



BASEL COMMITTEE ON BANKING SUPERVISION

BANK FOR INTERNATIONAL SETTLEMENTS

Chairman

**VIA FACSIMILE**

Sir David Tweedie  
Chairman  
International Accounting Standards Board  
30 Cannon Street  
London EC4M 6XH  
United Kingdom

30 July 2004

**Comments on the IAS 39 fair value option proposal**

Dear Sir David,

The Basel Committee on Banking Supervision welcomes the opportunity to comment on the Exposure Draft of proposed *Amendments to IAS 39, Financial Instruments: Recognition and Measurement – The Fair Value Option*, published for comment in April 2004. The Committee has a strong interest in promoting sound accounting standards that result in transparent and high quality financial statements by banks.

Please find our detailed comments in the attached note. The Committee's Accounting Task Force, chaired by Prof Arnold Schilder, Executive Director of De Nederlandsche Bank, has prepared the note. This note has been approved by the Basel Committee. The development of our comments was coordinated by an *ad hoc* subgroup on IAS 39 under the direction of Gerald A Edwards, Jr, Associate Director and Chief Accountant – Supervision, Federal Reserve Board. The Basel Committee trusts that you will find its comments useful and constructive.

If you have any questions regarding our comments, please feel free to contact Prof Schilder (+31 20 524 3360), Mr Edwards (+1 202 452 2741), or Ms Donna Bovolaneas at the Basel Committee Secretariat (+41 61 280 9278).

Yours sincerely,

Jaime Caruana

Attachment



30 July 2004

## **Basel Committee Comments on the IASB Exposure Draft of Proposed "Amendments to IAS 39, Financial Instruments: Recognition and Measurement – The Fair Value Option"**

### **Introduction**

The Basel Committee on Banking Supervision<sup>1</sup> (Committee) has been issuing extensive guidance and policy papers on risk management activities of banks for over a decade. These releases have included guidance and research studies on sound practices for managing credit risk, market risk (including interest rate and foreign exchange risk), operational risk, and other banking risks. In addition, in its work on the *International Convergence of Capital Measurement and Capital Standards: a Revised Framework*, commonly referred to as Basel II, the Committee has developed new rules and proposals for comprehensively relating capital adequacy to bank risk profiles. All of these efforts have involved extensive consultation with global banks and others, and have been designed to promote the adoption of sound risk management by banks around the world. In reviewing the proposal to amend the IAS 39 fair value option accounting approach, the Committee has drawn upon its expertise in these areas.

Furthermore, the Committee has long held that the transparency of banks – facilitated by sound accounting and disclosure – is an important objective, and this has been the topic of a number of the Committee's policy papers, surveys and supervisory guidance documents in support of this objective. Most notably, the revised capital framework that the Committee released in June 2004 recognises the important role of transparency in effecting market discipline as a complement to effective banking supervision. In addition, since 1998 the Committee has been actively involved in important projects, with the IASB and its predecessor, to enhance financial instruments accounting and disclosure. In all of these efforts, the Committee has been actively seeking to improve the overall quality of financial reporting in ways that will enhance transparency and market discipline, and facilitate financial stability. Thus, the Committee has brought these perspectives to bear in reviewing the IASB's June 2002 proposal to amend IAS 39 as well as the current exposure draft of proposed amendments to the fair value option.

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<sup>1</sup> The Basel Committee on Banking Supervision is a committee of banking supervisory authorities which was established by the central bank Governors of the Group of Ten countries in 1975. It consists of senior representatives of bank supervisory authorities and central banks from Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Spain, Sweden, Switzerland, the United Kingdom and the United States. It usually meets at the Bank for International Settlements in Basel, where its permanent Secretariat is located.

This note presents our main comments in the section below. The section provides important background and essentially provides summary answers to the specific questions 1, 3, 4 and 6 that were raised by the IASB in the exposure draft.

## **Main Comments**

In its previous public comments to the IASB on the fair value option under IAS 39, the Committee has noted that in theory, there are certain benefits to a fair value designation through the standard's guidance that would permit any financial instrument to be designated as at fair value through profit and loss when initially recognised.<sup>2</sup> For example, asset and liability positions in financial instruments that are managed together can receive a common accounting treatment that may not be currently available due to the mixed-attribute accounting model in IAS 39. In addition, this fair value treatment could potentially reduce the calculations and complexity associated with the IAS 39 hedge accounting rules, if the risk exposures and the derivatives that hedge them are designated as at fair value through profit and loss and accounted for on a fair value basis.

However, the Committee's previous comments also noted that there are a number of potential problems associated with this approach. In fact, this designation could result in the same problems as the Committee noted in its previous comment letters about the potential adoption of full fair value accounting.<sup>3</sup> For example, it could permit companies to report increased profits when their own creditworthiness deteriorates. Additionally, for financial instruments without observable market prices arising from active markets, it may be difficult for companies to determine reliable fair values and for auditors to audit these estimates. Thus, the Committee noted that if the fair value option is applied to financial instruments that are not traded in active markets and lack reliable fair values, this option may permit companies to manage earnings in ways that would not easily be detected by financial statement users. For example, organisations could use potentially self-serving models to determine fair value for illiquid instruments in ways that improved their reported financial condition and performance. In addition, the relevance for decision making is questionable when the instruments purportedly reported at fair value are actually illiquid.

We also noted in our comments that the fair value option essentially permits a further reporting option, which is contrary to one of the main objectives of the IASB improvement projects, which is to eliminate or simplify reporting options. Thus, the fair value option may reduce the comparability of financial statements.

In consideration of these and other issues – particularly the potential to allow companies to benefit from deterioration in their own credit risk, which could seriously undermine the transparency of financial reports – the Committee recommended in prior comments that the IASB reconsider its planned guidance for the fair value option in IAS 39.

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<sup>2</sup> These public comments were provided in the Committee's October 2002 comment letter on the IASB's June 2002 proposal to amend IAS 39.

<sup>3</sup> These comments were provided in the Committee's comment letters to the IASC Board on its 1997 Discussion Paper on fair value accounting issues and its 1998 E62 exposure draft, and in 2001 to the IASB on the Joint Working Group of Standards Setters' Draft Standard and Basis for Conclusions entitled "Financial Instruments and Similar Items".

## **Enhanced dialogue and transparency and main recommendations**

The Committee welcomes the increased dialogue and discussions between the IASB and its constituents that has been taking place since late last year. Moreover, the Committee supports the IASB's announcement that it is setting up specific international working groups, one of which will focus on financial instruments, composed of representatives from the accounting profession, banking industry, supervisors, central banks, and other important constituencies to tackle longer-term issues. These developments, coupled with the revisions to the IASB's due process procedures, should result in better input to the IASB as it considers ways to improve its guidance and more transparency in its standard setting process over time.

The Committee also welcomes the IASB's planned new project to examine the fundamentals of IAS 39's guidance. As noted in our previous comments, the Committee believes that a more suitable approach to hedge accounting that is consistent with sound risk management practices might well obviate the perceived need for a fair value option. In this respect, we hope that the IASB will consider as soon as possible the development of a more adequate, streamlined approach to hedge accounting as it starts this new project to rethink IAS 39.

As discussed more fully below, we recommend that the exposure draft's guidance on the fair value option be revised as follows:

- Exclude the mark to market of own credit risk from the fair value option by limiting the mark to market of liabilities solely to valuation changes due to general market movements (including the interest rate yield curve, foreign exchange rates, and equity indices). This approach is broadly consistent with the approach used in fair value hedge accounting under IAS 39, which requires the valuation of the hedged item to reflect the targeted hedging strategy (eg, solely reflecting changes in interest rate risk or foreign currency risk) instead of requiring such items to be fully fair valued.
- Establish the guiding principle that the fair value option could be used to reduce the "accounting volatility" that occurs for financial assets and the liabilities that fund them (as part of a coordinated funding strategy) arising from the mixed attribute accounting model in IAS 39 and to economically hedge exposures subject to similar risks. The guidance in the exposure draft's current paragraphs 9(b)(ii) and (iii) (on the use of the fair value option for certain substantially offsetting exposures or contractually linked exposures) could be set forth as examples of this principle. Thus, the criterion in paragraph 9(b)(i) on embedded derivatives could be eliminated.
- The exposure draft includes a requirement that a financial instrument utilising the fair value option must have a verifiable fair value. We recommend that this verifiability requirement be enhanced by including a presumption that an illiquid financial instrument would not qualify as an instrument with a verifiable fair value, and thus it could not be eligible for the fair value option. This presumption could be rebutted only where values could be credibly inferred for illiquid financial instruments. This approach would also address the issue of the use of the fair value option for many loans, and we also discuss related issues that the final standard should address with respect to the treatment of loans and possible window dressing situations. Moreover, we support applying the verifiability requirement, including our suggested enhancements, to all financial instruments carried at fair value that are not held for trading.
- The final standard should require identification of the categories or types of assets and liabilities (and their related fair values) to which the fair value option has been applied, and the related gains or losses for each category reflected in the profit and

loss account and the effect on equity. This is needed to enable users of financial statements to fully understand the impact of a company's application of the fair value option. Moreover, the final standard should include a requirement for the company to explain how and why it uses the fair value option, for example, to fulfill specific risk management policy objectives. In particular, if the IASB continues to allow the fair value option to be used in ways that result in the mark to market of own credit risk, we recommend that a new line item be included in equity that would identify the effect on equity of the mark to market of a company's own credit risk.

The following section of this technical note discusses more fully the Committee's comments on the exposure draft's guidance on the fair value option.

### **Discussion of issues arising from the current proposal**

The IASB has attempted to address some of the Committee's concerns in its current proposal on the fair value option. For example, the IASB sought to address the fair value reliability issue raised by supervisors by adding the new proposed verifiability language, and by pointing to the possible authority of supervisors over the implementation of the fair value option in regulated institutions. However, the fair value option still raises a number of significant issues, particularly since the proposal does not appear to reduce the possible use of the fair value option.

### ***Own credit risk***

We would caution that the fair value option, as currently specified, might lead to shortcomings in financial reporting on a scale which could conceivably undermine confidence in the standard setting process. Specifically, it would be wholly unsatisfactory if an entity which was insolvent in the sense of its assets being worth less than the par value of its liabilities nonetheless appeared to be solvent because the fair value of its liabilities was recognised on its balance sheet, with the fair value below nominal value. We recognise that IAS 32 requires disclosure that is intended to allow the user of financial statements to determine the impact of own credit risk with respect to the application of the fair value option to a company's liabilities. However, notwithstanding this disclosure, which is likely to be in the footnotes to the company's financial statements, the reported measures of profit and loss and equity would be distorted.<sup>4</sup>

The proposal's restrictions on the use of the fair value option do not limit the problem associated with the "own credit risk issue". For example, a liability with an embedded derivative would still qualify for the fair value option. Indeed, a company that wished to abuse the fair value option could simply design a liability to have a very small embedded derivative, thus qualifying it for the fair value option. This situation would still result in the own credit risk problem that would obfuscate the reported equity and profit and loss accounts.

While the impact of the fair value option on the assessment of banks' financial condition and performance by regulators and market participants is likely to be mitigated by the actions of

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<sup>4</sup> In a related matter, the Committee has examined the appropriate regulatory capital treatment of any fair value gains and losses arising from changes in an institution's own credit risk as a result of applying the fair value option to its own liabilities. In a release on 8 June 2004, the Committee noted that the potential inclusion of these gains and losses in Tier 1 or Tier 2 capital raises significant supervisory concerns. Accordingly, the release noted that the Committee believes it would be appropriate for national supervisors to not recognise these gains or losses in regulatory capital.

regulators in excluding the impact of 'own credit risk' from regulatory capital, this does not fully address the impact of 'own credit risk' on reported equity. In addition, there remains the worrying possibility that the financial condition of major non-regulated corporations could be seriously misrepresented. Thus, some borrowers and other counterparties of banks or other companies could mark to market their own credit risk or otherwise abuse the fair value option to overstate their financial condition or performance and thus obtain loans or enter into other contractual arrangements for which they would not have otherwise qualified. This could have adverse consequences on bank financial condition and performance if these borrowers were not able to perform in accordance with their contractual obligations. This inability to perform could have significant implications for bank soundness, and financial stability more generally, since extensions of credit to corporates represent a significant part of banks' assets.

We therefore urge that where own liabilities are measured at fair value, only valuation changes due to general market movements (including the interest rate yield curve, foreign exchange rates, and equity indices) be taken into account, and not own credit risk features specific to the reporting entity. This approach is broadly consistent with the approach used in fair value hedge accounting under IAS 39, which requires the valuation of the hedged item to reflect the targeted hedging strategy (eg, solely reflecting changes in interest rate risk or foreign currency risk) instead of requiring such items to be fully fair valued.

### ***Fair value option criteria and overall risk management strategy***

Some banks and other companies have as their primary objective to use the fair value option to reduce the "accounting volatility" that occurs for financial assets and the liabilities that fund them (as part of a coordinated funding strategy) arising from the mixed attribute accounting model in IAS 39 and to economically hedge exposures subject to similar risks. The Committee recommends that this should be set forth in the final standard as a guiding principle with respect to the use of the fair value option, and paragraphs 9(b)(ii) and (iii) could be set forth as examples of this principle. The Committee also recommends that banks and other companies using this principle should be required to disclose their accounting policies and risk management policies that underpin the application of the fair value option – that is, the policies that specify the circumstances under which the option is applied and the rationale for its use.

If this guiding principle is clearly set forth in the final standard, we do not see a need to retain the criterion in paragraph 9(b)(i), which would allow financial assets and liabilities with embedded derivatives to qualify for the fair value option. The criterion in paragraph 9(b)(i) is so broad that almost any financial asset or liability could qualify for this treatment.

The section below discusses certain reliability concerns associated with illiquid financial instruments, including some loans (eg, those addressed in paragraph 9(b)(iv)), and certain other issues.

### ***Reliability issues and concerns about loans***

Broadly, a key issue underlying the use of the fair value option is whether fair values can be obtained directly from observable market prices, or a robust valuation technique. If neither is possible, the Committee believes there is a presumption that an estimated fair value would not be reliable or verifiable. Even with apparently observable prices, for example, from brokers' screens, care needs to be taken that the market in question is reasonably liquid, and the screen prices are representative of actual trades.

However, the issues surrounding valuation models need further consideration. Some valuation techniques do not raise significant issues of reliability – for example, the derivation



of the interest rate yield curves for major currencies with deep markets for which there are well established techniques. Moreover, some complex structured products can be broken down into a set of more straightforward instruments for which market prices are available. Nevertheless, serious reliability concerns arise where there are not established valuation techniques with a clear and rigorous basis and/or one or more important inputs to valuation are not observable, even indirectly, from liquid markets.

It is not clear that these concerns are fully addressed by the notion that a valuation is 'verifiable' if a panel of experts would independently come up with prices within a narrow range. One concern is that new, innovative products could receive similar, but nonetheless erroneous, valuations from the small number of investment banks which tend to drive such innovations.

It is also not clear how the Board will defend two standards of reliability: one for fair value changes through profit or loss arising from trading and fair value changes through equity from available-for-sale (AFS) financial assets; but another, stricter standard for fair value changes arising from the fair value option. As we are generally concerned with valuations derived from non-liquid markets, we support the case for harmonising the standard using the stricter verifiability criteria and applying these criteria to all financial instruments not held for trading (including other recommendations discussed below).

As a way of addressing concerns about the reliability of fair values for instruments accounted for using the fair value option, the proposal may seem to some, at first glance, to prohibit the use of the fair value option for "loans and receivables" not otherwise qualifying for the option under the other four criteria (eg, simple, plain vanilla loans without embedded options). However, the IAS 39 definition of loans might be interpreted by some to allow companies to place a loan at inception in the AFS category *without limitation*, and once placed in the AFS account, to reclassify the loan and place it in the fair value option category at inception. This situation would mean that some financial instruments that banks and supervisors consider "loans" could be in the loan account, others would be in AFS assets, and others might be in the fair value option category. Those in the fair value option category would be there as a result of this two-step initial recognition placement process. Also, there is the possibility that loans and receivables could be in the fair value option category through window dressing transactions that would take place at a date after their origination. In these transactions, originated loans and receivables would on paper be sold to another company and then repurchased. The originator of these ostensibly "acquired loans" would "upon initial recognition" designate them as assets at fair value through profit or loss. Since we do not believe that this was the IASB's intent, if the IASB decides to keep the limitation in paragraph 9(b)(iv), we recommend that the final standard make it clear that loans cannot be transferred to the AFS category upon initial recognition and then immediately into the fair value option category.<sup>5</sup> We also recommend that the final standard prohibit possible window dressing situations like the type mentioned above.

In view of this and consistent with the Committee's previous comments on fair value issues, the Committee believes that the fair value option should not be applied to illiquid financial instruments, including illiquid instruments other than loans and other receivables. Thus, we recommend that the concept of verifiability include a presumption that an illiquid financial instrument would not qualify as an instrument with a verifiable fair value, and thus it could not

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<sup>5</sup> It is also important that if the IASB retains the criterion in paragraph 9(b)(iv), then the definition of loans and receivables in paragraph 9 of the standard should be amended consistent with the recommended changes in this section of our comment letter.

be eligible for the fair value option. This presumption could be rebutted only where values could be credibly inferred for illiquid financial instruments. Examples include where there exists a very similar financial instrument that actually trades in a liquid market, or where an illiquid financial instrument can be rigorously broken down into components for which prices can be taken from liquid markets or from sound valuation approaches.

Consistent with our previous comments to the IASB, the Committee notes that while the IASB has taken some steps to include additional guidance on fair values in the exposure draft, we encourage the IASB to consider devising enhanced guidance for determining fair value. In addition, as noted in our September 2001 comment letter to the IASB on the Joint Working Group's draft standard on fair value accounting for financial instruments, we recommend that the IASB consider the formation of an expert panel to: (i) examine best practices in the area of valuation techniques; and (ii) assess the feasibility and practicality of formulating reasonably specific sound practices guidance on appropriate methods for valuing illiquid instruments, such as bank loans. The creation of this panel would complement the international working groups that the IASB is establishing to address longer-term issues.

The Committee would envision that such a panel should be comprised of experts representing both preparers and users of financial statements, as well as limited numbers of other interested parties, such as accounting standard setters, auditors, and banking supervisors and other regulators. As envisioned, such a group should ideally have a broad perspective of expertise encompassing such areas as risk management, financial modelling and valuation and auditing. This recommendation was recently reiterated by the Group of Thirty in its report on enhancing public confidence in financial reporting. This effort could greatly assist preparers and users of financial reports in understanding the practical approaches that are necessary to estimate fair values that are reliable and verifiable.

### ***Enhanced disclosure***

Given the complexity and scope for accounting choices in IAS 39, a high level of disclosure of accounting and risk management policies and their rationale is called for, including in the area of the fair value option. We note that the proposal does not require identification of the categories or types of assets and liabilities (and their related fair values) subject to the fair value option, nor the related gains or losses for each category reflected in the profit and loss account and in equity. Thus, it would be difficult for users of financial statements to fully understand the impact of a company's application of the fair value option. Moreover, there is no requirement for the company to explain how and why it uses the fair value option, eg, to fulfill specific risk management policy objectives. If the IASB goes forward with the proposal, these disclosures should be required.

Furthermore, if the IASB continues to allow the fair value option to be used in ways that result in the mark to market of own credit risk on financial liabilities, we recommend that a new line item be included in equity that would identify the effect on equity of fair value changes attributable to changes in a company's own credit risk.