EUROPEAN COMMISSION
Internal Market and Services DG
The Director-General

Brussels, 15/9/2009
DG MARKT/F3/RC/AD/ga (2009) 267471

Dear Sir David,

Subject: Exposure Draft Financial Instruments (IAS 39): Classification and Measurement; Consultation ending 14.09.2009

We welcome the opportunity to comment on the IASB's Exposure Draft (ED) concerning *Financial Instruments: Classification and Measurement* published on 14 July. We also draw your attention to the comment letter that EFRAG will submit about the proposals set out in the ED. The purpose of this letter is to raise key concerns we have identified.

In response to the G20's call to improve accounting for financial instruments, the IASB has decided to complete the revision of IAS 39 in three phases. Such an approach makes it difficult to fully assess earlier phases until the full project has been completed. As you explained to Ministers at the ECOFIN Council on 9 June, the IASB is committed to adopt amendments concerning the first phase of the project (classification and measurement) in time for the preparation of 2009 year-end accounts, taking into account the time needed by the EU to endorse the resulting amendments.

We welcome the IASB's intention to address some of the key concerns that have come to light about the current accounting rules for financial instruments during the current financial crisis, while achieve a significant simplification of the current IAS 39. We recall however that the key issue, already raised in our letter of 27 October 2008, that should be solved by the end of this year – in line with the request of the ECOFIN Council – concerns the impairment rules applicable to debt securities classified as "Available For Sale" (AFS) under the current standard. In addressing this issue, consideration should also be given to appropriate disclosure requirements – in particular to address the needs of regulators. While there may be some benefit in taking a comprehensive approach to the revision of IAS 39, any delay of phase I of this comprehensive review should not prejudice the implementation of a timely and effective solution concerning the specific problem related to the impairment of AFS debt securities – highlighted by the changes to US GAAP adopted by the FASB in April – in order to allow for its endorsement by the EU in time for its application to 2009 year-end accounts.

To assess reactions to the IASB's proposals concerning the classification and measurement of financial instruments, the Commission has organised two meetings (on 22 July and 4 September) to exchange views about the ED with European stakeholders, including representatives of preparers, investors, auditors and supervisors. This letter has also been the subject of consultations with the 27 EU Member States and informally with the Economic and Monetary Affairs Committee of the European Parliament.

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We would like to draw your attention in particular to significant concerns that the proposals set out in the ED will, for some categories of reporting entities, result in an inappropriate application of fair value accounting – which would *de facto* become the default category – in particular to instruments for which this is not the most decision-useful measurement basis. Such an impact should be avoided, as it would result in an inappropriate broadening of reporting under fair value rules that risks exacerbating income volatility and undermining financial stability.

Such an outcome would be inconsistent with the recommendations of the G20 process "*to dampen adverse dynamics associated with fair value accounting*"[1] and to "*improve standards for the valuation of financial instruments, based on their liquidity and investors' holding horizons, while reaffirming the framework of fair value accounting.*"[2] In addition, we recall the ECOFIN conclusions of 7 July 2009, which stated that "*while recognising the benefits of the fair-value principle ... mark-to-market valuation of many categories of financial instruments should be reviewed and adjusted as appropriate, particularly taking into account the uncertainty of valuations, the reality of the business models of the banks, the holding horizons and the actual liquidity of the markets.*" The key objective expressed both by the G20 and by the ECOFIN Council is thus to ensure that accounting standards do not undermine financial stability while improving the decision usefulness and relevance of financial reporting – rather than simplification *per se*.

Furthermore, we note that the proposals set out in the ED could lead to a reversal of the reclassifications (from fair value to amortised cost) implemented following the amendments of IAS 39 adopted in October last year. From our point of view, a policy reversal of the reclassification implemented last October would be unwarranted from an economic point of view and politically contentious.

Classification criteria

The proposed classification and measurement approach requires financial instruments to be measured either at amortised cost or at fair value (either through profit or loss or through equity). There is overwhelming support for the retention of a mixed measurement model, as both measurement bases can provide decision-useful information to users of financial statements. However, the prevailing view in the EU is that the amortised cost category has been defined too narrowly. Furthermore, the definition of "basic loan features" and "managed on a contractual yield basis" should be clarified to ensure that financial instruments can be measured at amortised cost when this is the most decision-useful measurement basis.

There are two essential issues in this regard:

- first, significantly greater emphasis should be given to the business model as a classification criterion: the classification of financial instruments should be based primarily on the business model and only then should the characteristics of the financial instrument be taken into account;

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[1] See Recommendation 13 of G20 Working Group 1, http://www.g20.org/Documents/g20_wg1_010409.pdf.

[2] See G20 Leaders' Declaration on strengthening the financial system - London, 2 April 2009; http://www.g20.org/Documents/Fin_Deps_Fin_Reg_Annex_020409_-_1615_final.pdf, p. 5.

- second, the line drawn between the amortised cost and fair value categories is not appropriate for some types of instruments, for example subordinated securitisation tranches or instruments acquired at a discount, it is inconsistent with a principles-based approach and does not adequately take into account market liquidity.

In this context, we also refer to the relevant provisions of the *Guiding principles for the replacement of IAS 39* published by the Basel Committee on Banking Supervision on 27 August 2009, in particular, fundamental principle 1 (Usefulness and relevance), which recommends that "*the new two-category approach for financial instruments should not result in an expansion of fair value accounting, in particular through profit and loss for institutions involved in credit intermediation*" and fundamental principle 2 (Faithful representation: reflecting the business model), which recommends that "... *there should be a strong overlay reflecting the entity's underlying business model.*" The FSB also shares the position that changes to accounting rules applicable to financial instruments should not expand the use of fair value in the calculation of profit and loss for the lending activities (involving loans and investments in debt instruments) of financial intermediaries.

Reclassification

Moreover, the revised standard should permit or require reclassification after initial recognition in limited circumstances, in particular to reflect changes in the business model. It would not be compatible with the use of a business model criterion to exclude reclassifications altogether. Appropriate disclosure should also be considered.

Other issues

In addition, further reflection concerning possible significant modifications is required about some other important issues, in particular:

i. The extent to which income and expenses for equity instruments classified at fair value through Other Comprehensive Income (OCI) should be recognised in the profit or loss account. The ED allows an entity to measure non-trading equity instruments at fair value through Other Comprehensive Income (OCI) or through profit or loss. Under the former option, all gains and losses on the equity investment (as well as any dividend income) are to be presented in OCI and cannot (when realised) be subsequently recycled to the profit or loss account. There is a widespread view, including from representatives of financial analysts, that it is unwarranted to completely exclude recycling of such cash flows to the profit or loss account, as it would result in a misrepresentation of reporting entities' financial performance in the profit or loss account. The possibility of a "third category" including recycling should therefore be seriously considered.

   Furthermore, the proposals set out in the ED create specific difficulties for the insurance industry, in view of the absence of a robust basis for the valuation of the corresponding *liabilities* that may result in accounting mismatches depending on the outcome of the insurance contracts project. Indeed, the IAS 39 revision should not pre-empt or prejudice future work on IFRS 4. Moreover, the proposals set out in the ED would either incur greater income volatility (if equity instruments were classified at fair value through profit or loss) or reduced earnings (if equity instruments were classified at fair value through OCI). Such an outcome does not reflect the business model of many European insurance undertakings.

Finally, any decision today regarding the functioning of the OCI category, as it relates to the financial instruments, could prejudge broader ongoing debates, such as concerning performance reporting more generally.

ii. The treatment of embedded derivatives, where there is a broad view that some kind of bifurcation should still be allowed. Under the proposal in the ED, many hybrid instruments will be recognised in their entirety at fair value through profit or loss, including the funding component of the instrument that, as a standalone instrument, would have met the criteria of the amortised cost category.

iii. The measurement of financial *liabilities*, in particular, but not only, for long term debt. In this area too the line drawn between the use of fair value and amortised cost is not appropriate. This is also linked to the IASB's ongoing consultation about own credit risk.

These last three issues could be scoped out of phase I of the IAS 39 review to allow more time for consensus-building, especially since there is no urgency to adopt a solution for these issues by the end of 2009.

Finally, the transitional arrangements for early adopters should not be overly burdensome. Similarly, the new classification approach should not have an impact on hedge accounting and practices (which the IASB intends to address in an ED in December of this year). Every effort should be made to facilitate a cohesive and smooth implementation of the three IAS 39 revision phases, in particular taking into account the interaction between phase I concerning classification and measurement and phase III concerning hedge accounting.

This project is also part of the response to the G20 mandate for a single set of high quality accounting standards. The issue is of particular importance in the area of financial instruments. Every effort should be made by both the IASB and the US FASB to find a convergent approach, but one that does not come at the expense of high quality financial reporting.

We therefore urge the IASB to give due consideration to these concerns and to the key concerns expressed by both the G20 and the ECOFIN Council in its final amendments concerning classification and measurement. A final decision should be adopted by the IASB without delay within the timetable agreed by ECOFIN in June. In the meantime, my services remain at your disposal to explain and if needed elaborate further on these issues.

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