Bundesverband
Öffentlicher Banken
Deutschlands

Sir David Tweedie
Chairman
International Accounting Standards Board
30 Cannon Street

London EC4M 6XH
United Kingdom

Name: Jan-Velten Große
Telephone: +49 (30) 81 92 – 1 72
Telefax: +49 (30) 81 92 – 1 79

21 October 2004

Position of the Association of German Public Sector Banks on the draft standard "ED 7 Financial Instruments: Disclosures"

Dear Sir David

We thank you for giving us the opportunity to comment on the draft standard "ED 7 Financial Instruments: Disclosures" published on 22 July 2004 by the International Accounting Standards Board (IASB).

A. General remarks

In view of the latest developments in the areas of accounting and risk management, ED 7 is aimed at combining the disclosure provisions for financial instruments previously contained in different standards into one single standard and extending them to also include details concerning risk management. We support, in principle, the endeavours of the IASB to bundle these disclosure provisions with the objective of the accounts conveying a picture of the financial position and performance which corresponds with the real situation.

However, with ED 7, the IASB is continuing the trend towards sector-independent standards.

Lennéstraße 11
10785 Berlin
Postfach 11 02 72
10832 Berlin
Telefon (030) 81 92 - 0
Telefax (030) 81 92 - 222
E-Mail: postmaster@voeb.de
Internet: http://www.voeb.de

The existing disclosure requirements for banks and other financial institutions in accordance with IAS 30, which are particularly geared to the structure and business activities of such enterprises, are to be replaced. In this way, the IASB can no longer take account of the specialties of the banking sector to the necessary extent. By nature of their business model, financial institutions are liable to a high degree of risks from financial instruments and have to comply – in addition to accounting disclosures – with regulatory disclosure obligations which do not exist in a comparable manner for other sectors of the economy. For this reason, we plead at least for a sector-specific interpretation of the standard and admissibility of the "recognition of positions and their breakdown" as practiced in banks' accounting procedures.

We furthermore assume that the type and extent of the disclosure requirements concerning risks arising from financial instruments and the risk management correlate with the content of the risk and the scope of the transactions. The description of risks arising from financial instruments as preferred by the IASB is a purely product-related risk specification which takes insufficient account of risk-reducing correlation effects and does not correspond to the practice of the financial institutions' internal risk management. This can give rise to misjudgements.

We see part of the disclosure requirements as being subsequent clarification or interpretation guidance for balance sheet and profit and loss account disclosures which are only necessary because of the complexity and deficient nature of a number of recognition and measurement provisions. For this reason, we consider the proposed disclosure provisions to be too extensive in part and recommend that they be amended.

We do not share the view according to BC20 that the disclosure provisions of ED 7 are consistent with the disclosure requirements of the Basle Committee for the Supervision of Banks (i.e. Basle II, Pillar 3). While ED 7 is geared to financial instruments, Basle II, Pillar 3 requires details of the risk structure of credit and loan business, in particular, and on the composition of the capital resources of financial institutions. Furthermore, the provisions can result in a different basis of consolidation, which considerably affects the clarity of the description for addressees.

Where the same elements are to be disclosed under both ED 7 and Basle II, Pillar 3, we call for an exemption effect of the Basle requirements for reasons of clarity and economic efficiency.

In addition, we would like to point out that the requirements of para. 46-48 highlight the problems concerning the concept of "balance sheet equity". The discussion surrounding shares in co-operative entities in relation to IAS 32 is again a very bitter one in this regard. The IASB should, in our view, also concern itself with shareholder contributions in partnerships and shares in dormant partnerships, which are deemed balance sheet equity under certain conditions in the understanding of Continental Europe.

For more specific details, we refer to the following replies.

B. Replies to questions

Question 1 – Disclosures relating to the significance of financial instruments to financial position and performance:
Are these proposals appropriate? If not, why not? What alternative disclosures would you propose?

We welcome, in principle, the call for minimum disclosures concerning risks arising from financial instruments.

We see the disclosure of details from the balance sheet and profit and loss account according to categories of financial instruments, as provided for in para. 10 et sqq., as a useful criterion. However, it is not exhaustive for providing an informative statement of the inherent risks since certain properties and characteristics of the financial instruments which are essential for the presence of risks cannot be recognised on the basis of the category.

We do not consider the requirement of para. 11(a) to disclose changes in fair value attributable to the interest rate risk to be in line with the objective.

We support the intention to display changes in fair value arising from certain market risks separately so as to separate these from changes in fair value attributable to changes in one's own credit spread. However, achieving this objective requires the separate disclosure of changes in fair value arising from *all* market risks. In this respect, we plead for separate disclosure of changes in fair value induced by all market risks but not those induced by interest rate risk only.

We consider the profit and loss account structure proposed in para. 21 to be misleading.

Para. 21(a) requires the disclosure of "net gains/losses" for all categories of financial instruments. Such a net result is, in our estimation, only meaningful for the "at fair value through profit or loss" category – and only for "held for trading"-instruments. For all other categories, the net gains/losses from measurement on the one hand and the net gains/losses realised, including the interest and dividend income, on the other hand should be shown separately. We recommend to adjust para. 21(a) accordingly.

Para. 21(b) requires the disclosure as to whether interest and/or dividend income is included in net gains/losses referred to in (a). In our view, this can only relate to "held-for-trading" transactions. We recommend a corresponding restriction to instruments "held for trading".

Para. 21(c) requires the separate disclosure of interest income/expense of all financial instruments except the fair value category. However, para. 21(c) also needs to be adjusted – as a consequence of the previously proposed changes to para. 21(a) and (b). In this case, we recommend the separate disclosure of the interest result for all financial instruments which do not belong to the "held-for-trading" sub-category and the interest results of which are thus not shown within the item "net gains/losses" according to para. 21(a).

On the other hand, if para. 21(a) in conjunction with BC16 is interpreted in such a way that there is an option whether the interest result of "held-for-trading" instruments is shown as part of net gains/losses in accordance with para. 21(a) or separately as interest income/expense in accordance with para. 21(c), para. 21(c) needs to be adjusted to the option.

All in all, the breakdown of all profit or loss positions on the basis of measurement categories in accordance with para. 21 is not purposeful and possibly does not represent the economic origin of the result correctly.

Furthermore, we assume that the listing and differentiation of risk types in accordance with para. 33 serves only as an example and that other risk types can be added. In addition, no account is taken of the fact that part of the risk or individual risk types also emerge outside of financial instruments and that correlation effects exhibit a risk-reducing effect. We feel that additional clarification is needed in this respect.

We regard the disclosure requirement of para. 30(d) as partially unreasonable, especially in the case of investments which are recognised in the balance sheet as a financial instrument (cf. our comments referring to question 10). We ask for deleting this provision.

Question 2 – Disclosure of the fair value of collateral and other credit enhancements:
Is this proposal appropriate? If not, why not? What, if any, alternative disclosures would you propose to meet the stated objective?

We consider the presentation of the credit risk remaining after taking account of collateral to be relevant information for decision-making with regard to the loss to be expected in case of default.

We regard the separate disclosure of fair values for collaterals pledged as security being inappropriate. The classification of collateral depending on the item secured can lead to one type of collateral being taken into account either by way of the fair value or amortised cost or – in accordance with reasonably prudent commercial judgement – by way of marking down the market value where regular measurement bears no relation to the benefit.

In our view, a disclosure of credit exposure in compliance with Basle II before and after taking account of collateral is therefore better suited to provide the users of financial statements with information on existing credit risks relevant to the decision-making process.

In order to attain the greatest possible convergence between the disclosure requirements of Basle II, Pillar 3 and the disclosure obligations of ED 7 and avoid cost-intensive redundant reporting that confuses the users of financial statements, we propose that the corresponding Basle II requirements should have an exemption effect for the banking sector.

Question 3 – Disclosure of a sensitivity analysis:
Is the proposed disclosure of a sensitivity analysis practicable for all entities? If not, why not and what, if any, alternative disclosures of market risk would you propose to meet the stated objective of enabling users to evaluate the nature and extent of market risk?

Internal identification of the market risk at portfolio level based on sensitivity analyses and value-at-risk models are already common practice in the banking sector.

However, we consider the disclosure of sensitivity analyses to be problematic in principle by virtue of their containing information, the publication of which is ruled out on competition grounds. For this reason, we prefer disclosure on the basis of value-at-risk ratios.

We are of the opinion that the disclosures required under Basle II cover the requirements of ED 7 and therefore propose that these should have an exemption effect.

Question 4 – Capital disclosures:
Is this proposal appropriate? If not, why not? Should it be limited to only externally imposed capital requirements? What, if any, alternative disclosures would you propose?

We understand the requirements of para. 46-48 on "capital" in the sense of disclosures concerning the "company's equity". Otherwise, we request a specific distinction between the terms "capital" and "equity".

According to para. 47, companies are to make disclosures, among other things, on infringements against external capital requirements and the resulting consequences. Although we agree with this disclosure obligation in principle, we are critical of the redundancy of information that arises since the banking sector already has to make such disclosures for the bank supervision monitoring procedures under Basle II. For this reason, we call for an exemption clause which recognises the disclosures made in accordance with Basle II as being sufficient.

Furthermore, we do not find it acceptable for details concerning internal planning figures and possible changes to have to be published. No external third party can assess the quality of management on the basis of the publiccation of planned figures and their difference to actual figures. Misjudgements and legal disputes would then be preconditioned. This requirement represents an unacceptable intervention in the internal company decision-making process. We therefore ask for deletion of this requirement.

We would also point out that the problems associated with the concept of balance sheet equity are becoming evident again, as revealed by the discussion surrounding shares in co-operative entities in relation to IAS 32. In our view, the IASB should also concern itself with shareholder contributions in partnerships and shares in dormant partnerships, which are deemed balance sheet equity under certain conditions in the understanding of Continental Europe. We therefore request that the argumentation paper issued by the Institut der Wirtschaftsprüfer (IDW) in December 2003 be dealt with as quickly as possible and a consistent solution be drawn up for IAS 32 and ED 7.

Question 5 – Effective date and transition:
Are the proposed effective date and transition requirements appropriate? If not, why not? What alternative would you propose?

We reject any unequal treatment of first time adopters before 1 January 2007 under para. 49 in conjunction with B9.

Question 6 – Location of disclosures of risks arising from financial instruments:
Do you agree that the disclosures proposed by the draft IFRS should be part of the financial statements? If not, why not?

We agree with the view of the IASB that disclosure requirements concerning risks arising from financial instruments constitute part of financial reporting.

In order to avoid the above-mentioned negative effects of redundant risk reporting, we suggest an opening clause to enable the relevant disclosure requirements to be met within the context of the management report. The latter is mandatory under European and German law and includes the publication of a risk report.

In this respect we point out again our request for an exemption clause for financial institutions regarding redundant disclosure due to requirements by Basle II, pillar 3 (cf. comments referring questions 2, 3, and 4) in order to enable unique and consistent financial reporting.

Question 7 – Consequential amendments to IFRS 4 (paragraph B10 of Appendix B):
Do you agree that the risk disclosures in IFRS 4 should be amended to make them consistent with the requirements proposed in the draft IFRS?
If not, why not and what amendments would you make pending the outcome of phase II of the Board's Insurance project?

The amendments are consistent. We therefore agree with the adjustment of the disclosure provisions in IFRS 4.

Question 8 – Implementation Guidance:
Is the Implementation Guidance sufficient? If not, what additional guidance would you propose?

No comments.

Question 9 – Differences from the Exposure Draft of Proposed Statement of Financial Accounting Standards "Fair Value Measurements", published by the US Financial Accounting Standards Board (FASB):
Do you agree that the requirements in the draft IFRS provide adequate disclosure of fair value compared with those proposed in the FASB's Exposure Draft? If not, why not, and what changes to the draft IFRS would you propose?

We argue for a principle-based and consistent development of the IFRS. We have therefore refrained from passing judgement on the corresponding US-GAAP provisions concerning disclosures.

Question 10 – Other comments:
Do you have any other comments on the draft IFRS, Implementation Guidance and Illustrative Examples?

According to para. 30(d) and (e), disclosures in relation to intentions to sell and earnings from sale are required. We consider these disclosure requirements to be too extensive because of the danger that exists with regard to violations of protection of confidence in relation to other business partners and resulting detrimental effects on business.

Typically, value-at-risk models are used to measure market price risks in the banking sector. These take account of concentration risks via model parameters and express them by risk values. For this reason, we feel that a separate statement of concentration risks is dispensable.

In this respect, we ask for a corresponding restriction of para. 38.

According to para. 39 (IG 17(c)), disclosures have to be made regarding historical default rates. However, these do not provide the user with any information concerning defaults to be anticipated in the future. We therefore suggest deletion of this requirement.

We argue for clarification of para. 39-41 that financial institutions may, based on application of the Management Approach in accordance with BC22, use the term "credit" the same way it is applied to disclosure under Basle II, Pillar 3 and to internal reporting.

The analysis of the age structure of financial assets that are past due required under para. 40(a) does not, in our opinion, provide any information for those who the accounts are addressed to. For this reason, we suggest to delete this requirement.

Under para. 42(a), an analysis for liabilities that shows the remaining contractual maturities is to be disclosed for the purpose of computing the liquidity risk. We are, in principle, critical of the disclosure of detailed liquidity ratios according to concepts specific to banks because they are comparable with each other to a limited extent only. This can give rise to misinterpretations by users with corresponding effects on the stability of the banking system.

As the liquidity risk cannot be shown solely by an analysis of the maturities of liabilities, we call, alternatively, for the possibility to show the liquidity risk on the basis of liquidity figures in accordance with supervisory law.

C. Further need for clarification and additional information

We would ask the IASB to provide further clarification and additional information on the following elements within the context of ED 7:

Draft Implementation Guidance

In accordance with IG 5 and IG 6, the disclosure requirements under ED 7 are to be made dependent on the materiality of the information. In our view, IG 5 and IG 6 should be interpreted to the effect that, from the viewpoint of risk, "insignificant" entities of a group can be excluded from reporting.

We recommend that this interpretation be incorporated into the Implementation Guidance.

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

Yours sincerely,
Association of German Public Sector Banks

(Karl-Heinz Boos) (Lothar Jerzembek)