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By e-mail to: CommentLetters@iasb.org.uk

Dear Ms Thompson

Australian Bankers' Association Comments on Exposure Draft on Fair Value Option

The Australian Bankers' Association ("the ABA") is the national organisation representing all licensed banking institutions in Australia, including all of the major retail banks. We are responding to your invitation to comment on the exposure draft of proposed amendments to IAS 39 Financial Instruments: Recognition and Measurement ("IAS 39") in relation to the fair value option, as detailed on your website at http://www.iasb.org/uploaded_files/documents/8_38_ed-ias39fv.pdf ('the Exposure Draft').

The ABA support the full retention of the Fair Value Option (FVO") as originally proposed in IAS 39.

Background

In April 2004, the IASB published the Exposure Draft to IAS 39 regarding the FVO. The revisions were flagged in Board minutes from January and February this year. Previously, entities could account for quite a broad range of financial assets and liabilities using the FVO, with changes in the valuation going through Profit and Loss ("P&L") and to the balance sheet item itself. The IASB now wish to restrict what items can be accounted for in this way due to concerns from some regulators over:

- whether the items can be accurately measured;

- the FVO may be applied selectively to one part of a matched position, leading to increased P&L volatility and "cherry-picking"; and
- a downgrade in the entity's credit standing may see a reduction in the recorded value of issued liabilities and a rise in profits if applying the FVO to those instruments, which is counter-intuitive.

The new restrictions limit the application of the fair value option to four categories:

1. financial assets or liabilities containing embedded derivatives (where measuring each component separately may be difficult in practice);
2. financial liabilities where the cashflows are contractually linked to assets that are fair valued;
3. financial assets, liabilities and derivatives where the revaluation "substantially offsets" each other; and
4. any financial asset other than a loan or receivable.

In addition, the fair value must be "verifiable", not just "reliably measured".

ABA Comments

<u>Question 1</u> – Do you agree with the Proposals in this Exposure Draft? If not, why not? What changes do you propose and why?

The ABA does not agree with the latest proposals. A summary of our reasons is set out below. We note that the main impact of the latest proposals is to severely restrict the use of the FVO on some instruments. This is discussed more fully in our response to Question 2.

<u>Valuations</u>

We do not agree that one group of assets or liabilities should necessarily be subject to a stronger measurement discipline than others. This view was also expressed by a number of IASB (Board) members, who wrote dissenting opinions. As a matter of principle, we also note that in the Board's revenue recognition project the Board tentatively decided that the reliability threshold for estimates affecting revenue recognition should be <u>the same</u> as for estimates affecting other elements of financial statements. The ABA believes all financial statement items should be measured on a "best endeavours" basis using all relevant market data and making clear the key assumptions used. These key assumptions are to be disclosed within the financial report, as required by IAS 32 Financial Instrument: Disclosure and Measurement ("IAS 32"). Any valuation methodology should stand up to auditor, market and regulator scrutiny.

<u>Credit Spreads & Disclosure</u>

The IASB has shifted ground by moving to severely restrict what instruments, and in particular liabilities, can be fair valued through P&L. In June 2002, the IASB proposed that the entity only needs to disclose in the notes to the accounts the amount not attributable to changes in benchmark interest rate risk (primarily to reflect changes in credit spreads). This was to ensure readers of the financial statements could evaluate how much impact a credit downgrade may have on the fair value of an entity's liabilities. The ABA maintains that this simple reporting measure should be sufficient to allow key stakeholders to draw their own informed conclusions.

Under Fair Value accounting, a lower credit standing results in a lower market value of an entity's liabilities and a corresponding increase in the value of equity (other things being equal).). It also results in a higher effective interest rate going forward, which is representative of the fact that a lower credit rating increases cost of funds. As with all assets and liabilities measured at fair value, changes in the market value are taken through the P&L (as well as reflected in the value of the balance sheet item itself).

From an economic perspective, it is likely that the decline in the entity's credit worthiness will be caused by declines in its asset values, rising costs of funding or other factors that have been assessed to negatively impact financial position and/or performance. Both will act to reduce the net market value of the entity. However, 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.

Policing and Regulator Concerns

The ABA believes the accounting rules should be designed for the majority of users and based on principles, with appropriate "policing" to prevent and remedy any abuse. This will need to be decided on a case-by-case basis.

We believe bank and insurance company supervisors should (and generally do) have sufficient authorities to prevent these entities from inappropriately using the FVO.

We are also concerned that the due process of the IASB is being politically influenced to alter decisions previously made. For the IASB to react to these influences undermines their credibility as an independent standard-setter.

Arguments in "Basis for Conclusions"

We concur with the arguments provided in the Basis for Conclusions in paragraphs 5 to 8. These provide a compelling summary of the case for using the FVO. These include:

- ease and accuracy of measuring an instrument in its entirety, rather than decomposing it into component parts – particularly for items with multiple embedded options;
- partial offsets to other assets, liabilities or derivatives which are fair valued but where the offset may not be strong (or measurable) enough to pass the stringent hedge effectiveness rules;
- restrictions on non-derivative items as formal hedges of other balance sheet items in IAS 39; and
- less administration by using the FVO methodology compared to hedge accounting.

Other Arguments in "Alternative Views"

We also wish to re-iterate some of the arguments put forward by dissenting directors of the IASB to the Exposure Draft, with which we concur:

- there have been no substantive new arguments in favour of tightening the eligibility for the use of the FVO since it was last reconsidered;
- the latest changes merely introduce a complex set of rules with little practical effect (other than, we note, on liabilities);
- the term "substantially offset" in the proposed category 3 requires an initial administrative effort comparable to hedge accounting; and
- the proposals will delay finalisation of IAS 39.

***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?***

Banking products

a) Wholesale liabilities

A number of banks are currently considering marking to market parts of their wholesale funding book, as allowed under the previous version of the FVO.

Bank dealing rooms are typically responsible for wholesale funding, managing liquidity and for external hedging. They normally manage these risk positions on a net / portfolio basis, utilising natural offsets where possible. Using fair value reporting for those liabilities that are used to fund and manage the interest rate risk of linked / matched assets better reflects this underlying risk management process. We also note that any net difference in the changes in fair value of assets, liabilities and derivatives is reported to P&L under the existing FVO. However, under the latest FVO proposals, these liabilities are likely to be recorded at amortised cost, which may create a distortion to the P&L.

Internal bank reporting of dealing room positions, for performance evaluation and risk assessment / compliance, also tends to be on a fair value basis. Hence, using the FVO for various wholesale liabilities would lead to a more consistent internal and external reporting regime.

Most banks are unlikely to be able to prove that the wholesale liability book “substantially offsets” the risk of wholesale assets under management. The ABA freely acknowledges that, in most cases, the correlation will regularly be outside any reasonable estimate for the “substantially offset” test. However, we believe that so long as there is some natural offset and they are managed under a comprehensive and consistent measurement , limit structure and risk management regime then the use of the FVO is appropriate.

Compared to hedge accounting, the original FVO offers the prospect of substantially reduced compliance costs. However, the proposed changes to the FVO mean banks need to formally match certain assets, liabilities and derivatives and undertake effectiveness testing. This has the efecct of incorporating the more difficult and onerous aspects of the hedge accounting requirements, which will erode any cost savings.

The ABA point out that repurchases of issued bank debt is generally insufficient in volume, regularity and intent to allow classification of these liabilities as “traded” items. Therefore, without the FVO the liability would otherwise be required to be measured at cost under IAS 39.

We note that hedge accounting may not be workable for wholesale liabilities due to the sheer volume of deals involved. Similarly, the degree of expected correlation between the hedged liability and the derivative can regularly be outside the 80% / 125% range required for hedge effectiveness testing. Hence, banks may not even be able to obtain hedge accounting and will be reliant on using the existing FVO.

In the vast majority of cases, the impact on the fair value of liabilities of changes in issuer credit spreads will usually be relatively small. We note that under the existing FVO, they are to be reported separately in any event.

The ABA stresses that we are not advocating the compulsory use of fair value reporting of banks' wholesale debt issues. Rather, we point out that there are legitimate reasons why some banks may choose to use the FVO for some liabilities and the importance of maintaining the FVO.

b) Wholesale loans

Some Australian banks are also considering designating parts of their corporate loan book to be measured at fair value through profit or loss. These loans would be linked to a portfolio of credit derivatives, which will be fair valued. The banks' aim is achieve comparable accounting treatment.

However, the latest FVO proposals appear to preclude this treatment. Typically, there is no contractual link between the corporate loans and the credit derivative. Even the "substantially offset" test is unlikely to be consistently met in practice.

The ABA urges that financial institutions have the flexibility to use the FVO on <u>all</u> financial assets and liabilities – subject to their auditor and regulator being able to veto inappropriate classifications. (See response to Question 3 below).

<u>Non-banking financial products</u>

Under revisions to the Standards, "investment products" are to be separated from "insurance products". The former will be treated under IAS 39 and the latter under IAS 4 Insurance Contracts.

In Australia (and other countries), it is quite common for consumers to sign up for products which combine aspects of an investment product with insurance (commonly life-related). Indeed, they comprise a significant overall portion of most insurers' books.

We are fearful that the proposed restrictions on the FVO will create anomalies in the reported equity of these funds.

We also note that under the Australian revised AASB 1038 Life Insurance Business ("AASB 1038"), assets and liabilities in "investment contracts" are to be fair valued. The ABA would see it as a step backwards if IAS 39 prevented use of fair value accounting.

An example of a product which we believe would not be eligible for FVO treatment is term-certain annuities. These have no insurance element, so would be classified as investment contracts for the purpose of IAS 39. If they do not have an embedded derivative, they would fail the first category. They fail the second category because the liabilities are not contractually linked to the performance of any specific pool of assets. They are likely to fail the third category because the liabilities are fixed dollar amount and do not necessarily "substantially offset" a financial asset or derivative. As they are not financial assets, these annuity liabilities would fail the fourth category. The only reason the liabilities may be fair valued is if AASB 1038 requires it. However, we would prefer that IAS 39 properly cater for investment contracts.

Further, where term certain annuities are backed by assets which are not traded in the market and whose value are difficult to obtain or ascertain (such as mortgages or Collateralised Debt Obligations, etc), the liabilities might be fair valued per AASB 1038. However, the assets may fail the "verifiable" test, in which case a P&L mismatch would exist.

<u>Question 3</u> – 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 BC9? If not, how would you further limit the use of the option and why?

The ABA believes that the Exposure Draft has gone too far, particularly in placing unnecessary restrictions on the measurement burden. We have demonstrated that it may create accounting anomalies, especially in the reported P&L.

Corporate and banking regulators should (and in most countries, do) have the power to prevent or clamp down on any abuse of the IFRS rules. Auditors and the national accounting bodies can be expected to come up with guidelines as to what categorisations are acceptable or not, given all the circumstances. We prefer to emphasise effective policing rather than an outright ban, which can throw up its own set of anomalies.

The ABA also believes it is important to clearly disclose to the market the key valuation assumptions underlying the figures. Informed market participants may then make up their own mind as to the appropriateness or otherwise of the valuations.

<u>Question 4</u> – Paragraph 9(b)(i) proposes that the fair value option could be used for a financial asset or 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 of this Exposure Draft. However, the Board recognises that a substantial number of financial assets and financial liabilities contain embedded derivatives and, accordingly, a substantial amount 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, how 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?

The ABA supports the IASB position on this point, for the reasons outlined in the Exposure Draft.

<u>Question 5</u> – 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 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 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 not previously recognised in profit or loss shall not be reclassified into the separate component of equity in which gains and losses on available-for-dale 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 the Exposure Draft be applied retrospectively by restating the comparative financial statements?

The ABA does not support the blanket and complete restatement of prior period financial statements based on the current period classifications and concurs with the proposed transitional requirements. However, at a minimum, it would be necessary for a bank to provide a detailed reconciliation of the changes to impacted items in its notes to the accounts. Our preferred position is to leave this choice of the extent of the disclosure to the entity to decide.

The ABA recognises that it is important to disclose the impact of any change in how assets and/or liabilities are categorised. This is particularly important where the changes could impact volatility of reported profits or equity levels. We also note that there may be a number of such changes, including potential offsets from related liabilities / assets and the reporting of hedging strategies. Key stakeholders need to understand the changes, both in isolation and as a package.

***Question 6* – Do you have any other comments on the proposals?**

The Financial Reporting Council of Australia / Australian Accounting Standards Board ("AASB") has stated that it will adopt the version of the standards issued by the IASB as at 31 March 2004. This version of IAS 39 does not contain the current proposed amendments for the FVO. The AASB proposes to allow Australian companies to delay IFRS amendments made after 31 March 2004 until 1 January 2006. The ABA supports the AASB stance on this matter to expedite IFRS implementation.

However, to the extent that the rest of the world may be using a different set of standards, Australian companies will not be fully IFRS-compliant. This can be a material problem for banks with substantial overseas funding programmes and US SEC foreign registrants that are required to be fully IFRS-compliant from the first period of reporting under IFRS. To the extent that the latest FVO proposals do not go ahead, then one potential difference between the "Australian version" of the standards and those of the IASB will disappear. The retraction of the changes proposed in this Exposure Draft would therefore assist transition for Australian banks, particularly those that are US SEC foreign registrants.

In conclusion, limiting the application of the FVO creates unnecessary complexity and the need for additional compliance procedures to satisfy the proposed amendments. Many of the significant benefits introduced with the FVO originally are reduced by the Exposure Draft. Benefits such as lower levels of documentation and compliance processes and the alignment of accounting and risk management practices are eroded with the proposed changes. Whilst we acknowledge the reasoning for the introduction of these changes as outlined in the Background to the Exposure Draft, we are not of the view that the issues are sufficient to warrant the amendment of IAS 39. We believe the issues raised are adequately addressed through other factors, as outlined within our response.

We thank you for the opportunity to respond to the exposure draft, and hope that you find our feedback helpful and constructive. Please do not hesitate to contact me if you would like to discuss our members' views in more detail.

Yours sincerely

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