EUROPEAN SAVINGS BANKS GROUP
GROUPEMENT EUROPEEN DES CAISSES D'EPARGNE
EUROPÄISCHE SPARKASSENVEREINIGUNG

Ms Sandra Thompson
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30 Cannon Street
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CPE (0633/04)

Brussels, 20 July 2004

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

Dear Ms Thompson,

The ESBG welcomes the opportunity to provide the IASB with its views on IASB's Exposure Draft of proposed amendments to IAS 39 *Financial Instruments: Recognition and Measurement* issued on 21 April 2004.

Question 1

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

Generally, the ESBG does not agree with the proposed amendments in this Exposure Draft as the ESBG believes that they do not meet the rationale explained in BC9. The ESBG therefore supports the opinions expressed by three Board members in alternative views AV2 and AV3 as listed below:

AV2: "First, these Board members note that the concerns expressed by prudential supervisors were considered by the Board when it finalised IAS 39. At that time the Board concluded that these concerns were outweighed by the benefits, in terms of simplifying the practical application of IAS 39, that result from allowing the fair value option to be used for any financial asset or financial liability. In the view of these Board members, no substantive new arguments have been raised that would cause them to revisit this conclusion."

AV3: "...... They believe that the Exposure Draft introduces a series of complex rules with consequential costs to preparers of financial statements, in order to obtain substantially the same result as the much simpler and more easily understood fair value option that was included in the December 2003 version of IAS 39."

The changes proposed by the ESBG will be described in line with the answers to the following questions posed by the IASB. Additionally, the ESBG would like to express its concerns regarding the introduction of the verifiability notion and the possible creation of double standards.

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?*

Paragraph 9 of the Exposure Draft limits the application of the fair value option to specific categories of financial instruments. Category (ii), which deals with financial liabilities whose cash flows are contractually linked to the performance of assets that are measured at fair value, and category (iii), which deals with the exposure to changes in the fair value of the financial asset or financial liability, which has to be substantially offset by the exposure to the changes in the fair value of another financial asset or financial liability including a derivative, are linked to the following further conditions:

- The designation of a financial asset or financial liability as at fair value through profit or loss requires the identification of the offsetting exposure.
- If either the financial asset or the financial liability is to be designated as at fair value through profit or loss, the identified related financial liability or financial asset shall also be measured at fair value through profit or loss, either by designation or by classification as held for trading.
- However, such designation is only possible if the fair value of the financial asset or financial liability to be designated is verifiable according to the provisions of paragraph 48B.

Referring to Question 2a) - 2c), the ESBG would like to provide the following answers:

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 when lending to large internationally active well-known companies where an active market exists.

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

- 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.
- All the above examples funded via a treasury centre, which has laid off the interbank interest rate risk externally but funded the different portfolio using internal contracts, which are eliminated in the consolidated accounts.

With regards to retail lending and lending to small unrated companies there are no prices available for the basis risk. Furthermore, since the purpose of the lending transaction is to hold the loan until maturity, the basis risk is of no interest, since the effects on earnings are already known.

ESBG Members pointed out that banks are managing risk with regard to different **risk categories** and not **instruments**. Therefore, the drafted amendments misjudge the use of the fair value option in so far as the rules are only drafted for financial instruments. The fair value option should therefore be revised considering the fact that not only instruments should be eligible for the option but also its different risk components e.g. benchmark interest rate risk. In this respect the ESBG would like to support the view expressed by the British Bankers' Association in their comment letter to the IASB on 24 October 2002:

"Page 9 regarding Para 17A: Fair value option

Given the complexity of the rules-based hedge accounting measures, we support the introduction of the fair value option. However, the option needs to be on a components basis in that it should be possible to isolate and fair value a particular risk – e.g. interest rate risk.

Following on from the components approach above, own credit risk should be specifically excluded from risks where the fair value option is allowed.

There should be a requirement for the option to be applied in a structured and logical fashion. This should involve management identifying within its accounting policies the components and circumstances for which it believes fair value to be the more relevant measurement basis. The reasons for exercising the option should be explained.

This would help guard against cherry picking or systematic profit manipulation made possible by asymmetrical accounting for matched economic positions, e.g. by buying fixed rate assets – classified as available for sale – and funding with fixed rate liabilities measured at fair value under the option."

The ESBG would therefore like to make the following proposal in order to simplify the practical application of the fair value option of IAS 39 allowing that the fair value option could be used for components of risk and for all other examples listed above:

Change of the wording of paragraph 9 (*as proposed in the Exposure Draft*):

Because designation as at fair value through profit and loss is at the entity's discretion, 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 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.*

This revision of paragraph 9 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.

Furthermore, the ESBG would like to point out that 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 decreasing volatility in profit and loss,
c) entities will not need to value their own credit spread at fair value and will as a consequence not recognise gains and losses in earnings due to changes in the entities' 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 as set out in paragraph BC9? If not, how would you further limit the use of the option and why?

The ESBG does not believe that the concerns set out in paragraph BC9 are addressed adequately by the Exposure Draft. Instead of limiting the option as proposed by the Exposure Draft, the fair value option in its December 2003 version should be developed and improved.

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 a financial liability containing one or more embedded derivatives that paragraph 11 of IAS 39 requires to be separated?

The ESBG supports the current fair value option because it eases the application of IAS 39 and allows the reduction of accounting volatility and the ESBG believes therefore that no limitations as proposed in question 4 are required.

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 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?

The ESBG supports the pragmatic approach as regards the transitional requirements – i.e. no retrospective application.

Question 6

Do you have any other comments on the proposals?

Regarding the reference to prudential supervisors and other regulators, the ESBG thinks that it is important to point out that this could lead to the wrong conclusion that they do have the authority to amend or overrule IFRS.

On behalf of the ESBG, I would be happy to discuss the above-mentioned issues with you as you may wish.

Yours sincerely,

Chris DE NOOSE
Chairman of the Management Committee