
BBVA views regarding financial instruments accounting reform

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Topics to discuss

01

ISSUE OF IFRS 9 AS A SIMPLIFICATION OF IAS 39 – FINANCIAL INSTRUMENTS: RECOGNITION AND MEASUREMENT

02

NO ENDORSMENT OF IFRS 9 BY EC IN 2009

03

WAYS OF ADDRESSING PROCICLYCICALITY RELATED TO IMPAIRMENT LOSSES

IAS 39: a very criticized standard

- IAS 39 has traditionally been claimed for being a very complex standard both for preparers to apply and for investors to understand.
- In addition, the financial crisis has brought to spotlight some accounting rules included in IAS 39 for having intensified and exaggerated report losses (i.e. fair value in illiquid markets or impairment of available – for – sale securities).
- Therefore, in response to all these criticisms, the IASB issued IFRS 9 in November 2009. However, it is only the first phase of a complete financial instruments accounting reform.

Issue of IFRS 9: Phases of the complete reform

Project stage	Exposure draft/ final standard	Finalization
1.A. Classification and Measurements of financial assets	IFRS 9 – issued 12 November	In time for year end financial statements 2009. Not endorsed by EU.
1.B. Financial Liabilities	2010	Full replacement of IAS 39 during 2010
2. Impairment	ED published on 5 November 2009. Comment period until June 30 2010.	Full replacement of IAS 39 during 2010
3. Hedge accounting	1Q 2010	Full replacement of IAS 39 during 2010

- In addition, there is another Exposure Draft on Derecognition of financial instruments.

IFRS 9: a simplification of IAS 39

- Although the banking industry welcomes this reform, banks:
 - ✓ Had just **asked for some urgent and limited accounting changes** for financial instruments, and
 - ✓ Had expressed concerns regarding an accelerated complete reform that could jeopardise the quality of the new standard.
- The declared objective of IASB with this reform is to improve the ability of investors and other users of financial statements to understand the accounting for financial instruments.
- But in fact, IFRS 9 has resulted in a simplification of the accounting for financial assets. It can be said that **simplification is a by-product of the overall objective.**
- As any simplification, **IFRS has its limitations and ignore some details so it is impossible for everybody to like it entirely.**

Issue of IFRS 9: Our view

Although we don't agree with some aspects in IFRS 9 (i.e. prohibiting the recycling of any gain/losses on equity instruments whose FV changes are presented in OCI when sales occur)...

...we consider that this kind of disagreements is part of the necessary dialogue among constituents and are conscious that any new financial instruments accounting standard will have parties both in favour and against, as business and interests are very different.

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The European Commission decided not to endorse IFRS 9 in 2009

- Although IASB finalized IFRS 9 in time to allow, but not require, early application for 2009 year-end financial statements, the European Commission decided not to endorse it at this stage. So, **European banks are still not able to apply it.**
- There are **different views across interested parties** regarding endorsement of IFRS 9:
 1. Endorsement should have taken place in 2009 or as soon as possible.
 2. Endorsement is completely necessary but should be analyzed once all the phases of the reform are completed.
 3. If certain criteria are not finally included in the standard, endorsement shouldn't take place.

No endorsement of IFRS 9 in 2009 - Our view

- Which is the true reason for not to endorse IFRS 9 in 2009?
- Are there only technical reasons to postpone the analysis of endorsement or are there some inalienable topics for some preparers that must be in the standard otherwise they would force a European solution?

- **Endorsement must take place** once the whole reform is completed.
- **Any carve out is not desirable.** Otherwise convergence with US GAAP would be at risk and the reinstatement of reconciliation IFRS – US GAAP would be a fact.
- As an international group listed in USA, the US GAAP–IFRS **reconciliation is seen as a source of significant and financial reporting unnecessary costs.**

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LOSSES

G-20 recommended to address procyclicality in lending

- Procyclicality related to impairment losses is one of the main issues currently discussed regarding financial instruments accounting reform.
- G20 recommended reducing procyclicality in financial statements thorough reforming current impairment model (incurred loss model): **Impairment losses are said to be recognised "too little to late"**.
- In this regard, IASB published a standard draft with a new impairment model based on the expected cash flows of the financial assets that is open to comment until June 30, 2010.

IASB expected cash flow model for impairment losses

- The proposed model implies a change of philosophy in assessing when a loss is inherent in a financial asset.
- According to IASB itself, the benefits of this new approach would be an earlier recognition of expected losses in the life of an asset and a better reflection of the economic interest that the lender expects to earn from an asset over its life.
- But the **IASB is not looking for a countercyclical or a less pro-cyclical model**. In fact, IASB rejects any countercyclical model because:
 - It would not reflect the economic characteristics of the loans.
 - It would be against the overall objective of financial statements: be neutral and present a faithful representation of the situation and operations of the entities.

But some regulators and the EC want to address procyclicality through accounting

- **Why do they want to introduce prudential measures in accounting?**
- **Are there other ways to address procyclicality?**

The Spanish system: a model to follow

- Regulators want banks to hold big reserves for possible problems of tomorrow.
- In 2000, Bank of Spain was aware of this objective and, apart from other regulators, introduced dynamic provisions in accounting for Spanish financial institutions.
- The Spanish dynamic provisioning system is designed for:
 - Offset the high procyclical behaviour of specific loan losses.
 - Stabilize the Profit and Loss Account.
- Taking into account that **it has been proved that this system has worked quite well in the financial crisis providing some relief**, politicians and other regulators think that this is the way to follow.

Procyclicality in Lending – Our view (1)

1. Addressing procyclicality through capital requirements (capital buffers) could be a solution more in accordance with the objective of solvency requirements objective:

Protect soundness and stability
of the international banking system

2. Joining all these ideas, it can be said that:

- A **possible solution that is proved that would work** is:
Spanish system (accounting provisions)
- A **possible solution that could work** is:
Capital buffers in solvency requirements
- A **possible solution that would not work** is:
Current incurred loss model + lack of capital buffers

Procyclicality in Lending – Our view (2)

- Therefore, any of the two solutions could be feasible.
- Whichever is the definitive solution, we consider that the following topics must be taken into account:

1. Overlap should not exist between "new provisions – new capital requirements": new accounting provisions should be taken into account in order to calibrate the new capital needs
2. Coordination between accounting setters and regulators is completely necessary,
3. Any excess of accounting provisions over the expected loss is a capital buffer.