



2 July 2010

## EFRAG

### Comments to the IASB ED on FVO for Financial Liabilities

IASB published on 11 May 2010 an exposure draft on *Fair Value Option for Financial Liabilities* and EFRAG published its draft comment letter (DCL) on the 9 June 2010.

The Danish mortgage banks represented by the Association of Danish Mortgage Banks (Realkreditrådet) and the Danish Mortgage Banks' Federation (Realkreditforeningen) - the two organizations cover the whole mortgage bank sector in Denmark - are very concerned about the exposure draft. The reason is that the exposure draft will create an accounting mismatch for the Danish mortgage banks.

Firstly we would like to appreciate the considerations made by EFRAG in relation to the Danish mortgage concern in the paragraphs 12 to 14 in the DCL. We also appreciate the opportunity to meet with EFRAG representatives to present the Danish system. Below we give our comments to the EFRAG DCL and we attach our Comment Letter to IASB and below we will refer to comments made in the comment letter to IASB.

#### **EFRAG Cover Letter**

We generally agree with the view of EFRAG TEG'S view that fair value changes due to changes in liabilities own credit risk (LOCR) should go to OCI when financial liabilities have been designated under the Fair Value Option (FVO), however we still believe that EFRAG in section three of the cover letter ought to insert a "subject to the extremely rare cases when financial assets are linked to the LOCR and the use of the FVO reduces or off-set an accounting mismatch". We will below propose a slightly amended wording to paragraph 12 – 14 of Appendix 1, and the amended wording should also go through and amend the above quotation "subject to..."

#### **Question 1**

Generally we support EFRAG in its response to Q 1, and we would again recommend that EFRAG in paragraph 3 includes a subject to comments given to Q 2 in paragraphs 12 – 14. However we strongly support that entities should be able to recognise all changes in fair value of liabilities designated under the FVO including the change in LOCR if it avoids creating an artificial accounting mismatch (see our response to Question 2).

#### **Question 2**

./ The Danish mortgage banks support the alternative approach as described in Question 2 for the reason described below and in the attached comment letter to IASB.

Whilst we accept that the scenarios where an accounting mismatch under the proposals could arise are limited nevertheless they exist and are of the utmost importance to the Danish mortgage banks. Therefore we disagree with EFRAG'S conclusion in paragraph 6. EFRAG may be right in many cases, but the Danish mortgage system is unique and it is not



the case that credit risk of liability relate to the reporting entity or only does in some situations and then only for a very tiny part as further described in our attachments.

Since adoption of IFRS in 2005 the Danish mortgage banks have used the fair value option to fair value the issued covered loans (the asset) and the issued listed covered bonds (the liability) according to IAS 39 9(b)(i) and IAS 39 AG4E(d). The mentioned treatment has ensured that no accounting mismatches were created by IAS 39.

The exposure draft will create an accounting mismatch for the Danish mortgage banks. The reason is exactly as described in the ED on page 8, namely that the entire change in the fair value of the assets would be presented in profit and loss but a portion of the change in the fair value of the liability would not.

When an entity has chosen to designate financial liabilities under the FVO to avoid an accounting mismatch (i.e. artificial mismatch) it is strange to have inserted rules that will create a mismatch.

It is important to maintain the option with full effect in P&L to avoid the mismatch. We refer to the explanation of the Danish mortgage system to the attachment.

The Danish mortgage banks would accept strict criteria so that LOCR should NOT go to profit and loss when the FVO was chosen to and actually avoided a mismatch. We refer to our letter to the IASB for the proposal.

The reporting entity (the Danish mortgage banks) cannot realise gains or losses on the changes in fair value attributable to LOCR, because the benefit of changes in the credit risk of the financial liability is directly linked to the loss on the related financial asset (and it is only the counterparty to the asset (the borrower) that can realize the gain or loss). The reason is – as described in the attachment – that the Danish mortgage banks have a one-to-one relationship between granted covered loans and issued listed covered bonds and the borrowers have a right to prepay the loan and the bonds are having the equivalent prepayment option. Therefore the change in the fair value of the listed bonds will equate the change in the value of the prepayment option and thereby the fair value of the loan. Therefore – under the proposal in the ED - the mortgage bank would get the volatility in P&L from the asset side, but not the full offsetting volatility from the liability side.

In relation to the Danish mortgage system the profit and loss will be misleading if the proposals in the ED become standard. Therefore there should be a possibility to take the entire change in the fair value of the liability to P&L including LOCR, but only in limited situations

We would like to point EFRAG'S attention to our comments in the attached comment letter to the IASB in relation to BC 21.

1. There has been no requests from users of financial statements of Danish mortgage banks to get LOCR to OCI.
2. In addition we find the argument about comparability in BC 21(c) very surprising when one reminds the many options in IFRS. We believe it is more important to get a faithfully representation than comparability with other entities in other industries or countries and with very different fact patterns.



We agree with EFRAG that the term LOCR should be clearly and narrowly defined, and we refer to our comment on the matter in our response to Q 8 below.

We would further point to EFRAG'S attention that we believe it will be very difficult to measure the LOCR reliably, and that will of course create an – for us – unwanted room for manoeuvre, and under the Danish mortgage system the proposed rule will create possibilities for manipulation of P&L.

### **Questions to EFRAG'S constituents in paragraph 15 and 16**

We refer to our attached letters describing the Danish mortgage system and also the comment letter to IASB to FVO ED. For reasons mentioned above and in the attached letters we agree with EFRAG'S view as expressed in paragraphs 12 – 14 in the way we do not support the ED proposals when they create accounting mismatches.

As mentioned above we strongly support that entities should be able to recognise in profit and loss all changes in fair value of liabilities designated under the FVO including the change in LOCR if it avoids creating an artificial accounting mismatch. We also believe that the wording in paragraph 14 should rather conclude "...extremely rare cases when the financial liabilities are designated to be measured at fair value in order to reduce or avoid an accounting mismatch the effects of the changes in the fair value of the liability should be recognised in profit and loss. However...."

In response to EFRAG'S paragraph 16 we understand that your intention has been to cover the Danish mortgage system and therefore we have no further comments.

### **Question 3 to 7**

The Danish mortgage banks offer no specific views on the questions raised.

### **Question 8**

We believe EFRAG should take into account in your response to question 8 the below mentioned:

It would be important to get an explicit definition and measurement of the credit risk of the liability and at least we would support to have the price of credit risk in the financial liabilities segregated from the credit quality of the liability.

It is important to define well the credit risk of the liability, when the element gets a very different treatment, this in order to ensure – should IASB go ahead – to avoid that more components than LOCR go to OCI.

### **Question 9**

We disagree with EFRAG and we refer to our response to Q 9 in our comment letter to IASB.



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### Question 10

We believe that there might be situations to be carefully considered, please see our comment to Q 10 in our comment letter to IASB

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Should you have questions or comments to the above please do not hesitate to contact Mette Saaby Pedersen, at [msp@rkr.dk](mailto:msp@rkr.dk)

Best regards

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