Danish Bankers' Association

Finnish Bankers' Association

Norwegian Financial Services Association

Swedish Bankers' Association

POSITION PAPER

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EXPOSURE DRAFT OF PROPOSED AMENDMENTS TO IAS 39 FINANCIAL INSTRUMENTS: RECOGNITION AND MEASUREMENT – THE FAIR VALUE OPTION

The Danish Bankers' Association, the Finnish Bankers' Association, the Norwegian Financial Services Association and the Swedish Bankers' Association (the Associations) welcome the opportunity to comment on the Board's Exposure Draft regarding proposed restrictions to the fair value option. We fully agree with the European Financial Reporting Advisory Groups's (EFRAG's) preliminary views on the Exposure Draft dated May 19. In its draft response to Question 2 EFRAG says that:

"certain financial institutions intend to apply the fair value option to asset and liability positions that offset each other partially in order to reflect economic exposures and reduce accounting volatility. Under the proposed amendments such a designation would become subject to the stringent hedge accounting requirement of "substantial offset". If the IASB were to adopt the proposed amendments, the "substantial offset" requirement should be replaced by "partially offset".

We will in our response elaborate further on this topic and propose an approach which is in line with risk management practice and which considers the concerns of prudential supervisors. The approach is similar to the one that was proposed by the British Bankers' Association in its response to the Exposure Draft of proposed amendments to IAS 32 and IAS 39 dated 24 October 2002.

Summary

The original introduction of the fair value option into IAS 39 was a substantial improvement, since the option could be used to reduce the substantial accounting volatility in banks' financial reporting caused by the mixed measurement approach of the standard. If the option is limited in line with the proposal, especially through the verifiability requirement, key benefits of the option will be lost since the usage of the option will be restricted inappropriately and far beyond what is needed in order to address the concerns raised by some central banks and supervisors.

One of the main activities for a bank is to manage its interest rate risks. For this purpose none of the present hedge accounting alternatives is workable in practice. The option is therefore a prerequisite for our member banks to be able to give a true and fair view of the banking business and in particular the economic performance of banks risk management.

With this letter the Nordic banking industry proposes the following changes to the drafted wording in paragraph 9(b) (iii) of the Exposure Draft (see below), which will make it possible to apply the option to **components of risk**, in cases where the fair value can be verified with reference to publicly quoted rates:

"*Because designation as at fair value through profit and loss is at the entity's election, such designation shall be used only if the fair value of the financial asset or liability to be designated is verifiable (see paragraph 48B).* **Parts of an interest rate might be verifiable. Therefore an entity may, under this option, measure changes in the fair value of financial assets and liabilities by taking account of changes in a publicly quoted reference interest rate, holding the credit risk margin above it constant at the level set at the origination of the asset or liability, and via the impairment test under amortised cost measure the effect of increased credit risk on loans and advances."**

Our proposed adjustment to the fair value option will create an accounting framework, which will enhance the possibilities for an entity to avoid accounting volatility on positions that are economically matched. A components approach also adequately considers all the concerns raised by prudential supervisors and others set out in BC9 of the Exposure Draft. This is because:

a) it is limited to components of risk where the fair value can be verified with reference to publicly quoted rates,
b) it will be used with a view to decrease accounting volatility in profit and loss,
c) entities will not, if they apply the option on their own debt, be forced to fair value their own credit spread and will as a consequence not recognise gains and losses in earnings due to changes in their own creditworthiness.

Further, it is our belief that banks' usage of the option aims at reducing volatility in earnings and equity as presented in the financial statements to reflect the management appetite for interest rate risk. No bank ought to be interested in uncontrollable volatility in earnings. The requirement to designate at fair value at the inception of a transaction prevents any attempt of cherry picking.

Question 1

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

We agree with the preliminary views of EFRAG. Especially we are concerned about the double standard on application of fair value that will arise, if the verifiability requirement is maintained as currently proposed. Some gains and losses will be presented in profit or loss and some will be presented directly in equity depending on whether the item is required to be accounted for at fair value or whether it is permitted to be accounted for at fair value but does not meat the verifiability criteria.

Question 2

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?

In the Exposure Draft there is a requirement in paragraph 9, which says that the fair value of a financial asset or financial liability shall be verifiable. Paragraph 48B stipulates under which circumstances this requirement is met. This paragraph focuses on how a verifiable fair value is achieved for **instruments**. The requirement that the fair value shall be verifiable for instruments will make it impossible for banks to apply paragraph 9 (b) (iii) for loan portfolios other than lending to large international well-known companies where an active market exists. With regard to retail lending and lending to small unrated companies there are no prices available for the basis risk (pricing of the interest rate margin above the interbank interest rate, compared to own funding rate compared to the interbank interest rate). Furthermore since the purpose of the lending transaction is to hold the loan until maturity the basis risk is not of interest, since the effect on earnings already is known.

Examples of transactions where the current wording of the Exposure Draft no longer underpins the use of the fair value option are:

- Time-deposit portfolios with a mixture of interbank, corporate and retail counterparts managed without any or very limited interest rate risk with regard to changes in the interbank interest rate.
- Portfolios of fixed rate assets in different currencies funded by fixed rate liabilities in one or several other currencies economically hedged with cross-currency interest rate swaps and/or single currency interest rate swaps.
- Portfolios of corporate bonds funded by issued debt where the interest rate risk with regard to the interbank reference rate is hedged using interest rate swaps.
- Fully funded mortgage loan portfolios with limited interest rate risk with regard to changes in the interbank interest rates. (Note however that Danish mortgage loans linked to issued bonds still will be eligible for the option)
- All the above examples funded via a treasury centre, which has laid off the interbank interest rate risk externally but funded the different portfolios using internal contracts which are eliminated in the consolidated accounts.

The reasons for this is either that the fair value of the basis risk may not be verifiable and/or that although there is a substantial offset in the interbank interest rate risk there is no offset when it comes to basis risk.

Banks are managing risk with regard to different risk categories and not instruments. For e.g. fixed rate lending, with prepayment conditional on full yield maintenance fees, the best risk management practice is to actively manage the interest rate risk with regard to changes in reference rates. Credit risk is managed separately. The interest rate risk is managed with reference to changes in a publicly quoted interbank interest rate (e.g. LIBOR). It would therefore be possible to meet the requirement regarding a verifiable fair value for that part of the loan. For the credit risk on the other hand it is very difficult to estimate a fair value, since there is no active market for such loans.

The Associations are of the opinion that the use of the option should be aligned with best risk management practice. **Therefore, not only instruments should be eligible for the option but also their different risk components e.g. benchmark interest rate risk.** We believe such an approach to be sound and also foreseen in the cash-flow hedging rules and the macro hedging rules within IAS 39. British Bankers' Association also proposed such an approach in its response to the Exposure Draft of proposed amendments to IAS 32 and IAS 39 dated 24 October 2002.

The Associations propose changes to the proposed text, which will make it possible to apply paragraph 9 (b) (iii) to components of risk, in cases where the fair value can be verified with reference to publicly quoted rates, and not only to instruments. A preferred solution would be to allow entities to estimate the current market interest rate by using a relevant interbank interest rate, holding the credit spread constant and adjusting for the change in the interbank interest rate from the origination date.

If the proposal was rephrased the fair value option could be used for components of risk and for all the other examples listed above. We therefore propose that the wording in the beginning of section three under paragraph 9 should be as follows:

"Because designation as at fair value through profit and loss is at the entity's election, such designation shall be used only if the fair value of the financial asset or liability to be designated is verifiable (see paragraph 48B). **Parts of an interest rate might be verifiable. Therefore an entity may, under this option, measure changes in the fair value of financial assets and liabilities by taking account of changes in the publicly quoted reference interest rate, holding the credit risk margin above it constant, at the level set at the origination of the asset or liability, and via the impairment test under amortised cost measure the effect of increased credit risk on loans and advances."**

Finally, the proposed components approach also adequately considers all the concerns raised by prudential supervisors and others set out in BC9 of the Exposure Draft. This is because:

a) it is limited to components of risk where the fair value can be verified with reference to publicly quoted rates,
b) it will be used with a view to decrease accounting volatility in profit and loss,
c) entities will not, if they apply the option on their own debt, be forced to fair value their own credit spread and will as a consequence not recognise gains and losses in earnings due to changes in their own creditworthiness.

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?

We agree with the preliminary views of EFRAG but would like to add the following:

Three Board members voted against the publication of the Exposure draft. They noted among other things the following:

- Concerns expressed by prudential supervisors were considered by the Board when it finalised IAS 39.
- The Board concluded that these concerns were outweighed by the benefits of simplifying the application of the standard.
- No substantive new arguments have been raised that would cause them to revisit this conclusion.

The Associations agree with the alternative views expressed by these Board members. We are of the opinion that instead of restricting the fair value option it should be improved and developed to be in line with risk management practice. This must be a high priority also to prudential supervisors and central bankers. To our understanding banks will use the option with a view to reduce accounting volatility in earnings. No bank ought to be interested in uncontrollable accounting volatility in earnings or for that sake in the balance sheet. The requirement to designate at fair value at the inception of a transaction prevents any attempt of cherry picking. The concerns of prudential supervisors are therefore from our point of view overstated in this regard.

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 Board 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 Board recognises that 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?

We agree with the preliminary views of EFRAG.

Question 5

Paragraph 103A proposes that an entity that adopts early the December 2003 version of IAS 39 may change the financial assets and financial liabilities designated as at fair value through profit or loss from the beginning of the first period for which it adopts the amendments in this Exposure Draft. It also proposes that in the case of a financial asset or financial liability that was previously designated as at fair value through profit or loss but is no longer so designated:

(a) if the financial asset or financial liability is subsequently measured at cost or amortised cost, its fair value at the beginning of the period for which it ceases to be designated as at fair value through profit or loss is deemed to be its cost or amortised cost.

(b) if the financial asset is subsequently classified as available for sale, any amounts previously recognised in profit or loss shall not be reclassified into the separate component of equity in which gains and losses on available-for-sale assets are recognised.

However, in the case of a financial asset or financial liability that was not previously designated as at fair value through profit or loss, the entity shall restate the financial asset or financial liability using the new designation in the comparative financial statements.

Finally, this paragraph proposes that the entity shall disclose:

(a) for financial assets and financial liabilites newly designated as at fair value through profit or loss, their fair value and the classification and carrying amount in the previous financial statements.

(b) for financial assets and financial liabilites no longer designated as at fair value through profit or loss, their fair value and the classification and carrying amount in the current financial statements.

Are the proposed transitional requirements appropriate? If not, what changes do you propose and why? Specifically, should all changes to the measurement basis of a financial asset or financial liability that result from adopting the amendments proposed in this Exposure Draft be applied retrospectively by restating the comparative financial statements?

We agree with the preliminary views of EFRAG.

Question 6

Do you have any other comments on the proposals?

The proposed paragraph 9 part (b) leaves uncertainty about whether an equity instrument that does not have a quoted price in an active market also is subject to the verifiability requirement. If these instruments are subject to the verifiability requirement it seems unnecessary to mention the reliability requirement. In this case the reliability requirement should be moved to paragraph 9 part (a) concerning items classified as held for trading. If, however, equity instruments which do not have a quoted price in an active market are not subject to the verifiability requirement it could be mentioned more clearly in paragraph 9(b).

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