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Comments on the Discussion Paper "Reducing Complexity in Reporting Financial Instruments"

Dear Sir David,

Thank you for the opportunity to respond to the discussion paper "Reducing Complexity in Reporting Financial Instruments". The issue of how to measure financial instruments is highly significant for banks and the joint committee of German banking associations known as the Zentraler Kreditausschuss has long been involved in the intensive discussions of this subject.

We consider it extremely important to have a broad debate on new and less complex methods of reporting financial instruments and welcome the publication of a consultation paper on this key issue. This is the only way to involve all relevant parties at an early stage in a comprehensive discussion on the future approach to measuring financial instruments. But this discussion must be conducted fairly, meaning that all alternatives need to be considered. We therefore have serious reservations about the exclusion from the discussion paper of the current mixed measurement model and the sole focus on mandatory full fair value accounting of all financial instruments.

...

The idea of using a single method to value all instruments is admittedly an attractive one at first sight. Such a solution would, however, give rise to a number of fresh problems and difficulties which are at odds with the objective of making accounting more relevant, credible, comparable and transparent.

Owing to the differences in the banks' business models, the differentiated approach of the existing mixed model better reflects economic reality than could full fair value measurement. The mixed model is consequently the most appropriate means, in our view, of providing users with decision-useful information on the basis of which an entity's long-term performance can be assessed.

The discussion paper focuses on reducing the complexity of reporting financial instruments. Less complexity would certainly be desirable. Nevertheless, we do not see the reduction of complexity as one of accounting's primary objectives. It is, rather, a secondary objective, which should always be borne in mind when contemplating changes. But the criteria at the forefront of all deliberations should be the information value and relevance of financial statements.

Since the questions posed in the discussion paper implicitly assume that full fair value will be the only suitable method of measuring all types of financial instruments in the long term, we would like to begin with a few general comments outlining the reasons for our strong reservations about full fair value accounting.

We would also like to stress that any discussion about full fair value accounting should bear in mind that the standards will be used not only by a few globally active investment banks, but also by a large number of smaller banks which pursue differing business strategies and often focus primarily on the retail sector. The standards must enable all banks to report their performance in an appropriate manner.

In our view, two ways of enhancing the decision-usefulness of financial information while at the same time reducing the complexity of the current rules would be to make the fair value option more flexible and introduce a component approach. These measures have the potential to largely reduce the accounting mismatch which can arise under the mixed model approach and allow the preparation of relevant and understandable financial statements.

I. General remarks

The decision on whether or not to measure a financial instrument at fair value should depend on the individual business model and holding strategy involved. A sound accounting regime must be able to accommodate different business models. There is therefore a need for a differentiated approach which enables entities to report financial instruments appropriately regardless of whether they are managed on a fair value or amortised cost basis, thus delivering relevant, reliable and decision-useful information.

Objective of financial reporting

Any valuation model for financial instruments must be judged on the extent to which it is able to achieve the objectives of financial reporting and deliver decision-useful information. The relevance of a full fair value approach for users of financial statements must be questioned, however.

The IASB often argues that only fair value can show the real economic reality of an instrument at a particular point in time. It takes the view that any associated volatility is consequently merely a reflection of that economic reality. But if volatility is very high, the relevance of reporting date values, which give no indication of target cash flows, is extremely limited. Volatility makes it especially difficult to evaluate the long-term performance of an entity's revenue source if ongoing valuation at market prices is inconsistent with management intention. When financial instruments have not been acquired for trading purposes and are to be held for a lengthy period, short-term market fluctuations have few implications for the future development of cash flows. The IASB itself recognises historical cost measurement as an alternative to fair value when instruments have fixed cash flows and will in all probability not be sold or transferred.

Under a full fair value approach, a bank's annual performance would comprise long-term interest-bearing results and effects from short-term market fluctuations. Yet short-term fluctuations, caused by fair value measurement, in the present value of long-term non-trading instruments are not a sustainable performance indicator. So non-tradable instruments, in particular, should not have to be reported on the basis of short-term price changes if the theoretical sale on which the market valuation is based does not reflect the actual business strategy. If the entity manages an instrument on the basis of amortised cost with the aim of achieving long-term cash flow, fair value is therefore not a suitable measurement method.

Instruments of this kind should be reported on an amortised cost basis, with additional fair value information provided if necessary in the notes.

The concept of management intention is already present in IAS 39 by virtue of the categorisation of financial instruments. Recent developments concerning other standards, such as segment reporting under IFRS 8, also highlight the importance of management intention. These mechanisms provide users with information which is relevant to their investment decisions. Full fair value accounting, by contrast, would conflict with the management intention concept.

For this reason, the categories in the existing version of IAS 39 should be retained. Only if adequate account is taken of entities' different holding strategies and business models can financial statements supply external users with decision-useful information. A differentiated approach to measurement is also needed to reflect an entity's intended long-term business development.

We disagree, too, with the IASB's argument that full fair value accounting enhances comparability. Entities have to comply with extensive disclosure requirements regarding the reporting of financial instruments (risk report, information to be provided in the notes under IFRS 7). Fair value figures and the parameters used in their calculation are already disclosed to give interested users supplementary information. So even if valuation methods other than fair value are applied, an adequate level of transparency is guaranteed.

Determining fair values

As long as financial instruments are traded in active and liquid markets, fair values can normally be determined without difficulty. In such cases, fair value measurement is perfectly appropriate. But most financial instruments are not traded on active markets or exchanges and fair value has to be calculated with the help of valuation models based on estimates and assumptions. The IASB recognises the problems involved in such a process and acknowledges that, in the absence of objective market parameters, the calculation of fair values often requires the assistance of valuation or other non-accounting experts.

II. Replies to the questions

The questions posed in the discussion paper implicitly assume that, in the long term, full fair value measurement is the only suitable method of accounting for all types of financial instrument. As explained in our general comments, we fundamentally reject this approach.

Question 1:

Do current requirements for reporting financial instruments, derivative instruments and similar items require significant change to meet the concerns of preparers and their auditors and the needs of users of financial statements? If not, how should the IASB respond to assertions that the current requirements are too complex?

As outlined in our general comments, we have serious reservations about the idea of full fair value accounting for all financial instruments. We nevertheless see potential for improving some of the existing rules in IAS 39.

We agree with the IASB that less complex requirements would be desirable but take the view that reducing complexity is not, in itself, a primary objective of accounting standards. It is, rather, a secondary objective which should always be borne in mind when proposing changes.

As the IASB itself points out, one of the main reasons for the complexity is the economic phenomenon that many financial instruments are themselves highly complex. A certain amount of complexity therefore cannot be avoided if a large number of heterogeneous products are to be measured and reported appropriately.

Given this inherent complexity, it is not possible in our view to report all financial instruments in a meaningful way on the basis of full fair value accounting. This solution only appears straightforward at first sight. We see a risk of such a shift in approach leading to even greater complexity, since it would represent a departure from tried and tested valuation methods. A far more effective approach would be to retain the current mixed model and make targeted improvements to certain existing rules. We believe this has the potential to deliver economically appropriate results – also in the long term.

Question 2 (a):
Should the IASB consider intermediate approaches to address complexity arising from measurement and hedge accounting? Why or why not? If you believe that the IASB should not make any intermediate changes, please answer questions 5 and 6, and the questions set out in Section 3.

We have fundamental reservations about the intermediate changes outlined in the discussion paper. The aim should be to develop generally accepted, long-term valuation standards. Temporary solutions would not promote acceptance, would require the investment of considerable resources (personnel, IT, etc.) and would therefore be extremely costly.

Furthermore, the proposed intermediate solutions imply a basic recognition that full fair value accounting is the suitable long-term goal to which the intermediate steps are intended to lead. As explained above, we reject such a development. We do, however, believe that the IASB's medium-term proposals contain some sensible elements which could help to improve the current rules and complement the principles-based mixed model approach in an appropriate manner. We are in favour of simplifying hedge accounting, for example, but see the proposed changes not as an intermediate solution, but as a means of reducing the complexity of IAS 39 in the long term.

Question 2 (b):
Do you agree with the criteria set out in paragraph 2.2? If not, what criteria would you use and why?

We do not agree with all the criteria in paragraph 2.2. The criteria in 2.2(a) (making information more relevant and understandable) and 2.2(d) (appropriate cost-benefit ratio) have our unqualified support.

By contrast, we reject the criterion in paragraph 2.2(b) – namely consistency with the objective of full fair value accounting in the long term – because this is diametrically opposed to our fundamental position (cf. our general comments). We also have very strong reservations about the criterion of not increasing complexity mentioned in 2.2(c). Reducing complexity is a secondary consideration in our view, not the primary aim of financial reporting (cf. our reply to question 1).

Question 3:
Approach 1 is to amend the existing measurement requirements. How would you suggest existing measurement requirements should be amended? How are your suggestions consistent with the criteria for any proposed intermediate changes as set out in paragraph 2.2?

As explained in our reply to question 2, we have reservations about intermediate measures. For this reason, our following suggestions for ways of improving existing measurement and accounting methods are intended to be long-term solutions.

The restrictions under IAS 39 on reclassifying instruments after initial recognition are very strict. As soon as an instrument is acquired, it has to be placed into a specific category depending on its intended purpose and it is very difficult, if not impossible, to change this classification. Business plans and strategies can alter over time, however. If the rules on reclassification were made less stringent – we believe, for example, that the removal of the tainting requirement for the held-to-maturity category should be considered – it would be possible for entities to reflect changes in management intention in their financial statements and thus give users more relevant and realistic information. The elimination of the tainting rule could be replaced with a requirement to explain the reasons for the reclassification in the notes. Fewer financial instruments would have to be classified as available for sale and, as a result, this category would lose its present "residual" character.

The reclassification restrictions also pose problems when more than one intended purpose is involved. This applies to financial instruments which have been purchased for the purpose of generating long-term revenue but whose sale prior to maturity cannot be ruled out. Since the intention is not to sell the instrument in the short term, it would make good sense to manage it on a historical cost basis. But because the tainting rule prevents it from being assigned to the held-to-maturity category, it will normally be placed in the residual available-for-sale category. Here, however, it has to be measured at fair value, with changes in value reported either directly in equity and/or the profit and loss account. Management intention is therefore not accurately reflected. We believe that it should be possible in these cases either to measure the instrument at historical cost or assign it to the held-to-maturity category, which would require the tainting rule to be dropped.

Another improvement could be achieved by amending the asymmetrical reverse impairment rule for equity instruments in the available-for-sale category. While IFRS allows a previous impairment of a debt instrument to be reversed by writing up the instrument, this is not currently

possible with equity instruments. Aligning the rules would enhance decision-usefulness, in our view, and help to reduce complexity.

Question 4:

Approach 2 is to replace the existing measurement requirements with a fair value measurement principle with some optional exceptions.

(a) What restrictions would you suggest on the instruments eligible to be measured at something other than fair value? How are your suggestions consistent with the criteria set out in paragraph 2.2?

(b) How should instruments that are not measured at fair value be measured?

(c) When should impairment losses be recognised and how should the amount of impairment losses be measured?

(d) Where should unrealised gains and losses be recognised on instruments measured at fair value? Why? How are your suggestions consistent with the criteria set out in paragraph 2.2?

(e) Should reclassifications be permitted? What types of reclassifications should be permitted and how should they be accounted for? How are your suggestions consistent with the criteria set out in paragraph 2.2?

As explained above, we do not agree with intermediate solutions. The following proposals for improving existing measurement and accounting methods are therefore intended for long-term application.

We see a need to broaden the fair value option. Paragraph 2.37 contains some interesting ideas for doing so and these should be explored further. The fair value option is used in a targeted manner to reduce complexity and avoid distortions in an entity's financial statements. We therefore believe it would make good sense to extend the permitted uses of the fair value option in certain circumstances. This is the only way to ensure that financial reporting can reflect the economic substance of a transaction as accurately as possible. In our opinion, the fair value option could be enhanced by

a) introducing a component approach,
b) allowing financial instruments to be removed from the fair value category under certain circumstances and
c) permitting financial instruments to be designated at fair value even after initial recognition.

a)
A key improvement could be made by introducing a component approach to the present fair value option. The basic principle of this approach is to break down a financial instrument into its individual risk components and measure these separately. Risks which are clearly separable and reliably measurable at fair value should then be measured at fair value.

The breakdown should be based on the intended purpose of the instrument and on its internal management. If it were made part of the existing mixed model approach in IAS 39, the proposed component approach would forge a link between fair value and historical cost accounting. Greater alignment of financial reporting and internal risk management would be possible. We believe that this differentiated approach would help to provide investors with decision-useful information.

b)
We are also in favour of allowing, under strict and clearly defined conditions, financial instruments assigned voluntarily to the fair value category on acquisition to be subsequently removed from this category if the reason for exercising the fair value option no longer applies. This might be the case, for instance, if hedging or funding arrangements were terminated through close-out.

c)
Furthermore, we believe that designation of financial instruments at fair value should be permitted not only on initial recognition but also, without restrictions, at a later date. An important reason for creating a hedge subsequent to initial recognition would be in the following circumstances, for example. If a portfolio is made up of a large number of small loans, it makes good sense from a treasury perspective to wait until the portfolio reaches a certain minimum size before entering into a hedging transaction, typically an interest rate swap to hedge interest rate risk. Initially, the loans would have to be assigned to the loans and receivables category and only after the creation of the hedge would it make economic sense to designate the portfolio at fair value to avoid an accounting mismatch. The subsequent designation would be in line with the management intention. In the discussion paper, the IASB cites as a drawback to broadening the fair value option that, without further restrictions, comparability would not be improved and investors would not be provided with more relevant and understandable information. We are convinced that the reverse is true. First, a more flexible fair value option would enable entities to report their performance in a way which better reflected their specific business model and

thus give users understandable and relevant information. Second, entities are required to provide numerous detailed disclosures in the notes. As for comparability, it must be borne in mind that financial statements could only be made more comparable if all entities measured their financial instruments at fair value using precisely the same market price or valuation model. Owing to the number of different and sometimes highly individual financial instruments which exist, this is not feasible. An adequate level of comparability is already ensured by the present rules in our opinion.

Question 5:

Approach 3 sets out possible simplifications of hedge accounting.

(a) Should hedge accounting be eliminated? Why or why not?

(b) Should fair value hedge accounting be replaced? Approach 3 sets out three possible approaches to replacing fair value hedge accounting.

(i) Which method(s) should the IASB consider, and why?

(ii) Are there any other methods not discussed that should be considered by the IASB? If so, what are they and how are they consistent with the criteria set out in paragraph 2.2? If you suggest changing measurement requirements under approach 1 or approach 2, please ensure your comments are consistent with your suggested approach to changing measurement requirements.

Question 6:

Section 2 also discusses how the existing hedge accounting models might be simplified. At present, there are several restrictions in the existing hedge accounting models to maintain discipline over when a hedging relationship can qualify for hedge accounting and how the application of the hedge accounting models affects earnings. This section also explains why those restrictions are required.

(a) What suggestions would you make to the IASB regarding how the existing hedge accounting models could be simplified?

(b) Would your suggestions include restrictions that exist today? If not, why are those restrictions unnecessary?

We have serious reservations about the idea of eliminating hedge accounting, but would welcome improvements in certain areas.

The IASB admits that, as things stand, the fair value option is not a viable alternative to fair value hedge accounting for the reasons outlined above. This would only be the case if the fair value option could be used as flexibly as can fair value hedge accounting. In our opinion,

however, hedge accounting should be retained and should not be replaced with full fair value measurement. We do not believe it would be either useful or appropriate to eliminate the fair value hedge. The fair value hedge is well established and is actively used by a large number of entities. There is no economic justification for eliminating it. For the same reasons, we also reject the idea of eliminating partial hedges.

Measures aimed at reducing complexity in hedge accounting should focus on documentation and effectiveness testing. Small banks/entities, in particular, often refrain from making use of hedge accounting because of the onerous requirements involved. To reduce complexity, it could, for example, be made sufficient to document effectiveness prospectively by demonstrating that the principal terms (nominal amount, maturity, etc.) of the hedging instrument and the hedged item are the same (critical term match) or by demonstrating that an appropriate and effective risk management system is in place. The 80% to 125% effectiveness test could then be dispensed with. Retrospectively, a quantitative effectiveness test would continue to be performed. In addition, ineffectiveness would be taken into account from an economic point of view because it would be reflected in the profit and loss account. We also believe it would make good sense to have a fallback method for effectiveness tests, as proposed in paragraph 2.61. In the interests of convergence between IFRS and US GAAP, alignment with the planned changes to FAS 133 should be sought.

We would also like to see an easing of the existing restrictions in the area of portfolio hedge accounting. This would enable more entities to apply hedge accounting and allow the management of economic exposures to be reflected more accurately. Portfolio hedging should be opened up for other types of market risk such as currency risk, for example.

Question 7:
Do you have any other intermediate approaches for the IASB to consider other than those set out in Section 2? If so, what are they and why should the IASB consider them?

As explained above, we disagree fundamentally with the idea of intermediate approaches. Our suggested improvements are consequently intended as long-term measures.

Questions 8:
To reduce today's measurement-related problems, Section 3 suggests that the long-term solution is to use a single method to measure all types of financial instruments within the scope of a standard for financial instruments.

Do you believe that using a single method to measure all types of financial instruments within the scope of a standard for financial instruments is appropriate? Why or why not? If you do not believe that all types of financial instruments should be measured using only one method in the long term, is there another approach to address measurement-related problems in the long term? If so, what is it?

Question 9:

Part A of Section 3 suggests that fair value seems to be the only measurement attribute that is appropriate for all types of financial instruments within the scope of a standard for financial instruments?

(a) *Do you believe that fair value is the only measurement attribute that is appropriate for all types of financial instruments within the scope of a standard for financial instruments?*

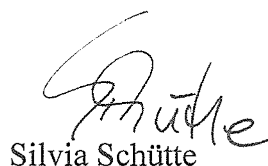
(b) *If not, what measurement attribute other than fair value is appropriate for all types of financial instruments within the scope of a standard for financial instruments? Why do you think that measurement attribute is appropriate for all types of financial instruments within the scope of a standard for financial instruments? Does that measurement attribute reduce today's measurement-related complexity and provide users with information that is necessary to assess the cash flow prospects for all types of financial instruments?*

For the reasons mentioned above, we have strong reservations about using a single method to measure all financial instruments. Instead, we are in favour of retaining the mixed model while incorporating the improvements suggested in our replies to the previous questions.

The mixed model reflects the economic realities of very different financial instruments and business models more appropriately than would be possible using full fair value measurement. As a result, a mixed model provides more decision-useful and credible information while delivering an adequate level of transparency.

Yours sincerely
on behalf of the Zentraler Kreditausschuss,
Bundesverband deutscher Banken

Dirk Jäger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