European Association of Public Banks

- European Association of Public Banks and Funding Agencies -

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

CL 41

11 October 2002

- EAPB Opinion -

on the IASB Exposure Draft of proposed
amendments to IAS 32 and IAS 39

Dear Sir/Madam,

The European Association of Public Banks (EAPB), which represents the interests of approximately 100 public banks and funding agencies of the European Union, would like to thank the IASB for giving it the opportunity to discuss the improvement of IAS 32 and IAS 39.

The International Accounting Standards represents the point of reference for the accounting rules and several countries in the world are committed to introduce these IAS. In the European Union, the adoption of "regulation n°1606/2002 on the application of international accounting standards" emphasises their importance for EU listed companies which have to prepare their consolidated accounts according to IAS as of 1 January 2005. These requirements will surely be extended to other types of companies or even to the whole banking sector. Moreover, the latest Commission proposal to modernise the accounting directives will gradually lead to the introduction of IAS for all EU companies. The EAPB therefore recognises the significance of the IAS and attaches the greatest importance to the actual improvement project - more especially concerning IAS 312 and IAS 39.

In June 2002, the International Accounting Standard Board (IASB) published an exposure draft of proposed amendments to IAS 32 *Financial Instruments: Disclosure and Presentation* and IAS 39 *Financial Instruments: Recognition and Measurement*. This document proposed a number of important changes to the existing standards. We would therefore be grateful if the IASB could take into account the following remarks, which are based on the practical experience gathered by our members.

I. General remarks

The opportunity is offered of correcting the central weaknesses in the accounting of financial instruments in such a way that the parties at which the rendering of accounts is directed are given a true picture of the financial, assets and earnings situation in the sense of a true and fair view. This also presents an opportunity to tighten up the two regulations, correct inconsistencies and redundancies as well as generally consolidate the regulations concerning the estimate and valuation, identification and disclosure of financial instruments to produce one overall set of regulation.

However, the IASB has not made full use of the possibilities open to it. We see a need for change and amendment on a number of important points, particularly in view of the expectation voiced by the IASB itself that the modified standards are to remain in force for some considerable time.

1. Standardised provisions for the accounting of financial instruments urgently require corresponding areas of application. In our view, the proposed amendments to IAS 32 and IAS 39 do not harmonise the areas of application of the two standards. This is, however, a precondition for any consolidation of the two standards in one set of collective regulations.

2. The revision of the standards is characterised by numerous casuistic provisions. This goes against the principle-based approach favoured by the IASB, as the example of paragraphs IAS 32.29 C - IAS 32.29G shows. It also leads to an unnecessary distension of the Standard. Although the IASB has, for example, reorganised the provisions concerning the subject of “trade date – settlement date” into the Annex, new examples have been incorporated into the standard text at the same time (cf. IAS 39.48 ff).

   We call for the standards to be cleaned up. Explanatory examples and application aids should be incorporated into Annexes in a logically consistent manner. The examples should also be structured step by step according to their complexity. Furthermore, it should be ensured that annexes of the same classification are awarded the same valence (integral pat of illustrative nature).

3. The IASB should clarify as a matter of urgency what legal status the questions and answers drawn up by the Implementation Guidance Committee will have in the future. This applies, in particular, to those Q&As that have not been incorporated into the standard text or annexes or which provide for provisions differing from the future standard. We call for an unequivocal statement by the IASB in this regard.

4. We welcome, in principle, the possibility of being able to assess all financial instruments at fair value in the future. We are strictly opposed to any prejudicial effect for Full Fair Value Accounting emanating from this option. Nor does more extensive Fair Value assessment represent a satisfactory solution to the problems resulting from the Hedge Accounting rules according to IAS 39.

5. We regret that the restrictive provisions on Hedge Accounting have not been subjected to revision. However, it is precisely these provisions that have been the subject of harsh criticism since the publication of IAS 39 by virtue of the fact that they stand in the way of modern risk management in fundamental terms. This distorts the picture of the results emerging from economically meaningful business control, which is inconsistent with the principle of fair presentation. Furthermore, we do

not consider it apt or proper for the balancing of basic business to follow the balancing of hedging business in the case of hedge-related contexts.

In our opinion, the provisions concerning Hedge Accounting should be oriented more towards principles before the two standards are adopted, with due regard for the business control methods recognised today.

We would therefore like to take this opportunity to address the essential weaknesses of the present regulations one by one from the viewpoint of the credit sector.

Hedging of net risk items

Under IAS 39.132 in conjunction with IAS 39.133, the hedging of net risk items ("overall net exposure") is explicitly precluded. The consolidation of items to be hedged is only possible in a narrowly defined portfolio resulting from assets or liabilities of a similar risk structure whose changes in value are, related to the risk protected, roughly proportionate to the change in value of the portfolio. The widely practised hedging of net risk items from an overall view of assets and liabilities is therefore not recognised for Hedge Accounting according to IAS 39. We strongly oppose this. (Annex 1)

Internal contracts

Under IAS 39.126B, it is still only contracts in which an external party not belonging to the entity is involved that continue to qualify as collateral instruments for Hedge Accounting within the meaning of IAS 39. Internal contracts are only recognised where they are passed on to an external partner on an individual business transaction basis. This means that the efficiency gains linked with internal repackaging cannot be realised. We therefore make an urgent plea for internal business transactions to be treated as external business transactions in principle (Annex 2).

"Short-cut" method

Under IAS 39.147 in conjunction with Q&A 147-1, the "short cut" method continues to be inadmissible. This unnecessarily impedes the effectiveness test of hedging relations. We consider the requirements to be inappropriate.

We recommend that the "short-cut" method be permitted under the conditions referred to in IAS 39.147 and IAS 39.148 and in view of US-GAAP, with IAS 39.147 also adapted in line with SFAS 133.68. This would be a further step towards the convergence of international accounting standards.

6. We reject the retrospective application of both standards envisaged with the revision of IAS 32 and IAS 39. A retroactive change in the balancing and valuation methods used for financial instruments without any limitation of time means accommodating the previous years. This is

inconsistent with the objective of simplifying application and is associated with high costs and a very considerable workload. We are in favour of retaining the previous arrangement of prospective application.

7. A special standard for banks, recognising the special importance of financial institutions in the economy, has already been created in the form of IAS 30, “Information in the accounts of banks and similar financial institutions”. This standard is currently being revised by the IASB. Urgent attention must be paid to consistency of the content of the provisions in accordance with IAS 32 and IAS 30.

II. Answers to the questions preceding the draft standards

IAS 32

Question 1: Probabilities of different manners of settlement (paragraphs 19, 22 and 22A)
Do you agree that the classification of a financial instrument as a liability or as equity in accordance with the substance of the contractual arrangement should be made without regard to probabilities of different manners of settlement? The proposed amendments eliminate the notion in paragraph 22 that an instrument which the issuer is economically compelled to redeem because of a contractually accelerating dividend should be classified as a financial liability. In addition, the proposed amendments require a financial instrument that the issuer could be required to settle by delivering cash or other financial assets, depending on the occurrence or non-occurrence of certain future events or on the outcome of uncertain circumstances that are beyond the control of both the issuer and the holder of the instrument, to be classified as a financial liability, irrespective of the probability of those events or circumstances occurring (paragraph 22A).

We agree in fundamental terms with the provision of IAS 32.19, under which a financial instrument is to be classified as equity or a liability by the issuer based on an economic viewpoint (“substance over form”).

In our view, the principle of “substance over form” implies, however, that the probabilities of different manners of settlement are to be taken into account in the classification. In this respect, we are not in agreement with the addition of “and without regard to probabilities of the manners of settlement”.

Question 2: - Separation of liability and equity elements (paragraphs 28 and 29)
Do you agree that the options in IAS 32 for an issuer to measure the liability element of a compound financial instrument initially either as a residual amount after separating the equity element or based on a relative-fair-value method should be eliminated and, instead, any asset and liability elements should be separated first and then the residual assigned to the equity element?

We reject the proposed restriction of methods of assessment. Within the context of separation, it should always be possible to assess a “partial product” using the residual figure. The advantage of this is that the net value resulting from all “partial products” concurs with the actual cash flow at the time of emission. In our estimation, the order in which this is determined is not important.

Question 3: - Classification of derivatives that relate to an entity's own shares (paragraphs 29C - 29G)

Do you agree with the guidance proposed about the classification of derivatives that relate to an entity's own shares?

IAS 32.29C – 32.29G provide for derivatives relating to an entity's own shares to be classified as equity only when delivery ensues through a fixed number of shares at a fixed price. We regard this provision as excessively restrictive compared with the previous IAS 32.16 and recommend that the latter be retained. The grounds according to which a contractually envisaged "net share" settlement can prevent classification as an equity instrument are not apparent to us.

Question 4: - 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 Board is not proposing such a change in this Exposure Draft, it may consider this possibility in finalising the revised Standards.)

In principle, we support consolidation of the regulations set out in IAS 39 and IAS 32 in one standard on grounds of consistency. Despite the substantial content of such a standard that this would necessitate, combining them would be consistent in terms of the internal logic of the IAS. This could, in our view, improve understanding as well as avoid duplication of explanations and contradictory formulations.

However, as long as the areas of application of IAS 39 and IAS 32 do not coincide (e.g. in relation to open loan commitments, leasing contracts, an entity's own equity instruments), we regard the consolidation of accounting, valuation and disclosure regulations for financial instrument in one comprehensive Standard as problematic.

IAS 39

Question 1: - Scope: loan commitments (paragraph 1(i))
Do you agree that a loan commitment which cannot be settled net and which the entity does not designate as held for trading should be excluded from the scope of IAS 39?

We agree in principle with the exclusion of “loan commitments” from the area of application of IAS 39. It should, however, be made clear that the question of the area of application only arises in relation to irrevocable loan commitments as it is only these that can be subject to a market price risk, thus making them comparable to derivative instruments with regard to their risk profile.

However, we strongly oppose the “tainting” provision, under which as a result of the short-term resale of loans originating from irrevocable loan commitments all loan commitments are to be treated in accordance with the provisions of IAS 39.

With due regard for the special features of the financial sector and the specific running of its business, this condition should only apply to individual portfolios organised separately and not to all of a company’s irrevocable loan commitments across the board. Furthermore, additional provisions should be included in the area of application of IAS 39 in relation to credit commitments arising within the framework of syndicates. In our view, it needs to be made clear that credit commitments resold to third parties within the context of syndicates should not be covered by IAS 39, either, as such resale is carried out for the purpose of reducing risk rather than realising profit or margins from trading activities.

It should also be expressed clearly in IAS 39.1(i) that the envisaged relief applies for both the potential lender as well as the potential borrower.

Question 2: - Derecognition: continuing involvement approach (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?

The arrangements for balancing financial assets are, in our opinion, not made any clearer or more manageable in practice by the proposed principle of "continuing involvement". This is particularly true in instances of a partial retention of risks – the normal case in practice. This means that one of the main objectives of the proposed changes (see IAS 39 C28 "the purpose of the proposed amendments is to facilitate the implementation and application of IAS 39") is not achieved.

We also find the "continuing involvement approach" unconvincing in its conception for the following reasons, amongst others:

- The reason for the estimate of (fictitious) liabilities instead of existing contractually fixed contracts (e.g. put or call options, guarantees, etc.) which prevent "derecognition" because of "continuing involvement" remains unclear. The representation as fictitious "collateralised borrowing" leads to a distorted picture of the actual economic state of affairs.

- The provisions concerning the estimate of "servicing assets" or "servicing liabilities" are very problematic. Such assets or liabilities are based on an estimation of the appropriateness of remunerations to be received for services. Corresponding regulations relating to other service remunerations would then also be conceivable in other areas, such as rents. Provisions regarding service contracts should, in our opinion, definitely not be included under IAS 39. The method of assessing the appropriateness of remuneration contains a huge speculative element. Although the estimate of "servicing liabilities" is to ensue at fair value in accordance with IAS 39.44, subsequent valuation nonetheless remains unclear. Furthermore, the "servicing assets" or "liabilities" definitely do not, in our view, correspond to the definitions of the outline concept.

- The restriction to the effect that a purchaser may only categorise the receivable as an original claim where the transferring party has the right and obligation to reassignment is far from comprehensible. This is inconsistent with the general categorisation provisions for original claims (IAS 39.18).

The proposed revision continues to give rise to broad scope for interpretation of the balancing regulations with numerous exceptions and fictions. This makes insight into the financial, asset and earnings situation difficult. The underlying economic position is not illustrated adequately.

We therefore agree with the differing view of the two IASB board members (see IAS 39 D5 "The proposed approach replaces one set of conceptual inconsistencies with another and have significant consequences not anticipated."). We would welcome the "component approach" addressed in IAS 39 C47 as an appropriate alternative. The previous provisions on the balancing of assets should be retained until a new concept is elaborated.

Question 3: - Derecognition: pass-through arrangements (paragraph 41)

Do you agree that assets transferred under pass-through arrangements where the cash flows are passed through from one entity to another (such as from a special purpose entity to an investor) should qualify for derecognition based on the conditions set out in paragraph 41 of the Exposure Draft?

A "pass-through arrangement" in line with IAS 39.41 (with, where applicable, the emergence of service rights or liabilities) does not represent any obstacle to "derecognition" in accordance with the continuing involvement approach.

The provisions on "pass-through arrangements" are helpful with the prerequisite of the continuing involvement approach. We interpret conditions (a) to (c) as follows:

Re condition (a):

It is deemed non-prejudicial for balancing where

- bridging is used to offset differences in the maturity structures of the assets and of the liabilities issued by the special purpose entity, and
- the structure of incoming payments from the assets is changed through the use of derivatives (e.g. interest rate swap) and the net amount if passed on to the investor.

Re condition (b):

It is deemed non-prejudicial for balancing where disposals are necessary because of differences in the maturity structures of the assets and of the liabilities issued by the special purpose entity in order to be able to repay the liabilities.

Re condition (c):

It is deemed non-prejudicial for balancing where payments received from assets are not passed on to the investor immediately but, rather, at the next point in time of the payment of interest. This means – as previously permitted under Q&A 35-2 – that short-term investments should also continue to be non-prejudicial for the transferring party's own purposes.

Question 4: - Measurement: fair value designation (paragraph 10)

Do you agree that an entity should be permitted to designate any financial instrument irrevocably at initial recognition as an instrument that is measured at fair value with changes in fair value recognised in profit or loss?

We welcome the introduction of this option, especially in view of the resulting relief relating to structured products and different valuation approaches for fundamentally similar asset and liability transactions. Nonetheless, the option proposed does not present any satisfactory solution to the problems that exist with regard to Hedge Accounting (cf. preamble).

The envisaged provision partially anticipates proposals by the Joint Working Group of Standard Setters for Fair Value Accounting in the form of options. However, we strongly oppose any prejudicial effect in the direction of Full Fair Value.

We recommend the introduction of an independent category, such as "Other financial instruments at fair value (through net income)", to be shown separately in the balance sheet accordingly. The associated separation of the original Held-for-Trading values would increase transparency.

We reject the general ban on subsequent reorganisation (IAS 39.89B). The proposed ban on reallocation to the "Held for Trading" category would lead to artificial divergences between internal and external accounting. Subsequent reallocation to the "Held for Trading" category should be permitted in the sense of a "true and fair view" where it is proven that the trading of these financial instruments has been included (portfolio view). Reallocating from the new category should also be permitted where this reflects the actual risk management.

There is an urgent need for additional application aids relating to the fair-value determination of an entity's own liabilities, especially on the question of consideration of the entity's own credit standing risk.

Question 5: - Fair value measurement considerations (paragraphs 95 - 100D)
Do you agree with the requirements about how to determine fair values that have been included in paragraphs 95 - 100D of the Exposure Draft? Additional guidance is included in paragraphs A32 - A42 of Appendix A. Do you have any suggestions for additional requirements or guidance?

The provisions concerning the determination of fair values are, in part, very theoretical and of little relevance in practice. The workload associated with the stipulations for determining fair value does not, in our estimation, justify the additional knowledge attained.

This concerns the following situations, for example:

- We reject the strict guideline of a methodological hierarchy based on the quoted market price. If there is no quoted price available, the balancing entity should have the option to decide whether a market comparison or calculation model is better suited for valuation purposes. The following sequence for determining value could – for more complex products, for instance – constitute an improvement: "quoted price", "valuation technique", "recent market transactions".

- The market comparison is often the most imprecise form of valuation and in many cases does not lead to a reliable value at all. The required adaptation to changed market conditions is particularly impracticable.

- According to the present wording, non-fulfilment of the conditions set out under IAS 39.101 (a) and (b) must be substantiated in each case for an "at cost" valuation of equity instruments and derivatives coupled to such instruments. This requires repeated and costly auditing. Furthermore, it would be virtually impossible to carry out the determination of probabilities in practice.

The quality of the fair value in the cases referred to often does not give rise to any better economic assessment of the items. We therefore call for greater freedom for the alternative use of acquisition costs, without the imperative conducting of the audits provided for in IAS 39.101.

We interpret the passage "fair value of a portfolio" in IAS 39.99 to the effect that block premiums or discounts are taken into account for purchases/sales already finalised. Should the IASB not share this view, we request clarification accordingly. Furthermore, the restrictive condition concerning the use of mid-market prices should at least be deleted in the wording not altered by the draft standard. The technical outlay for bid / offer can be very high and differing pricing times can lead to substantially greater value differences than in the case of bid-offer spreads.

We are furthermore of the view that the determination of fair values is a fundamental issue, which also opens up validity for other standards (e.g. IAS 40, Investment Property). We therefore propose that the provisions relating to the determination of fair value be incorporated into the outline concept.

Question 6: - Collective evaluation of impairment (paragraph 112 and 113A – 113D)

Do you agree that a loan asset or other financial asset measured at amortised cost which has been individually assessed for impairment and found not to be individually impaired should be included in a group of assets with similar credit characteristics that are collectively evaluated for impairment? Do you agree with the methodology for measuring such impairment in paragraphs 113A - 113D?

We are, in principle, in favour of an (additional) impairment test being conducted on a group basis where the examination of an individual asset for reduction in value does not result in any finding. However, we reject any obligation to carry out an (additional) group assessment. The balancing entity should have the optional right of carrying out a global value assessment on the basis of risk classes. From the viewpoint of the credit sector, the proposed provisions should also be examined to see if they are consistent with the option for forming global value adjustments granted under IAS 30.

We reject the method set out in IAS 39.113A – 39.113D. The aim of the draft standard is, amongst other things, to establish a regulation that is easy to apply. The procedure proposed in the paragraphs referred to above indicate, as we understand it, a migration analysis in accordance with US-GAAP. This is, however, complex and can only be implemented at high cost in terms of financial outlay and time since it requires extensive as well as historical calculations. The outcome is not any more meaningful.

Question 7: - Impairment of investments in available-for-sale financial assets (paragraphs 117 - 119)

Do you agree that impairment losses for investments in debt and equity instruments which are classified as available for sale should not be reversed?

We find the ban on an earnings-effective write-up for financial instruments of the "Available for Sale" category incomprehensible and therefore reject this notion. In our view, "impairment losses" should be dissolved via the profit and loss account. This would be consistent with the value pick-up procedures for other assets, e.g. for classic credit business in accordance with IAS 39.114 (draft), for tangible assets according to IAS 36.104 f. or intangible assets under IAS 38.76.

We consequently plead for the previous earnings-effective value pick-up in accordance with IAS 39.119 to be retained. This procedure should, furthermore, also apply to assets valued "at cost" (cf. comment (see below) regarding IAS 39.116)

Question 8: - Hedges of firm commitments (paragraphs 137 and 140)

Do you agree that a hedge of an unrecognised firm commitment (a fair value exposure) should be accounted for as a fair value hedge instead of a cash flow hedge as it is at present?

We agree wit the amendment in principle. The question arises whether, in view of Q&As 137-9 f., both fair-value and cash-flow hedge accounting should also be permitted for "firm commitments" in foreign currencies.

Question 9: - 'Basis adjustments' (paragraph 160)

Do you agree that when a hedged forecast transaction results in an asset or liability, the cumulative gain or loss that had previously been recognised directly in equity should remain in equity and be released from equity consistently with the reporting of gains or losses on the hedged asset or liability?

We do not support the amendment because it leads to increased cost and workload plus reduced practicability – without producing any gain in information or differing effect in the profit and loss account. Correction of the acquisition costs of an asset or liability arising from a hedged transaction corresponds to a due and proper representation of the actual hedging intention (safeguarding acquisition costs that arise in the future).

Question 10: - Prior derecognition transactions (paragraph 171B)

Do you agree that a financial asset that was derecognised under the previous derecognition requirements in IAS 39 should be recognised as a financial asset on transition to the revised Standard if the asset would not have been derecognised under the revised derecognition requirements (i.e. that prior derecognition transactions should not be grandfathered)? Alternatively, should prior derecognition transactions be grandfathered and disclosure be required of the balances that would have been recognised had the new requirements been applied?

We strongly oppose the transition provision proposed in IAS 39.171B. Such an adjustment entails considerable – and in our view, disproportionate – costs and effort. This assessment also applies with regard to the alternative formulated in the question (grandfathering with disclosure of the values that would otherwise have to be estimated in the balance sheet). It also implies extensive preparation and processing of historical data. We therefore call for the present transition provision in accordance with IAS 39.172 (h) to be retained.

III. Comments concerning individual paragraphs

IAS 32

Paragraph	**Comment**
32.36 in conjunction with 32.37 and 32.41	It should be ensured that the requirements under IAS 32.36, 32.37 and 32.41 are identical to the requirements for the international registration system to the greatest possible extent.
32.43 in conjunction with 32.56 ff.	The simultaneous specification of “fair value interest rate risk” and “cash flow interest rate risk” under IAS 32.43 in conjunction with 32.56 ff. is questionable. The distinction between these two interest rate risks is not apparent to us and should be deleted. Furthermore, stating these simultaneously harbours the danger of risks being oversubscribed.
32.42 in conjunction with 32.45	The information frequently required at product level gives rise to the danger of information having to be disclosed which jeopardises the existence and earning capacity of the entity. Other market players could utilise such information to the detriment of the balancing company. We therefore propose that a protective clause be inserted with the following wording: “Reporting is to be omitted when and only when the given information causes substantial detriment to the balancing enterprise or another entity.” *(See § 286 HGB (Commercial Code))*. For drafting reasons, this amendment should be inserted into IAS 32.42. In addition, the first paragraph concerning the disclosure requirements (Disclosure) should be clearly identified as a principle.
32.52A	The reference required is IAS 39.57A (not IAS 39.30)
32.64	Re (a): The outlay and effort entailed in providing a detailed account of the maturity time frames is utterly disproportionate to the benefit resulting from the information. This requirement is inconsistent with the principle of “materiality”. One possibility is to adapt to banking supervisory regulations, e. g. Basle II.
32.66 in conjunction with 32.68	Collateral should definitely be taken into account in the consideration of default risks since an incorrect picture and, therefore, “true and fair view” would otherwise emerge.
32.74	We interpret the content of IAS 32.74 to the effect that IAS 14 provides support in the case of segmentation for purposes of risk reporting but that this is not linked to any mandatory adoption of the segment formed for segment reporting within the meaning of IAS 14.
32.77A	We reject the stating of an estimated value margin for those equity instruments and derivatives for which there is no market price and for which a fair value cannot otherwise be reliably determined and which are, inasmuch,

valued “at cost”. If a fair value cannot be reliably determined, estimating the value margin does not make any sense.

32.77B Re (a):

The benefit of disclosing methods and essential assumptions in the estimate of fair values is slight because the investor relies on the methods having to be reliable, i.e. examined by the auditor. This requirement is therefore inconsistent with the principle of “materiality”. In our view, the obligations to provide information on the use of discounted cash flow methods and assumptions in determining fair value are too far-reaching in this form.

Re (d):

We reject the disclosure of the impact of alternative assumptions on value estimates. Calculating the effects is not only very costly and time-consuming, it is also misleading as the figures cannot be aggregated. We recommend that the corresponding provision be deleted and that the cases in question be included in a “value at risk” review.

Re (e):

The obligation to state the proportions of fair value changes in terms of the overall result arising from market prices or valuation models should be deleted as it cannot be implemented in practice.

32.93A Re (b) and (c):

Under IAS 32.93A (b) and (c), details of receivables evidenced by way of ABS transactions which do not qualify for balancing because of “continuing involvement” are required. We reject the “continuing involvement approach” in line with our position stated in relation to IAS 39, Question 2. The alternative concept of a “component approach” is not compatible with the disclosure requirements provided for under (b) and (c). Furthermore, the wording of the information required overlaps to some extent.

Re (h):

We interpret the term “designated” under IAS 32.93A (h) to the effect hat the obligation to state the differential amount between fair value and the contractual repayment amount only relates to financial instruments on the liabilities side which are subjected to voluntary fair value assessment in accordance with IAS 39.18 (e).

Re (i):

We reject the requirement contained in IAS 32.93A (i) for stating details of mutually dependent components in hybrid financial instruments as well as disclosing the effective interest rate of liabilities after excluding such derivative components. In our estimation, the cost of obtaining such information does not bear any acceptable relation to the additional knowledge that can be attained through the details required.

IAS 39

Paragraph	**Comment**
39.1	Re (f): Broadening the area of application of AS 39 to include financial guarantees with regard to the valuation of additions should be avoided by deleting the first half of the clause. Up to now, financial guarantees that do not adhere to the definition of a loan derivative within the meaning of IAS 39 are covered by IAS 37. Consequently, there is an obligation to estimate a liability reserve if recourse arising from the guarantee is probable (more likely than not) and the recourse level can be reliably estimated. If recourse is not likely and/or the level of such recourse cannot be estimated reliably, this results in an obligation to disclose this in the notes accordingly insofar as the likelihood of recourse cannot be classified as being (negligibly) small. The estimate of a liability at the time of addition is not justified in our opinion since a financial guarantee does not automatically lead to liability to be shown in the balance sheet in conjunction with a future outflow of assets. Should the IASB abide by the proposed amendment, an explanatory numerical example should be included in the Annex for the purpose of clarifying the proposed extension of the area of application to include financial guarantees, with such example illustrating, in particular, how the liability to be estimated is to be valued at the time of addition within the meaning of the new provision. Clarification should also be given in relation to valuation in the subsequent period as balancing would, in our view, have to be carried out again in the absence of any likelihood of recourse.
39.10	We welcome the possibility to classify financial instruments under the “Available for Sale” category, even where these financial instruments meet the classification criteria for the “Held to maturity” or “Loans and receivables originated by the entity” categories. In coordination with this new provision, we agree with the proposal concerning the possibility for financial instruments traded on an active market to no longer be classed as “Loans and receivables originated by the entity” in future.

39.10 in conjunction with 39.18 (c)	According to the draft standard, liabilities that are intended to be re-acquired in the short term must be classified manadatorily under the “Held for Trading” category. The question arises within the context of this new provision as to how balance sheet value deferment is to be carried out within the financial liabilities in this case. We consider orientation towards the market nursing or price nursing value held on the assets side, which has to be deducted from the liabilities side, to be practicable. Such netting would consequently no longer give rise to any effect on earnings with identical valuation of the asset and liability sides (fair value).
39.10 in conjunction with 39.18 (d)	We explicitly welcome the addition of point (d) to IAS 39.18 because the incorporation of such liabilities into the Held-for-Trading value will help to provide a distinctly better picture of the commercial reality.
39.10 in conjunction with 39.92	According to IAS 39.92, it would appear to be due and proper to value a financial asset at continued acquisition costs in the case of a change in holding intention or ability instead of at fair value. This provision permits the conclusion that reallocating from the “Available for Sale” category to the “Held to maturity” category is permissible insofar as the holding intention and ability occurs at a later date (at a time after the addition). In IAS 39.10, on the other hand, negative deferment is exercised for the “Held to maturity” value category. Accordingly, only financial assets not designated as “Held for Trading” or “Available for Sale” at the time of addition or which comply with the definition characteristics of “Originate loans and receivables” can be allocated to this category. In relation to allocation to the “Held to maturity” category, IAS 39.89 also requires proof of holding intention or ability not only at the time of the first estimate but also at all subsequent cut-off dates. In our view, it is not clearly regulated whether it is possible to subsequently reallocate to the “Held to maturity” category from the “Available for Sale” category. We recommend in this respect that prospective reallocation from the “Available for Sale” category to the “Held to maturity” category be permitted in justified cases (e.g. change in risk management, expiry of the tainting freeze period).

39.27	The reference should be IAS 39.57A (instead of IAS 39.30).
39.28	The final clause stipulates that an asset may only be entered for the purchaser once this has been debited by the vendor (cf. also IAS 39.56, or, to be correct, IAS 39.57). We interpret this passage to the effect that this does not establish any obligation regarding mutual reconcilement. This would not be feasible in practice and should be rejected. We recommend that the passage be deleted.
39.69 in conjunction with 39.126	It continues to be assumed in principle that the fair value necessary for subsequent valuation can be reliably determined for virtually all financial instruments. In the draft standard, the exceptional category (c) has, however, been restricted to investments in equity instruments for which no market price is determined on an active market and to corresponding derivatives linked to such instruments or which have to be fulfilled through the delivery of such instruments. In contrast, the current version of IAS 39 provides for an “at cost” valuation for all financial instruments for which no market price is established on an active market and whose fair value cannot be reliably determined in any other way. This amendment raises the question of whether it is to be assumed that a fair value can always be reliably determined for fixed-interest securities and that valuation of loan capital securities at (continued) acquisition costs outside the “Held to maturity” and “Originated loans and receivables” categories is prohibited without exception. In this context, we also refer to IAS 39.126 (Exclusion of equity instruments and related derivatives as collateral instruments where the fair value cannot be reliably determined, but no exclusion of loan capital instruments). It cannot, in our view, be assumed that a fair value can always be reliably determined for all financial instruments not covered by IAS 39.69 (c) (cf. the financial instruments referred to under IAS 32.22B, for example). We are consequently not in agreement with the envisaged restriction and recommend that the previous provision be retained.
39.81 in conjunction with 39.83	Under IAS 39.81, a hybrid instrument with an embedded call option on the part of the issuer can be assigned to the “Held to maturity” category where the acquiring party receives virtually the entire book value on exercising the option. In principle, the decision concerning the value allocation of such instruments requires a calculation of the continued acquisition costs at the time of exercising as well as a comparison of this value with the strike price (after correction by the option bonus). The term “substantially all” does, however, require interpretation. Orientation towards IAS 39.83 (b) would allow the conclusion that the acquiring party must receive at least 90% of the book value on exercising the option.

We interpret the quantifying of “substantially all” in terms of at least 90 % in IAS 39.83 (b) to the effect that an amount of up to10 % is to be regarded as “insignificant”. Should the IASB not share this view, we request clarification accordingly.

IAS 39.83 requires the mandatory reallocation of values in the “Held to maturity” category to the “Available for Sale” category in future where the tainting regulation applies. Up to now, reallocation to the “Held for Trading” category” has also been possible in accordance with Q&A 83-2 and Q&A 83-4. We regard compulsion to reclassify to the “Available for Sale” category as inappropriate for those cases in which trading of these financial instruments can be proved to have commenced; reclassification to the “Held for Trading” category should continue to be permissible in such cases.

39.90 in conjunction with 39.89B	IAS 39.90 requires the mandatory reallocation of values of the “Held to maturity” category to the “Available for Sale” category where holding intention and/or ability no longer exist. Under the previous provision, reallocation to the “Held for Trading” category could also be considered. Here, too, we regard compulsion to reclassify to the “Available for Sale” category as inappropriate for those cases in which trading of these financial instruments can be proved to have commenced; reclassification to the “Held for Trading” category should continue to be permissible in such cases.
39.106	Incorrect reference to IAS 39.30 (now: Annex)
39.116	We reject the prohibition of write-up – either via “equity” or via the profit and loss account. This is inconsistent with the general IAS fair value principle. We recommend that earnings-effective appreciation be permitted as, in our view, the question of the dissolution of “impairment losses” should be regulated independently of the respective categorisation of a financial instrument (see comments on Question 7 to IAS 39).
39.117 and 39.118	We interpret the stipulation that the “cumulative net <u>loss”</u> must be balanced via the profit and loss account to the effect that all accrued positive and negative fair value changes recorded under “equity” are to be included in the case of “impairment loss”. This would lead to accumulated fair value write-ups being set off against default risk-related write-downs. In our view, it would be more appropriate to book “impairment losses” in general via the profit and loss account. An explanatory entry example in the Annex would be helpful in this respect.
39.127	Under IAS 39.127, “Held to maturity” book values can only be hedged against default or currency exchange risks. Financial instruments in the “Loans and receivables originated by the entity” category are not affected by this restriction. We reject this differentiation. Hedging the interest rate risk should also be permissible for “Held to maturity” values. The aim of such protection is

to fix the interest margin, not to safeguard the capital proceeds. We therefore propose that the last two clauses in IAS 39.127 be deleted completely.

39.142 in conjunction with 39.146	Where the effectiveness of a hedge relationship lies within a period of time (e.g. on the last day of a month according to the audit) outside the effectiveness limits during the documented hedging term, though it is, however, presumed prospectively for the remaining hedging period that the hedge is effective, we presume on the basis of Q&A 142-3 that hedge accounting can be continued. Should the IASB not share our interpretation, we request clarification accordingly.

The condition relating to the effectiveness of hedging correlations is explained in IAS 39.146. According to this, effectiveness is deemed to exist where the changes in value of the collateral and hedged business compensate for up to 80% - 125%. In the example, the **absolute changes in value** are places in proportion to each other. This method is also known as the Dollar Offset method (cumulative or periodic measurement).

The disadvantage of measuring effectiveness in this manner is that adherence to the effectiveness limits is jeopardised if the overall fair value/face value of the hedged business is positive or negative to a very high degree and the changes in value occurring are very low in terms of amount related to the total fair value or face value of the instruments.

<u>Example</u>:
Hedged business:
Nominal amount: € 1,000,000
Fair value at the time hedging commences: € 1,000,000

Hedge derivative (on the same nominal amount):
Fair value at the time hedging commences: € 0

Changes in value up to the next cut-off date:
Hedged business: € +8 (change: 0.0008 %)
Hedge derivate: € - 11

The changes in value are compensated for at a rate of 72.73 %, thus lying outside the effectiveness limits. The changes in value are, however, to be regarded as negligibly low (far below 1%) related to the nominal underlying volume, both for the hedged business and the hedge derivative. Such low change of value amounts will have to be shown, in particular, where the risk parameters do not change in the meantime. In our view, greater importance should be given to the principle of materiality in such cases so that hedge accounting could be continued. This should be made clear in the Standard through a corresponding opening clause, for instance.

39.171 Users should be granted a reasonable period of time for the initial application of the revised Standard to permit them to change over their systems and adapt internal processes and documentation.

Although the Draft Standard does not mention a specific date on which the proposed amendments are to enter into force, application to the financial year commencing on 1 January 2003 is strongly opposed in view of the arguments set out above. Nor is it possible to adapt the systems and internal processes during the year, in our view.

We consider mandatory application from 1 January 2005 on, coinciding with the IAS regulation guidelines, to be appropriate. Earlier voluntary application with prospective effect for the future should be permitted. Furthermore, entering into force should be regulated concurrent to the amendments proposed in relation to IAS 32.

39.171A	We welcome the fact that IAS 39.171A provides for the granting of a de-facto option for reclassifying financial instruments as “Held for Trading” or “Available for Sale”.
Annex A: A4c, A4g and A5e	In Annexes A4 and A5, the examples on assessment of the characteristic “clearly and closely related” between the embedded derivative and the basic contract have been carried forward or revised. In our view, it can no longer be clearly deduced even from the revised examples whether the original classification of creditor’s termination rights continues not to be subject to mandatory separation. An unequivocal statement on this matter is urgently needed in our opinion.
Annex A: A10 in conjunction with 39.57A	A10 should be revised. Standardised application of “trade date” and “settlement date accounting” should, for data-processing reasons, apply to identical product types if need be, but not to identical categories of “financial assets”. We had not expected any change by the IASB in this respect.

IAS 32 and IAS 39 could be substantially improved if these comments were given due consideration. We also take the liberty of sending a copy of this opinion to the European Financial Reporting Advisory Group (EFRAG) in Brussels. Should you wish to discuss any of the above mentioned points in further detail, please do not hesitate to contact us.

Yours faithfully,

Henning Schoppmann
EAPB - Secretary General

Example: net risk item

In this example, the bank book position resulting from the different banking transactions is safeguarded via a macro-hedge interest rate swap.

In Germany, all-purpose banks normally repackage their interest rate positions in the Treasury, with the positions arising from the lending and borrowing transactions that arise concluded on the market via interest rate swap when above a recognised commercial magnitude.

Hedge accounting is not possible because there is no individual link. Although no perfect (individual) hedge exists, the risk of the position is eliminated.

Documentary proof at the position level is possible via the Treasury systems, for instance.

The interest rate change risk of a fixed-interest item is converted into floating interest via a macro-hedge.

This variable interest is not subject to any interest rate change risk as the refinancing of the balance also ensues on a variable basis. The interest rate change risk of the (balanced) fixed-interest item has been eliminated (synthetic floater).

Loan Department 1

Loan	
10 years	
1 * 10 million euros	
7.0%	

Issue

	Issue
	10 years
	20 million euros
	6.5%

Loan Department 2

40 loans	
10 years	
40 * 0.5 million euros	
7.5%	

Deposits etc.

Deposits	
10 years	
5 * 10 million euros	
7.0%	

80 million euros assets

20 million euros liabilities

60 million euros assets - fixed interest
sum = bank book 10 years - result of several assets and liabilities

Derivate dealings -

Interest rate swap (macro-hedge)

10 years	10 years
60 million euros	60 million
6 months Euribor	6.75%

Money dealings

	Borrowing
	60 million euros
	6 months Euribor

Valuation result of swap:
e.g. in year 1 - 6 million euros
and in year 2 + 5 million euros

60 million euros assets - floating interest
= bankbook transformed into a floating position

overall interest risk position = ZERO (without spread)

There is no recognition of the hedge correlation in the regulations concerning the fair-value hedge under IAS 39. The valuation result would therefore be shown in the trading result and would lead to incorrect results for the individual periods.

Valuation of the macro-swap as a trading value would, under the existing IAS 39, lead to a one-sided profit and loss result in the account books while the interest surplus is determined on the basis of deferment. Nonetheless, periodic displacements do arise, as do shifts between the profit and loss positions, which are incorrect in substantive terms.

The individual transactions of the bank book position cannot be documented at reasonable expense as only the peaks of the lending and borrowing transactions are hedged.

A look-through within the meaning of the existing IAS 39 and the formation of a valuation unit for fair value hedge accounting cannot therefore be applied.

Applying the alternative variant of IAS 39, i.e. cash-flow hedging, is rejected at this juncture by virtue of the fact that the aim of the macro-hedge is not to fix variable transactions but, rather, precisely the opposite, i.e. to eliminate the interest rate change risks from fixed interest risks. These are replaced by variable interest rate structures that can be controlled at any time.

Example: "Representative function" of internal transactions and illustrating them in an economically meaningful manner

In this example, the loan departments of a bank in London and Frankfurt each grant a long-term fixed-interest loan, which they refinance on the basis of a variable interest rate. The interest rate change risk is hedged by concluding internal payer swaps in line with market conditions.

The motives for this procedure include:

- Term-congruent refinancing is uneconomical in most cases.
- The concluding of external swaps through loan departments is not possible due to lack of market access.
- Internal transactions are required for profit centre control and presentation.
- The loan departments may not taken on any interest rate change risk.
- The interest rate change risk is controlled and monitored centrally in the Trading Department.

Loan Department London

Loan	Money borrowing
10 years	10 years
10 million euros	10 million euros
7.0%	3 months Euribor

Internal swap

10 years	10 years
10 million euros	10 million euros
3 months Euribor	5.5%

Derivative Trading London

Internal swap

10 years	10 years
10 million euros	10 million euros
5.5%	3 months Euribor

Loan Department Frankfurt

Loan	Money borrowing
9 years	10 years
10 million euros	10 million euros
6.6 %	6 months Euribor

Internal swap

9 years	9 years
10 million euros	10 million euros
6 months Euribor	5.2%

Internal swap

9 years	9 years
10 million euros	10 million euros
5.2%	6 months Euribor

To close the position that has occurred as well as other existing positions within the framework of the value-at-risk limit, the following external swap, for example, is concluded by the Trading Department:

External swap

9.5 years	9.5 years
30 million euros	30 million euros
6 months Euribor	5.4%

(The Trading Department actually takes over the interest rate change risk generated in the Loan Departments in the item to be assessed by it; concluding (external) micro-hedge swaps would be uneconomical because of the many excessively small lot sizes and would lead to an expansion of external transactions plus an associated increase in the contracting party limit capacity.)

Hedge accounting would not be possible applying the present IAS regulations; the interest deferments arising from the Loan Departments' external loan and funding transactions would be shown in the interest result, while the interest deferment and the valuation result for the external swap would be shown in the trading result. Consequence: high profit-and-loss volatility due to the one-sided consideration of the valuation result for the external swap. An economically nonsensical result that does not reflect the bank's economic situation.

The option possible under the new Exposure Draft with regard to valuing the loan and funding transactions at fair value borders on the known limits of determinability of valid credit spreads; Furthermore, a mark-to-market?? of the default risk arising from the loans would not be appropriate in our view by virtue of the individual book credit not being negotiable and their being no intention to sell or trade.

The following scenario would be meaningful in our estimation:

- The Loan Departments are not exposed to any interest rate change risk; an interest result amounting to their customer margin of 1.5 and 1.4 % p.a. respectively is shown, i.e. the internal hedge derivatives are dealt with following the basic business transactions (loans and receivables originated by the entity).
- The Trading Department values its side of the internal swaps as well as the external swap. Consequence: the bank's interest rate risk position is shown correctly. The internal swaps act as "representatives" for the loan and funding transactions of the Loan Departments with regard to the hedged interest rate change risk assessed in the Trading Department.
- The recipient default risk arising from the awarding of the loans is taken into account within the framework of credit risk control and monitoring, including the impairment test.

Essential requirements for this procedure:

- effective risk management in accordance with the supervisory guidelines,
- internal transactions in line with market conditions,
- recording and entering of both internal and external transactions,
- full compliance with monitoring and documentation requirements, as also apply to external transactions.