DEXIA

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Brussels, August 31, 2009

Dear Sir/Madam,

Dexia (www.dexia.com) is a European bank, with about 36,000 members of staff and a core shareholders' equity of EUR 17.7 billion as of March 31st , 2009. Dexia Group focuses on Public Wholesale Banking, providing local public finance actors with comprehensive banking and financial solutions worldwide, and on Retail & Commercial Banking in Europe (mainly Belgium, Luxembourg and Turkey). Main activities encompass retail, commercial and private banking, but also insurance, asset management and investor services activities.

We welcome the opportunity to comment on the IASB exposure draft dealing with classification and measurement of financial instruments.

Dexia's comments on IASB's Exposure Draft Financial Instruments and Classification and Measurement could be summarised as follows:

1) we find it difficult to comment on the proposed classification and measurement principles on a standalone basis as other aspects of the IAS 39 replacement project (phase II Impairment and Phase III Hedge Accounting) as well as other IASB projects (such as Insurance Contracts) have not yet been published,

2) we agree that a mixed measurement basis should be retained: one at amortised cost and another at fair value,

3) we do not agree with the proposal that the classification of financial instruments into the amortised cost category is primarily based on the characteristics of the underlying—basic loan features— but believe it should depend solely on the business model, the way the entity is managed. This would be in line with other recently published standards such as IFRS 7, IFRS 8, ...

4) aligning the business model approach in the ED—managed on a contractual yield basis— with the trading and banking book model, which is used by many banks, would be an important simplification. The guidance in the ED is not sufficiently clear on this subject,

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5) we do not agree with the accounting treatment proposed by the ED of embedded derivatives,

6) we believe that reclassifications between categories should be allowed to reflect a subsequent change in the business model,

7) we do not agree with the accounting treatment of 'strategic investments' whereby the cost measurement basis is no longer allowed as well as recycling from OCI to Profit or Loss of dividends and realized gains and losses arising from these investments,

We share the view of the IASB to be committed to the convergence of IFRS and US GAAP requirements for financial instruments insofar as the convergence process improves transparency, comparability and performance reporting for users of financial statements. Hence, we have concerns with the FASB recent decisions to move towards a general global fair value.. In this context, we are supporting the mixed measurement model approach proposed by the IASB rather than FASB's full fair value approach

If you wish to discuss our comments further, please do not hesitate to contact Nico Deprez, Head of Accounting policies of Dexia group.

Yours sincerely,

Philippe Rucheton
Chief Financial Officer, Dexia S.A.

Pierre Mariani
Chief Executive Officer, Dexia S.A.

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 ?

1. We believe that amortised cost provides in some cases more decision-useful information than fair value and therefore agree with IASB's conclusion stated in BC 13 "...The board decided that measuring all financial assets and financial liabilities at fair value is not the most appropriate approach to improving the financial reporting for financial instruments".

2. However, we do not agree that the scope of financial assets and liabilities measured at amortized cost be limited to financial instruments that meet the two following conditions: (i) having 'basic loan features' and (ii) 'managed on contractual yield basis'. The classification in our view should be solely based on the business model. We believe that this would lead to a standard which is easier to understand and will lead to a more consistent application.

3. As many financial institutions, Dexia uses also a trading book/banking book model. All financial assets acquired or financial liabilities incurred principally for short-term profit taking are classified into a trading book, all other financial instruments are allocated to a banking book. We suggest that all financial instruments allocated to a 'banking book' are reported at amortised cost because that measurement basis provides the users of the financial statements the most appropriate information as it best reflects the future cash flows arsing from these instruments. We agree that financial instruments allocated to a trading book should subsequently be measured at fair value.

4. In addition, we think that the current principles of the bifurcation of embedded derivatives should be retained so that the host contract can be reported at amortised cost.

5. The exposure draft does not directly deal with the classification and measurement of financial derivatives. In our view, considering the business model as unique criteria to determine classification of financial assets, implies to define mandatorily in the ED, principles relating to classification and measurement of derivatives

6. Before determining whether amortized cost is decision useful information for financial assets or financial liabilities, we believe that the scope of IAS 39 should be clearly stated. Having said that, we are not convinced, as underlined in BC7, that the Board should consider in the later phase of the project the scope of IAS 39, in particular when the main purpose of this project itself is to replace IAS 39.

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?

7. If the IASB's intention is to come up with a principle based standard rather than a rule based standard, then the ED fulfils that requirement by introducing the 'basic loan features'. Nevertheless, applying the notion of "basic loan feature" for the banking environment risks to lead to a diversity in practice due to the limited illustrative examples which are :

   (i) oversimplified (for instance, there is no clarification in the text on how to deal with certain instruments as inflation linked instruments or subordinated debt instruments),

   (ii) subject to interpretation,

   (iii) sometimes inconsistent (inconsistency between BC 29 and BC13),

   For these reasons, we do not support the use of the 'basic loan features' criteria to drive the classification and measurement of financial assets and liabilities. In addition, we believe that adding too much guidance will probably lead to a rule based accounting standard which differs from the IASB's intent.

8. The application of the 'basic loan features' criteria will lead to recognise certain financial assets and liabilities at fair value whereas they are managed on contractual yield basis. For instance, some structured loans could be categorized as instruments measured at fair value whereas they are managed and reported on contractual yield basis since their exposure to the structured index is systematically micro-hedged. The application of both conditions makes the performance reporting in fair value inappropriate and misleading for financial statements' users.

9. Due to the criteria 'basic loan features', many structured financial liabilities (such as subordinated debt issues), currently bifurcated, will be subsequently measured at fair value through profit or loss. Consequently, the debate on whether or not own credit risk should be incorporated in the fair value becomes much more important. In particular, we would like to highlight that some rating agencies and regulators neutralize the effect of the own credit spread in their analysis. We believe that the IASB is aware of this issue, hence the publication of the discussion paper on *Credit Risk in Liability Measurement* and we expect that comment letters on this discussion paper will be analysed carefully and an unbiased manner

10. We do not support the IASB's position taken in BC 29 saying "if a financial asset is acquired at a discount that reflects incurred credit losses, it does not have a basic loan feature. An investor acquiring an instrument at such a discount believes that the actual losses will be less than the losses that are reflected in the purchase price" because :

a. the discount rate can reflect the market expectations (fair value);

b. the discount rate reflects liquidity cost and counterparty reputation (example : assets wrapped by monolines);

c. the same type of rational may exist when a financial asset is originated whereby an entity hopes that the actual losses will be lower than the expected ones.

The above arguments demonstrate that the position taken by the IASB in BC 29 may lead to a fair value measurement of these types of assets and liabilities whereas it does not reflect the business model.

11. The guidance on 'managed on a contractual yield basis' in the application guidance and the basis for conclusions is confusing which will, again, result in diversity in practice. Since, the exposure draft is not clear about the level at which the condition 'managed on a contractual yield basis' must be applied, the following examples stress the practical diversity:

    a. some activities are developed purely for fixed income purposes but are followed by the Chief Risk Officer on a fair value basis because this is the best measurement basis for monitoring risks associated with these investments;

    b. an entity creates a portfolio of financial instruments in order to realise a certain yield but in order to maximise that yield, instruments could be sold in order to acquire other high yielding financial instruments.

    As such, we think it is important not to assimilate the way an instrument is accounted for solely based on its risk monitoring but on the business model for that activity.

12. As mentioned in our answers to question 1, we believe in a classification solely based on the business model together with maintaining the current bifurcation principles so that host contract could be reported at amortised cost, will lead to a principle based standard which is much easier to understand and leading to a more consistent application of it.

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?**

13. As already mentioned in our answers to question 2, we believe that classification solely based on the business model together with maintaining the current bifurcation principles so that host contract could be reported at amortised cost, will lead to a principle based standard which is much easier to understand and leading to a more consistent application.

14. We believe that the guidance in the current IAS 39 on closely versus non-closely related embedded derivatives is sufficiently clear and does not lead to important diversified applications. The main comments on the current principle are the following: (i) operational workload to split both elements and (ii) non-closely related embedded derivative can lead to volatility in the income statement if the risk is not hedged (from an economic perspective). During the crisis, the accounting treatment of non-closely related embedded derivatives has never been questioned nor criticized. We consider that, removing such guidance related to the analysis of embedded derivatives for the purpose of simplification could open the door for interpretation and harm the consistency between financial statement's entities.

15. By expanding the scope of financial instruments eligible for amortised cost measurement basis, the issue of own credit risk becomes less important. The recognition of own credit risk is not assessed as being decision-useful information.

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 ho 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 (ie 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?

16. As already mentioned in our answers to question 2, we believe that classification solely based on the business model together with maintaining the current bifurcation principles so that the host contract could be reported at amortised cost, will lead to a principle based standard which is much easier to understand and leading to a more consistent application. Therefore, it should be allowed under the new standard to apply the fair value option to hybrid financial instruments for which bifurcation of embedded derivative and host contract is otherwise required.

17. We do not agree with the proposal under the exposure draft to forbid amortised cost measurement basis for contractually subordinated financial instruments, except for the most senior tranche, based on the argument that such instruments do not contain basic loan features. We may find many debt instruments, which are not the most subordinated senior tranche issued by a structured investment vehicle, measured at fair value, even though they are held on a long-term basis and do have cash flows that can be managed on a contractual yield basis. In particular, those tranches could present a lower credit risk than underlying assets which may be managed on a contractual yield basis and meet basic loan features criteria. Indeed, the purpose of those tranches (and the way it is structured) is to reduce the volatility of the cash flows generated by the underlying assets which have to be classified in financial assets at amortized cost.

18. In addition, the current text of the exposure draft is unclear on whether or not subordinated debt issued by an entity should be measured at fair value. We believe that the text should be clarified so that subordinated own debt issues are exempted from a fair value measurement.

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?

19. We are in favour of the proposal which retains the fair value option. However, the need for such a fair value option will depend on (i) how the final standard will deal with embedded derivatives (see our answer to question 2), (ii) the underlying principles for hedge accounting and (iii) the way insurance contracts are dealt with under the ED and final standard on insurance contracts. We encourage the IASB to review its position on the fair value option when all above stated elements are known.

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?

20. Yes it should. We refer again to our answers to question 2. We support an amortised cost measurement basis for host contracts after the non-closely related embedded derivative is bifurcated. However, the standard should allow classifying the entire instrument into the FVO category subject to the publication of the principles on hedge accounting (phase III-replacement of IAS 39) and insurance contracts (amendment to IFRS 4).

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?

21. We believe financial statements should reflect the way an entity is managed. Therefore, if the business model changes, the financial instrument should be reclassified into the most appropriate category. Prohibition of such a reclassification will lead to (i) financial instruments reported into a category no longer meeting the criteria nor reflecting the way the entity is managed and (ii) decrease comparability between companies having similar business model after one changed its model.

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?

22. The number of equity instruments currently reported at cost is limited and not material compared to the total equity portfolio. These investments are mainly related to private equity companies for which the only public information available is financial statements reported in accordance with local GAAP.

23. The ED requires that such equity instruments should be reported at fair value. We do not support the new approach based on the following arguments: (i) due to lack of information it will be very difficult to come up with a reliable fair value, (ii) cost/benefit balance will be very negative, (iii) comparison between entities will be difficult as each entity will develop its own fair value models. In other words, an exemption from fair value reporting is relevant in some cases.

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 be required and why?

24. As said in our answers to question 8, we believe that requiring a fair value measurement basis for some equity instruments would be inappropriate from both a preparer's (costs) and user's perspective (reliability and comparability).

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?

25. We agree with the proposal to provide preparers the opportunity to separately report the equity instruments held for 'strategic purposes' from those held for 'trading purposes'. Such a distinction is also useful for users of the financial statements. However, we have the following general remarks:

    a. rather than introducing a new concept (strategic investments), we prefer to make the distinction based on 'banking book' versus 'trading book' which simplifies the standard;

c. remove the choice feature for the accounting treatment for strategic investments (OCI or P&L) by imposing to report movements through OCI to increase comparability between entities and within equity investment portfolios;

d. independent of the classification of the equity instrument into 'banking book' or 'trading book', dividends should always be reported in Profit or Loss because:
   - (i) the internal management reports dividends as realized income and
   - (ii) it compensates the funding cost;

d. when the amounts are reported in OCI, the recycling via Profit or Loss should be allowed when the underlying is derecognised.

26. We also support the position taken regarding impairment losses on strategic equity investments when fair value changes are recorded in OCI. The fact that there is no recycling to Profit or Loss of the impairment losses makes information much more reliable and comparable.

27. The relevance of such a presentation also depends on the outcome of IASB's project on Financial Statements and impairments.

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?

28. As mentioned above, such a presentation should not be permitted but required in order to increase comparability of the financial statements. However, we would identify these equity instruments not based on a 'strategic character' but on the 'banking book/trading book' notion. Finally, we believe that dividends, independent the classification, should always be reported in Profit or Loss. This because that is the way they are reported to management and it is a compensation of the funding cost.

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?

29. We understand that additional disclosures are required for early adopters of the standard in order to allow users to understand the changes made on the one hand and provide them with comparable information compared to those entities still reporting in compliance with the existing standard on the other hand. However, attention should be paid to the number of information to be disclosed. Probably the new standard will require significant modifications to the existing IT systems whereby it is no longer possible to obtain all comparable information.

30. We would not accept if the IASB required similar information to be disclosed for those entities applying the new standard from 2012 onwards this because comparative information of previous period is yet to be provided. This ensures that users can compare the information from one year to another but also between companies.

Question 13 – Do you agree with applying the proposals retrospectively and the related proposed transaction guidance? If not, why? What transition guidance would you propose instead and why?

31. We appreciate the IASB's understanding that a full retrospective application of the new standard is impractical. We therefore support the idea that an entity should assess the facts and circumstances that existed at the date of initial application.

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?

32. We do not believe that the alternative approach provides more decision-useful information compared to the model described in the ED.

    a. limiting the scope of amortised cost basis by adding an additional criteria (Loans and Receivables) will lead to a reporting much further away from the way an entity is managed. Financial instruments which are managed on a contractual yield basis will be reported differently in the financial statements;

b. amortised cost basis is also decision-useful information for other financial instruments than loans and receivables;

c. a move from amortised cost towards fair value means that models should be developed in order to determine the fair value because most of these financial instruments are not quoted on a market. The question is whether the cost/benefit for preparers, the reliability and the comparability of the information for users is worth introducing such a concept;

d. disaggregated information between amortised cost and fair value for those financial instruments reported at amortised cost basis is yet available in the disclosures;

e. distinction between OCI and Profit of Loss depends on IASB's project on Financial Statements.

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?

33. We do not support the alternative approach whereby amortised cost is too narrow (see our answer to question 14) neither a full fair value measurement for financial instruments.