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**Position of the Association of German Public Sector Banks on the proposed
"Amendments to IAS 39 Financial Instruments: Recognition and Measurement –
The Fair Value Option"**

Dear Sir David,

We should like to thank you for giving us the opportunity to comment on the proposed amendments to IAS 39 "The Fair Value Option", published on 21 April 2004 by the International Accounting Standards Board (IASB).

A. General remarks

In our position paper of 9 October 2002 on the revision of IAS 39, we already welcomed the option to value financial instruments at fair value. We confirmed our call to allow proper balance sheet presentation of the economic hedging activities and we expressed our firm opposition to any prejudicial effect for full fair value accounting.

We considered and still consider the option to be a worthwhile supplement to the prescribed presentation variants to achieve fair presentation.

We refer once again to the fact that, even with the supplement of 31 March 2004, the hedge accounting rules are still inadequate. Economic hedging processes at banks, which are subject to highly complex risk management, underpinned by capital market theory and recognised for banking supervision purposes, still cannot be presented correctly on the balance sheet according to the requirements you have adopted.

For this reason, the importance for those making use of the fair value option is confined to eliminating the volatility in profit or loss or equity, caused by IAS rules, but economically absurd. Furthermore, it can be used to avoid the complex obligation to separate structured products. In all other cases, there is no point in applying it.

We adhere to our rejection of a general fair value assessment of all financial instruments.

Furthermore, we are convinced that in the case of hedging relationships, the accounting of the hedging instrument must follow the accounting of the hedged item. This is obviously contradictory to the principles of the IASB.

In the interests of all investors and analysts wishing to obtain a true picture of the financial and earnings situation of an entity, the unlimited fair value option published in December 2003 is therefore necessary. This allows some of the basic presentation problems arising from hedge accounting to be resolved.

Should all other currently valid IAS rules remain in existence, the **unlimited fair value option is the only acceptable variant**. We expressly support the alternative views of some IASB members presented in AV1-7.

B. Replies to the questions

Question 1:

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

We do not agree with the proposals in this Exposure Draft. We support without reservation the alternative views set out in AV1-7, which we shall not set out in detail again.

In particular, we reject the following aspects of the draft:

- the material limitation of the fair value option (application only possible in selected cases);

- the formal limitation of the fair value option (application in selected cases only possible subject to further conditions being met);
- the demand for a “verifiable” fair value, which is apparently superior to the “reliably measured” fair value required hitherto. The IASB generates fair values of varying quality which is inconsistent with the principles of IFRS accounting;
- the reference to the oversight by supervisors or regulators of how the fair value is determined;
- the fact that all motivations and conclusions on the form of the fair value option have already been discussed and led to unlimited admissibility in IAS 39 (rev. 2003) (cf. IAS 39.BC87), but now have subsequently been re-examined and give rise to a (partially) contrary result (cf. ED IAS 39.BC10 and BC14). This last point even contradicts the argumentation of IAS 39.BC87.

The subsequent limitation of an only recently adopted accounting standard on the basis of the arguments already known at that time gives rise to serious doubt about the decision-making process of the IASB. It reduces its credibility and leads to legal uncertainty among the entities concerned.

Question 2:

Are you aware of any financial instruments to which entities are applying, or intending to apply, the fair value option that would not be eligible for the option if it were revised as set out in this ED?

- Please give details of the instrument(s) and why it (they) would not be eligible.*
- Is the fair value of the instrument(s) “verifiable” and if not, why not?*
- How would applying the fair value option to the instrument(s) simplify the practical application of IAS 39?*

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.

Question 3:

Do the proposals contained in this ED 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?

No. We do not share the concerns set out in paragraph BC9 (a) to (c). Apart from this, we doubt that these concerns can be addressed at all by any form of limitation of the fair value option whatsoever.

The concerns according to BC9(a) can also be resolved, and the concerns according to BC9(b) even much better, without limitation of the fair value option. The concerns according to BC9(c) are not addressed in spite of the limitation.

(a) No “verifiable” fair value is needed to avoid the **risks according to BC9(a)**.

The requirements of the “reliably measured” fair value meet the same purpose. All criteria which essentially define the “verifiable” fair value are already part of the definition of fair value existing hitherto.

In particular, this refers to the following aspects, which according to paragraph 48B result in the range of possible fair value estimates being minimised:

- observable market transactions in the same instrument,
- a valuation technique, which is calibrated periodically to market parameters,
- a valuation technique that is commonly used by market participants.

With the definition of the “reliably measured” fair value, IAS 39 (rev. 2003) already ensures that the range of the fair value estimates is minimised. We cannot discern any stricter requirements for a “verifiable” fair value and

therefore reject this superior classification. We regret that at the same time the Exposure Draft thereby questions the reliability and accuracy of the fair value according to IAS 39 (rev. 2003) and undermines the basis for its recognition as a correct valuation approach.

(b) The limitation of the fair value option is a considerable impediment to avoiding the **risks according to BC9(b)**.

Reducing an economically unjustified volatility, produced artificially by accounting rules, is already for this reason alone an aim of IAS users in order to be able to satisfy the basic principle of "fair presentation" and to communicate to the addressees of the financial reporting the truest possible picture of the actual financial and earnings situation.

In addition, we recall the fact that the fair value assessment can only be opted for on the day of the first recognition and remains irrevocable until derecognition. The entity therefore has no opportunities to use the fair value option purposefully to increase the volatility and also no logical reason to pursue this aim.

As a result, it should be noted that the Exposure Draft systematically creates and considerably reinforces the concerns from BC9(b) instead of resolving them.

(c) Limitation of the fair value option is inappropriate to avoid the **risks according to BC9(c)**.

The risk of volatility as a result of changes in the entity's own creditworthiness and taking them into account in the valuation is a fundamental problem. It is true that by limiting the instruments concerned a reduction in the "risk potential" is logical, but the problem continues to exist in principle.

The limitation of the fair value option does not therefore achieve the objective and is no systematic means to resolve the concerns according to BC9(c). Furthermore, these concerns are already taken into account by the current rules, since IAS 32 requires the publication of creditworthiness-based fair value amendments for the liabilities in question.

Question 4:

Is the proposal in paragraph 9(b)(i) appropriate – application to financial instruments with embedded derivatives, irrespective of whether they have to be separated? If not, should this category be limited to a financial asset or financial liability containing one or more embedded derivatives which are required to be separated?

Yes. In our view, the proposal is the only right one and – if in spite of considerable objections the fair value option were to be limited – also only acceptable in the version in paragraph 9(b)(i) existing to date.

The application of the fair value option entails acceptance of the considerable disadvantage of the irrevocability and the impact on profit or loss of the credit risk (including the entity's own creditworthiness). On the other hand, there are the following advantages:

- avoidance of the investigation concerning the separation requirement,
- in the case of structured products subject to the separation requirement, avoidance of separation and separate valuation as well as the possibly necessary hedge accounting,
- in the case of structured products not subject to the separation requirement, avoidance of the possibly necessary hedge accounting.

If in the case of the fair value option a distinction were made between derivatives subject to the separation requirement and those which are not, these advantages would for the most part be lost. Furthermore, all requirements to be taken into consideration in the course of the examination regarding the separation requirement, would continue to be relevant – but with the additional requirements on the application of the fair value option. This would greatly increase the complexity of IAS 39.

In BC6(c)(i) and BC21(a), no difference was made explicitly with regard to the separation requirement. We agree with this because the presentation advantage exists equally with and without separation requirement. We reject a differentiation depending on the separation requirement because this would make IAS 39 far more difficult to apply and would not facilitate it.

In addition, we point out that the risk referred to in BC22 of the fair value option being used "too broadly" is totally unfounded. Once again, we emphasise that the limitation of the fair value option planned in this Exposure Draft already represents an application too narrow, thereby no longer allows it to be implemented as foreseen in the objective.

Question 5:

Are these proposed transitional requirements appropriate? If not, what changes do you propose and why?

No. It is true that so far the fair value option in the form according to IAS 39 (rev. 2003) have been applied only in a few cases.

In principle, however, we point out that the limitation of the fair value option would lead to accounting alternatives now being necessary for essential financial instruments, for which the fair value option was hitherto applicable. In particular, the application of hedge accounting comes into consideration as a substitute for the no longer admissible fair value option. In this case, considerable extra expenses are incurred which will be particularly high as they are retrospective.

In particular the valuation of the transactions after the fair value option ends is considerably more difficult because now the current fair value is the basis for further measurement at amortised costs. This fair value can no longer be determined and updated on the basis of historical amortised costs and all other historical valuation parameters.

The problems arising from the subsequent measurement can only be resolved if the original (unlimited) proposal for the fair value option is retained.

Question 6:

Do you have any other comments on the proposals?

We reject the pronouncement in BC28(a), which refers to the time scale for the implementation of the Amendments of this Exposure Draft.

We refer again to the risk that the current amendment of IAS 39 generates new problems of time required for the preparations and the first-time adoption.

We do not support the opinion of the IASB that since the publication of this Exposure Draft "sufficient time" exists for the planning of the possibly necessary implementation of these amendments. In particular, due to the limitation of the fair value option which only in december 2003 was published as unlimited, entities will in no case start any activities to implement the fair value option by the date of its proposal, but by the date of its final version.

Entities which are planning the first-time adoption as of 1 January 2005 now have serious difficulties to completely implement IAS 39 by this date.

C. Aspects so far not considered by the IASB

We should like to take the opportunity to call attention once again to important aspects connected with the accounting of financial instruments, which so far have not been given the necessary consideration.

1. Admissibility of internal transactions

For the real reconstruction of economic hedging activities, it is necessary also to be able to consider hedging by internal transactions. To this end, it is furthermore indispensable to furnish proof of the hedge and in particular the effectiveness on the basis of internal transactions (derivatives).

To this end – and only to this end – we ask for a renewed discussion of the extent to which internal transactions can be used in the context of hedge accounting. We refer once again to the fact that in the absence of their admissibility, the hedge accounting rules are insufficient.

2. Interest rate margin hedge

We consider the interest rate margin hedge to be a worthwhile supplement to the accounting variants available so far and at the same time a possibility to remedy shortcomings inherent in the approaches to the fair value hedge and cash flow hedge.

We therefore ask for the discussion on the interest rate margin hedge to be continued and for the approach to be included as additional variant in IAS 39.

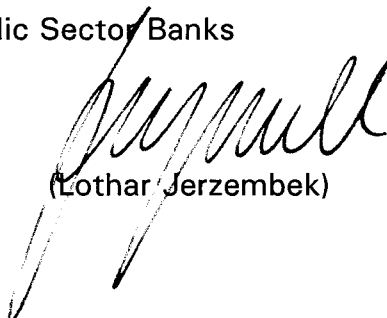
To sum up, we find that only the unlimited fair value option can, in some cases, remedy the shortcomings inherent in the hitherto admissible hedge accounting variants and therefore call for the withdrawal of this entire Exposure Draft.

Please do not hesitate to contact us with regard to any further questions or discussions.

Yours sincerely,
Association of German Public Sector Banks



(Karl-Heinz Boos)



(Lothar Jerzembek)