European Banking Federation

Secretary General

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Brussels, 1 September 2010

Subject*:** ***EBF preliminary response to the FASB Exposure Draft Accounting for Financial Instruments and Revision to the Accounting for Derivative Instruments and Hedging Activities

Dear Mr Golden,

The European Banking Federation (EBF) welcomes the opportunity to provide comments on the Exposure Draft Accounting for Financial Instruments and Revision to the Accounting for Derivative Instruments and Hedging Activities.

By the end of the comment period, the EBF intends to submit a detailed comment letter including responses to the specific questions raised in the Exposure Draft.

At this point of time, we are presenting you with our major concerns about the ED, which we have emphasized in the enclosed document.

At the same time, we would like to express our interest to represent European banks in the FASB Public Roundtable meetings which are scheduled for October 12 and 21.

Given that the EBF represents more than 5000 European banks, many of which have offices around the world, including in places where reporting under US GAAP is required, we are confident that our request to participation can be accommodated.

We hope that you will find our comments useful and are at your full disposal should you wish to discuss further any of these considerations.

Yours faithfully,

Guido Ravoet
Secretary General

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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 response to the FASB Exposure Draft Accounting for Financial Instruments and Revision to the Accounting for Derivative Instruments and Hedging Activities

Key points

- **The EBF has significant concerns with the approach adopted by the FASB. There is no reflection of business practices and the proposed requirement will not reduce complexity, improve transparency or be acceptable to most users of financial statements.**
- **The EBF continues to support the convergence objective, however not at the expense of quality. Adverse impact on the decision on equivalence and mutual recognition of IFRS and US GAAPs must be avoided.**
- **Financial instruments accounting should be based on a mixed measurement model. Support for classification criteria that differentiate between financial instruments measured at amortized cost and those measured at fair value, based on the business model used by the entity. Amortized cost should be required for instruments held for the collection/payment of contractual cash flows which should be complemented with an impairment model allowing earlier recognition of credit losses compared to current incurred loss model. Reclassification should be allowed or even required if the business model for a particular instrument portfolio has changed as a consequence of external events.**
- **Fair Value Option (FVO) should be available. Own credit changes on FVO liabilities should be moved out of the P&L. Entities should have an option either to bifurcate the embedded derivative or to carry the whole financial instrument at fair value with changes in profit and loss.**
- **An impairment model for financial assets should be based on an expected loss approach over the life of the portfolio where estimates of the losses should reflect all existing information. Any model should be applicable to open portfolios. Expected loss allowances should be amortized over the life of the portfolio. Changes in estimations should be treated symmetrically with initial estimations.**
- **Support for the removal of the quantitative assessment of hedge effectiveness and for the adoption of a qualitative analysis to assess effectiveness. However unless the FASB reconsiders the types of risk eligible for hedging for accounting purposes, the practical benefit of the proposals is limited**
- **Hedge of a portion of a financial instrument's contractual cash flow should be allowed. The hedged item should be permitted to include a net exposure comprised of financial assets, financial liabilities and derivatives. The FASB should incorporate the IASB recent deliberations on macro hedging into the proposal.**
- **Disagreement with the proposal to prohibit the voluntary dedesignation of hedge accounting relationship.**

EBF response to the Commission's consultation on data protection sent on 23.12.2009 (EBF Reference D1865E-2009).

General remarks

The EBF has always been committed to a single set of high quality global accounting standards. The EBF expects standard-setters to provide the industry with workable standards in order to foster a sound and sustainable convergence.

Although the Boards have reaffirmed their commitment to converge and to consider jointly the comments received from their constituencies, the FASB is clearly and surprisingly adopting a direction which diverges from the IASB.

The EBF is very concerned about the approach adopted by the FASB in its proposed standard for financial instruments. While the IASB decided to keep the mixed measurement model for accounting for financial instruments, the FASB proposal which requires measurement of almost all financial instruments at fair value through profit and loss, clearly ignores the previous comments of its constituents. The revisions could lead to radical changes in the banks' business models. The recent crisis showed that the increased use of fair value accounting, not justified by the business model of the institution, could in time of severe crisis negatively impact banks' capital positions or even jeopardize their business due to the variations in credit spreads and negatively influence the picture that investors and customers have on banking institutions financial position.

Considering impairment, the FASB proposal does not follow the path of the IASB either, leading to further broadening of the gap between both standards.

While the EBF understands that full convergence may not be achievable in the short term, it is important that differences between both sets of standards would not have any adverse impact on the decision on equivalence and mutual recognition of IFRS and US GAAPs. It should also be noted that the remaining differences could negatively influence the SEC decision on whether, how and when to make IFRS eligible for the US reporting system.

Although the EBF supports the convergence objective, this should not be at the expense of quality. The EBF believes that the approach proposed by the IASB is more in line with the business practices and provides users of financial statements with better information. Such view is also supported with many strong arguments of the dissenting FASB Board members. Therefore the FASB should reconsider the proposals in the Exposure Draft and work together with the IASB to develop a standard in line with the principles reflecting the business practices of reporting entities.

Classification and Measurement

The EBF is of a strong view that financial instruments accounting should be based on a mixed measurement model as amortized cost is the most relevant measurement basis for financial instruments which are not held within the context of trading or otherwise managed on a fair value basis. The EBF considers appropriate the amortized cost measurement attribute for debt instruments which have relatively basic cash flow characteristics and which are held for the purpose of collecting/paying the instruments' contractual cash flows. Consequently, the EBF disagrees with the FASB proposed requirement to measure these instruments at fair value.

The EBF considers that such proposal would be misleading as it would lead to the reflection of gains that might not be realized and losses that are not expected to occur. The FASB proposals would increase the use of fair value through profit or loss resulting 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 would not improve the quality of financial statements. The EBF believes this proposed requirement will not reduce complexity, improve transparency or be acceptable to most users of financial statements. Also comparability would be undermined. In the view of the EBF, comparability should ensure that similar transactions under similar business models are treated in a similar way and not only that similar financial instruments are treated in the same way.

The EBF supports classification criteria that differentiate between financial instruments measured at amortized cost and those measured at fair value, based on the business model used by the entity.

The EBF believes 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. In this context, the EBF would support the dissenting views expressed in BC 244 by two Board members on the irrelevance of fair value measurement for certain financial instruments.

While reclassification is not an option under the FASB proposal, the EBF supports the IASB’s view to allow or even require reclassification of financial instruments. The EBF believes reclassification from one accounting category to another should be available for financial instruments when there are clear indications that the business model for a particular instrument portfolio has changed as a consequence of external events, providing appropriate disclosure.

Concerning the proposals on the treatment of changes in own credit, the EBF considers that the effects of changes in the own credit risk should not impact the P&L for financial liabilities designated under the fair value option. Therefore, the EBF welcomes and supports the principles in the IASB proposal under which own credit changes on FVO liabilities are moved out of the P&L.

The EBF supports the retention of the fair value option where companies are allowed to make an irrevocable election for the fair-value option at initial recognition for financial assets if measuring at fair value eliminates or significantly reduces a measurement or recognition inconsistency (accounting mismatch). For financial liabilities, the irrevocable option would also be available under certain scenarios under the IASB proposal. The EBF therefore regrets that the fair value option is not available in the FASB's proposed guidance.

The EBF encourages the development of a simplified and principles-based identification of embedded derivatives which should be applied to the bifurcation of embedded derivatives for both, hybrid financial assets and hybrid financial liabilities. The EBF believes that entities should have an option either to bifurcate the embedded derivative or to carry the whole financial instrument at fair value with changes in profit and loss.

Finally, the EBF is concerned about the extended use of other comprehensive income (OCI) without further fundamental discussions on the topic. It remains unclear at this point in time why certain OCI items get recycled and others do not. The EBF believes all items should be recycled. The objectives of OCI and its subsequent treatment need to be addressed, debated and clearly defined with an appropriate link into the framework.

The recently published ED 'Presentation of Items of Other Comprehensive Income' fails to address the fundamental issues including the presentation of the performance statement, which should not be a single statement of comprehensive income. The EBF, therefore, urges the FASB and the IASB to cooperate closely and establish a robust and consistent framework for OCI.

Impairment

The EBF does not support a single fair value measurement model for financial instruments and supports the IASB model requiring amortized cost for instruments held for the collection/payment of contractual cash flows which should be complemented with an impairment model allowing earlier recognition of credit losses compared to current incurred loss model.

The EBF supports an expected loss approach impairment model based on the following main principles:

- Expected losses should be the best estimates of the most likely losses to be experienced on the financial assets existing in the performing portfolio at the balance sheet date;
- The impairment methodology should be based on the "expected loss over the life of the portfolio";
- The impairment model should be primarily developed for application in an open portfolio context;
- Expected loss allowances should be amortized over the life of the portfolio;
- Initial expectations of future losses and changes in those estimations should be treated symmetrically;
- The current definition of amortised cost and the current Effective Interest Rate (EIR) calculation of IAS 39 should not be changed;
- Expected loss allowances are built up to be used and should not be kept as buffers; and
- Impaired loans should be treated as in the current IAS 39.

The EBF believes that an impairment model for financial assets should be based on an expected loss approach where estimates of the losses should reflect all existing information. The EBF does not support the FASB model which leads to immediate recognition of credit losses (D1 loss), resulting in artificial distribution of revenues (understating of revenues in early years and overstating of revenues in later years).

The EBF agrees with the IASB that expected losses should be amortized over the life of the portfolio. As expected losses represent expectations of losses occurring in the future, these are distinguished from losses that have been incurred. Any changes in those expectations also relate to possible future events and should therefore also be recognized prospectively.
The EBF believes that such an approach would provide for a treatment in the income statement consistent with the principles of the revenue recognition over the life of the instruments and also with the risk management practices of financial institutions. It would also avoid introducing artificial P&L volatility resulting from the inaccuracy of expected loss estimations.

Finally, the EBF supports the FASB proposal to remove the probability threshold which is considered one of the major improvements compared to the current FASB requirement on loan loss impairment.

Hedging

The EBF supports the FASB's efforts to simplify the accounting for hedging activities, resolve practical issues that have arisen under Statement 133 and to move from a rule-based approach towards a principle-based one. That said, the EBF welcomes the removal of the quantitative assessment of hedge effectiveness and supports the adoption of a qualitative analysis to assess effectiveness as this would help reduce complexity in applying the hedge accounting rules.

Although preparers' concerns regarding the consequences of unintentionally misapplying the two methodologies (e.g. with corresponding or attendant risk of financial reporting restatement) will be addressed by the elimination of the shortcut method and the critical terms matching criteria, new concerns and practical issues will likely arise, such as the ability of companies to operationally comply with the "long haul" calculations prescribed in Topic 815. The EBF has suggested below some changes to the ED that would eliminate these concerns.

In efforts to simplify the current hedge accounting model, the hedge of a portion of a financial instrument's contractual cash flows (e.g. the LIBOR component of a fixed-rate bond) should be allowed. In addition, the ED should expand the current bifurcation-by-risk approach population to allow hedges of other identifiable and reliably measurable/observable interest rate risk exposures such as the Federal Funds Rate, the Prime Rate, inflation indexes, etc. This would ease preparers' concerns with performing the complex "long haul" calculations and would achieve convergence with current IASB decisions.

The EBF disagrees with the proposal to prohibit the voluntary dedesignation of a hedge accounting relationship currently permitted in Topic 815. In addition, the EBF considers as nonoperational and cost prohibitive the proposed guidance on effective terminations. Companies commonly add new economic hedge relationships and remove, or dedesignate, existing hedge relationships as changes occur in the risk profile of the hedged risk exposure. As a result, the EBF finds the FASB's basis for conclusions regarding dedesignation to be flawed and inaccurate as such risk management strategies are prudent and appropriate.

The EBF does not understand how an entity could accomplish earnings management through a decision to dedesignate, as hedge accounting designations must be made in advance of market movements. The EBF believes that FASB's concerns can be address by enhanced disclosure about why companies redesignate or dedesignate hedging relationships.

Although the ED would allow more hedges to qualify for hedge accounting and relax certain current demands to qualify for hedge accounting, some valid and effective hedges would result in significant income statement volatility without the ability to define the hedged risk associated with a nonfinancial contract in a manner that reflects the economic risk being hedged. As a consequence, unless the FASB reconsiders the types of risks that can be hedged for accounting purposes, many companies may find limited practical benefit from the ED. The IASB Board recently decided that a contractually-specified nonfinancial risk component is a permitted hedged risk. Therefore we believe that the FASB should incorporate the IASB's final decisions into its final standard in order to improve accounting and make it converge in this area.

Companies often manage on a portfolio or macro basis their exposure to interest rate risk in both their investment portfolios and liabilities. Contrary to how companies manage risk, current US GAAP prohibits entities from designating the combination of financial instruments as a single hedged item unless those individual instruments are expected to respond similarly to changes in the hedged risk. It also prohibits aggregating a combination of financial assets and financial liabilities to be a hedged item. This requires companies that are looking to hedge their net interest rate risk exposure to define the hedged item as either an individual asset or liability, or groups of similar assets or liabilities, which often requires frequent dedesignation/redesignation of the hedge relationship as the net risk exposure within the portfolio changes.

At recent Board meetings, where the hedge accounting project was debated, the IASB decided to expand the existing hedging approach in IAS 39 and considered permitting a net position to qualify as hedged item by changing how the hedged item can be defined. The decisions of the IASB would permit the hedged item to include a financial company's net interest rate exposure comprised of financial assets, financial liabilities and derivatives, which will ease the burden associated with hedging a company's net interest rate exposure. While the FASB has not formally deliberated the merits of "macro hedging" under its Financial Instruments project, the FASB should consider incorporating the IASB decisions in this area for inclusion in the final standard on hedge accounting, resulting in further convergence of accounting, all while improving the accounting standards on hedge accounting.

The ED contains a proposed change in cash flow hedge accounting to recognise ineffectiveness from under-hedging <u>and</u> over-hedging in profit and loss. We oppose the proposed inclusion of recognising ineffectiveness arising from under-hedging in profit & loss for cash flow hedge accounting. This would indeed be in conflict with the logic of cash flow hedge accounting since the hedged items are not currently recognised on the financial statements (i.e. highly probable forecast transactions) and hence it would not be appropriate to recognise such ineffectiveness (cumulative fair value of hedged items greater than hedging instruments). Similarly, it would be inappropriate to treat under-hedged portions of cash flows as under-hedge and thereby requiring to recognise their ineffectiveness.

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