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Via email: director@fasb.org

Mr. Lawrence Smith
TA & I Director
Financial Accounting Standards Board
of the Financial Accounting Foundation
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Dear Mr. Smith:


The Canadian Bankers Association ("CBA") appreciates the opportunity to comment on the U.S. Financial Accounting Standards Board's ("FASB") Exposure Draft ("ED") on The Fair Value Option for Financial Assets and financial Liabilities, Including an amendment of FASB Statement No. 115 ("FVO").

The CBA is the main professional industry association representing over 50 of Canada’s domestic and foreign-owned Chartered banks and it is a principal contributor to the development of accounting standards and public policy on issues that affect banks. As several of our members are SEC registrants, they are impacted by the accounting standards that are implemented in the U.S. since they must apply U.S. GAAP when preparing financial statements for U.S. filings.

The Canadian banking industry endorses the FASB’s proposal that would allow an entity to elect fair value as the initial and subsequent measurement base for financial assets and liabilities recognized in financial statements. Our members believe that there is value in utilizing the FVO for specific areas as it allows banks to more closely match economics and accounting.

One of the main reasons for using the FVO is where economic offsets cannot be similarly accounted for under the strict hedge accounting rules, but would be under the FVO. Banks believe that a matching of economics and accounting, while at the same time safeguarding regulatory concerns around reliable measurements and models, would lead to an appropriate use of the FVO.

While our members are generally in agreement with the FASB’s overall approach to the FVO, the Canadian banking industry makes the following comments.
Global Convergence

The International Accounting Standards Board ("IASB") and the Financial Accounting Standards Board ("FASB") have agreed on a roadmap to global convergence. On January 10, 2006, the Canadian Accounting Standards Board ("AcSB") announced their intention to adopt International Financial Reporting Standards ("IFRS") in Canada. The US Securities Exchange Commission ("SEC") has also announced that it would consider eliminating the reconciliation requirements between US GAAP and IFRS by 2009. If the reconciliation requirement were to be eliminated, it would firmly support the true emergence of a globally converged set of accounting standards.

Our members are supportive of the global convergence of accounting standards provided that this results in high quality standards. The move by the accounting standards setters towards one set of high quality globally accounting standards would create significant efficiencies and reduce some of the current standards and regulatory burdens faced by globally active banks. However, convergence does not necessarily mean that all US GAAP, IFRS and Canadian GAAP standards be identical, as long as they have a broadly equivalent effect, and no major jurisdiction would require reconciliation between the various standards.

As you would appreciate, the fair value accounting of financial instruments is a complex and evolving area. Guidance from international accounting standards-setters and prudential regulators continues to emerge in response to changing and different circumstances. As a result, we believe that the FVO should be a broad and general statement of principles on the use of the FVO as it relates to financial instruments. A broad set of principles, rather than detailed application and disclosure guidance, would facilitate the banks' evaluation of the potential use of the FVO. As such, we believe that the major standard setters should adopt a globally converged standard on fair value and that one national standard on the FVO should not be more restrictive than that of another national standard.

Scope of Phase 1

We are concerned about the fact that both demand deposits and loan commitments are excluded from the scope of Phase 1 of the FVO. We understand that the FASB excluded these two products from scope due to the concern that non-financial components affect the determination of their fair value. We believe loan commitments and demand deposits are financial instruments and thus should be included within scope.

Our view is that the concern regarding the effect non-financial components would have on the determination of the fair value of demand deposits and loan commitments is a fair value model/valuation issue that would be more appropriately addressed via the fair value measurement framework and thus, should be addressed separately. In fact, the issue of non-financial components affecting fair value is much broader and affects more than just demand deposits and loan commitments. Many instruments including retail loans, term deposits and mortgages have non-financial components that affect fair value.

Also, excluding these two products from the scope of Phase 1 will create US GAAP/IFRS differences. Our members are concerned that these differences will give rise to differences in reconciliation and disclosure. Under Canadian GAAP, which is the same as IFRS in this respect, banks are permitted to fair value loan commitments as derivatives in certain circumstances. Limiting the FVO to exclude loan commitments will result in reporting differences for some of our members who have been, or will be recognizing loan commitments at fair value.
In addition, when reporting under Canadian GAAP, some of our members currently recognize mortgage loan commitments in their financial statements as derivatives and offset the impact on earnings through the use of economic hedges. Loan commitments are economically hedged on a portfolio basis to reduce the banks' exposure to changes in interest rates. Due to the complexity of hedge accounting rules for this type of hedge, a hedge accounting solution is often not viable and the fair value option is the only practical alternative to achieve matched P&L. Not recognizing the loan commitment at fair value will result in artificial accounting volatility that does not reflect the economic reality.

It should also be noted that IFRS technically allows the fair value option to be applied to demand deposits, but states that the fair value of demand deposits cannot be below the amount repayable on demand. It would help to reduce US GAAP/IFRS differences if FASB could include demand deposits within the scope of the fair value option. The question on fair value determination for demand deposits should be addressed via the fair value measurement framework. Our view departs from IFRS in that the fair value for demand deposits should be measured on a pooled basis, which is an approach allowed per the Basel framework for risk and capital purposes.

Unit of Measurement

The ED requires the FVO, if elected, to be applied on a "contract-by-contract" basis. This requirement is restrictive and would render the application of the FVO impossible for instruments that could be split up legally and sold as individual units.

A syndicated loan is a typical example. A lead bank may advance a loan to a borrower before the loan is fully syndicated out to other lenders. Since the lead bank only intends to keep a certain percentage or a certain amount of the total loan, it would elect to apply the FVO only to that portion it intends to retain, and potentially hedge. Applying the FVO to that portion of the loan that a bank intends to syndicate out is not preferred as this would create accounting P&L volatility. This portion is not typically hedged during the period awaiting syndication completion. In addition, the initial loan syndication agreement may refer to the participants/lenders at an aggregate group basis and would not indicate the exact split of the loans by lenders. This also would make the application of the "contract-by-contract" basis difficult.

Corporate loan portfolios are another example. When our members extend corporate loans they generally would have a target hold threshold on the amount of credit risk that they would want to take. The portion of the loan above the target hold is usually hedged with credit derivatives. To reduce an accounting mismatch, the FVO should only be applicable to that portion of the loan that is hedged via credit derivatives. Applying the FVO to the whole loan at the contractual level would result in an even larger accounting mismatch. The FVO should be allowed to be applied to a portion of a loan because, by nature, a loan can be legally split up into smaller portions, and these smaller portions can be tradable.

Thus we suggest that the fair value option should be allowed to be applied at a unit smaller than the contractual unit as long as that unit can be legally separated into smaller units. This legally separable unit may be the same as the contractual basis for some instruments. Alternatively, the legally separable unit could be a portion of the contractual unit, as is the case in the examples mentioned above. At present, we do not believe this preferred approach would create a US GAAP/IFRS difference since the "unit of account" question is currently being discussed internationally as per the published IASB's Discussion Paper on measurement bases.
Level of Aggregation

While the ED requires the FVO to be applied on a "contract-by-contract" basis we also hope FASB can expressly clarify that this requirement is not intended to be unduly restrictive in the context of fair value determination. For example, the fair value determination may only be reasonably determined for certain instruments such as mortgages whose prepayment assumptions are more readily determinable on a pooled basis.

The fair value for mortgage pools can be reliably measured based on credit curves internally generated based on actual origination data. These internally generated curves can be compared with similar curves generated by other banks which are published information. In addition, the fair value of mortgage pools is calculated based on a reliable process that has been in existence for years. The fair value of mortgages has also been disclosed in notes to financial statements for several years.

Clarification of the term “At Inception”

We agree with the requirement, as stated within the ED, that the FVO should be applied at inception. To facilitate practical application, however, additional clarification on the meaning of the term "at inception" would be useful, particularly for cases where the legal form of an instrument changes after initial recognition. It would be helpful to clarify that the FVO option can also be irrevocably designated when there is a change in legal form and substance subsequent to initial recognition.

This feature has specific implications for the Canadian mortgage backed securities ("MBS") issuers. In Canada, an origination bank can securitize mortgage pools meeting specific criteria by converting them into MBS through a stamping process that is endorsed by the Canadian Mortgage Housing Corporation ("CMHC"). The act of stamping changes the legal form as well as the economics of the mortgage pool into MBS, which could then be transferred to CMHC and subsequently sold to investors.

After stamping, the origination bank may hold the MBS temporarily pending their transfer into CMHC. The fixed rate MBS held on a temporary basis are usually hedged via interest rate derivatives. Thus fair value treatment for these pools is more representative and would reduce accounting mismatches.

Since the legal form as well as the economics of the mortgages have changed, it would be reasonable that the MBS should be allowed for the FVO treatment, even though such designation was not made earlier on the mortgages. It is our view that the FVO designation should be allowed whenever the legal form and substance of an existing instrument changes, even if that happens after initial recognition.

Thank you for considering our comments, views and the information we have provided on this important matter. Please do not hesitate to contact me if you have any questions or wish to discuss our comments in greater detail.

Sincerely

cc: Sir David Tweedie, Chairman; IASB
RKS/ghp