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EACB Comments on the EFRAG DCL on the FASB ED on *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities*

13 September 2010

The European Association of Co-operative Banks (EACB) is the voice of Co-operative Banks in Europe. It represents, promotes and defends the common interests of its 28 members and co-operative banks in general. Co-operative banks form decentralised networks which are governed by banking as well as co-operative legislation. The co-operative banks business model is based on three pillars: democracy, transparency and proximity. Through those pillars co-operative banks act as the driving force of sustainable and responsible development by placing the individual at the heart of their activities and organization. In this respect they widely contribute to the national and European economic and social objectives laid down in the Lisbon Agenda. With 63.000 outlets and 4.200 banks, co-operative banks are widely represented throughout the enlarged European Union playing a major role in the financial and economic system. In other words, in Europe one out of two banks is a co-operative. Co-operative banks have a long tradition in serving 160 million customers, mainly consumers, retailers and SMEs. They have also developed a strong foothold in the corporate market providing services to large international groups. Quantitatively co-operative banks in Europe represent about 50 millions members, 750,000 employees with a total average market share of about 20%.

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General Comments

The members of the European Association of Cooperative Banks (EACB) are pleased to comment on the EFRAG Draft Comment Letter on the FASB Exposure Draft on *Accounting for Financial Instruments Revisions to the Accounting Derivative Instruments and Hedging Activities*.

EACB members strongly support the joint effort undertook by the IASB and the FASB to achieve a single set of high-quality global accounting standards. We actively follow the boards' projects to simplify the accounting for financial instruments, which is a very complex area. We recognise the efforts made by the boards to achieve convergence of IFRSs and US GAAP and the difficulties they have met to deal simultaneously with all the aspects of accounting for financial instruments in a very short time frame.

However, in our responses to the IASB consultations, EACB expressed in many occasions, our members' disappointment, as regards the lack of coordination between the boards. We noticed the inconsistency of the FASB's tentative decisions with the IASB's. Today, looking at the FASB's ED, we regret that, the FASB approach differs significantly than the IASB's IFRS 9.

In fact, like the EFRAG, the members of the EACB support the broad direction set by the IASB to replace IAS 39 *Financial Instruments: recognition and measurement*. In this respect, we agree that the directions set by the IASB should form the basis for the development of a converged standard.

Furthermore, EACB members also believe that the convergence should not be achieved at the expense of quality. European Co-operative Banks particularly agreed that a "high quality" accounting standard on financial instruments would result in reporting which will best depict the economic realities behind businesses and help users to make economic decisions.

Therefore, the members of the EACB are, like the EFRAG, strongly concerned by the FASB's proposals, which we do not expect to help in reducing complexity and improve transparency of financial statements.

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EACB comments on the EFRAG's recommendations

We provide comments only on the EFRAG's recommendations to the FASB set out in the cover page of the draft comment letter.

IASB Directions

Classification criteria

EACB members strongly support the EFRAG's assessment regarding the multiple measurement options presented by the FASB.

Please allow us to recall our position taken on the matter last year during the IASB's consultations, as we still consider those comments relevant as regards FASB's proposals.

While, EACB members do not think that the number of measurement categories in the existing IAS 39 is in itself a source of complexity, we supported the IASB proposal to reduce their number.

We share, like the EFRAG, that the business model should be the main classification criterion for all financial instruments. In this respect, European Cooperative Banks recall their strong support to the *Guiding Principles for the replacement of IAS 39* set out by the Basel Committee on Banking Supervision on 27th August 2009. In particular:

- Principle 1: Usefulness and relevance, "*the new two category approach for financial instruments should not result in an expansion of fair value accounting (...)*"; and
- Principal 2: Faithful representation: reflecting the business model, *"(...) there should be a strong overlay reflecting the entity's underlying business model as adopted by the Board of Directors and senior management, consistent with the entity's documented risk management strategy and its practices, while considering the characteristics of the instruments*."

Mixed measurement model

EACB members particularly share the EFRAG's views that financial instruments accounting should be based on a mixed measured model, which allows for the accounting of some debt instruments at amortised cost.

Reclassification

Our members have always supported a new standard that will permit the reclassification after initial recognition when the business model has changed. From our views, the standards setter should not focus too much on the characteristics of the certain instruments but rather on how it is managed. Moreover, in case of reclassification, additional (one-time) disclosures should be required.

Primary financial statements reflections one measurement attribute only

Like the EFRAG, we are not convinced by the FASB's proposal to present two measurement attributes on the face of the statement of financial position for certain debt instruments. We also think that “amortised cost” is the measurement attribute that best represents the business model for debt financial instruments held for collection or payment of contractual cash flows. FASB’s proposal would only lead to additional complexity without any benefit for the presentation and the comprehension of primary statements.

Expected loss approach for impairment

While we agree with the EFRAG’s views that amortised cost and impairment model for financial assets should be based on an expected loss approach, we cannot be so positive regarding the IASB’s proposal on the matter. In fact, EACB members note significant weaknesses of the IASB’s expected cash flow approach as well, which have been partially addressed in paragraph 116 of the EFRAG’s Draft Comment Letter. Such weaknesses are implementation costs and effort for applying the effective interest rate method, non-applicability for open portfolios and incompatibility with the internal business models of entities.

Therefore, EACB members call both standard setters for a credit impairment approach that would take into account the economic reality and limitations of date processing systems of banks.

Moreover, we take the opportunity, to advocate, one more time, for the introduction of the Expected Loss model over the Life of the Portfolio (ELLP) approach as developed by the European Banking Industry a few months ago. The ELLP approach would separate the calculation of effective interest revenue and expected losses on a portfolio basis. It would also allocate the estimates cash flows and effects of changes of estimates over the life time of the portfolios.

Furthermore, regarding adjustments due to changes of estimates, we are not fully convinced by the “differentiated approach” proposed by the EFRAG. EFRAG proposes to differentiate between changes which result from past and future events. With regard to past events EFRAG proposes to immediately recognize the effects in profit or loss, whereas in case of future events the changes should be allocated until maturity. EACB members would instead recommend, allocating changes over the remaining time until maturity, notwithstanding whether the change results from past or future events.

Own credit risk

The members of the European Association of Co-operative Banks always argued that changes in the credit risk of a liability, which is not held for trading and not actively traded, should not be recognised in profit or loss. Therefore, in our comment letter to the IASB’s ED in July 2009, we welcomed that changes in an entity’s own credit risk from re-measurement of liabilities designated under the fair value option should not affect profit or loss.

However, some of our members expressed their strong concerns regarding proposals set up in the IASB’s ED for the own credit risk measurement and the asymmetrical treatment of financial assets and liabilities. In fact, by principle, some of our members would have preferred that the IASB proposed a complete exclusion of the effect of changes in the own credit risk in the measurement of a liability. In this respect, they particularly believe that a "frozen spread approach" would have been the most relevant measurement method for financial liabilities designated at fair value.

Suggested improvements for the formulation of the final standard

Greater emphasis on the business model

According to the paragraph 82a of the EFRAG's Draft Comment Letter, the principle defining the boundaries between amortised cost and fair value measurement should more closely reflect the business model adopted for the different contractual cash flows present in a financial instrument, giving great emphasis to the business model.

EACB members strongly support that proposed direction of future development of accounting for financial instruments.

Separate accounting for embedded derivatives

EACB members particularly appreciate that the EFRAG supports a separate accounting for embedded derivatives for assets and liabilities. In this respect, we are pleased to read the arguments outlined in paragraph 81 of the EFRAG's Draft Comment Letter.

The prohibition of bifurcation of embedded derivatives in IFRS 9 (assets' side) is a big concern for the banking industry. European Cooperative Banks strongly believe that the bifurcation of these instruments from host contracts should be allowed. In fact, banks have many structured financial assets and liabilities where embedded derivatives are clearly identifiable, measurable and separable. Instead, a prohibition of bifurcation of embedded derivatives from the financial host would probably lead to an increase of the fair value measurement because the hybrid instrument as a whole must be measured at fair value. Therefore, we asked the IASB Board to extend the current IAS 39 bifurcation requirements for embedded derivatives to financial assets since it better reflects the nature and cash flows of a hybrid instrument.

Moreover, following the publication of the IASB ED on Fair Value Option for Financial Liabilities (ED/2010/4) (where the bifurcation is allowed on liabilities' side), our members particularly worried about accounting inconsistencies between financial assets and financial liabilities whereas these instruments may be managed together.

Therefore, we strongly support the EFRAG's intention to support joint efforts of the FASB and the IASB for the development of converged requirements to improve the classification criteria and achieve a simple, symmetrical and principle-based approach to the bifurcation of embedded derivatives (as expressed in paragraph 82 of the EFRAG's Draft Comment Letter).

Investments in equity instruments

According to the EFRAG, equity investments not held-for-trading should be accounted for differently from equity investments held-for-trading and measured at fair value through profit or loss. Specifically, equity investments not held-for-trading should be measured at fair value with changes in fair value recognised in other comprehensive income, subject to an impairment test.

EACB members would recommend the EFRAG to add in their draft letter that for the measurement of unquoted equity instruments an exception should be available. We think that, entities should be allowed to measure such investments at cost, if their fair value cannot be measured reliably. We do not consider the guidance in IFRS 9 that says that cost might be representative of fair value in specific circumstances as very helpful in practice, since the requirements for such an assumption are rather strict.

Consistent measurement of financial assets and liabilities that are linked together

EACB members agree with the EFRAG's recommendation that a mixed measurement model should be combined with an option that allows for a consistent measurement basis for financial assets and financial liabilities that better reflects the links existing between those assets and liabilities in order to avoid accounting mismatches.