



EUROPEAN CENTRAL BANK

Jean-Claude TRICHET
President

6 September 2004

Sir David Tweedie
Chairman
International Accounting Standards Board
30 Cannon Street
London EX4M 6XH
United Kingdom

Dear Sir David,

Exposure Draft of proposed amendments to IAS 39 – The fair value option

I am writing with regard to the Exposure Draft of proposed amendments to International Accounting Standard (IAS) 39 on the fair value option, published on 21 April 2004.

In its letter dated 19 February 2004, the Governing Council of the European Central Bank (ECB) expressed its appreciation that the proposed amendments broadly addressed the concerns set forth by the ECB and were in accordance with what had been agreed between the ECB and the IASB at the meeting held on 4 February 2004.

In the meantime, the broad endorsement given by the Governing Council to the proposed amendments was conditional on further analysis of their actual implications. Indeed, given the uncertainty regarding the potential impact of the limited application of fair values to the categories of instruments in question, an empirical test was carried out to evaluate whether the restrictions introduced in the Exposure Draft are sufficient to appease the financial stability concerns. The main findings of this analysis are summarised in the Annex to this letter.

Overall, in the view of the Governing Council, the results of the empirical analysis did not reveal, on the assumption that banks implement the option in a prudent manner, any additional elements of concern for financial stability that would lead to a reversal of the ECB's previous stance. In this context, it is recalled that the considerations on the stringent conditions under which the fair value option could be applied – conveyed to the IASB in the letter of 19 February - remain valid.

The exercise did, however, highlight two important aspects which should be taken into account by the IASB in the finalisation of the Exposure Draft in order to ensure a reasonable application of the option.

First, the main objective which has been declared by banks for using the fair value option is to reduce the artificial volatility arising from the mixed accounting model and, in their view, the lack of appropriate

hedge accounting rules. Rather than supporting the use of the fair value option on a case-by-case basis, the ECB would favour the adoption of consistent and harmonised hedge accounting rules designed to favour sound and prudent risk management. The ECB therefore welcomes the IASB's decision to set up a working group to examine hedge accounting issues on IAS 39.

However, pending the adoption of these provisions, it might be appropriate, in the category of "natural offsets" in the Exposure Draft, to include a reference requiring banks to state clearly that the fundamental objective of reducing artificial volatility is the underlying reason for applying the fair value option and to provide a description of how this would be achieved by making an explicit link with their risk management practices.¹ This would contribute to ensuring that the use of the fair value option would not raise financial stability concerns.

Furthermore, the Exposure Draft could require banks to use the option only when the associated reduction in artificial volatility cannot be achieved by applying other Standards. In this way, banks would be prevented from circumventing the more appropriate and stricter hedge accounting rules, once in place, via the fair value option.

Second, with regard to the category of "embedded derivatives", the banks in the sample only stated the need to apply the fair value option to embedded derivatives that would be required to be separated from the host contract. Hence, we propose that this category be limited to financial assets or liabilities containing one or more embedded derivatives that paragraph 11 of IAS 39 requires to be separated.

As a general comment, let me add that the inclusion of a financial instrument in any one of the categories proposed in the Exposure Draft on the fair value option should be justified by economic and risk management purposes, as provided by the IASB in the Basis for Conclusion of the Exposure Draft.

Finally, I should like to underline that the Governing Council's position on the fair value option is without prejudice to the way in which the controversial issues surrounding the final adoption of IAS 39 and its transposition into Community legislation are settled.

Let me stress that the ECB highly values the dialogue with the IASB and I look forward to further opportunities to cooperate with you.

Yours sincerely,

[signed]

c.c. Mr Frits Bolkestein, Member of the European Commission

¹ In this respect it should be noted that the Exposure Draft does not make it sufficiently clear that "natural offsets" can be considered only with reference to interest rate risk and foreign exchange risk, not to credit risk, the rationale being that the credit risks underlying banks' assets and liabilities are different (counterpart and own credit risk, respectively) and cannot naturally offset each other.

ANNEX

The following is a summary of the main findings and conclusions of the empirical analysis of the proposed amendments to IAS 39 on the fair value option. The aim of the exercise was to assess whether the limitations introduced in the application of the fair value option are sufficient to appease the financial stability concerns raised by the ECB. The data used in this exercise were provided by a sample of nine European banks².

The information received from the banks was very diverse. The banks had difficulty in providing concrete data at this juncture, given the uncertainty regarding the interpretation of key criteria (e.g. verifiable, substantial offset) and the outcome of the discussions regarding the hedging rules with the IASB.

It should be noted that the main objective of this exercise was not to provide a fully-fledged impact study but to analyse concrete examples of the application of the fair value option at a small number of representative banks.

Keeping this in mind, the exercise has provided insightful information and has enabled the following main findings to be made:

1. Overall, the answers given by the banks concerning the intended use of the fair value option painted a diverse picture, which raises concerns about the future comparability of accounts. Furthermore, the answers indicated a large gap between the reported intended use of the fair value option (a maximum of around 6% of total assets for some categories of financial instruments) and the reported potential use (maximum potential use of the fair value option represented around 60% of total assets).
2. The main reason underlying banks' intentions to use the fair value option is for it to serve as an alternative to hedge accounting rules and to reduce, in their view, the artificial volatility arising from the mixed accounting model. The objective should therefore be for the IASB to reach an agreement with the industry on prudent and risk-focused hedging rules in order to make the option, which could be detrimental to the comparability of financial accounts both on a national and European basis, less useful or even redundant.
3. The banks did not identify any major restrictions to applying the fair value option to the five categories of instruments in question. Several banks indicated, however, that the more restrictive "verifiability" and "substantially offset" criteria were unclear. Further guidance by the IASB on these issues is desirable.
4. Given the widespread use of financial instruments with at least one embedded derivative, there was a concern that a very substantial part of the banks' balance sheets could potentially fall into the category of embedded derivatives. However, the answers received did not reflect this³, possibly because the banks may have included instruments with embedded derivatives in the "natural offsets"

² Two banks are among the four largest banks operating in their respective countries, while the others have market shares ranging from 10% to 30%.

³ Eligible instruments represent 0.4% to 6% of total assets for six of the banks and as high as 14% for one bank. The intended use reduces the range to less than 2% of total assets for six of the banks and represents approximately 6% for one bank.

category. The majority of financial instruments in this category concern liabilities, namely issued bonds. The two main reasons given by the banks for using the option for this category of financial instruments (reducing the burden of separating the embedded derivative from the host contract, and substituting for hedge accounting) could also be dealt with under the category of “natural offsets” and paragraphs 12 and 13 of IAS 39.

5. The current Exposure Draft, which was intended to be more restrictive, permits the fair value option to be applied to all financial instruments with an embedded derivative, irrespective of whether the embedded derivative is required to be separated or not.
6. Neither the valuation impact of applying the fair value option to all eligible assets nor the respective volatility impact of a 100 basis point interest rate shock can be computed from the answers provided by the banks. Thus, the earlier ECB study of full fair value may serve as a point of reference where an interest rate shock of 100 basis points decreased equity by 24% compared with 12% under the current mixed accounting framework. However, this may be considered a worst case scenario as it omits the impact of off-balance sheet and offsetting positions.