New Zealand Bankers' Association

CL 53

12 July 2004

The Director – Accounting & Professional Standards
Institute of Chartered Accountants
PO Box 11 342
WELLINGTON

Dear Sir / Madam

NEW ZEALAND BANKERS' ASSOCIATION COMMENTS ON EXPOSURE DRAFT ON FAIR VALUE OPTION – IAS 39

We are responding to your invitation to comment on the exposure draft of proposed amendments to IAS 39 in relation to the fair value option (FVO) ('the exposure draft'). The following comments are made on behalf of the following member banks of the New Zealand Bankers' Association, ("NZBA"):

ANZ National Limited
ASB Bank Limited
Bank of New Zealand
Westpac Banking Corporation
Citigroup NA

In response to the discussion documents' specific questions, NZBA have the following comments.

General Comments

NZBA supports the introduction of the fair value option because it simplifies the application of IAS 39 and allows for the use of natural hedges, to reduce volatility in profit and loss on positions that are economically matched.

NZBA considers the proposed amendment adds unnecessary complexity to the classification and measurement of financial assets and liabilities and is contrary to the spirit of previous IASB rulings, which appeared to be moving towards the use of more fair value accounting.

NZBA does not support the restriction of the use of the fair value option or the introduction of a new "verifiable" test for use of fair value and recommend that the IASB reconsider its approach. Our reasons are set out in our responses to the specific questions below.

Specific Matters for Comment

IASB Question 1
Do you agree with the proposals in this Exposure Draft? If not, why not? What changes do you propose and why?

No. NZBA supports the existing broader provisions for the use of fair value. Comments on the specific aspects are set out below.

Valuations
NZBA does not agree that one group of assets and liabilities should necessarily be subject to stronger measurement criteria than others. We consider that the "reliably measured" test for the calculation of fair value contained in the existing standard contains sufficient guidance and control over the valuation methods to be used for all financial assets and liabilities. The measurement of balance sheet items using the "best endeavours" basis uses all relevant market data and making clear the key assumptions used. Introducing a dual standard may produce uncertainties and accounting anomalies.
Review of the development and use of acceptable valuation methodologies for particular circumstances is more properly left to auditors, regulators and national accounting bodies than prescribed in an accounting standard. Also if key valuation assumptions are disclosed to the market, informed users of the financial statements can make their own decisions as to the appropriateness of the valuations.

Volatility in profit and loss
NZBA agrees with the points set out in paragraphs 5 to 8 of the Basis for Conclusions explaining the reasons for first introducing the fair value option, particularly those regarding the use of the fair value option to account for natural hedges as an alternative to hedge accounting. We are concerned that restricting the use of the fair value option will have the effect of reintroducing artificial volatility in cases of natural hedges and partial offsets which will no longer meet the conditions for fair value accounting. We also note that including the term "substantially offset" in the proposed category (iii) makes its application very restrictive because it requires an administrative burden comparable to that under hedge accounting.

Policing and Regulator Concerns
The NZBA believes the accounting rules should be designed for the majority of users, with appropriate "policing" to prevent and remedy any abuse. This will need to be decided on a case-by-case basis.

We believe bank and insurance company supervisors should (and generally do) have sufficient authority to prevent these entities from inappropriately using the fair value option.

Credit Spreads and Disclosure
The IASB has shifted ground by moving to severely restrict what liabilities can be fair valued through P&L. In June 2002, the IASB proposed that the entity only needs to disclose in the notes to the accounts the amount not attributable to changes in benchmark

interest rate risk (primarily to reflect changes in credit spreads). This was to ensure readers of the financial statements could evaluate how much impact a credit downgrade may have on the fair value of an entity's liabilities. We believe that, rather than moving to restrict which liabilities can be fair valued through Profit and Loss, the IASB should return to its previous proposal to require entities to disclose in the notes to the accounts the amounts not attributable to changes in benchmark interest rate risk (primarily to reflect changes in credit spreads). This disclosure should allow informed readers of the financial statements to draw their own conclusions as to how much impact a credit downgrade may have on the fair value of an entity's liabilities
One of the IASB's objectives in restricting the use of the fair value option for financial liabilities was to prevent entities from recognising gains or losses in Profit and Loss for changes in their own credit-worthiness.

We do not agree with IASB's comment that fair value accounting for a fall in the entity's credit standing is counter-intuitive. From an economic perspective it is likely that the decline in an entity's credit-worthiness will be caused by declines in its asset values or rising costs of funding, both of which changes will act to reduce the net market value of the entity. A decrease in the market value of some of its liabilities can be seen as a natural response to this process and a partial cushion to the impact on equity.

<u>Other Arguments in "Alternative Views"</u>
We also wish to re-iterate some of the arguments put by dissenting directors of the IASB -

- there have been no substantive new arguments in favour of tightening the eligibility for the use of the FVO since it was last reconsidered
- the term "substantially offset" in the proposed category 3 requires an initial administrative effort comparable to hedge accounting
- the FVO designation may no longer be appropriate under categories 2 and 3 should circumstances change (eg if an asset is derecognised)
- the proposals will delay finalisation of IAS 39

<u>IASB Question 2</u>
Are you aware of any financial instruments to which entities are applying, or are intending to apply, the fair value option that would not be eligible for the option if it were revised as set out in this Exposure Draft? If so:
(a) Please give details of the instrument(s) and why it (they) would not be eligible.
(b) Is the fair value of the instrument(s) verifiable (see paragraph 48B) and if not, why not?
(c) How would applying the fair value option to the instrument(s) simplify the practical application of IAS 39?

NZBA believes that fair value reporting of assets and liabilities gives the best theoretical picture of an entity's financial position. Financial Institutions should have the flexibility to apply the fair value option to all assets and liabilities, subject to the agreement of their auditors and regulators as to appropriate classifications.

It is possible that NZBA member banks may apply the fair value option to banking products, including certain loan receivables and deposits, which are often managed by a dealing room. Although some bank products e.g. wholesale funding do not in themselves meet the definition of held for trading (because they are not individually bought and sold for short-term profit), they are taken into consideration when reviewing the overall position in the trading book. As such, banks often consider them to be part of the trading book and currently report them at fair value. It is unclear how widely banks will be able to interpret the held for trading definition contained in paragraph 9(a) (ii) i.e. "a portfolio of identified financial instruments that are managed together". To remove uncertainties around the interpretation of what constitutes "held for trading", and for the reasons below, we recommend that the use of fair value reporting for banks' funding not be restricted.

Specific reasons for banks are considering apply the fair value option include;

- There is an expectation that the impact of debt issue credit spreads will usually be relatively small and will be reported separately in any event.
- Internal reporting of dealing room positions, for performance evaluation and risk assessment / compliance, tends to be on a fair value basis. Hence, using the FVO for various wholesale liabilities would lead to a more consistent internal and external reporting regime.
- Bank dealing rooms are typically responsible for wholesale funding, managing liquidity and for external hedging. They normally manage these risk positions on a net / portfolio basis, utilising natural offsets where possible. Using fair value reporting for those "matching" liabilities better reflects this underlying risk management process.

Another reason is under the current fair value hedge accounting rules it is difficult and administratively burdensome to match and track an external hedge against underlying balance sheet items within the required 80% - 125% correlation range. It is possible banks may not adopt fair value hedge accounting because of the onerous systems requirements for banks, but will achieve the same accounting effect by adopting the fair value option: any net hedging ineffectiveness is correctly reported to the Profit and Loss under the fair value option. If, however, under the proposed amendment to the fair value option, an asset (or derivative hedge) is fair valued but the "matching" liability is not (or vice versa), then the Profit and Loss can be distorted and will not reflect economic reality.

The proposed changes to the FVO mean banks need to formally match certain assets, liabilities and derivatives, thereby dramatically increasing compliance costs. Given the dealing model and limit structure that most banks use, they are also likely to fail the proposed "substantially offset" test. Repurchases of issued debt is generally insufficient to allow classification as "traded" items.

NZBA stresses that we are not advocating the compulsory use of fair value reporting of banks' wholesale debt issues. Rather, we point out that there are legitimate reasons why some banks may choose to use the FVO for some liabilities.

IASB Question 3

Do the proposals contained in this Exposure Draft appropriately limit the use of the fair value option so as to address adequately the concerns set out in paragraph BC9. If not, how would you further limit the use of the option and why?

NZBA believes that the latest FVO Exposure Draft has gone too far, particularly in placing unnecessary restrictions on liabilities and on the measurement burden. Corporate and banking regulators should (and in most countries, do) have the power to prevent or clamp down on any abuse of the IFRS rules. Auditors and the national accounting bodies can be expected to come up with guidelines as to what categorisations are acceptable or not, given all the circumstances. We prefer to emphasise effective policing rather than an outright ban, which can throw up its own set of anomalies.

NZBA also believes it is important to clearly disclose to the market the key valuation assumptions underlying the figures. Informed market participants may then make up their own mind as to the appropriateness or otherwise of the valuations.

NZBA does not think that these concerns should be addressed by a rules based standard but rather by effective policing by auditors and regulators as set out in our response to question 1.

IASB Question 4

Paragraph 9(b)(i) proposes that the fair value option could be used for a financial asset or financial liability that contains one or more embedded derivatives, whether or not paragraph 11 of IAS 39 requires the embedded derivative to be separated. The IASB proposes this category for the reasons set out in paragraphs BC6(a) and BC16-BC18 of the Basis for Conclusions on this Exposure Draft. However, the IASB recognises that a substantial number of financial assets and financial liabilities contain embedded derivatives and, accordingly, a substantial number of financial assets and financial liabilities would qualify for the fair value option under this proposal.

Is the proposal in paragraph 9(b)(i) appropriate? If not, should this category be limited to a financial asset or financial liability containing one or more embedded derivatives that paragraph 11 of IAS 39 requires to be separated?

Although we would prefer to continue with the existing fair value option, if the IASB decides to proceed with restrictions to the use of the fair value option we agree with the proposals on this point.

IASB Question 5

NZBA have no comments on this issue.

IASB Question 6
Do you have any other comments on the proposals?

We are concerned that making amendments to the stable platform of standards at this late stage does not give 2005 adopters sufficient time to change their implementation plans.

We also consider that any decision to amend the fair value option should be deferred at least until the outcome of the discussions on further hedge accounting options is known.

FRSB New Zealand Specific Questions

1) *whether the ED The Fair Value Option should contain any additional material to allow public-benefit entities to comply with the proposed requirements;*

NZBA have no comments on this issue.

2) *whether there are any regulatory issues or other issues arising in the New Zealand environment that may affect the implementation of the proposals, particularly any issues relating to:*
   a) public-benefit entities;
   b) public sector profit-oriented entities; and
   c) the Privacy Act 1993; and

NZBA have no comments on this issue.

3) *whether adoption of the proposed amendments, in the IASB's ED The Fair Value Option, to NZ IAS 39 is in the best interests of users of general purpose financial reports in New Zealand*

In general we do not support New Zealand adopting different versions of the IFRS from those issued by the IASB. We note, however, that the Financial Reporting Council of Australia has stated that it will adopt the version of the standards issued by the IASB as at 31 March 2004 i.e. without the current proposed amendments to IAS 39. Given New Zealand's close economic relationship with Australia, it could prove beneficial for New Zealand not to adopt a version of the standards which conflicts with Australian requirements.

We continue to have concerns about the current hedge accounting rules in IAS 39, which are not workable for banks without substantial procedural change. While these rules are still under review by the IASB, it would seem sensible to allow banks (and other entities) to continue to use fair value accounting for assets, liabilities or derivatives where there is a natural fair value offset but that offset is either: not permitted under hedge accounting rules e.g. because it uses a non-derivative; or is not strong or measurable enough to meet the stringent hedge effectiveness tests. In such circumstances use of the fair value option achieves a similar accounting result to fair value hedging but does not require the designation and monitoring of individual hedges and could provide a workable alternative for banks.

If you would like any more information concerning our submission please do not hesitate to contact me.

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New Zealand Bankers Association