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JH/NJ

IASB
Comment letters
30 Cannon Street
LONDON EC4M 6XH
UNITED KINGDOM

n°37

Re : Exposure Draft ”Fair value option for financial liabilities”

Dear Sir or Madam,

I am writing on behalf of the Autorité des Normes Comptables (ANC) to express our views on the above-mentioned Exposure Draft.

The IASB published this exposure draft in order to finalize the first phase of the comprehensive project of replacement of IAS 39 regarding classification and measurement of financial assets and liabilities.

The IASB decided to maintain the current requirements in IAS 39 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.

1- Decisions related to own credit risk

The ANC has on numerous occasions consistently argued in favor of excluding the effect of changes in the price of own credit risk from profit or loss, which is counter-intuitive and does not result in decision-useful information as underlined by the Board. We therefore welcome the Board’s proposal that changes in own credit risk would not impact profit or loss for all liabilities designated under the fair value option.

However, we are opposed to the approach retained by the Board to recognize in OCI the portion of fair value change attributable to credit risk for the following reasons :

- the counter-intuitive effect underlined by the Board is only transferred from net income to OCI but remains in the financial statements, whereas users confirmed that they remove the effect of own credit risk from the fair value measurement. Moreover, regulators will still have to maintain a prudential filter to neutralize the own credit risk effect in OCI for capital requirements. These adjustments made by users and regulators demonstrate that the own credit risk effect is not useful in the financial statements and should be only provided in disclosures.
- this will generate undue volatility in OCI.
- the IASB adds a new component in OCI which becomes more and more heterogeneous and confusing.

- the decision to prohibit recycling in profit or loss because "*gains or losses on those liabilities should be recognized only once [and] therefore, recognising a gain or loss in OCI and subsequently reclassifying it to P&L is inappropriate*" (BC37) clearly leads to the promotion of a unique statement of comprehensive income and to marginalizing net income as indicator of performance. This is a direction to which the ANC is strongly opposed as already expressed in the past and it would result in maintaining in a so-called "income statement" changes in own credit risk contrary to the Board's decision to avoid this counter-intuitive effect.
- if some users consider changes in own credit risk to be useful, then providing such information in the notes is relevant and would meet their needs.

As a consequence, the ANC believes that a **"frozen spread" approach** is the most relevant measurement method for financial liabilities designated at fair value.

2- Decisions related to classification of financial liabilities and interaction with IFRS 9 (financial assets)

We welcome the decision made by the IASB on financial liabilities to :
- not extend the use of fair value through P&L by retaining the held for trading financial liabilities category (contrary to its decisions on the asset side) ;
- maintain the bifurcation requirements for embedded derivatives (contrary to its decisions on the asset side) ;
- maintain the fair value option.

However, the proposals made in this exposure-draft and the global picture that, in combination with IFRS 9 (financial assets), would result in terms of accounting for financial instruments, would raise a number of issues :

- as regards embedded derivatives, beyond the inconsistency resulting from a difference in the accounting treatment of assets and liabilities, whereas these instruments may be linked or managed together, the simplification principle used by the Board to justify the prohibition of bifurcation on the asset side (perceived as complex) becomes senseless since this complexity will remain for financial liabilities. According to BC8c) "the bifurcation methodology in IAS 39 is generally working well", there is consequently no reason to retain this requirement only for financial liabilities. **We therefore ask the 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 ;

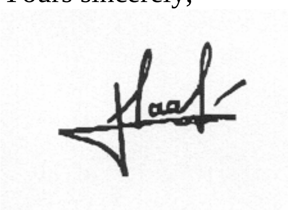
- as regards the elimination of the cost exception, although this would conversely align assets and liabilities, this would only confirm our problem with the consequences of such move made on the asset side, when we believe this exception was obviously justified in a number of cases where market valuation is not relevant.

This same kind of problem arises, for example, as regards the market valuation of instruments with no relevant price. It must be noted that this is only one of the many major problems resulting from the current IFRS 9 which have still not been solved as requested by all relevant authorities.

Our detailed answers to the Exposure draft's questions are set out in the Appendix I to this letter.

If you have any questions concerning our comments, we would be pleased to discuss them.

Yours sincerely,



Jérôme Haas

Appendix I
Detailed comments

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?

As explained in our letter on the IASB's DP *Credit risk in liability measurement,* the ANC has on numerous occasions consistently argued against recognising the effects of the change in own credit risk in profit or loss for the following reasons :

- taking into account an entity's own credit risk, which reflects the possibility of an insolvency, contradicts the going concern presumption in § 23 of the Framework for the Preparation and Presentation of Financial Statements ;

- the fact that a drop in an entity's credit rating would give rise to immediate profits is **counter-intuitive** as an entity would usually not have any discretion regarding the settlement of its own debt. It also has a misleading effect in that an entity which is becoming insolvent will appear solvent and profitable.

- such a situation does not result in decision-useful information for users in their objective of assessing the amounts, timing and uncertainty of the cash outflows from its obligations ; in practice, we note that users generally eliminate effects of own credit risk's changes;

- 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 standards. This creates an accounting mismatch, as noted in the DP.

Moreover, it is consistent with the fact that regulators use a prudential filter to neutralize the own credit risk effect for capital requirements.

Therefore, the ANC agrees that for all liabilities designated under the fair value option, changes in the credit risk of the liability should not affect profit or loss.

Moreover, the ANC considers that the IASB should further look into the accounting treatment of own credit risk for financial liabilities held for trading, since the change in own credit risk may not always be realizable in practice (e.g. derivatives are managed by entering into offsetting derivatives rather than repurchase).

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?

We are opposed to the approach retained by the Board to recognize in OCI the portion of fair value change attributable to credit risk for the following reasons :

- the counter-intuitive effect underlined by the Board is only transferred from net income to OCI but remains in the financial statements, whereas users confirmed that they remove the effect of own credit risk from the fair value measurement. Moreover, regulators will still have to maintain a prudential filter to neutralize the own credit risk effect in OCI for capital requirements. These adjustments made by users and regulators demonstrate that the own credit risk effect is not useful in the financial statements and should be only provided in disclosures.

- this will generate undue volatility in OCI.
- the IASB adds a new component in OCI which becomes more and more heterogeneous and confusing
- If some users consider changes in own credit risk to be useful, then providing such information in the notes is relevant and would meet their needs.

As a consequence, the ANC believes that a "frozen spread" approach is the most relevant measurement method for financial liabilities designated under the fair value option. In other words, the credit risk incorporated in liabilities upon initial recognition should remain fixed throughout the life of the liability.

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?

We do not understand why presenting the change in the liability's credit risk separately in the face of the income statement provides more useful information than posting directly this change in OCI. Such a requirement comes from a misunderstanding of fair value assessment of instruments designated at fair value through P&L, i.e. mainly OTC instruments. Those instruments are firstly priced by using market inputs (interest rate curve, etc.) and then an adjustment may be made in order to add own credit risk input.

Moreover, since we believe that presenting the change in own credit risk is not relevant neither in Profit or loss nor in OCI, a two-step approach is not relevant.

Question 5

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

As explained in Q4 above, the ANC believes that a one step approach is preferable to a two-step approach.

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?

As explained in Q2, we believe that a "frozen spread" approach is the most relevant measurement method for financial liabilities at fair value. Therefore, presenting the change in credit risk in equity rather than OCI is not relevant, even if this would avoid some of the drawbacks raised by the OCI approach.

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?

We agree with the Board 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.

> However, we are concerned by the reason given by the Board to justify the prohibition of recycling. According to BC 37, a "*gains or losses on those liabilities should be recognized only once [and] therefore, recognising a gain or loss in OCI and subsequently reclassifying it to P&L is inappropriate*". This clearly leads to the promotion of a unique statement of comprehensive income and to marginalizing net income as indicator of performance. This is a direction to which the ANC is strongly opposed as already expressed in the past and it would result in maintaining in a so-called "income statement" changes in own credit risk contrary to the Board's decision to avoid this counter-intuitive effect.

The ANC also believes that gains or losses realised in cash should by principle be recognised in the net income since it is an accurate representation of performance. This is consistent with our opposition to the prohibition of recycling for equity instruments measured at fair value through OCI under IFRS 9. Moreover, recognising a gain or loss upon a buy-back of a liability at fair value is consistent with our preference for a "frozen spread" approach.

Hence, even if we believe this could arise only in rare cases, we are in favour of recycling credit risk in profit or losses when a gain or loss is realised in cash.

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?

We agree that method used for determining the amount of the change in fair value attributable to change in credit risk (which should be frozen) should be consistent with the existing guidance in IFRS 7 currently used by entities.

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?

The ANC disagrees with the proposal to permit early application since it will undermine the comparability among IFRS reporting entities. On the contrary, the ANC considers that all phases of IFRS 9 should be mandatory applicable at a single effective date with no earlier application.

Question 10

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

We agree with the retrospective application proposed by the Board.

However, in order to deal with mismatch that could arise from the new accounting treatment for financial instruments, we recommend that reclassification should be available on implementation of any phases of the IAS 39 revision project.