ABI
ASSOCIAZIONE BANCARIA ITALIANA

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OF/ /

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International Accounting Standards Board

LONDON

Proposed amendments to IAS 39: Fair Value Option

Dear Madam,

please find enclosed the ABI's comments on the proposed amendments to IAS 39 on Financial Instruments, regarding the Fair Value Option.

Yours sincerely,

Giuseppe Zadra
(General Manager)

Enclosure

LG
lettera PPfvo

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ED of proposed Amendement of IAS 39: The Fair Value Option

19 July 2004

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

ABI welcomed the fair value option as far as it simplified the application of IAS 39 and simplified the use of natural hedges.

ABI notes that the exposure draft, limiting the use of the fair value option, has been introduced to address the concerns of prudential supervisors and other regulators, with the following objectives:

1) address the use of inappropriate fair values;
2) reduce volatility in profit or loss; and
3) avoid the recognition of gains or losses in profit or loss arising from changes in an entity's own creditworthiness.

With reference to the first point, ABI notes that IAS 39 precludes entities from reclassifying financial instruments into or out of the fair value category - which is a safeguard against possible abuses.

Regarding the second point, it should be noted that the banks that will make use of the fair value option will have less volatility in earnings and provide greater transparency and enhanced financial reporting.
In fact, the use of full fair value option for correlated financial assets and liabilities would determine only a limited increase of volatility.
Finally, ABI notes that the limitation of the use of the fair value option can have the effect of reintroducing artificial volatility in cases of "natural hedges".

Concerning the third point, ABI notes that the paradox of the acknowledgement of a profit as a result of the entity's downgrading can be avoided. In particular, entities would not need to fair value the credit spread of their own debt and would, as a consequence, not recognise gains and losses in earnings due to changes in their own creditworthiness.

ABI proposes to improve and develop the fair value option with a view to bringing it in line with sound risk management practices, and not restricting its scope. This solution implies that, coherently with the logic of risk management, the components of an instrument that are managed on a fair value basis should be measured at fair value (when the fair value of such components is observable).

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?

As mentioned above (see our answer to question 1), to simplify the practical application of IAS 39, entities should be allowed to apply the option to the components of risk (provided the effect of the risk component on fair value is observable).

ABI considers undesirable the proposed requirement in paragraph 9 of the exposure draft, concerning the introduction of a "verifiable test", for the following reasons:
1) it is likely to severely restrict the use that can be made of the fair value option. In fact for many tipes of financial instruments, the fair value is not verifiable and, therefore, the fair value option could not be applied;
2) it would create confusion about the application of fair value measurement to all financial instruments and introduce an additional layer of complexity;
3) it seems highly inconsistent to prohibit the use of the fair value option concerning financial instruments which in other situations may be required by the standard to be measured at fair value without a verifiability threshold.

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?

ABI agrees to maintain the original fair value option because it simplifies the application of IAS 39 and reduce accounting volatility. However, in order to avoid the paradox of the acknowledgement of a profit as a result of the entity's downgrading, ABI proposes to amend the original fair value option to exclude the credit spread.
Therefore ABI doesn't believe that the use of the fair value option should be restricted beyond what is being proposed.

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?

ABI believes this category should not be limited.

QUESTION 5 Transition requirements
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?

ABI opposes any retrospective application when an entity changes the measurement from at fair value through profit and loss to amortised cost.

QUESTION 6
Do you have any other comments on the proposals?

- With reference to the introduction of a paragraph requiring that changes in the fair value of the assets or liabilities be substantially offset by the item used to hedge, ABI believes that certain financial institutions intend to apply the fair value option to asset and liability positions that offset each other partially, in order to reflect economic exposures and reduce accounting volatility. Under the proposed amendments such a designation would become subject to the stringent hedge accounting requirement of "substantial offset". If the IASB were to adopt the proposed amendments, the "substantially offset" requirement should be replaced by "partially offset".

- ABI considers as a serious concern for the banking industry the Fair Value Option requirement imposing entities to consider their own credit spreads when determining the fair value of their own debts. In fact, an undesirable consequence of the fair value option (as opposed to hedge accounting, where the hedged risk is the interest rate risk) is that credit spread will cause the profit or loss to be more volatile. This is contrary to the primary objective of prudential supervisors and other regulators to minimize volatility.