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Sir David Tweedie
Chairman of the
International Accounting Standards Board
30 Cannon Street

London EC4M 6XH
United Kingdom

Düsseldorf, 14 July 2010
540/602

Dear Sir David

Re.: Exposure Draft 2010/4 "Fair Value Option for Financial Liabilities"

We appreciate the opportunity to comment on the exposure draft mentioned above. As we have previously expressed in several letters on discussion papers and exposure drafts (for example, in our comment letter on the discussion paper 2009/2 "Credit Risk in Liability Measurement", dated 24 July 2009), we strongly disagree with the idea that the subsequent measurement of liabilities should reflect changes in the credit risk of an entity's liabilities, unless the liabilities are held for trading or transfer (including all derivative liabilities). In all other cases, realisation of changes in the credit risk is only hypothetical.

Excluding the effect of changes in credit risk from profit or loss is not sufficient

We welcome the Board's tentative decision to exclude the effects of changes in a financial liability's credit risk from profit or loss. However, according to the Board's proposals, all liabilities designated under the fair value option would continue to be measured at fair value in the statement of financial position and the effects of changes in a liability's credit risk would still be recognised and presented in the statement of comprehensive income. We doubt whether pre-

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senting such effects in (other) comprehensive income rather than in profit or loss is a sufficient improvement – especially given the fact that the IASB is proposing a (mandatory) single / continuous statement of profit or loss and other comprehensive income. Contrary to the IASB's view (see paragraph BC34(a)), we believe that changes in the liability's credit risk should <u>not</u> affect the entity's performance as presented in the statement of comprehensive income (unless the liability is held for trading or transfer).

Moreover, it should be noted that there is, at present, no principle for measuring and presenting "performance". Therefore, constituents hold different views as to whether profit or loss on the one hand or comprehensive income on the other hand is preferable as a performance indicator. Consequently, even after implementation of the Board's proposals, users of financial statements would continue to receive information that might be misleading and counter-intuitive (if comprehensive income were used as a performance indicator).

In this context, we would like to emphasise the need to address the conceptual question as to which items must or may be presented in other comprehensive income and whether, when and how items of other comprehensive income must be reclassified to profit or loss ("recycling"). Currently, neither the Framework nor IAS 1 have established a principle for identifying items to be recognised in other comprehensive income rather than in profit or loss. In addition, there is no consistent policy on "recycling" in IFRSs.

Given these unresolved issues, it is unsatisfactory from a conceptual viewpoint that the IASB is introducing or proposing new items of income or expense to be included in other comprehensive income, e.g. as part of IFRS 9. We believe that the use of other comprehensive income should not be expanded until the Board has fully addressed these issues.

<u>Retaining the bifurcation methodology for hybrid contracts with hosts that are financial liabilities is inconsistent</u>

The Board decided to retain almost all of the requirements in IAS 39 for the classification and measurement of financial liabilities, except for particular presentation requirements related to the fair value option. Therefore, the bifurcation methodology in IAS 39 would be retained for hybrid contracts with hosts that are financial <u>liabilities</u>. In contrast, the embedded derivative guidance for hybrid contracts with hosts that are financial <u>assets</u> was eliminated when IFRS 9 was issued in order to reduce the complexity of the accounting requirements. In our view, these decisions are inconsistent and should not be implemented in the final version of IFRS 9. In this area, we favour a single solution for all hosts that are either assets or liabilities.

Classifying all hybrid contracts in their entirety according to the current classification approach of IFRS 9 would be one way of simplifying the accounting requirements because it would eliminate the complex, rules-based and internally inconsistent provisions on embedded derivatives.

However, the problematic "closely related" assessment in IAS 39 may merely be replaced with an equally difficult assessment of the contractual cash flow characteristics of the hybrid contract. Moreover, as long as the (identical) requirements for hybrid contracts with non-financial hosts remain in place, the accounting treatment of like transactions is not consistent, thus impairing comparability and introducing structuring opportunities.

Consequently, we believe that there need to be further deliberations before a final decision can be taken as to whether the embedded derivative requirements for hybrid contracts should be eliminated. We also refer to our comment letter on the exposure draft 2009/7 "Financial Instruments: Classification and Measurement", dated 9 September 2009, in this context.

<u>The "frozen credit spread method" is conceptually sound and practicable</u>

In order to exclude the effects of changes in a liability's credit risk from profit or loss and other comprehensive income, we propose that entities measure financial liabilities that are neither liabilities held for trading or transfer (measured at fair value through profit or loss) nor liabilities without structured features (measured at amortised cost) at an "adjusted" fair value, whereby the liabilities would be remeasured for all changes in fair value except for the effects of changes in credit risk (i.e. the "frozen credit spread method"). Thus, the effects of changes in own credit risk would be ignored in the primary financial statements.

In our view, adjusting a measurement attribute in order to avoid negative consequences is not new to current IFRSs: According to paragraph 49 of IAS 39 the fair value of a financial liability with a demand feature is not less than the amount payable on demand, discounted from the first date that the amount could be required to be paid. In this case the IASB accepts the necessity to modify the pure measurement attribute "fair value" without changing the term. In March 2010 the IASB even decided to retain the term "fair value" for measuring financial liabilities with a demand feature in the coming IFRS on fair value measurement.

We concede that it is sometimes difficult to determine the precise amount of the change in the fair value of a liability attributable to changes in credit risk. Nevertheless, we believe that our proposal will not cause significant difficulties in practice:

- All financial liabilities that are <u>held for trading or transfer</u> (including all derivative liabilities) would be subsequently measured at fair value through profit or loss. In such cases there is no need to separate out the effects of changes in the liability’s credit risk.
- Financial liabilities <u>without structured features</u> (e.g. embedded derivatives) would be measured subsequently at amortised cost. This measurement attribute will be applicable in many cases, provided that the issuer plans to hold the liabilities to maturity and pay the contractual amounts.
- Only financial liabilities <u>with structured features</u> (provided that - after further deliberations - the provisions on embedded derivatives are to be eliminated in respect of all hybrid contracts, as referred to above) and financial liabilities that are <u>designated at (“adjusted”) fair value through profit or loss</u> would be measured subsequently at an “adjusted” fair value through profit or loss.

  In these cases, the default method in IFRS 7 can often be used for determining the amount of the change in fair value attributable to changes in the liability’s credit risk. This default method attributes all changes in fair value, except for changes in an observed (benchmark) interest rate (and any other changes in market conditions that give rise to market risk), to changes in the liability’s credit risk. This method is, in our view, acceptable as a practical expedient or reasonable proxy in many circumstances.

<u>Some aspects of the default method in IFRS 7 should be clarified</u>

In spite of our general support we request clarification of some aspects of the default method in IFRS 7 and its application, for example:

- According to paragraph 10 of IFRS 7, an entity shall disclose the amount of the change in the fair value of the financial liability that is attributable to changes in the credit risk of that liability. Neither paragraph 10 nor paragraph B4 define “credit risk” in detail, i.e. in excess of the definition in Appendix A of IFRS 7. From a conceptual point of view, credit risk should only reflect the credit quality of the issuer; including the price of credit and the liquidity risk is inappropriate. Nevertheless, the default method in IFRS 7, as a practical expedient, seems to determine credit risk more comprehensively, including the credit quality of the issuer, the price of credit and the liquidity risk. In any case, credit risk should be defined in the final standard.

- Additional guidance should be provided to clarify when an alternative method must be used because the default method does not faithfully represent the amount of the change in fair value that is attributable to changes in the credit risk of the liability (paragraph 10(a)(ii) of IFRS 7).
- Paragraph B4 of IFRS 7 gives an example how the amount of the change in the fair value of the financial liability that is attributable to changes in the liability's credit risk can be estimated if the only relevant changes in market conditions for a liability are changes in an observed (benchmark) interest rate. This example assumes that a market price of the liability can be observed. In most cases, however, markets for an entity's liabilities do not exist. Therefore, the IASB should provide guidance how to determine the effects of changes in a liability's credit risk in the absence of an observable market price of the liability.
- Paragraph 10 and paragraph B4 of IFRS 7 refer to a benchmark interest rate without defining what a benchmark interest rate is, thus resulting in different policies to determine the applicable interest rate. Despite the fact that the benchmark rate is generally interpreted as a risk-free rate, it is often understood to include inter-bank rates such as LIBOR for US dollar or sterling liabilities or EURIBOR for euro liabilities. Hence, one could argue that these rates may include a credit-risk premium above the highest-quality government bond rates for the same term and currency. Therefore, we believe that the benchmark interest rate should be defined in the final document.
- Some debt agreements protect the creditor against increases in the issuer's own credit risk by increasing the rate of contractual interest payable if the issuer's credit rating deteriorates. Neither IFRS 7 nor the exposure draft discuss how the effect of changes in contractual cash flows arising from such clauses should be considered. The same is true with regard to debt agreements that allow the issuer to avoid or defer payments of interest or principal if it fails to achieve some measure of financial health (e.g. subordinated debt instruments). In our view, some clarification would be helpful in these cases.

The clarifications mentioned above are, in our view, important because the default method in IFRS 7 is currently used to determine amounts that have to be disclosed in the notes. In contrast, under the proposals of both the IASB and the IDW, such amounts would have a direct impact on profit or loss.

Information about the effects of changes in credit risk should be provided in the notes

The exposure draft states that many users expressed the view that information about the effects of changes in the liability's credit risk is useful. They would use it for purposes such as determining the overall riskiness of the entity, identifying when the entity is in distress, indicating when an entity's assets may be impaired, estimating the entity's future financing costs and comparing the entity with others in the same industry. In our opinion, such information should be provided in the notes rather than on the face of the primary financial statements.

The cost exception in IAS 39 for derivative liabilities should not be abolished

Finally, with regard to practicability, the cost exception in IAS 39 should not be eliminated for derivative liabilities that will be physically settled by delivering unquoted equity instruments whose fair values cannot be reliably determined.

We would be pleased to answer any questions that you may have or discuss any aspect of this letter.

Yours sincerely

Klaus-Peter Naumann
Chief Executive Officer

Norbert Breker
Technical Director
Accounting and Auditing