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Exposure Draft of Proposed Amendments to IAS 39 Financial Instruments: Recognition and Measurement "The Fair Value Option"

Introduction

The Deutsche Bundesbank welcomes the opportunity to comment on the "Exposure Draft of Proposed Amendments to IAS 39 Financial Instruments: Recognition and Measurement – The Fair Value Option" presented by the IASB. The comments by the Bundesbank's Banking and Financial Supervision Department are made primarily in the context of the potential impact of the Exposure Draft on credit institutions and thus focus on the prudential perspective. We agree with the comments made in the Basel Committee on Banking Supervision's Comment Letter and wish our remarks to be viewed as supplementing these comments.

In general, we welcome the IASB's willingness to amend IAS 39 so that the unlimited fair value option originally introduced into IAS 39 in December 2003 should, in principle, be applied only in cases where it makes economic sense. In this context we also support the IASB's verifiability concept which aims to strengthen the verifiability of fair values.

We recognise the progress made by the current Exposure Draft with regard to an appropriate limitation of the fair value option. Nevertheless, we also recognise that the Exposure Draft would have considerable difficulties in actually limiting the fair value option. Moreover, initial feedback from the banking market seems to indicate wide variation in the extent to which the proposed fair value option would be used by market participants. This could have a negative effect on more than just the prudentially relevant comparability of financial statements.

General remarks

We are, in general, open to any initiative which, by promoting clarity, transparency, reliable valuations and a risk-adequate presentation of the business situation in the balance-sheet depiction of enterprises' – in particular credit institutions' – economic circumstances, helps to strengthen the stability of the financial system.

Thus, as in the case of designing accounting standards in general, we are in favour of an accounting standard for financial instruments based on the modern, proven and recognised risk management practices as applied by credit institutions. We therefore firmly believe that the fair value option is no substitute for an appropriate and practicable hedge accounting approach in IAS 39 which is compatible with the banks' risk management practices.

Applying the fair value option to the reporting entity's liabilities poses a particular problem, especially from a prudential point of view. As, under the fair value option, fair value measurement is not restricted to market developments (eg market interest rate fluctuations or changes in the exchange rate parities), but is all-encompassing, ie it also includes fluctuations caused by changes in the reporting entity's credit rating, a deterioration in the reporting entity's credit rating and the resultant devaluation of its own liabilities leads to an increase in its capital. From a prudential point of view, this is unacceptable. The IASB has not commented on this problem in the Exposure Draft. Consequently, in its press release on 8 June 2004, the Basel Committee on Banking Supervision recommended that the capital impact of fluctuations in the reporting entity's credit rating be excluded for the purpose of regulatory analyses. But the associated accounting problem remains.

Even if we may assume that this problem can be eliminated under the constraint set forth in paragraph 9 (b) (iii) ("natural offset"), paragraph 9 (b) (i) makes it possible to use fair value measurement under the fair value option simply by including a rather insignificant embedded derivative in a liability.

Even though we welcome the introduction of the verifiability concept into the fair value option, we consider setting different criteria for the fair value measurement in IAS 39 – ie the reliability concept for the trading book and the financial instruments in AfS on the one hand and the verifiability concept for the fair value option on the other hand – to be inconsistent. We would therefore wish to see the verifiability concept, which is qualitatively of a higher standard, introduced into IAS 39 as the sole valid concept for fair value measurement and consequently also applied to the measurement of financial instruments in held for trading and in AfS.

Individual questions raised in the Exposure Draft

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?

Paragraph 9 (b) (iv) states that financial instruments can be measured at fair value provided that they do not fulfil the definition of loans and receivables. As we see it, this only apparently excludes loans, in particular, from fair value measurement under the fair value option. By simply including a rather insignificant derivative in the construction of a loan it would clearly be possible to classify this loan under paragraph 9 (b) (i) and consequently to measure it at fair value. In our opinion, there should generally be no question of a fair value measurement of loans because of the associated problems particularly concerning reliability. We would therefore welcome clarification in IAS 39 that the exclusion of loans and receivables from fair value measurement in paragraph 9 (b) (iv) is not a conditional provision, but rather a definitive rule. This means, however, that the fair value option can no longer be deemed a suitable substitute for the overly complex regulation of the portfolio hedging of the interest rate risk in the banking book. If this option, of which we are fundamentally sceptical, is to be adhered to at all in the future, it would seem appropriate to restrict it to very limited exceptional circumstances. However, we fail to see any obvious examples of such circumstances given that the existing provisions on embedded derivatives in IAS 39.12 already provide for the possibility of measuring complex combined instruments as held for trading at fair value.

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?

As previously mentioned, the possibility of a fair value measurement of structured financial instruments with embedded derivatives (paragraph 9 (b) (i)) involves the problem of the capital impact of fair value measurement of the reporting entity's own liabilities. From a prudential perspective, a positive impact on an entity's capital as a result of its deteriorating credit rating via a devaluation of its liabilities is particularly unacceptable. We would therefore welcome a modification of the provision in paragraph 9 (b) (i) so that the mere presence of an embedded derivative or even the addition of an embedded derivative to a liability cannot result in the possibility of measuring such liabilities at fair value, with the impact mentioned on capital. In our view, such a provision would not only mean that all reporting entities would present their actual assets and liabilities, financial position and profitability more fairly; it would also avoid the need for a separate prudential regulation disregarding any corresponding impact on capital, as already recommended by the Basel Committee on Banking Supervision in its press release on 8 June 2004. This would also prevent a growing discrepancy between regulatory and balance sheet definitions of capital.