THE BUILDING SOCIETIES ASSOCIATION

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14 October 2002

ACCOUNTING STANDARDS BOARD

FRED 30 Financial Instruments:

Disclosure and Presentation & Recognition and Measurement

Respons e by The Building Societies Association

Introduction and Background

1. This paper sets out the comments of The Building Societies Association on the ASB Financial Reporting Exposure Draft 30 **Financial Instruments: Disclosure and Presentation & Recognition and Measurement.**

2. The Association represents all 65 building societies in the UK. Those societies have total assets of over £l8Obn, about 15 million adult savers and over two and a half million borrowers. Building societies account for around 19% of outstanding residential mortgage balances and over 18% of retail deposit balances in the UK.

3. Building societies are mutual institutions with both shareholding and borrowing members, constituted under the Building Societies Act 1986 (as subsequently amended), and regulated by the Financial Services Authority under the Financial Services and Markets Act 2000.

4. Under the 1986 Act a building society is generally prohibited from acting as a market maker in securities, commodities or currencies and from trading in commodities or currencies (subject to certain exceptions for transactions under £100,000). Since 1998, building societies have been permitted to trade in securities (subject to compliance with the appropriate regulatory requirements), but no society has so far done so. Accordingly, no building societies have a "trading book"; all their relevant balance sheet and off-balance-sheet items fall within the "non-trading", or "banking" book. Accordingly, building societies currently account for their financial assets and liabilities on the historical cost I accruals basis.

5. Under the 1986 Act a building society is also subject to restrictions on entering into transactions involving derivatives (such as options, futures and contracts for differences). A society may enter into such a transaction broadly only for hedging purposes; ie where the

transaction is for the purpose of limiting the extent to which the society (or a connected undertaking) will be affected by changes in interest rates or exchange rates, in certain indices or in the creditworthiness of any borrower(s), or where the transaction is for the purpose of limiting the extent to which an investor or borrower will be affected by changes in interest rates or exchange rates in connection with their share, deposit or loan account with the society (or a connected undertaking).

6. Accordingly, building societies currently use hedge accounting for their transactions in derivatives. Some societies will use derivatives only for the purposes of matching risks' on individual products, such as a tranche of fixed rate mortgages or retail savings. Other, generally larger, societies will use derivatives to hedge risks over the whole of their balance sheet (but subject to the statutory restrictions referred to in paragraph 5 above).

Potential Direct Application of International Accounting Standards in the UK Beyond Listed Companies

7. Since the issue of FRED 30, the Department of Trade and Industry has published a consultation document on the possible extension of the direct application of international accounting standards (IAS) in the UK, beyond listed companies, to other companies and undertakings. One of the options in that consultation asks if the European Regulation on IAS should be extended to the individual and/or consolidated accounts of all companies that are prudentially regulated under the Financial Services and Markets Act 2000. A further option then asks the same question in relation to undertakings that do not have the status of companies but that are regulated under that Act (for example, building societies). The Association has yet to determine its response to that element of the DTI consultation document.

Implications of Early Implementation of IAS in the UK

8. Given the possibility of the direct application of IAS to many UK companies, and possibly to building societies also, by 2005, the Association considers that it would be inappropriate, and unhelpful, for "interim" changes to be introduced meanwhile by way of new UK accounting standards. In relation to provisions on measurement of financial instruments the ASB's proposed timetable is for

(a) FRED 23 on hedge accounting to be implemented in early 2003,

(b) if a firm chooses to apply fair value accounting (assuming the necessary changes are made to UK legislation), FRED 30 to be implemented at the beginning of 2004, and

(c) with potential direct application of IAS 39 (as it then stands) at the beginning of 2005.

9. Coping with the change to IAS, either on direct application (if the Government so decides) or by convergence of the ASB 's standards with IAS' will be a substantive, lengthy and potentially costly task for building societies (and, no doubt, for other entities). It does

not seem helpful, either for prepares or users of financial statements, to require firms to move to IAS at different times and, in the case of IAS 39, while there are potentially further changes to be made.

10. The ASB itself states, in paragraph 14 of Appendix Ill to FRED 30

> **the ASB considers that a UK standard based on IAS 39 will probably be the' single most difficult and time-consuming of all the IFRS-based standards for listed entities to implement. For that reason it believes there would be considerable merit in giving entities as much flexibility as possible as to when they implement it, so that they can manage the work involved some entities will not so far have given it much thought and may therefore need some time to put in place the necessary systems and procedures to implement the standard accurately."**

Given that the final version of the FRSs proposed in FRED 30 are unlikely to be available until well into 2003 it would seem essential, to allow sufficient time for preparation, that the required implementation date is not earlier than accounting periods beginning on or after 1 January 2005. As with its previous standards, the ASB could always include the usual reference to "earlier adoption is encouraged". This would allow those entities that wish to do so, to implement IAS 39 earlier.

Responses to the Particular Issues on which Comments are Invited in FRED 30

11. The Association notes that the IASB does not currently intend to reconsider the fundamental approach to the accounting for financial instruments established by IAS 32 and 39.

12. Responses to some of the issues on which comments are invited in FRED 30 are given below.

ASB (i) Treating IASs 32 and 39 as a package (Appendix Ill, paragraph 15)—The ASB has concluded that it is best to view the requirements in IASs 32 and 39 as a single package of requirements that should, as far as is practicable, be implemented in the UK at a single point in time. Do you share this view?

13. The Association agrees that IAS 32 and 39 should be treated as a single package of requirements, although we do not necessarily agree with the ASB that they should be implemented in the UK at this stage.

ASB (ii) Implementation in 2004 (Appendix III, paragraphs 17-20 the general approach referred to in (i) above, the ASB is proposing to implement, at a single point in time, some parts of the standards in mandatory form, some in non-mandatory form and some not at all for the time being. At the same time, it is proposing to withdraw FRSs 4 and 13 (and related UITF Abstracts) and keep in place most parts of FRS 5. Do you believe that, in the circumstances, this represents the best possible approach of implementing in the UK the international requirements in this area?

14. While not agreeing that IAS 32 and 39 should be implemented in the UK, the Association understands the ASB's reasons for the proposed implementation approach. However, we believe that implementation should not be required before 1 January 2005.

ASB (iii) ***Recognition and derecognition (Appendix III, paragraphs 23-29)—The*** **FRED proposes that the proposed new IAS 39 approach to recognition and derecognition should not be implemented in the UK at the present time. Instead, when the direction of international convergence on this subject becomes clearer, a further consultation document will be issued. Do you agree with this approach?**

15. **Yes**, the Association agrees with the ASB's proposal not to implement the proposed new IAS 39 approach to recognition and derecognition in the UK at present.

ASB (iv) ***Measurement (Appendix III, paragraphs 30-49)—The*** **ASB is proposing that, prior to 2005, companies should be required to adopt IAS 39's measurement requirements only if they' choose to adopt the fair value accounting rules that will be set out in companies legislation. Entities that do not choose to adopt those rules will not initially be required by UK standards to adopt the measurement requirements at all. Do you agree with this approach?**

16. Yes, the Association agrees with the ASB's proposal not to require entities to adopt IAS 39's measurement requirements before 2005, unless they choose to adopt the fair value accounting rules that are expected to be set out in UK accounting legislation.

ASB (v) ***Hedge accounting—The*** **ASI3 is proposing a similar approach to IAS 39's hedge accounting requirements as to its measurement requirements.** ***(Appendix III, paragraphs 57-63, 69 and 70)*** **Do you agree with this approach?**

17. **Yes,** the Association agrees with the ASB's proposal not to require entities to adopt IAS 39's hedge accounting requirements before 2005, unless they choose to adopt the fair value accounting rules that are expected to be set out in UK accounting legislation. In its response to FRED 23 the Association considered that, given the possibility of the direct application of IAS to many UK companies, and possibly to building societies also, by 2005, it would be inappropriate, and unhelpful, for "interim" changes to be introduced meanwhile by way of new UK accounting standards.

18. In its paper on FRED 30 "Some questions answered" the ASB notes that hedge accounting will be less widely available, once IAS 39 is applied in full, than at present and than under FRED 23. It also notes that the accounting numbers are likely to become more volatile and that it is possible that IAS 39 could make hedging strategies more cumbersome as companies (especially retail banks) restructure their strategies to ensure that hedge accounting is still available. These impacts arise partly from the restrictive nature of the hedge accounting provisions of IAS 39, but also because of the standard's focus on fair value risk.

19. The Association does not believe that it is appropriate for an entity's hedging strategies to be driven by the accounting requirements; rather, the accounting requirements should reflect the hedging strategies. Although the Association notes that the IASB does

not currently intend to reconsider the fundamental approach to the accounting for financial instruments established by LAS 39, we believe that, in relation to hedge accounting, it should do so urgently.

ASB (vi) ***Unlisted entities and individual financial statements***

(a) The FRED proposes that, prior to 2005, entities should be required to comply with IAS 39's measurement and hedge accounting provisions in certain circumstances only. That will change in 2005 for the consolidated financial statements of listed entities but, the FRED suggests, not for other entities or other types of financial statement. Thus, from 2005 listed entities that do not prepare consolidated financial statements and unlisted entities will not be required to adopt IAS 39's measurement and hedge accounting provisions unless they choose to adopt the fair value accounting rules set out in the Companies Act 1985. Similarly, listed entities that prepare consolidated financial statements will not be required to adopt IAS 39's measurement and hedge accounting provisions in their individual financial statements unless they adopt the fair value accounting rules in those financial statements. Do you agree with this approach?

20. **Yes,** the Association agrees with the ASB's proposal not to require unlisted entities to adopt IAS 39's measurement and hedge accounting provisions from 2005, unless they choose to adopt the fair value accounting rules that are expected to be set out in UK accounting legislation.

ASB (vi) ***Unlisted entities and individual financial statements***

(b) FRS 13's disclosure requirements apply only to entities, other than insurance entities, that are listed or have publicly-traded securities and all banks. The ASB is proposing to revise the disclosure requirements on 1 January 2004 and to apply those new requirements to all listed entities, all other entities that have publicly-traded securities and all banks (in other words, the exemption for listed insurance entities will be removed, but otherwise the scope will be unchanged). Do you agree with this approach or do you believe that, from 2004, the requirements should apply to some other entities (for example, unlisted insurance companies) or, alternatively, to a narrower range of entities?

21. The ASB appears to have overlooked the fact that the disclosure requirements in Part B of FRS 13 apply not only to banks, but also to an entity whose business is to receive deposits or other repayable funds from the public and to grant credits for its own account (eg entities such as building societies).

22. Paragraph OA of the proposed FRS on Disclosure and Presentation (on page 29 of FRED 30) states that the standard shall apply to all financial statements that are intended to give a true and fair view of a reporting entity's profit or loss (or income and expenditure) **except** that paragraphs 42 to 95 (on disclosure) shall apply **only** to banks (defined by reference to the Companies Act) or to entities that have listed capital instruments.

23. This definition will **exclude** a number of building societies (or even all, depending on the meaning of "capital instrument" see paragraph 24 below), since they are not within the definition of "bank" in paragraph 5 of the proposed FRS.

24. On the question of the meaning of “capital instrument” in paragraph 0A(b) which does not appear to be defined in the proposed FRS a number of building societies have permanent interest bearing shares (PIBS) listed on the London Stock Exchange. PIBS are a form of permanent fixed income capital that counts as “tier 1” for capital adequacy purposes. Is it intended that such building societies (but not others) would be within the scope of the disclosure requirements (paragraphs 42 to 95) of the proposed FRS merely by virtue of the issue of PIBS?

25. On the substance of the ASB’s proposed disclosure requirements, new disclosures required include

(a) the fair value of each class of financial asset and financial liability in a way that permits it to be compared with the corresponding carrying amount in the balance sheet, and

(b) numerical credit risk information.

“Fair value” is proposed to be defined as “the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm’s length transaction”.

26. Assuming the disclosure provisions of the proposed FRS will apply to (some or all) building societies, the question arises as to how the fair value of a society’s financial instruments would be ascertained. Presumably, the fair value of a building society’s share and deposit liabilities (at least those at a variable rate of interest) might reasonably be taken to be equivalent to book value? It is’ not clear however what would be the fair value of a society’s variable rate mortgage book, or of those fixed rate assets and liabilities for which there is no active market. Although there are occasional sales of residential mortgage portfolios in the UK, there is not often public disclosure of the price paid, nor, more importantly, of the precise characteristics of the loans, borrowers and properties involved.

ASB (vi) Unlisted entities and individual financial statements

(c) FRS 13’s disclosure requirements apply both to consolidated financial statements and to individual financial statements, except that they do not need to be applied in the individual financial statements of entities that are preparing FRS 13-compliant consolidated financial statements. The FRED proposes to retain a similar exemption. Do you agree with this approach?

27. Yes, the Association agrees that the proposed new disclosure requirements should not need to be applied in the individual financial statements of entities that prepare consolidated financial statements.

IAS 32 (iv) Consolidation of the text in IAS 32 and IAS 39 into one comprehensive Standard—Do you believe it would be useful to integrate the text in IAS 32 and IAS 39 into one comprehensive Standard on the accounting for financial instruments? (Although the IASB Board is not proposing such a change in this Exposure Draft, it may consider this possibility in finalising the revised Standards.)

28. **Yes,** there seems no good reason to continue with separate IAS on disclosure! presentation, and recognition/measurement

IAS 39 (ii) *Derecognition: continuing involvement approach (Appendix I paragraphs 35-57)*—Do you agree that the proposed continuing involvement approach should be established as the principle for derecognition of financial assets under IAS 39? If not, what approach would you propose?

29. No, the Association does not agree that the proposed continuing involvement approach should be established as the principle for derecognition of financial assets under IAS 39. We would prefer that IAS 39 be amended to follow the approach to derecognition adopted in FRS 5.