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

Dear Sandra,

Citigroup appreciates the opportunity to respond to the Exposure Draft, *Proposed Amendments to IAS 39, Financial Instruments: Recognition and Measurement – The Fair Value Option* (Proposed Amendments).

As stated in our comment letter of 16 October 2002, Citigroup strongly supports the option in *IAS 39, Financial Instruments: Recognition and Measurement* (December 2003) that permits an entity to designate any financial asset or financial liability on initial recognition as one to be measured at fair value, with changes in fair value recognized in profit or loss ("the fair value option"). Citigroup believes that the option to measure all financial instruments at fair value enables financial institutions and other entities to better align their external financial statements with their internal management reporting and risk management procedures.

One of the most challenging aspects to the accounting for financial instruments under IAS 39 relates to the question of scope. That is, when evaluating what recognition and measurement principles to apply to a specific financial instrument, it is often time-consuming and difficult to determine the appropriate method(s) from those contained in IAS 39. For example, significant judgments may be required to determine whether a financial instrument meets the characteristic-based definition of a derivative, contains embedded derivatives that require separation, or is held for trading. Those complex evaluations now will have a significant impact on the eligible accounting treatment due to the proposed limitations to the fair value option. The enormous appeal and power of the fair value option in the December 2003 version of IAS 39 is that it eliminates such confusion and wasted effort; instead, it facilitates greater utilization of fair value accounting for financial instruments. In contrast, the Proposed Amendments introduce yet another layer of scope complexity to IAS 39 making accurate and consistent application more difficult for the Board's constituents.

We believe it is unfortunate that the Board has decided to propose limiting the fair value option due to concerns raised by certain constituents late in the IAS 39 finalization debate. Those constituents appear to lack sufficient knowledge regarding the detailed workings of IAS 39. The concerns of those constituents as outlined in paragraph BC9 have all been deliberated prior to the issuance of the December 2003 version of IAS 39. We believe the more effective approach would be to educate those constituents as to why their concerns are not justified to such a degree to warrant the Proposed Amendments that cause significant reduction in the operationality of the fair value option.

Citigroup does not agree with the premise raised by certain constituents that the option to fair value financial instruments is likely to increase volatility in earnings. As the Board is already aware the mismatch between the measurement principles for financial assets and financial liabilities leads to potential earnings volatility and the option to fair value all financial instruments is a vital tool to removing this artificial volatility.

Citigroup does not support the proposed complex rules-based limitations to the use of the fair value option and considers it a step back compared to the current version of IAS 39. We believe the proposed limitations may reduce the applicability of the fair value option where we would find it to be appropriate for risk management purposes and offer examples to illustrate our concerns below. Citigroup believes that the concerns raised by certain constituents are already addressed within the current fair value framework and we expect the proposed limitations may increase rather then reduce earnings volatility.

We encourage the Board to consider the Proposed Statement of Financial Accounting Standards, *Fair Value Measurement*, issued by FASB on 23 June 2004 and note that the requirement that the fair value for certain financial instrument must be "verifiable" will lead to another potential difference between IFRS and US GAAP.

IASB pronouncements that address accounting for non-financial instruments increasingly contain fair value measurement guidance. In general, we would expect the Board to be more cautious in the application of fair value measurement in those areas. Unfortunately, with the Proposed Amendments the Board seems to have a stronger bias against fair value measurement for certain financial instruments that clearly have fair values that are more reliably measurable than most non-financial instruments.

Notwithstanding Citigroup's opposition to the proposed limitations to the fair value option, we provide detailed comments on the questions raised by the Board in the Proposed Amendments below. Because the Proposed Amendments add more complexity to the scope determinations in connection with accounting for financial instruments, we believe it is imperative that the Board clarifies the new concepts and terminology introduced. Otherwise, we believe that practice will interpret the conditions in paragraph 9 in a much more restrictive manner than intended by the Board.

**Questions 1 and 2 – Proposal in Exposure Draft**

Our responses to questions one and two follow the conditions set out in draft paragraph 9(b) of the Proposed Amendments that provides proposed guidance on when a financial asset or financial liability may be designated as "a financial asset or financial liability at fair value through profit or loss."

***Draft paragraph 9(b)(i) - embedded derivatives***

We strongly agree with the Board's considerations in paragraph BC21 for permitting all structured products and other hybrid financial assets and financial liabilities that contain embedded derivatives to be measured at fair value, regardless of whether the embedded derivative is required to be bifurcated from the host contract. Below we highlight some of the reasons why we believe this is appropriate and also explain why we would have serious concerns about any change to only permit fair value measurement for hybrid financial assets and financial liabilities where the embedded derivative is required to be bifurcated from the host contract.

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Citigroup issues an enormous variety of structured note liabilities (e.g. equity-linked notes and credit-linked notes) that contain multiple embedded derivatives. As currently drafted, paragraph 9(b)(i) would permit Citigroup to measure all such notes at fair value, consistent with how Citigroup manages and accounts for the financial instruments (primarily derivatives) we utilize to economically hedge our financial risks relating to the issuance of such notes. This option is not currently available to Citigroup under US GAAP and hence we spend a significant amount of time bifurcating out and monitoring embedded derivatives when required. Depending on the terms of the debt host contract, we often expend further time and effort to achieve interest rate hedge accounting for that debt host contract. Thus, the current proposals in paragraph 9(b)(i) would afford tremendous administrative efficiencies (while preserving transparent, accurate reporting) in the overall accounting for structured notes and the related activities to manage that risk.

The principles for determining whether an embedded derivative must be bifurcated are complex and a crisp definition of when the economic characteristics and risks of the embedded derivative are not "closely related" to the host contract currently does not exist. Most of the guidance in this area is provided via illustrations and examples often demanding significant judgments to determine whether separation is required. Embedded interest rate features in structured notes represent a class of hybrid debt instruments that demand significant time, effort and judgment to evaluate for bifurcation. The "two times, two times" test contained in paragraph AG33(a) of IAS 39 is very time consuming to perform, highly judgmental and generally requires bifurcation for only those instruments with significant leverage. If the Board decides to limit the fair value option to only those hybrids where IAS 39 requires bifurcation of the embedded derivative, then entities will be required to continue to expend significant resources on the bifurcation analysis regardless of the bifurcation conclusion.

When analyzing structured notes under IAS 39, it is not always clear how to identify and measure the contractual cash flows from the underlying host contract. As an example consider a structured note that pays a fixed rate for a period and then a (leveraged) floating rate for a subsequent period. In this case it is not clear whether the underlying interest rate on the debt host contract is a fixed or floating rate. The determination of whether an embedded feature should be bifurcated often depends on this highly judgmental evaluation.

As another example consider a fixed rate note that has an embedded leveraged floater under which the interest on the note would be a leveraged return on LIBOR. Under IAS 39 paragraph AG33(a), to determine whether to bifurcate this embedded derivative Citigroup would need to consider whether the embedded derivative could (i) at least double the holder's initial rate of return on the host contract and (ii) could result in a rate of return that is at least twice the then-current market return for a contract with the same terms as the host contract. That is, Citigroup would need to apply the "two-times, two-times" test mentioned above. In some cases these requirements would not be met and Citigroup would not be allowed to separate out the embedded derivative. However, from a risk management perspective Citigroup would want to manage the embedded derivative on a fair value basis and would want to hedge its exposure by use of derivatives entered into with external counterparties. However, because of the complex structure of the hybrid note Citigroup may not be able to achieve hedge accounting for this proposed hedge and hence would create earnings volatility when little or no economic volatility exists.

We also note that IAS 39 currently does not include any guidance on how holders of beneficial interests in structured notes issued by Special Purpose Entities (SPEs) should account for their beneficial interests. More precisely it is not clear under what circumstances such holders are required to bifurcate embedded derivatives from the notes when the issuing SPE itself has entered into one or more derivatives to alter the cash flows from the underlying assets that the SPE holds.

FASB has been working on this issue for some years now and has issued temporary guidance in *DIG Issue D1 – Recognition and Measurement of Derivatives: Application of Statement 133 to Beneficial Interests in Securitized Financial Assets.* This guidance recognizes the complexity involved in determining whether an embedded derivative exists in such structures and effectively allows two options for accounting for such beneficial interests. The Proposed Amendments to IAS 39 as currently drafted would provide one possible approach for entities to account for such beneficial interests under IAS 39 and hence would provide one solution to this complex issue. However, a decision to limit the scope of paragraph 9(b)(i) to only allow fair value measurement for financial assets and liabilities with embedded derivatives *that are required to be bifurcated* from the host contract would require entities to first determine whether embedded derivatives must be separated and hence would be unhelpful in resolving this pervasively important issue.

Given the above concerns in identifying and bifurcating embedded derivatives in complex structured notes we are concerned that any further limitations would dramatically reduce the operationality and practical relief provided by the fair value option.

***Draft paragraph 9(b)(ii) - contractually linked***

No comments. We would expect this paragraph to have limited practical applicability outside unit-linked contracts.

***Draft paragraph 9(b)(iii) - Substantial offset***

We note that the term "substantial offset" is a concept new to IFRS and that the term has not been defined in the Proposed Amendments to IAS 39.

Paragraph BC6(c) suggests to us that this term is to be understood as requiring a lower correlation between the offsetting financial asset and financial liability than that required to achieve hedge accounting. For an entity to apply hedge accounting paragraph 88 of IAS 39 requires the hedge to be "highly effective in achieving offset" which most often is understood to mean an off-set of 80-125%. We would assume this means a correlation of less than 80% is required for financial assets and financial liabilities to be considered to be substantially offsetting. This conclusion seems reasonable insofar that the Board's intention is to increase the scope of situations where "natural offset" can be achieved outside of those situations where the technical hedge accounting principles can be satisfied. If this is the Board's intention we would find it helpful if the Board states this in the standard. We assume that the requirement for documenting a "substantial offset" between an asset and a liability would be less onerous than those required to achieve hedge accounting but would find clarification of this matter helpful as well.

One situation where the current principles for hedge accounting are often insufficient to achieve a (partial) offset of changes in value of a hedged item and hedging instrument is in the area of credit risk hedged with a credit derivative. Citigroup frequently enters into credit derivatives for protection against certain credit events occurring with respect to a specific counterparty to another transaction. For example, Citigroup may purchase a credit derivative for protection against losses on a loan made to a borrower. Credit derivatives may be linked to the entire creditworthiness of an entity whereas Citigroup's claim on the counterparty will have a specific ranking in case of the counterparty's default. Because of this basis difference, the change in fair value of the credit derivative and the loan issued to the counterparty (with respect to credit risk) will often times not be sufficiently correlated to achieve hedge accounting. As a result Citigroup frequently will have to record changes in fair value of the credit derivative through the income statement while not being allowed to record the change in fair value of the loan (with respect to credit risk) to create a partial offset.

In order for the above example to be eligible for the fair value option, the "substantial offset" requirement should relate only to specific risks and not to the entire fair value of an item economically hedged. We note that the Proposed Amendments are silent regarding whether a financial asset may substantially offset only portions or proportions of the risk inherent in a financial liability or whether substantial offset of all risks and for the entire value of both the financial asset and the financial liability is required.

For example, a credit derivative may substantially offset the changes in fair value of an issued loan with respect to credit risk but will not offset changes in fair value of the loan with respect to other factors such as changes in interest rates or foreign currency rates. Similarly a financial asset with a three-year maturity may substantially offset the risk for the first three years of a financial liability with a ten-year maturity. We request that the Board clarify whether the "substantial offset" test may be applied to portions and/or proportions of risk and values as is the case for hedge accounting or whether other principles apply for financial assets and financial liabilities at fair value through profit or loss. If the Board intends for credit derivatives to generally be eligible for the "fair value option" we recommend that the final standard clarify that the concept of substantial offset can focus on individual risks within a financial instrument.

Finally, we note that the Proposed Amendments require that a financial asset or financial liability is designated as "a financial asset or financial liability at fair value through profit or loss" upon initial recognition. In practice derivatives purchased to "substantially offset" the exposure on a financial asset or financial liability may not be entered into on exactly the same day as the financial asset or financial liability. Using the example above, Citigroup may enter into a number of loans with counterparties with very similar credit exposures and a short time period later purchase a credit derivative to hedge the exposure on those loans. Provided that Citigroup would otherwise meet the requirement for "substantial offset" we would support a modification to the Proposed Amendments in paragraph 9(b)(iii) that permits a small timing difference between the date of initial recognition of the financial asset or financial liability and the purchase of the offsetting credit derivative. That practice seems reasonable to us because it accommodates the standard timing for such transactions and minimizes the opportunity to manage earnings.

A similar concern relates to the requirement in the Proposed Amendments that once a financial asset or financial liability is classified as "a financial asset or financial liability at fair value through profit or loss" this designation cannot be changed. Clearly situations will occur where an entity enters into offsetting financial assets and financial liabilities but subsequently derecognizes one of the positions. In this case the remaining financial asset or financial liability is required to be measured at fair value even if no offsetting position exists. This could inappropriately increase volatility in profit or loss, which goes against the objectives of the Proposed Amendments.

***Draft paragraph 9(b)(iv) – Financial Assets other than loans and receivables***
No comments.

***Draft paragraph 9(b)(v) - Allowed to be fair valued under other standards***
No comments.

***Verifiable***

We note that the proposed requirement for the fair value of a financial asset or financial liability to be "verifiable" in order to qualify for the fair value option effectively sets a different and higher threshold for proving the fair value than the existing threshold (often referred to as "reliably measurable") for other types of financial assets or financial liabilities that are either allowed or required to be measured at fair value. We are concerned of the prospect of having two different fair value hierarchies for different types of financial instruments. We believe the creation of the verifiable condition represents a conceptual departure from the existing fair value measurement provisions in IAS 39.

The introduction of an undesirable dual standard for fair value measurement will result in a multitude of inconsistencies. Now we will encounter circumstances that may require fair value for certain financial instruments even though fair value is not verifiable (for example, certain financial instruments that are held for trading) and entities may be denied the ability to apply fair value accounting for those same financial instruments under the fair value option provisions of IAS 39. Why is it acceptable to account for a loan receivable at fair value if it is the hedged item in a qualifying fair value hedging relationship even though its fair value is not verifiable? Why is it appropriate to account for a loan commitment at fair value when its fair value may not be verifiable while a funded loan (perhaps originating from the same commitment) is not permitted to be accounted for under the fair value option? Why must derivative financial instruments have a fair value that is only reliably measurable in order to be accounted for at fair value while other financial instruments must satisfy the higher threshold of verifiable to qualify for fair value measurement? We do not understand the conceptual basis for such conflicting guidance.

We note that IAS 39 requires that derivatives be measured at fair value (unless embedded in a host contract and not required to be separated or when the derivative is related to an unlisted equity investment for which no fair value can be reliably determined) even though observable market data may not be available to support such valuations. In contrast, certain financial instruments that may be prohibited from fair value measurement under the Proposed Amendments could be confirmed with observable market data. For those derivatives without supporting observable market data, entities would apply the guidance in paragraph AG76 of IAS 39 and not recognize any profit at inception. We find this current guidance appropriate and sufficient to deal with most of the concerns relating to the validity of the fair value measurement and are not supportive of an additional requirement for the fair value of certain financial assets and financial liabilities to be verifiable.

The revised IAS 28 – *Investment in Associates* allows venture capital organizations to measure investments in associates at fair value by either classifying such investments as "held for trading" or "financial assets at fair value through profit or loss." We question whether such financial investments would meet the requirement to have a fair value that is verifiable.

**Question 3 – Limitations of the Exposure Draft**

We do not believe the concerns outlined in paragraph BC9 of the Proposed Amendments to IAS 39 warrant limitation of the fair value option. We believe those concerns have already been adequately addressed in the finalization of the December 2003 version of IAS 39.

**Question 4 – Embedded derivatives**

For the conceptual and practical reasons set out in our responses to questions one and two we support the option to fair value all financial assets and financial liabilities that contain embedded derivatives regardless of whether they are required to be bifurcated from the host contract.

**Question 5 – Transition**

No comments.

**Question 6 – Other Matters**

No comments.

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We would be pleased to discuss our comments with you at your convenience.

Sincerely,

Robert Traficanti
Vice President and Deputy Controller
Citigroup