

31 October 2005

Basel Committee on Banking Supervision
Bank for International Settlements
Centralbahnplatz 2
CH-4002 Basel
Switzerland

Email: baselcommittee@bis.org

Dear Sirs

Supervisory guidance on the use of the fair value option by banks under International Financial Reporting Standards

Deloitte Touche Tohmatsu is pleased to comment on the Basel Committee on Banking Supervision's Consultative Document *Supervisory Guidance on the use of the fair value option by banks under International Financial Reporting Standards* (referred to as the Consultative Document). Our comments are limited to the first part of the document since the second part is addressed to banking supervisors.

We believe that the guidance proposed by the Basel Committee on Banking Supervision will be perceived as an additional set of accounting rules applying to the banking industry in order to limit the use of the fair value option. We recognise that on page 1 of the Consultative Document it is stated that the Committee does not consider this proposal to be a set of additional accounting requirements, but we believe that this will be the effect, in practice. We are strongly of the view that the objective of the International Accounting Standards Board (IASB) is to set high quality accounting standards that entities across all industries have an equal opportunity to apply. We believe Banking Supervision has an important but separate and different objective and we support the Committee's work in promoting Prudential Supervision. We are concerned therefore that the proposals in the Consultative Document go beyond addressing the regulatory objective and will hinder the ability of a specific industry to apply an explicit option in the IASB's accounting standards.

The Fair Value Option Amendment was introduced in order to reduce complexity of accounting by mitigating some anomalies that result from the different measurement attributes and by simplifying the accounting for contracts that incorporate embedded derivatives. The IASB consulted widely on its proposals and reached its conclusions following considerable deliberation. We would like to draw your attention to the following reasons for their conclusions:

- The measurement mismatches arise in a wide variety of circumstances. Financial reporting is best served by providing entities with the opportunity to eliminate perceived accounting mismatches whenever this results in more relevant information. The fair value option achieves this. Furthermore, the IASB concluded that the fair value option could be used in place of hedge accounting for hedges of fair value exposures, thereby eliminating the related burden under IAS 39's hedge accounting rules of designating, tracking and analysing hedge effectiveness. The IASB therefore decided not to

develop detailed prescriptive guidance in the amendment about when the fair value option could be applied, opting instead to require complementary disclosure.

- In respect of embedded derivatives, the IASB sought to strike a balance between reducing the costs of complying with the complex requirements on separation of embedded derivatives and the need to respond to concerns expressed regarding possible inappropriate use of the fair value option. The IASB decided to restrict this use of the fair value option by specifying those situations in which an entity cannot justify using the fair value option where (i) the embedded derivative does not significantly modify the cash flows that would otherwise be required by the contract or (ii) is one for which it is clear with little or no analysis that separation is prohibited considering similar hybrid instruments.
- The IASB decided to restrict the use of the fair value option only for investments in equity instruments that do not have a quoted market price in an active market and whose fair value cannot be reliably measured. For less liquid instruments, such as loans, the IASB requires additional disclosure. The IASB considered introducing the requirement that the instrument's fair value be "verifiable". This suggestion was rejected by the vast majority of commentators because it would introduce an additional tier in fair value measurement. The fair value measurement model in IAS 39 already clearly differentiates between the numbers that are derived from active markets and those where a valuation technique is used. Detailed requirements apply in the latter case and extensive additional disclosures highlight to the users of the accounts that the numbers derived from valuations techniques are less reliable.

In view of the above, our main concerns with your proposals are as follows:

- The proposal to require a bank to "understand the impact of embedded derivatives upon its financial condition and risk profile when it chooses not to account for the derivatives separately from the host contract and instead applies the fair value option" would result in a bank having to keep dual accounting records, thus completely defeating the IASB's stated objective of simplifying accounting for embedded derivatives. We object to any proposal that would create a disincentive for entities to apply the IASB's fair value option amendment. In our view, the IASB's accounting safeguards on the use of the fair value option in this respect are appropriate and sufficient.
- We object to your proposed additional condition for fair value measurement to be a "reliable measurement" as we consider that your Consultative Document would result in banks applying a different fair value hierarchy, which would (a) limit their ability to apply the IASB's fair value option whereas other industries would not be subject to this measurement restriction; and (b) create an anomaly where a corporate counterparty will be able to claim to fair value the same instrument, whilst a bank that will often run its business on a fair value basis will not.

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If you have any questions concerning our comments, please contact Ken Wild in London on + 44 (0)20 7007 0907.

Yours faithfully

A handwritten signature in black ink, appearing to read "Ken Wild", written over a horizontal line.

Ken Wild
Global IFRS Leader