IFRS 9: proposals of Long Term Investors to reflect their business model

The objective of long term investors is to generate steady returns by managing financial instruments for their contractual cash flows or by holding those assets for a long to medium term.

We believe that as of today this specific business model characterising long term investors, and the business model criterion in general, is not sufficiently taken into account in the recent accounting and regulatory proposals.

Consequently, the purpose of this document is to present the issues faced by long term investors in respect of the IASB recent proposals on financial instruments accounting (i.e. IFRS 9). The document describes also possible approaches to solve the reported issues.

We are confident that our comments and proposals, while reflecting the particular point of view of long term investors, will contribute to improve the accounting principles also from the perspective of other preparers and users of financial statements.

I. Classification and measurement of financial instruments

1. Issues

1.1 Prominence of the business model not reflected in IFRS 9

As many other European long-term investors, we welcomed G20 conclusions calling for a valuation of financial instruments that should be based on their liquidity and investors' holding horizons, taking into account valuation uncertainty.

However, we believe that IFRS 9, as published in November 2009, does not give enough prominence to the investor's holding horizon criterion.

We illustrate hereafter typical examples of situations where we believe that IFRS 9 does not achieve a fair representation of the long term investor's business model:

- Long term investors usually hold a large portfolio of assets which they manage with a long term view with the aim of generating steady returns and thus contributing to a specific part of the financing of economic development. Under IFRS 9, equity instruments, hybrid instruments and subordinated instruments will be recognised at fair value through profit or loss, even if held on a long term basis in accordance with the business model of the holder. We believe that the proposed classification does not adequately reflect the purpose of the entity in holding the instrument thus leading to an unjustified volatility of the income statement.

Although we acknowledge the possibility offered by the standard to make an irrevocable election to present in other comprehensive income fair value changes of an investment in an equity instrument, we believe that the prohibition to "recycle" fair value changes in profit or loss is inappropriate as it would be equivalent to denying the very concept of the income statement that is to be the best indicator of the entity's performance.

- Entities specialised in long term lending usually issue bonds on the capital markets and disburse loans with the borrowings proceeds. The vast majority of both the assets and liabilities of such entity would consist of precisely these financial instruments.

  In order to broadly match the interest rate reset dates (for fixed rate instruments, the maturity) and the currencies of assets and liabilities, the entity will enter into swap contracts that may or may not match a single asset or liability. More often the swaps will correct the net position of one "bucket" of assets and liabilities.

  The entity will keep the swaps until maturity, according to its business model, and it will therefore manage the contractual cash flows of the swaps together with those of its borrowings and loans.

  Under IFRS 9, in order to reduce the accounting mismatch arising as a consequence of measuring derivatives at fair value, the entity would be required to report loans/borrowings at fair value which is in contradiction with its business model. We believe that such a mismatch should be compensated by the use of an appropriate hedge accounting model, as proposed later in this document.

1.2 Counterintuitive effects induced by the measurement of derivatives at fair value

Given that the IASB has several times stated that hedge accounting is to be considered as a departure of "normal" accounting, the measurement of derivatives at fair value required under "normal" accounting leads to counterintuitive effects.

Indeed, with regards to the needs of the analyst who wishes to discern the vulnerability of an entity to default of one or more counterparts to its derivatives, we believe that the IASB proposed approach under "normal" accounting for derivatives is counter-intuitive, paradoxical and does not result in a faithful representation of the credit risk faced by the reporting entity.

Indeed, when an entity reports a positive replacement value on its derivatives the entity's own funds are increased. On the other hand, a negative replacement value results in a reduction of own funds. On this basis, one could conclude that the user of the financial statements would favour a situation whereby the entity reports a positive replacement value on its derivatives.

We believe in the first place that the resulting perception of the entity's financial position is inappropriate within a "contractual cash flow" business model, because within such model, the entity does not seek to realise fair value gains on its derivatives, but holds them for their cash flow characteristics.

Furthermore it might give a false sense of comfort towards those entities that report a positive replacement value. Indeed, those entities do have a credit risk towards their derivatives counterparts, while the ones reporting a negative replacement value do not.

1.3 Financial liabilities and Fair Value Option (FVO) – the "own credit risk" issue

In its Exposure Draft dated May 2010, the IASB proposes that for all financial liabilities designated under the FVO, an entity would be required to

- recognise the total fair value change in profit or loss; and
- recognise the portion attributable to changes in own credit risk in other comprehensive income (OCI) (with an offsetting entry to profit or loss).

Furthermore, the Exposure Draft retains the current bifurcation possibility for hybrid financial liabilities.

We appreciate the proposal to retain the opportunity for bifurcation of hybrid financial liabilities. By this mean, the preparer will be able to report its liabilities in a manner consistent with the principles of classification and without reporting volatility induced by its own credit spread. As the cash flow of the host contract of the hybrid instrument are solely payments of principal and interest on the principal outstanding, the recognition at amortised cost is adequate. The embedded derivative would then be recognised consistently with the requirements for stand alone derivatives.

However, we believe that the proposed amendment to the FVO also needs to be considered in conjunction with developments currently taking place in the IASB project on Financial Statements Presentation.

Indeed, early February 2010, the IASB confirmed its tentative decision to eliminate the current option available in paragraph 81 of IAS 1 which allows for the presentation of a separate income statement and statement of comprehensive income.

Consequently, OCI items (among which fair value changes attributable to own credit risk) would have to be presented in a single statement together with the result for the financial year. One can therefore wonder whether the proposed transfer of own credit risk changes to OCI will still help in providing a true and fair view of the entity's business model since the proposed presentation will imply having both the financial result and the "own credit risk" value presented on the same page.

The volatility induced by own credit risk will continue to affect own funds where OCI changes will be directly reflected. As a consequence, the IASB proposal will still lead to volatility of the entity's equity and possibly jeopardise its capital requirement ratio.

Finally, we believe that the own credit risk subject has to be considered together with the definition of a new hedge accounting model. Indeed, many entities have elected the Fair Value Option because of weaknesses in the current hedge accounting model of IAS 39. Consequently, in order for entities to have a better alternative to the Fair Value Option, there is a need for a more appropriate hedge accounting model to be developed.

2. Proposed solution

2.1 True and fair representation of long term investor's business model

- **<u>Instrument characteristics criteria</u>**

We propose to maintain the current rules of IAS 39 on embedded derivatives and to extend the opportunity for bifurcation on financial assets in order to treat financial assets and financial liabilities consistently. Those rules could replace the contractual cash flow test currently required by IFRS 9.

In our opinion the IAS 39 provisions on embedded derivatives have been a successful approach to represent adequately determinable contractual cash flows which are managed on a cash flow basis and on the other hand to consider a possible variability of cash flows to be presented on a fair value basis.

- **Alternative to the classification proposal**

When the business model of the long term investor involves the use of derivatives for hedging purposes, we believe that the best way to depict such situation is by using an appropriate hedge accounting methodology (refer to point 3 below).

With regards to business models where equity instruments are held on a long term basis, we believe that the mixed measurement model should be retained and include the following categories, based on a business model criterion:

a) **Amortised cost category**: financial instruments that the entity holds (or issues) for the purpose of collecting (settling) contractual cash-flows.

b) **Fair value through profit or loss category**: actively traded financial instruments which are held for trading purpose by the entity

c) **A third category**: financial instruments that are held as investments in a medium or long term perspective or that do not meet the definition of either the amortised cost category or the fair value through profit or loss category.

For this third category, we strongly recommend a measurement model at the lowest of the acquisition cost or value in use, assessed according to the holding horizon and management judgment (with adjustments recognised through profit or loss).

An alternative approach could be a measurement at fair value, through other comprehensive income (with recycling in profit or loss). Under this alternative approach, the impairment model should consider the value in use, based on the holding horizon and on the management judgment.

Under the proposed approaches, reversal of impairment should be allowed.

In both approaches, the concept of "value in use" could be based on the one defined in IAS 36.6, i.e. "*The value in use is the present value of the future cash flows expected to be derived from an asset"*.

In this specific case, the present value could be estimated taking into account the overall prospects of business development of the issuer and the holding horizon of the holder.

This estimate could be based on criteria such as the average quoted prices on a long period, the level of equity, the profitability or the forecast of profitability, the economic environment, etc…

- **Clarification of the reclassification requirement**

With respect to the classification of financial assets, we generally support the business model as the primer criterion for classification. However the requirement for reclassification needs – in our opinion –some more precision.

Indeed, in practice there may be sales out of a cash flow collecting portfolio with the aim to realise gains in a special market situation (e.g. shrinking credit spreads) however, the general aim of the portfolio to collect cash flows in the long term is still valid. In such situation, the need not to reclassify the entire portfolio should be made more explicit in paragraph B.5.9of IFRS 9.

2.2 Financial liabilities and Fair Value Option (FVO) – the "own credit risk" issue

We believe that the volatility induced by the effect of own credit risk does not reflect the business model of the entity and does not lead to a faithful representation of its financial position.

Therefore, we disagree with the proposals made by the IASB in its Exposure Draft published in May 2010 i.e. to have changes in own credit risk reported in other comprehensive income.

Instead, we believe that the fair value of financial liabilities should only incorporate the level of own credit risk observed at inception (an approach similar to the "frozen credit spread" method discussed by the IASB in October 2009). This revised approach for fair valuing liabilities would:

a) Provide a true and fair representation of the transaction dynamics by better aligning the hedged items with the hedging items. The act of designating a liability at fair value under the FVO would serve its original purpose under IFRS 9, i.e. reducing the accounting mismatch (up to the extent to which the risks intended to be covered are actually hedged), without polluting the picture by introducing an exposure to own credit risk factors which can neither be controlled nor hedged.

b) Respect the concept that the reporting entity is contractually bound to reimburse the initial amount of its liability, irrespective of what happens to its own credit quality in terms of likelihood or willingness to pay back the debt.

c) Introduce consistency in the treatment of liabilities. A financial liability would incorporate the same level of credit risk (that at inception of the transaction) irrespective of it being carried at amortized cost or designated at fair value.

2.3 A well designed and simplified hedge accounting model

In case of mixed measurement, hedge accounting should be considered as the "normal accounting rule" and no longer an "exception" as it is currently under IAS 39.

This requires a well designed and simplified hedge accounting model, along the lines we present later in this document.

3. Transition requirements

In the context of transition to the new accounting rules we strongly support an approach which opens the opportunity to reclassify financial liabilities and to revoke the previous designation to the FVO as required by paragraph 8.2.9 of IFRS 9. The preparer should be able

to revise its previous decisions taking into consideration the overall framework of the new accounting rules.

Therefore, we recommend to modify IAS39.103M to allow a reclassification in both cases, when a financial liability was designated as fair value through profit or loss in accordance with IAS39.9(b)(i) (accounting mismatch) and when it was designated as fair value through profit or loss in accordance with IAS39.11A (embedded derivative).

II. Impairment

1. Issues

Generally speaking, we agree with a periodic Expected Loss as a reasonable component of provisions for loan losses.

However, we believe that, as its stands today, the IASB Exposure Draft does not address the impediments attached to the particular situation of long-term credit investors as preparers. For example:

- the limited availability of observed credit loss parameters over a time span equivalent to the future life of the loan, in particular in the case of loans subject to a particular creditor/debtor relationship or other "niche products", rendering peer group comparison irrelevant and
- the difficulty to define valid credit loss expectations over a very long period of time and also allocate them correctly over each year until maturity.
- the inadequacy of the proposed amortisation method of initial expected loss through the effective interest rate followed by the immediate recognition of revisions to the Expected Loss.

2. Proposed solution

We propose to recognise, on a portfolio basis, an annualised expected loss in a loan loss provision account which would include a minimum threshold of loan loss provision in case of reversals.
The determination of expected losses should be complemented by an adjustment based on expert estimates and should be amortised through the maturity of the instrument or portfolio. In that respect, we promote a consistent treatment of the initial expected loss and revisions to the expected loss.

Finally, under the proposed approach, write-off would be recognised through the allowance account when related to expected losses while the part relating to unexpected losses would be recognised in profit or loss.

We also welcome the proposal made by the Basel Committee[1] which is in many respects very similar to our approach.

[1] Refer to the presentation made by the Basel Committee to the Expert Advisory Panel on 24-25 March 2010

III. Hedge Accounting

Long term investors have an economic value that is best represented by their ability to generate steady returns. Therefore, analysts of long-term investors are interested in the long-term, recurring value drivers that impact future cash flows. Their goal is to project an underlying earnings figure that excludes one-off, non-recurring items such as interim fair value changes on derivatives that might never be realised. This makes the hedge accounting principles that neutralise such interim fair value changes even more important in the context of long-term credit investors.

Generally speaking, we would like to emphasise that, if the financial statements are to give a faithful representation of the entity's financial position, hedge accounting is not to be regarded as an exception to "normal accounting" but rather as the accounting technique used when there is both mixed measurement and the achievement of risk reduction.

Furthermore, we strongly advocate that the measurement of risk reduction, in situations where the entity holds financial assets and liabilities with the objective of collecting their contractual cash flows, be consistent with this same underlying amortised cost business model, i.e. the transformation of contractual cash flows in accordance with the entity's risk management policy (e.g. to close interest rate gaps) and not restricted to the reduction of fair value sensitivity.

Finally, we strongly recommend that the IASB takes into account the knock on effects of the other project phases. Indeed, we believe that the hedge accounting model should also consider the new classification proposals. In particular, it should analyse the practicability of designating as hedged item an investment in equity instruments (other than held for trading) accounted for in OCI (with no recycling of gain or loss).

We believe that the new hedge accounting requirements must be clearly articulated with the first phase of the project i.e. new categorisation of assets (and with the financial liabilities question). This exercise should not simply consist in a "patch" of the existing requirements of cash flow hedge accounting.

1. Issues

1.1 Individual fair value hedge accounting model

As at 30 September 2009, the IASB tentatively agreed to replace fair value hedge accounting by permitting recognition outside profit or loss of gains and losses on financial instruments designated as hedging instruments (an approach similar to cash flow hedge accounting). Under this approach changes in the fair value of hedging instruments would be recognised in OCI (for the effective portion of the hedge) and the hedged item would not be re-measured.

We believe this proposal is not an appropriate solution to simplify current hedge accounting requirements. Indeed, OCI changes being directly reflected in own funds, recognition of fair value changes through OCI would result in even more volatility of own funds, as compared to the current situation. As a consequence, the entity's equity and capital requirement ratio will become even more volatile. Furthermore, given the amplitude of movements in the fair value of derivatives, an entity may end up having negative own funds which does not give a true and fair view of the entity's financial position.

1.2 Portfolio hedge accounting model

Asset Liability Management (ALM) is concerned with managing risks and rewards in the context of the balance sheet structure. The most apparent risk in ALM is the interest rate risk which arises when assets and liabilities differ in terms of maturity, interest rate type and embedded options. To close maturity gaps between assets and liabilities, derivative instruments are used. Derivatives are - in contrast to most assets and liabilities - accounted at fair value through P&L. This leads to an accounting mismatch when hedge accounting is not applied. The current portfolio hedge accounting requirements are not fully compatible with the economic logic underlying the most common approaches to Asset and Liability Management (ALM).

The major features of the most common ALM methodologies which should be considered in developing a new portfolio hedge accounting approach are:

- Assets and liabilities can be analysed based on outstanding notional amounts, on an amortisation scheme or on interest and principal payments. The analysis can generally be made on an aggregated basis. Usually the ability to identify single financial instruments is not a requirement

- The analysis of assets and liabilities is generally based on a specific structure of time buckets

- Methods to measure the interest rate risk vary from a gap analysis to sensitivity-measures like a present value of a basis point (PVBP) or an interest rate modelling combined with a VaR analysis

- The identified gaps will be closed by derivative instruments. These are generally interest rate swaps but could also be cross currency swaps, inflation swaps, caps, floors, swaptions and other exotic products

- The hedging derivatives generally link long term capital market transactions with short term money market transactions. The controlling of both parts of the balance sheet is often executed in different departments. Sometimes, for controlling purposes the hedging instrument might be split into two different components (e.g. floating leg and fixed leg) contributing to different controlling units.

2. Proposed solution

Both the individual and the portfolio fair value hedge accounting rules should allow to rely on internal controlling methods in order to prove effectiveness and to derive hedge results.

In addition, portfolio hedging of inflation risk should be explicitly allowed in the same way as portfolio hedging of interest rate risk.

2.1 Designation

For individual hedge accounting, we agree with the current designation requirements of IAS 39.

For portfolio hedging, we consider it as vital to allow a dynamic hedge designation. This could be achieved if a hedge relationship is not constituted by documentation of the individual items but by documentation of well defined portfolios e.g. if there is a clear definition of an ALM portfolio every single transaction which falls into the definition of this

portfolio should automatically be designated without a formal documentation of the individual item. This is a precondition to accurately account for ALM businesses where daily transactions are regularly involved. Only by such an alignment of accounting requirements with the internal risk management strategy economic effects can adequately be reflected in the P&L.

2.2 Effectiveness test

Both for individual and portfolio hedge accounting we suggest the following changes to the hedge accounting rules of IAS 39.

- Effectiveness should be measured according to the risk management method chosen by the preparer to document the risk reduction: the chosen framework should be documented and have sound financial and statistical foundations. The application guidance should provide a non-exhaustive list of at least 4-5 admitted classes of methods (for example: Regression Analysis, volatility reduction, VaR reduction, Dollar Offset Ratio, comparison of bucketed sensitivities).

- The principle should state explicitly that the widely used Dollar Offset Ratio has no special role, i.e. it is by no means the only admitted method nor the benchmark against which to judge the results of other methods.

In the case of portfolio hedging, in order to analyse the risk reducing effect of the hedging instruments, the risk of the hedged items should be measured at first stand alone and a second time in combination with the designated parts of the hedging instruments. As long as the risk of the combined position is less than the risk of the hedged items stand alone the hedge can be considered as effective.

If the combined risk exposure is less than the stand-alone risk exposure of the hedged items the difference can be allocated to the effect of the hedging activities. Hence, the fair value change of the hedging derivatives does represent the part of the fair value change of the hedged item attributable to the hedged risk. The hedge effectiveness is always 100%. Only in the case that the combined risk exposure exceeds the stand-alone exposure of the hedged items the derivatives can not be considered as hedging instruments and a compensating effect from hedged items should not be recognised.

The effectiveness test should consider the parts of the hedging derivative which are designated in the hedge relationship, i.e. if the entity designates the fixed leg to the 4 year investment it should measure effectiveness of the fixed leg in conjunction with the 4 year investment. In contrast the variable leg should not be considered, as long as this is documented in the hedge designation.

The method used to measure the risk exposure should be consistent with the internal risk management. If the preparer calculates a single measure for the risk exposure over all time buckets, then the minimum requirement should be a statistical or VaR analysis. If the preparer relies on different measures for each time bucket a gap analysis or a PVBP analysis is adequate.

2.3 Measurement of changes in fair value

In the case of individual fair value hedge accounting, instead, we suggest adhering to a measurement framework similar to the one used in IAS 39 however with following important changes.

- The same method used for measuring retrospective effectiveness should be used to calculate the change in fair value of the hedged item: the retrospective effectiveness test should lead to an effectiveness measure in the range 0.8-1.25, and the cumulative change in fair value of the hedged item should be calculated as the opposite of the fair value of the hedging derivative times the effectiveness measure.
- The use of the so-called hypothetical derivative simplification should be explicitly allowed not only for cash flow hedging, but also for fair value hedging.

In the case of portfolio fair value hedge accounting, since effectiveness would be 100% as long as risk-reduction is achieved, changes in the fair value of the hedged items would be the opposite of the fair value of the hedging derivatives.