Committee of European Banking Supervisors

CL 106

Annex to letter of 28 July 2004

to the IASB

General Comment.

The Committee of European Banking Supervisors – CEBS – welcomes the opportunity to comment on this Exposure Draft on the fair value option (FVO).

CEBS is aware that there are ongoing discussions at the level of the European Commission and Member States' governments about the endorsement of IAS 39, notably in view of further analysis of the FVO-issue. CEBS wants to stress that it is not making any statement in that debate by commenting herewith on the exposure draft of the FVO. The comments offered in this letter are solely with reference to the questions that the IASB has put out for comment.

Among the constituents of IASB, banking institutions can be regarded as the entities most affected by IAS 39, since this standard will have a significant impact on their accounting practices and management policies, with potential implications for the European financial system. As a consequence, banking supervisors are particularly interested in the outcome of the revision of IAS 39.

Against that background, CEBS has a strong interest in making sure that the fair value option will be used in an appropriate way, while easing when necessary the practical implementation of IAS 39. CEBS is aware that there is work currently being carried out within the European Central Bank in order to assess, from a financial stability point of view, the use of the fair value option by European banking institutions. CEBS will be monitoring closely the results of such a work.

As a preliminary comment, CEBS wishes to emphasize that in most member States, considering their banking system structure, adequately designed, suitable and practical accounting rules for hedging operations and, more precisely, for macro hedging operations remain highly necessary in the short term. CEBS believes that there is room for such rules within IFRS framework, consistent with sound risk management practices. In that respect, CEBS welcomes the Board's initiative to set up a working group to examine longer-term issues on IAS 39, and is looking forward to participating in this initiative, which constitutes a good step forward in the broader perspective of the Constitution review of the IASCF and the review of the deliberative process of the IASB. CEBS believes this is an opportunity for a good dialogue with the Board.

In addition, CEBS wants to highlight that the proposed amendments do not address the concern for recognition of profit and loss due to changes in the own creditworthiness of an entity. CEBS acknowledges that disclosure rules are required by the standard in relation to the own credit risk for an entity. Nevertheless, CEBS welcomes the recent recommendation of the Basel Committee on Banking Supervision to not recognize for regulatory purposes any gains and losses arising from changes in an institution's own credit risk as a result of applying the fair value option to its liabilities. Furthermore, CEBS believes that the Board should take further action to prohibit changes in the fair value of a financial liability that would be attributable to changes in the creditworthiness of an institution.

Question 1
Do you agree with the proposals in this Exposure Draft?

Our response
CEBS agrees with some of the proposals in this Exposure Draft.

If not, why not? What changes do you propose and why?

Our response
CEBS welcomes the introduction of the verifiability requirement in paragraph 9 and the guidance on this concept, as set out in paragraph 48B and further explained in paragraph BC25. However, CEBS believes that the Board should unify the concept of reliability and verifiability, extending the verifiability requirement as a general requirement, in order both to avoid the introduction of a double concept for fair valuation requirements of financial instruments and to strengthen the reliability of fair value estimates.

CEBS also appreciates the recognition of the role of prudential supervisors in overseeing the application of these requirements and of relevant risk management systems and policies by entities subject to prudential supervision. CEBS is very well aware and acknowledges that this statement does not give banking supervisors the power to amend or overrule the requirements of IAS 39. In that respect, CEBS believes that enforcers of the accounting framework should play an important role in considering the quality of the valuation methods used by banking institutions. However, it is necessary for banking supervisors to oversee the application of the requirements set out in paragraph 48B and of relevant risk management systems, in order to avoid for prudential purposes, a potential misuse of the option following an inappropriate determination of the fair value of a financial instrument.

Some proposed changes and their rationale are detailed further in our response to question 4.

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?

Our response

CEBS is not aware of any financial instruments to which entities 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.

However, one CEBS member raised the current situation in its country, where fixed interest rate loans that are not hedged are required to be marked down by financial institutions, so that their return corresponds to the current interest rate observed in the market for similar claims. On the contrary, financial institutions are at present prohibited to mark up the loans above their nominal value. However, due to the existence of a prepayment option, this would to a large extent also be considered to be the case in a fair value model considering the nature of prepayment option and customers behavior in this country. If simple prepayment options are not captured by paragraph 9(b)(i) –see our answer to question 4-, these financial institutions will not be able to use the fair value option on these loans and they will no longer be able to include the effects of interest rate changes in the measurement of such loans in their income statements (because they would normally not qualify for another category of eligible to the fair value option). The element of fair valuation that exists at present will thus no longer be possible.

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?

Our response

The rationale for paragraph 9(b)(v) is set out in paragraph BC7, namely loan commitments and investments in associates and joint ventures held by venture capital organizations or mutual funds, unit trusts and similar entities.

More generally, CEBS believes that the introduction of this paragraph should be viewed as an effort, for classification and disclosure purposes, to include any particular instrument for which there is a fair value option through profit and loss within the first category of financial instruments as defined in paragraph 9 (e.g. financial asset or financial liability at fair value through profit or loss) and, more specifically, within the category defined in paragraph 9(b) (instruments to which the fair value option is applied). CEBS believes however that paragraph 9(b)(v) should not be viewed as a possibility to avoid fulfilling conditions set out in paragraph 9(a) for the classification of a financial instrument as held for trading and would welcome a clarification by the Board on that point.

CEBS has no further comment, save the general comment and the answers to question 1 and
question 4.

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?

Our response

The rationale for paragraph 9(b)(i) is set out in paragraph BC6(a), where the Board explains that, in situations where IAS 39 requires an embedded derivative that is not closely related to its "host" contract to be separated and measured at fair value, it would be easier for the institution to measure the entire instrument (e.g. "host" contract + embedded derivative) at fair value. However, it is not explained why financial instruments with embedded derivatives that do not have to be separated could be eligible also to the fair value option.

As such, the proposed version of paragraph 9(b)(i) allows the designation as at fair value through profit or loss for any financial asset or financial liability that contains one or more embedded derivatives, whether or not the embedded derivatives should be separated from the "host" contract. Hence, a very substantial number of financial assets and financial liabilities would qualify for the fair value option under the proposal –at election of the entity and item by item- even if the embedded derivative is not required to be recognized separately and measured at fair value.

CEBS believes that the IASB should clarify whether it did intend or not to capture every single embedded derivative and should provide more guidance on the type of embedded derivatives which could be captured using the fair value option, for example by defining what makes them material.

From that perspective, most CEBS members would recommend to restrict the use of paragraph 9(b)(i) to financial instruments where paragraph 11 of IAS 39 requires the embedded derivative to be separated.

Proposed amendments:

9(b)(i) The item is a financial asset or financial liability that contains one or more embedded derivatives as described in paragraph 10, where paragraph 11 requires the embedded derivative(s) to be separated.

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 wa s 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?

Our response

CEBS does not expect a lot of European credit institutions to adopt IAS 39 early. For those who might adopt early IAS 39, CEBS supports the pragmatic approach followed by the Board (no retrospective application).

Question 6

Do you have any other comments on the proposals?

Our response

No.