ABI Associazione Bancaria Italiana

ABI Comments on the FASB guidance regarding fair value measurement and impairments of financial instruments

April 2009

POSITION PAPER

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Thank you for the opportunity to reply to the FASB guidance regarding fair value measurement and impairments of financial instruments.

In general we do not support the FASB's unilateral amendments to the fair value guidance and impairments requirements. In line with EFRAG comments:

- "*we believe that the FASB's actions do not appear to be consistent with the notion of working co-operatively and in an internationally co-ordinated manner to consider accounting issues emerging from the global crisis contained in the recent joint announcements issued by the IASB and the FASB;*
- *we are very concerned that, in the current climate, unilateral changes to requirements by one partner will create pressure on the other partner to follow suit and will as a result fuel a move towards accounting standards representing the lowest common denominator;*
- *we are concerned that amendments in the nature of piecemeal quick fix solutions will inevitably slow down the development of a comprehensive global solution to the concerns mentioned above and as a result will pose a threat to what is already a very tight timetable;*
- *we are concerned that the FASB has issued proposals that could have a significant impact on financial instruments reporting in haste and with a comment period of just two weeks. Such standard setting has a tendency of not taking properly into account the needs of all stakeholders and as a result may compromise on the quality of the financial reporting standards and information provided to users*".

On the other hand, we believe that IASB has to work expeditiously for a new accounting standard on financial instruments that would replace IAS 39. This new standard needs to be developed as soon as possible in time for implementation in the 2009 financial statements.

Please find below the specific remarks of the Italian Banking Association (ABI) on these two sets of FASB guidance.

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1. FSP FAS 157-4 "*Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly*"

Our comments mainly refer to the FASB Staff Position FSP 157 – 4 as issued on 9 April 2009.

We do not believe that adoption of FSP would significantly improve the already existing guidance: in fact IASB EAP document "*Measuring and disclosing fair value of financial instruments in markets that are no longer* *active*" (October 2008) already states that transaction prices in inactive markets are not determinative of fair value which must instead be determined by considering a variety of market inputs.

However we think it could be worth considering to further examine the factors to assess "market activity" as provided by FSP 157 -4.
In fact, current IASB guidance lacks similar criteria and the concept of active market now substantially drives, in the current accounting frameworks, the measurement techniques, the portfolio allocation as well as the respective disclosures.

We believe it would be useful if IASB, similarly to the actions taken by FASB with regard to the amendment made to FAS 157, also included its guidelines on the issue in the set of accounting principles, specifically regarding the Application Guidance.

On a side note we welcome FASB decision to eliminate in the final version of FSP, the Step 2 which allowed entities to consider transactions in non active market as distressed unless the contrary was demonstrated.
Proposed guidance could lead to an interpretation departing not only from market prices but also from market inputs.
If this should be the case, uncertainty would arise about which kinds of inputs need to be employed within the available ones (historical, averages, plain management assumptions, etc.) thus decreasing the reliability of the interested portfolios (and ultimately of the financial statements if the weight is material) and introducing possible differences between accounting and the way positions are measured by relevant risk units.
If, as indicated in relevant FASB handouts[1], one of the aims of the FASB guidance is to address concerns regarding write-downs recognized due to an increase in liquidity risk, it might probably be better to instead focus on the matter of portfolio allocation and reclassification: in fact, when the market for a financial instrument (or its significant underlying) becomes illiquid, the very same principle of measuring financial instruments at fair value should be questioned.

As long as financial instruments are concerned, it should be advisable to focus on identifying what kinds of financial instruments are allowed to be measured at fair value rather than on modifying the definition of fair value.
For this reason, it might be worth considering if:
- restricting the possibility to allocate instruments in held-for-trading only when there is an active market;
- introducing in IAS 39 the possibility to reclassify as long as market activity disappears, extending this possibility also to FVO instruments and liabilities;
- reviewing AFS impairment rules by better qualifying the criteria for impairment recognition: are impairment thresholds still necessary?

[1] FASB meeting of 16 March 2009 - http://www.fasb.org/board_handouts/03-16-09.pdf

- simplifying hedge accounting rules, in particular with reference to documentation and hedge effectiveness.

2. FSP FAS 115-2 and FAS 124-2, "*Recognition and Presentation of Other-Than-Temporary Impairments*"

Our comments mainly refer to the FASB Staff Position FAS 115 – 2 and FAS 124 - 2 as issued on 9 April 2009.

Basically the FSP position amends existing US guidance on the matter by:

1) slightly changing indicators of impairment in order to make them more operational, and
2) allowing the recognition of, as impairment losses, only the part of decrease in fair value which relates to credit losses with the remaining part recognized in other comprehensive income.

On a general basis, considering current IAS 39 impairment rules, the changes do not seem to be particularly useful.

Changes mentioned in bullet *point 1)* are a clarification by FASB of guidance already existing. The same would instead introduce a new criteria in IFRS, namely in IAS 39, for the assessment of impairment of securities.

In addition, we believe that FASB impairment model is contradictory: on the one hand, a financial instrument is classified as available for sale but, on the other hand, management states that it will not be sold until its market value exceeds its initial book value once again. Moreover, we believe that recording non-temporary losses is excessively arbitrary, as a company's statement concerning the fact that it intends to or can hold a security in its portfolio until its fair value is at least equal to its initial cost is sufficient. In addition, there does not appear to be a penalty clause in case this statement does not have a factual basis: there is a high risk of deferred impairments regarding previous accounting periods.

Changes mentioned in bullet *point 2)* would not be useful either for HTM nor for AFS securities, in fact:
- on HTM debt securities, impairment losses already reflect actual losses related to the default of the issuer;
- on AFS debt securities, IAS 39 has been interpreted as requiring impairment only in case of actual financial difficulties/default of the counterparty in servicing its debt. In such cases, the relevant fair value already tends to approximate the actual incurred credit losses.

Moreover, there seems to be an inconsistency with respect to the impairment accounting rationale regarding the credit loss component of debt securities and its possible reversal. Actually, it seems as the latter component may not be recognized in the profit and loss account, thereby contradicting, in our opinion, what appears to be the rationale behind the above-mentioned measure, i.e. ensuring equal treatment of the impact on the profit and loss account of an impairment of the credit loss component concerning loans and issued debt securities.

In conclusion, the adoption of the FSP position would not help entities in solving the issues they are facing concerning the current impairment model, such as:
- the "prolonged or significant decline of fair value below cost" criterion, which gives rise to different interpretations and applications (in fact this rule, de facto, obliges the entities to define and implement internal policies fixing pre-defined thresholds as the trigger for the impairment);
- the fact that reversal of impairment on equity securities is currently not allowed to be recognized through P&L.

In addition, regarding the impairment of AFS we emphasise the necessity that IASB and FASB resolve this issue urgently because of their implications under current market conditions. One of the implications of the current crisis is that equity markets are very volatile, with significant general market movements occurring frequently. This has caused to consider whether the existing requirements in IAS 39 for impairment of AFS equity securities are appropriate. In fact, under the current market conditions, we are not sure whether we can consider the current "market price" level as fair value also for equity securities which do not reflect the entities' performance, forcing the entities to recognise the impairment in the profit or loss. To avoid the inconsistence between market price and fair value (possibly temporary), this case could be treated in the same way as equity instruments that do not have a quoted market price by modifying the IAS 39 requirements. A solution may be to determine the impairment of this equity instruments measured at cost on the basis of the recoverable amount (i.e. the higher of the asset's fair value and its value in use, which is the value of expected future cash flows). This solution would obviously enable firms not to record impairments with respect to securities' prices deemed not reasonable, if any.