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5 July 2004

The Director – Accounting & Professional Standards
Institute of Chartered Accountants
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WELLINGTON
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Dear Sir/Madam

Comments on IASB Exposure Draft of Proposed Amendments to IAS 39 Financial Instruments: Recognition and Measurement *The Fair Value Option*

The following submission on the proposed amendments to IAS 39 is on behalf of ASB Bank Limited.

General Comments

We supported 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.

We consider that 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.

We do 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. We support the existing broader provisions for the use of fair value. Comments on the specific objectives listed in paragraph 3 of the background to the amendment are set out below.

<u>Valuations</u>

We do 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. 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

We agree 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.

Credit Spreads and Disclosure

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.

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.

IASB 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?

We believe 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.

We are intending to apply the fair value option to banking products, including certain loan receivables and deposits, which are managed by the dealing room. Although some of the 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, we consider them to be part of the trading book and currently report them at fair value. It is unclear how widely we 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.

ASB Bank's dealing room, like that of most other banks, is responsible for wholesale funding, managing liquidity and certain investment assets, and for external hedging. Risk positions are managed on a net or portfolio basis, utilising natural offsets where possible. Using fair value reporting better reflects this underlying risk management process.

Internal reporting of dealing room positions, for performance evaluation, risk assessment and compliance is also prepared on a fair value basis. Using the fair value option for financial assets and liabilities managed by the dealing room will enable us to continue to report results on a consistent basis for both internal and external reporting.

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. We are unlikely to 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.

We are also considering using the fair value option to account for fixed rate loans, for reasons similar to those noted above and in the absence of hedge accounting rules which reflect the way in which most banks manage the interest rate risk on their fixed rate portfolio.

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?

We do 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, f 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

IASB question 5 addresses transitional provisions for entities that have already adopted IAS 39 and, as such, is not relevant to ASB Bank Limited.

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;*

We 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

We 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.

Yours faithfully

Annis O'Brien
Manager Technical Accounting
ASB Bank Limited

Unless otherwise specified, IFRS refer to International Accounting Standards (IAS) (inherited by the IASB from its predecessor body), IFRS, and the interpretations of both types of standards.

[2] Refer to the Discussion Document by the Ministry of Economic Development "Review of the Financial Reporting Act 1993 Part I: The Financial Reporting Structure", March 2004, www.med@govt.nz for a discussion of the proposed financial reporting structure.

[3] The ASRB and the FRSB have agreed that New Zealand standards should continue to apply to both profit oriented and public benefit entities. However, Standards and Interpretations issued by the IASB have been developed for application by profit-oriented entities. As a consequence, the FRSB intends, where necessary, to introduce additional material to the international accounting standards and IFRIC Interpretations to ensure that they can be applied in the New Zealand environment by all reporting entities.