EFRAG

European Financial Reporting Advisory Group

Dr. Alexander Schaub
Director General
European Commission
Directorate General for the Internal Market

1049 Brussels

26 September 2004

Dear Dr. Schaub,

Re: Adoption of the amended IAS 39 *Financial Instruments: Recognition and Measurement*

You have invited EFRAG to give its technical input on the 'carve-outs' proposed by the European Commission in relation to IAS 39 *Financial Instruments: Recognition and Measurement* and have asked us to give you our view by Friday, September 24.

EFRAG is committed to a system of due process prior to expressing any formal opinion. In the limited available time it has not been possible to carry out our usual due process and accordingly the views expressed in this response can only be regarded as those of the members of EFRAG's Technical Expert Group that discussed the issues based on a limited review.

Your request was that we consider the carve-outs with a technical view to whether they achieve the objectives explained by the Commission, namely

(i) to remove the Fair Value Option as it applies to liabilities, and
(ii) to facilitate the use of fair value hedge accounting for the interest rate hedges for core deposits on a portfolio basis.

Our evaluation is based on the assumptions that the carve-outs are intended to be temporary and that the Commission will embed these proposals in a comprehensive package of recitals, which will ensure that the carve-outs will only be used for the intended purposes. In the time available to us, we have not fully considered material side effects and unintended consequences. Nor have we considered the related legal issues such as whether the carve-outs meet the legal requirements that they are distinct and separable, though we believe that the matters identified in this letter and appendix are relevant to such analysis. We do not express any opinion, favourable or unfavourable,

on whether the carve-out is a desirable solution. Our response should therefore not be interpreted as implying support for the carve-out itself.

Our work involved inviting views from the public through a request for comments posted on our website on September 15 with comments requested by September 21 in order to be discussed at an open meeting of our Technical Expert Group on September 22. The invitation sought views on whether the carve-outs 'would lead to a technically robust, sound and consistent solution'. Respondents were warned that the aim was not to evaluate whether the carve-out solution in principle was the preferred solution.

Despite the short notice, EFRAG received responses from approximately 20 organisations and corporations from Denmark, Sweden, Germany, UK and European organisations[1]. Several indicated that a lack of time given by the EC and the normal due process prevented them from giving a more considered opinion. We believe many other organisations may not have responded for the same reason.

Many of the comments received referred to significant side effects of the carve-out, which were also noted by members of EFRAG.

In relation to the carve-out of the fair value option for liabilities the concerns are that the carve-out will create artificial volatility for many entities in Europe and the effect may be serious for those entities and countries affected. We have in the appendix explained these issues more fully, but we can mention the cases of economically or contractually linked or matched financial assets and liabilities where artificial volatility is introduced if assets and related liabilities are not accounted for on the same basis. Examples are unit linked instruments and the Danish mortgage institutions.

In relation to hedge accounting the effect of the carve-outs is not just to allow fair value hedging of core deposits on a portfolio basis but to extend the range of items that can be designated as hedged items and to relax the effectiveness test requirements for all hedges. The effects of their relaxation are significant.

In practice the tightening of the provisions in relation to the fair value option prevents entities from using certain sensible accounting practices that they would be able to use under the full IAS 39. On the other hand the relaxation of the effectiveness test for hedging transactions will allow entities to apply accounting that the full IAS 39 would not.

In the appendix under the heading "Other issues" we draw your attention to issues of a different nature in relation to compliance with the IFRSs in the EU.

EFRAG has not, in the limited time available, considered whether there are other significant side effects that would have a severe impact on European entities.

Findings

The result of our limited review is that we have identified one point in relation to the Fair Value Option in that paragraph 9 as it stands would still permit an entity to designate a

[1] These responses have been posted to our website.

liability as at fair value through profit-loss because the heading to 9(a) and 9(b) coupled with the initial phrase of 9(b) would still allow it.

In relation to the hedging carve-out EFRAG's members discussed whether paragraph 49 might work against the Commission's objective. The members accepted that the recitals should resolve the issue and that a carve-out of paragraph 49 would have unacceptable side effects.

The TEG members believe that there are significant side effects that could result in less reliable accounting relating specifically to the relaxation of the hedging effectiveness test.

Conclusion

We have, in the time available, only been able to carry out a very limited review. On the basis of that review we have identified only the points referred to above - as explained in the attached appendix - that would prevent the carve-outs achieving the objectives specified by the European Commission.

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On behalf of the members of EFRAG, I should be happy to discuss our letter with you, other officials of the EU Commission or the Accounting Regulatory Committee.

Yours sincerely,

Stig Enevoldsen
EFRAG Chairman

Appendix to EFRAG's letter on IAS 39 Carve-outs

1. Introduction

We have considered the carve-outs proposed by the European Commission purely from a technical perspective – as to whether they achieve their stated objectives. Our conclusions should not be taken to imply support for or opposition to the carve-outs. Set out below is our analysis of the two groups of carve-outs – those relating to restricting the use of the fair value option and those relating to facilitating the use of fair value hedging of core deposits on a portfolio basis. In section 4 we draw to your attention three other issues of a different nature.

2. Restriction on the use of the fair value option

Background

2.1 IAS 39 as published in December 2003 introduced a fair value option whereby any financial asset or liability could be designated as 'at fair value through profit and loss' provided that the designation was made irrevocably at inception. It was designed to simplify application of IAS 39, particularly in situation where, without the option, IAS 39's mixed measurement model could result in an entity reporting volatility on positions that are economically matched. An example would be 'unit linked' contracts issued by insurers (in which the amount payable on the policy directly reflects the performance of a pool of specified assets). In this case, use of the option avoids reporting the volatility that would arise if the assets were measured at fair value but the offsetting liabilities were at amortised cost.

2.2 The fair value option was well received by industry but not by regulators – in particular by the European Central Bank, the Basel Committee and prudential supervisors - who feared the fair value option might be used inappropriately by weaker financial institutions to reduce the reported amount of liabilities to their fair values. They regarded this possibility as a danger to financial stability.

2.3 Accordingly the European Commission prevailed upon the IASB to introduce changes to IAS 39 restricting the use of the fair value option. An exposure draft was issued for comment by 21 July 2004 and the responses were overwhelmingly against the proposed limitations. IASB has not yet decided what action to take in modifying the fair value option in the light of reactions to the exposure draft.

2.4 While the IASB and the European Central Bank and the Basel Committee are continuing to seek a solution that would avoid certain applications of the fair value option whilst preserving those aspects of the option that are recognised as being beneficial, the European Commission has proposed the temporary carve-out of the fair value option as it applies to liabilities from the endorsed version of IAS 39. It has expressed the hope that sufficient progress will have been made by early 2005 to be able to remove this carve-out in the short term.

2.5 EFRAG was asked to consider whether the carve-out achieved its purpose of eliminating the ability to use the fair value option for liabilities. The result of the evaluation is summarised in the following paragraphs:

Evaluation

2.6 The Fair Value Option carve-out applies only to the liability side of the balance sheet and affects paragraphs 9 and 35 of the standard.

2.7 We believe that deletion of the fair value option may bring significant side effects to those entities affected. Strong representations have been made to EFRAG that deletion of the option would lead to artificial volatility in contractually linked or economically matched transactions such as unit linked contracts where the liability is linked to the value of pool of investments. The investments would normally have to be shown at fair value whereas the liability would be on a different basis, amortised cost. The view of the members of EFRAG is that the requirement to use a different basis for such linked transactions is an undesirable side effect that can result in misleading accounting for such transactions.

2.8 We note that one of the reasons argued by IASB for introducing the fair value option in IAS 39 was to enable the assets and liabilities arising from contractually linked investment contracts (e.g. unit linked investments contracts) to be measured on the same basis – namely fair value. Various suggestions have been made to overcome the artificial volatility problem if the carve-out applies but the members of EFRAG are not convinced that they are workable.

2.9 We would also like to note the specific issue for the Danish mortgage institutions where the limitation may create artificial volatility, because of the set up and composition of the institutions and the Danish bond market.

2.10 The deletion of the fair value option for financial liabilities would require companies to bifurcate financial instruments containing embedded derivatives in financial liabilities. Furthermore hedges of complex structured financing transactions could not be measured at fair value by designation in order to prevent having to comply with hedge accounting requirements. This could lead to artificial volatility in situations where the hedge accounting requirements of IAS 39 would be difficult or could not be complied with, while economically (some) risk offsetting was achieved.

2.11 We have identified a point in that IAS 39 paragraph 9 is proposed to be carved out only by the deletion of 'financial liability' in two places in the second sentence within 9(b). The heading to 9(a) and 9(b) is left unchanged. The first sentence in 9(b) is not changed. Condition (a) is not relevant but the first sentence of paragraph (b) is. The overall effect therefore is that 'a financial asset or financial liability at fair value through profit or loss is a financial liability that …upon initial recognition…is designated by the entity as at fair value through profit or loss'.

We regard this as a significant flaw in the proposal that – if not adjusted - might lead to the effect that the proposal does not meet the stated objective.

2.12 For consistency reasons there should be a consequential adjustment to the introduction of the standard. We therefore propose that IAS 39 IN16 and IN 17c should be amended accordingly.

Conclusion:

2.13 On the basis of our limited review we have identified only the points mentioned above that would prevent the proposed carve-outs for the fair value option meeting the objective of eliminating the ability to use the fair value option for liabilities.

3. Facilitating the use of fair value hedging of core deposits on a portfolio basis

Background

3.1 The European Commission proposed to carve out certain requirements related to hedge accounting in IAS 39 in order to enable portfolio hedging of core deposits on a fair value measurement basis. These carve-outs concerned the following areas:

- allowing hedging of core deposits on a portfolio basis (carve-outs in paragraphs 83, AG118);
- amending certain aspects of what can be designated as a hedged item (carve-outs in paragraph AG 99A and AG 99B);
- relaxation of the effectiveness testing, so that underhedging does not lead to ineffectiveness, and in this respect adoption of a layer approach (carve-outs in paragraphs 81A, AG107A, AG114, AG119, AG121, AG122, AG126, AG127, AG129 and AG130).

Evaluation

3.2 The members of EFRAG believe that any carve-outs should be limited to the minimum necessary to meet the stated objectives. However, in the last sentence of paragraph AG122 there appears to be a carve-out that is unnecessary and is significant in its consequential effects. The sentence says:

> "It is not appropriate to assume that changes in the fair value of the hedged item equal changes in the fair value of the hedging instrument."

Changes in value of the hedged items due to interest risk have to be valued independently from the changes in value of the hedging instruments as indicated in AG114(g).

The carve-out of the sentence could result in inappropriate application of hedge accounting to portfolios of core deposits as well as to all other hedging relationships. The deletion of this sentence would enable the change in fair value of a portfolio of core deposits (and other financial instruments) to be measured as the change in fair value of the hedging derivative, in which case it is clear that no ineffectiveness will ever be measured and reported for that hedging relationship. This would undermine the concept of fair value hedge accounting as being the offset of two separate changes in fair value.

Paragraphs 49 and 86

3.3 These two paragraphs were carefully considered in the light of representations made to EFRAG that they presented obstacles to the effectiveness of the carve-out proposals. The members of EFRAG agreed that both paragraphs should be retained but that in the absence of further action they could give rise to difficulties as further explained below:

Paragraph 49

3.4 This paragraph stipulates that the fair value of a financial liability is not less than the amount payable on demand (discounted from the earliest date the amount could be required to be repaid). A number of commentators in the letters received by EFRAG suggested that the application of fair value hedge accounting to portfolio hedges of core deposits appears to contradict this requirement. For example if the change in fair value attributable to the hedged risk measured on a portfolio basis were to reduce the overall fair value of the portfolio to a level below that allowed by paragraph 49 it would still not be possible to recognise this change under the proposed carve-outs.

3.5 The proposed recitals to the carve-outs draw a clear distinction between individual demand deposits and a portfolio of core deposits, arguing that paragraph 49 applies only to individual liabilities and therefore not to portfolios. On balance the members of EFRAG accepted that argument, believing also that a carve-out of paragraph 49 would have serious consequential effects. Members strongly believe, for example, that paragraph 49 contains an important requirement that prevents entities recognising a gain on day 1 that they consider inappropriate. It is therefore important that paragraph 49 is retained but that the recitals are effective in drawing the distinction referred to above.

Paragraph 86

3.6 Paragraph 86 sets out some clear distinctions between different kinds of hedging relationship and the conditions applicable to them. Cash flow hedges may include highly probable forecast transactions but fair value hedges may not. This means that only existing core deposits can be hedged and that no assumptions can be made about future deposits. The effect is to reduce the average duration below that commonly used for hedging core deposits (e.g. 9 months average duration for existing core deposits compared to say 5 or 7 years for highly probable existing and future deposits). If it is intended that only existing core deposits can be hedged there is no problem; but if it is intended that future new deposits can be included in the hedged item the present wording may give rise to difficulties if no further changes or clarifications are made in the proposed regulation. The question is whether a portfolio of core deposits can be defined to include the renewals of the portfolio (as a part of the existing liability). The requirement is fulfilled if the portfolio is regarded as a sole item, so that in- and outflows within the existing portfolio do not constitute future transactions and should not be regarded as such in implementing paragraph 86. Only new additions to the portfolio would be considered to be future transactions. The members of EFRAG believed that the recitals could be helpful to ensure that the carve-out can meet the stated objective.

Other issues

3.7 The Commission has proposed the carve out of the second sentence of paragraph 83 ("the change in fair value attributable to the hedged risk for each individual item in the group shall be expected to be approximately proportional to the overall change in fair value attributable to the hedged risk of the group of items") to allow the hedging of a portfolio of core deposits. However, the basis of conclusions (BC 181) makes it clear that IASB does not intend that paragraph 83 should apply in a portfolio hedge of interest rate risk. Therefore, it appears not to be necessary to delete this paragraph to achieve the stated objective.

3.8 Some concerns were expressed that deletions in paragraphs AG99A, AG99B and AG124 (d) go beyond designation of portfolios of core deposits as hedged items and may allow abuses when designating hedges and evaluating hedge effectiveness. The deletions could allow an entity to apply hedge accounting even if there is no evident relationship between the hedging instrument and the hedged item and still claim that the hedge relationship is effective (for example when the hedging instrument generates cash flows that exceed the cash flows generated from the hedged item.)

General

3.9 Generally we have concerns that the relaxation of the effectiveness tests for core deposit hedging might result in a significant weakness in accounting for other hedges. By the extension of the relaxation to all hedges the carve-outs enable entities to designate hedged items that would not be so qualified under the full IAS 39 and to avoid application of effectiveness tests that would otherwise be required.

Conclusion

3.10 On the basis of our limited review we have identified only the points mentioned above that would prevent the carve-outs meeting the stated objective of facilitating the use of fair value hedging of core deposits.

4. Other issues

4.1 A more general comment raised by some commentators concerned the effect of the carve out on the requirements of IFRS 1 that a first time adopter is one that adopts IFRS by an explicit and unreserved statement of compliance with IFRS. This standard has been adopted without modification for use in Europe and concern has been expressed as to whether an entity making use of hedging carve outs can give such a statement. While the proposed wording of the recitals accompanying the carve-outs indicates that IFRS 1 does not provide such an impediment the legal status of the recitals in this context seems unclear. However EFRAG has not considered this or any other legal issues related to the carve-out.

4.2 Some commentators raised the point that confusion also exists as to whether companies that choose to use the full IAS 39 can do so. We understand the situation to be that they can only do so if they do not make use of the full fair value option – by virtue of the application of article 42(a) of the modified 4th Directive which applies in the absence of the full endorsement of IAS 39. Overall, however, EFRAG has not given consideration to legal issues.

4.3 The SEC is considering allowing entities filing their accounts in the USA an exemption from providing two years of comparative figures when first-time adopting IFRS. European entities may not be able to apply this exemption if they are not fully in compliance with IFRS, including IAS 39.