Fédération Bancaire Européenne
European Banking Federation

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Sir David TWEEDIE
Chairman
International Accounting Standards Board
30 Cannon Street, 1st Floor
UK - London EC4M 6XH

Brussels, 28 July 2004

Subject: IAS 39 – Fair Value Option

Dear Mr Chairman,

Please find attached an FBE position paper on the Exposure Draft of proposed amendments to IAS 39 Financial instruments: Recognition and Measurement – The Fair Value Option.

Yours sincerely,

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Enclosure: 1

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FBE COMMENTS ON THE EXPOSURE DRAFT OF PROPOSED AMENDMENTS TO IAS 39 FINANCIAL INSTRUMENTS: RECOGNITION AND MEASUREMENT – THE FAIR VALUE OPTION

QUESTION 1
Do you agree with the proposals in this Exposure Draft? If not, why not? What changes do you propose and why?

Introduction

The European Banking Federation is aware of the concerns that have been raised by banking regulators over the option which allows entities to designate any asset or liability at fair value.

We are sympathetic to the banking regulators' concerns and, particularly, their concerns about any IASB medium term strategy aiming at extending fair value measurement to all financial instruments. We agree that full fair value accounting would not be an appropriate way forward. However, the banking industry regards the Fair Value Option as a tool which enables entities to overcome the basic flaws of IAS 39 which it has criticised on many occasions and, in particular, the hedge accounting rules which will be the main source of increased volatility.

It should be noted that IAS 39 precludes entities from reclassifying financial instruments into or out the fair value category - which is a safeguard against possible abuses.

Restricting the fair value option will not reduce volatility in profit and loss.

We disagree with the assertion that allowing the fair value measurement of any financial asset or liability would result in an increased volatility in earnings and unreliable financial reporting.

In fact, the exact opposite will occur in practice: banks that will make use of the fair value option will have less volatility in earnings and provide greater transparency and enhanced financial reporting. This results from the fact that asymmetry within the current mixed measurement model of accounting - where some financial assets are measured at fair value and related financial liabilities are measured at amortized cost - contributes significantly to the volatility in financial statements. Permitting entities to consistently measure matched asset and liability positions will greatly reduce this volatility.

A principle-based approach is preferable

Instead of restricting the use that can be made of the fair value option, the option should be improved and developed with a view to bringing it in line with sound risk management practices. The proper solution would be to adopt a more principle-based approach. The basic principle should be that the fair value option can be applied to those components of a financial instrument that result in inconsistency within the profit and loss account or Equity due to the mixed accounting model approach of IAS 39 or to those that, according to the risk management policies of the entity, are managed on a fair value basis. It can indeed be expected that many of the gains and losses arising on the financial asset or financial liability measured under the fair value option would be offset by the portfolio hedging that bank's routinely undertake.

The introduction of the proposed principle could be coupled to stringent disclosure requirements and, more particularly, a requirement to provide both qualitative and quantitative disclosures describing the risk management process and the possible effects on earnings, equity and the asset and liabilities. This framework could also require individual entities to have a documented policy explaining under what circumstances they would make use of the option and to communicate this policy to the market. The bank regulators can then review this and assess if it is being used in a sound manner.

The option should be adapted so as to permit a components approach

Banks may manage their interest rate risk exposures on a fair value basis for different components of interest rate risk (e.g. benchmark interest rate risk). However, for this purpose none of the present hedge accounting alternatives is workable in practice. We would, therefore, recommend that the Exposure Draft be amended to permit a components approach.

Such an adjustment to the fair value option would create an accounting framework which would make it possible for an entity to avoid accounting volatility on positions managed on a fair value basis with regards to different risk components (i.e. interest rate risk). Adopting a components approach would also address the concerns raised by banking regulators and which are set out in BC9 of the Exposure Draft because:

a) a components approach is limited to components of risk where the fair value can be verified with reference to publicly quoted rates;
b) it would be used with a view to decreasing volatility in profit and loss;
c) entities would not need to fair value the credit spread of their own debt and would, as a consequence, not recognise gains and losses in earnings due to changes in their own creditworthiness[1].

The basic advantage of such a solution would be to restrict the option in practice to those components of risk having an observable value. Furthermore it would make it possible to make use of the fair value option even where some open positions exist since those open positions would be recognised in earnings immediately. The proposed solution would also have the benefit of being perfectly in line with banks' risk management strategies. In practice it is not possible to document every hedge at inception since the risk management process is a continuous process

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.

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[1] It is worthwhile emphasising that this would not imply that the credit spread on the assets would be ignored. However this is normally handled internally focusing on mitigating the risk for credit losses and applying the IAS 39 rules regarding loan loss provisioning.

(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?

Fair Value Measurement of Risk Components

As mentioned above (see our answer to Question 1) entities should be allowed to apply the option to components of risk (provided the effect of the risk component on fair value is observable). Normally this will in practice be applied by measuring changes in the fair value of financial assets and liabilities by taking account of changes in publicly quoted reference interest rates, holding the credit risk margin above it constant at the level set at the origination of the asset or liability.

Obstacles put by the verifiability requirement

The proposed requirement in paragraph 9 that the fair value of a financial asset or financial liability shall be verifiable, will severely restrict the usefulness of the fair value option.

- *Loans* - The requirement will be capable of being met where loans to large, international well known companies are concerned because active markets exist for such loans. However, the proposed requirement will make it impossible for banks to make use of the fair value option in respect of other loans. In particular, retail loans as well as loans provided to small unrated companies will not qualify since 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). This is due to the fact that banks assess the pricing of such single transactions on an individual basis against the background of the bank's entire business relationship with the customer and his negotiation power. Concerning the pricing of such loans many other factors than the credit risk exposure are taken into account.

- *Structured notes*, including:
    - Structured credit notes[2];
    - Capital protected notes[3];
    - Equity linked notes[4] with single hedge fund or mutual fund underlyings or indices as well as medium to long dated Equity linked notes with single stock underlyings;
    - Prepaid Variable Forward Contracts[5];
    - Variable maturity range accruals[6] and laggards[7];

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[2] Structured notes are tradable securities, deposits or other debt instruments with an embedded derivative of derivatives affecting either (i) the coupon or principle repayable at maturity or (ii) the maturity date of the security.

[3] Capital protected notes are structured notes in which the principal amount is guaranteed to the investor. The return is usually reduced to compensate for the principal protection.

[4] Equity linked notes are structured notes in which the embedded derivative is an Equity Derivative. Such a derivative provides a return based on an Equity, a basket of Equities or an Equity Index/

[5] If the customer has a stock position which he wants to realise, he can enter into a purchased collar (capping the highest sales price and the lowest sales price) with the bank. The bank also prepays the customer the put strike price (the lowest future price which he would receive under the collar). Final settlement of the collar price less the prepaid put value is usually in stock. The transaction does not trigger a tax event and the collar leaves the customer with some limited exposure.

[6] Buyers of range accrual products received fixed payouts for each day during the entire life of the transaction that the spot price of a reference asset stays within a pre-specified range. A day is

- Target redemption notes[8];
- Unit linked notes[9].

Due to the lack of verifiable valuation inputs, their fair value cannot be considered to be "verifiable".

- *Other examples* - As a result of the proposed verifiability requirement the Exposure Draft would no longer underpin the use of the fair value option concerning the following other transactions:
  - 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 has funded the different portfolio using internal contracts which are eliminated in the consolidated accounts.

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 are opposed to the limitations to the use of the original fair value option and do not believe that the use of the fair value option should be restricted beyond what is being proposed.

Should the IASB wish to pursue with a restriction, then the standard should:

- improve the option with a view to bringing it in line with sound risk management practices and, more particularly, adopt a more principle-based approach. The basic principle should be that entities could apply the fair value option to those components of financial instruments that result in inconsistency within the profit and loss account or Equity due to the mixed accounting model approach of IAS 39, or to those that, according to the risk management policies of the entity, are managed on a fair value basis;
- permit a components approach (as described above);
- address the concern of recognition of gains or losses in profit loss for changes in an entity's own creditworthiness.

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counted towards the payout accrual of the structure if at expiry on that day, spot is inside the range. The return is "Digital" in nature. Maturity date for the note can also be linked to the spot price of the underlying reference asset.

[7] This is an example of a structured note in which the final settlement is based on an underlying Equity Put strike price. Payment is either the note notional value plus coupon, or the shares underlying the Put option, also plus coupon. The underlying is often a basket of equities.

[8] This is an example of a structured note where payout is based on a target coupon rate being met. The maturity is variable and payout is either notional plus coupon or is Equity settled.

[9] This is an example of a structured note in which the embedded derivative is linked to the performance of Hedge Fund "Units".

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 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?

We do not believe that this category should be limited.

QUESTION 5 Transition requirements
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 FBE opposes any 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?

- We are concerned about the introduction of a paragraph requiring that changes in the fair value of the assets or liabilities be *substantially offset* by the item used to hedge. Such a requirement would introduce an effectiveness test defeating one of the benefits of having this option in the first place. It will put further obstacles on the faithful reporting of natural hedges in numerous circumstances. Furthermore, without alternative guidance there is a risk that "substantially offset" in this context is interpreted as having the same meaning as "highly effective" in the context of hedge accounting.

- The introduction of a *verifiability threshold* is highly undesirable not only because it is likely to severely restrict the use that can be made of the fair value option but also because it will create confusion about the application of fair value measurement to all financial instruments and introduce an additional layer of complexity. Finally, it seems highly inconsistent to prohibit the use of the fair value option for certain financial instruments which in other situations may be required by the standard to be measured at fair value without a verifiability threshold.

- The proposed amendments do not address the concern of recognition of gains or losses in profit or loss for changes in an entity's own creditworthiness. This should be remedied. The requirement which the Fair Value Option imposes on entities to consider their own credit spreads when determining the fair value of their own debts is a serious concern to the European banking industry.

  As it stands now, the Fair Value Option requires the credit component of the financial instrument to be considered in the fair value calculation. This is unlike hedge accounting where the entity 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 the application of hedge accounting (where the hedged risk is the interest rate risk) is that the effect of credit spreads will cause the profit or loss to be more volatile. This is contrary to the primary objective of prudential supervisors and other regulators to minimize volatility in the first place by ring fencing the application of the fair value option with tougher restrictions.

  As an illustration, banks often hedge interest rate risk of their structured issues. The benefit of applying the fair value option to the structured issue is that it reflects the economic reality of the hedge and provides the means to recognize the missing offsetting gains or losses from the hedged items, thereby eliminating the artificial and misleading swings in profit or loss. However, this improvement to profit or loss reporting is lost if the own credit spread is incorporated into the fair value assessment for the structured issues. That is because banks hedge solely the market risk and not the own credit spread. Credit spreads for major financial institutions may exhibit potentially extreme amplitude movements. As a result, the impact on the profit and loss account is likely to be more volatile due to the uneconomic swings of fair valuing the own credit component.