Committee of European Banking Supervisors

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Financial Accounting Standards Board
Technical Director
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Dear Madam, dear Sir,

FASB Exposure Draft: Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities

The Committee of European Banking Supervisors (CEBS), comprised of high level representatives from banking supervisory authorities and central banks of the European Union, welcomes the opportunity to provide comments on the US Financial Accounting Standards Board (FASB)'s recent exposure draft on accounting for financial instruments.

Banking supervisory authorities and central banks have a strong interest in promoting sound and high quality accounting and disclosure standards for the banking and financial industry, as well as transparent and comparable financial statements that would strengthen market discipline.

Although the European Union uses IFRS rather than US GAAP, CEBS notes that the IASB and the FASB are collaborating on their review of financial instrument accounting in the context of widespread calls to achieve convergence in this important area. Therefore, we agree with the IASB that it is important that the international community provides feedback on the FASB's proposals, so that the Boards can take this into account when finalising their respective standards. We are also copying this letter to the IASB.

CEBS is very concerned that, despite the collaboration mentioned above, the proposals put forward by the IASB and the FASB are fundamentally different in many respects. This is particularly surprising given the shared commitment of the two standard setters to both improving IFRS and US GAAP and achieving convergence.

In particular, CEBS strongly believes that financial instruments should be accounted for using a mixed attribute measurement model – which aligns with the business model of most banks – and not an (almost) full fair value measurement model, as has been proposed by the FASB. We believe that this significant expansion of the use of fair value does not take into account the concerns expressed by a number of international bodies (among which the G20 and the Financial Stability Board) on this matter.

This significant expansion of the use of fair value and the presentation of both the fair value and the amortised cost on the face of financial statements are not likely to achieve convergence. We therefore strongly encourage the FASB to work with the IASB on a single underlying (mixed attribute) measurement model for financial instruments that eliminates the need for reconciliation between accounts prepared under IFRS and under US GAAP.

We also note that although the FASB's (almost) full fair value model may at first sight appear to have the advantage of simplicity, the various options and exceptions (such as the measurement approach for demand liabilities) could in fact reduce comparability. In addition the proposals could increase complexity, given the absence of active markets for many financial instruments and the additional measurement complexity in calculating fair value for complex or illiquid instruments.

The comments put forward in this letter have been coordinated by CEBS's Expert Group on Financial Information (EGFI) chaired by Mr. Didier Elbaum (Deputy Secretary General, Autorité de Contrôle Prudentiel) - in charge of monitoring any developments in the accounting area and of preparing related CEBS positions - and in particular by its Subgroup on Accounting under the direction of Mr. Ian Michael of the UK FSA. If you have any questions regarding our comments, please feel free to contact Mr. Elbaum (+33.1.4292.5801) or Mr. Michael (+ 44.20.7066.7098).

Yours sincerely,

Giovanni Carosio

Chair, Committee of European Banking Supervisors

Appendix - CEBS comments on the ED

Use of fair value measurement

CEBS strongly believes that financial instruments should be accounted for using a mixed measurement model, allowing the entity to portray consistently its business model, and would not support amending IFRS to follow the FASB's proposals to require fair value measurement of almost all financial instruments. The G20 and the Financial Stability Board mandated the accounting standards setters to revise current rules on accounting for financial instruments "without expanding the scope of application of the fair value principle". The accounting model proposed by the FASB proposal is not consistent with this mandate.

For many financial instruments held by banks, fair value measurement is not consistent with the business model under which the instruments are held and managed – for example, loans held for traditional credit intermediation and bonds held to receive cash flows rather than for trading. CEBS also questions whether all equity instruments should be accounted for at fair value through profit or loss if they are not held for trading.

Furthermore, CEBS would be concerned about the likely lack of reliability and verifiability inherent in measuring items at fair value for which there is an absence of active markets in most jurisdictions (e.g. bank loans or deposits). In the light of this, we do not believe that expanding the use of full fair value measurement to the extent foreseen in the ED would result in more decision-useful information for users.

Therefore, CEBS believes that such a wide-ranging use of fair value through profit or loss, as included in FASB proposals, would not be appropriate in IFRS (although we note that the potential use of fair value measurement, through the 'fair value option', is already considerably broader under US GAAP). In particular, we understand that the FASB has chosen fair value with all changes in fair value recognised in net income as the default measurement for financial instruments (BC 90) and that the use of fair value through other comprehensive income (OCI) is essentially an option when specific criteria are met. We note in that respect that the business model is a criterion only for financial instruments where the option to record fair value changes in OCI has been elected. Amortised cost is left as a residual measurement basis for short term receivables and payables, or permitted (but not required) for certain qualifying financial liabilities.

This could lead to comparability issues, with similar instruments managed in the same way being accounted for differently. Moreover, this is a very significant difference from IFRS 9, where the use of amortised cost is mandatory when the relevant criteria are met. In addition the criteria for requiring the display of amortised cost information on the balance sheet under the FASB's proposals are similar but not identical to the criteria in IFRS 9 for measurement at amortised cost.

While CEBS acknowledges that some degree of symmetry between assets and liabilities is desirable, we do not believe that the argument for symmetry is convincing in all cases. In particular, the funding role of many financial liabilities within an entity's business model means that amortised cost measurement has the greatest relevance, since it faithfully reflects the value of contractual cash flows owed. Such a measure will generally be fairly close to the contractual amount owed. Moreover, the credit risk of an entity's liabilities does not have the same relevance for the entity itself as for the holders of the liabilities. As mentioned in our comments on ED/2010/4, the main concern of the issuing entity is to settle the liabilities or to find alternative funding and is therefore, in most cases, not able to take substantive advantage of changes in OCR. In that context, the exception allowing some financial liabilities to be accounted for at amortised cost (paragraphs 28-30) seems to us to be overly restricted.

Presentation of amortised cost information for some instruments

CEBS notes that the FASB proposes to require amortised cost information on the face of the balance sheet for instruments measured at fair value through OCI, and for the entity's own outstanding "debt instruments" (as narrowly defined in this ED) accounted for at fair value through profit or loss[1].

CEBS does not support presenting, in some instances, two sets of measurement information in such a manner, as we believe that this could be interpreted as there being "two versions of the truth", and thus could be confusing to users of financial statements. Although we understand that presenting information in this manner could aid comparability between IFRS and US GAAP reporters, we do not believe that such presentation in itself is an adequate solution. Instead, we strongly believe that the FASB should work with the IASB to achieve a single underlying (mixed attribute) measurement model for financial instruments which eliminates the need for further reconciliation.

Instruments that are held to collect cash-flows should be measured at amortised cost, as their fair value is of only limited relevance in the context of the primary financial statements as such (i.e. the balance sheet and the income statement), given that these instruments are not held to be sold (fair value gains and losses will in principle never be realised).

CEBS believes however that disclosing fair value information in the notes is appropriate and also sufficient, in line with both current IFRS and US GAAP. Indeed, we recognise that the fair value of instruments which are not traded can provide useful information, for example on the interest rate risk to which the entity is exposed.

We also believe that the wide-ranging use of instruments at fair value through profit or loss (as discussed above) could reduce how effective this presentation approach is at achieving comparability.

[1] The use of Other comprehensive income (OCI) in the FASB ED differs from that in IFRS 9, in both the scope (in the FASB ED the OCI relates to potentially all financial instruments other than those classified in the FVNI; vice versa, in IFRS 9 OCI is applied only to a subset of equity instruments) and the functioning (the FASB ED allows the re-cycling of realised gains/losses in net income; IFRS 9 forbids this re-cycling)

Impairment

In CEBS' view, it is difficult to see from the text of the FASB's exposure draft exactly how the proposed impairment model would work and whether it would lead to earlier recognition of credit risk. In fact, the text does not seem very clear - in particular, the interaction between individual and collective impairment - and there is only limited additional guidance.[2] Against that background, we understand it to be essentially an incurred loss model, modified to require earlier provisioning than current US GAAP (in particular, by removing the "probable" threshold for recognising impairment losses). We also understand that, contrary to the IASB Expected Cash Flow model, the FASB proposal does not permit an entity to forecast future cash events or economic conditions in developing cash flow estimates, requiring entities to consider only the effects of past conditions and existing events in developing such estimates. Thus it seems to us that the IASB model allows entities to take into account a broader range of credit information. In addition, the FASB believes that all credit impairments should be recognised in the period in which they are estimated rather than be allocated over the life of a financial asset, which is an essential characteristic of the IASB's approach for recognising initial expected losses, that we favour.

As stated in our comment letter of June 2010 on the IASB's ED/2009/12, CEBS is in favour of an impairment model based on the concept of expected loss, and considers the IASB to be moving in this direction. In our view, the FASB's proposed impairment model does not follow this route. We acknowledge however that certain issues highlighted by the Expert Advisory Panel (EAP)[3] are reflected in the FASB's approach, notably with regard to the issue of 'open' versus 'closed' portfolios, and the distinction between financial assets evaluated on a collective basis and those evaluated individually.

Embedded derivatives

We recognise that the need for the FASB to consider bifurcation of hybrid financial instruments containing embedded derivatives is reduced by the proposed adoption of an (almost) full fair value measurement model. In such a model, bifurcation of hybrid instruments would broadly only affect whether fair value changes were taken to profit or loss in their entirety or whether a portion of the changes was taken to OCI.

Nonetheless, we consider bifurcation to be a necessary part of a mixed attribute measurement model, especially for financial liabilities. Very often, the most appropriate accounting for straightforward host contracts

[2] In the case of individual impairment calculations, allowances are calculated on the basis of the net present value technique, using as the discount rate the original effective interest rate. In the case of collective calculations, the annual flow of allowances is equal to the difference between two stocks: the impairment losses estimated at time T on the pool of financial assets and the impairment losses estimated at time T-1 on the same poolof financial assets.

[3] See the IASB's Summary of the EAP Discussions, July 2010.

will be amortised cost, because that better reflects the underlying business model.

Own credit risk

Consistently with most stakeholders, banking regulators have long questioned whether unrealised gains or losses from changes in an entity's credit standing should be recorded in the profit or loss account. The information resulting from this accounting treatment is misleading in a prudential context and possibly also for other users. The key reason is that very often it will be difficult to realise changes in the fair value of liabilities, which for the most part are not transferred or settled prior to maturity.

The IASB has proposed to address this by recording such gains and losses, where they arise in the context of the fair value option, in OCI (ED/2010/4). The FASB proposal is different – all gains and losses arising from own credit risk would remain in profit or loss, but they would be presented separately (and this would be required for all financial liabilities measured at fair value). CEBS is not convinced that a response to the issue of own credit risk based purely on presentation is sufficient: the fundamental issue is whether or not gains and losses arising from this should be recognised, especially in profit or loss.

CEBS also notes that there is a difference between the concepts of 'own credit risk' in IFRS and the FASB proposal. In IFRS, the concept is defined as the changes in fair value other than changes in a "benchmark" interest rate and, therefore, it could refer to gains and losses arising from changes in the market price of an entity's own credit risk, whether due to factors specific to the entity or changes in the market price of credit generally. However, in the FASB ED the concept is restricted to the first element only (factors specific to the entity). CEBS urges both Boards to debate which of those approaches is more appropriate, and to converge on this issue.

At a more practical level, CEBS wonders whether all entities will be able robustly to isolate the portion of the change in fair value of their liabilities which is due to a change in the creditworthiness of the entity. If they are required to present such information, a wide variety of estimation techniques may be used, which could impair comparability, and the usefulness of the information generally.

Demand liabilities

CEBS believes that demand deposits should be measured at the amount contractually owed. This is one of a number of reasons why CEBS strongly favours the use of a mixed measurement approach.

In our view, the most relevant information about demand deposits is the amount contractually due. Furthermore, we think that it could be highly misleading to represent deposits at a value different to what depositors can demand. The new measurement attribute specifically introduced in the ED for this type of deposits (the present value of the average core deposit amount during the period discounted at the difference between the alternative funds rate and the all-in-cost-to-service rate over the implied maturity of the deposits), increases complexity.

We are particularly concerned about the proposed measurement of 'core' deposits, which is likely to deliver values below the amounts contractually due (because interest rates paid on core deposits are typically low in relation to market funding rates, or frequently zero) with a related anticipation of future interest income that will be realised later in time through the investments on the asset side and not through the sale of core deposits.

Furthermore, in our opinion, the measurement of deposits in this way would require use of data which may be hard to obtain, and considerable management judgement, for example about the nature of alternative funding sources and which costs should be allocated to deposit-gathering. This raises questions about the reliability of such a measure.

Finally, we note that this approach is inconsistent with that in IFRS, in which financial liabilities, other than those held-for-trading and derivatives, are generally measured at amortised cost, which is considered more appropriate by CEBS.

Hedge accounting

CEBS considers that hedge accounting is an inherent aspect of a mixed attribute model for financial instrument accounting. We do, however, acknowledge that hedge accounting is likely to be a less significant matter within a largely fair value-based model, as suggested by the FASB, than in a mixed attribute model, in which mismatches of measurement basis will be more common, and the need for hedge accounting to address that issue greater.

In CEBS' opinion, the standard setters should undertake a fundamental review of the hedge accounting models, to ensure that hedge accounting remains fit for purpose. In particular, it is important that hedge accounting is consistent with current approaches to financial risk management. Our understanding is that the IASB is undertaking such a review. While FASB's work has been somewhat more limited in scope, we nonetheless see a number of positive aspects.

Overall we think that hedge accounting needs to be put onto a more principles-based basis, and we regard the FASB's proposals as a step in that direction. In particular, we acknowledge that the requirements surrounding testing for effectiveness may need to be relaxed, although it is important that requirements for adequate documentation are retained and that any ineffectiveness is recognised immediately in profit or loss.

However, at the same time, it is important – as FASB recognises – that there is appropriate discipline. We believe that the reduction of complexity should be tied to the objective of promoting sound hedging and risk management practices. In that regard, we support the proposal that hedge accounting should only be discontinued if the criteria for applying this technique cease to be met, or the instrument expires, is sold, terminated or exercised.

Furthermore, we share FASB's view that it should continue to be possible to apply hedge accounting to individual risks. This is important in the context of banking, where very often one or more selected risks – such as interest rate risk – are hedged, rather than, for example, the full fair value of an instrument.

Recycling

Our understanding is that in US GAAP all elements of Other Comprehensive Income are subject, in specific circumstances, to recycling to the profit or loss account. CEBS broadly supports this approach. In particular, we think it is important that gains or losses recognised in OCI are recycled to profit or loss as and when they become realised.

Reclassification

The FASB proposal does not envisage instruments being moved between the different categories which determine measurement and presentation subsequent to initial recognition. In CEBS' view, reclassifications are sometimes needed, for example when the business model changes, so as to keep the measurement method in line with the business model in place at the balance sheet date. This should, however, occur only in rare circumstances, and requires robust documentation and disclosures.