Committee of European Banking Supervisors

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International Accounting Standards Board
30 Cannon Street,
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United Kingdom

Dear Madam, dear Sir,

Exposure Draft: Derecognition

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 comment on the IASB's Exposure Draft on Derecognition (ED).

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.

CEBS welcomes the efforts of the IASB to improve financial reporting in the area of financial instruments. In this respect, CEBS encourages the IASB to maintain a coherent approach when making changes to IAS 39 and related standards, ensuring that concepts are used consistently and that appropriate consideration is given to the wider context in which financial assets are developed and used.

The proposed model for derecognition would result in significant changes to the way that banks present their financial reports, some of which we question both in terms of relevance and from a practicality point of view. In particular, CEBS is concerned about the effect of the proposals on certain transactions common in the banking sector (specifically repurchase agreements and securitisations).

Taking the example of repurchase agreements, we question whether the 'practical ability to transfer' test will be effective and practical. More importantly, we doubt that the new proposed way of accounting will result in more decision-useful information for users, notably for repurchase agreements. In that context in particular, we are not aware that the current accounting treatment has been criticised by users and are not convinced that the IASB's proposal better reflect the economic reality of such operations.

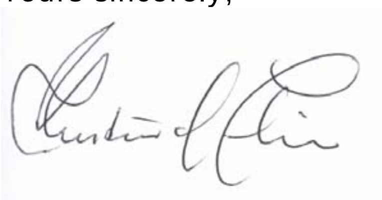
On the whole, we believe that the current emphasis on risk and rewards is a more appropriate basis for a derecognition model. Such a test has demonstrated its robustness in the past and has not resulted in financial instruments being inappropriately derecognised (or vice versa).

In this response, rather than answering each of the specific questions raised in the exposure draft, we intend to focus predominantly on issues which are of particular relevance and importance from a banking supervisory perspective and notably those that could have significant consequences for financial reporting in the banking industry.

Finally, considering the importance of the changes proposed in the ED would entail for the banking industry, we would strongly encourage the IASB to undertake field tests before moving on.

The comments put forward in this letter and in the related appendix have been coordinated by CEBS's Expert Group on Financial Information (EGFI) chaired by Mr. Didier Elbaum (Deputy Secretary General, Commission Bancaire) - 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,



Kerstin af Jochnick
Chair, Committee of European Banking Supervisors

Appendix

General Comments

The exposure draft on derecognition would result in significant changes to a wide range of common financial asset transfers within the banking sector.

The approach proposed does not have a test to evaluate the extent of risks and rewards retained, which we believe will lead to inappropriate accounting treatments for certain transactions (in particular repurchase agreements and securitisations). In our response to Exposure Draft 10 Consolidated Financial Statements, we recommended that the IASB 'gives prominence to the role of risks and rewards in identifying control, particularly with respect to structured entities'. We believe that same applies in the case of derecognition.

The IASB should carefully consider the effects of its proposals on banks and on the functioning of the market for repurchase agreements, bearing in mind other changes in the legal and regulatory environment which have either been recently passed or which are under consideration, especially amendments to European capital requirements legislation (see section on securitisation transactions). CEBS recommends that the IASB carries out a field test and an impact analysis before finalising the proposals. CEBS supports high quality accounting standards, but believes that changes should only be made where these result in real improvements, i.e. primarily in decision-useful information for the users of financial statements.

CEBS notes that the IASB will consider the responses to this exposure draft with the FASB, and recommends the IASB and the FASB to work together towards convergence on derecognition criteria for financial instruments. CEBS is concerned that the proposed model broadens the gap with the FASB's current position on derecognition. In particular even if the FASB model appears to take a more legal approach, we note that the current FAS 166 (recently released) considers a repurchase agreement as a secured borrowing and thus the underlying financial assets used as collateral are not derecognised.

In deliberating the responses to this exposure draft with the FASB, CEBS urges the IASB to avoid issuing standards which will require significant further changes (possibly in the short to medium term) in order to achieve convergence, thus causing considerably uncertainty for market participants.

CEBS also encourages the IASB to ensure that its proposals on derecognition are consistent with its proposals on closely related projects, including 'Consolidated Financial Statements', 'Revenue Recognition in Contracts with Customers' and other aspects of its comprehensive review of IAS 39. In particular, the definition of 'control' and 'transfer' are pivotal to this exposure draft, and should be consistent with the use of those terms in related contexts.

The 'practical ability to transfer' test

CEBS is in doubt about the feasibility of applying this test, where the transferor's ability to derecognise a financial instrument depends on the ability of another party to do something (even if it is the transferee in the transaction). Although the test already exists in IAS 39, we believe that, in practice, it has been little applied. In addition, we consider that the proposed test on whether the transferee has the practical ability to transfer the asset could lead to significant difficulties in practice. In particular:

- We do not believe that continuing involvement on the part of the transferor will always provide sufficient information for the transferor to be able to judge whether or not the transferee considers that they have the practical ability to transfer the asset;
- Even once the transferor has taken a view on the practical ability of the transferee to transfer the asset, there is no guarantee that the transferor and the transferee will come to the same conclusion. Therefore, there is a risk that assets are either recognised simultaneously by both entities, or not recognised by either entity ("double counting or no accounting");
- This situation is exacerbated by the distinction made between 'readily obtainable' and 'not readily obtainable' assets. The assessments of both the transferor and the transferee on whether an asset is readily obtainable may change over time. This implies a significant burden in terms of ongoing review and also gives greater scope for divergence in the assessment of whether or not the transferee has the practical ability to transfer;
- The IASB is encouraged to provide further guidance on the criteria for ascertaining whether or not an asset is 'readily obtainable' and how this relates to other guidance published on active and inactive markets; and
- CEBS is not clear on how the transfer of a readily obtainable asset would be judged where the transferee was not a regular market participant (because the transferee might not know how obtainable such an asset was).

With particular reference to paragraph AG52E, CEBS believes that there would be a need for robust disclosures on management judgements made in this area.

Repurchase transactions

Repurchase transactions are widely used by central banks for monetary policy objectives and by banks both within the inter-bank market and to lend to consumers. The current accounting model treats repurchase transactions as secured lending. From the transferor's point of view, a repurchase agreement is economically equivalent to taking out a loan, with a security provided as collateral for the term of the agreement. The transferor receives a consideration and agrees to pay an interest rate on it. Although the transferee has the legal ability to exercise the rights associated with the security during the term of the agreement, the transferor receives the cash-flows generated by the security and bears the associated risks of any changes in these cash-flows until the maturity of the agreement (under usual market practice).

CEBS considers that a risks and rewards test better captures the substance of these transactions and results in a more appropriate accounting treatment. This accounting treatment has not led to any significant concerns in practice. CEBS also notes that the proposals would create inappropriate recycling of unrealised gains or losses through the income statement for assets transferred under repurchase agreements, will increase the amount of financial assets at fair value and would prohibit entities entering into repurchase agreements using assets in the held to maturity category.

For all these reasons, CEBS does not believe that the proposed derecognition model, whereby readily obtainable assets would be derecognised, better captures the economic substance of a repurchase agreement than the current approach, which treats it as secured financing. A risks and rewards test better captures the substance of these transactions and results in a more appropriate accounting treatment.

Therefore CEBS urges the IASB to reconsider the proposed treatment for repurchase transactions, particularly in view of the changes to classification of financial instruments under its comprehensive review of IAS 39.

Securitisation transactions

Under the proposed derecognition approach, entities operating under an ‘originate and distribute’ model and retaining a subordinated interest in (or providing a credit enhancement for) a pool of assets would no longer be able to derecognise any of the securitised assets, since the transferor retains an interest in the performance of the whole pool of assets. The assets will continue to be recognised in full by the transferor, even if there has been a substantial transfer of the risks and rewards. This requirement, combined with European Union legislation which will require the retention of at least 5% of the nominal value of the securitised assets from 2011, would have a significant impact on the securitisation industry. Furthermore, this could be difficult for users to understand. CEBS believes that the inclusion of some notion of risk transfer would be more appropriate to assess who should recognise the assets in such transactions, and is in favour of keeping a risks and rewards test to determine the accounting treatment in these cases.

Disclosure requirements in IFRS 7

CEBS acknowledges that this exposure draft aims to address the recommendations of the Financial Stability Forum, which seek improvements in disclosure standards particularly for ‘off-balance sheet’ activities (of which derecognised financial assets form a part). CEBS is of the view that the proposed extension of disclosure requirements in IFRS 7 to derecognised financial assets is in line with the disclosure requirements proposed in Exposure Draft 10 Consolidated Financial Statements, and is a step forward in providing users with decision-useful information with which to properly evaluate the risks faced by the reporting entity. Even where a reporting entity does not control an asset (and thus derecognises it), it may retain other kinds of involvement which should be captured to enable users to analyse its financial position.

Alternative approach

CEBS acknowledges the views of those Board members proposing an alternative approach, who argue that, under the proposed approach, the history of ownership affects the way that transactions are accounted for. However, CEBS feels that the alternative approach has the potential to significantly increase volatility of balance sheets. It also provides opportunities for unrealised gains and losses to be realised by transferring an immaterial proportion of the cash flows. With this in mind, we request that consideration be given to the allocated cost basis to restrict the level of fair value measurement introduced by the alternative approach, were this to be adopted.