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EACB Comments on IASB Exposure Draft on Fair Value Option for Financial Liabilities (ED/2010/4)

16 July 2010

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Introduction

On behalf of the European Association of Cooperative Banks, we appreciate the opportunity to present our views on the exposure draft on "Fair Value Option for Financial Liabilities" issued in May 2010.

The IASB proposes to maintain the current requirements in IAS 39 regarding financial liabilities except for specific amendments on the cost exception for equity derivatives and the treatment of credit risk for liabilities designated under the fair value option.

The members of EACB particularly welcome the IASB Board's proposal that changes in own credit risk for financial liabilities designated under the fair value option would not impact profit or loss. Moreover, members strongly support the decision made by the IASB on financial liabilities to maintain bifurcation of embedded derivatives and not to extend the use of fair value through P&L.

However, some of our members still have strong concerns regarding proposals set up in the ED for the own credit risk measurement and the asymmetrical treatment of financial assets and liabilities.

Contact:

The EACB trusts that its comments will be taken into account.

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General Comments

1. Own Credit Risk

As expressed, in our comment letter to the IASB Discussion Paper on *Credit Risk in Liability Measurement* in September 2009, the members of the European Association of Co-operative Banks argued that changes in the credit risk of a liability, which is not held for trading and not actively traded, should not be recognised in profit or loss. Therefore, our members welcome the Board's proposal that changes in an entity's own credit risk from re-measurement of liabilities designated under the fair value option should not impact profit or loss.

However, our members are not convinced by the benefit of the two-step approach retained by the Board. Particularly, we think that the introduction of such a new presentational method to IFRS is not justified.

Regarding the special issue of the own credit risk measurement, EACB members' have different views on the matter:

- **Some of our members, by principle, would have preferred that the IASB proposes a complete exclusion of the effect of changes in the own credit risk in the measurement of a liability. In this respect, they particularly believe that a "frozen spread approach" would be the more relevant measurement method for financial liabilities designated at fair value.** According to their views, presenting the fair value changes attributable to own credit risk in other comprehensive income (OCI) would imply a number of additional issues.
- **Other EACB members would agree with the IASB's proposal to present the fair value changes of financial liabilities in OCI.**

Their respective arguments are detailed in our responses to the ED questionnaire below.

Concerning the recycling issue, EACB members think that it would make sense to recycle realized changes from OCI to income statement.

2. Classification of financial liabilities and link with IFRS 9 (financial assets)

By issuing the new rules on the classification and measurement for financial liabilities, the IASB will complete the phase I of the review of IAS 39 *financial instruments: recognition and measurement*. In this respect, **EACB members welcome the decision made by the IASB on financial liabilities** on the following aspects:

1. **To not extend the use of fair value through P&L** by retaining the held for trading financial liabilities category (at the contrary to the decision made on the asset side) ;
2. **To maintain the bifurcation requirements for embedded derivatives** (at the contrary to its decision on the asset side) ;
3. **To maintain the fair value option**

However, **EACB members wonder why the Board did not assess the asymmetrical treatment between financial assets and liabilities.** In particular, we have the

following concerns regarding the interaction of this ED with IFRS 9 (i.e. the accounting treatment for financial assets):

- From our perspective, **the uncertainty related to illiquid instruments is not taken into account.** Hence, the IASB is still not addressing one of the main issues raised by the financial crisis as requested by the G20 and does not meet the ECB recommendations regarding financial instruments that are not actively traded.
- We think that **decisions taken, notably on bifurcation, would create accounting inconsistencies between financial assets and financial liabilities whereas these instruments may be managed together.** Moreover, the simplification principle used by the Board to justify the prohibition of bifurcation on the asset side (perceived as complex) becomes senseless since this complexity will remain for financial liabilities. According to the paragraph BC8c "*the bifurcation methodology in IAS 39 is generally working well*", there is consequently no reason to retain this requirement only for financial liabilities. We therefore ask the Board to extend the current IAS 39 bifurcation requirements for embedded derivatives to financial assets since it better reflects the nature and cash flows of a hybrid instrument.
- **EACB members are opposed to the elimination of the cost exception for derivatives on unquoted equity** since measuring illiquid instruments at fair value through profit or loss is not relevant when fair value cannot be reliably measured.

Our views are more detailed in our responses to the ED questionnaire below.

EACB responses to the ED questionnaire

<u>**Presenting the effect of changes in a liability's credit risk in profit and loss**</u>

Question 1: Do you that for all liabilities designated under the fair value option, changes in the credit risk of the liability should not affect profit or loss? If you disagree, why?

Question 2: Or alternatively, do you believe that changes in the credit risk of the liability should not affect profit or loss unless such treatment would create a mismatch in profit or loss (in which case, the entire fair value change would be required to be presented in profit or loss)? Why?

The members of the European Association of Co-operative banks have already expressed in the past their disagreement to recognise the effects of the change in own credit risk in profit or loss for the following reasons:

- EACB members believe that taking into account an entity's own credit risk, which reflects the possibility of insolvency, notably contradicts with the going concern presumption in paragraph 23 of the IASB's *Framework for the Preparation and Presentation of Financial Statements*.
- We think that a drop in an entity's credit rating would give rise to immediate profits is counter-intuitive, as an entity would usually not has any discretion regarding the settlement of its own debt. It would also have a misleading effect in that an entity, which is becoming insolvent, would appear solvent and profitable.
- EACB members underline that such a situation would not result in decision-useful information for users in their objective of assessing the amounts, timing and uncertainty of the cash outflows from its obligations. In practice, we note that users generally eliminate effects of own credit risk's changes.
- The effects of changes in own credit risk reflect changes in an entity's internal operational activities and affairs. However, it may also reflect changes in its internally generated goodwill, which is not recorded under existing accounting standards. Our members fear that this would create an accounting mismatch, as it is noted in the ED.

Moreover, from our perspective, excluding the effects of the change in own credit risk in profit or loss is consistent with the fact that regulators use a prudential filter to neutralize the own credit risk effect for capital requirements.

Therefore, our members agree that for all liabilities designated under the fair value option, changes in the credit risk of the liability should not affect profit or loss.

<u>**Presenting the effects of changes in a liability's credit risk**</u>

Question 3: Do you agree that the portion of the fair value change that is attributable to changes in the credit risk of the liability should be presented in other comprehensive income? If not, why?

Concerning the presentation of the effects of changes in a liability's credit risk, **EACB members have different views**:

- **Some EACB members have strong concerns regarding the approach retained by the Board to recognize in OCI the portion of fair value change attributable to credit risk**:
    a. They think that the counter-intuitive effect underlined by the Board would be transferred from net income to OCI and therefore would remain in the financial statements. Moreover, users confirmed that they remove the effect of own credit risk from the fair value measurement. Indeed regulators will still have to maintain a prudential filter to neutralize the own credit risk effect in OCI for capital requirements. According to our members, a better solution could have been to provide the information in disclosures. Furthermore, they fear that this proposal might generate undue volatility in OCI.
    b. From their perspective, The IASB adds a new component in OCI which will becomes more heterogeneous and confusing. OCI has proven to be difficult to understand by users of financial statements.
    c. Finally, members think that the IASB decision to prohibit recycling in profit or loss because "*gains or losses on those liabilities should be recognized only once [and] therefore, recognising a gain or loss in OCI and subsequently reclassifying it to P&L is inappropriate*" (BC37) would lead to the promotion of a unique statement of comprehensive income marginalizing net income as indicator of performance. Furthermore, some of our members fear that this proposal would result in maintaining a so-called "income statement" changes in own credit risk, at the contrary of the aim to avoid this counter-intuitive effect.

  Therefore, those members believe that a "**frozen spread**" approach would be the most relevant measurement method for financial liabilities designated under the fair value option. In other words, the credit risk incorporated in liabilities upon initial recognition should remain fixed throughout the life of the liability.

- Taking into account that users are strongly opposed to a new measurement attribute that would create adjusted fair values, (as it is noted in paragraphs BC26 and BC27 of the Basis for Conclusions to the ED), **some other EACB members support that liabilities designated under the fair value option should be measured at the full fair value in the statement of financial position with fair value changes presented in OCI.**

However, all EACB members stress (like the EFRAG) that no proper debate has taken place yet on performance reporting.

Question 4: Do you agree that the two-step approach provides useful information to users of financial statements? If not, what would you propose instead and why?

EACB members do not support the two-step approach, because they think that the introduction of such a new presentational method to IFRS is not justified.

Our members do not understand why presenting the change in the liability's credit risk separately in the face of the income statement provides more useful information than

posting directly this change in OCI. Members think that this approach may confuse users of financial statements.

- Moreover, EACB members fear that such a requirement comes from a misunderstanding of fair value assessment of instruments designated at fair value through P&L, i.e. mainly OTC instruments. Those instruments are firstly priced by using market inputs (interest rate curve, etc.) and then an adjustment may be made in order to add own credit risk input. Furthermore, since some of our members believe that presenting the changes in own credit risk is not relevant neither in Profit or loss nor in OCI, a two-step approach would particularly not be not relevant.

All EACB members are convinced, that the transparency needed can be achieved with a disclosure requirement in the notes.

Question 5: Do you believe that the one-step approach is preferable to the two-step approach? If so, why?

As explained in our response above to Q4 above, **we believe that a one-step approach is preferable to a two-step approach.**

Question 6: Do you believe that the effects of changes in the credit risk of the liability should be presented in equity (rather than in other comprehensive income)? If so, why?

EACB members believe that the portion of the fair value change that is attributable to changes in the credit risk of the liability should not be recorded in equity.

Members agree with the IASB's observation in the Basis for Conclusions in paragraph BC34 (b) that re-measurements of assets and liabilities should not be presented directly in equity because re-measurements meet the definition of gains (or losses) and are not transactions with equity holders.

- Moreover, for our members, who believe that a "frozen spread" approach is the most relevant measurement method for financial liabilities at fair value, they think that presenting the change in credit risk in equity rather than OCI is therefore not relevant, even if this would avoid some of the drawbacks raised by the OCI approach.

<u>Reclassifying amounts to profit or loss</u>

Question 7: Do you agree that gains or losses resulting from changes in a liability's credit risk included in other comprehensive income (or included in equity if you responded 'yes' to Question 6) should not be reclassified to profit or loss? If not, why and in what circumstances should they be reclassified?

We agree with the Board that in most cases, there would be no amount to recycle because the cumulative effect of any changes in own credit risk will be zero.

However, we are concerned by the reason given by the Board to justify the prohibition of recycling. According to the paragraph BC 37, a "*gains or losses on those liabilities should be recognized only once [and] therefore, recognising a gain or loss in OCI and*

subsequently reclassifying it to P&L is inappropriate". This clearly leads to the promotion of a unique statement of comprehensive income and to marginalizing net income as indicator of performance. We fear that would result in maintaining in a so-called "income statement" changes in own credit risk contrary to the Board's decision to avoid this counter-intuitive effect.

We also believe that gains or losses realised in cash should, by principle, be recognised in the net income since it is an accurate representation of performance. This is in line with our opposition to the prohibition of recycling for equity instruments measured at fair value through OCI under IFRS 9.

- In this respect, our members who are in favour of a "frozen spread" approach underline that recognising a gain or loss upon a buy-back of a liability at fair value is consistent with their preferred approach. Hence, even if our member believe this could arise only in rare cases, we are in favour of recycling credit risk in profit or losses when a gain or loss is realised in cash.

Determining the effects of changes in a liability's credit risk

Question 8: For the purposes of the proposals in this exposure draft, do you agree that the guidance in IFRS 7 should be used for determining the amount of the change in fair value that is attributable to changes in a liability's credit risk? If not, what would you propose instead and why?

Our members agree that method used for determining the amount of the change in fair value attributable to change in credit risk should be consistent with the existing guidance in IFRS 7 currently used by entities.

Effective date and transition

Question 9: Do you agree with the proposals related to early adoption? If not, what would you propose instead and why? How would those proposals address concerns about comparability?

EACB members fear that an early application would undermine the comparability among IFRS reporting entities. **Thus, they consider that all phases of IFRS 9 should be mandatorily applicable at a single effective date.**

- However, since the own credit risk issue was one of the main concerns raised by the financial crisis, some EACB members suggest considering **an option for banks for an early adoption of the new provisions regarding the accounting treatment of own credit risk**, independently from IFRS 9 process. However, those members still prefer an implementation of IFRS 9 as a whole package.

Question 10: Do you agree with the proposed transition requirements? If not, what transition approach would you propose instead and why?

Our members support an approach, which opens the opportunity to reclassify financial liabilities and to revoke the previous designation to the fair value option. The preparer should be able to revise its previous decisions taking into consideration the overall

framework of the new accounting rules. Therefore, our members recommend modifying IAS 39.103M to allow a reclassification in both cases:

1. When a financial liability was designated as at fair value through profit or loss in accordance with IAS39.9 (b)(i) in order to avoid an accounting mismatch
2. When it was designated as at fair value through profit or loss in application of IAS39.11A for not having to separate an embedded derivative.

However, in order to deal with mismatch that could arise from the new accounting treatment for financial instruments, we recommend that reclassification should be available on implementation of any phases of the IAS 39 revision project