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Amendments to IAS 39: The Fair Value Option

Dear Ms Thompson,

The Association of German Banks appreciates the opportunity to comment on the Exposure Draft "Proposed Amendments to IAS 39 Financial Instruments: The Fair Value Option". We should like to begin by making some general remarks. These are followed by our replies to the questions.

General remarks

German banks strongly welcomed and supported the fair value option when it was first introduced in the revised IAS 39 published in December 2003. The reason is that the option allows users to align the accounting treatment of financial instruments with the economic substance by alleviating the potentially misleading impact on earnings stemming from the mixed measurement model and the strict hedge accounting rules. We have criticised the strict hedge accounting rules on many occasions.

We are aware of the concerns voiced by European regulators about the volatility in profit and loss that would follow from inappropriate use of the fair value option. However, we think that the restrictions envisaged will preclude the use of the option in situations which are entirely appropriate and, indeed, necessary if the artificial volatility caused by the current shortcomings of the standard is to be avoided.

We are therefore convinced that the planned rules run counter to the Exposure Draft's intended aim of reducing the volatility in the profit and loss.

As explained in our detailed response, we have the following main concerns:

- the new rules would undermine the mitigation of undesired consequences of the mixed measurement model,
- the restrictions would endanger a pragmatic alternative to hedge accounting,
- the rules would complicate accounting treatment for hybrid instruments and
- the rules would result in an undesirable dual standard for fair value measurements.

Additionally, we would like to express our concern that the issue of own credit spread has not been addressed in the Exposure Draft. As we explain in our detailed response, the consideration of own credit spread leads to artificial and misleading swings in profit and loss.

Replies to the questions:

Question 1

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

As set out above, we welcome the fair value option introduced in the revised December 2003 version of IAS 39. The reason is that the fair value option enables adopters to align the accounting treatment of financial transactions with the underlying business and risk management practices. It is regarded as a viable tool which can help alleviate the potentially misleading impact on earnings stemming from the current strict hedge accounting rules that prevent banks in many cases from portraying their business appropriately. These rules lead to swings in the profit and loss statement and in equity that are not caused by the underlying economic transactions but by accounting rules only.

We disagree with the concerns raised by the supervisors that banks might use the fair value option as a means of increasing volatility. The opposite is true, since the use of the fair value option mitigates some anomalies that result from the different measuring attributes when some parts of a portfolio are measured at fair value while others are measured at amortised cost. Reporting all financial instruments in a portfolio using the fair value option not only eliminates the resulting artificial volatility, it also enables the banks to show a profit and loss impact that is in line with the economic results that risk management is seeking to achieve.

Proposed limitations

The proposed limitations introduce criteria such as "substantially offset" and "verifiability", which effectively reinstate some of the stringent rules of hedge accounting. The "substantially offset" criterion might introduce another form of effectiveness testing. The "verifiability" criterion, on the other hand, could create a dual measurement criterion for financial instruments in IAS 39: financial instruments classified as "held-for-trading" and "available-for-sale" would have to be measured at fair value without the verifiability test while the verifiability test would be needed for financial instruments designated at fair value through profit or loss.

Both these criteria substantially restrict the potential application of the fair value option and in most cases eliminate the many benefits of its use. In our opinion, the Board's decision to prohibit financial instruments from being reclassified into and out of the fair value category through profit and loss after initial recognition already ensures adequate discipline to prevent the misuse of the fair value option. In this regard, we are not convinced that there is a need to redraft IAS 39 to restrict the fair value option.

Own credit spread

The inclusion of a bank's own credit risk in the fair value of its liabilities is causing grave concerns among German banks. The fair value option as it stands now would require the credit component of the financial instrument to be considered in the fair value calculation. This is unlike hedge accounting, where a bank can designate only the market interest risk as the risk being hedged and exclude credit spreads when determining the fair value of the hedged asset or liability. An undesirable consequence of the fair value option as opposed to hedge accounting (where the hedged risk is the interest rate risk) is that credit spread will cause the profit and loss to be more volatile. Because of this, the potential benefit of using the fair value option to stabilise profit and loss and equity would be eradicated. Besides, this is contrary to the primary objective of prudential supervisors and other regulators to minimise volatility in the first place by ring fencing the application of the fair value option with tough restrictions.

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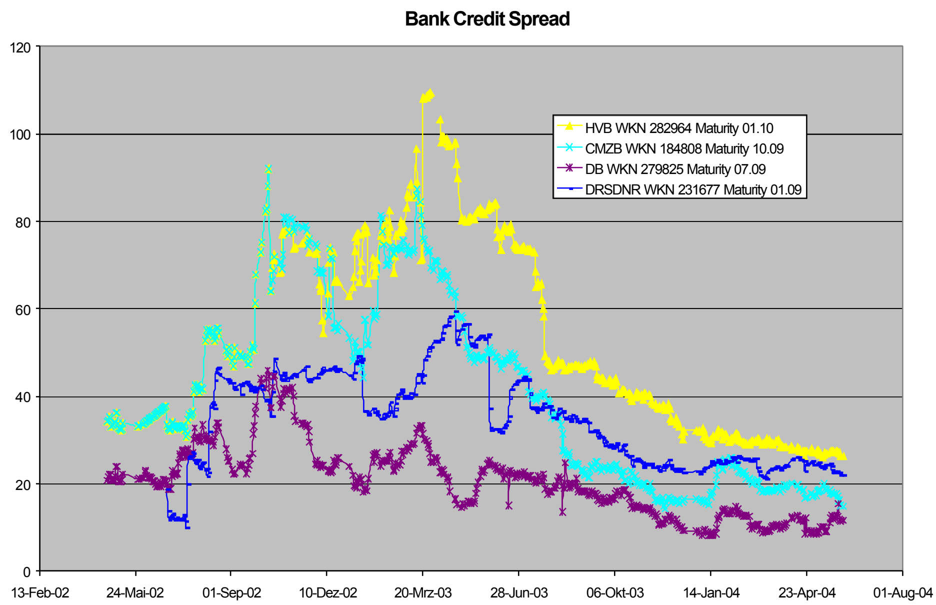
As an illustration, banks often hedge their structured issues. A benefit of using the fair value option is that it eliminates swings in profit and loss. However, this improvement would be lost if own credit spread was incorporated into the fair value assessment for the structured issues. As shown in the graph below, credit spreads for major financial institutions in Germany (based on a 5-year time horizon) have exhibited potentially extreme movements over the past 2 years. As a result, the impact on the profit and loss account is likely to be more volatile due to the uneconomic swings in fair valuing the own credit component.



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?**

Banks want to apply the fair value option to a component of risk attributable to a financial asset or financial liability that they want to hedge against so as to reduce

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accounting volatility arising from the current hedge accounting rules. This would not be possible with the envisaged restrictions on the use of the fair value option. A good example of a situation where banks might not want to apply the fair value option is when they want to hedge their own debts against adverse changes in market interest rates. As mentioned above in our reply to Question 1, the fair value of a bank's own debts includes not only interest rate risks but also its own credit risk. On the other hand, the fair value of the hedging instruments includes only the interest rate risks. As a result, volatilities in the profit and loss are inevitable since the basis for the fair value of the hedging instruments is different from the own debts. However, if the own credit component is excluded, banks would not need to fair value the credit spread of their own debts. In consequence, the accounting results would resemble the economic results of risk management, thereby eliminating volatility in profit and loss.

As mentioned our reply to Question 1, the proposed requirement that the fair value option can be used only if the fair value of the financial instrument is verifiable is likely to restrict its use. In the case of structured transactions such as equity-linked notes, the verifiability criteria would impede the use of the fair value option depending on whether the structured transactions needed to be revalued as a whole (in which case the verifiability test might fail if these transactions were not traded in the market).

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 believe that the proposals contained in this Exposure Draft over-address the concerns set out in paragraph BC9 and thereby severely limit the use of the fair value option. As mentioned in our reply to Question 1, we believe that an adequate safeguard is already in place to prevent the misuse of the fair value option, namely the prohibition of reclassifying financial instruments into and out of the fair value category through profit and loss after initial recognition.

We therefore favour maintaining the original fair value option with the following amendment – addressing the concern of recognising gains and losses in profit and loss due to changes in own creditworthiness.

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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 BCI6-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 fully support applying the fair value option to all financial instruments that contain an embedded deriavtive and do not favour any further restriction in this area.

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.

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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 agree with the proposed transitional requirements.

Question 6

Do you have any other comments on the proposals?

The reference to prudential supervisors and other regulators might lead to the incorrect assumption that regulators have the power to amend or overrule IFRS for the purposes of financial reporting. We therefore recommend deleting this reference.

Taking into account our comments we recommend the IASB reconsider its approach to meeting the concerns raised by prudential supervisors.

We would be pleased to discuss our comments with you if it would be of assistance.

Yours sincerely,
Association of German Banks

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