Committee of European Banking Supervisors

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

Discussion paper Reducing Complexity in Reporting Financial Instruments

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 Discussion Paper Reducing complexity in Reporting 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.

CEBS has a particular interest in the reporting of financial instruments to the extent that these instruments account for the large majority of the activities of banks and financial institutions and thus fundamentally affect these institutions' financial statements.

While CEBS agrees that some complexity could be removed from the standard, we have some concerns about the avenues proposed in the paper to achieve this objective. We have developed our main concerns in that respect in the general comments part of the appendix to this letter.

Our comments have been coordinated by CEBS's Expert Group on Financial Information (EGFI) - in charge of monitoring any developments in the accounting area and of preparing related CEBS position - and in particular by its Subgroup on Accounting under the direction of Mr. Patrick Amis of the French Commission Bancaire. If you have any questions regarding our comments, please feel free to contact Mr. Didier Elbaum (+33.1.4292.5801), Chair of the EGFI or Mr. Patrick Amis (+33.1.4292.6032).

Yours sincerely,

Kerstin af Jochnick
Chair, Committee of European Banking Supervisors

Appendix

General comments

While CEBS agrees that the standard is unnecessarily complex in some instances, we have at the same time concerns about the avenues proposed in the paper in order to achieve these objectives.[1]

Single measurement attribute and wider use of fair values

The discussion paper limits the complexity discussions to considerations of ‘the many ways financial instruments’ are measured and to ‘hedge accounting’ (BD19). CEBS is concerned about the implications of this limited approach which, as set out in the Discussion paper, puts a lot of focus on a wider use of fair values in reporting financial instruments.

In that context CEBS has some doubts about the mandatory use of fair value as the most appropriate measurement attribute for the measurement of all financial instruments for all entities. Our members also question the long-term objective of a single measurement attribute for financial instruments set out by the IASB in section 1, which is further detailed in section 3. We believe that the question of the long term objective in measurement would be better addressed through an open and comprehensive debate about the use of fair value and not through the willingness of reducing complexity in IAS 39.

In particular, our members consider that a wider use of fair values for financial instruments should not be envisaged before the following criteria, which are consistent with the position expressed by the Basel Committee in 2001, are met:

- The conceptual and practical issues associated with fair value are resolved;
- Active markets develop for major aspects of banking book positions;
- Bank risk management evolves to rely on fair value measurements, and
- A broad range of users of financial statements, including depositors and other creditors of banks, find fair value to be the best measure in the primary financial statements.

Although some developments have been observed, our view is that all these criteria have yet to be met.

Reducing complexity

CEBS considers that some of the complexity of reporting financial instruments is not a question of accounting standards. Rather it is directly related to the diversity of financial instruments and more importantly to the business models adopted by entities. As long as the standard does not raise any concerns regarding the fair presentation of the transactions, according to a particular

[1] It should be noted that of the 27 members (and 3 observers) of CEBS, one member – Denmark - and one CEBS observer - Norway - do not share the views expressed in the letter.

business model, this apparent complexity is not a source for concerns as such, notably because it avoids a dissociation between the way financial instruments are reported and managed. To support our case, we would like to recall that some of the economic functions assumed by banks, in particular credit intermediation, are explained precisely because the conditions for active markets are not in place (such as for retail and small business lending).

However, CEBS considers that much of the complexity of the standard relates to the provisions relating to hedge accounting and therefore agrees with the IASB's objective to simplify IAS 39 in that area (see our answer to question 5). We noted also that complexity in IAS 39 could be significantly reduced through streamlining and reordering of the standard.

That being said, we found it difficult to engage in a discussion aiming at the reduction of complexity in reporting financial instruments in isolation from a discussion on the scope of the standard for financial instruments and the definition of financial instruments themselves. In fact, given that much of the paper concerns the possible wider use of fair values, CEBS is of the view that these issues need to be considered at the same time. In going forward, it is also suggested that the IASB carefully considers the implications of this project with the work it carries out on measurement, adopting a more integrated approach.

Indeed, the emphasis the IASB puts on widening the use of fair values comes at a point in time when institutions and in particular a number of banks have encountered significant fair value measurement problems during and in the wake of the market turmoil. CEBS is of the opinion that a number of issues in that respect, as pointed in its recent report on the valuation of complex and illiquid financial instruments[2] should be addressed as a priority. In other words, we do not believe that a full fair value model would necessarily reduce, per se, the complexity of *applying* the standard.

Finally, when considering changes of this magnitude, we would expect that the IASB would carry out an extensive impact assessment and field-testing before deciding on any definite measures, using a cost-benefit approach.

Specific comments

Question 1

Do current requirements for reporting financial instruments, derivative instruments and similar items require significant change to meet the concerns of preparers and their auditors and the needs of users of financial statements? If not, how should the IASB respond to assertions that the current requirements are too complex?

As mentioned in our general comments, CEBS supports the IASB's objectives of reducing complexity in reporting financial instruments. At the same time it is

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[2] The report on the valuation of complex and illiquid financial instruments published on 18 June 2008 identifies a number of issues in the area of valuation that CEBS would like the IASB (as well as the banking industry and the auditing standard setters) to address.

felt that some of the approaches proposed by the Board, while they might reduce the complexity of the standard, would not necessarily reduce the difficulty in applying the standard. We have explained notably what we consider to be the prerequisites for a wider mandatory use of fair values to financial instruments.

However, we commented that in our view much of the complexity relates to the standard's provision relating to hedge accounting and that we agree with the objective for simplification in that area. CEBS also believes that simplification of the standard could be achieved through improving its presentation and possibly through reorganising certain parts of IAS 39 (including the application and/or implementation guidance).

Question 2

(a) Should the IASB consider intermediate approaches to address complexity arising from measurement and hedge accounting? Why or why not? If you believe that the IASB should not make any intermediate changes, please answer questions 5 and 6, and the questions set out in Section 3.

(b) Do you agree with the criteria set out in paragraph 2.2? If not, what criteria would you use and why?

(a) As follows from the above, CEBS has concerns about intermediate approaches 1 and 2.

With regard to approach 1. CEBS is of the view that there is a need to distinguish between financial instruments that are held for trading, held for investment purposes and those that are held with a long term perspective, in particular when there is no active market for the instruments. This is important not only for purposes of presentation but also for measurement, as it allows reflecting differences in the use of financial instruments as a result of different business models (see our general comments). In that respect CEBS considers necessary to maintain the current categories and the measurement attributes that are applied to them.

With regard to approach 2., we have discussed our concerns in some detail in the general comments part of the letter.

Approach 3 on the other hand should be further explored.

(b) CEBS questions some of the criteria used in paragraph 2.2 against which any recommendations for a reduction of complexity shall be examined especially as concerns approaches 1 and 2. In particular we do not believe, as already mentioned, that the reduction of complexity should be tied necessarily to the long term objective of increasing the use of fair value.

Criteria (b) and (c) of paragraph 2.2 can even be difficult to reconcile in some instances, to the extent that the consistency with the long-term objective (i.e. the use of fair value as single measurement attribute) may imply, as shown by the current market turmoil, increased complexity in the practical valuation of financial instruments. CEBS considers the latter complexity to be of far greater concern than the use of different measurement attributes.

There are a number of other issues – hedge accounting, improving the clarity of the standard, addressing the pressing issues related to the valuation of illiquid financial instruments - that could reduce complexity in IAS 39 in a surer and quicker way.

Question 3

Approach 1 is to amend the existing measurement requirements. How would you suggest existing measurement requirements should be amended? How are your suggestions consistent with the criteria for any proposed intermediate changes as set out in paragraph 2.2?

CEBS does not see a need for reducing the number of measurement categories in IAS 39, because these are required to capture the reporting needs arising from the use of different business models.

At the same time CEBS expressed a number of proposals regarding reclassification issues between the different categories of financial instruments in its above mentioned report.[3]

We would also encourage the IASB to consider the opportunity to introduce stricter requirements for the initial classification of financial instruments into the trading category, for example by linking it– at inception - to the existence of an active market.

Question 4

Approach 2 is to replace the existing measurement requirements with a fair value measurement principle with some optional exceptions. [...]

As explained under question 2 (a) and in the general comments CEBS has some concerns on the second intermediate approach put forward by the IASB. Such an approach could be expected to raise potentially major comparability issues between preparers having the same business model.

Question 5

Approach3 sets out possible simplifications of hedge accounting

(a) Should hedge accounting be eliminated? Why or why not?

(b) Should fair value hedge accounting be replaced?. [...]

(a) CEBS is strongly opposed to the elimination of hedge accounting. Indeed, in a mixed-attribute model hedge accounting is crucial to overcome some of the measurement differences that occur in such an environment. Therefore CEBS encourages the IASB to further examine how hedge accounting could be simplified. We would like to stress that hedging is used routinely by preparers in the course of their business.

(b) Our comments on this issue are the following:

a. The use of the fair value option would not replace the need for hedge accounting as it would require the institutions to fair value the whole item, as opposed to only a portion corresponding to the hedged risk. As it would not always be possible or desirable to

[3] Paragraphs 38 and 39 of the CEBS report on the valuation of complex and illiquid financial instruments raises address a number of classification-related aspects.

hedge the whole instrument, this would introduce additional complexity in the standard. Moreover, hedging strategies are not always initiated – we believe for valid reasons that should be discussed further with the preparers - at inception of the financial instrument.

b. We are not convinced by the other approaches to eliminate or replace the existing hedging requirements.

c. The IASB might consider simplifying the existing hedging requirements, relating in particular to the calculation of hedge effectiveness. However, we would be in favour of maintaining sound documentation requirements that provide a basis for sound risk management practices, as well as the requirement that ineffectiveness is always booked in profit or loss

Question 6

Section 2 also discusses how the existing hedge accounting models might be simplified. At present there are several restrictions in the existing hedge accounting models to maintain discipline over when a hedging relationship can qualify for hedge accounting and how the application of the hedge accounting models affects earnings. This section also explains why those restrictions are required. [....]

Rather than eliminating or replacing some or all hedge accounting it is felt that the IASB could simplify effectiveness testing while ensuring that proper discipline and recognition of ineffectiveness in profit or loss are maintained. We encourage the IASB to pursue its discussions with preparers and users in that respect. In any case, we would like to emphasize the importance of retaining the possibility to hedge portions of exposures, as preparers may choose or be forced (in the absence of relevant hedging solutions) to hedge only particular risks to which a financial instrument is exposed.

Question 7

Do you have any other intermediate approaches for the IASB to consider other than those set out in Section 2? If so, what are they and why should the IASB consider them?

In addition to the simplification measures suggested in our response to question 1, CEBS has raised in its report on valuation of complex and illiquid financial instruments an issue that could if addressed by the Board help to reduce the complexity of reporting for financial instruments.

- This issue relates to the impairment rules for available for sale assets in IAS 39. We are of the opinion that consideration should be given to a possible change to impairment rules applicable to available for sale instruments, as discussed in paragraph IV.1.4b) of our above mentioned report.

Question 8

To reduce today's measurement-related problems, Section 3 suggests that the long-term solution is to use a single method to measure all types of financial instruments within the scope of a standard for financial instruments

Do you believe that using a single method to measure all types of financial instruments within the scope of a standard for financial instruments is appropriate? Why or why not? If you do not believe that all types of financial instruments should be measured using only one method in the long term, is there another approach to address measurement-related problems in the long term? If so, what is it?

Please see our general comments as well as our answer to question 2 in particular.

Question 9

Part A of Section 3 suggests that fair value seems to be the only measurement attribute that is appropriate for all types of financial instruments within the scope of a standard for financial instruments.

(a) Do you believe that fair value is the only measurement attribute that is appropriate for all types of financial instruments within the scope of a standard for financial instruments?

(b) If not, what measurement attribute other than fair value is appropriate for all types of financial instruments within the scope of a standard for financial instruments? Why do you think that measurement attribute is appropriate for all types of financial instruments within the scope of a standard for financial instruments? Does that measurement attribute reduce today's measurement-related complexity and provide users with information that is necessary to assess the cash flow prospects for all types of financial instruments?

CEBS does not concur, for the reasons given above, with the suggestion to extend the mandatory use of fair value to all types of financial instruments. 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.

Question 10

Part B of Section 3 sets out concerns about fair value measurement of financial instruments. Are there any significant concerns about fair value measurement of financial instruments other than those identified in Section 3? If so, what are they and why are they matters for concern?

Part B of section 3 sets out a number of important concerns about the fair value measurement of financial instruments even though the list, in our view is not comprehensive and balanced.

In fact CEBS is of the view that the part dealing with the difficulty in estimating fair values of financial instruments has not been given sufficient importance especially given the problems that have arisen during and in the wake of the market turmoil. Additionally, we would like to mention that the calculation of fair values requires a strong infrastructure of valuation and controls that is not necessarily present among smaller preparers.

In its report CEBS evidenced a number of issues that caused problems for the valuation of financial instruments. These arise in the context of:

- Fair value hierarchy and the factors evidencing the existence of an active market;
- Practices and governance surrounding the use of modelling techniques;
- Risk factors to be considered when determining a fair value.

Finally, users might be concerned by fair value numbers affecting primary financial statements where those numbers would not represent the way financial instruments are managed, giving rise potentially to relevance, governance and control issues.

Question 11

Part C of Section 3 identifies four issues that the IASB needs to resolve before proposing fair value measurement as a general requirement for all types of financial instruments within the scope of a standard for financial instruments.

(a) Are there other issues that you believe the IASB should address before proposing a general fair value measurement requirement for financial instruments? If so, what are they? How should the IASB address them?

(b) Are there any issues identified in part C of Section 3 that do not have to be resolved before proposing a general fair value measurement requirement? If so, what are they and why do they not need to be resolved before proposing fair value as a general measurement requirement?

(a) Many issues that the IASB, in our view, needs to consider before proposing fair value measurement as a general requirement for all types of financial instruments within the scope of a standard for financial instruments have been raised in the present letter and in CEBS's report on valuation of complex and illiquid financial instruments. Additionally, a number of conceptual and implementation issues would have to be resolved before proceeding to further mandatory use of fair value, such as the treatment of the "own credit risk" or the "core deposit intangibles".

CEBS is of the view that the IASB has to carefully consider these issues and apply due diligence and process (including impact studies and field testing) before taking this issue forward.

(b) No.

Question 12

Do you have any other comments for the IASB on how it could improve and simplify the accounting for financial instruments?

No.