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Group Finance

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<Comments to ED IAS 39 – Fair Value Option>

Dear Mrs. Thompson,

We have put together our comments on question 1 to question 6 in one comment because, from our point of view, the answers are dependent so much on the underlying weaknesses of the whole exposure draft:

We disagree with the proposals in this exposure draft for the following reasons:

1. As a matter of fact one of the underlying principles of IFRSs, substance over form, has been put out of operation within IAS 39: derivative financial instruments always have to be shown at their fair values in the balance sheet with the ongoing valuation differences in the income statement, whatever the reasons for which an entity has become a party to the contract, whereas other financial instruments have to be shown in different ways, regarding their use (mixed measurement model). Especially for banks using derivatives as hedging instruments - from the economic point of view - this was not only painful and led to increasing volatility; this regulation also makes it impossible for users to find the economic truth in the financial reporting of a bank.

2. As IASB became aware of this problem, and under strong international pressure, it allowed hedge accounting under severe restrictions (efficiency tests, backtesting, burdensome documentation). But still this was not an appropriate method of showing banking business in the way banks manage their risks.

3. This unsatisfactory situation should be resolved partly by improving the existing IAS 39 with the December 2003 revision of IAS 32 and IAS 39, allowing financial instruments to be valued at their fair values with changes in value being shown in the income statement, if the entity irrevocably at inception designates an asset or a liability in this category. Although this would result in assets and liabilities being shown in the same way as corresponding derivatives, at first sight, this could not solve an underlying problem: using the fair value means to take into account all factors which influence the fair value, for liabilities especially the credit spread of the issuer. As derivatives generally only take into account a specific risk, e.g. the interest rate risk, the use of this option would lead to unplanned volatility in the income statement. As long as the change in the fair value of a financial asset or a financial liability is not restricted to the corresponding change in the value of the derivative, this new option will not reduce volatility in the income statement.

4. In April 2004, this fair value option was improved by an exposure draft which brought new

problems:

- In the definitions, all financial assets or financial liabilities that meet "one of the following conditions" can be used for designation to this category. One of these conditions says that a financial asset which meets the definition of loans and receivables is excluded from this option. Is a loan excluded if it meets one of the other four conditions, or is it not?
- One of the conditions states that this designation can be made if the exposure to changes in the fair value of the financial asset or the financial liability (or portfolio of financial assets or financial liabilities) is substantially offset by the changes in the fair value of another financial asset or another financial liability (or portfolio of financial assets or financial liabilities), including a derivative (or portfolio of derivatives)." How should this "substantially offset" be checked? From our point of view, this regulation need not lead to new efficiency testing or backtesting as we know from hedge accounting, because otherwise the whole new regulation is senseless.

So for the reasons stated above, especially point 3, we do not see a great step forward to reaching the goal of showing the way in which banks manage their risks in the IFRS financial statements. For the reasons stated in point 4 we see the new regulation as too unclear to be a stable platform, ensuring that the same business is shown in the same way following IFRS rules.

Moreover, what we really cannot understand and accept is the last sentence in the revised Paragraph 9, which states that "the powers of the relevant prudential supervisor may include oversight of the application of these requirements and of relevant risk management systems and policies." We can understand that the relevant supervisor may be empowered by the local legal authority to oversee sound banking practices in management aspects. But this broad formulation would – from our point of view – not only give the prudential supervisor the right to check the bank management and control systems in this way – a right which IFRS cannot give to a local supervisor -, but could be interpreted as the acceptance by IASB that the local prudential supervisor can reduce the applicable treatments of IFRS in entities which are subject to supervision, in other words, is a local co-standard setter for the application of IFRS: The effect would be that the local prudential supervisor would determine whether an entity under his supervision may use this option or not, on the one hand, and would lead to internationally different applicable IFRS, on the other hand. This would be a total turnaround from the situation as it is now, where only the IASB is standard setter for IFRS and the entity has the right to choose among the allowed treatments, how they would fit best to existing management practices and information needs of the users of the IFRS reports. We cannot believe that the IASB really intends internationally applicable IFRS to be reduced by local prudential supervisors. We see a great problem for a single level playing field on the one hand, and the danger of additional reporting burdens, especially for international groups with different local prudential supervisors, where different allowed alternative treatments would lead to a great burden for reporting, leading to different reporting packages, depending on the local supervisory authority`s different decisions.

Best regards,

E. Heiss R. Nessmann