EBF European Banking Federation

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Set up in 1960, the European Banking Federation is the voice of the European banking sector (European Union & European Free Trade Association countries). The EBF represents the interests of some 5000 European banks: large and small, wholesale and retail, local and cross-border financial institutions.
The EBF is committed to supporting EU policies to promote the single market in financial services in general and in banking activities in particular. It advocates free and fair competition in the EU and world markets and supports the banks' efforts to increase their efficiency and competitiveness.

EBF preliminary views on the IASB ED IAS 39 "Financial Instruments: Classification and Measurement"

General comments

The banking industry welcomes the efforts of the IASB to undertake a review and replacement of IAS 39 with the aim of simplifying the accounting for financial instruments.

Accounting for financial instruments is a complex area. We appreciate the difficulties of trying to deal simultaneously with all the aspects of IAS 39 within an extremely short timeframe. However, we are concerned that splitting the project into three phases will result in the piecemeal development of the standard and fragmented approach to the consultation process which may have a detrimental effect on the quality of the final standard. There is insufficient time for evaluation of all the pieces taken together and for field-testing and impact assessment. Since the later phases of impairment and hedge accounting could change views on the first phase, there is some risk of further changes to classification and measurement being made after some have implemented the requirements and, at the very least, there will be a need to allow entities to reconsider and change classification decisions made before the standard as a whole is complete. A piecemeal approach to implementation also raises concerns about comparability in the market and about the risks of unintended consequences if the pieces do not fit together during the transition. The approach also runs contrary to that being developed by the FASB, which has implications for convergence, which was a theme of the G20 leaders.

We urge the Board to carefully deliberate the comments received in response to the consultation to make sure the need for urgency does not override quality. It is desirable to have in place a high quality standard which will be stable over time and will result in reporting which will best depict the economic realities behind businesses and help users to make economic decisions. The banking industry is prepared to assist the IASB in this project.

The EBF has always supported the objective of a single set of high quality accounting standards. We therefore support principle 3 in the report that the Financial Crisis Advisory Group sent to the G20 on the 28th of July: "Because of the global nature of the financial

markets, it is critically important to achieve a single set of high quality, globally converged financial reporting standards that provide consistent, unbiased, transparent and relevant information, regardless of the geographical location of the reporting entity”.

Being supportive of the convergence process with the FASB we are disappointed by the lack of coordination between the Boards and by the FASB’s current tentative decisions which are inconsistent with those of the IASB. Although not fully developed, initial indications are that the FASB’s overall approach would not reduce complexity, improve transparency or be acceptable to most users of financial statements. The direction the IASB is taking is likely to be more appropriate for the reporting of financial instruments. Therefore we believe the IASB proposal should serve as the basis for future discussion with the FASB and the future global standard for financial instruments.

The current uncertainty in the other areas of financial instrument accounting (e.g. impairment, hedging) and the interaction of the different consultations (e.g. financial statements presentation, derecognition, consolidation, fair value measurement including credit risk in liability measurement) makes it difficult to provide final comments. Therefore the views expressed in this letter may be subject to change as a more complete picture emerges on all of financial instrument accounting.

General direction of the proposal

We support in the IASB proposals the mixed measurement model for financial instrument and the principles based approach for accounting standards. The current IAS 39 is too rules based and unnecessarily complex. We support the removal of tainting rules for the current HTM category.

We support the IASB’s decision to retain the mixed measurement model for financial instruments and agree with its conclusion in BC 13 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.

We support the retention of the fair value option to eliminate or significantly reduce accounting mismatches and note that it may be necessary to have a fair value option in other circumstances, depending on the final hedge accounting requirements.

To simplify the financial reporting, the IASB is proposing to reduce the number of measurement categories. While we do not believe the number of measurement categories are the source of the complexity of the existing IAS 39, we would support reducing the number of measurement categories, provided that the rationale for classification of financial instruments into one of the measurement category reflects the economics behind financial transactions and the management of the associated risks and hence provides the best information about future cash flows. Banks invest in financial instruments which generate different types of risks (interest rate risk, currency risk, equity risk, credit risk and liquidity risk) that the bank has to manage using a number of risk management models. In doing this, it is also important to consider how the financial instruments are being funded and the existence and depth of the relevant markets for the risks.

The key issue is how to draw the line between fair value and amortized cost to provide the most useful information for users. It is also important that the whole constituency understands why and how the line is drawn.

We do not support the concept of fair value through Other Comprehensive Income (OCI) with no recycling and no recognition of dividends in income for certain equity investments. This seems inconsistent with existing IFRS requirements for recycling on disposal and there are no clear criteria that distinguish investments where it is appropriate to not recognise realised gains or losses in profit or loss. We do not believe the category will provide useful information to investors. In jurisdictions that rely on the concept of realised and distributable profits, not including realised profits in the income statement could have legal consequences.

We believe that there are circumstances where the Available For Sale (AFS) category could provide the most useful information about certain equity investments, although we acknowledge that further consideration should be given to when and how to measure impairment and that impairment should be reversed if there are indications that the causes of the impairment have cured.

Classification criteria – business model

The IASB is putting forward a model where the characteristics of an instrument rather than how the risk arising from the instrument is being managed is the main classification criterion. Instruments that present contractual financial flows (or determinable ones) and do not present any “leverage” are eligible for amortized cost measurement while all other instruments are measured at fair value. The first criteria is the technical characteristics of the financial instruments and the second criteria is the business model resulting in only instruments with basic loan features that are managed on a contractual yield basis being eligible for amortised cost.

We firmly believe that the “business model” should be the primary criteria for the classification and measurement of a financial instrument. It is only through consistency between the management of a financial instrument and its measurement criteria that the financial statements can provide an adequate representation of the results and present information which is predictive of future cash flows. Classification based on the business model would be more in keeping with how the requirements are likely to be applied in practice. It is likely to improve understanding of the requirements, if the criteria were reversed so the business model is considered before the technical characteristics of the instrument. This would be a more natural way of expression and therefore potentially reduce complexity. The technical characteristics of the instrument would also have to be considered in determining classification for example, in the case of derivatives, where amortised cost does not provide the most useful information about future cash flows..

In a business model where the underlying strategy is to draw a benefit from short-term variations in the value of the instruments and where the entity is actively engaging in opening and closing market risk positions, it is appropriate for the entity to fair value such instruments and this is the most relevant information for financial statements users.

However, when an entity does not manage instruments on a fair value basis, amortised cost including impairment is the most appropriate way to estimate future cash flows. If the

instrument is held for use in the business to generate cash flows and there is no current or future intention to sell, the aim is to achieve a stable income flow earned on an ongoing basis over a certain period. In this case, there is no intention to profit from the expected short-term market movements. The instrument will be held until maturity (or at least until prepayment without change of the terms), and this means that the future cash flows are readily identifiable. While fair value information should be disclosed, its use in the financial statements would not result in the most useful financial reporting.

We agree with the conclusions in BC 32 that the business model is not a voluntary choice but is a matter of fact that can be observed by the way the entity is managed and the information that is provided to management.

Classification criteria – Basic loan features

We have concerns that the “basic loan feature” criterion results in the line being drawn in the wrong place and could result in instruments being measured at fair value even though this does not reflect the business model and therefore does not provide the most useful information.

We are concerned that this could increase fair value measurement as a measurement basis without gaining any better quality in the financial statements and result in increased artificial volatility in earnings reflecting only the characteristics of instruments rather than their actual performance based on how they are managed in practice. This may be particularly problematic for liabilities held by companies as well as banks, where the liability contains an embedded derivative or is leveraged. The discussion paper on credit risk in liability measurement will be important in this regard.

The “basic loan feature” criteria cause concern in how the leverage principle has been applied, particularly for tranches other than the most senior in a tranched structure and for financial assets acquired at discount that reflects incurred credit losses. Many investments in tranches that are not the most senior are considered to be plain vanilla loans and have no more risk and potentially less risk than the underlying loans and are managed on a contractual yield basis. Setting a rule in this area may be easy to operate (and easy to structure around) but does not seem the best solution. Since the current proposals are symmetrical for assets and liabilities, we are particularly concerned at the implication for issued tranched liabilities which would be measured at fair value. Any credit protection in the structure is not relevant to the issuing entity that owes the entire liability and measuring the less senior parts of the liability at fair value when the underlying assets, which may not achieve derecognition, are likely to be measured at amortised cost creates an artificial accounting mismatch and recognises movements in fair value relating to own credit risk. There may be merit in at least considering tranches together when they are owned by or issued by the same entity, for example if an entity owns two tranches which together are the most senior, then there seems little point in measuring the uppermost tranche at amortised cost and the second tranche at fair value. The entity cannot provide credit protection to itself.

Financial assets can be acquired at a discount as part of a business model that treats them the same as any other loan intended to be held for the long term to generate contractual cash flows. For example, loans with incurred losses can be acquired as part of a business acquisition or as part of a purchase of a portfolio including performing loans. There is no

logic in suggesting that the same instruments have basic loan features if issued by the entity and do not have basic loan features if acquired after issue when there may be incurred losses somewhere in the portfolio. Where entities acquire deeply discounted loans as part of a trading strategy, it is appropriate for these instruments to be measured at fair value. Where entities acquire portfolios of instruments that may have incurred losses as well as performing loans to enlarge their existing lending business, it is appropriate for these instruments to be measured at amortised cost.

Placing greater emphasis on the business model may result in more useful accounting in these situations.

Classification criteria – Embedded derivatives

While reduction in complexity is welcome, we have concerns with the interaction of the proposal to eliminate the concept of embedded derivatives in financial instruments and the "basic loan feature" criterion. Together, these requirements to consider the instrument as a whole could result in more instruments being included in the fair value category when they are managed on an amortised cost basis. We are particularly concerned that more liabilities will be measured at fair value and that the definition of fair value would result in movements in fair value relating to own credit risk being included in profit or loss. The elimination of embedded derivatives could also have implications for hedge accounting. We would, therefore, retain the concept of embedded derivatives in financial instruments. If an instrument meets the business model test to be measured at amortised cost but contains a substantial embedded derivative, we would require bifurcation unless the instrument as a whole is measured at fair value under the fair value option.

Classification criteria – Equity investments

Although equity investments do not have contractual cash flows, we believe they can be managed on a long term basis such that period to period fair value movements are not as relevant to performance as it is for those instruments held for trading. For example, unconsolidated strategic investments and certain private equity investments may be managed to obtain cash flows over the longer term, such as dividends. For this reason, in our opinion fair value may not provide the most relevant information. While it would be possible to rely strictly on the business model and permit all such investments to be carried at cost, we are aware that this is not in keeping with the criteria in the ED. Consequently, we believe that the AFS category could be appropriate for such investments, although there are issues with whether and how impairment should be reported. The concept of fair value through OCI with no recycling and no recognition of dividends in income for certain equity investments in the ED is appropriate only for a very few (if any) investments, potentially in jurisdictions outside the EU. It also appears to be inconsistent with other requirements under IFRS, for example recycling foreign exchange gains and losses on the disposal of a subsidiary, and therefore does not seem a satisfactory solution.

We believe further consideration should be given to when and how to measure impairment and that impairment should be reversed if there are indications that the causes of the impairment have cured. A way of addressing impairment of equity securities may be to look for indications of actual default, for example, the failure of the investee to make payments on

its debt securities or negative operating results. We do not agree that the decline in market values alone should be the main criteria for the recognition of impairment.

We agree that other equity investments should be measured at fair value. However, we maintain that in circumstances where fair value cannot be reliably measured, cost would provide more useful information.

Reclassification

As set out above, we consider that the business model being operated by an entity is a matter of fact. Also as matter of fact, circumstances change and, in rare circumstances, external and internal factors can force changes in the business model. Therefore, we disagree with prohibiting reclassification. While this may introduce additional complexity for preparers in making sure any changes are fully disclosed, this seems preferable than continuing to record instruments in a manner inconsistent with the business model and inconsistent with transactions entered into after the change in business model. In accordance with this principle, we would advocate that reclassification, although expected to be rare, should be made mandatory if the circumstances require.

Transition provisions

Lastly, we have concerns about the transition provisions. As mentioned above, we believe it is likely that entities will wish to reassess classification decisions made, particularly the use of the fair value option, when the impairment and hedge accounting proposals are final. This will require further ability to re-classify on implementing the second phase of the new financial instruments standard. We also think that the transition provisions as set out are impractical. While we are not adverse to retrospective application where this is practicable, we do not think the requirement to restate comparatives is reasonable. It is not clear how financial instruments no longer held by the entity when the standard is adopted, for example as a result of a disposal of a business, would be classified. Where financial instruments are reclassified and the hedge arrangements previously documented are no longer effective, the failed hedges will result in volatility that is unrepresentative of the hedge relationships entered into at the time and unrepresentative of hedge accounting in the future. Therefore, we do not think the comparatives would be meaningful or understandable and, particularly for companies with US listing where five year comparative tables are required, the effort to obtain them seems to exceed any benefit. Therefore we propose that the new requirements should be applied from the start of a reporting period with the transition addressed in a similar manner to how IAS 39 was first applied, with a reconciliation of the closing balance sheet under the old rules and opening balance under the new rules being required for all entities, regardless of whether or not they early adopt.

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