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Amendments to IAS 39: The Fair Value Option

Dear Sandra,

ISDA appreciates this opportunity to comment on the Exposure Draft ("ED") of *'Proposed Amendments to IAS 39 Financial Instruments: Recognition and Measurement, The Fair Value Option'* which was published by the International Accounting Standards Board ("IASB" or "the Board") on 21 April 2004.

Our members represent leading participants in the privately negotiated derivatives industry and include most of the world's major financial institutions, as well as many of the businesses, governmental entities and other end users that rely on over-the-counter derivatives to manage efficiently the financial market risks inherent in their core economic activities. As such we believe ISDA brings a unique and broad perspective to the IASB's work on accounting for financial instruments.

ISDA fully supported the fair value option when it was introduced by the IASB, and we have actively encouraged the FASB to introduce similar provisions. The fair value option alleviates the potentially misleading earnings impact stemming from the mixed measurement model and strict hedge accounting rules of IAS 39. Under the mixed measurement model some financial assets are fair valued through profit or loss and others through equity, whilst other financial assets and almost all financial liabilities are carried on an amortised cost basis. The fair value option is therefore necessary to reduce volatility resulting from this asymmetric accounting and enables adopters to align the accounting treatment of financial transactions with the underlying business and risk management practices.

We appreciate that some regulators could have concerns if it were possible to use the fair value option inappropriately, such that it results in volatility in profit or loss. However, we do not see the creation of volatility as an objective of using the fair value option. In addition, the restrictions proposed to prevent this abuse have also, perhaps inadvertently, prohibited the use of the fair value option in situations which are entirely appropriate. As a result, ISDA does not support the proposals in the ED to restrict the fair value option and it is our view that additional disclosure may be a preferable way in which to alleviate the concerns around its use.

However, should the Board continue with its proposal to amend the fair value option the following critical issues must be addressed so that it retains the benefits originally envisaged: -

- Verifiable – ISDA invested a considerable amount of time working with the IASB on the concept of fair value measurement and consider the existing standard to be strict enough to prevent abuse. The proposals in the ED introduce another test that would only allow entities to apply the fair value option to financial instruments whose fair value is 'verifiable'. We do not consider it appropriate to have two different fair value standards for identical financial instruments depending upon the purpose for which the instruments are held or whether an election has been made to fair value. IAS 39 already establishes guidance on fair value accounting and this should be applied consistently to all financial instruments.

- Substantially offset – The proposals include rules that would only allow an entity to apply the option where the changes in the fair value substantially offset each other. The term substantially is used in other parts of IAS 39 and is normally considered to be a very high percentage of the total amount. We are concerned this could force the market to apply a stricter test than envisaged by the Board and therefore severely restrict the use of the option.

- Held for trading – The definition of held for trading captures a much narrower range of instruments than those actually managed on a fair value basis. Without the fair value option, entities may be required to record certain assets at amortised cost even though they are included in the trading book and managed on a fair value basis. We therefore urge the Board to reconsider the definition of held for trading as part of any discussions to amend the fair value option.

- Further changes – Should the Board continue with their proposals to restrict the fair value option, ISDA would support the decision to allow the fair value option to be applied to all financial instruments that contain embedded derivatives. Any additional changes to restrict this category or amend other parts of the fair value option, at such a late stage, could further reduce its benefits and should not be made without re-exposure.

The appendix to this letter sets out our detailed answers to the questions posed by the Board. We have also included examples which highlight the practical issues in applying the fair value option should it be restricted by the proposed amendments.

We would be pleased to discuss our comments with the Board or staff. Please contact Ed Duncan on 7330 3574.

Yours sincerely

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Ed Duncan
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cc.
Sir David Tweedie
Chairman, IASB Board of Directors

Jean Claude Trichet
Chairman, European Central Bank

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Appendix

We outline below our responses to the questions raised by the IASB in the invitation to comment.

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

ISDA does not agree with the proposals in the ED to restrict the use of the fair value option. We are strongly in favour of the fair value option included in the revised IAS 39, issued in December 2003, as it allows users to align the accounting treatment of a financial transaction with the economic substance.

Some regulators have expressed concerns that entities will misuse the fair value option to create volatility in the profit or loss account. However, it is our expectation that entities will select the option where the financial asset or liability is managed on a fair value basis so the financial statements better reflect the risks taken. It is important to emphasise that management would not seek to introduce unnecessary volatility in reported results without a sound risk management policy, as volatility in earnings could increase the cost of new debt issuance and lead to a lower equity price.

Whilst we appreciate the concerns raised, the fair value option is necessary in order to avoid the potentially misleading profit or loss volatility stemming from the mixed measurement model and strict hedge accounting rules of IAS 39. Under a mixed measurement model, some financial assets are fair valued through profit or loss and others through equity, whilst other financial assets and almost all financial liabilities are carried on an amortised cost basis. Accordingly, without the fair value option, an entity may be forced to report volatility from this accounting mismatch even if the position is, to an extent, matched from a risk perspective.

The proposed restrictions to the fair value option, whilst drafted to prevent abuse, could prohibit the use of the fair value option in situations which are entirely appropriate. It is our view that additional meaningful disclosure, as outlined below, could provide a more appropriate mechanism by which to alleviate the concerns around misuse of the fair value option. However, should the Board continue with the proposed restrictions, the following critical issues must be addressed to ensure the fair value option can continue to be applied so the financial statements fairly reflect an entity's financial position.

Verifiable fair value measurement

The ED would only allow application of the fair value option for a financial asset or financial liability when its fair value is 'verifiable'. The Board clearly indicates that this standard of measurement should convey a 'narrower meaning' than the standard of 'reliably measurable' applied to financial instruments which are required to be measured at fair value.

We agree with the Board that fair value is the best measure of many financial instruments. We invested a considerable amount of time working with the IASB on the concept of fair value measurement and although we believe the provisions could be improved, the fair value measurement considerations do provide a single framework for measuring financial instruments at fair value. We consider this guidance to be strict enough to address the concerns of the regulator.

ISDA is concerned that these proposals establish two different fair value measurement regimes, for identical financial instruments, depending upon the classification and purpose for which the instrument is held. It is inconsistent to *require* an instrument to be recorded at a reliable fair value through profit or loss if held for trading yet only allow the fair value option to be applied if the same valuation is considered 'verifiable'.

Furthermore, if an instrument (other than a loan or receivable or held to maturity asset) were not eligible for the fair value option, it would be classified as available-for-sale. In this situation, the entity would still be required to record the instrument at fair value through equity at a reliable fair value. ISDA believes that suggesting certain fair values included in the accounts may not be verifiable would undermine the measurement concepts already established in IAS 39.

It is our view that the guidance in IAS 39 on establishing fair values should be consistently applied to all financial instruments as we find no conceptual basis for applying a different measurement standard to instruments valued under the fair value option.

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 financially 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 a derivative….".

As noted by the Board, one of the primary reasons for introducing the fair value option was to ease the burden of hedge accounting. In many instances a hedging relationship may not meet the stringent requirements of IAS 39 and a more 'perfect' hedge may not be cost effective to execute. In other instances an entity may choose not to fulfil the complex documentation and testing requirements for hedge accounting under IAS 39. Without the fair value option, the instruments may not be accounted for on the same measurement basis, resulting in increased volatility in the financial statements.

Although the Basis for Conclusions (BC6, BC10) suggests the Board considers the substantially offset condition to be a lower hurdle than that required for effectiveness testing under hedge accounting, no guidance is provided within the text of the standard to explain how the concept should be applied in practice. The term "substantially" is not defined in the proposals and is generally used to imply both an absolute amount and a relative size. It is used on three other occasions in IAS 39 and is normally interpreted in those circumstances as a very high percentage of the total amount. This could force the market to apply a much stricter test than had been envisaged by the Board. Furthermore, the documentation required to support the use of this condition may be interpreted to be similar to that required for hedge accounting.

ISDA considers that the 'substantially offset' principle does not provide an appropriate condition to determine whether the fair value option may be applied, as the size of offset, whether relative or absolute, is irrelevant. Should the Board continue to require an "offset" type condition we suggest a more appropriate requirement is to allow the use of the fair value option where a financial instrument is to be part of a portfolio of financial instruments that is measured on a fair value basis (or portfolio of instruments) and where fair value would provide a more appropriate reflection of the economic position.

However, if the Board does not follow our suggestion, we would urge them to clarify in the main body of the standard (not the Basis for Conclusions) that the criterion is intended to be a lower hurdle than the effectiveness testing required under hedge accounting rules. It should also be clarified, in the main body of the standard, that the proposals do not require similar documentation as required when applying for hedge accounting.

Definition of Held for Trading

The definition of held for trading in IAS 39 captures a narrower range of instruments than those actually managed on a fair value basis by trading institutions. It is also a narrower definition than provided under other GAAPs. As such, without the use of the fair value option, entities may be required to record financial instruments at amortised cost or at fair value through equity even where they are part of the trading activities and managed on a fair value basis. Should the fair value option be restricted, the definition of held for trading would also need to be reviewed.

ISDA understands that to revise the definition of held for trading without exposing the change as an Exposure Draft would be a failure of due process. Therefore, as an alternative, the Board could extend the fair value option to those financial assets or liabilities which are managed on a fair value basis.

Disclosures

ISDA believes that the concerns with the fair value option identified by certain bodies may be better met by additional disclosure. In particular, ISDA considers that the following disclosures may provide a reader of financial statements with sufficient information to alleviate the concerns raised.

a. If the fair value option is being applied (as already required by IAS 32); and
b. The reasons why it is being used. This should be a high level qualitative description of all the material uses of the fair value option only.

These disclosures would not only show the magnitude of use of the option, it would also provide greater transparency on an entity's risk management practices.

Should the Board decide to address these issues using disclosures, other supplemental information may also be beneficial to the users of the accounts. We would be happy to discuss our members' views on this subject if it would be helpful to you.

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 IAS 39?

We set out below some examples of financial instrument transactions that may not be eligible for the fair value option if it were restricted as set out in the ED.

<u>Practical issues with applying the 'verifiable' criterion:</u>

Fair value not verifiable - capital investments

With the revisions to IAS 28, Investments in Associates, published December 2003, the Standard now no longer applies to investments in associates held by venture capital or mutual funds, unit trusts and similar entities that, upon initial recognition, are designated at fair value through profit or loss or are classified as held for trading and accounted for in accordance with IAS 39. However, these instruments would not normally be held for short-term profit taking and thus would fail to meet the held for trading criteria. As such, these organisations would need to meet the proposed requirements of the fair value option should they wish to record these assets at fair value through profit or loss, and demonstrate that the fair value of any such investment is verifiable. The Basis of Conclusions states that the verifiable criteria would be met where several independent and knowledgeable observers were asked to estimate the fair value of a particular instrument they would all arrive at approximately the same amount. There is a well-established industry practice of determining the fair value of unquoted equities using valuation techniques. However, applying these techniques require the use of assumptions that is likely to result in a range of fair value estimates. This issue is already addressed in IAS 39 in paragraph AG81. It is difficult to see how the fair value of these instruments would meet the verifiable requirements in most situations.

Fair value not verifiable at inception

An entity may buy/issue a financial instrument that does not meet the verifiable criteria and thus the entity will not be able to use the fair value option. However, during the life of the instrument, if the price becomes verifiable, the entity may wish to designate it at fair value through profit or loss. This could be a common issue in new or developing markets. The proposals only allow designation of a financial asset or liability at fair value through profit or loss at inception, with no subsequent reclassification permitted.

An example would be where a bank buys shares in a new investment trust set up to invest only in an emerging market where there are currently certain restrictions on foreign investment. Due to these restrictions and the fact that it is an emerging market, there is not currently an active and liquid market for the shares. However, the local government has announced that in 6 to 18 months the restrictions will be relaxed allowing for an active and liquid market to be developed. The bank initially invests on its own account to take a propriety position for the next 6 to 18 months before trading them when the restrictions are relaxed, and it manages the risk on a fair value basis using well established valuation methods developed and monitored within a controlled environment.

Assuming this medium term proprietary position would not qualify as held for trading under IAS 39, the bank would need to apply the fair value option in order for the accounting treatment to reflect the way the risk is managed. However, this investment is unlikely to meet the "verifiable" criteria at inception so the fair value option would not be available. The investment would instead be classified as available-for-sale with movements in fair value taken to equity.

Moreover in 6 month's time when the market has become more active, the bank may decide to hedge its investment in the form of an equity-linked note. According to the standard the embedded derivative would not be closely related and must be separated and recorded as held for trading. This would lead to volatility in reported profits, as the fair value movements on the embedded derivative would be recorded in profit or loss with the fair value movements of the shares in equity.

Practical issues with applying the 'substantially offset' criterion:

Substantially offset - entering into the offsetting contract at inception

Some economic hedging relationships may not meet the strict hedge accounting rules of IAS 39, resulting in one side of the position recorded at fair value through profit or loss with the other side recorded at amortised cost or at fair value through equity. In these situations, the fair value option is necessary to alleviate the volatility caused by this inconsistency, enabling both sides of the position to be reflected at fair value, and allow movements in fair value to offset through profit or loss.

For example, an entity may purchase a loan asset and hedge the credit risk with a Credit Default Swap ("CDS"). The transaction may not qualify for hedge accounting if the change in fair value of the loan asset for the hedged risk (i.e., the credit risk) is not highly effective in offsetting changes in the fair value of the CDS trade. This may be where there is an option to transfer either the loan asset or substitute a similar asset such as a bond issued by the same counterparty upon default. At the time of default an educated party would transfer the financial instrument that is the cheapest to deliver. Accordingly, it may not be possible to meet the strict hedge accounting criteria.

As this transaction does not qualify for hedge accounting, it could be concluded that the CDS does not, by definition, 'substantially offset' the risk of the loan and the fair value option would be prohibited.

Substantially offset - Entering into the offsetting contract at a subsequent date

An entity may buy a loan or receivable one day and then enter into a substantially offsetting position with a derivative on the following day. As the hedge is not in place on the date the asset is initially recognised, the proposals would not allow the bank to record the financial asset at fair value through profit or loss, as there is no offsetting instrument. This would result in the financial asset being held at amortised cost and the derivative at fair value through profit or loss.

For example, banks often purchase loans and receivables over 6 to 12 months with the intention of building a pool of assets to securitise. During this period the bank will be at risk for any changes in fair value of the loans and receivables and may manage the risk of the portfolio on a fair value basis. At the end of the period the bank will sell the assets to a securitisation vehicle which, in turn, will issue bonds to pay for the loans and receivables. During the period, the bank will often enter into derivatives to offset its exposure to changes in interest rate or credit risk of certain loans up to the date of sale to the securitisation vehicle. However, the derivatives will not normally be entered into concurrently with the purchase of the loan and therefore the bank would not be able to record the loans at fair value through profit or loss because at inception there is no offsetting instrument. This would increase the volatility in the financial statements, as although the bank has offset its credit or interest rate risk, the loans would be held at amortised cost and the credit and interest rate derivatives at fair value.

Practical issues with applying the held for trading definition:

Certain financial instruments are held for longer periods than envisaged by the definition of held for trading, but nevertheless represent assets which are managed on a fair value basis and are most appropriately recorded at fair value through profit or loss. Without the fair value option, the accounting for these instruments will not reflect the true economic purpose of the transaction.

Held-for-trading – trading strategy

Derivatives and non-derivative instruments will often be part of a trading strategy that will result in the instruments being held for the medium to long term. As such, the portfolio may not provide evidence of ‘short-term profit taking’, and therefore the instruments may not meet the definition of held for trading.

It is our belief that fair value is the most appropriate measure for these instruments. However, the restrictions in the ED will prohibit the use of the fair value option in such strategies. As such, the derivatives will be required to be recorded at fair value through profit or loss while other instruments in the portfolio will be recorded at amortised cost.

Held-for-trading – cash positions

Debt instruments will often trade at significantly below their market value as a result of a market event such as a profit warning or poor trading conditions. Banks will purchase these debt instruments where they consider the discount is too high and will sell them in the short to medium term when the price has corrected itself in the market. The bank will hold the asset as part of a distressed debt portfolio, which it will manage on a fair value basis. However, while the intent is to sell the debt instruments in the near term, depending on market factors, an entity may hold onto the instrument for a longer period of time. Therefore, we are concerned that holding a trading position for a longer period of time may “taint” the remainder of the portfolio and thus the entity will not be able to classify the instruments as held for trading. Unless the debt instruments meet the conditions of the fair value option, the entity would have to record the instrument as available-for-sale.

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 stated before, we do not believe the proposals to limit the use of the fair value option address adequately the concerns set out by regulators. ISDA believes the concerns raised by regulators would only arise in an institution that did not apply good corporate governance principles and therefore we are concerned these proposals would actually exacerbate the risk of increased volatility in the profit or loss account.

Some regulators have raised the concern that banks would record a profit by fair valuing their own debt when their credit rating declines. Whilst we accept that regulators are right that an improvement in a bank's "solvency position resulting from a deterioration of the own credit risk is counterintuitive" we would point out that financial statements are never intended as the sole basis for calculating regulatory capital and we would expect this, and other adjustments, to be made for this purpose (we note the Basel Committee on Banking Supervision Press Release of June 8th, 2004, recommending that international supervisors exclude such gains and losses from tier 1 and tier 2 capital calculations).

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?

Should the IASB decide to continue with its proposal to restrict the fair value option, we would fully support the decision to allow the option to be applied to all financial instruments that contain an embedded derivative, regardless of whether separation is required by IAS 39. Embedded derivatives are commonly found in structured notes issued by banks and the process required by IAS 39 to identify and separate such embedded derivatives, if they are not closely related to the host, can be complex and administratively burdensome. Furthermore, the IAS 39 guidance on whether to separate an embedded derivative is based on a series of rules rather than principles and can result in a relatively arbitrary decision on whether to separate. It is also important to note that many of these instruments are managed on a fair value basis and therefore the option to fair value provides a more appropriate accounting presentation of the instrument.

5) Do you agree with the proposed transitional provisions?

If the Board continue with the proposals outlined in the ED then we consider that they should amend the transitional rules and allow an entity to apply the changes to the fair value option retrospectively.

We are concerned that several practical issues may arise if the standard has to be applied prospectively. For example, where a financial instrument no longer qualifies for the fair value option and is subsequently measured at amortised cost, the deemed cost of the instrument will be its fair value at the point of transition. The entity would then be required to calculate an effective interest rate for the instrument which is unlikely to be the same as the rate contained in the contract. The difference in these rates may also cause significant issues should the entity decide to hedge the interest rate risk in the instrument.

The host contract identified at transition, where its initial carrying value is its fair value at that time, will be different to the US GAAP carrying value of the same debt host contract which will have been accrual accounted for. As a result if a fair value hedge is put in place, which is expected to be effective under IFRS there is little chance of it also being effective under US GAAP.

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

Reclassifications of financial instruments

Paragraph 50 of IAS 39 does not allow reclassification of a financial instrument into or out of the fair value through profit or loss category. As the "substantially offset" criteria need only be met at inception, if one side of a position was sold, the other offsetting instrument would continue to be recorded at fair value. This could result in inappropriate volatility, which is exactly what the proposals are trying to avoid.

In addition, since paragraph 50 also includes items which are held for trading, does this mean that a financial instrument can never be reclassified as held for trading subsequent to its initial recognition? In the previous version of IAS 39 we had read the held for trading definition to mean that a loan or receivable (for instance) was *required* to be recorded held for trading if it became part of a portfolio of instruments which are managed together and for which there is evidence of short term profit-taking.

Should the IASB decide to amend the fair value option ISDA recommends the IASB reconsider the wording of Paragraph 50 of IAS 39.

Entities subject to prudential supervision

Paragraph 9, as revised in the ED, includes the statement that for entities subject to prudential supervision, the powers of the prudential supervisor may include oversight of the application of the accounting requirements and of relevant risk management systems and policies.

This wording is unsatisfactory since it is a reference to how and by whom an accounting standard may be enforced. We consider that these concerns are outside the scope of standard setting and could potentially take the process of determining appropriate accounting policy away from accounting standards setters and reporting entities. This might not only lead to accounting treatments which are inconsistent with the overall conceptual framework but also result in inconsistency between the treatment of similar instruments by entities governed by different regulators. As a result, IFRS would not lead to greater transparency and consistency between the financial statements of entities prepared in different countries until such time as the regulators had a common set of rules.

ENDS.