Committee of European Banking Supervisors

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International Accounting Standards Board
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Dear Madam, dear Sir,

Exposure Draft ED/2010/4 Fair Value Option for Financial Liabilities

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 the Fair Value Option for Financial Liabilities (ED/2010/4).

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, and in particular the IASB's careful analysis of the phenomenon of 'own credit risk' (OCR).

We set out our comments on some specific matters and on the questions posed by the IASB in the appendix below.

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, 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 - General comments

Scope of the ED

The ED only addresses the effects of own credit risk for liabilities under the fair value option but not for other liabilities at fair value (liabilities held for trading and derivatives). Indeed the IASB considers that recognizing the effects of changes in the credit risk of a liability in profit or loss provides useful information for liabilities held for trading (and derivatives).

However, CEBS is not convinced of the decision usefulness of accounting for the impact of the own credit risk in profit or loss even for some traded liabilities and derivatives. We believe that only gains due to own credit risk that are demonstrably capable of being realised by the entity should be admissible within accounts. We have some doubts as to whether banks are always able effectively to realise gains (or losses) even on traded liabilities or derivatives (e.g. for long-dated instruments or instruments that are infrequently traded).

Therefore CEBS invites the IASB to explore this issue further and examine whether there is a need to extend the approach set out in the ED to a wider set of liabilities measured at fair value through profit and loss (and not just those under the fair value option). This further exploration should consider both conceptual arguments and practical considerations.

Asymmetric treatment of financial assets and liabilities

The IASB highlighted that "*symmetry between how an entity classifies and measures its financial assets and its financial liabilities is not necessary and often does not result in useful information*" (BC8 a).

CEBS believes that symmetry between financial assets and financial liabilities would facilitate faithful representation of the asset-liability management (ALM) activities of banks, and the analysis of financial institutions more generally. Nonetheless, symmetry has some limits. The own credit risk on the liabilities' side is in most cases not part of the ALM activities. More generally, the credit risk of liabilities does not have the same relevance for the holders of the liabilities issued by an entity and for the entity itself. 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.

Regarding the specific topic of bifurcation, CEBS agrees with the IASB that "*the bifurcation methodology in IAS 39 is generally working well and practice has developed since that Standard was issued*" and supports the decision to keep bifurcation for financial liabilities. However CEBS does not see any analytical or practical reason to retain this requirement for financial liabilities only. Such a 'one sided' retention calls into question the argument of simplification used by the Board to justify the prohibition of bifurcation on the asset side (such bifurcation was perceived by the Board as complex). Therefore CEBS reiterates its support for reintroducing bifurcation requirements for financial assets, consistently with its comment letter of 14 September 2009 about the Exposure Draft "*Financial Instruments: Classification and Measurement*": "when various components of a hybrid instrument are managed on different bases, bifurcation is the best way to represent the nature and cash flows of the instrument".

Although we support and want to maintain the bifurcation treatment for financial liabilities, the IASB should take care that the difference in approaches for financial assets and liabilities does not lead to unwanted inconsistencies. More generally and notwithstanding our support, the IASB, in going forward, should take care to explain fully why it has proposed only limited changes to the accounting for financial liabilities, in contrast to the more fundamental changes for financial assets set out in IFRS 9

CEBS also notes the IASB's view that the benefits of changing practice at this point do not outweigh the disruption expected due to the change (BC10). However, CEBS believes that the IASB's proposals for measurement of liabilities should be seen as part of the broader package of reforms to financial instrument accounting. Therefore, when considering costs and benefits, these should be evaluated in the context of the complete set of changes to IAS 39, rather than a number of distinct parts. The price of changes to one part might be outweighed by benefits elsewhere, particularly in terms of producing a coherent and complete principles-based financial instruments accounting regime.

As regards the fair value option itself, CEBS is concerned about the inconsistency between assets and liabilities, given that the IASB proposes to retain three eligibility conditions for liabilities and IFRS 9 defines only one for the assets side. It seems necessary to further clarify the rationale behind choosing different criteria for financial assets and liabilities and explore the practical implications.

Furthermore, as the IASB has decided to keep the trading category for financial liabilities and as trading is one of the main activities for many financial institutions, CEBS is of the view that it could be very useful for users of financial statements to have separate presentation of assets held for trading. This would be based on the definition of paragraph 9 of IAS 39 which has been retained in IFRS 9 Appendix A. Such information would enable users better to appreciate the risks and performance of entities undertaking significant trading activity.

Responses to the questions

Recognition of changes in own credit risk (Questions 1 to 3 and 6)

As mentioned in CEBS' Comment letter of 1st September 2009 on the Discussion Paper "*Credit Risk in Liability Measurement*", "*we believe that for subsequent measurement in many circumstances it is not decision-useful for users to recognise gains and losses on own credit risk in profit or loss*". Therefore CEBS welcomes the IASB proposal to exclude changes in the credit risk of all liabilities designated under the fair value option from profit or loss and to present them in the statement of comprehensive income (OCI).

However, in some rare cases financial liabilities may be closely linked to financial assets[1] and the proposal could lead to an accounting mismatch. In such a situation the entire fair value of own credit risk should go to profit or loss.

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[1] For example, in some countries (e.g. Denmark) credit institutions are for example granting loans financed with bonds where these loans can be prepaid by delivering the underlying bonds or paying the fair value of the underlying bonds. In such a situation an accounting mismatch will arise with the proposal because the value of the loan can never exceed the fair value of the underlying bonds. The value of the asset will in such a situation include an element that reflects the entity's own credit risk and this will be reflected in P&L whereas the own credit risk part of the corresponding liability will be reflected in OCI.

That said, CEBS reiterates its view 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. We would expect that own credit risk would be taken to P&L only in exceptional circumstances.

Although CEBS generally supports the IASB's proposal not to recognise the effect of subsequent variations in own credit risk in profit or loss, we have concerns - from a prudential point of view - about the undue volatility generated in OCI as the portion of fair value attributable to credit risk is only transferred from profit or loss to OCI and will still remain in the financial statements. Banking regulators will have to maintain a prudential filter to eliminate the element of own credit risk from regulatory own funds. In the European Union, such a filter is in fact required by Article 64.4 of Directive 2006/48/EC (known as Capital Requirements Directive or CRD).

Furthermore, we believe that the cumulative amount of OCR gains and losses recognised through OCI should be presented as a separate line item either within equity in the balance sheet statement or in the statement of changes in equity.

Two-step approach (Questions 4 and 5)

Although CEBS can see arguments for the two step approach, on balance CEBS prefers a one step approach over a two step approach as OCR is not believed to reflect an entity's performance. Nonetheless, CEBS would like to emphasise the importance of obtaining reliable measurement of the changes in OCR (see below).

Also a one-step approach is believed to be more efficient as information about the amount of change in the fair value of the liability during the period that is attributable to changes in the credit risk has to be provided directly in OCI.

Recycling (Question 7)

CEBS considers that if an entity is able to settle or transfer a financial liability prior to its maturity, own credit risk gains and losses accounted for in OCI should be recycled to profit or loss. Indeed, recycling would allow banking transactions to be more faithfully represented. That said, CEBS would expect gains from OCR to be realised only infrequently.

If the proposal in the ED were left unchanged, CEBS suggests that, when a financial liability is derecognized prior to its maturity, the part of the cumulative amount of OCR generated by this instrument should be always transferred from accumulated OCI to other components of reserves (for instance, to retained earnings). This accounting mechanism would allow users properly to assess the impact of OCR on the equity of the reporting entity.

Measurement of own credit risk standing (Question 8)

The ED suggests using the guidance in IFRS 7 for determining the amount of the change in fair value of a liability that is attributable to own credit risk. CEBS does not have a view on specific methods of measurement, but is aware of a range of possible techniques, and that these can give materially different results.

For that reason, disclosures on measurement method could prove useful for users of financial statements. Currently, banks' accounts tend to provide limited information on measurement methods. Therefore, the disclosure requirements in IFRS 7, paragraph 10 should be enhanced such that: (i) they cover all liabilities measured at fair value; and (ii) they require banks to explain the way in which they measure own credit risk including the impact of any changes on the assumptions and parameters used. The proposed enhancement in the disclosures would be particularly decision useful for the assessment of the financial statements of banks because, as noted above, Article 66.4 of the CRD excludes from banks' regulatory capital OCR gains or losses generated by all financial liabilities measured at fair value.