COMMITTEE OF EUROPEAN SECURITIES REGULATORS

EFRAG

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RE: EFRAG's draft comment letter on the IASB's Exposure Draft *Fair Value Option for Financial Liabilities*

The Committee of European Securities Regulators (CESR) has considered, through its standing committee on corporate reporting (CESR-Fin), EFRAG's draft comment letter on the IASB's Exposure Draft (ED) *Fair Value Option for Financial Liabilities*.

The ED is part of the IASB's revision of IAS 39 – *Financial Instruments: Recognition and Measurement*, of which IFRS 9 – *Financial Instruments: Classification and Measurement* as published in November 2009 was the first part.

CESR supports the IASB's tentative decision to maintain the current IAS 39 requirements regarding financial liabilities except for specific amendments on the cost exception for equity derivatives and the treatment of credit risk for liabilities designated under the fair value option.

CESR welcomes the IASB's initiative to maintain the bifurcation of embedded derivatives on the liabilities side but is at the same time concerned that this might create inconsistencies with the assets side where bifurcation is prohibited. CESR therefore would like the IASB to consider further assessment in due course whether bifurcation of a hybrid contract with a financial asset host would provide users with more decision-useful information.

CESR agrees with EFRAG that changes in credit risk should not impact directly profit or loss for liabilities designated under the fair value option. We agree that fair value changes resulting from credit risk should not impact the income statement. This is in line with our response to the IASB's discussion paper *Credit Risk in Liabilities Measurement* where we stated we believed that the "subsequent measurement of financial liabilities should, in principle, not reflect changes in own credit risk". Based on the feedback provided by users of financial information to the IASB and EFRAG it seems an acceptable compromise to present these changes in Other Comprehensive Income (OCI).

Our responses to the detailed questions are set out in the Appendix but to summarise our main concerns:

(a) We believe that the proposal would create a mismatch for some companies (banks) where assets and liabilities are closely matched due to changes in assets going to profit or loss and some changes in liabilities going to OCI. A solution could be to allow the entire fair value change to go to profit and loss when doing otherwise would create an accounting mismatch.

(b) CESR thinks that the IASB should clarify the role of OCI and the income statement. We believe that some might still find it counter-intuitive that a positive impact on the balance sheet and in OCI might be recognised when the financial situation of the entity worsens.

The proposal only transfers this positive impact from net income to OCI. This raises a question regarding the role attributed to OCI. There was a broadly shared understanding that OCI had been intended to report movements that are outside control of the entity's management (and as a consequence, the income statement reports movements that result from decisions taken by management).

CESR therefore has mixed views on EFRAG's concerns regarding the two-step approach. We note that reclassifying the impact of changes in credit risk into OCI would achieve more transparency than registering this impact directly in OCI. We however acknowledge that recognising debit and credit entries at the same time in the income statement might seems strange to some from a conceptual point of view.

I would be happy to discuss all or any of these issues further with you.

Yours sincerely,

Fernando RestoyChairman of CESR-Fin

APPENDIX – CESR'S DETAILED RESPONSES TO THE QUESTIONS IN THE ED

Question 1
Do you agree that for all liabilities designated under the fair value option, changes in the credit risk of the liability should not affect profit or loss? If you disagree, why?

Question 2
Or alternatively, do you believe that changes in the credit risk of the liability should not affect profit or loss unless such treatment would create a mismatch in profit or loss (in which case, the entire fair value change would be required to be presented in profit or loss)? Why?

Question 3
Do you agree that the portion of the fair value change that is attributable to changes in the credit risk of the liability should be presented in other comprehensive income? If not, why?

CESR believes that all changes in the credit risk of the liability should not affect profit or loss. The main reason for this is that we believe that:

(a) the fact that a decrease in an entity's credit rating gives rise to a positive impact in profit or loss (or even OCI for that matter) is counter-intuitive. It is also not decision-useful information for users because it does not help them assess the amounts, timing and uncertainty of the cash outflows to which an entity is obligated (as an entity has less and less discretion regarding the settlement of its own debt when its financial situation deteriorates, this approach is misleading in that the entity will appear less insolvent than it really is); and

(b) the effects of changes in own credit risk reflect changes in an entity's internal operational activities and affairs and may also, at least in part, reflect changes in its internally generated goodwill, which is not recorded under existing accounting.

However, we believe that the proposal will create a mismatch for some companies where assets and liabilities are closely matched due to changes in assets going to profit or loss and changes in liabilities going to OCI. Some banks for example which grant loans financed with bonds that can be prepayed by paying the fair value of the corresponding bonds. This banks will experience an accounting mismatch because the value of the loan can never exceed the fair value of the corresponding bonds. Any increase in own credit risk will hence have full effect in P/L which will not be the case if the change in own credit risk on the bonds goes to OCI.

Therefore CESR would accept the recognition of changes in value due to credit risk in OCI as a compromise, but would also suggest allowing the entire fair value change to go to profit and loss when doing otherwise would create an accounting mismatch. In this regard, CESR would agree with the alternative presented in Question 2 in the ED.

Question 4
Do you agree that the two-step approach provides useful information to users of financial statements? If not, what would you propose instead and why?

Question 5
Do you believe that the one-step approach is preferable to the two-step approach? If so, why?

In its draft response EFRAG suggests that the proposed two-step approach would not be helpful for users of financial information. CESR sees two different conceptual approaches to the use of OCI: on the one hand the approach that considers that movements in OCI should be limited to items that are outside the control of management (which would probably also consider that presenting a debit entry at the same time as a credit entry in the income statement in order to reclassify the change in value attributable to credit risk lacks conceptual merit) and on the other hand the approach that considers that the reclassification of a change in value attributable to credit risk from OCI to income statement provides more useful information than posting this change directly to OCI.

Question 6
Do you believe that the effects of changes in the credit risk of the liability should be presented in equity (rather than in other comprehensive income)? If so, why?

CESR believes that there is a broadly shared understanding that equity (outside OCI) allows for the recognition of transactions with shareholders acting in their capacity as shareholders. Recording the effects of changes in the credit risk of a liability in equity would not be consistent with this view and thus likely to be confusing. We therefore believe that it is not appropriate to recognise such changes directly in equity.

Question 7
Do you agree that gains or losses resulting from changes in a liability's credit risk included in other comprehensive income (or included in equity if you responded 'yes' to Question 6) should not be reclassified to profit or loss? If not, why and in what circumstances should they be reclassified?

CESR agrees with the IASB that in most cases, there would be no amount to recycle because the cumulative effect of any changes in own credit risk will be zero at the day the liability expires and is paid back to the lenders.
Though CESR sees some merit in recognising the effects of transactions that result in cash inflows or cash outflows in profit and loss, we believe this recognition to be counter-intuitive in this case. An entity that would be able to buy back its own debt in order to benefit from an increased risk of default perceived by markets would most probably have to finance its activities at a higher cost.
Some might believe that those gains or losses should be recognised only once in the comprehensive income – either within net income or OCI. We remain unconvinced that the transaction is represented appropriately with recycling, i.e. by recognising an immediate gain in profit and loss and by the recognition over the duration of the replacement financing of a higher cost of borrowing. Others would be of the opinion that such recycling in the income statement is consistent with the fact that a cash outflow has occurred.

Question 8
For the purposes of the proposals in this exposure draft, do you agree that the guidance in IFRS 7 should be used for determining the amount of the change in fair value that is attributable to changes in a liability's credit risk? If not, what would you propose instead and why?

Like EFRAG, CESR agrees that consistency with the existing guidance in IFRS 7 – *Financial Instruments: Disclosures* is important.

Question 9
Do you agree with the proposals related to early adoption? If not, what would you propose instead and why? How would those proposals address concerns about comparability?

Question 10
Do you agree with the proposed transition requirements? If not, what transition approach would you propose instead and why?

The option to apply the proposed amendments earlier than the required effective date is conditional upon application of all requirements set out in IFRS 9. CESR finds it hard to assess what those requirements will be as the other parts of the IFRS 9 projects are currently open for consultation or are to be published soon. We are however afraid that the long transition period of three years will undermine comparability for a number of reporting periods.

However, this concern might be mitigated by the complexity of adapting information systems to the new provisions regarding financial instruments. As a result, many entities may wish to wait until all new standards dealing with financial instruments are available before transitioning. Another mitigating aspect may lie in the requirement in paragraph 30 of IAS 8 – *Accounting Policies, Changes in Accounting Estimates and Errors* regarding the effects of standards that have been published but not yet applied. In the case of the fair value option for financial liabilities, information on the effects of the new standard may be easier to assess than for impairment of assets accounted for at amortised cost.

As regards transition requirements, CESR agrees with EFRAG that the proposed amendments should be applied retrospectively.