EFRAG
European Financial Reporting Advisory Group

CL 90

23 July, 2004

Sir David Tweedie
Chairman IASB
30 Cannon Street
London EC4M 6XH
UK

Dear David,

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

On behalf of the European Financial Reporting Advisory Group (EFRAG) I am writing to comment on the Exposure Draft *of proposed Amendments to IAS 39 Financial Instruments Recognition and Measurement: The Fair Value Option.* This letter is submitted in EFRAG's capacity of contributing to IASB's due process and does not necessarily indicate the conclusions that would be reached in its capacity of advising the European Commission on endorsement of the definitive amendments to IAS 39 on the fair value option.

Our comment letter dated 18 October 2002 welcomed the fair value option in so far as it simplified the application of IAS 39 and facilitated the use of "natural hedges". We note the concerns raised by prudential supervisors and other regulators, which have led to the issuance of this exposure draft restricting the original proposal. We understand and support IASB in its attempt to accommodate the concerns raised while trying to retain the main thrust of the original intention.

Nevertheless, we find the proposals "rules based" and not effective in meeting their stated objectives (i) to address the use of inappropriate fair values, (ii) reduce volatility in profit or loss and (iii) avoid the recognition of gains or losses in profit or loss arising from changes in an entity's own creditworthiness. We are particularly concerned that the limitation of the use of the fair value option can have the effect of reintroducing artificial volatility in cases of "natural hedges".

As explained in detail in our responses to the questions raised in the exposure draft in the appendix to this letter, we have the following main concerns:

- We believe that the IASB should not introduce the *verifiability* notion because it appears to downgrade the "reliability" notion. The term *verifiable* is not effective in describing a stricter test than the *reliability* notion because it is generally accepted that when something is reliable it should be verifiable. The practical consequence could be considerable confusion about the application of fair value measurement to all financial instruments.

- We disagree with the introduction of a double standard on the application of fair value. Indeed, the criteria that need to be met if a change in fair value is to be recognised immediately in profit or loss now vary depending on whether the item is *required* to be accounted for at fair value through profit or loss or whether it is *permitted* to be accounted for at fair value through profit or loss. We do not believe that a convincing case has been made for such "double standards" and are once again concerned that the proposals will lead to considerable confusion and complicate the application of fair value measurement in practice. It should be noted that the *verifiability* notion does not exist in other areas of measuring fair values in IFRS.

- The proposals limit the December 2003 improvement of IAS 28 *Investments in Associates* as regards the option to measure investments in associates at fair value in accordance with IAS 39, with changes in fair value recognised in profit or loss in the period of change. Such a limitation seems in conflict with the underlying reason for the IAS 28 option that fair value information is considered by the Board often to be readily available because fair value measurement is a well-established practice in the industries of venture capital, mutual funds and unit trusts (see BC 7 of IAS 28). We believe that it is not the objective of this Exposure Draft to amend IAS 28.

- The reference to prudential supervisors and other regulators could incorrectly lead some to believe that regulators have power to amend or overrule IFRS for the purposes of financial reporting.

Therefore, taking into account our comments raised in this letter, we urge the IASB to withdraw the current proposal for limitation of the Fair Value Option, because it does not meet its objective in a satisfactory way. As an alternative, we have suggested, in our response to Question1, certain improved disclosures. We hope that our concerns and those of other commentators may encourage prudential supervisors and other regulators opposed to the original fair value option to think again and withdraw their objections. We would, however, not be opposed to a limitation on recognising the deterioration of an entity's own credit risk.

If you would like further clarification of the points raised in this letter Paul Rutteman or myself would be happy to discuss these further with you.

Yours sincerely,

Stig Enevoldsen
EFRAG, Chairman

Question 1

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

Response

In our comment letter dated 18 October 2002 EFRAG welcomed the fair value option in so far as it simplified the application of IAS 39 and facilitated the use of natural hedges. We note that the exposure draft, limiting the use of the fair value option, has been introduced to address the concerns of prudential supervisors and other regulators. We have studied the proposals to see whether they achieve their objective efficiently and if not what alternatives can be put forward.

One effect of the current proposals is that the criteria that need to be met if a change in fair value is to be recognised immediately in the profit or loss now vary depending on whether the item is *required* to be accounted for at fair value through profit or loss or whether it is *permitted* to be accounted for at fair value through profit or loss. EFRAG does not believe that a convincing case has been made in the exposure draft for such "double standards" and is concerned that this will lead to considerable confusion and difficulties of application in practice. For instance, it should be noted that the *verifiability* notion does not exist in other areas of measuring fair values in IFRS.

The proposed limitations introduce the *verifiability* notion which is explained as a stricter test than the *reliability* notion. The Basis for Conclusions (BC 25) explains that the notion of *verifiability* has been proposed by analogy to its usage by other standard setters, for example the US standard setter, FASB. We were unable to reconcile the IASB's proposed definition of *verifiable*, which we do not support, with the FASB definition of the term and fail to see how the FASB definition would result in a stricter test than the reliability notion. Following the quoted definition from FASB's concept statement, we believe that such verifiability would need to be applied to any fair value measurement. We are therefore not persuaded by the IASB's reasoning for the introduction of the *verifiability* notion. Furthermore, we consider the three examples (a – c), illustrating when the fair value option can be used, redundant since they are merely a repetition of the existing application guidance in IAS 39 (see AG 74 and 76).
In general, we believe that the use of the word *verifiable* in the attempt to introduce a stricter test than *reliable* is not achieving its objective because it is generally accepted that, if something is reliable, it should also be verifiable.

More fundamentally, it is our understanding that the objectives of the proposed amendments (to address the inappropriate use of fair values, reduce volatility in profit or loss and avoid recognition of gains or losses in profit or loss for changes in an entity's own creditworthiness) will not necessarily be met. For instance, where a debt instrument contains an embedded derivative, it would still be possible to apply the fair value option. Similarly, the original fair value option allows (partially) offsetting assets and liabilities to be accounted for in the same way while the proposed limitations introduce criteria such as "contractually linked" and "substantially offset" thereby reinstating some of the stringent hedge accounting rules. As a result, an entity could be required to measure certain items at amortised cost while (partially) offsetting items would need to be measured at fair value, leading to full accounting volatility, despite the fact that from an economic point of view a partial offset exists. Finally, because IAS 39 often mandates the use of fair value, an inappropriate application of that basis of measurement cannot be excluded.

It is our understanding that the five criteria for applying the fair value option (paragraph 9 (b)) need to be read sequentially. This means for instance that a loan (excluded by the fourth criterion) could be eligible for the fair value option as long as it contains an embedded derivative (criterion i) or meets criterion (iii), which says that "the exposure to changes in the fair value of the financial asset or financial liability (or portfolio of financial assets or financial liabilities) is substantially offset by the exposure to the changes in the fair value of another financial asset or financial liability (or portfolio of financial assets or financial liabilities), including a derivative (or portfolio of derivatives)."

The proposals limit the December 2003 improvement of IAS 28 *Investments in Associates* as regards the option to measure investments in associates at fair value in accordance with IAS 39, with changes in fair value recognised in profit or loss in the period of the change. Such a limitation seems in conflict with the underlying reason for the IAS 28 option that fair value information is considered by the Board to be often readily available because fair value measurement is a well-established practice among venture capital entities, mutual funds and unit trusts (see BC 7 of IAS 28).

EFRAG does not support the reference to prudential supervisors and other regulators because such a reference could lead some to believe that regulators have authority to amend or overrule IFRS for the purposes of financial reporting. While we note that the IASB stresses in its Basis for Conclusions that this is not the case, we do not support the reference to supervisors because EFRAG strongly believes that there should be a clear dividing line between IFRS and prudential requirements.

We support the IASB's attempt to accommodate the concerns raised by prudential supervisors and other regulators while trying to retain the main thrust of the original intention of the fair value option. It is our view, however, that far less drastic modification is required to the original fair value option in order to achieve the protection against abuse that these institutions are seeking.

We believe that the principal protection against abuse is the existing IAS 39 requirement that an entity should designate irrevocably at inception those financial instruments it intends to recognise at fair value through profit or loss. We would add to that a requirement for disclosure of the amounts of such instruments and the gains and losses arising from them in the period. The accounting policies note should, moreover, set out the designation policy and its business rationale.

In addition to our proposal in the previous paragraph, we would not be opposed to some limitation of the recognition in the income statement of gains and losses reflecting changes in an entity's own credit risk.

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?*

Response

It is our understanding that certain financial institutions intend to apply the fair value option to their loans in order to reduce accounting volatility. Further, certain (other) financial institutions intend to apply the fair value option to asset and liability positions that offset each other partially in order to reflect economic exposures and reduce accounting volatility.

Under the proposed amendments such a designation would become subject to the stringent hedge accounting requirement of “substantial offset”. If the IASB were to adopt the proposed amendments, the “substantially offset” requirement should be replaced by “partially offset”. After all, it is our understanding that the 80% - 125% prospective effectiveness test does not apply in the case of the fair value option. Certain organisations responded in detail to EFRAG on this Question. We draw your attention to the extracts from these comments given in Appendix 2 to this response.

<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 paragraph BC9? If not, how would you further limit the use of the option and why?

<u>Response</u>

EFRAG is content with the original fair value option, since it simplifies the application of IAS 39 and facilitates the use of “natural hedges”. Our comments on the means used to limit its application are mostly made in our response to Question 1. We note that the proposed amendments do not specifically address the concern of recognition of gains or losses in profit or loss for changes in an entity’s own creditworthiness (see BC9 (c)). For instance, as long as a debt instrument contains an embedded derivative, it will be possible to apply the fair value option. Our final comment against Question 1 indicates that we would not be opposed to some restriction in this area.

<u>Question 4</u>

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?

<u>Response</u>

Since we are in general supportive of the current fair value option because it eases the application of IAS 39 and allows the reduction of accounting volatility we do not favour any (further) restriction. As regards our comments on the proposed limitations, we refer to our response to question 1.

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?

Response

EFRAG supports the pragmatic approach as regards the transitional requirements – i.e. no retrospective application when an entity changes the measurement from *at fair value through profit and loss* to amortised cost.

Question 6

Do you have any other comments on the proposals?

Response

If, despite our comments expressed above, the IASB decides to move forward with the introduction of the *verifiability* notion, we recommend that it should require companies to disclose information on how they have met the verifiability test (e.g. by obtaining several independent estimates).

Extracts of the comment letters from those organisations responding in detail on 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?

Bundesverband Öffentlicher Banken Deutschlands

Yes. The following exemplary financial instruments are excluded from the fair value option according to the Exposure Draft:

- unstructured own issues, the relevant risk of which is only partially hedged by financial instruments;
- unstructured fixed-interest own issues, which are used for the refinancing with matching maturities of fixed-interest bonds portfolios, but which do not represent full risk compensation;
- unstructured loans from the cover fund, which serve to reduce the credit risk of structured issues and at the same time are "loans and receivables" according to the IAS 39 definition;
- unstructured financial instruments which are not hedged on the same day.

a) All the examples contain no structures, are not debts with cash flows contractually linked to the performance of assets, are not substantially offset by other financial instruments and may be receivables according to the IAS 39 definition.

b) The fair value is always verifiable.

c) An unlimited fair value option would allow the income statement-related assessment of all risks of these instruments and as a result help to avoid unjustified volatility in profit or loss or equity.

Through this list of authorised applications, the Exposure Draft introduces a "rule-based approach" with regard to the fair value assessment, which is fundamentally inconsistent with the "principle-based approach" of all IAS.

This is a further reason to reject limitation of the fair value option.

CAR (Council for Annual Reporting)

We have in our comment letter included the following examples of situations where we expect that the limitations may be problematic:

- The assets (and liabilities) of an investment fund where assets only partially offset the liabilities or where loans are entered into an investment.
- The assets, such as a portfolio of mortgage loans, of insurers to back certain liabilities of insurers, where the criteria of this proposal are not fully met or cannot be met as a result of further development of products. For example it has not been determined how insurance liabilities could be measured at fair value. The option included in paragraph 24 of IFRS 4 relates to measurement at a current value, using current interest rates. It is therefore not clear whether 9b (iii) is available to the insurance industry.
- The measurement of mortgage loans at amortised cost, while insurance liabilities are measured at fair value would lead to a measurement mismatch.
- A last example is where loans and receivables are used to back unit-linked insurance contracts, however where a formal contractual link is lacking and only an economic link exists.

Under paragraph 9 b(ii) liabilities are eligible for measurement at fair value if they are contractually linked to the performance of assets. Although we do not have a current example of a mirror situation, we are unclear about the limitation to financial liabilities to be optionally measured at fair value.

ESBG

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.

→ **Result:** Equity instruments that do not have a quoted price in an active market and whose fair value cannot be reliably measured shall not be designated as at fair value through profit or loss.

Referring to Question 2a) the ESBG would like to provide the following answer:

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.

Referring to Question 2b) the ESBG would like to provide the following answer:

With regards to retail lending and lending to small unrated companies there are no prices available for the basis risk (pricing of the interest rate margin above the interbank interest rate, compared to own funding rate compared to the interbank interest rate). Furthermore, since the purpose of the lending transaction is to hold the ban until maturity, the basis risk is not of interest, since the effects on earnings are already known.

Referring to Question 2c) the ESBG would like to provide the following answer:

ESBG Members pointed out that banks are managing risk with regards to dfferent **risk components** and not **instruments**. Therefore the drafted amendments misjudge the use of the fair value option so far as the rules are only drafted for financial instruments but not for related risks. 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 we 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 under ESBG's answer to Question 2a) (see 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 election, 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.***

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 decrease volatility in profit and loss,
c) entities will not need to fair value the credit spread of its own debt and will as a consequence not recognise gains and losses in earnings due to changes in its own creditworthiness.

FEE

We agree with the response to this question. We have in our comment letter included the following examples of situations where we expect that the limitations may be problematic:

- The assets (and liabilities) of investment funds where assets only partially offset the liabilities or where loans are entered into an investment.

- it might be difficult to apply the fair value option for assets held to back insurance liabilities. Paragraph 9b (ii) and (iii) might be unavailable to insurers on the asset side, given the requirement that the related liability be measured at fair value and this has yet to be defined for insurance liabilities. This could be problematic for insurers, particularly when insurance liabilities are measured using current value based estimation techniques, such as current interest rates, in accordance with the option in paragraph 24 of IFRS 4.

- A specific example of an instrument where the fair value option may be unavailable is a portfolio of mortgages used to match a long term insurance book, for the reasons noted above (unless embedded derivatives were artificially found in the mortgage contract). The restrictions might also inhibit product development if companies are unable to use the fair value option on assets backing and matching liabilities under new types of contract.

- Under paragraph 9 b(ii) liabilities are eligible for measurement at fair value if they are contractually linked to the performance of assets. We are unclear about how this option allowing financial instruments to be measured at fair value applies to financial liabilities.

The Danish Accounting Standards Committee (DASC)

Yes. The verifiability criterion could create difficulties for those venture capital organizations that elect to use the fair value option; regardless of the fact that the intention of the IAS 28 and IAS 31 scope exclusion introduced in December 2003 was to make it possible for such entities actually to measure their investments at fair value. In our view there should only be one reliability-criterion in IAS 39 for use of fair value.

Another instance where it is currently unclear to us as to whether or not companies will be affected is the area of investment properties. We believe that it is currently unclear whether and how investment property companies will be affected by the ED in relation to related financing of their investments. Some jurisdictions allow for enterprises to measure both assets *and related financial liabilities* at fair value subsequent to initial recognition. We kindly ask that the Board clarify its intentions related to this issue in the final standard.

ACTEO-MEDEF

At the time of its inception, the fair value option was welcome because it helped compensate for the unnecessary limitations put to the hedge accounting in IAS 39. The fair value option is particularly helpful to account for natural hedges. The limitations “contractually linked” and “substantially offset” included as (ii) and (iii) in IAS 39 paragraph 9 are likely to annihilate the benefit of the option in that area. Moreover the wording used immediately calls for interpretations and clarifications.

CESR

Based on a discussion that some SISE members have had with IASB staff, we understand that the proposed limitations to the fair value option are designed to prevent free standing liabilities and loans from being measured at fair value (unless loans are traded on an active market).

As far as loans are concerned, EFRAG should ask IASB to clarify how this limitation might apply to such instruments, especially as this ED on fair value does not change the definition of loans and receivables, ie it seems possible to apply the fair value option to such instruments (even if this option leads to the fact that these instruments do not fall into the loans & receivables category anymore), but the present ED apparently contradicts this in saying that it is not possible to apply the fair value option to loans & receivables (§9biv). Is it because §9bv mentions that the FV option might be used to items that this standard or another standard allows or requires to be designated at fair value? Or is it an apparent inconsistency?
As a general comment, we agree with EFRAG that there should be a clarification of the way the different Fair value option criteria should be read. For example, it should be stated that it is possible to measure a loan at fair value when it contains an embedded derivative (§9bi), though §9biv mentions that, in order to be eligible to the fair value option, the item is a financial asset other than one that meets the definition of loans & receivables. In addition, it would be very helpful to have a kind of float chart that could give an overview of the consequences of the different definitions in IAS39.

We agree with EFRAG’s comment on the fact that the proposed limitations might have adverse consequences on the ability to use the Fair value option for investments in associates as proposed in the scope paragraph of IAS28 modified in December 2003. The Board indicated that fair value information of investments held by venture capital organizations, mutual funds, unit trusts and similar entities is often readily obtainable because fair value measurement is a well-established practice in these industries including for investments in entities in the early stages of their development or in non-listed entities. However, under the proposed ED, though this kind of investments might fall in the §9bv criterion (the item is one that this or another standard allows or requires to be designated as at fair value through profit or loss), SISE members are uncertain whether the verifiability criterion would allow or prevent the use of the fair value measurement of this kind of instruments in certain circumstances (see our comments to question 3). EFRAG should ask IASB to clarify this issue.

Swedisch Bankers' Association

In the Exposure Draft there is a requirement in paragraph 9, which says that the fair value of a financial asset or financial liability shall be verifiable. Paragraph 48B stipulates under which circumstances this requirement is met. This paragraph focuses on how a verifiable fair value is achieved for **instruments**. 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 lending to large international well known companies where an active market exists. With regards to retail lending and lending to small unrated companies there are no prices available for the basis risk (pricing of the interest rate margin above the interbank interest rate, compared to own funding rate compared to the interbank interest rate). Furthermore

since the purpose of the lending transaction is to hold the loan until maturity the basis risk is not of interest, since the effect on earnings already are known.

In the Nordic Market the pricing of single transactions is individually based on the banks entire business relation with the customer and his negotiation power. It might be worthwhile having a low mortgage interest rate and instead compensate with commissions on custodian accounts, mutual funds and insurance products. Also expectations of future business opportunities are taken into account. Hence many other factors than risk are taken into account when a loan is priced. Loans granted at the same point in time with similar risk characteristics could be priced very differently.

Examples of transactions where the current wording of the Exposure Draft no longer underpin 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.
- 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.

The reason for this is either that the fair value of the basis risk may not be verifiable and/or that although there is a substantial offset in the interbank interest rate risk there is no offset when it comes to basis risk.

Banks are managing risk with regards to different risk categories and not instruments. For e.g. fixed rate lending, with prepayment conditional on full yield maintenance fees, the best risk management practice is to actively manage the interest rate risk with regard to changes in reference rates. Credit risk is managed separately. The interest rate risk is managed with reference to changes in a publicly quoted interbank interest rate (e.g. LIBOR). It would therefore be possible to meet the requirement regarding a verifiable fair value for that part of the loan. For the credit risk on the other hand it is very difficult to estimate a fair value, since there is no active market for such loans.

Swedish Bankers' Association is of the opinion that the use of the option should be aligned with best risk management practice. **Therefore, not only instruments should be eligible for the option but also its different risk components e.g. benchmark interest rate risk.** We believe such an approach to be sound and also foreseen in the cash-flow hedging rules and the macro hedging rules within IAS 39. British Bankers' Association also proposed such an approach in its response to the Exposure Draft of proposed amendments to IAS 32 and IAS 39 dated 24 October 2002.

We propose changes to the proposed text, which 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.

If the proposal was rephrased the fair value option could be used for components of risk and for all the other examples listed above. We therefore propose that the wording in the beginning of section three under paragraph 9 should be as follows:

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

Finally, 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 decrease volatility in profit and loss,
c) entities will not, if they apply the option on their own debt, be forced to fair value the credit spread and will as a consequence not recognise gains and losses in earnings due to changes in their own creditworthiness.