7 July 2004

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Senior Project Manager
International Accounting Standards Board

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Dear Madam

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

The Banking Council South Africa appreciates the opportunity to comment on the Exposure Draft on the proposed amendments to IAS 39 Financial Instruments: Recognition and measurement (The fair value option). The main concern of South African banks is that one of the prime objectives of the exposure draft, to reduce volatility created by the fair value option in IAS 39, will not be achieved. Indeed, we believe that volatility would be further increased by limiting the fair value option.

As South African banks have already adopted IAS39 in the form of South African Standard AC133, the Banking Council has been able to poll member banks as to the materiality of financial instruments where the value thereof is determined by derived formulae or other techniques. The results of this poll show that, on average 7% of South African banks' financial assets are valued by derived formulae and not direct market rates. At face value it appears that this percentage may not be that material, but individual banks ranged from a low of 1% to a high of 13%. The Banking Council therefore believes that the volatility factor will be material if the proposed amendments are adopted.

The Banking Council would also like to draw your attention to the fact that the thinness of the market in listed or quoted instruments in South Africa and other developing markets will result in a higher proportion of financial instruments being excluded from the fair value option, even though banks, in their risk management processes will use such instruments for hedging and trading. This exclusion factor will result in valuation volatility, even where there is no economic volatility.

With reference to the six questions posed by the Board we would like to respond as follows:

<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?

Banks do not agree with the proposals to limit the fair value option. The following further matters also require clarification:

(a) Trading assets' fair values are not always externally verifiable, as many of them are unlisted. The statement does not limit the use of valuation techniques for these instruments that could potentially be more complex to value. However, there should be consistency in valuation methodology between trading and hedging assets.

The revised requirement may introduce volatility and not reduce volatility. South African banks typically hold large portfolios of non-originated financial instruments for both economic, as well a regulatory needs. From a funding perspective, small value, large volume deposits from clients may be used to purchase these assets. For a financial institution to contractually match this funding to the underlying assets may not be practical. Also, in order that the fair value adjustments of the funding "substantially offset" those of the assets, they would need to have a similar duration. This places onerous effectiveness test obligations on the entity that may be difficult to meet. This will result in increased volatility if the fair value option cannot be exercised.

(b) Profit or losses on an entity's own creditworthiness is unavoidable where a fair value model is applied. The limitations on the fair value application on liabilities will introduce volatility. The solution, in our view is not to limit the application, but to require disclosure of the impact of fair value changes of liabilities on the income statement.

(c) The term "substantially offset", mentioned in condition (iii), paragraph 9, is not clearly defined and banks are concerned that this term could give rise to a significant level of administrative work if the enterprise had to do a detailed proof that the above condition is met. As with the proof required for hedge effectiveness, the effort associated with such administration might be so significant that entities may avoid using the fair value option altogether, resulting in earnings volatility.

(d) Banks have a concern with the term "contractually linked" mentioned in condition (ii), paragraph 9. Instances may arise where a financial asset or liability is entered into in contemplation of another liability or asset. These, for various reasons, may not be contractually linked and would therefore not be allowed to be fair valued under the proposed conditions. Without the option to fair value both transactions, the asset could be measured at fair value and the liability at cost, resulting in volatility in earnings.

(e) According to paragraph 48A, the fair value of a financial asset or financial liability is verifiable if, and only if, the variability in the range of reasonable fair value estimates made is low. Banks would need further guidance on the variability of the range of reasonable fair values referred to above. What impact would a change in credit margins have on the fair value election if changes in credit margins are not readily observable? Banks often price instruments off the "SwapFra" curve, which is a series of future expected market spot rates. Would this continue to be acceptable in terms of the above requirements?

As the issues above are in contrast with the concerns raised in the introduction to the Exposure Draft, South African banks believe the Exposure Draft will not achieve its intended effect.

<u>Question 2</u>

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?

There are numerous instruments bought and sold in the South African market that would not be eligible for the application of the fair value option for the reasons stated above.

The onerous IAS 39 hedging requirements may require a simplified "economic" hedging mechanism that is currently available through the fair value option: By eliminating or limiting this option, the ability of an entity to apply an informal form of hedge accounting is removed.

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?

As set out in question 1 banks do not believe that the Exposure Draft will achieve it's objective and therefore do not support a limitation of the use of the fair value option.

Furthermore, the limitation, as proposed, will introduce an accounting variation that conflicts with banks economic risk management practices.

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. 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?

Currently, banks that issue long term structured products with embedded derivatives that are considered clearly and closely related to the host instrument are unlikely to apply hedge accounting, as the hedging costs are too prohibitive. To obtain hedge accounting, the entity would have to meet various conditions, including detailed designation and documentation of the hedging relationship, and tracking the hedge to show that it is highly effective. This can require significant time, effort and systems, and therefore considerable expense. As banks will economically hedge these positions, volatility will result if the fair value option is restricted, as the hedging instrument is measured at fair value, while the host contract is carried at amortised cost. In order to achieve hedge accounting an entity would have to enter into a highly structured derivative, which would make the entire transaction uneconomical. As such, these positions typically are left un-hedged for accounting purposes, leading to volatility in earnings. Having the ability to designate the entire transaction as held at fair value will eliminate this volatility.

Banks agree that one of the most common uses of the fair value option is likely to be for structured products that contain embedded derivatives. IAS 39 requires such embedded derivatives to be separated, whereas it requires other embedded derivatives not to be separated. It may take time and effort to identify all of the derivatives embedded in a structured product and to determine whether they have to be separated. Furthermore, the structured product will typically be hedged with derivatives that offset all (or nearly all) of the risks contained in it, regardless of whether the embedded derivatives that give rise to those risks are separated. Hence, the simplest way to account for such products is to apply the fair value option so that the entire product (and the derivatives that hedge it) is measured at fair value through profit or loss.

The Banking Council South Africa therefore suggests that the proposal in paragraph 9(b)(i) is appropriate although the reasons for the exceptions are unclear. Banks agree that in this case the fair value option can be used to measure the entire instrument, rather than separately measuring the embedded derivative. It achieves a similar accounting result whilst avoiding the designation, tracking and assessing of hedge effectiveness that hedge accounting entails. Banks do however propose that the requirement to identify embedded derivatives in each financial instrument that is fair valued in terms of this exception is unnecessary.

<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 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 general principle relating to new accounting policies is to apply the policy retrospectively. These arrangements propose a mixed approach. Banks believe the application should be retrospectively corrected and full disclosure of changes to balance sheet values and amounts recognised in the income statement. This will ensure transparency in the application of the transitional provisions.

<u>Question 6</u>

Do you have any other comments on the proposals?

Most non-originated financial assets will have to be carried at fair value, either as trading or available-for-sale. The conditions set out in paragraph 9 could place restrictions, whether administrative or based on the conditions, on fair valuing related liabilities, resulting in a possible mismatch. Banks therefore believe that the IASB's contention that restricting this option will increase volatility in earnings is incorrect and that placing restrictions on the use of the fair value option will have a higher probability of causing such volatility. Banks believe that the unrestrictive fair value option will enhance financial reporting, while at the same time reducing the administrative cost associated with hedge accounting.

According to the revised IAS 39, reclassifications are prohibited into and out of the fair value through profit or loss category, but according to the previous IAS 39, reclassifications out of the trading category are prohibited, but reclassifications into the trading category are allowed. Banks propose that entities be allowed to reclassify financial assets into the trading category (sub category of the fair value through profit or loss category), if there is evidence of a recent actual pattern of short-term profit taking that justifies such reclassifications. Placing such restrictions on the reclassifications into the trading category could result the true nature of assets not being reflected where the intention of holding the assets has changed.

Additional Comment

The Banking Council does not support the proposed amendment suggesting that the relevant prudential supervisor of banks and other regulated bodies be involved in the oversight of the application of the requirements of IAS39. Supervisors generally have the power and authority to regulate and oversee risk management systems of the entities being supervised. It is not necessary or desirable to imply responsibility in an accounting standard.

Conclusion

The Banking Council South Africa would be happy to further discuss these views on the impact of the fair value option, as banks believe a restriction on the fair value option would result in increasing earnings volatility that does not necessarily represent the economic reality and will restrict management's ability to reduce the artificial volatility created by further restrictions in the accounting standards.

Yours sincerely,

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