Realkreditrådet
ASSOCIATION OF
DANISH MORTGAGE BANKS

REALKREDIT FORENINGEN

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Comments to the IASB ED on FVO for Financial Liabilities

IASB published on 11 May 2010 an exposure draft on *Fair Value Option for Financial Liabilities.*

The Danish mortgage banks represented by the Association of Danish Mortgage Banks (Realkreditrådet) and the Danish Mortgage Banks' Federation (Realkreditforeningen) - the two organizations cover the whole mortgage bank sector in Denmark - are very concerned about the exposure draft. The reason is that the exposure draft will create an accounting mismatch for the Danish mortgage banks.

Our comments to the questions in the ED follow below.

Question 1

Generally we support that changes in the credit risk of the financial liability ("Liability's Own Credit Risk" or "LOCR") go to OCI when financial liabilities has been designated under the fair value option ("FVO"). However we strongly support that entities should be able to recognise all changes in fair value of liabilities designated under the FVO including the change in LOCR if it avoids creating an artificial accounting mismatch (see our response to Question 2).

Question 2

We can support the alternative approach as described in Question 2.

Whilst we accept that the scenarios where an accounting mismatch under the proposals could arise are limited nevertheless they exist and are of the utmost importance to the Danish mortgage banks.

Since adoption of IFRS in 2005 the Danish mortgage banks have used the fair value option to fair value the issued covered loans (the asset) and the issued listed covered bonds (the liability) according to IAS 39 9(b)(i) and IAS 39 AG4E(d). This treatment has ensured that no accounting mismatches were created by IAS 39.

The exposure draft will create an accounting mismatch for the Danish mortgage banks. The reason is exactly as described in the ED on page 8, namely that the entire change in the fair value of the assets would be presented in profit and loss but a portion of the change in the fair value of the liability would not.

When an entity has chosen to designate financial liabilities under the FVO to avoid an accounting mismatch (i.e. artificial mismatch) it is strange to have inserted rules that will create a new mismatch.

It is important to maintain the option with full effect in P&L to avoid the mismatch. We refer
./. for explanation of the Danish mortgage system to the attachment.

It also seems strange to limit the full effect of the FVO by taking some part of the effect to OCI (in reality although through two steps), when the objective is to get the same treatment for financial liabilities that entities want to treat like traded financial assets and financial liabilities, because they have similar characteristics. In the Danish case the financial liabilities (e.g. the issued bonds) are listed and traded in a normally active market.

We could propose that the criteria for using the FVO are maintained and that further restrictive criteria are to be met as follows in order to recognise all changes in fair value of financial liabilities in P&L (including changes in the credit risk of the financial liability ("LOCR")):

1. When using the FVO it significantly reduces an accounting mismatch

2. There is a one-to-one relationship between the financial liabilities and financial assets classified under the fair value option (market risks, including LOCR are eliminated for the mortgage bank and lies with the bondholders and borrowers only)

3. The designation to use the option to take the changes in "LOCR" through P&L should only be available at initial recognition and should not to be reassessed.

Due to the "one to one relationship" the reporting entity cannot realise gains or losses on the changes in fair value attributable to LOCR, because the benefit of changes in the credit risk of the financial liability is directly linked to the loss on the related financial asset (and it is only the counterparty to the asset (the borrower) that can realize the gain or loss). The reason is – as described in the attachment – that the Danish mortgage banks have a one-to-one relationship between granted covered loans and issued listed covered bonds and the borrowers have a right to prepay the loan and the bonds are having the equivalent prepayment option. Therefore the change in the fair value of the listed bonds will equate the change in the value of the prepayment option and thereby the fair value of the loan. Therefore - under the propsal in the ED - the mortgage bank would get the volatility in P&L from the asset side, but not the full offsetting volatility from the liability side.

We put forward, as proposal, very demanding restrictions to illustrate that we accept the main objective for the IASB, but that the proposal in the ED is very negative to the Danish mortgage system, because profit and loss will be misleading to read for users. Therefore there should be a possibility to take the entire change in the fair value of the liability to P&L including LOCR, but only in limited situations. However we can of course support to have less than all the proposed restrictions.

We would furthermore refer to BC 19 and BC 20, where we agree entirely with the IASB, however we come to the opposite conclusion compared to the Board's decision described in BC 21. We do that because

1. Users of financial statements of Danish mortgage banks want to have parallel treatment of the assets and liabilities, and we have never heard that users of these financial statements should have told the IASB that LOCR should not affect P&L

2. We find the argument about comparability in BC 21(c) very surprising when one reminds that IFRS contains many options that could be said to undermine comparability without the IASB disallowing them. We believe it is more important to get a faithfully representation than comparability with other entities in other industries or countries and with very different fact patterns.

We would also like to mention that we find it important that it will be very difficult to measure the LOCR reliably, and that will of course create an – for us – unwanted room for manoeuvre.

Under the Danish mortgage system the proposed rule will also create possibilities for manipulation of P&L, and our proposals should also be seen as our support to the IASB not to create such possibilities in the IFRS standards.

It is our understanding that the LOCR is to be calculated for each individual liability designated under the FVO for financial liabilities. We find that burdensome because the mortgage banks have many bonds issued using the FVO. It is to be noted that there in the Danish case normally are differences in the credit ratings of the bonds and the mortgage banks other liabilities.

Question 6

No.

Question 8

It would be important to get an explicit definition and measurement of the credit risk of the liability and at least we would support to have the price of credit in the financial liabilities segregated from the credit quality of the liability.

It is important to define well the credit risk of the liability, when the element gets a very different treatment, this in order to ensure – should IASB go ahead – to avoid that more components than LOCR go to OCI.

Question 9

We do not agree with the requirement to only be allowed to early adopt if entities also use other already approved changes to IFRS 9 and other specific standards. The requirements in the ED are rather unique and not linked to IFRS 9 and the financial assets. In addition, at this stage IASB might in theory change or amend IFRS 9 before this ED is approved as standard and therefore an application of IFRS in order be able to use this amendment might create future unintended consequences.

Question 10

We do not agree with the proposed transitional requirements, because designation of financial liabilities on initial recognition to use the FVO cannot be reassessed today. However if this ED goes through Danish mortgage banks might prefer not to use the FVO (and change accounting policies to amortised cost for both financial assets and financial liabilities in question), and if that is the case they should have the fair opportunity to reassess the designation

carried out already. Therefore we believe that there should be a possibility to de-designate all financial liabilities out of the fair value option at initial application of this amendment.

In addition we will mention that we generally support the use of retrospective application of new standards, however the Danish mortgage banks and others might be in the situation that they do not have, or it might be very cumbersome, to gather information of LOCR from past years and particularly not if the IASB accepts – which they ought to as mentioned in the response to Q 8 – to provide a specific, explicit and more narrow definition of LOCR.

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We look forward to our meeting with You on the 23 August.

Best regards

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