BNP PARIBAS

CL 89

Paris, 21st July, 2004

Mrs. Sandra Thompson
IASB
30 Cannon Street
London EC4M 6XH
United Kingdom

Re: Exposure Draft of Proposed Amendments to IAS 39 Financial Instruments: Recognition and Measurement – The Fair Value Option

Dear Mrs. Sandra Thompson,

BNP Paribas appreciates the opportunity to comment on the Exposure Draft of "*Proposed Amendments to IAS 39 Financial Instruments: Recognition and Measurement, the Fair Value Option*" recently issued by IASB.

In contributing to IASB's due process, we issued a comment letter on IAS 39 Exposure Draft sent to Sir David Tweedie and dated October 14th, 2002, that set out our concerns regarding IASB's proposals.

As regards the option to designate at inception any financial instruments as at fair value through profit or loss, we pointed out that this proposal was only necessary to mitigate some of the deficiencies of the mix-attribute model in IAS 39. We were also concerned that this option may be used by unscrupulous members of management to manipulate what is the real financial position of an entity.

However, the revised version of IAS 39 does not solve these concerns. Therefore, given the mix-measurement model and the problems inherent to hedge accounting rules, we believe that the option would considerably ease the application of IAS 39, even if it is not a perfect solution.

As mentioned in the Background and the Basis For Conclusions of this Exposure Draft, prudential supervisors and other regulators were also concerned by the volatility in profit and loss that would follow from the inappropriate use of the fair value option. That is why "the Board decided to propose that the fair value option be amended so as to limit its use while preserving the key benefits of the option."

We support the Board to accommodate the concerns raised and we welcome the attempts to limit the use of the fair value option. However, the restrictions proposed to prevent the abuse have also, perhaps inadvertently, prohibited the use of the fair value option in situations that are entirely appropriate.

As a result, we would like to mention our strong reservations on the following points:

- The "verifiable" notion introduces a second-tier threshold for fair value measurement and could lead to record at fair value through equity an available for sale asset that could be prohibited from being designated as at fair value through profit or loss because its fair value does not meet the verifiability test. We believe this concept creates confusion and that there should be a single definition of fair value. Consequently, we would suggest that the current provisions of IAS 39, requiring a reliable measurement, be also considered appropriate for the application of the fair value option, as they are considered as being qualitative for trading deals or available-for-sale assets.

- Liabilities used for the funding of trading activities are not considered as part of the trading category under IAS 39. As such, without the use of the fair value option, companies may be required to reflect these financial instruments at amortised cost when they should in fact be reflected as part of the trading activities. Therefore, if the Board does not want to reconsider the "held-for-trading" definition, it should at least extend the fair value option to those liabilities as the fair value measurement is consistent with the way they are managed.

- The most important benefit of the fair value option is to ease the practical application of IAS 39, in particular in those situations in which the option enables to achieve a similar accounting result as the fair value hedge whilst avoiding the designation, tracking and assessing of the hedge effectiveness that hedge accounting entails.
  Should the Board impose formal requirements on the entity in order to prove compliance with this condition, e.g. documentation of the relationship demonstrating the "substantial offset", this would in fact annihilate the benefit to applying the fair value option as opposed to designating a hedging relationship.

Furthermore, we would like to express once again our concern that if an entity apply the fair value option to a financial liability (for example because it is "naturally" offset by a derivative) it might result in the entity recognising a profit when its credit rating declines.

On this issue, the current answer of IASB is a specific disclosure requirement on the changes in fair value due to other factors than the reference interest rate. We do believe that such a disclosure is not sufficient and does not solve the concerns raised by the European supervisors. We would suggest that when applying the fair value option to a financial liability, only changes relating to risks other than own credit should be taken into account: when fair valuing the instrument, the credit spread component should be crystallised at its value at inception.

As detailed below, allowing the application of the fair value option to risk components of a financial instrument (the interest rate risk in that case) would solve this problem.

You will find enclosed our detailed answers to the questions posed by the Board on the Exposure Draft. If you have any further queries regarding our comments, please do not hesitate to contact me on 33 (01) 40 14 29 28.

Sincerely,

Philippe Bordenave
Chief Financial Officer

Question 1:

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

As mentioned in the cover letter, at the time the Exposure Draft of IAS 39 was published, we did not support the introduction of the fair value option as we considered that its purpose was to mitigate some deficiencies of the mix-measurement model and stringent hedge accounting rules in IAS 39. As the revised version of IAS 39 has confirmed this mix-measurement model, we regard the fair value option as a mean to overcome this flaw and to ease the application of IAS 39.

The proposed restrictions to the fair value option, while presumably drafted to prevent abuses, could prohibit its use in situations which are entirely appropriate and necessary in order for the financial statements to appropriately reflect the economical position.

Therefore, it is our view that it is crucial that the Board considers the following issues:

- *"Verifiable" fair value measurement*

In order to narrow the use of the fair value option, the Exposure Draft allows its application to the extent that the fair value of the financial asset or liability is "verifiable".
The Exposure Draft clearly states that the "verifiability" test is stricter than the "reliably measurable" criteria applied to held-for-trading and available-for-sale instruments.

By introducing this notion, the Board has created a second-tier of fair value that could lead to record at fair value through equity an available for sale asset that could be prohibited from being designated as at fair value through profit or loss because its fair value does not meet the verifiability test. We believe that this is inconsistent.

Moreover, if the "verifiable" requirement would be introduced it would become doubtful if it is possible to designate hybrid instruments that do not qualify for bifurcation at fair value. The perverse effect might be that bifurcation would be needed but that it would not allowed to measure the host contract itself would at fair value.

This will lead to considerable confusion for the purposes of rules relating to fair value measurement. Indeed, this notion does not exist in other areas of measuring fair values in any other Standards, such as IAS 40 "Investment Property", nor in the Framework. We believe there should be one definition of fair value.

Thus, we would suggest that the current provisions of IAS 39, requiring reliable measurement, be also considered appropriate for the application of the fair value option, as they are both robust and strict enough to prevent abuse.

- *Funding of trading activities*

In the current text of IAS 39, the definition of the held-for-trading category does not enable to account for at fair value financial assets and liabilities that are part of the funding of trading activities, as they are not held for short-term profit taking.

Therefore, it is necessary to designate them as at fair value through profit or loss in order to avoid to reflect them at amortised cost, when they should be in fact reflected as part of the trading activities.

Therefore, if the Board does not want to reconsider the "held-for-trading" definition, it should at least extend the fair value option to those trading book funding liabilities for which the fair value through profit or loss is the most appropriate measure.

- *"Substantial offset"*

Should the Board impose formal requirements on the entity in order to prove compliance with this condition, e.g. documentation of the relationship demonstrating the "substantial offset", this would in fact annihilate the benefit to applying the fair value option as opposed to designating a hedging relationship.

As the most important benefit of the fair value option is to ease the practical application of IAS 39, in particular in those situations of "natural offset", we believe that this is not the objective of IASB.

Accordingly, we encourage the Board to clarify in the Standard, as stated in the Basis for Conclusion, that the fair value option can be used as an alternative to hedge accounting without any need for the designation, tracking and assessing of hedge effectiveness.

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?

The most important benefit of the fair value option is that it enables to account for asset and liability positions offsetting each other, where hedge accounting cannot be apply. The limitations "contractually linked" and "substantially offset" with the necessary identification included in the proposed restrictions are likely to prohibit the use of the option in situations that are entirely appropriate.

We provide hereafter several examples of financial instruments to which entities may be unable to apply the fair value option under the proposals in the Exposure Draft, although the changes in fair value of these financial instruments are substantially offset by the ones of other financial instruments.

- *Entering into the "natural hedging" contract the following day*

An entity may buy a financial asset (or incur a financial liability) but enter into a derivative that "substantially" offsets the exposure to changes in fair value of the financial asset (or liability) on the following day. Indeed, in practice, it is not possible to identify an offsetting position at inception since the risk management process is a continuous process.

Under the Exposure Draft proposals, as the identification of the offsetting exposure cannot be brought at the date the asset (or liability) is initially recognised the entity would not be able to apply the fair value option. This would lead to the financial asset being held at amortised cost and the derivative at fair value, resulting in volatility from one reporting period to the next: the natural hedge will not be reflected in the financial statements.

This argument could be refuted in the motive that we could enter into a fair value hedge relationship. However, the designation of a hedging relationship is a heavy process to implement. Therefore, the fair value option could for example be very useful as regards funding deals of the Treasury centre which are mainly short term deals and for which hedge accounting will be too much burdensome, and this especially since the volumes processed are heavy.

Therefore, the standard should be revised to allow a financial instrument to be designated at "fair value through profit or loss" even after inception, if the entity makes a decision that the financial instrument will be "hedged" through a substantially offsetting position. Indeed, where a financial instrument has been purchased as a natural hedge of another financial asset or financial liability, the standard should allow both of these instruments to be recorded at fair value through profit or loss. In this case, the changes of fair value of the hedged financial instrument should be calculated as of it is designated as at fair value through profit or loss.

- *Fair value measurement of portfolios*

As mentioned above, where a financial instrument has been entered into as a natural hedge of another financial instrument, then it should be allowed to be designated as at fair value through profit or loss. Without the use of the fair value option, the entity will not be able to consistently measure matched asset and liability positions.

However, it is crucial to highlight that banks do not manage risk in respect of instruments but with regards to various risk categories and at a portfolio level that includes both financial assets and financial liabilities. Therefore, the "substantial offset" cannot be appreciated between two financial instruments, but rather at a portfolio level, based on the VaR of the portfolio for example.

Consequently, we believe the standard should permitted to apply the fair value option to those assets or liabilities for which the fair value through profit or loss is the most appropriate measure, as it enables to reflect the underlying economic substance.

Therefore, we recommend that the standard allows to apply the option where a financial instrument forms part of an economic hedging relationship with another financial instrument or portfolio of instruments and where fair value provide a more appropriate reflection of the true risks involved.

Finally, we would like to point out that the Exposure Draft proposals do not deal with the case where the offsetting instruments is early terminated or unwounded before the maturity of the one to which the option is applied. As the designation as at fair value through profit or loss is irrevocable, we understand that in that case the instrument at fair value through profit or loss "by option" is maintained as such.

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 support IASB to accommodate the concerns raised and we welcome the attempts to limit the use of the fair value option. Nevertheless, we believe that the proposed criteria for applying the fair value option create confusion, prohibiting the use of the fair value in situation where entirely appropriate while not restricting it in many cases, as many financial instruments contain embedded derivatives.

We believe that the limitations may impede the objective to ease the implementation of IAS 39, while some concepts such as "verifiability of the fair value" are vague and do create confusion.

Moreover, one of the concerns from European prudential supervisors was linked to the requirement, which the fair value option imposes on entities to consider their own credit spreads when determining the fair value of their own debts.

This concern has not be taken into account in the proposed amendments, as the Board considers that it has already responded to it by requiring that in this case the entity discloses the amount of the change in the fair value of the financial liability that is not attributable to changes in a benchmark interest rate.

However, we consider that such a disclosure is not a proper solution for the problem, and that this question has to be treated in the further amendments to IAS 39.

Thus, we would suggest that when applying the fair value option to a financial liability, only changes relating to risks other than own credit should be taken into account: the credit spread component should be crystallised at its value at inception.

We would like to highlight that if the fair value measurement could be applied to risk components, this concern would be solved. Indeed, the bank does not hedge its own credit spread but only the market risk. Therefore, the fair value option would be applied to the liability but only the "hedged" component of the liability would be fair valued (in order to achieve the same result as in a fair value hedge relationship and not reflect gains in the case of a deterioration of the bank's credit rating).

Furthermore, among others, this risk components approach would enable the fair value option to be perfectly in line with banks' risk management practices.

Question 4:

Paragraph 9(b)(i) proposes that the fair value option could be used for a financial asset or financial liability that contains one or more embedded derivatives, whether or not paragraph 11 of IAS 39 requires the embedded derivative to be separated. The Board proposes this category for the reasons set out in paragraphs BC6(a) and BC16-BC18 of the Basis for Conclusions on this Exposure Draft. However, the Board recognises that a substantial number of financial assets and financial liabilities contain embedded derivatives and, accordingly, a substantial number of financial assets and financial liabilities would qualify for the fair value option under this proposal.
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?

We do not believe that this category should be limited.

Indeed, the process required by IAS 39 to conclude whether an embedded derivative has to be separated or not is complex and administratively burdensome. Furthermore, valuing the whole instrument often more accurately reflects the way the instruments are managed by the Bank.

Question 5:

Paragraph 103A proposes that an entity that adopts early the December 2003 version of IAS 39 may change the financial assets and financial liabilities designated as at fair value through profit or loss from the beginning of the first period for which it adopts the amendments in this Exposure Draft. It also proposes that in the case of a financial asset or financial liability that was previously designated as at fair value through profit or loss but is no longer so designated:

(a) if the financial asset or financial liability is subsequently measured at cost or amortised cost, its fair value at the beginning of the period for which it ceases to be designated as at fair value through profit or loss is deemed to be its cost or amortised cost.

(b) if the financial asset is subsequently classified as available for sale, any amounts previously recognised in profit or loss shall not be reclassified into the separate component of equity in which gains and losses on available-for-sale assets are recognised.

However, in the case of a financial asset or financial liability that was not previously designated as at fair value through profit or loss, the entity shall restate the financial asset or financial liability using the new designation in the comparative financial statements.

Finally, this paragraph proposes that the entity shall disclose:

(a) for financial assets and financial liabilities newly designated as at fair value through profit or loss, their fair value and the classification and carrying amount in the previous financial statements.

(b for financial assets and financial liabilities no longer designated as at fair value through profit or loss, their fair value and the classification and carrying amount in the current financial statements.

Are these proposed transitional requirements appropriate? If not, what changes do you propose and why? Specifically, should all changes to the measurement basis of a financial asset or financial liability that result from adopting the amendments proposed in this Exposure Draft be applied retrospectively by restating the comparative financial statements?

We support the proposed transitional requirements.

However, we would like to highlight that:

- On the one hand, according to IFRS 1, an entity shall reflect in its opening balance sheet all hedging relationships that it had designated as such under its previous Gaap, except for a hedging of a type that does not qualify for hedge accounting under IAS 39.

- On the other hand, IAS 39 stipulates that when it is first applied, "an entity is permitted to designate a previously recognised financial asset or financial liability as a financial asset or financial liability at fair value through profit or loss despite the requirement in paragraph 9 to make such a designation upon initial recognition".

This Exposure Draft reasserts that the reason for introducing the option was to simplify the implementation of IAS 39 and explicitly deals with the "natural offsets". Therefore, we understand that when an entity is first applying IAS 39 the use of the fair value option in the case of the "natural offsets" is an exception at the IFRS 1 principle.

We therefore ask IASB to clarify the structuring of these two standards.

Question 6:

Do you have any other comments on the proposals?