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Email

Financial Accounting Standards Board:

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Brussels, 1st October 2010

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

Dear Mr Golden,

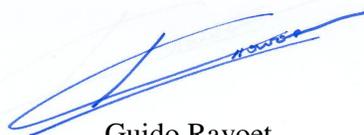
The European Banking Federation (EBF) welcomes the opportunity to provide comments on the Exposure Draft Accounting for Financial Instruments and Revision to the Accounting for Derivative Instruments and Hedging Activities.

In addition to our major concerns about the ED, which we have presented to you in our letter of 1 September 2010, we are providing you with our answers to specific questions raised in the Exposure Draft (*see DI518D-2010*).

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 therefore regret that we have not been provided with an opportunity to represent our members in the Roundtables organized by the FASB.

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

Yours faithfully,



Guido Ravoet

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D1518D
Brussels, 1st October 2010

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 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. Reclassification should be 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, unless this would cause an accounting mismatch. 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 accounting should permit the hedging of a portion of a financial instrument's contractual cash flow. The hedged item should be permitted to**

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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.**

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 the financial position of banking institutions.

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 key criterion alongside of the technical characteristics of the instrument 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 require reclassification of financial instruments when the business model changes. 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 when realized. 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 mixed measurement model. Amortized cost measurement 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 believes 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.

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 and 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.

Answers to the specific questions raised in the FASB Exposure Draft

Question 1: Do you agree with the scope of financial instruments included in this proposed Update? If not, which other financial instruments do you believe should be excluded or which financial instruments should be included that are proposed to be excluded? Why?

It is unclear whether it is the FASB's intention to include contracts which currently qualify as normal purchases and sales within the scope of the ED. The EBF would appreciate further clarification.

Question 2: The proposed guidance would require loan commitments, other than loan commitments related to a revolving line of credit issued under a credit card arrangement, to be measured at fair value. Do you agree that loan commitments related to a revolving line of credit issued under a credit card arrangement should be excluded from the scope of this proposed Update? If not, why?

No. The limitation to loan commitments is not justified. The EBF believes that the ED should introduce a principle to ensure the same treatment to all commitments with similar features and economic substance, instead of listing certain categories. Once that distinction has been made, it would be possible to differentiate between those commitments that should be classified as financial instruments and those that should be measured using some other standard for financial reporting.

Question 3: The proposed guidance would require deposit-type and investment contracts of insurance and other entities to be measured at fair value. Do you agree that deposit-type and investment contracts should be included in the scope? If not, why?

No. The fair value measurement is only appropriate for 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. The above mentioned types of instruments are generally not trading instruments and therefore should generally not be measured at fair value.

Question 4: The proposed guidance would require an entity to not only determine if they have significant influence over the investee as described currently in Topic 323 on accounting for equity method investments and joint ventures but also to determine if the operations of the investee are related to the entity’s consolidated business to qualify for the equity method of accounting. Do you agree with this proposed change to the criteria for equity method of accounting? If not, why

No, we do not agree with the proposed change to the criteria for equity method of accounting. The proposed changes to how equity investments need to be accounted for would unnecessarily complicate the accounting for all investments in private companies that do not qualify for the equity method because the information needed to reliably estimate fair value for each reporting period is often not readably available.

In addition, most of the investments are made for strategic purposes. Therefore, the investee’s operations might not always be directly related to the consolidated business. For these reasons, the proposal in the ED would decrease the usefulness and reliability of the financial statements for investors. Also, the EBF members are not aware of a need to change the current accounting rules for investments in associates.

Question 8: Do you agree with the initial measurement principles for financial instruments? If not, why?

We agree that when an entity initially recognizes a financial instrument, it has to determine whether there is reliable evidence to indicate whether there may be a significant difference between the transaction price and the fair value of the instrument. Such departure is indicative of other elements or subsidies in the deal which must be recorded as such. Nevertheless, the critical term in this statement here is “significant”: many financial instruments are not actively traded and only a range of plausible, therefore acceptable fair values can be determined for them. Furthermore, many factors affect the pricing of a financial instrument, and it is not obvious to assess that two instruments share all of the same characteristics taken into consideration to price them. Only significant departure of the transaction price from other prices of “similar transactions” can be identified.

Question 9: For financial instruments for which qualifying changes in fair value are recognized in other comprehensive income, do you agree that a significant difference between the transaction price and the fair value on the transaction date should be recognized in net income if the significant difference relates to something other than fees or costs or because the market in which the transaction occurs is different from the market in which the reporting entity would transact? If not, why?

Entities may be present in several different markets. This may be the case for both local as well as for globally active entities. Entities' sub-units (e.g. branches or subsidiaries) may also have several different principle markets. There may therefore be several markets for the same instrument within a consolidated entity as well as within a single entity.

We believe that it would be irrelevant, misleading and very time consuming should the requirement be implemented that the most advantageous market must be decided on a consolidated basis. Instead, each entity that holds the same instrument should define the most advantageous market based on the special circumstances that apply to that entity.

Question 10: Do you believe that there should be a single initial measurement principle regardless of whether changes in fair value of a financial instrument are recognized in net income or other comprehensive income? If yes, should that principle require initial measurement at the transaction price or fair value? Why?

We agree that a single measurement principle should govern the first recordings of transactions. In most cases, the transaction price will be representative of instruments' fair values. Please, see our answer to question N° 8.

Question 11: Do you agree that transaction fees and costs should be (1) expensed immediately for financial instruments measured at fair value with all changes in fair value recognized in net income and (2) deferred and amortized as an adjustment of the yield for financial instruments measured at fair value with qualifying changes in fair value recognized in other comprehensive income? If not, why?

Instruments that are measured at fair value should expense immediately transaction fees and costs while instruments that are held for the purpose of the yield should be at amortized cost and the transaction fees and costs should be deferred and amortized as an adjustment of the yield for that instrument.

Question 12: For financial instruments initially measured at the transaction price, do you believe that the proposed guidance is operational to determine whether there is a significant difference between the transaction price and fair value? If not, why?

As pinpointed in our answer to question N° 8, there are some operational difficulties to operate the distinction between transaction prices and fair values. But, additional guidance cannot solve them.

Question 13: The Board believes that both fair value information and amortized cost information should be provided for financial instruments an entity intends to hold for collection or payment(s) of contractual cash flows. Most Board members believe that this information should be provided in the totals on the face of the financial statements with changes in fair value recognized in reported stockholders' equity as a net increase



(decrease) in net assets. Some Board members believe fair value should be presented parenthetically in the statement of financial position. The basis for conclusions and the alternative views describe the reasons for those views. Do you believe the default measurement attribute for financial instruments should be fair value? If not, why? Do you believe that certain financial instruments should be measured using a different measurement attribute? If so, why?

No, the EBF does not believe that the default measurement attribute should be fair value. If the purpose of the financial statements is to assist users in their estimates of future cash flows as a basis for estimating the value of the business today, the focus should indeed be on estimation of future cash flows for those assets and liabilities held with the intention of cash flow collection.

There is no obvious reason in presenting both, the settlement value and amortized cost, as it is impossible to both liquidate a financial asset and keep it for the future collection of contractual cash flows at the same time. For financial instruments held for the collection of cash flows, the settlement value should be indicated in the notes to financial statements as it is only relevant as a value in liquidation and should not affect the present net asset of the entity.

Question 14: The proposed guidance would require that interest income or expense, credit impairments and reversals (for financial assets), and realized gains and losses be recognized in net income for financial instruments that meet the criteria for qualifying changes in fair value to be recognized in other comprehensive income. Do you believe that any other fair value changes should be recognized in net income for these financial instruments? If yes, which changes in fair value should be separately recognized in net income? Why?

No. These items should be measured at amortized cost.

Question 15: Do you believe that the subsequent measurement principles should be the same for financial assets and financial liabilities? If not, why

Yes.

Question 16: The proposed guidance would require an entity to decide whether to measure a financial instrument at fair value with all changes in fair value recognized in net income, at fair value with qualifying changes in fair value recognized in other comprehensive income, or at amortized cost (for certain financial liabilities) at initial recognition. The proposed guidance would prohibit an entity from subsequently changing that decision. Do you agree that reclassifications should be prohibited? If not, in which circumstances do you believe that reclassifications should be permitted or required? Why?



No. As the EBF believes a key criterion for determining measurement categories should be based on the business model, alongside the technical characteristics of an instrument, it is logical that transfers between categories should be allowed or required when there is a change in the business model as a result of external factors. Entities should be required to provide sufficient information about their business models and therefore be able to explain how and why their business models have changed. In addition, disclosures should be required about transfers. This should provide market discipline around reclassification.

Question 17: The proposed guidance would require an entity to measure its core deposit liabilities at the present value of the average core deposit amount discounted at the difference between the alternative funds rate and the all-in-cost-to-service rate over the implied maturity of the deposits. Do you believe that this remeasurement approach is appropriate? If not, why? Do you believe that the remeasurement amount should be disclosed in the notes to the financial statements rather than presented on the face of the financial statements? Why or why not?

No. The proposed measurement approach for core deposit liabilities is inappropriate and would add additional complexity arising from data determination.

Question 18: Do you agree that a financial liability should be permitted to be measured at amortized cost if it meets the criteria for recognizing qualifying changes in fair value in other comprehensive income and if measuring the liability at fair value would create or exacerbate a measurement attribute mismatch? If not, why?

We believe that financial liabilities that are not actively traded should be at amortized cost, to reflect the way they are used in the business and to provide users with most relevant information.

Question 21: The Proposed Implementation Guidance section of this proposed Update provides an example to illustrate the application of the subsequent measurement guidance to convertible debt (Example 10). The Board currently has a project on its technical agenda on financial instruments with characteristics of equity. That project will determine the classification for convertible debt from the issuer's perspective and whether convertible debt should continue to be classified as a liability in its entirety or whether the Board should require bifurcation into a liability component and an equity component. However, based on existing U.S. GAAP, the Board believes that convertible debt would not meet the criterion for a debt instrument under paragraph 21(a)(1) to qualify for changes in fair value to be recognized in other comprehensive income because the principal will not be returned to the creditor (investor) at maturity or other settlement. Do you agree with the Board's application of the proposed subsequent measurement guidance to convertible debt? If not, why?

If the intention is not to trade the debt, then it should be accounted for using amortized cost, with no impact on other comprehensive income.

Question 28: Do you believe that the proposed criteria for recognizing qualifying changes in fair value in other comprehensive income are operational? If not, why?

Recognizing qualifying changes in fair value in other comprehensive income is only appropriate for items measured at fair value and not amortized cost. If a financial instrument is measured using amortized cost, then there should be no recording of any change in the fair value.

Question 29: Do you believe that measuring financial liabilities at fair value is operational? If not, why

If the business model of an entity is to manage assets with the aim of holding, then the objective is normally to hold the liabilities until the final maturity of the corresponding assets. Therefore, in those circumstances the net present value created when buying back a present obligation and replacing it with a new one is close to zero (in a perfect market equal to zero). If the net present value of such an action is zero, one should question the relevance of measuring those liabilities at fair value.

In the EBF's view, the fair value measurement of liabilities normally should be of relevance in two basic circumstances:

1. To eliminate artificial volatility in earnings when assets that are directly related to the liabilities are measured at fair value
2. When there is intent to buy back issued debt instruments before final maturity without intention to replace them with new ones. This is normally the aim in trading portfolios or other portfolios that are managed on a fair value basis.

Question 30: Do you believe that the proposed criteria are operational to qualify for measuring a financial liability at amortized cost? If not, why?

Measuring a financial liability at amortized cost under current standards is operational. Adding a fair value component into the measurement is not appropriate.

Question 31: The proposed guidance would require an entity to measure its core deposit liabilities at the present value of the average core deposit amount discounted at the difference between the alternative funds rate and the all-in-cost-to-service rate over the implied maturity of the deposits. Do you believe that this remeasurement approach is operational? Do you believe that the remeasurement approach is clearly defined? If not, what, if any, additional guidance is needed?

No. Such instruments are normally not held for trading and should be measured at amortized costs.

Question 32: For financial liabilities measured at fair value with all changes in fair value recognized in net income, do you agree that separate presentation of changes in an entity's credit standing (excluding changes in the price of credit) is appropriate, or do you believe that it is more appropriate to recognize the changes in an entity's credit standing (with or without changes in the price of credit) in other comprehensive income, which would be consistent with the IASB tentative decisions on financial liabilities measured at fair value under the fair value option?

The Federation has consistently rejected the remeasurement through P&L of changes in the fair value related to own credit spread. It would be counter intuitive and misleading to show gains when the own credit quality is worsening and losses when it improves. In both circumstances, there is an obligation to repay the nominal amount and therefore the settlement value is the most relevant measure of the size of the obligation.

The unrealised changes in the value of own credit spread is only decision useful when the liability itself is used for trading purposes, or when the liability finances a trading portfolio held for short term profit purposes. In all other circumstances, the own credit spread should be allocated during the life of the contract to reflect the interest expense of the entity.

In the absence of a robust conceptual framework on the use of other comprehensive income(OCI), the EBF remains concerned that the frozen credit spread approach has not been chosen as the basis for excluding changes in the fair value of own credit spread from re-measurement.

However, if own credit were to be reported in OCI, then the gain or loss on derecognition of the liability should be recycled to profit or loss.

Question 33: Appendix B describes two possible methods for determining the change in fair value of a financial liability attributable to a change in the entity's credit standing (excluding the changes in the price of credit). What are the strengths and weaknesses of each method? Would it be appropriate to use either method as long as it was done consistently, or would it be better to use Method 2 for all entities given that some entities are not rated? Alternatively, are there better methods for determining the change in fair value attributable to a change in the entity's credit standing, excluding the price of credit? If so, please explain why those methods would better measure that change.

See our response to question 32.

Question 34: The methods described in Appendix B for determining the change in fair value of a financial liability attributable to a change in an entity's credit standing (excluding the changes in the price of credit) assume that the entity would look to the cost of debt of other entities in its industry to estimate the change in credit standing, excluding the change in the price of credit. Is it appropriate to look to other entities within an entity's industry, or should some other index, such as all entities in the market



of a similar size or all entities in the industry of a similar size, be used? If so, please explain why another index would better measure the change in the price of credit.

See our response to question 32.

Question 37: Do you believe that the objective of the credit impairment model in this proposed Update is clear? If not, what objective would you propose and why?

While the EBF agrees with a move to recognize and measure credit impairment of financial assets at fair value that have changes reflected in other comprehensive income, the EBF does not agree with the types of instruments that the FASB is putting into this category. The members of the EBF believe that instruments that are held for the collection of cash flows should be measured using amortized cost and not fair value. These instruments should then measure the amount of expected losses, which would then be amortized over the economic life of the portfolio.

Question 38: The proposed guidance would require an entity to recognize a credit impairment immediately in net income when the entity does not expect to collect all contractual amounts due for originated financial asset(s) and all amounts originally expected to be collected for purchased financial asset(s).

The IASB Exposure Draft, *Financial Instruments: Amortised Cost and Impairment* (Exposure Draft on impairment), would require an entity to forecast credit losses upon acquisition and allocate a portion of the initially expected credit losses to each reporting period as a reduction in interest income by using the effective interest rate method. Thus, initially expected credit losses would be recorded over the life of the financial asset as a reduction in interest income. If an entity revises its estimate of cash flows, the entity would adjust the carrying amount (amortized cost) of the financial asset and immediately recognize the amount of the adjustment in net income as an impairment gain or loss.

Do you believe that an entity should immediately recognize a credit impairment in net income when an entity does not expect to collect all contractual amounts due for originated financial asset(s) and all amounts originally expected to be collected for purchased financial asset(s) as proposed in this Update, or do you believe that an entity should recognize initially expected credit losses over the life of the financial instrument as a reduction in interest income, as proposed in the IASB Exposure Draft on impairment?

The EBF does not agree with the immediate recognition of credit impairment in net income as it is proposed by the FASB. Although the EBF supports a principle that initial expectations of future credit losses should be amortised over the life of the portfolio the EBF does not support the IASB model either as its members believe that changes in expectations which are related to the future expected losses should be treated symmetrically to the initial expectations. To be consistent with risk management, an impairment model should be

applicable to open portfolios. Since the changes in expectations cannot be distinguished from the original expectations, they must be treated the same way as the original estimations. 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 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. It would also avoid introducing artificial P&L volatility resulting from the inaccuracy of expected loss estimations.

Question 39: Do you agree that a credit impairment should not result from a decline in cash flows expected to be collected due to changes in foreign interest rate? If not, why?

Yes. If cash flows are reduced due to exchange rate fluctuations but the impairment assessment of the counterparty remains unchanged, there is no need for a change in provisioning. Loan loss provisions should only relate to changes in expected or incurred losses from the respective counterparty. Changes from foreign interest rate should not trigger impairment.

Question 40: For a financial asset evaluated in a pool, the proposed guidance does not specify a particular methodology to be applied by individual entities for determining historical loss rates. Should a specific method be prescribed for determining historical loss rates? If yes, what specific method would you recommend and why?

The EBF believes that no particular methodology should be prescribed for determining loss rates. A variety of risk models should be allowed to be used within a reporting entity as long as the selection of risk models is consistent with the objective of providing the best estimate of the expected loss over the life of the financial assets.

Question 41: Do you agree that if an entity subsequently expects to collect more cash flows than originally expected to be collected for a purchased financial asset, the entity should recognize no immediate gain in net income but should adjust the effective interest rate so that the additional cash flows are recognized as an increase in interest income over the remaining life of the financial asset? If not, why?

The EBF is of the view that any change in expectations that implies collecting of more cash flows than originally expected should be amortised over the life of the financial assets.

Question 42: If a financial asset that is evaluated for impairment on an individual basis has no indicators of being individually impaired, the proposed guidance would require an entity to determine whether assessing the financial asset together with other financial assets that have similar characteristics indicates that a credit impairment exists. The amount of the credit impairment, if any, would be measured by applying the historical

loss rate (adjusted for existing economic factors and conditions) applicable to the group of similar financial assets to the individual financial asset. Do you agree with this requirement? If not, why?

The proposed requirement to have a financial asset, which is not impaired on an individual basis, assessed for impairment subsequently with other financial assets of similar characteristics is reminiscent of the same existing requirement under the incurred loss model for impairment. On the contrary, in an expected loss impairment model, which the EBF supports, a portfolio approach is adopted when evaluating credit impairment and estimating expected losses a portfolio approach. Hence, there is no necessity to keep the above requirement proposed by FASB. Whether for conceptual or operational reasons, it is important that the accounting approach reflects the way credit risk is managed. Therefore the expected loss is typically managed on a portfolio basis, requiring a certain level of aggregation to derive meaningful statistical parameters. The estimates generated by statistical models are the expected losses of the portfolio and not of a specific loan.

Unless a portfolio is actually closed to new business, portfolios are mainly managed on an open basis. Therefore it is essential to ensure that the new impairment model is applicable in an open portfolio context, and that information may be derived as much as possible from the existing systems and statistical information already available for regulatory capital purposes, adjusted as appropriate (e.g. based on IRBA requirements).

Question 46: The proposed guidance would require that in determining whether a credit impairment exists, an entity consider all available information relating to past events and existing conditions and their implications for the collectibility of the cash flows attributable to the financial asset(s) at the date of the financial statements. An entity would assume that the economic conditions existing at the end of the reporting period would remain unchanged for the remaining life of the financial asset(s) and would not forecast future events or economic conditions that did not exist at the reporting date. In contrast, the IASB Exposure Draft on Impairment proposes an expected loss approach and would require an entity to estimate credit losses on basis of probability-weighted possible outcomes.

Do you agree that an entity should assume that economic conditions existing at the reporting date would remain unchanged in determining whether a credit impairment exists, or do you believe that an expected loss approach that would include forecasting future events or economic conditions that did not exist at the end of the reporting period would be more appropriate? Are both methods operational? If not, why?

The EBF believes that historical loss experience should provide the basis for estimating expected losses. However, historical loss experience should be adjusted to reflect the effects of conditions that did not affect the period on which the historical loss experience is based and to remove the effects of conditions in the historical period that do not exist at the reporting date, using their best estimates.



Question 47: The proposed guidance would require that an appropriate historical loss rate (adjusted for existing economic factors and conditions) be determined for each individual pool of similar financial assets. Historical loss rates would reflect cash flows that the entity does not expect to collect over the life of the financial assets in the pool.

Would such an approach result in a significant change in practice (that is, do historical loss rates typically reflect cash flows that the entity does not expect to collect over the life of the financial assets in the pool or some shorter period)?

For regulatory purposes, the concept “expected loss” refers to the 1-year expected losses as it is used in Basel II. However, it is possible to estimate lifetime expected loss taking into account the following considerations:

- Many entities can reasonably estimate expected losses in the “short term” based on historical information which is adjusted for management’s expectations of future conditions and changes in the credit characteristics of the portfolio. This period differs between entities due to differences in systems, customer base/products offered in an economic environment.
- For financial products with longer maturities entities may revert to a long term average loss rate as, although it is less accurate, it represents their best estimate of lifetime expected loss.

For entities using Basel II (IRB), Basel II expected loss can be used as one possible starting point for estimating lifetime expected loss. In this case, the time horizon for the expected loss would have to be adjusted to reflect the financial asset’s lifetime expected loss. For entities not using Basel II, lifetime Expected Losses could be calculated using historical charge off rates, peer banks public information or other useful information that is relevant for the entity.

Question 48: The proposed guidance would require interest income to be calculated for financial assets measured at fair value with qualifying changes in fair value recognized in other comprehensive income by applying the effective interest rate to the amortized cost balance net of any allowance for credit losses. Do you believe that the recognition of interest income should be affected by the recognition or reversal of credit impairments? If not, why?

No. the recognition of interest income should not be affected by the recognition or reversal of credit impairments. The EBF supports the current definition of amortised cost and the current Effective Interest Rate (EIR) calculation of IAS 39. The EIR calculation should be separate from the expected loss calculation.

Question 56: Do you believe that modifying the effectiveness threshold from *highly effective* to *reasonably effective* is appropriate? Why or why not?

Yes. The EBF is supportive of the simplification of existing guidance for hedge effectiveness and for the removal of the quantitative assessment of hedge effectiveness, which is too



restrictive. The EBF, therefore, supports the adoption of a qualitative analysis to assess hedge effectiveness, as this would reduce complexity in applying the hedge accounting rules. The EBF believes that the *reasonably effective* standard should be principle-based. The entity should provide explanations of its assessment in the financial statement.

Question 57: Should no effectiveness evaluation be required under any circumstances after inception of a hedging relationship if it was determined at inception that the hedging relationship was expected to be reasonably effective over the expected hedge term? Why or why not?

We are supportive of the FASB's proposed prospective approach to assessing hedge effectiveness at the inception of a hedging relationship. In most circumstances, there should be no requirement for the entity to perform a retrospective effectiveness test.

If there is a change in the economics on which the hedge was initially built (e.g. changes in the correlation of two associated rates) and this change results in the initial hedge relationship being no longer effective, then the entity will normally de-designate the hedged items of the initial hedge, enter into additional hedging relationships and re-designate the hedged items of the new hedging relationship. As discussed further in Q.63, we believe that entities should be permitted to de-designate a hedging relationship at their discretion. Thus, if and when management needs to re-balance, re-calibrate or simply eliminate a current hedge relationship in response to factors arising after the inception of the hedge, it should not be artificially constrained by accounting rules.

Accordingly, a reassessment of ongoing hedge effectiveness should only be required in circumstances in which the terms of the hedged or hedging instruments are modified. We acknowledge that forecasts are inherently imperfect and unforeseen events may cause currently correlated relationships to diverge in future periods. However, we believe that entities would generally seek to economically limit hedge ineffectiveness if and when it arises in the future. As ineffectiveness is reflected in current income, accounting and risk objectives are already aligned. The requirement to continue or discontinue a hedge should thus be taken solely as a risk-management decision; not through accounting rules.'

Question 65: Do you agree with the proposed disclosure requirements? If not, which disclosure requirement do you believe should not be required and why?

As the EBF disagrees with the underlying methodology it does not support the proposed disclosure requirements which seem to be overly extensive and cause significant operational problems and costs.