Dear Madam, dear Sir,

Thank you for the opportunity to comment on the consultative document *Supervisory guidance on the use of the fair value option by banks under IFRS*.

Comments of the Zentraler Kreditausschuss

General comments

The German banks firmly supported the adoption of the IAS 39 fair value option amendment in June of this year. It is true that not all of the banks’ key proposals, such as that for an appropriate treatment of own credit risk, were taken on board by the IASB in the course of the consultation process and incorporated into the final standard. We nevertheless approved the amendment because, given the problematic nature of the rules on hedge accounting, the option represents an important means of aligning accounting and risk management in the banks.

The Basel Committee was able to exert a strong influence on the final form of the amended standard and the IASB accommodated its wishes by limiting the scope of the option and
introducing a number of disclosure requirements in IAS 39 and IFRS 7. Nonetheless, the consultation document gives the impression that the Committee continues to see the fair value option as a critical and flawed case in the accounting rules whose application needs to be restricted still further by supervisory principles. This is reflected, first, by far-reaching recommendations on how the banks’ risk management should be structured. Second, the consultative document envisages a number of accounting rules going beyond IAS 39 which would limit the scope of the option. Though the Basel Committee stresses in the introduction that the intention is not to set additional accounting requirements beyond those established by the IASB (para. 6), this is almost immediately contradicted by the statement that banks are expected to use the fair value option in a manner “that addresses prudential concerns” (para. 8). Further restrictions are imposed by setting conditions for determining reliable fair values (paras. 28-32) and specifying that the use of hedge accounting rules should be given preference over the fair value option in certain circumstances (para. 14).

The German banks reject the notion that the fair value option is a flawed technique with the potential to undermine the stability of the financial system, as well as the ensuing attempt to use prudential rules to impose severe restrictions on the banks’ use of this accounting practice. The implied danger of the banks using the option arbitrarily does not, in fact, exist. The banks have to designate financial instruments irrevocably on initial recognition as assets or liabilities to be measured at fair value and thus cannot misuse the option to “massage” results. What is more, the option is used to avoid economically unjustified fluctuations in the profit and loss account, not to enter into additional risks.

Given the problematic and highly restrictive rules on hedge accounting, we strongly advocate permitting the banks full use of IAS 39’s provisions concerning the fair value option. This is, moreover, absolutely essential if the comparability of financial statements is to be ensured. The task of monitoring compliance with accounting rules must be left to the auditors.

For details, please see below:
Detailed comments

Principle 1:
Supervisors expect a bank’s application of the fair value option to meet the criteria set forth in IAS 39 in form and in substance.

Compliance with the form and substance of the IAS 39 rules on the fair value option is ensured by the auditor. The audit is mandatory by law and cannot be circumvented. Additional monitoring by banking supervisors of compliance with accounting rules would serve no useful purpose and the idea should therefore be dropped. As we pointed out in our general comments, the implied danger of arbitrary use of the option does not in fact exist. Irrevocable designation on initial recognition of a financial instrument rules out the possibility of using the option to massage results.

Para. 14 calls on a bank to use the hedge accounting rules rather than the fair value option if it is seeking to hedge only a component risk and if the hedge accounting rules could be satisfied. We are highly critical of the envisaged precedence of hedge accounting over the fair value option. The IASB has allowed companies to use the fair value option as long as the requirements set out in IAS 39.9 or IAS 39.11 are met. The standard imposes no further conditions. On the contrary, the option is explicitly described as an alternative to application of the restrictive hedge accounting rules. We reject the envisaged restriction on use by the banks of IAS 39’s provisions. The envisaged documentation of the option’s use should be sufficient for supervisory purposes.

The expectation in para. 15 that a bank using embedded derivatives should understand what impact these instruments will have on its financial situation and risk profile if it decides to apply the fair value option gives the impression that the Basel Committee sees the bank’s economic situation as being influenced by the way it reports its accounts. This is by no means the case and the expectation should therefore be deleted.

Para. 17 calls for banks to provide supporting documentation – thus in effect imposing more stringent disclosure requirements – if they use the fair value option. It is not indicated precisely what information this additional documentation should contain to be deemed sufficient for supervisory review purposes. We would point out that IFRS 7 already prescribes extensive disclosure requirements, which are perfectly adequate in our view. Any requirements going beyond these would, moreover, contradict what is stated in para. 6.
Principle 2:
Supervisors expect banks to have in place appropriate risk management systems (including related risk management policies, procedures and controls) prior to initial application of the fair value option for a particular activity or purpose and on an ongoing basis.

The Basel Committee’s expectation that banks should have in place appropriate risk management systems for their operations is as self-evident as the supervisory recognition and monitoring of these systems. If risk management gaps open up which threaten the stability of a single bank or the financial system, these naturally have to be filled.

This statement is true independent of accounting issues, however. The purpose of financial reporting is to portray a company’s economic situation, not to enter into additional business risks. Yet the envisaged requirements for risk management systems in banks using the fair value option give the impression that the Basel Committee is indeed assuming that use of the option gives rise to additional risks. Para. 20(a), for example, refers to the bank’s “risk appetite”, which must be consistent with risk management objectives if the fair value option is used. This approach makes no economic sense. The fair value option is particularly beneficial in situations where the IAS 39 rules otherwise make it impossible or extremely difficult to report transactions in a manner which is consistent with risk management.

Principle 2’s far-reaching criteria for risk management systems would require banks using the option to have an organisational framework in place which met the minimum standards for trading activities. Cost considerations would rule out application of the option by “non-trading” banks. Para. 22, for example, in effect makes use of the fair value option conditional on the existence of an operationally separate risk control unit, while para. 23 envisages approval standards for valuation models along the lines of those for trading activities. These rules constitute inappropriate interference, in our view, and are to be rejected.

Para. 27 asks banks utilising the fair value option to adopt the best practices set out in the G30 report. No. 5 of these best practices requires banks to establish, approve and monitor risk limits for market and credit risk. This requirement makes no economic sense. The reason is that banks using the fair value option would have to establish risk limits for economically hedged positions to which hedge accounting rules are not applied for cost reasons, for example, or
because they are hedged by internal transactions. The general reference to the G30 report should therefore be deleted.

The German banks take the view that use of the fair value option should be conditional on satisfying the criteria set out in IAS 39.9 and 11A alone.

**Principle 3:**
Supervisors expect banks to apply the fair value option only to instruments for which fair values can be reliably estimated.

Under IAS 39 all companies have to follow mandatory rules on determining fair values. The standard lists a series of conditions that must be met to ensure that the calculated values are reliable. In its consultative document the Basel Committee spells out the IAS 39 rules in even more detail and adds additional requirements.

As we pointed out in the introduction, the German banks are highly critical of the Basel Committee's attempt to exert direct influence on accounting practices. It is, as a matter of principle, up to the auditor and not to regulators to monitor compliance with accounting rules. We assume that the certification of a company's financial statements by the auditor will be deemed sufficient evidence that the rules have all been observed.

**Principle 4:**
Supervisors may require banks to provide supplemental information to assist them in assessing the impact of banks' utilisation of the fair value option.

Some of the disclosure requirements set out in Principle 4 go beyond what is required under IFRS 7. This would impose a considerable burden on the banks without providing any discernible additional insight for supervisory purposes. Unless the intended additional benefit for prudential purposes is explained, we regard the disclosure requirements in IFRS 7 as sufficient and ask for the request for supplemental information to be deleted.

**Principle 5:**
Supervisors should assess whether a bank's internal financial analysis of counterparties evaluates the impact of the counterparties' use of the fair value option.
This requirement has nothing to do with the banks' accounting practices or capital adequacy. Instead, it is interference in their analysis of the risk position and creditworthiness of their customers and should therefore be deleted.

In any event, the notes of a company's accounts do not indicate the extent to which fluctuations in the market value of assets and liabilities marked to market with the help of the fair value option are being compensated by offsetting movements of derivatives that are not eligible for hedge accounting and are therefore reported under "trading". Furthermore, the credit assessment primarily focuses on analysing anticipated future cash flows. These are not affected by the use of the fair value option.

Principle 6:
Supervisors should evaluate a bank's risk management and control practices as they pertain to the use of the fair value option.

We are at a loss to understand the reason for requiring periodic information on the banks' risk management and control practices as they pertain to the use of the fair value option. First, these systems are already evaluated by supervisors irrespective of whether the option is used or not. There is no discernable economic justification for an additional supervisory assessment in connection with the use of the fair value option. Second, this point is covered by the disclosure requirements in IFRS 7. Requiring supplementary information is inappropriate, in our view. See also our comments on Principle 2.

Principle 7:
Supervisors should consider risk management and control practices related to the use of the fair value option when assessing capital adequacy.

The Basel Committee deems it necessary to carry out a separate, specific assessment of the effects of using the fair value option and envisages a number of possible sanctions in the event of its extensive use. The impression arises that the Committee is assuming that extensive use of the option inevitably goes hand in hand with weaknesses in a bank's risk management strategy. This is not the case. One of the strengths of using the fair value option is that it allows economic hedging transactions to be accounted for in an appropriate manner in situations where IAS 39's restrictive hedge accounting rules would otherwise make this impossible (see also our comments on Principles 2 and 6). We therefore firmly reject requiring banks to hold more
regulatory capital because of alleged weakness in risk management policies and controls (para. 38) connected with the extent or alleged inappropriateness of using the fair value option.

There can only be a general assessment of whether the impact of using the fair value option should increase or decrease regulatory capital. It makes no sense to judge this on the basis of the extent of the option's use alone.

**Principle 8:**

_Regulatory capital should be adjusted for gains and losses from changes in own credit risk as a result of applying the fair value option to financial liabilities._

Use of the fair value option for accounting purposes takes place independent of its consideration when determining regulatory capital. However, adjustments to regulatory capital may lead to a conflict of interests between the management of a bank’s regulatory capital for prudential, risk-oriented and accounting purposes.

We would welcome our comments being taken into account and would be pleased to supply any further information you may require.

Yours sincerely
for the Zentraler Kreditausschuss,
Bundesverband deutscher Banken

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