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20th July 2004

Mrs Sandra Thompson
International Accounting Standards Board
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

We are pleased to provide our comments on the above exposure draft.

Before answering specifically to each question that has been put in the invitation to comment, we wish to underline the most significant issues raised by the proposals included in this Exposure-Draft.

General comments

As mentioned in previous answers to past invitations to comment on exposure drafts related to the standard IAS 39 Financial Instruments: Recognition and Measurement, we had concerns with IAS 39's proposal to allow any financial instruments to classified in the held for trading category and measured at fair value with gains and losses recognised in profit or loss. We explained that such an option was too wide, damaging the comparability of the financial statements of an entity through time and between entities, and was not the appropriate answer to mitigate some of the deficiencies of the mixed-attribute model in IAS 39 and to ease its application.

The Exposure Draft issued in April 2004 by the IASB proposes to restrict the use of the option to designate any financial instrument as measured at fair value with gains and losses recognized in profit or loss. Furthermore, it introduces some changes in the revised IAS 39 issued in December 2003 and especially proposes to limit the type of instruments to which the fair value option may be applied and to state that fair value should be "verifiable".

In our past answers related to IAS 39, we proposed to use such a Fair Value option for allowing the marking-to-market of liabilities used to fund trading activities and for measuring any hybrid instrument at fair value without recording separately the embedded derivative.

The scope of instruments and situations where the use of the Fair Value option could be allowed seems closer to these proposals than in the current IAS 39 revised in December 2003:

- In many situations, a separate recording of embedded derivatives is difficult, onerous and subjective, and it should be noted that the valuation of the entire instrument is less prone to error and furthermore reflects the way these instruments are managed by the bank
- We also understand that the ED will enable financial assets or financial liabilities that are entered into as a natural offset to be measured on a consistent basis, and avoid the need to comply with the complex accounting rules for hedge accounting. This disposal is particularly welcomed to account assets and liabilities that are used to fund trading activities in order the results of the business be consistent with the way it is managed and the risk management practices.

We then welcome the evolution of the application scope of the Fair Value option as it appears in the Exposure Draft.

However we have strong concerns with new issues and concepts raised by the Exposure-Draft:

- The proposed amendments do not specifically address the concern of recognition of gains or losses for changes in an entity's creditworthiness as required in Basis of Conclusion (BC9c) We noticed that IAS 32 already requires an entity that has designated a financial liability at fair value through profit and loss account to disclose the amount of change in its fair value that is not attributable to the change in the benchmark interest rate. So we understand that the information is available to make any regulatory adjustments. But we consider that such a disclosure is not a proper solution for the problem, and we ask the Board to look forward to the exclusion of the own credit risk from the fair value valuation to be used under that option.

- The proposed limitations introduce criteria such as "contractually linked" and "substantially offset". These notions are not precisely defined in the Exposure-Draft. It could then lead to an inappropriate extensive application of the option.

- The Fair Value Option is only available for financial instruments whose fair value is qualified as to be "verifiable". It introduces a stricter requirement than "reliably measurable" which is used generally in IAS 39 as a requirement for an item to be measured at fair value. That new concept does not exist in other areas of measuring fair values in other Standards, nor in the Framework, and we are concerned that it will create two different fair value measurement regimes, as trading instruments and available for sale assets are required to be recorded at fair value without needing to satisfy the verifiability area. We request IASB to address the fair value concept within IAS 39 in only one way and to keep the “reliable” concept.

Finally, we do not understand and do not agree with the reference relating to the powers of prudential supervisors. This could lead some to believe that those supervisors have powers to overrule the application of IASB’s standards, introducing a lack of consistency and damage to comparability among companies and among countries which are supposed to apply the same international accounting standards.

Appendix 1 sets out our answers to the questions raised in the draft Standard.

If you have any queries regarding our comments, please do not hesitate to contact me at 33 (1) 42 14 49 86 or Mr DAMOTTE at 33 (1) 42 14 04 10.

Yours sincerely,

Ms Geneviève COUTANT
Head of Group Accounting Department

Exposure Draft of proposed amendments to IAS 39 Financial Instruments: Recognition and Measurement – The Fair Value Option

Question 1

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

We were pleased to read that the instruments and situations where the use of the Fair Value option could be allowed is close to our past answers to previous Exposure-Drafts on IAS 39.

Nevertheless, we do not agree with some new concepts to be introduced in IAS 39 through this Exposure-Draft:

a) " substantially offset"

The ED allows the use of the fair value option when the "exposure to changes in the fair value of the financial asset or financial liability (or portfolio of…) is substantially offset by the changes in the fair value of another financial asset or financial liability (or portfolio of …) including derivative". Although the basis of conclusions suggests the Board considers this is a lower hurdle than required for hedge accounting, the term is too imprecise to be capable of being applied without further clarification from the IASB dealing with tests to be achieved or documentation to be provided, to support that concept. It is hoped that the test will be significantly less onerous than for hedge accounting, otherwise the FV option could be of limited use. The Board could replace those tests by controls dealing with risk management and matching of costs and revenues.
Besides it is our understanding from §iii) that the offsetting exposure is considered on a portfolio basis and not item by item. This condition is crucial, particularly to apply the FV option at the liabilities used to fund trading activities because in this case the hedge is global and needs several instruments to be performed. However this portfolio basis of §iii) disappears in the paragraph that follows. The IASB would clarify whether or not there is a conflict between these two paragraphs and at last on which basis the substantially offsetting exposure has to be demonstrated. If the portfolio basis would finally not be kept, it would significantly restrict the use of the FV option and lead to some asymmetrical accounting among the instruments.

b)"verifiable"

The FV option is only available for financial instruments whose fair value is "verifiable" (§9). We disagree with that notion because it introduces a stricter requirement than "reliably measurable" which is used generally in IAS 39 as a requirement for an item to be included at fair value (BC 25).

That new concept does not exist in other areas of measuring fair values in IFRS, nor in the Framework. It leads to create two different fair value measurement regimes, as trading instruments and available for sale assets are required to be recorded at fair value without needing to satisfy the verifiability area. Furthermore we have a concern that it will often be hard to value an instrument with an embedded derivative using only the “verifiable” approach, whereas IAS 39 requires embedded derivatives to be recorded at fair value using the “reliable” approach when splitting of compound instruments is not possible. So the proposals of the Exposure-Draft have to be amended to avoid conflicts within the standard.
We request IASB to address the fair value concept within IAS 39 in only one way and to keep the “reliable” concept.

c)”contractually linked”

Such a criteria introduced in paragraph 9 (b) (ii) is not defined precisely, which could lead to an inappropriate extensive use of the Fair Value option. Further guidance and definitions are then needed.

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 have not identified financial instruments that would not be eligible for the option if IAS 39 were revised as set out in the Exposure-Draft.

As mentioned in the cover letter, and in the answer to question one, we do not support the introduction of the “verifiable notion” since we consider that it will lead to considerable confusion in applying the fair value measurement depending on which concept is used (reliable or verifiable).

For improving and simplifying the application of IAS 39 whilst limiting the use of a Fair Value option, we suggest to amend the definition of the trading category in order to allow classification of liabilities that are used to fund assets that are classified as held-for-trading.

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?

Due to a lack of understandability of some new concepts introduced in the Exposure-Draft, we are concerned with a possible restriction of the application scope of the Fair Value option.
We understand that each parameter entered in the valuation model has indeed to be observable and that the rule limits the Fair Value option to the instruments for which a day-one profit can be recorded. That is too much restrictive and precludes a lot of instruments from being able to be recorded at fair value under the option, to begin with embedded derivatives.

Furthermore, the criterion of "substantially offset" is also too restrictive. One could interpret "substantially offset" to be a bar that is equally as high as "highly effective". If this is the case, imposing a criterion to the fair value option category that is similar to hedge accounting criteria is counterintuitive to at least part of the purpose of the category's existence. "Substantially offset" should either be explained to be a criterion that is more lenient than "highly effective" or this criterion should be removed all together.

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?

SG supports the decision of the IASB to allow the option to be applied to all financial instruments that contain an embedded derivative because the separation of such embedded derivatives is both difficult and subjective and the valuation of the entire instrument is less prone to error and reflects the way the instruments are managed by the bank.

Nevertheless, when valuing financial liabilities that contain embedded derivatives, we ask again for an exclusion of the own credit risk from the valuation, as mentioned in the cover letter. For financial liabilities measured at fair value through profit and loss, disclosing the amount of change in its fair value that is not attributable to the change in the benchmark interest rate is not an appropriate answer to this issue. We would rather measure the financial liability in the balance sheet excluding the effect of the own credit risk and provide in the disclosure an information about its full fair value.

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 agree with the proposal which is a prospective application and not a retrospective one.

Question 6

Do you have any other comments on the proposals?

The reference to prudential supervisors and other regulators could incorrectly lead some to believe that regulators have power to amend or overrule IFRS for the purposes of financial reporting.

Such an amending capacity could lead to a lack of consistency and comparability between companies and countries depending on their respective prudential supervisor.

We then disagree with such a proposal.