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**ED Proposed Amendments to IAS 39 Financial Instruments:
Recognition and Measurement – The Fair Value Option**

Introduction

The Irish Bankers' Federation welcomes the opportunity to comment on the Boards exposure draft on the fair value option. We also welcome the continuing and constructive dialogue that is taking place with the industry through the Federation Bancaire De L'Union Europeenne ('FBE') in relation to IAS 39. We strongly urge all parties to focus on these discussions so that a realistic timetable can be agreed for the resolution of the issues with the standard. We also fully support the FBE response to this consultation on the Fair Value option. Notwithstanding that, we set out our views on the questions posed in the current exposure draft below.

Comments on specific questions

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

The Irish Bankers Federation is aware of the concerns that have been raised by banking regulators over the option which allows entities to designate any asset or liability at fair value.

While we are sympathetic to the banking regulators' concerns and, particularly, their concern about any IASB medium term strategy aiming at extending fair value measurement to all financial instruments, accounting rules cannot be driven by the requirements of regulators. There are many areas where accounting and regulatory treatment diverge and regulators have mechanisms at their disposal to apply their own rules where appropriate. This should in no way influence the correct accounting for transactions. The industry's concerns in relation to fair value accounting are well known. However, based on where we now are with IAS 39, the option provides a degree of flexibility which enables entities to overcome some of the issues with IAS 39 which we have raised on many occasions. In particular, it may help to alleviate volatility resulting from the hedging rules in the standard.

One of the core activities of any bank is to manage its interest rate risk. IAS 39 does not currently accommodate this basic function. The option is therefore a prerequisite for banks to be able to give a true and fair view of the banking business and in particular the economic performance of banks underlying risk management. The proposed restrictions to the fair value option would take flexibility away from the banks and remove the simplifications which the option was expected to bring.

We also disagree with the assertion that the fair value measurement of any financial asset or liability would result in an increased volatility in earnings and unreliable financial reporting. In fact, the current mixed model approach is what generates this volatility and permitting entities the ability to consistently measure matched asset and liability positions will greatly reduce this volatility.

We agree that maintaining the present fair value option may not be a perfect solution. However, pending the resolution of the current issues with IAS 39, it is the most practical solution available at this point.

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?

Fair Value Measurement of Risk Components
Entities should be allowed to apply the option to components of risk (provided the fair value can be verified). Parts of an interest rate might indeed be verifiable. Normally this will in practice be applied by measuring changes in the fair value of financial assets and liabilities by taking account of changes in publicly quoted reference interest rates, holding the credit risk margin above it constant at the level set at the origination of the asset or liability.

Retail Loans and Loans to SME's
The proposed requirement in paragraph 9 according to which the fair value of a financial asset or financial liability shall be verifiable, is likely to severely restrict the use that can be made of the fair value option. The requirement will be easily met where loans to large, international well known companies are concerned because active markets exist concerning such loans. However, the proposed requirement will make it impossible for banks to make use of the fair value option in respect of other loans and, more particularly, retail loans as well as loans provided to small unrated companies since there are no prices available for the basis risk. (Basis risk defined as pricing of the interest rate margin above the interbank interest rate, compared to own funding rate compared to the interbank interest rate). This is due to the fact that banks assess the pricing of such single transactions on an individual basis against the background of the banks' entire business relation with the customer and his negotiation power. Concerning the pricing of such loans many other factors than the credit risk exposure is taken into account.
Other Examples

Examples of other 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. The reason being that it might be hard to apply both the criteria of verifiable prices and the substantial offset rule.
- 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. Same reason as in the previous paragraph.
- 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. Same reason as in the previous paragraph.
- Fully funded mortgage loan portfolios with limited interest rate risk with regard to changes in the interbank interest rates.
- All the above examples funded via a treasury centre, which has laid off the interbank interest rate risk externally but has funded the different portfolio using internal contracts which are eliminated in the consolidated accounts.

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 are in favour of maintaining the original fair value option and, therefore, do not believe that the use of the fair value option should be restricted beyond what is being proposed.

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 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?

We do not believe that this category should be limited.

QUESTION 5 Transition requirements
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 liabilities 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 liabilities 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 these 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 oppose any retrospective application.

QUESTION 6
Do you have any other comments on the proposals?
The proposals as they stand severely dilute the practical usefulness of the option. In particular we are concerned about the following

- the introduction of a paragraph requiring that changes in the fair value of the assets or liabilities be <u>substantially offset</u> by the item used to hedge. This essentially introduces another effectiveness test.
- The option imposes a requirement on entities to consider their own credit spreads in determining fair value of their own debts. This is of serious concern to the IBF as it is likely to lead to increased volatility.

<u>Conclusion</u>
We welcome the opportunity to comment on the exposure draft. We have serious concerns about the implications of the proposed changes which we feel will be echoed by many other respondents. We strongly urge you to consider these issues and to ensure that the opportunity to give some flexibility to overcome the recognised problems within the standard is not lost.

Yours sincerely

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