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Sir David Tweedie
Chairman
International Accounting Standards Board
30 Cannon Street
London
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Email: commentletters@iasb.org

16 July 2010

Dear Sir David,

Re: Exposure Draft ED/2010/4 Fair Value Option for Financial Liabilities

Deloitte Touche Tohmatsu is pleased to respond to the Exposure Draft, ED/2010/4 *Fair Value Option for Financial Liabilities* (the 'ED').

We agree with the Board's objective to address the issue of own credit risk in the measurement of financial liabilities and further agree with the Board's decision to retain the basic model contained in IAS 39 *Financial Instruments: Recognition and Measurement* for classifying and measuring financial liabilities. However, we disagree with the Board's conclusion that credit risk can be identified following the approach set out in IFRS 7 *Financial Instruments: Disclosures.* The Board needs to articulate clearly the principle that underlies the mechanics of identification of credit risk and we believe that it is only the changes in fair value due to changes in one's **own** credit risk that should be identified separately and reported in other comprehensive income (OCI). In our view, own credit risk represents the risk that a reporting entity will not perform its financial obligations under a contract. The IFRS 7 approach encompasses many more components (e.g. asset-specific risk) and, as a result, would include additional amounts within OCI not related to one's own credit risk and thereby distorting the amounts reported in profit or loss and OCI. We encourage the Board to reach out to constituents, in particular valuation professionals, to gather views on what they believe are components of own credit risk, how they can be separated, and if any meaningful practical expedients can be employed by preparers in isolating one's own credit risk. Furthermore, we disagree with the prohibition of recycling on a transfer or early settlement of a liability and with the two-step approach to presentation of changes in credit risk.

We note that this is a convergence project with the FASB and that the FASB's recently issued Proposed Accounting Standards Update *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities* takes a different approach to identifying changes in fair value due to changes in own credit risk. We urge the IASB to work jointly with FASB in determining the most appropriate methodology for classifying and measuring financial liabilities.

Our detailed responses to the invitation to comment questions are included in the Appendix to this letter.

If you have any questions concerning our comments, please contact Veronica Poole at +44 (0) 207 007 0884 or Andrew Spooner at +44 (0) 207 007 0204.

Sincerely,

Veronica Poole
Global IFRS Leader – Technical

Appendix: Invitation to Comment

Presenting the effects of changes in a liability's credit risk in profit or loss

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?

Based on the definition of credit risk in the ED, we disagree with the broadness of the principle that changes in the credit risk of a financial liability measured at fair value under the fair value option should not affect profit or loss. However, we agree that changes in fair value specifically due to changes in **own** credit risk should not affect profit or loss as in many cases the reporting entity has little ability to realise the changes in its non-performance. In other words, we disagree with the proposal to use the method of identifying credit risk described in paragraphs 10(a)(i) and B4 of IFRS 7 *Financial Instruments: Disclosures.* The IFRS 7 method, in addition to changes in own credit, captures other risks within a fair value measurement that do not represent the risk of non-performance by the reporting entity.

We would define own credit risk as the risk that a reporting entity may not perform its financial obligations under a contract. We believe the method of isolating own credit risk in paragraphs 10(a)(i) and B4 of IFRS 7 does not adequately reflect this definition. Isolating own credit risk should exclude, for example, asset-specific risk (e.g. in asset-backed securities structures) where an amount is never owed to the counterparty if the assets do not generate the contractual cash flows. In many asset-backed instruments the credit risk of the liability is limited because the obligation only requires payment should cash flows be received on specified assets.

We encourage the Board to reach out to constituents, in particular valuation professionals, to gather views on what they believe are components of own credit risk, how they can be separated, and if any meaningful practical expedients can be employed by preparers in isolating this risk from other risks. We also believe providing guidance regarding valuation approaches to isolate own credit risk from other changes in fair value would prove beneficial.

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?

If the Board re-defines credit risk consistently with our proposal as described in the answer to question 1 (i.e., limited to one's own credit risk), we would agree with the position taken in the ED that there should be no exception from the principle to recognise changes in own credit risk in OCI. If the amount recognised in OCI is truly the issuer's risk of non-performance, this will largely eliminate the potential accounting mismatches in profit or loss that the ED would create. Further, a narrower definition of credit risk will reduce the inconsistency that credit risk on derivatives, whether freestanding or bifurcated embedded derivatives, are recognised in profit or loss whereas credit risk on a liability designated under the fair value option is recognised in OCI.

However, if the Board decides not to narrow the amounts recognised in OCI to the issuer's own credit risk as we propose and instead retains the approach set out in the ED with its broad definition of credit risk we would prefer the final guidance to include an option to recognise all changes in fair value in profit or loss if that avoids creating accounting mismatches. The reason for this exception from recognition in OCI is that a broader definition of credit risk is likely to capture asset-specific risk which, if recognised in OCI, will generate an accounting mismatch if the assets that are linked to the liability are fair valued through profit or loss. As a practical example of such a potential mismatch, in some jurisdictions mortgage banks issue covered bonds to fund their mortgage loan operations. The bonds are collateralised by the underlying mortgages. A borrower can early prepay its loan by buying back the covered bonds in the market which is in effect a prepayment. As a consequence, the value of the embedded prepayment option in the mortgages is not only sensitive to interest rate risk but also to the credit risk of the bonds, and hence, requiring recognition of changes in credit risk of the liabilities in OCI would create an accounting mismatch that is not a representationally faithful depiction of the economics of the reporting entity.

Presenting the effects of changes in a liability's credit risk in other comprehensive income

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?

Yes, if credit risk is defined as **own** credit risk only as described in our answer to question 1.

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 disagree with the two-step approach of including all changes in fair value in profit or loss and then deducting the portion attributable to own credit risk. The two-step approach is confusing, adds unnecessary complexity, and is at odds with the Board's intention to have a single comprehensive income statement. We

propose a one-step approach for recognition and a required disclosure in the notes to the financial statements of a reconciliation between the entire fair value change and the amount that is recognised in profit or loss and OCI for the period. The information provided in such a reconciliation would be similar to that provided by the two-step approach.

Question 5

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

We think that the one-step approach is preferable. See our answer to question 4.

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?

No. We disagree with an approach that presents the changes in credit risk of a financial liability directly in equity. Changes in the credit risk of a financial liability do not represent transactions with owners in their capacity as owners and hence, do not qualify for direct recognition in equity in accordance with IAS 1 *Presentation of Financial Statements.*

Reclassifying amounts to profit or loss

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 disagree with the proposed prohibition of recycling of any gains or losses for financial liabilities designated under the fair value option. A gain or loss should be recognised in profit or loss on derecognition, which is consistent with the user preference that 'realised' gains and losses are recognised in profit or loss and also consistent with the derecognition requirements for financial liabilities measured at amortised cost.

Determining the effects of changes in a liability's credit risk

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 disagree with this proposal (see our response to Question 1). The approach in IFRS 7 is not based on an explicit definition of credit risk. Instead, it assumes that everything above benchmark interest rate risk represents credit risk. As demonstrated by the financial crisis, liquidity risk can be a significant contributor to changes in fair value, although it will be challenging in many situations to identify separately the portion of the fair value change caused by liquidity risk. Additionally, asset-specific risk should be excluded from the calculation of own credit risk (see our answer to Question 1).

The Board should articulate clearly the principle that underlies the identification of credit risk and we believe that it is only the changes in fair value due to changes in **own** credit risk that should be identified and recorded separately within OCI. Guidance will need to be developed on how changes in credit rating, credit spreads and sector spreads should be factored in determining the change due to own credit risk. A reporting entity should disclose the approach it used in isolating own credit risk.

Effective date and transition

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?

We do not agree with the proposal to require an entity to adopt the entire financial instruments package if it chooses to early adopt this limited amendment. As the Board tentatively agreed to leave the classification and measurement of financial liabilities in IAS 39 largely unchanged we would view this amendment as a change in presentation only. Therefore, we consider it reasonable that, should any entity wish to early apply this amendment, that it should be able to do so without applying the rest of the financial instruments package. Further, if the amendment is early adopted without applying the entire financial instruments package we would not permit fresh designations and de-designation of the fair value option as this would be available to the entity when it applies the classification and measurement requirements of IFRS 9.

Question 10

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

In line with our answers above, full retrospective adoption is most appropriate. However, the Board may wish to consider an impracticability exemption. If an entity early adopts the entire financial instruments package, the transitional provisions of IFRS 9 should apply and would cater for fresh designations and de-designations as allowed by IFRS 9.

We note that many entities, in particular financial institutions, avoid the burden of bifurcation of embedded derivatives and hedge accounting under IAS 39 by applying IAS 39.11A instead of IAS 39.9(b)(i) as it is the more straightforward way for designation. Allowing entities to de-designate financial liabilities designated under the fair value option reduces the burden of recognising changes in the credit risk of a financial liability going forward. Hence, we suggest that on adoption of IFRS 9 the Board permits reporting entities to designate and de-designate all financial liabilities into and out of the fair value option and suggest the following changes to IAS 39 (deleted text struck through, inserted text underlined):

"103M At the date of initial application of IFRS 9, an entity:

(a) may designate a financial liability as measured at fair value through profit or loss in accordance with paragraphs 9(b)~~(i)~~ and 11A of IAS 39.

(b) shall revoke its previous designation of a financial liability as measured at fair value through profit or loss if such designation was made at initial recognition in accordance with paragraphs 9(b)~~(i)~~ and 11A of IAS 39 and such designation does not satisfy that condition at the date of initial application of IFRS 9.

(c) may revoke its previous designation of a financial liability as measured at fair value through profit or loss if such designation was made at initial recognition in accordance with paragraphs 9(b)~~(i)~~ and 11A of IAS 39 and such designation satisfies that condition at the date of initial application of IFRS 9.

Such designation or de-designation shall be made on the basis of the facts and circumstances that exist at the date of initial application of IFRS 9. That classification shall be applied retrospectively."

OTHER COMMENTS

Scope: financial guarantees and loan commitments

The proposals in the ED would be applicable to financial guarantee contracts as defined in IAS 39.9 and designated as at fair value through profit or loss in accordance with IAS 39.AG4 and to loan commitments designated as at fair value through profit or loss in accordance with IAS 39.4(a). Such instruments are derivatives from an economic perspective. As a result some changes in the fair value of derivatives that are not designated and effective hedging instruments would not be recognised in profit or loss, which seems to contradict the principle in IAS 39 that by default all derivatives are measured at fair value through profit or loss. We believe this was not the Board's intention, as evidenced by the FAQ on the ED published on the IASB's website that is clear on page 1, question 2 that the proposals aim to capture non-derivative financial liabilities designated under the fair value option only. We ask the Board to clarify that such instruments designated at fair value through profit or loss are measured with all fair value changes being recognised in profit or loss and propose the following amendment to paragraph 2 of the ED:

"2 Gains and losses on a financial liability designated at fair value through profit or loss, with the exception of financial guarantee contracts designated as at fair value through profit or loss in accordance with paragraph AG4 of IAS 39 and loan commitments designated as at fair value through profit or loss in accordance with paragraph 4(a) of IAS 39, shall be presented as follows […]"

Scope: mandatory fair value through profit or loss under IAS 39.12 and IAS 39.13

We ask the Board to clarify whether financial liabilities that are classified as 'designated' as at fair value through profit or loss as a result of the requirements in IAS 39.12 and IAS 39.13 are within the scope of this ED. In our view they should be included as they do not represent financial liabilities held for trading, although they are not measured at fair value through profit or loss as a result of a voluntary designation.