Committee of European Banking Supervisors

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14 September 2009

International Accounting Standards Board
30 Cannon Street,
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Dear Madam, dear Sir,

Exposure Draft: Financial Instruments: Classification and Measurement

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 Classification and Measurement.

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 as requested by the G20, in particular the requests for accounting standard setters to improve standards for the valuation of financial instruments based on their liquidity and investor's holding horizons and to improve accounting standards for valuation uncertainty.

As noted in previous contributions, CEBS supports the use of a mixed attribute model in order to provide decision-useful information on financial instruments and welcomes that the IASB proposes to continue with such a model.

Although CEBS supports the IASB's move to reflect an entity's business model in the determination of the appropriate measurement categories, we have some concerns about the proposed criteria to be used to determine whether financial instruments should be measured at amortised cost. Applying the two criteria (basic loan features and contractual yield basis management) may lead to fewer instruments being eligible for the amortised cost portfolio, and, therefore, to more instruments that are not actively traded being fair valued with changes taken to the income statement - especially complex instruments.

We would prefer that the use of a measurement category was more closely linked to an entity's underlying business model by focusing on the way in which the entity uses the instrument to generate cash-flows with due consideration given to the liquidity of an instrument.

Moreover, we question whether issues regarding reliability of fair value measurements, as demonstrated by the financial crisis, have been fully addressed. With this in mind, we would encourage the IASB to consider further

whether fair value through profit and loss is always an appropriate measurement category for instruments that are not actively traded.

In these instances, a number of members favour using an additional category with fair value through other comprehensive income (OCI). In that particular context, members see strong arguments for the recycling of realised gains and losses.

We also believe that there could be a role for limited reclassification, and for bifurcation of some embedded derivatives, where this would more fairly represent an entity's underlying business model.

Our general and detailed comments on the Exposure Draft (ED) have been provided in the appendix of this letter.

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,

Giovanni Carosio
Chair, Committee of European Banking Supervisors

Appendix

General Comments

CEBS supports[1] a mixed attribute model to accounting for financial instruments, and believes that fair value is appropriate in certain specified circumstances, for measuring financial instruments, in particular when they are traded in active markets. However, CEBS has concerns that the proposed model may lead to an increase in the use of fair value through profit and loss that may not result in more decision-useful information for users, especially bearing in mind the issues linked to the reliability of fair value estimates - in particular for complex instruments - which emerged during the financial crisis.

While the proposals have implications for financial liabilities and the treatment of own credit risk this issue is not explicitly discussed in that context. Instead we refer to our separate comment letter on the IASB's Discussion Paper on Credit Risk in Liability Measurement'.

Although CEBS supports the IASB's move to reflect an entity's business model in the determination of the appropriate measurement category, we believe that the Board could go further in this direction and consider the extent to which the entity's business model is affected by the liquidity of the financial instruments in question. In this context, a number of members would support wider use of fair value through other comprehensive income (OCI) as a way to address some of the concerns relating to reliability while, at the same time, allowing financial instruments to be fair valued on the balance sheet. We would welcome the IASB deliberating further on such a category.

Given the prominence we attach to reflecting an entity's business model, we believe that a classification approach based on business models must allow limited reclassification in rare circumstances. Where certain circumstances lead to a change in an entity's business model, instruments may no longer satisfy the criteria which governed classification at initial recognition, and reclassification should be permitted accordingly.

Moreover, this exposure draft is related to other projects, and thus it is difficult to assess these proposals in isolation from other aspects of IAS 39. CEBS encourages the IASB to ensure that its proposals are consistent with other aspects of its review of accounting for financial instruments, and to subject all proposals to a field test and impact assessment before they are finalised. In addition, it is important that the IASB allows entities to reconsider some accounting choices once all the revisions of IAS 39 are completed.

Another aspect in this context is the treatment of AFS debt instruments impairment rules. CEBS has suggested in earlier comment letters that the impairment rules in IAS and US GAAP are aligned before the end of 2009 (with a split of the credit risk component in the P&L and other fair value changes in unrealised losses and the reversal of impairment credit risk losses). This ED proposes to drop the AFS category, but not all institutions might be able to use the new standard for their 2009 figures, which could leave the impairment issue unresolved in the meantime.

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[1] The comments made reflect the views of the large majority of CEBS members. However the Czech Nationlal Bank dissents and supports the IASB exposure draft in full.

CEBS encourages the IASB and the FASB to work together towards convergence on accounting for financial instruments. We have noted that the proposals in the ED might be subject to further deliberations based on the FASB's proposals. With this in mind, we reiterate our concerns regarding the decision-usefulness of measuring instruments fair value through profit and loss in all circumstances. Although we would welcome convergence in this area, we believe that this should not be at the cost of high quality accounting standards for financial instruments.

Question 1

Does amortised cost provide decision-useful information for a financial asset or financial liability that has basic loan features and is managed on a contractual yield basis? If not, why?

As we said in our response to the DP: *Reducing Complexity in Reporting Financial Instruments* in October 2008, "we believe that the current mixed attribute model – which we do not believe to be especially complex – better represents the different ways entities generate cash flows." The mixed attribute model remains essential to fair representation of how earnings and cash flows are generated by banks, because a significant part of banking business is not primarily managed or regulated on a fair value basis.

Consequently, we urge the IASB to maintain at least two measurement categories: amortised cost and fair value. CEBS believes that financial instruments held or issued for the purpose of collecting (or settling) contractual cash flows should be measured at amortised cost. This is the most appropriate measurement attribute for representing the return on these transactions and their cash flows, in line with the business model of the entity.

However, we have some concerns with respect to the proposed conditions for being measured at amortised cost. Applying the two criteria – and in particular the 'basic loan features' criterion - may lead to fewer instruments being eligible for the amortised cost portfolio, and as a consequence, to more instruments being fair valued with changes taken to the income statement, especially for complex instruments. It would be preferable for this criterion to refer to "loan features". This more principles-based approach to this criterion would be more consistent with the other criterion (the entity's underlying business model), which we believe should be given greater emphasis (see below).

CEBS does not oppose the use of fair values as such, although the use of these criteria and the resulting measurement at fair value through profit and loss may in some cases lead to unreliable information. This could notably be the case because of difficulties regarding the reliability of measurement of illiquid instruments, as seen during the financial crisis.

We would also prefer a categorisation that gave more prominence to entity's underlying business model, i.e. the way in which the entity uses the instrument to generate cash-flows. The characteristics of the instrument, including its liquidity, should also be taken into account to ensure that the business model can be applied consistently and to make sure that the accounting approach provides decision-useful information. Indeed, much financial intermediation takes place through banks precisely because the conditions for the existence of a trading market are not in place.

To avoid recognising changes in fair value that may not be reliably estimated through the income statement (particularly for illiquid instruments), a number of members are in favour of retaining an additional category where fair value changes are recognised in Other Comprehensive Income (OCI). This is discussed further in our response to questions 10 and 11 below.

Question 2

Do you believe that the exposure draft proposes sufficient, operational guidance on the application of whether an instrument has "basic loan features" and "is managed on a contractual yield basis"? If not, why? What additional guidance would you propose and why?

Regarding financial instruments such as loans, deposits, corporate and government bonds, we believe that the exposure draft provides useful guidance on the application of the new two-category approach. However, it is not fully clear how the "basic loan features" condition is to be interpreted in relation to more complex instruments. Notably, the ED is not clear as to the status of usual features or covenants included in retail loans, extendable loans and preference shares.

We also are of the view that some tranched debt and certain hybrid instruments would be appropriately measured at amortised cost, yet would not clearly, under the current guidance, satisfy the "basic loan features" condition. Similarly, we have concerns over whether the approach leads to an appropriate treatment for senior tranches of securitised assets (other than the most senior). Therefore, we believe that IASB should develop further guidance for structured products in addition to paragraphs B7 and B8, giving due attention also to how banks manage these products (trading intent vs. investment intent), the type of securitised assets (low risk vs. high risk) and the characteristics of securitisations (traditional vs. re-securitisation). In particular, application guidance should explain how the waterfall structure of these products would affect their classification. The IASB should also clarify whether or not the assessment of the subordination of tranches is to be carried out at inception of the contract. This is discussed further in our response to question 4 below.

We agree with the ED's proposal that the condition on "managed on a contractual yield basis" should not be subject to "tainting rules". Appropriate disclosures setting out the amounts of instrument sold, the effect on profit or loss and the reason why the instrument is sold are sufficient. However, the guidance could be improved by adding explanations provided in the basis for conclusions BC33 mentioning that sales or transfers of financial instruments with basic loan features before maturity would not change the business model of an entity, as long as such transactions were consistent with managing the collection or payment of contractual cash flows rather than realising changes in fair values.

In addition, we believe that application of this condition could be improved by placing emphasis on classification at portfolio level, since this will reflect the different business models operated within a single entity. Also, a more precise definition of "held for trading", with, for example, an explicit reference to a reasonably high turnover consistent with the active frequent buying and selling requirement, could be useful to avoid distorted classifications. Financial instruments "held for trading" could be disclosed separately, as under current IFRS 7 disclosure requirements, since this information is very relevant for the users of the financial statements.

We question whether the treatment in paragraph B13(b) for financial assets acquired at a discount that reflects incurred credit losses is appropriate. Such assets could still be managed on a contractual yield basis and exhibit basic loan features, and therefore amortised cost measurement would result in decision-useful information. It is also not clear how a *portfolio* containing some loans with incurred losses would be dealt with under this model. Finally, we wonder whether the approach is consistent with the IASB's project to consider alternative impairment models.

Question 3

Do you believe that other conditions would be more appropriate to identify which financial assets or financial liabilities should be measured at amortised cost? If so,

> **(a) what alternative conditions would you propose? Why are those conditions more appropriate?**
>
> **(b) if additional financial assets or financial liabilities would be measured at amortised cost using those conditions, what are those additional financial assets or financial liabilities? Why does measurement at amortised cost result in information that is more decision-useful than measurement at fair value?**
>
> **(c) if financial assets or financial liabilities that the exposure draft would measure at amortised cost do not meet your proposed conditions, do you think that those financial assets or financial liabilities should be measured at fair value? If not, what measurement attribute is appropriate and why?**

As noted above, we are not convinced that the proposed classification fully addresses concerns regarding the use of fair value for complex financial instruments for which there is no active market, given that these proved to be particularly difficult and problematic to value during the financial crisis. We believe due consideration should be given to the presence or otherwise of liquid and active markets for these banking activities in deciding whether to extend the use of the fair value through profit and loss.

In particular, the main classification criterion should focus on how financial instruments are managed and give due regard to whether or not these instruments are traded in sufficiently active markets to enable reliable fair value measurement.

A number of members would support a wider use of an alternative approach, which would add a category with fair value changes going through OCI, comprising not only equity but also certain debt instruments where fair value estimates are based on unobservable data and where the instruments are held according to a medium- or long-term perspective, but do not meet eligibility criteria for the amortised cost category. This would reflect the way in which instruments are used to generate earnings and cash flows, and whether or not

active markets for the instruments exist (see also our response to questions 10 and 11 below).

Question 4

(a) Do you agree that the embedded derivative requirements for a hybrid contract with a financial host should be eliminated? If not, please describe any alternative proposal and explain how it simplifies the accounting requirements and how it would improve the decision-usefulness of information about hybrid contracts.

(b) Do you agree with the proposed application of the proposed classification approach to contractually subordinated interests (i.e. tranches)? If not, what approach would you propose for such contractually subordinated interests? How is that approach consistent with the proposed classification approach? How would that approach simplify the accounting requirements and improve the decision-usefulness of information about contractually subordinated interests?

(a) Although we recognise that removing the embedded derivative rules would achieve significant simplification of financial instrument accounting, we have concerns as to whether the new classification approach for embedded derivatives is appropriate. Where various components of a hybrid instrument are managed on different bases, we suggest that bifurcation is retained where it is the best way to represent the nature and cash flows of the instrument. This would mean that elements managed on a contractual yield basis and exhibiting basic loan features would remain eligible for amortised cost measurement, avoiding potential inconsistencies in application of the standard. This would provide more decision-useful information for users, since it would more fairly reflect an entity's business model. Otherwise, extending the use of fair value in this manner could also lead to an increase in accounting mismatches, which would in turn require more instruments that are not actively traded to be measured at fair value to resolve these mismatches.

CEBS does not believe that continuing to segregate some hybrid instruments would lead to excessive complexity. Issuers of hybrid instruments should be able to separate the embedded derivative from the host contract, where these are managed on different bases.

Further guidance on the features that the IASB considers as "basic loan features" would be very helpful in understanding the scale of the movements between fair value and amortised cost that would result from the IASB's proposed model for hybrid contracts. The comments above may be less relevant depending on the breadth of the scope of the "basic loan features" concept.

(b) CEBS disagrees with the requirement that only the most senior tranche in a waterfall structure would qualify as an instrument containing basic loan features. We believe that all senior tranches (not just the most senior) should qualify as having basic loan features as they are economically less exposed to credit losses than a proportionate interest in the securitised pool of assets.

Question 5

Do you agree that entities should continue to be permitted to designate any financial asset or financial liability at fair value through profit or loss if such designation eliminates or significantly reduces an accounting mismatch? If not, why not?

CEBS acknowledges that the changes proposed in the ED render some of the current eligibility criteria for the use of fair value option obsolete. We favour the retention of the fair value option, provided it is used to eliminate or significantly reduce an "accounting mismatch", and subject to whether its use will be significantly affected by any changes proposed by the IASB, especially in the area of hedge accounting rules. Given that the IASB is not expected to publish these proposals until later in 2009, it is difficult to assess this issue properly at this stage.

Question 6

Should the fair value option be allowed under any other circumstances? If so, under what other circumstances should it be allowed and why?

As mentioned before CEBS agrees with the use of the fair value option in circumstances where it is used for eliminating or significantly reducing an accounting mismatch, and subject to whether its use will significantly affected or not by any changes proposed by IASB. CEBS does not see any other circumstances for which its use should be allowed. Moreover, we think that the IASB should ensure that its use is consistent with the changes that will be decided in terms of hedge accounting.

Question 7

Do you agree that reclassification should be prohibited? If not, in what circumstances do you believe reclassification is appropriate and why do such reclassifications provide understandable and useful information to users of financial statements? How would you account for such reclassifications, and why?

As expressed earlier, CEBS favours a classification scheme that reflects the business model of the entity. Under the proposed model, a financial instrument is classified on initial recognition to be subsequently measured at amortised cost or fair value (via profit and loss or OCI) depending on whether it meets certain criteria. However over time circumstances may change, and what may have been an appropriate classification for a financial instrument at initial recognition may no longer be appropriate. While acknowledging that an entity's business model does not change frequently, the financial turmoil has demonstrated that in some cases, extreme circumstances (including stressed market conditions) may modify the way instruments are managed by an entity. More generally, it may happen that conditions for classification in a specific category are no longer met. Therefore, we do not agree with the IASB's proposal that reclassifications should be prohibited.

We believe that some limited reclassifications should be permitted, subject to very strict criteria. Such reclassifications will be necessary to fairly reflect changes in an entity's underlying business model. In our opinion, criteria similar to those introduced in the amendments to IAS 39 in October 2008 should be considered, when changes occur in the business model of the entity (such as may result when markets become very dislocated).

Comprehensive disclosures should be required for any reclassifications, so that the effect of the reclassification is fully transparent for users. This also enables market discipline to play a role in sanctioning entities that seek to reclassify instruments in anything other than very extreme circumstances.

Question 8

Do you believe that more decision-useful information about investments in equity instruments (and derivatives on those equity instruments) results if all such investments are measured at fair value? If not, why?

Question 9

Are there circumstances in which the benefits of improved decision-usefulness do not outweigh the costs of providing this information? What are those circumstances and why? In such circumstances, what impairment test would you require and why?

CEBS acknowledges that the IASB's proposed model would significantly increase measurement complexity for unquoted and illiquid equity investments whose fair value cannot be reliably measured. This increase in measurement complexity for these instruments would be significant, since, by definition, it may be challenging to estimate fair value reliably.

However, entities are already required to monitor such investments for impairment, and are party to information about the performance of the equities through information available due to shareholder rights. Providing sufficient application guidance could, to some extent, reduce the burden of additional measurement complexity for these items. Incorporating the Expert Advisory Panel's guidance, particularly the section on management's estimates in a fair value measurement and active versus inactive markets, could be helpful to preparers. In addition, in the case of unquoted equity investments, the cost could be considered as a proxy for fair value measurement where there is no additional information available to suggest that fair value changes have taken place could be a practical way to reduce measurement complexity. Therefore in those cases the cost exemption should be retained.

Additionally, given that the proposed standard foresees a specific treatment for equity investments, the IASB should consider whether there is a need for a definition and guidance on what should be considered as an equity instrument from the perspective of a holder and whether there are differences between a holder's and an issuer's perspective.

Question 10

Do you believe that presenting fair value changes (and dividends) for particular investments in equity instruments in other comprehensive income would improve financial reporting? If not, why?

While CEBS agrees with the presentation of fair value changes of particular investments in equity instruments in OCI, the proposal made by the IASB could create a mismatch between the revenues of such investments and the related funding costs. In order to avoid this mismatch, we can see arguments for permitting recycling of realised gains and losses, and in this case, dividends should be recognised via profit and loss.

Question 11

Do you agree that an entity should be permitted to present in other comprehensive income changes in the fair value (and dividends) of any investment in equity instruments (other than those that are held for trading), only if it elects to do so at initial recognition? If not, (a) how do you propose to identify those investments for which presentation in other comprehensive income is appropriate? Why? (b) should entities present changes in fair value in other comprehensive income only in the periods in which the investments in equity instruments meet the proposed identification principle in (a)? Why?

As expressed in previous questions, CEBS is of the view that the classification model should adequately represent the business models underlying the way the instruments are managed, while considering the characteristics and liquidity of financial instruments.

Therefore, a number of members believe that there are arguments for extending the fair value through OCI category to debt instruments which are held with a medium and long term perspective, where there is uncertainty over the reliability of fair value estimates and which do not meet eligibility criteria for the amortised cost category. Recognition of the changes of fair value for those instruments in OCI could reflect their potential lack of reliability and concerns in terms of the existence of active markets in the eyes of the users. It would also reflect the way that such instruments are used to generate earnings and cash flows, and give due regard to the absence of active markets for such instruments. Realised gains and losses on these instruments would be recycled to the income statement.

Reclassification into this broader fair value through OCI category would be permitted when circumstances prevent entities from continuing to apply their business model (such as when markets become very illiquid). Under this approach, the fair value through profit and loss category would be focussed on liquid instruments whose fair value could be measured reliably, and those held for trading.

As stated in our response to Q10 above CEBS believes that an accurate representation of the performance of the entity, in particular financial services companies, requires recognition of realised returns to profit and loss as well as

impairment losses. The proposal made by the IASB could create a mismatch between the revenues of such investments and the related funding costs. In order to avoid this mismatch, we can see arguments for permitting recycling of realised gains and losses, and in this case, dividends should be recognised via profit and loss.

CEBS also recommends that the IASB should address impairment principles for instruments classified in OCI and, in this regard, take into consideration the recommendations made by CEBS in its report on the valuation of complex and illiquid financial instruments (June 2008).

Question 12

Do you agree with the additional disclosure requirements proposed for entities that apply the proposed IFRS before its mandated effective date? If not, what would you propose instead and why?

Question 13

Do you agree with applying the proposals retrospectively and the related proposed transition guidance? If not, why? What transition guidance would you propose instead and why?

Overall, we agree that the proposals on the effective date and transition should reflect the principle of retrospective application, with some exceptions.

Although the retrospective application, as defined in IAS 8, involves greater difficulties and costs compared to other alternatives, this seems necessary to ensure the comparability of the financial information over time. This is necessary to enable an adequate evaluation of performance, as well as to increase the usefulness of the financial information. Therefore we believe that the benefits justify the costs related to the retrospective application.

We think that the requirements on transition related to hedge accounting will require further analysis (with proposals only expected during the second phase of the project to replace IAS 39), because this issue is closely related to the classification of the financial instruments.

The requirements presented in paragraphs 44H and 44I added to IFRS 7 seem to be relevant for early adoption to enhance comparability between institutions. We would like to emphasise the importance of qualitative disclosures; these are essential to avoid undermining confidence in the financial information.

Question 14

Do you believe that this alternative approach provides more decision-useful information than measuring those financial assets at amortised cost, specifically:

> **(a) in the statement of financial position?**
>
> **(b) in the statement of comprehensive income?**

If so, why?

We acknowledge that there may be some important advantages of this alternative, notably if the category of amortised costs is widened according to CEBS proposals in this CL:

- It appears to mimic the FASB rules regarding other than temporary impairment (OTTI), issued in April 2009. Financial markets welcomed the introduction of these rules, and we, like many others, support greater convergence between the IASB and the FASB as regards financial instrument accounting.
- disaggregation of fair value changes offers investors and depositors more information than aggregated information alone;
- fair value changes are held in OCI, which appears equivalent to the treatment of AFS debt securities, and has desirable prudential properties; and
- it may dovetail nicely with the treatment of liabilities. The alternative implies that fair value gains on own credit risk are kept in OCI until the moment of realisation.

However, we have doubts regarding the following features of the alternative approach. The no-recycling requirement is too restrictive, since it may prevent banks from realising losses. It may also create undesirable incentives for banks to avoid using the fair value category. Furthermore, this alternative approach appears to eliminate the fair value through profit and loss category which does not seem to be appropriate for the trading portfolio.

Overall, the alternative approach appears to significantly expand the use of fair value, by narrowing the scope of the amortised cost category. We do not believe that such a broadening of the use of fair value would provide more decision-useful information for users (as discussed above, we believe that amortised cost provides more useful information in certain circumstances), and therefore we prefer the model proposed by the IASB.

Question 15

Do you believe that either of the possible variants of the alternative approach provides more decision-useful information than the alternative approach and the approach proposed in the exposure draft? If so, which variant and why?

CEBS does not favour either of the possible variants. Such variants would have two undesirable properties. First, this would require banks to measure assets with basic loan features on a fair value basis. These fair values will likely be at Level 3. Level 3 valuations are not standardised and hence offer limited valuable information to investors or depositors. Secondly, the disaggregation of financial instruments with basic loan features that are managed on a contractual yield may impose a significant burden on banks.