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CL 78

21 July 04

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Dear Sandra

The Fair Value Option: Proposed Amendments to IAS 39

J.P. Morgan Chase & Co appreciates the opportunity to comment on the International Accounting Standards Board's ("IASB" or the "Board") Exposure Draft of Proposed Amendments to IAS 39: Recognition and Measurement – The Fair Value Option (the "Exposure Draft").

We have been supportive of the ability under IAS 39 *Financial Instruments: Recognition and Measurement* (*December 2003)* ("IAS 39"), for entities to choose to fair value through profit or loss any financial asset or financial liability. In our comment letter dated 30 October 2003, on the proposed improvements to IAS 39, we agreed with the then proposal that an entity should be permitted to designate, irrevocably at initial recognition, any financial instrument at fair value through profit or loss ("the Fair Value Option" or "the Option"). Our view was based on the belief that this choice would (i) alleviate problems of earnings distortions that result from the current mixed measurement model, and (ii) eliminate the complexity inherent in bifurcating financial instruments with embedded derivatives. As a result it was with concern that we read the Exposure Draft since its proposals could limit these key benefits.

Although we understand the issues raised by prudential supervisors, we believe that explicitly limiting the situations in which the Fair Value Option can be used is not the most effective means of addressing those issues and may result in restricting its legitimate use. We consider that the concerns raised by prudential supervisors could be more appropriately addressed via disclosure.

We have set out the reasons for our views in more detail by addressing the specific questions raised in the Exposure Draft below.

Question 1

Do you agree with the proposals in the Exposure Draft? If not, why not? What changes do you propose and why?

We do not agree with proposals in the Exposure Draft for three broad reasons:

1. The proposals will limit a valid means by which entities can minimise the asymmetry caused by the mixed measurement accounting model and the burden of bifurcating financial instruments with embedded derivatives;
2. The proposals add a new category of "verifiable" to IAS 39's fair value measurement considerations ("the Fair Value Hierarchy") that is not conceptually supportable; and
3. Limiting the Fair Value Option in the manner proposed will lead to unintended consequences in application.

1. **Reducing Accounting Asymmetry and the Burden of Bifurcation**

We are supportive of the Fair Value Option as currently drafted in IAS 39 because it enables entities to minimise the asymmetry in financial statements caused by the mixed measurement accounting model. Asymmetry results in earnings distortions where a position is required to be measured at fair value through profit or loss, but its offsetting risk position is required to be measured at amortised cost.

The Fair Value Option also eliminates the complexity of bifurcating embedded derivatives from hybrid instruments such as structured notes issued by financial institutions. Structured notes are designed to provide investors with exposure similar to that found in a freestanding derivative. A common example is an equity-linked note, where coupons and/or repayments of principal on the debt host reflect the performance of a specific equity security or equity index. Unlike other debt issuances, these notes are not issued to raise funds but are structured to meet client needs. Structured notes form part of an entity's trading activities and are managed on a fair value basis. Bifurcation of these instruments results in an artificial allocation of value to an implied debt host and does not best reflect the fact that a market price may be available for the entire instrument.

In both these cases the Fair Value Option increases transparency by enabling entities to align risk management and financial reporting views.

2. **Additional Category in the Fair Value Hierarchy**

It is proposed in the Exposure Draft that a financial instrument can only be designated at fair value through profit or loss where that instrument's fair value is "verifiable", as defined in paragraph 48B of the Exposure Draft. We do not consider that there is any conceptual basis for adding the additional "verifiable" test and thus do not agree with the proposals in the Exposure draft for the following reasons:

a. The fair value measurement considerations contained in paragraphs AG69 to AG82 already provides sufficient guidance on how an entity should fair value financial instruments; and
b. The "verifiable" test is not consistently applied across all financial instruments.

If an entity issued structured debt with a complex embedded derivative, in certain circumstances it may not meet the "verifiability" criteria. This is because some of the material parameters used to model a more complex derivative element may not be observable in the market. If the Fair Value Option is unavailable the structured notes would be required to be bifurcated, with the debt host measured at amortised cost and the embedded derivative separately measured at fair value through profit or loss. This result is illogical; it is the derivative component of the structured debt which is causing the compound instrument to be unverifiable and outside scope of the Fair Value Option, yet it is also the derivative that will be measured at fair value through profit or loss after bifurcation.

We see no conceptual basis for adding the verifiable threshold and would therefore recommend that it is removed. We consider that required adherence to the fair value measurement considerations contained in paragraphs AG69 to AG82 of IAS 39 and the disclosure requirements of paragraph 92 of IAS 32 would be sufficient to ensure appropriate recognition of profit or loss.

If the IASB decides to retain the "verifiability" proposals in the Exposure Draft, then we would recommend that the "verifiable" test does not apply where a financial instrument's fair value is not verifiable due to a component of a hybrid instrument that is required to be measured at fair value through profit or loss in any case.

3. Unintended Consequences - Irrevocable Designation

We consider that adding restrictions to the Fair Value Option could lead to unintended consequences in application. We have highlighted one unintended consequence here: the impact of paragraph 50 on irrevocable designation.

We agree with the concept of irrevocable designation, however we are concerned with the additional offset criteria in paragraph (iii) which must also be met at the inception of the financial instrument or an entity cannot apply the Fair Value Option. This prohibition applies even if upon initial recognition of the financial instrument, the entity knows it will meet the conditions of the Fair Value Option in the near future.

For example, as part of its warehousing activities, an entity may build-up loans on its balance sheet for transfer at a later date into a securitisation vehicle. It will hedge that position with derivatives, however the derivatives and the loans may not be purchased at the same time; i.e. hedges may be applied periodically to cover portfolios only once they have accumulated to a certain size. Under the proposals in the Exposure Draft, an entity would be unable to utilise the Fair Value Option, because at initial recognition of the loans there is no offsetting risk position.

In this example hedge accounting would be the only mechanism by which the entity could minimise the earnings distortion caused by carrying the derivative at fair value and the warehoused loans at amortised cost. This result contradicts one of the IASB's intended uses for the Fair Value Option as detailed in paragraph BC6(c)(i) of the Exposure Draft, namely as an alternative to hedge accounting.

JPMC Suggested Changes

In light of the inconsistencies detailed above and our view that the impact of Exposure Draft will be detrimental rather than helpful, it is our recommendation that the Fair Value Option be retained as currently drafted in IAS 39.

We consider that a more appropriate mechanism to address the prudential supervisor's concerns is to enhance the disclosure contained in IAS 32.94(e) & (f) regarding the use of the Fair Value Option. We propose that entities using the Fair Value Option should not only disclose the carrying amounts of financial assets and liabilities where the Option has been used, but should also provide details, at an appropriate level, as to why the Option has been invoked. Such disclosure would provide users of financial statements with insight into both the reasons and pervasiveness of the Option's use.

Question 2

Are you aware of any financial instruments to which entities are applying, or are intending to apply, the fair value option that would not be eligible for the option if it were revised as set out in this Exposure Draft? If so:

(a) please give details of the instrument(s) and why it (they) would not be eligible.
(b) is the fair value of the instrument(s) verifiable (see paragraph 48B) and if not, why not?
(c) how would applying the fair value option to the instrument(s) simplify the practical application of IAS 39?

We refer to the examples given to support our concerns raised in Question One above. In addition, we wish to highlight one further, significant instance where we are concerned use of the Fair Value Option may be ineligible; the application of the "substantially offset" criteria to hedges of credit risk.

It is the intention of the Board, as set out in paragraph BC10 and BC6(c)(ii), that the Fair Value Option can be used to alleviate the earnings mismatch where derivatives fail to meet the hedge effectiveness criteria Our concern is that “substantially offset” will be equated with the hedge effectiveness criteria in IAS 39. If this was the case, there are number of legitimate offset situations where the Fair Value Option could not be utilised.

For example, a hedge of the credit risk on a single name loan may not meet the hedge effectiveness criteria under IAS 39 because of the basis risk between the credit derivative and the hedged item. This basis risk arises because the standard credit default swap terms often reference credit events in the form of bankruptcy, default on specified obligations, etc. and do not reflect the actual hedged loan. If the “substantially offset” condition aligns with hedge effectiveness rules, this hedge relationship may fall outside both the hedge accounting provisions and the Fair Value Option.

As stated previously in this letter, we believe that there should be no further restrictions placed on the Fair Value Option. However, if the IASB were to retain the proposals in the Exposure Draft, we urge the Board to clarify within the body of IAS 39 that “substantially offset” does not equate to “hedge effectiveness”.

Question 3

Do the proposals contained in this Exposure Draft appropriately limit the use of the fair value option so as to address adequately the concerns set out in paragraph BC9? If not, how would you further limit the use of the option and why?

We are not convinced that the proposals in the Exposure Draft are the most appropriate means to address the concerns set out in paragraph BC9.

BC9(a) sets out the concern that the valuation of financial instruments with non-verifiable fair values is subjective and could inappropriately impact profit or loss. We consider that estimating fair value requires informed judgement. Consistent application of the fair value hierarchy in IAS 39 coupled with clear corporate governance, control, price verification and audit practices is the best way to ensure the objectivity, consistency and integrity of fair valuation and accounting practices.

BC9(b) sets out the concern that use of the Fair Value Option might increase rather than decrease volatility in profit or loss, for example if an entity applied the Option to only one part of a matched position. We consider that this should not be a significant issue where meaningful disclosure makes use of the Option transparent to users of financial statements. In addition, requiring fair value designations to be irrevocably made at the inception of an instrument should help to mitigate this concern. Finally, since the proposals in the Exposure Draft limit a valid means of reducing the earnings distortions caused by the mixed measurement accounting model, the proposals in the Exposure Draft may increase rather than decrease earnings volatility.

Question 4

Is the proposal in paragraph 9(b)(i) appropriate? If not, should this category be limited to a financial asset or financial liability containing one or more embedded derivatives that paragraph 11 of IAS 39 requires to be separated?

As stated above, we consider that the Fair Value Option should not be restricted as proposed in the Exposure Draft. If conditions are placed on its use we would be supportive of broader rather than narrower conditions.

Questions 5

We have no comment.

Question 6

Do you have any other comments on the proposal?

The proposals in the Exposure Draft mean that the definition of "held for trading" in paragraph 9 of IAS 39 has increased significance. Prior to the proposals, an entity wanting to fair value a financial instrument was not constrained by whether it met the definition of "held for trading" since it was able to reflect its intention to hold the instrument as part of its trading business by utilising the Fair Value Option.

We note that the definition of "held for trading" is narrower in scope than US GAAP and is based primarily on being able to demonstrate an intention to sell or repurchase in the near term. Per Statement of Financial Accounting Standards ("SFAS") No. 115, *Accounting for Certain Investments in Debt and Equity Securities,* classification of a security as trading is not precluded simply because the entity does not intend to sell it in the near term. However, the decision to classify a security as trading should occur at acquisition (see Financial Accounting Standards Board Implementation Guide- SFAS No. 115 question 35).

As a result of the proposals in the Exposure Draft, we are concerned that an entity may not be able to fair value a financial instrument (or portfolio) that it intends to manage on a fair value basis as part of its trading business, because the instrument will be held for the medium to long-term. For example, an entity may hold a non-marketable cash security for the longer term with a derivative as part of a relative value arbitrage strategy in its trading portfolio. If the fair value of the security was not verifiable, the entity would not be able to designate the security at fair value or classify it as held for trading. As a result, the instrument would be classified as available for sale. Because of the accounting asymmetry between the cash security and the derivative it is hedging, the entity would suffer earnings and equity volatility. We consider that this overall strategy is more appropriately reflected on a fair value basis.

Should the IASB proceed with its proposals in the Exposure Draft, then we would strongly recommend that the IASB revisit the "held for trading" definition with a view to aligning with it US GAAP. This recommendation is not made solely with a view to convergence, but also to enable entities to more accurately reflect the trading nature of certain activities.

* * *

In conclusion, we believe the Exposure Draft as currently written will limit rather than increase the potential for transparency that the Fair Value Option previously gave. For this reason, we strongly urge the Board to consider the comments in this letter.

We appreciate the opportunity to submit our views and would be pleased to discuss our comments with you at your convenience. If you have any questions, please contact me on +1 212.270.7559.

Sincerely,

Joseph Sclafani, EVPCC
J.P. Morgan Chase

c.c.
Simon Peerless - Project Director
Accounting Standards Board