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July 21, 2004

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Ms Sandra Thompson
Senior Project Manager
International Accounting Standards Board
30 Cannon Street, London EC4M 6XH, United Kingdom

By email to: iasb@iasb.org.uk

Re: Amendments to IAS 39: The Fair Value Option

Dear Ms Thompson,

Goldman Sachs appreciates this opportunity to comment on the "Exposure Draft of Proposed Amendments to IAS 39 Financial Instruments: Recognition and Measurement - The Fair Value Option" ("the proposal") recently issued by the International Accounting Standards Board (the "Board").

The introduction of the fair value option was a major step forward in accounting for all financial instruments at fair value through profit or loss. We supported the fair value option when it was introduced within the original IAS 39 amendments because it helped rectify many of the anomalies and problems with the current mixed measurement model of fair value and cost-based approaches for financial instruments.

Recently, some constituents raised concerns that the fair value option may be applied inappropriately. Specifically, these constituents were concerned that:

a) entities might apply the fair value option to financial assets or financial liabilities whose fair value is not verifiable;
b) use of the option might increase, rather than decrease, volatility in profit or loss; and
c) if an entity applied the fair value option to financial liabilities it might result in the entity recognising gains or losses in profit or loss for changes in its own creditworthiness.

In response to these concerns, the Board developed the proposal, which would (i) limit the types of financial assets and liabilities to which the option may be applied and (ii) require that the option be applied only to financial assets and financial liabilities whose fair value is "verifiable".

We do not share these concerns and believe that any restriction on the fair value option is a step backwards. Consequently, we do not support the proposal and find ourselves agreeing with the three Board members who voted against it.

Moreover, we do not believe the proposal achieves its objectives and, in the process, moves away from a principles-based approach in favour of detailed rules.

Verifiability – Introduction of an Undesirable Dual Standard

The proposal introduces the concept of verifiability in an attempt to relieve concerns over the use of inappropriate fair values. We understand the Board means "verifiable" to be a stricter test than "reliably measured", i.e., the variability in the range of fair value estimates is low. By requiring a stricter test, the Board has created a dual measurement standard between those instruments that are *required* to be fair-valued and those for which the use of fair value is *optional.*

Under the proposal, fair values are required to be verifiable only for those financial instruments where the fair value option is used and not for those financial instruments where the use of fair value through profit or loss is obligatory, i.e., instruments that satisfy the criteria of held for trading. Where an instrument meets those criteria and therefore is measured at fair value through profit or loss, fair value must be determined in accordance with the hierarchy in paragraphs AG69 through AG82 of IAS 39. That hierarchy provides guidance about determining fair values of financial assets or financial liabilities across a wide spectrum of price transparency, i.e., the range of fair value estimates is not always low. Nevertheless, changes in fair value are still required to be recognised through profit or loss.

Conceptually, we believe a *dual* standard is inconsistent with the objective of fair value measurement, which is to arrive at the *single* exchange price between two parties.

Proposal Aggravates Rather than Mitigates Volatility Concerns

The proposal focuses on concerns that an entity will choose to introduce volatility into its financial statements by selectively applying the fair value option. The proposal attempts to mitigate this perceived risk by limiting the availability of the option. Our experience is that most entities would not seek to introduce artificial volatility into their financial statements. Thus, we question the premise underlying these concerns.

Additionally, by restricting the use of the fair value option, the proposal could increase reported volatility (and not achieve its stated objectives) by failing to account for natural offsets. An entity could be required to measure certain assets at amortised cost and to measure naturally offsetting items at fair value, thereby introducing increased accounting volatility where economic volatility does not exist.

For example, the risks in a portfolio of loans may be economically hedged using a variety of derivative instruments, such as credit derivatives. In this situation, the economic hedges may not qualify as designated hedges and may not fulfill the stringent requirement of "substantial offset". The loan portfolio would be required to be measured at amortised cost but the derivatives would have to be measured at fair value through profit or loss. This mismatching would lead to considerable volatility in the profit and loss statement (but not economic volatility) which would not have occurred prior to the proposal.

Held for Trading – Criteria may Need Refinement

Should the Board ultimately conclude that these proposed restrictions on the use of the fair value option are required, we believe it will also be necessary to change the definition of "Held for Trading". As the Board noted, "IAS 39 contains a tighter definition of held for trading than US GAAP, with the result that fewer financial assets and financial liabilities can be measured at fair value through profit or loss by being classified as held for trading." That definition is such that financial instruments held by an entity for trading could be inadvertently and inappropriately excluded from this category. We believe that the use of fair value through profit or loss for a trading portfolio is widely recognised as the model which provides the most useful and relevant information and is therefore the most appropriate model. In order to ensure that this category properly captures the entire trading portfolio, we believe the definition needs to reflect the views of trading businesses.

Basel Capital Accord Implications

Within Europe, many entities significantly affected by IAS 39 will also be subject to the new Basel Capital Accord. This accord also addresses the issue of what should and should not be classified as trading. The Basel definition may require loans to be classified within the trading book, which subsequently would require them to be marked to market for regulatory purposes; however, the same loans would be excluded from being carried at fair value within the proposal. The Board should attempt to ensure that entities are not subject to conflicting definitions and requirements as this will be cumbersome and impractical.

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We appreciate the opportunity to provide you with our views on the proposal. If you have any questions regarding our comments, please contact Matthew Schroeder, Managing Director—Accounting Policy at 212-357-8437, or Stephen Davies, Managing Director—International Controller in London at (20) 7774-3804.

Sincerely,

/s/ Sarah E. Smith

Appendix

Question 1
1) Do you agree with the proposals in this Exposure Draft? If not, why not? What changes do you propose and why?

As described previously, we do not agree with the proposals in the Exposure Draft. The proposals move the standard away from the principles-based approach, which aligns the accounting for transactions with the economic substance of the transactions.

The proposals do not address certain constituents' concerns with the original fair value option and have exacerbated some of the problems. At the same time, the proposals have introduced inconsistencies in the treatment of financial instruments within and between financial statements and greatly increased the complexity of application of the statement

We would propose that the Board revert to the original fair value option which we believe results in better financial reporting.

Question 2
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 this 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 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 IAS39?

The main class of financial instruments which we are aware that entities are intending to apply fair value accounting to, but which would not be eligible for such treatment under the revised standard, is loans and receivables. Many entities actively originate loan facilities and trade in the secondary market. The loans held are unlikely to meet the definition of a trading asset as they could not be deemed to be traded in the near term.

This situation is further complicated by the potentially different treatments for commitments and loans. An originated but undrawn loan commitment would be recorded at fair value but once drawn down, the loan would be required to be recorded at amortised cost.

The accounting treatment required under the proposal is inconsistent with the management of these assets.

The restriction on the use of the option to those instruments with a verifiable fair value may limit its use for new financial instruments or instruments priced using new models. An entity may be forced to utilise a commonly used market technique in order to obtain fair value treatment for its instrument and hence will have a reduced incentive to establish new (and possibly better) fair value models. For example, the Black-Scholes model was for many years the market standard option pricing model and would have been the only commonly used market technique. However this technique has now been replaced to a certain extent by lattices. Under this proposal, lattices would never have been allowed to be used as they would not have generated a verifiable price, and hence would not have gained market acceptance. Therefore the market would still be using solely Black-Scholes. This demonstrates how the proposal could hinder the development of more accurate fair value measurement techniques.

Question 3
3) Do the proposals in the 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?

As supporters of the original fair value option within IAS 39 we do not agree with the attempt to limit its use as set out in the proposal. We do not believe the proposals address the concerns in BC9 of the proposal, and in particular believe they may increase rather than decrease volatility, and hence, do not believe any further limit to the use of the option would be appropriate.

Question 4
4) The Board decided that all financial instruments that contain an embedded derivative could use the FV option. Does this make the category too broad? If so, how would you limit the use of this category?

The process of identifying and separating embedded derivatives in order for the derivative to be carried at fair value can be a cumbersome and ambiguous procedure. As such we support the broad inclusion of the entire financial instrument containing the embedded derivative within the option.

Question 5
5) Do you agree with the proposed transitional provisions?

The proposed transitional requirements appear appropriate if the proposed restriction to the fair value option is implemented, and we would not support retrospective restatement of all assets whose designation would have changed.

Question 6
6) Do you have any other comments on the proposals?

If the Board continues in its attempt to restrict the use of the fair value option it is, in our view, important that they focus on the definition of “held-for trading” and ensure that it is expanded and refined so that it is robust enough to incorporate all instruments held for this purpose. The current definition is highly prescriptive and focused on time. We believe a greater focus should be placed on the motivation of the holder. To this extent financial instruments held in the normal course of business by a broker-dealer should fall into the trading category and we believe that should be the aim of any definition of held for trading.