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IBF OBSERVATIONS ON THE EXPOSURE DRAFT OF PROPOSED AMENDMENTS

TO IAS 32 AND 39 ON FINANCIAL INSTRUMENTS

Introduction

The IBF is fully supportive of the harmonization of financial reporting and welcomes the EU Regulation 2000/0044 (COD) which will require all listed companies to apply International Accounting Standards by 2005. The IBF also welcomes the opportunity to comment on the proposed amendments to IAS 32 and 39 and other issues raised by these standards. The IBF comments set out many issues already addressed by the European Banking Federation and British Bankers' Association and we fully support their comments in this regard.

Dating back to the exposure drafts that preceded IAS 32 and IAS 39, the banking industry has repeatedly made known its concerns over the detailed and unnecessary restrictions imposed by these standards. From the outset, IAS 39 was very clearly a rules-based standard drawn up to achieve maximum compatibility with US SFAS 133. In reviewing IAS 32 and 39, it needs to be borne in mind that the purpose of accounting is to give market participants a true and fair view about the economic activity and financial position of an entity. Its function is not to change the way in which a company is managed. These standards, however, will prove intrusive and the rules concerning hedge accounting and internal transactions in particular will produce economically inaccurate information in the financial statements and may force the widespread use of the "true and fair override".

Furthermore, a number of changes to IAS 39, particularly the new requirements on impairment loss provisioning, radically reshape loan accounting in a way that is inconsistent with the principles underlying the standard and is highly impractical. It appears that a new definition of *effective interest method* has been introduced which has no basis in the way in which banks operate their business. The fact that these fundamental changes in measurement were introduced at exposure draft stage without prior consultation with the industry is of particular concern to the Irish banking industry.

Hedge accounting

While few regard IAS 39 as a quality standard, the IASB has taken the view that it is "necessarily complex" as a result of the need to span two measurement bases - amortised cost and fair value. The banking industry, on the other hand, considers that the complexity of the standard results from the decision that all derivatives should be held at fair value, irrespective of whether they are hedging positions that are themselves measured at amortised cost or fair value. The result is a loss of symmetry and an injection of volatility into the balance sheet and profit and loss account that is unrelated to the economic substance of the transactions in question.

We consider that the requirement that all derivatives must be measured at fair value should be reviewed. In Europe, for example, it is banking practice for all derivatives to be on-balance-sheet, but for derivatives hedging positions held at amortised cost to be measured on an equivalent basis, to ensure that the gains and losses on the hedge unfold at the same time as the equal and opposite gains and losses on the hedged item. While we appreciate the Board's desire for market values to be disclosed for liquid instruments, we believe that this should be achieved through disclosure and that the more compelling economic model would be for the hedging instrument to follow the accounting treatment of the hedged item. The underlying position clearly comes first and the hedge seeks to counterbalance an exposure to risk. Hedges in essence involve foregoing possible future profit to insulate against possible future loss. Good accounting determines that the two should be treated symmetrically and economic ally the hedge should follow the hedged item.

At the very least we we would again ask for a review of the detailed and unnecessary restrictions on enterprise-wide risk management given the significant disruption to Asset and Liability Management that would result from the application of the IAS 39 hedging rules. IAS 39 was evidently not written with portfolio risk management in mind and is unsuited to the circumstances of financial institutions engaging in large volumes of financial transactions. Its hedging rules unduly hinder the risk management process and involve banks having to assume increased credit risk, the outcome of which can only be an increase in the cost of capital.

Specific flaws in the hedge accounting rules that have been criticised by the banking industry over the years include:

- The prohibition on internal transactions that effectively result in banks having to increase their exposure to credit risk by increasing the incidence of having to transact with third parties to hedge interest rate exposures.
  The rule that the interest rate element of held-to-maturity assets cannot be hedged.
- The rule that a non-derivative financial asset or liability may only be designated as a hedging instrument in respect of foreign currency risk.
- The prohibition on transfers between the trading book and banking book.
- The restrictions placed on the hedging of anticipated transactions, which differ from the way in which many corporates seek to manage financial risk.
  The rule that a portion of a derivative cannot be designated as a hedge.
- Restrictions on hedge accounting on a portfolio basis is contrary to the sound risk management approach.

The IBF can see no 'in-principle' basis for these restrictions and believes that the hedging rules should instead be drafted around straightforward requirements for designation, documentation and effectiveness. The IBF can see that recognition in equity of gains and losses on derivative hedging instruments may provide a means of avoiding false volatility, but would need to know more about the IASB 's plans under its 'Reporting Financial Performance' project before offering a definitive view. In any event, using equity in this way would not seem grounded in principle and could potentially have repercussions for a bank's capital base.

Provisioning
A number of proposed changes to IAS 39 particularly the new requirements on impairment loss provisioning radically reshape loan accounting. Ina way that is inconsistent with the principle underlying the standard and that is highly impracticable. Also, the definition of the "effective interest method" introduced in the June 2002 Exposure Draft without prior consultation with the industry is unrelated to current banking practice and would create problems for the banking industry of a magnitude that the IASB cannot have appreciated. As drafted it would involve massive change in accounting for core bank products and a significant overhaul of accounting systems.

Scope of IAS 39

- *Credit derivatives*

Paragraph 7 of the Exposure Draft on IAS 39 establishes criteria which contracts to buy or sell a non-financial item should meet to come within the definition of a derivative and, therefore, fall within the scope of the Standard. We believe that credit derivatives that meet these criteria should also be regarded as derivatives and come within the scope of IAS 39.

- *Hedging* of *loan commitments*

Loan commitments which cannot be settled net in cash or by some other financial instrument do not fall within the scope of IAS 39 (paragraph li). This has implications when such a loan commitment is hedged by a derivative. The hedging derivative is within the scope of the Standard while the loan commitment is not. The hedging derivative will in this case be measured at fair value with fluctuations in the profit and loss account as a consequence. We believe that derivatives hedging loan commitments should be excluded from the scope of IAS 39 or alternatively not be measured at fair value.

Fair value option

The fair value option should not be seen as an alternative to addressing the problems inherent in the hedge accounting rules. While we are still working through the potential use of the option, we would initially comment as follows:

- Requiring transfers to be made at fair value would seem more sensible from an economic viewpoint than dictating irrevocable designation.
- As presently drafted, the option could be exercised on an entirely discretionary basis and would permit selective profit-taking.

We are therefore opposed to the introduction of an option on this basis. However, we agree that the option would seem valuable in permitting trading liabilities to be measured at fair value. Therefore, IAS 39 should restrict the scope of the fair value option by presenting it as a rule to be applied to financial instruments specified by the standard itself

Recognition/derecognition

It is our understanding that, the recognition/derecognition rules proposed in IAS 39 are only partially reflective of the rules under consideration by the Board. Therefore, we see little merit in the inclusion at this stage of rules that will invariably change before 2005.

Insurance Contracts

The proposed inclusion of insurance contracts on a basis different from that reflected in the draft Statement of Principles on Insurance, which unless amended will cause considerable implementation difficulties if the changes required by IAS 39 are reversed when the full insurance standard is introduced.

IAS 32 disclosure rules

The existing netting rules in Ireland work well and reflect market practice. However, IAS 32 includes rules on offset that bear no resemblance to the way in which banks settle financial transactions. Unlike present Irish and US requirements, the standard requires “net and simultaneous” settlement and does not recognize master netting agreements. We also believe that the disclosure requirements of IAS 32 may require further work. The disclosures proposed are duplicative, excessively detailed and in some cases unrelated to the management of the business.

Other issues relating to IAS 39

Other aspects of the standard that are open to criticism include:

Strategic investments in equity securities have no fixed maturity date and will therefore be classified as 'available-for-sale' under IAS 39. As a result they will be measured at fair value with gains and losses recognised in the Statement of Changes in Equity during the period. Investments of this nature, however, are usually held for continuing use in the business as part of a longer term strategy. It would therefore be more appropriate for them to be measured at cost less provisions for any permanent impairment in value.

Only loans originated by an enterprise and not held for trading are permitted to be measured at amortised cost 'without regard to the enterprise's intent to hold them to maturity'. While purchased loans can be measured at amortised cost, requiring them to be classified as held-to-maturity precludes their being fully assimilated into the acquirer's mainstream loan book.

Closing **remarks**

We believe that the Exposure Draft on IAS 32 and IAS 39 raises serious issues concerning due process and that the IASB Board needs to be made aware of the significant harm that is being done by the controversy surrounding these standards. We do not consider the benefits of harmonised accounting to outweigh the need to deal with the many problems that the financial instruments standards would create. There is a compelling need for IAS 32 and IAS 39 to be revised substantially and the resulting standards to be exposed for consultation and comment. The time needed for this to be achieved could be obtained if the IASB were to determine that IAS 32 and IAS 39 would be implemented from 2005 solely on a prospective basis, thereby precluding the need for US overseas registrants to produce comparative information for the two preceding years. IBF also fully endorses the BBA proposal that the IASB should as a matter of urgency establish a task force to review the remaining controversial aspects of IAS 32 and IAS 39.