Rådet för finansiell rapportering

The Swedish Financial Reporting Board

RFR-rs 2010:11

To:
Financial Accounting Standards Board
401 Merrit 7
PO BOX 5116
Norwalk, CT 06856-5116

Cc:
International Accounting Standards Board
30 Cannon Street
London EC4M 6 XH
United Kingdom

Dear Sirs,

Re: FASB ED Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities (File Reference No. 1810-100)

As part of the response to the recent financial crisis, the G-20 called on the accounting standard-setters to work urgently to achieve a single set of high-quality global accounting standards. Consequently, the FASB and the IASB jointly affirmed their commitment to achieve convergence of IFRSs and US GAAP and we understand that the FASB Exposure Draft forms part of the global convergence project of the IASB and the FASB. Based on this basis for convergence, we are very surprised that the FASB has chosen to present an ED that significantly deviates from the basic principles for financial reporting that have been discussed. The FASB Exposure Draft has a significantly different approach to financial instruments reporting than that taken by the IASB and we are concerned about the difficulties the two Boards will face in reconciling those differences.

We support the IASB in their present line of work with financial instruments, i.e. to strive for an improvement of the mixed models approach which best portrays the different market circumstances around the world, i.e. for the constituents who apply and use IFRS. It seems clear from the FASB choice of methodologies that the business models that have been evaluated is focused on one single type of entities, i.e. those whose business model is to generate and sell, rather than those who have a traditional universal banking book business, where the majority of the assets are held to maturity. This letter responds to the IASB's invitation to comment on the FASB ED Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities.

Our main concerns with the ED are that it fails to recognise the differences between the income generating characterises of different transactions and how these transactions should effect the net assets of the entity, i.e. it fails to recognise the relevance of different valuation and recognition principles based on different business models. A mixed measurement model that considers the relevance of different measurement

methodologies based on business model should focus on the following:

- Classification criteria based on the characteristics of the financial instrument and the business model used by the entity in managing those financial instruments,
- Reclassification should be required when there is a change in the conditions that lead to initial classification,
- Impairment of financial assets measured at amortised cost should be based on an expected loss approach that uses all available credit-related information including present estimates of future conditions,
- Changes in the fair value of a financial liability attributable to an entity's own credit risk should not be recognised other than if the liability is held for trading or otherwise finances a trading position,
- Separate accounting for embedded derivatives should be required for both hybrid financial assets and hybrid financial liabilities,
- Equity instruments held for investment purposes should be measured at fair value with changes in fair value recognised in other comprehensive income and realised gains and losses and impairment recognised in profit or loss,
- Core deposits should be measured at amortised cost and not at some kind of current value.
- Consistent measurement of financial assets and liabilities when they are linked together.

Business model as the starting point for classification

We consider that reporting of financial instruments should be based on a mixed measurement model. We consider that amortised cost is the most relevant measurement basis for all financial instruments other than those held with a trading intent or otherwise are held with the purpose of managing them on a fair value basis. Instruments held for the collection or payment of contractual cash flows are therefore more appropriately measured at amortised cost, since this measurement attribute best represents the expected future cash flows that the entity will generate. It would be misleading and badly reflect the substance of an entity's business model to give prominence in balance sheet to a measurement at fair value other than when it is a trading intent since such measurement basis would reflect gains or losses that normally would never be realised.

Equally obvious is it for most users of financial statements that a machine held with the purpose of producing products should not be measured at fair value and it should also therefore be equally obvious for those users that the production resources for traditional banking book business (i.e. loans and other financial assets held until final

maturity) should be measured at amortised cost with the interest income allocated to the income statement and to the net assets during the life of the financial instrument.

The Swedish Financial Reporting Board therefore disagrees with the dual measurement requirement presented in the ED. Comparability between entities without overly complex requirements for financial reporting is instead, according to our firm view, best achieved by requiring a certain way of measuring and reporting financial instrument given certain characteristics. These characteristics should require a certain measurement basis for items in the balance sheet and in the income statement.

Changes in the measurement basis after initial recognition

Focusing on the business model, we are convinced that a high quality standard should require reclassification of assets and liabilities when the usage of an asset changes. Therefore reclassification into or out of different measurement categories should be required for financial instruments when there are clear indications that the business model for the instrument has changed. Usage of a measurement principle that does not reflect the present usage of the asset would undermine the relevance of the financial statements.

An expected loss approach reflecting the present credit risk of an asset should secure the quality of the recognised financial asset when assets are measured at amortised cost

Arguing for fair value as the sole measurement methodology for financial assets, based on arguments that impairments are recognised too late, are irrelevant when a comprehensive approach for recognition of expected losses during the life of the contract is used. Instead, amortised cost as a measurement basis complemented with the recognition of expected losses is superior in giving early indicators to the users of financial statements that the inherent credit risk in a portfolio of financial assets have changed. Measuring at fair value will distort information regarding the changes in credit quality due to the exaggerated changes in prices in the market place due to other factors than those directly related to the credit quality of a single asset.

An amortised cost and impairment model for financial assets should be based on an expected loss approach in which estimates of impairment losses should reflect all existing information including expected future developments and forecasts of future events and economic conditions. Modelling impairments in this way ensures that management estimates appropriately reflect forward-looking information in a superior way than what is intended by using market prices. Furthermore, we consider that requirements to isolate credit information that relates to past and existing trends from that which relates to forecasts of future developments unnecessarily adds complexity and judgement to the estimation process and could result in reduced comparability.

A consequence of maintaining amortised cost as a measurement basis is that expected losses should separately be recognised as a reduction of the gross interest income based on a similar allocation mechanism, not at initial recognition. We therefore

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support the basic principles in the IASBs proposal that credit losses expected at initial recognition should be allocated over the life of the financial asset.

Changes in the fair value of the inherent credit risk in the liabilities of the entity

We consider that an entity generally will not realise the effects of changes in the liability's credit risk unless the liability is held for trading or is financing a trading asset. Therefore we believe that a high quality standard normally should prohibit the remeasurement of changes in the value of own credit spread in all other circumstances.

That said there are good reasons for allowing the fair value measurement category for financial liabilities that are used together with other financial instruments that are required to be measured at fair value (e.g. derivative contracts).

The best way of portraying these circumstances is a mixed measurement attribute for those financial liabilities. We therefore consider that a frozen credit risk approach is the optimal way of handling these common circumstances for those entities that perform a traditional banking business, i.e. that act as an intermediary between customers with different needs using the own balance sheet instead of transferring the needs of the counterparts out of the financial sector.

The main reason for excluding the changes in credit spreads from the income statement is that the entity will otherwise recognise gains when the own credit quality deteriorates which in turn has a positive effect on the net assets. Information regarding the changes in own credit spread could instead be given in the notes; it should not affect the financial position of the entity.

The concerns that some IASB respondents have had with the frozen credit spread approach are in our view not relevant. This lack of relevance is due to the purpose of using the fair value option, which normally is to reduce a measurement mismatch, i.e. the same basic purpose as hedge accounting. Therefore the proposed frozen credit spread approach is not something new; the situation is equal or similar to the situation with respect to partial fair value hedges and portfolio hedges using the principles for macro hedge accounting. However, attention must be paid to the possibility that the own credit spread will differ from that of others. Our belief is that a frozen credit spread approach recognises the two different purposes that may exist for a single financial instrument, i.e. to manage the reference rate at fair value while collecting a steady interest income from the net of lending and funding activities in the banking book (i.e. on an amortised cost basis).

Separate accounting for embedded derivatives

A recognition and measurement model for financial instruments that focuses on the business model and the characteristics of the instrument needs to pay special attention to contracts with embedded derivative contracts. Normally there is a dual intent to generate those liabilities:

1. Generate funding of the banking book business,
2. Lock in a profit by selling a derivative contract that has been acquired at the whole sale market or at the retail market.

If the funding is used to finance the banking book business, the most relevant measurement basis is amortised cost.

At the same time the hedging instrument to the inherent market risk in the embedded derivative contract is required to be measured at fair value. Therefore there is a need to either change the unit of account or allow two different measurement principles for the same financial instrument.

We therefore consider that relevant measurement principles should be developed for those instruments that best capture the substance of those transactions.

When doing that it should be ensured that the same principle should be applied for bifurcation of embedded derivates for both hybrid financial assets as for hybrid financial liabilities.

Equity investments acquired with another intent than trading

We consider that equity investments that have been acquired for another intent than being held for trading should be recognised differently than instrument held for trading purposes.

We believe that equity instruments not held for trading should be measured at fair value with unrealised changes in fair value recognised in OCI. When realised, those realised gains or losses should be recycled to the income statement. That principle needs to be complemented with an impairment principle for those instruments if the issuer enters into default. Since the characteristics of the claim will change when the issuer is in default to a "normal" subordinated claim, the impairment rules that are used for loans and receivables could be applied.

Measuring core deposits at some kind of current value

We strongly disagree with the measurement requirements that are proposed for core deposits in the ED. Firstly they introduce a new measurement methodology without any convincing argumentation and secondly, we fail to understand the relevance of this hypothetical measurement approach. Using the marginal incremental cost of financing for volumes that normally are impossible to lend in a short time frame is misleading and irrelevant. As the recent financial crisis has demonstrated, weak banks do not have access to alternative funding sources sufficient to replace the volume of core deposits.

Financial assets and liabilities linked together

These assets and liabilities should be measured on the same basis when they are linked together.

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Rådet för finansiell rapportering

If you have any questions concerning our comments please address our Executive member Carl-Eric Bohlin by e-mail to: carl-eric.bohlin@radetforfinansiellrapportering.se

Stockholm, 13 September 2010

Yours sincerely

Anders Ullberg
Chairman

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