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DVFA conference
Frankfurt am Main
November 13, 2002

Remarks as prepared for delivery

Effects of IAS 39 on the interim report of the Commerzbank Group as of September 30, 2002

Today, I have taken over an especially thankless task again – namely that of outlining for you the impact of the application of IAS 39 on our interim report as of September 30. Since it was passed, IAS 39 has come in for severe criticism – from all sides: from users, analysts, rating agencies and the banking supervisory authorities. Nevertheless, the standard has to be applied by all companies applying IAS rules – together with the numerous implementation guidelines from the relevant committee. And where it is applied, it disrupts both the income statement and the presentation of the company's equity. I want to look at the effects of IAS 39 in that order.

In the **income statement**, IAS 39 initially makes itself felt in the prescribed measurement of derivative financial instruments at fair value. In particular, all those derivative financial instruments have to be measured at fair value, and their changes shown in the income statement, which count as hedges in economic, though not in accounting, terms. For this reason, we have to measure all derivative financial instruments that are used for controlling our interest income and which have not been included in a micro-hedge at fair value. The results of such measurement have to appear under the trading profit. Another outcome of IAS 39 is the item "Net result on hedge accounting". Unlike our competitors, we present this as an independent item in the income statement. Here, we show the net effect of measuring the hedged item and the hedging derivative instrument; above all, this item reflects ineffective hedges which remain within the permitted limits. But also changes in spreads are shown, such as those between the bond and the swap markets. In view of the nominal volumes that are hedged, these changes exert an influence over the published net results of measuring hedging instrument and hedged items.

Unfortunately, we cannot make reliable forecasts for these changes. And they repeatedly lead to quite large fluctuations in the income statement. You can see the impact of these two rules on this year's quarterly results in the chart *(chart 1)*. Our pre-tax profit was reduced by €40m from January to September. As our published pre-tax profit for the first nine months of the current year was €45m, this is a figure that cast a considerable influence over the presentation of Commerzbank Group's earnings performance.

Our glance at the income statement would not be complete if I failed to say something about the **impairment write-downs on investments and available-for-sale securities**. After the fresh, dramatic falls in share prices during the third quarter, we asked ourselves when preparing the financial statements as of September 30 whether we needed to recognize the unrealized valuation losses from individual items – which had previously been shown as the negative part of the revaluation reserve – as impairment write-downs. They would then have to be shown in the income statement as expenses in the current year. In accordance with IAS 39, companies must examine on each reporting date whether there is objective evidence of possible impairment. Such objective evidence can be, for instance, financial difficulties which can be reflected in losses and the erosion of equity in the balance sheet. Or it can take the form of ongoing negative operating cash flows.

But dramatic changes in the overall conditions, such as new competitors or technological changes may also be objective evidence of impairment. By contrast, a falling stock-market price, which remains below the acquisition price for a long time, is in itself not objective evidence of impairment. Instead, impairment must be explainable by means of strong financial indicators, e.g. ongoing losses. When we re-examined our investments and available-for-sale securities, we came to the conclusion that there were good reasons for impairment above all in the case of our investment in T-Online and several others, including private equity investments. We also decided to assume impairment in the case of all investment-funds held in the available-for-sale portfolio where the price per unit had fallen below the acquisition price. These items were then written down in the income statement as of September 30.

All told, we showed a net result of -€531m in our income statement for the third quarter of 2002 for investments and available-for-sale securities (*chart 2*). This includes impairment write-downs of €506m on the current share price of T-Online; investment-funds amounting to roughly €120m; and private equity investments of around €40m. At the same time, we realized gains, mainly through the disposal of securities and promissory notes. Following these extraordinary measures as of September 30, we do not believe that we will have to make major write-downs on our investments and available-for-sale securities in the final quarter of this year – insofar as there is no further sizeable drop in equity prices.

Let me now briefly look at the impact of IAS 39 on our equity. What I have said on the impairment write-downs on investments and available-for-sale securities applies here as well. This is because the effects of measuring securities at their price on the reporting date are reflected in the **revaluation reserve**, unless they have already appeared in the income statement as write-downs. However, please note that measurement at fair value only applies to listed investments and available-for-sale securities. Hidden reserves in unlisted investments do not appear here; nor do hidden reserves in fully-consolidated companies or associated companies. As expected, the revaluation reserve (*chart 3*) registered another decline – and quite a marked one – in the third quarter. As of September 30, it stood at -€1,282m, which due to the impairment write-downs that we made is far better than analysts expected.

The largest items within the revaluation reserve are split between the following investments and securities: unrealized losses on measurement primarily come from Banca Intesa, Santander Central Hispano, Generali, Linde and Munich Re. Unrealized gains primarily come from Crédit Lyonnais, MAN and Unibanco. These companies all have a sound financial condition, a healthy capital base, a good market position and above-average recovery potential. However, in the present market environment, they are not valued particularly highly, or – in the case of financial institutions, for example – they have suffered especially strongly from the fall in share prices. We are convinced that we will not have to make impairment write-downs on these investments and securities in the coming quarters.

Since September 30, the revaluation reserve has improved again, thanks to the recovery of various share prices. At the moment, it stands at -€1.1bn. Its volatility is enormous. On individual banking days, for example, we have registered changes in the revaluation reserve of up to about €400m. As the revaluation reserve in no way affects Tier I capital for regulatory purposes under the Basel capital accord, we have nothing to fear on this score.

But any one of you can work out on the basis of the details published in our interim report what will happen if we were to deduct the negative revaluation reserve from core capital – which, as I have pointed out, we do not need and do not intend to do. The results of this analysis would be anything but disturbing. They reveal that even if the negative revaluation reserve is fully deducted, we would still have capital ratios of 6% (core capital ratio including market-risk position) and more than 10% (own funds ratio including market-risk position) on the basis of September 30, 2002. This means that we have no need to fear comparison in the present environment.

In conclusion, I want to turn to the last equity item that has entered the limelight thanks to IAS 39. This is the **measurement of cash flow hedges**. Here (*chart 4*) we show a figure of -€1,045m as of September 30. This is a sizeable amount, which also fluctuates strongly over time and grew by €504m in the third quarter. What lies behind this item? Like other banks, Commerzbank hedges expected payment flows, so-called cash flow hedging. In the simple case – but one which serves as a good example – in which a fixed-interest investment refinanced at a variable interest rate is hedged by a payer swap, the principle becomes clear. If interest rates fall, the fair value of the swap, which was zero when the transaction was concluded, becomes negative. In accordance with IAS 39 rules for cash flow hedge accounting, the swap is recognized at its fair value. It is booked – naturally after deferred taxes have been taken into consideration – under the measurement of cash flow hedges in equity. The picture is distorted by the fact that the fixed-interest investment continues to be shown at acquisition cost. The distortion arises because the hidden reserve formed on the investment appears in interim reports in neither equity nor the notes. In the measurement of cash flow hedges, therefore, only one side of the coin is revealed, which in the outlined case of falling interest rates leads to negative values.

However, these negative values are not losses, nor are they negative changes in net asset value. They are merely the convention for presentation prescribed by IAS 39. To this extent, they are “phantom movements” in equity in my opinion. They are in no way relevant for a bank’s net asset value or earnings position. It is quite appropriate, therefore, that after an intensive debate on IAS 39, the central banks represented in the Basel committee for banking supervision also see this item as we do. Changes in the measurement of cash flow hedges are considered irrelevant in supervisory terms. All the same, the changes require some explanation when an interim report is published. And at least under the currently practised form in which derivative financial instruments are employed by Commerzbank for cash flow hedging purposes, changes in (euro) interest rates explain the changes in the measurement of cash flow hedges. This item increases if interest rates rise and declines if they fall (*chart 5*).