demonstrate that the assets are liquid, the entity’s business model is not to hold financial assets to collect contractual cash flows. The fact that the requirement to sell the financial assets is imposed by a third party rather than being at the discretion of the entity is not relevant to the analysis.*

⁶FASB - 825-10-55-34: *Certain regulatory requirements for managing some types of exposures would only entail sales of financial assets in accordance with paragraph 825-10-55-32(c) through (e). Those business activities may entail holding portfolios of highly liquid securities (that are held for collection of contractual cash flows) that are only used to comply with regulatory requirements that affect the industry (rather than the entity). That business activity would be consistent with the primary objective of a held-to-collect business model. For example, if a regulator directs a particular financial institution (rather than all institutions supervised by the regulator) to sell or transfer debt instruments classified at amortized cost, those sales and transfers are inconsistent with paragraph 825-10-55-32(c), which describes a change in regulations applicable to all entities that are affected by the legislation or regulator enacting the change. However, circumstances that cause a regulator to direct an institution to sell securities possibly could be considered an event that is isolated, nonrecurring, and unusual such that it could not have been reasonably anticipated at acquisition of the assets and would not be inconsistent with the primary objective of a held-to-collect business model.*

In conclusion, it is essential for the Board to consider broadening the definitions used in the SPPI test and to continue working on the business-model concept and specific examples and descriptions of business models as defined for accounting purposes before issuing the final standards. We are convinced that disconnecting the accounting results from actual economic business models would make financial reporting harder to understand.

In addition, if the IASB intends different outcomes from the FASB on either SPPI or business models, or both, the rationale for such intent should be set out in the basis for conclusions. As has been emphasized before, it will be very important to future clarity of reporting and consistency of interpretation if the Boards use identical terminology whenever possible where their intent is the same, and explain any divergences and the rationale therefore as clearly as possible if such divergences arise.

Finally, we urge the Boards to also consider whether the final standards result in significantly different accounting outcomes and improved information for investors than is the case today – otherwise there is a significant risk that costs will not justify benefits to investors.

Alongside the major issues discussed about definitions, the IIF SAG urges the Board to consider three remaining concerns. Two of them relate to the time needed to issue standards.

Need to delay IFRS 9 (2010)

We agree that, with the exception of the provisions for “own credit”, the final IFRS 9 standard should be applied as a whole and not on a phased basis. Given the time required to finalize impairment in IFRS 9 and the likely time that will be needed for firms to implement any final standard, it appears that the mandatory application date for IFRS 9 (2010) of 2015 is not achievable. Therefore, the IASB should urgently consider amending the mandatory effective date of this standard to provide certainty for the planning of implementation projects. In the absence of such certainty, large financial institutions, particularly those that are foreign private issuers in the U.S., will need to commence IFRS 9 implementation work on a standard that may change, and an effective date that may change. Such an approach is clearly inefficient and costly.

Furthermore, we are concerned that the revised IFRS 4 *Insurance Contracts* may need additional transitional provisions to allow IFRS 9 classifications to be revisited. For consolidated groups that include both bank and insurance activities, it would be more efficient, less costly, and more useful for users to implement both standards at the same time. We acknowledge that this additional delay does not address the need for urgent change for financial instrument accounting but, as stated above, we think that IFRS 9 still needs additional clarification.

Recycling own credit risk in Profit and Loss

We support the Boards’ decision to account for the own credit risk part of liabilities using Fair Value Option in OCI as we think that it is a significant improvement to current accounting. However, we think that own credit risk should be in Profit and Loss upon

settlement of the liability instead of being transferred within equity. This would be consistent with the proposals set out by the FASB with regard to the treatment of own credit for financial liabilities measured at fair value.

Support for the ability to early-adopt “own credit” provisions

In addition, we urge the Board to reconsider how early adoption of changes to the treatment of the fair value of own credit risk can best be facilitated. We continue to believe that this would be easy to implement, would not be contentious and should be readily adopted by the EC. Firms will of course raise this issue with the appropriate branch of the Commission’s services as well.

In light of results for 2012, it is clear that volatility in the income statement arising from own credit risk creates uncertainties as to the real recovery of banks, give misleading information to users despite additional voluntary disclosure to remove the effect of fair value of own credit on performance. This results in unnecessary complexity in financial reporting, including the proliferation of non-GAAP metrics.

Furthermore, IAS 39 will certainly be amended for novation of derivatives⁷. We believe that another limited amendment to IAS 39 for “own credit risk” would be welcomed as it would improve transparency while reducing complexity. This can most readily be done through amending IAS39, but would also welcome an amendment to IFRS 9 (2010) that can be implemented on a more timely basis.

Should you have any comments or questions on this letter, please contact the undersigned or Veronique Mathaud (vmathaud@iif.com; +1 202 682 7456). We appreciate your consideration.

Very truly yours,



⁷ Exposure Draft ED/2013/2 – *Novation of Derivatives and Continuation of Hedge Accounting*

Appendix A: Examples of Vanilla Assets that do not Pass the SPPI test

In this appendix, we gather examples of products that are standard in their markets and generally held to maturity but that analysis shows might not pass the proposed Solely Payment of Principal and Interest (SPPI) test. Such examples are not exhaustive.

Chinese loans

Chinese loans, including mortgage loans are made in a rate-regulated market: interest rates and maturities are set by the People's Bank of China (PBOC). Market forces do not have any role in the relevant interest rate market in China. Therefore loans follow the structure dictated by the Chinese central bank. As a consequence, a loan contract specifies that the interest rate is subject to revision according to the PBOC's regulations. When the official rates are changed, the interest rates on all retail and commercial loans and deposits of the same original maturity will change at the same time as directed. Interest rates are changed as and when directed by the PBOC.

For example, a five-year loan which has three years remaining will reprice according to the new rate set for five-year loans, not three years. As a result of this regulation, financial instruments with the same *remaining* maturity can have different interest rates set according to their *original* maturity for any given level of credit risk. If a five-year loan reprices one year before its maturity, the cash flows of the five-year loan repricing off the official rate structure will differ from that of a theoretical five-year loan repricing off a rate for the remaining maturity by an amount that is probably more than insignificant, depending on both the shape of the term structure that is determined by the authorities⁸ and the extrapolation needed to fill in theoretical rates that do not exist in the market.

Based on the definition and guidance that are provided in the ED, this kind of loan would probably need to be classified at FVPL. Because there is no available benchmark instrument for a floating rate loan in China that does not have the constant maturity feature, it would be difficult to assess the significance of the difference from an instrument that does not have this feature. However the vast majority of loans and deposits in China are 'plain vanilla' in nature except for the constant maturity feature. Moreover in the specific context of China, as the interest rates for all retail and commercial loans in China must be set with reference to the constant maturity feature, these interest rates are consistent with the notion of time value of money and credit risk compensation in China.

As a conclusion, we would like the Board to consider the example of such specific contextual features, both in terms of the practicality of performing the SPPI test as proposed, as well as the decision-usefulness of the accounting outcome.

Regulated saving products in Europe: "Livret A" receivables

⁸For example: PBOC Published Circular No. 190 (1998) *Retail Mortgage Lending Management Regulation*.

The French Government created Livret A to fund the French social residential sector. The Government organised the funding through deposits collected by banks' networks. Livret A is represented in banks' balance sheets as both a deposit and a receivable. Funds deposited by individuals are given over to the state through the "Caisse des Depots et Consignations" (CDC). All aspects of distribution and all conditions, including interest rates, are regulated and defined by law. They provide tax-free savings for customers. Banks are compensated by commissions for their role as intermediaries. In French banks' balance sheets, the deposits received ("Livret A deposits") are part of liabilities, whereas the funds retroceded to CDC ("Livret A receivables") are part of assets. They are accounted for simultaneously on both sides.

The rate is reset twice a year and it is partially indexed to the average of the daily fixings observed over the last month of the overnight interest rate (Eonia) and a three months' interest rate (Euribor 3M). The rate also bears a discretionary feature insofar as the Government can change the level of the rate resulting from the application of the formula. The variation from one period to another is however capped and floored to 1.5%. If this type of mismatch is considered "more than insignificant" (in accordance with paragraph B4.1.9 C) the Livret A receivable will have to be accounted for at fair value through FVPL.

We do not believe this accounting outcome would result in decision-useful information, and as a result such outcome would also fail to reflect the business-model context within which these products are managed. We are aware of the work done by the IASB staff summarized in a Board paper in October 2012 in which the staff suggested creating exceptions for specific market (such as Livret A or Chinese loans). We would welcome either a broadening of the definitions as suggested above or, at the least clear guidance to avoid such anomalous results.

Variable-rate mortgages with specific reset conditions

Numerous retail loans in Europe present specific characteristics and may be based on other factors than just time value of money and credit risk, although they are essentially held-to-collect, vanilla loans when looked at objectively. For example, some retail loans in France are granted with adjustable rates, with fixing of a Euribor three-month rate for an interest period of one year without refixing in the course of the year. It is also frequent that retail loans are granted on the basis of an averaged Euribor rate over a period of observation. The averaging of the rates for such loans has for its objective to protect customers from frequent or significant variations of rates.

As far as the SPPI test is concerned, the benchmark instrument which seems to be closest to the economic features of the customer loans would be an indexed loan at Euribor three months with fixation of a Euribor three-month rate. As Euribor 12 months is not usually used as a reference index, most of the revisable rate customer loans are indexed at a Euribor three month rate or at a Euribor six month rate. The SPPI test may end up with a difference between the interest on the retail loans and the benchmark especially because the test is done at inception by reference to a three month rate benchmark and all over the life of the loan. As a consequence, such loans may be disqualified from the amortised cost category. That would be even more likely if the benchmark product were required to have

the same reset period as the ED prescribes. We fail to understand why the ED is so prescriptive in determining the benchmark in such a case.

Such mortgages are vanilla products with practical expedients to facilitate their operational processing and understandability to customers. Given that this kind of loan is held to collect the cash-flows and not securitized or otherwise distributed, and given that the remuneration is not leveraged in any way, this outcome does not result in decision useful information or reflect the business context in which these instruments are managed.

Appendix B: Instruments Subject to Remote Contingencies

Given the quite possibly narrow interpretation of the guidance given by both the FASB in paragraph 825-10-55-57, and IFRS in paragraphs B4.1.8 – B4.1.8A, it is important for the Board to consider the following instruments, which will be increasingly issued by banks under the impetus of Basel III and national regulatory requirements. This is one example of instruments subject to remote contingencies, which appear likely to be required by the present SPPI proposal to be held at FVPL unless paragraph B4.1.18 (IFRS) or paragraph 825-10-55-24 (FASB) are revised or interpreted to alleviate the problem.

Forcing instruments subject to remote contingencies into FVPL, regardless of the business model in which they would otherwise be held, would distort investors' decisions on acquiring such instruments, if they would normally intend to hold similar instruments on a held-to-collect basis. It would also leave fair value movements these instruments unavailable to match any current value movements on any related insurance liabilities.

This Appendix focuses in particular on Contingent Convertible bonds (CoCos), which are debt instruments of financial-services firms (initially banks or bank holding companies, but possibly other firms depending future regulatory determinations) that are mandatorily transformed into shares of equity or written off upon a triggering event. A CoCo, in the same fashion as other hybrid securities, has both debt and equity-like features embedded within its structure. CoCos begin life as ordinary bonds, and, absent a triggering event, behave as such until maturity.

CoCos are not intended to be converted under normal circumstances; however, conversion (or write off) would occur if the issuing financial-services firm failed to meet solvency tests generally set which indicate that it is in danger of becoming seriously undercapitalized and needs to undertake recovery measures. Conversion is intended to provide a pre-arranged means to bolster the firm's capital ratios and hence to contribute to a regulatory-mandated program of recovery from weakened conditions. Neither firms nor investors intend CoCos ever to be converted, but they constitute a kind of regulatory capital insurance to help avoid resolution of the firm and the systemic issues that can arise therefrom.

In accordance with embedded derivative requirements, this type of instrument would be bifurcated and significant fair value movements would have appeared in Profit and Loss only when they would have been at or in the money. In accordance with IFRS 9, the default category would be FVPL as convertible bonds as a whole do not pass the SPPI test; but, as explained above, FVPL would not reflect the normal business intent of many holders of such instruments, and so would affect their purchase decisions.

Such default accounting treatment would discourage significant classes of institutional investors to buy Cocos, which would in turn undermine the macroprudential purposes of the authorities encouraging banks and other financial-services firms to issue Cocos. This would also deprive banks in particular of a degree of flexibility as they confront the substantial challenge of meeting the new global capital requirements.

As discussed in the main text, regulatory uncertainty may lead to conditions under which the same concerns apply to debt subject to “bail-in”, a category that is likely to include a substantial portion debt of banks and bank holding companies (and possibly other firms), subject to narrow exceptions.

For these reasons, the IIF urges the Board to consider adding a step in the SPPI test to allow holders of such instruments to assess the probability of trigger events and, if such events are determined to be remote upon acquisition of a given instrument, to hold them in amortized cost or FVOCI, if otherwise consistent with the applicable business model.

Appendix C: IIF responses to questions asked in the exposure draft

Question 1

Do you agree that a financial asset with a modified economic relationship between principal and consideration for the time value of money and the credit risk could be considered, for the purposes of IFRS 9, to contain cash flows that are solely payments of principal and interest? Do you agree that this should be the case if, and only if, the contractual cash flows could not be more than insignificantly different from the benchmark cash flows? If not, why and what would you propose instead?

Certain vanilla products appear to be excluded by the mechanics of the current proposal (See Appendix A).

The Board should consider modifying the definition of interest to ensure classification that provides decision-useful information by facilitating inclusion in a held-to-collect business model, hence reflecting the characteristics of the marketplace and the way that such assets are managed and funded. The benchmark, if needed, could refer to the market where such products are widely sold. Such an approach is likely to be more efficient than making product-specific exceptions. Furthermore, the Board should also consider the significant operational and audit burdens for preparers that would arise from the proposals as currently drafted might be alleviated.

For example, the Board could consider amending the proposed approach to capture:

- Products that are widely offered in a particular market and compensated by interest but for which it is not possible to construct a meaningful hypothetical benchmark, because of the structure of the market.
- Products of which essential characteristics are defined by law or regulation rather than market forces. This is particularly an issue for consumer products with regulation for consumer protection or market regulation. Such protection would not be expected to introduce leverage.
- Products with no additional leverage linked to specific non-principal and interest features.

Question 2

Do you believe that this Exposure Draft proposes sufficient, operational application guidance on assessing a modified economic relationship? If not, why? What additional guidance would you propose and why?

The requirement of assessment of cash-flow characteristics could be necessary for instruments with any degree of complexity, possibly on an instrument by instrument basis. This assessment would need to identify a reliable (or determine a hypothetical) benchmark. The practicability of such assessment is highly questionable, especially in particular market places. A reason why multiple assessments may be required is that, even if loans with the same terms can be assessed together, their date of issuance could affect the cash flows

resulting from a mismatch feature and could therefore change the result of the test, so monthly or even daily testing could be required in some cases.

The test would be more operational if only a qualitative assessment were required, such as describing the features of an asset and documenting the lack of leverage.

Question 3

Do you believe that this proposed amendment to IFRS 9 will achieve the IASB's objective of clarifying the application of the contractual cash flow characteristics assessment to financial assets that contain interest rate mismatch features? Will it result in more appropriate identification of financial assets with contractual cash flows that should be considered solely payments of principal and interest? If not, why and what would you propose instead?

As set out in response to question 1, we have concerns whether the IASB's objective has been achieved.

A somewhat related issue concerns instruments that are subject to possible but remote or unlikely conditions of conversion or suspension of payment of interest. Under IFRS 9 the *probability* of such an event's occurring, and consequent possible economic effects are not considered in applying the SPPI test, assuming the contractual term is considered to constitute a cash-flow characteristic that is "genuine"⁹. This is an excessively stringent test in light of the practical concerns set out below, or one that could be interpreted so narrowly as to make it almost irrelevant.

We believe that the SPPI test should be amended to require or permit additional consideration of whether terms of conversion or suspension of payment are materially likely to affect the actual receipt of interest that is to be expected to be received. If an instrument that otherwise has the basic principal and interest characteristics of debt includes involuntary conversion or suspension provisions that are highly unlikely to be triggered at the time of recognition, then the inclusion of such conditions in the terms of the instrument should not disqualify it under the SPPI test.

An example is "Instrument G", where payment of interest cannot be made unless the issuer is able to remain solvent immediately after payment. According to IFRS 9 paragraph B4.1.14, instrument G does not meet the SPPI test because "*the issuer may be required to defer interest payments and additional interest does not accrue on those deferred interest amounts*". Application of the proposed "highly unlikely" threshold would resolve the narrow SPPI test for such instruments. As it stands, the stated explanation of paragraph B4.1.14 is itself an excessively narrow interpretation that is likely to be applied by analogy to other instruments.

⁹ "... A cash-flow characteristic is not genuine if it affects the instrument's contractual cash flows only on the occurrence of an event that is extremely rare, highly abnormal and very unlikely to occur." IFRS 9 – B4.1.18. The proposed FASB test is similar, and poses similar problems: "...Although an entity must not consider the probability of occurrence of the contingent event that would affect the instrument's contractual cash flows, the entity must disregard the contingent term if it would affect the instrument's contractual cash flows only on the occurrence of an event that is extremely rare, highly abnormal, and very unlikely to occur." FASB – 825 -10-55-24.

An example of particular current concern to the Industry is conditionally convertible bonds (CoCos), which are debt instruments that are subject to being converted to equity or written down partially or entirely upon the issuer's breaching a solvency threshold. Appropriate treatment of CoCos is particularly important because CoCos and similar instruments are a significant feature of many regulatory and Industry considerations in improving the capital positions and resilience of financial service firms. Such instruments are, under all foreseeable circumstances, intended to act as subordinated bonds, paying interest to the holder. Their conversion or suspension features only apply under adverse circumstances that both issuers and holders would expect not to occur at inception of the instrument. The example of CoCos is set out in detail in Appendix B.

Question 4

Do you agree that financial assets that are held within a business model in which assets are managed both in order to collect contractual cash flows and for sale should be required to be measured at fair value through OCI (subject to the contractual cash flow characteristics assessment) such that:

(a) interest revenue, credit impairment and any gain or loss on derecognition are recognized in profit or loss in the same manner as for financial assets measured at amortized cost; and

(b) all other gains and losses are recognized in OCI?

If not, why? What do you propose instead and why?

Not all members are convinced that the third category is an improvement, although we welcome both Boards' efforts on convergence; however, subject to the other comments given in this letter, the approach is directionally correct on the assumption there will be such a category.

Question 5

Do you believe that the Exposure Draft proposes sufficient, operational application guidance on how to distinguish between the three business models, including determining whether the business model is to manage assets both to collect contractual cash flows and to sell? Do you agree with the guidance provided to describe those business models? If not, why? What additional guidance would you propose and why?

There is a serious concern that the proposal results in a HTC category that is essentially limited for practical reasons to loans and receivables held to maturity, while nevertheless requiring a relatively complex business-model analysis. This does not correspond to the business reality of business lines conducted on what can be called a "hold-to-collect" basis, which in actual fact needs to meet various management and risk-management imperatives, while still conforming to an overall HTC objective. Furthermore, as noted at the beginning of this letter, there is an issue of how to relate what, without significant clarification, would be a very technical, accounting-specific concept of "business model" to the broader business-model disclosures firms need to do for other purposes. Thus, the business-model criterion needs to be very clear and representative of how business is expected to operate in practice. Otherwise a business-model analysis would be unnecessary, and in some ways result in misleading or confusing information for investors. In addition, if the practical effect is that only loans and receivables are captured in the HTC category, then this could be more easily achieved by amending the classification criteria of IAS 39 *Financial Instruments: Recognition and Measurement*.

In many cases, the allocation of assets held vs. assets to be securitized takes place only some time after the origination of specific assets, as adequate pools must be built up before the decision to package or retain them can be made. In addition, recent regulatory “skin in the game” requirements will often require firms to retain a portion of securitized instruments. Therefore, it would be reasonable to interpret section 4.1 of the ED to allow the amortized cost classification for holdings of assets where portions may be retained or securitized after origination; any subsequent sale that achieves derecognition would be expected to be “infrequent”. This is notwithstanding Example 3 in IFRS 9 B4.1.4, which assumes that the entire portfolio is sold, albeit within the group. The deviation between the IASB proposal and the FASB proposal on this point is troubling because FASB paragraph 825-10-25-25 seems to require placing assets as to which a hold-or-securitize determination has not been made in FVOCI. This does not provide decision-useful information because, once the allocation is made, the assets retained are clearly held on a hold-to-collect basis. We urge the IASB not to follow the FASB on this point (and will urge the FASB to amend its proposal). If the final standards remain divergent, then it will be incumbent upon both Boards to explain clearly the points of difference and the reasons therefore.

Although both Boards make it clear that the tainting rules are no longer relevant, the IIF SAG is concerned that the guidance in both proposals describing the conditions as to when sales are allowed in the amortized cost category may be read as if those rules continue to exist, de facto if not de jure, unless there is further explanation.¹⁰

We note that sales are permitted if the credit quality of an individual financial asset has deteriorated such that it no longer meets the entity’s documented investment policy (paragraph B4.1.3). The use of past tense raises concerns about whether sales are permitted in advance of value’s being lost and whether firms are permitted to act on their own credit determinations (including risk concentrations), subject to documentation of their strategy. Classification in the HTC category should not be at the expense of being able to operate effective risk management. Analysis for this purpose would be akin to, but not necessarily the same as, analysis of credit deterioration for expected-loss determinations for provisioning purposes.

In many cases, assets are not managed instrument by instrument but on a portfolio basis. Specific portfolios often match assets and liabilities by maturity and interest rate at a defined level of interest margin. Under such conditions, changes in the liability structure of a given portfolio – caused, for example, by customer withdrawals – have to be replicated on the asset side to maintain the balance. Though this may predictably require assets to be sold, the original objective – namely to generate contractual cash flows – remains the same. Sales are not a way to optimize the earnings but just a way to maintain a stable interest rate margin. This is in no way at odds with the objectives of an amortised cost business model, because the firm’s intention in holding the portfolio continues to be to collect contractual cash flows, not to realise fair value changes in the near term.

¹⁰IFRS 9 - B4.1.3: *In determining whether cash flows are expected to be collected from contractual cash flows, the level of sales activity, as well as the reason for any sales, must be considered. Although the objective of an entity’s business model may be to hold financial assets in order to collect contractual cash flows, the entity need not hold all of those instruments until maturity.*

Clarity is also required in situations where sales (or repos) may take place only or principally to meet regulators' requirements. Given the impact and significance of the Basel III liquidity rules, compliance with such requirements does not constitute business decisions that should affect the business-model analysis.

Some are concerned that the upshot of the present proposal – with a narrow interpretation of permissible sales¹¹ as described in Example 4 in paragraphs B4.1.4 and paragraph 825-10-55-32 to paragraph 825-10-55-34¹² would be that the Industry would need to separate portfolios of similar instruments that would normally as a business matter be managed together for liquidity purposes, in order to meet accounting requirements. Dividing liquidity portfolios in order to meet both regulatory and accounting requirements would mean creating an artificial pool of instruments to be used for regulatory-mandated sales and another pool of the same instruments held for essentially the same business and regulatory purposes. This artificial separation would of course not reflect the business model, and would result in unnecessary administrative and systems complexity. Such an approach to achieve a particular accounting result is not consistent with high quality accounting standards.

¹¹IFRS 9 - B4.1.4 - Example 4: *...In contrast, if an entity holds financial assets to meet its everyday liquidity needs and that involves recurring and significant sales activity, the objective of the entity's business model is not to hold the financial assets to collect contractual cash flows. Similarly, if the entity is required by its regulator to routinely sell significant volumes of financial assets to demonstrate that the assets are liquid, the entity's business model is not to hold financial assets to collect contractual cash flows. The fact that the requirement to sell the financial assets is imposed by a third party rather than being at the discretion of the entity is not relevant to the analysis.*

¹²FASB - 825-10-55-34: *Certain regulatory requirements for managing some types of exposures would only entail sales of financial assets in accordance with paragraph 825-10-55-32(c) through (e). Those business activities may entail holding portfolios of highly liquid securities (that are held for collection of contractual cash flows) that are only used to comply with regulatory requirements that affect the Industry (rather than the entity). That business activity would be consistent with the primary objective of a held-to-collect business model. For example, if a regulator directs a particular financial institution (rather than all institutions supervised by the regulator) to sell or transfer debt instruments classified at amortized cost, those sales and transfers are inconsistent with paragraph 825-10-55-32(c), which describes a change in regulations applicable to all entities that are affected by the legislation or regulator enacting the change. However, circumstances that cause a regulator to direct an institution to sell securities possibly could be considered an event that is isolated, nonrecurring, and unusual such that it could not have been reasonably anticipated at acquisition of the assets and would not be inconsistent with the primary objective of a held-to-collect business model.*