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22 October, 2004

ED-7 Disclosures for financial instruments

Dear Ms Pryde,

ISDA appreciates the opportunity to comment on Exposure Draft 7 (“ED”) on Financial Instruments: Disclosures published by the International Accounting Standards Board (“IASB” or “the Board”) in July 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.

Key messages

ISDA is supportive of the IASB’s objective to develop a single standard covering the disclosure of financial instruments in an entity’s financial statements. However, we are concerned that whilst there is a clear move in ED 7 towards making the requirements principles-based, the disclosures are still prescriptive and are not sufficiently based on a clearly established set of principles. As is set out in more detail in this letter, we believe that the level and type of disclosure will often depend on the context. By rephrasing the standard in terms of a series of disclosure principles, it should then be left to reporting entities to determine what disclosure is necessary in order to communicate the entities’ risks adequately to the readers of financial statements. Much of the detail contained in the main body of the standard should therefore be moved to the application guidance, as examples of possible disclosures.

We also highlight the following specific concerns that will need to be addressed prior to finalising the standard:

- ISDA does not believe it is appropriate to require subsidiary companies, unless they have listed instruments in issue, to provide the detailed risk disclosures proposed (e.g. sensitivity analysis and capital disclosures), where this information is provided in the consolidated financial statements of their parent. An entity would still have the option to voluntarily adopt these disclosures should they consider them useful to their user group.

- We do not support the proposals to include all risk disclosures arising from financial instruments in the audited financial statements. Whilst risk disclosures provide valuable information to a user on the entity's use of capital and exposure to risks, they do not provide additional detail and understanding of the financial performance reported in the balance sheet and profit or loss account. We therefore consider these disclosures should be provided for outside the audited sections of the annual report.
- We believe that the proposed credit risk disclosures are not principles based and may lead to inaccurate presentation of an entity's credit exposures. In particular, the proposals do not permit the reporting of credit exposures after taking into account legally enforceable master netting agreements even though these provide an unconditional right and ability to settle net in the event of default.
- We share the Board's view that it is appropriate to disclose information that enables shareholders and analysts to evaluate the nature and use of an entity's capital but do not support the proposals to disclose whether it has complied with internal capital targets set by management. Internal targets are deployed in conjunction with other control measures and a breach of these limits is often acceptable with appropriate approval. We therefore do not consider this to be useful or relevant information for a user to assess the financial position and recent performance of the company.

The appendix to this letter sets out our detailed answers to the questions posed by the Board. We would be pleased to discuss our comments with the Board or staff. Please contact Melissa Allen at CSFB on (020) 7883 3598 or Ed Duncan at ISDA on (020) 7330 3574.

Yours sincerely

Melissa Allen
Chair of the ISDA European Accounting Committee.

Ed Duncan
Assistant Director of European Policy at ISDA.

Appendix

Question 1 – Disclosures relating to the significance of financial instruments to financial position and performance

The draft IFRS incorporates disclosures at present contained in IAS 32 Financial Instruments: Disclosure and Presentation *so that all disclosures about financial instruments are located in one Standard. It also proposes to add the following disclosure requirements:*

(a) financial assets and financial liabilities by classification (see paragraphs 10 and BC13).

(b) information about any allowance account (see paragraphs 17 and BC14).

(c) income statement amounts by classification (see paragraphs 21(a), BC15 and BC16).

(d) fee income and expense (see paragraphs 21(d) and BC17).

Are these proposals appropriate? If not, why not? What alternative disclosures would you propose?

ISDA agrees that the proposed additional disclosures could provide relevant information to users of financial statements. However, we consider the requirements should be less prescriptive and more principles based so as to allow preparers to provide disclosure in a format appropriate for the complexity of the business and that is consistent with the way the business is managed. For example, the proposals currently require an entity to disclose the net gains or losses by classification of the financial instruments when often it would be more appropriate to disclose this information by business line or function. Providing more flexibility is essential as there are many different users of financial statements and it is important the disclosures provide information that will help them evaluate the significance of financial instruments on the entity's performance.

Underlying our desire for ED7 to be revised to a series of disclosure principles is the recognition that the markets encourage and promote adequate disclosure. Many US organisations already disclose more financial information than is required by US GAAP, in order to seek to communicate adequately their risks to the readers of the financial statements. The level of disclosure should therefore, in part, reflect the demands of the users of financial statements which will vary significantly from one business to another, from one country to another, and will also depend upon whether the entity is listed or private, or part of a larger group.

ISDA is also concerned that many practical application issues will arise if entities are required to apply prescriptive minimum disclosures. For example, paragraphs 21 (a) (iv) and (v) require disclosure of the net gains and losses on loans and receivables and financial liabilities held at amortised cost. However, where these financial instruments are part of a fair value hedge relationship it is not clear whether the disclosure should include movements in the fair value attributable to the hedged risk.

Another example of the potential practical implementation issues is the disclosure required by paragraph 21 (d) regarding fee income and expense. Structured derivative trades often embed underwriting and origination fees in the overall pricing of the derivative. We are concerned that it could be interpreted that these fees should be separated and disclosed as fee income rather than net gains and losses on financial instruments at fair value through profit or loss. Separating income on derivatives for disclosure purposes would not provide valuable information to a user and would, in practice, be very difficult to produce as an entity does not analyse the fair value of derivatives on this basis.

If the Board continues with their proposal to require prescriptive minimum disclosures in the financial statements then they must provide further explanation of the purpose of the disclosures. Entities will then be able to interpret the requirements and provide what they consider to be the most appropriate and relevant disclosures.

Question 2 – Disclosure of the fair value of collateral and other credit enhancements

For an entity's exposure to credit risk, the draft IFRS proposes to require disclosure of the fair value of collateral pledged as security and other credit enhancements unless impracticable (see paragraphs 39, 40, BC27 and BC28).

Is this proposal appropriate? If not, why not? What, if any, alternative disclosures would you propose to meet the stated objective?

ISDA believes that an entity with financial assets should provide adequate disclosure on its exposure to credit risk and on the management of collateral. However, we consider that whilst all entities should be required to disclose their credit policy and the methods used to manage credit risk, the level of detailed disclosure should vary depending on the significance of their exposure to credit risk. As currently worded, we are concerned the proposed disclosure of the fair value of collateral and other credit enhancements lack context and may be better embedded in an over-arching disclosure principle. In particular:

a) the information required in respect of the fair value of collateral and other credit enhancements is more detailed and prescriptive than required by the proposals for other risk information; and

b) the information will be of limited value to the reader of financial statements without a wider understanding of the nature of the entity's credit activities and how the collateral is used.

When reviewing these disclosures, a user may draw the inference that collateralised loans are lower risk than uncollateralised loans, which will not necessarily be the case as it will depend on the nature of the lending activity and the credit worthiness of borrowers. Also, the fair value of collateral will be a meaningless figure, without comparison against the specific loans that it is designed to collateralise; an entity could have certain loans that are over-collateralised and other loans where insufficient collateral is held, and the disclosures required by ED 7 would not provide a reader with this understanding.

In addition, the proposals do not permit an entity to disclose their credit exposure after legally enforceable master netting agreements have been taken into account, even though these will provide an unconditional right and ability to settle net in the event of default. If the disclosures are to accurately reflect the credit risk of an entity, they should disclose the loss that the entity will suffer if a counterparty fails to meet its contractual obligations. Therefore the disclosure must be provided after applying any master netting agreements.

We would therefore prefer to see the disclosure requirements in respect of the fair value of collateral and credit enhancements focus more on providing sufficient information about the management of credit risk and methods of credit enhancement. This would enable the reader to obtain an understanding of the risks of the business. Much of the other proposed disclosures concerning collateral should be included in the application guidance, as a possible way of achieving this disclosure.

Finally, the Board should reconsider paragraph 39 (a) which requires disclosure by classification of financial instrument "the amount that best represents its maximum exposure to credit risk at the reporting date…". We are concerned that this disclosure could be misinterpreted since "maximum exposure" for a derivative is normally considered to be the potential maximum future exposure, which will usually be considerably greater than the fair value of the instrument suggested in the guidance. We therefore ask the IASB for further clarity on this issue.

Question 3 – Disclosure of a sensitivity analysis

For an entity that has an exposure to market risk arising from financial instruments, the draft IFRS proposes to require disclosure of a sensitivity analysis (see paragraphs 43, 44 and BC36 - BC39).

Is the proposed disclosure of a sensitivity analysis practicable for all entities?

If not, why not and what, if any, alternative disclosures of market risk would you propose to meet the stated objective of enabling users to evaluate the nature and extent of market risk?

ISDA agrees with the principle that an entity should disclose sensitivity analysis in the annual reports showing the effect of reasonable changes in market risk variables on the fair value of financial instruments. However, consistent with our responses to the questions above, we consider the requirements should be less prescriptive and more principles based to allow preparers to provide disclosure consistent with the information used to manage the business risks.

In particular, we do not believe that it is appropriate to require sensitivity analysis for entities that are subsidiaries and whose results are reflected in consolidated financial statements of a parent which provides the risk disclosures, unless that entity has itself listed securities or chooses to make the disclosure because of specific user requirements. In these situations the information will not normally be useful to stakeholders. For example, many lenders to subsidiaries make credit decisions, in large part, on the basis of guarantees provided by the parent and therefore detailed information on the subsidiary may be of limited value to this user group.

It is also important to note that many entities manage risk on a business unit or group wide basis. As such, the risk systems for these entities are designed to capture risk information at that level rather than at an entity level. Although this would mean the information is available, significant time and effort would be required to cut the information and provide it on a subsidiary-by-subsidiary basis. For completeness, the group would then need to capture intra-group risks that would often not be captured on the risk reporting system to the same level of detail. Furthermore, as risk management practices may span across portfolios which include assets and liabilities recorded under different accounting models, it would be difficult if not impossible to designate the potential impact on profit or loss versus equity, as required by the ED.

In measuring their sensitivity to market risk many banks will use a statistical Value at Risk ("VaR") methodology that expresses potential loss on a portfolio at a specified confidence level eg, 95% confidence. It is not clear in the proposals whether VaR is an acceptable way of meeting the sensitivity analysis requirements under all circumstances and we would like to see the Implementation Guidance amended to clarify the situations in which a VaR analysis is considered acceptable.

Finally, should the Board continue with the checklist of minimum disclosures, we are concerned the current proposals do not provide clarity on the amount of information that will normally be required. For instance, is it sufficient to provide the foreign exchange exposure analysis in aggregate or by currency? Consistent with our views expressed elsewhere in this letter, illustrative examples should be provided in the implementation guidance to help demonstrate the appropriate level of disclosure.

Question 4 – Capital disclosures

The draft IFRS proposes disclosure of information that enables users of an entity's financial statements to evaluate the nature and extent of its capital. This includes a proposed requirement to disclose qualitative information about the entity's objectives, policies and processes for managing capital; quantitative data about what the entity regards as capital; whether during the *period it complied with any capital targets set by management and any externally imposed capital requirements; and if it has not complied, the consequences of such non-compliance (see paragraphs 46-48 and BC45 - BC54).*

Is this proposal appropriate? If not, why not? Should it be limited to only externally imposed capital requirements? What, if any, alternative disclosures would you propose?

Given that much of the capital base of most entities is made up of retained earnings, which is not a financial instrument, and most of the risks faced by non-financial entities that prompt the need for capital are unrelated to financial instruments, it is not clear why capital disclosures are proposed in an ED on the disclosure of financial instruments.

Nevertheless, good management of capital is an integral part of providing consistent and high quality returns to shareholders. We therefore share the IASB's view that it is appropriate to disclose, where practical, information that enables shareholders and analysts to evaluate the nature and use of a company's capital. However, in our view there needs to be more flexibility provided so that an entity can determine appropriate capital disclosures. In particular, outside of financial institutions, there is no established framework for determining capital requirements. This is illustrated by the example given in the draft Implementation Guidance, IE1, where a debt to equity ratio is disclosed without an apparent logical justification. Quantitative measures of the required level of capital are not currently used by many entities for management purposes, would be onerous to produce, and would vary so significantly from one entity to another that comparison may not be possible. We consider it important, first, to establish a generally accepted basis of calculation and for this to be adequately field tested before disclosure is required to be given by all entities.

We also recommend that, except in the case of regulated entities, capital information disclosures should only be required at the group level (see our comments relating to sensitivity analyses above).

ISDA agrees that it is appropriate for financial institutions to disclose key capital figures and ratios compared to the minimum regulatory requirements at the period end, although we do not support the proposal to disclose internal capital targets and regulatory breaches arising in the period. Different organisations view internal targets in very different ways, some being set with the expectation that they will never be exceeded and others using them as a more active control framework, in much the same way as risk position limits, where capital excesses can be tolerated in limited circumstances, with appropriate approvals. Also, internal capital targets are often deployed in conjunction with other control measures, and so the proposed disclosure may at best only provide a small part of the picture.

Breaches of capital limits would in many cases be confidential information and we believe it should be the regulator that decides whether a breach is communicated to the public. For example, disclosure of a breach that occurred during the course of the year, which has since been corrected, would be of limited value and potentially misleading, especially if the breach was for minor or technical reasons.

Question 5 – Effective date and transition

The proposed effective date is for periods beginning on or after 1 January 2007 with earlier adoption encouraged (see paragraphs 49 and BC62 - BC67).

Entities adopting IFRSs and the draft IFRS for the first time before 1 January 2006 would be exempt from providing comparative disclosures for the draft IFRS in the first year of adoption (see Appendix B, paragraph B9).

Are the proposed effective date and transition requirements appropriate? If not, why not? What alternative would you propose?

The proposed effective date is appropriate, on the basis that certain of the proposals are not included in the final version of the Standard, as recommended in this response. In particular, we are concerned that non-financial institutions may not have the capability to produce the new detailed sensitivity analyses on their Available For Sale or Held To Maturity assets by 1 January 2007 and believe that it would be premature to require quantitative information concerning capital (see question 4) by this date. In addition, we do not see significant benefits from providing this information for subsidiary companies in this timescale, if at all.

With Europe and many other countries adopting IFRS in 2005, many companies will be preparing their first set of IFRS accounts towards the end of next year. Rather than preparing the disclosures under IAS 32 they may prefer to adopt the standard early. We would therefore encourage the Board to finalise these proposals as soon as practicable.

Question 6 – Location of disclosures of risks arising from financial instruments

The disclosure of risks arising from financial instruments proposed by the draft IFRS would be part of the financial statements prepared in accordance with International Financial Reporting Standards (see paragraph BC41). Some believe that disclosures about risks should not be part of financial statements prepared in accordance with IFRSs; rather they should be part of the information provided by management outside the financial statements.

Do you agree that the disclosures proposed by the draft IFRS should be part of the financial statements? If not, why not?

No, we do not believe that the financial statements are the best place for many of the disclosures proposed in the draft standard. While ISDA believes that disclosures which analyse the results reported in the balance sheet and profit or loss account should be included in the notes to the financial statements, ED 7 proposes comprehensive disclosure of an entity's risk positions (in particular, the sensitivity analysis and capital disclosures) and further disclosures that provide information on how a business manages its risk. Although these risk disclosures provide valuable information to a user of the impact in the movement of market variables, such as interest rate risk, on the business, they do not directly relate to the audited financial results reported in the balance sheet and profit or loss account.

We are also concerned that the costs involved in having this information audited would not be commensurate with the value of the information to readers. Therefore, although ISDA agrees that these disclosures should be included in a company's annual report we believe that they should not form part of the audited financial statements.

Question 7 – Consequential amendments to IFRS 4
(paragraph B10 of Appendix B)

Paragraph B10 of Appendix B proposes amendments to the risk disclosures in IFRS 4 Insurance Contracts *to make them consistent with the requirements proposed in the draft IFRS. The requirements in IFRS 4 were based on disclosure requirements in IAS 32 that would be amended by the draft IFRS. The Board's reasons for proposing these amendments are set out in paragraphs BC57 - BC61.*

Do you agree that the risk disclosures in IFRS 4 should be amended to make them consistent with the requirements proposed in the draft IFRS? If not, why not and what amendments would you make pending the outcome of phase II of the Board's Insurance project?

The majority of ISDA's members will not be affected by the proposals to amend the risk disclosures in IFRS 4 to be consistent with the requirements proposed in the ED 7. We therefore have not provided a response to this question.

Question 8 – Implementation Guidance

The draft Implementation Guidance accompanying the draft IFRS suggests possible ways to apply the risk disclosure requirements in paragraphs 32-45 (see paragraphs BC19, BC20 and BC42 - BC44).

Is the Implementation Guidance sufficient? If not, what additional guidance would you propose?

ISDA believes the Implementation Guidance should include additional comprehensive practical examples of applying the standard to both financial and non-financial companies. In particular, it would be helpful if examples were provided showing the level of disclosure expected of companies that make extensive use of financial instruments and those that use them for financing and for investment. In addition, there are a number of proposals where no guidance is currently provided at all, such as for paragraphs 31(a) and 40(b). We recommend the final standard include implementation guidance for all the proposed disclosure to encourage consistent application. In providing further illustration it should, however, be made clear, the level of disclosure will depend on the particular circumstances of each entity, and that this will mean the disclosures given by different entities may not be easily comparable.

Question 9 – Differences from the Exposure Draft of Proposed Statement of Financial Accounting Standards Fair Value Measurements *published by the US Financial Accounting Standards Board (FASB).*

The FASB's Proposed Statement of Financial Accounting Standards Fair Value Measurements, *which is open for public comment at the same time as this Exposure Draft, proposes guidance on how to measure fair value that would apply broadly to financial and non-financial assets and liabilities that are measured at fair value in accordance with other FASB pronouncements. That Exposure Draft proposes disclosure of information about the use of fair value in measuring assets and liabilities as follows:*

(a) For assets and liabilities that are remeasured at fair value on a recurring (or ongoing) basis during the period (for example, trading securities)

(i) the fair value amounts at the end of the period, in total and as a percentage of total assets and liabilities,

(ii) how those fair value amounts were determined (whether based on quoted prices in active markets or on the results of other valuation techniques, indicating the extent to which market inputs were used), and

(iii) the effect of the remeasurements on earnings for the period (unrealised gains or losses) relating to those assets and liabilities still held at the reporting date.

(b) For assets and liabilities that are remeasured at fair value on a non-recurring (or periodic) basis during the period (for example, impaired assets), a description of

(i) the reason for remeasurements,

> *(ii) the fair value amounts,*
>
> *(iii) how those fair value amounts were determined (whether based on quoted prices in active markets or on the results of other valuation techniques, indicating the extent to which market inputs were used), and*
>
> *(iv) the effect of the remeasurements on earnings for the period relating to those assets and liabilities still held at the reporting date.*

> *Disclosures similar to (a)(ii) above are proposed in paragraph 31 of the draft IFRS (and are currently required by paragraph 92 of IAS 32) and disclosures similar to (a)(iii) are proposed in paragraph 21(a).*
>
> *Do you agree that the requirements in the draft IFRS provide adequate disclosure of fair value compared with those proposed in the FASB's Exposure Draft? If not, why not, and what changes to the draft IFRS would you propose?*

ISDA agrees that the disclosure requirements of ED 7 would provide adequate disclosure of fair value changes compared with those proposed in the Financial Accounting Standards Board's Exposure Draft. We are supportive of the principles behind the disclosures required by the FASB's Exposure Draft, however we did recommend in our comment letter, a copy of which is attached, that the proposed disclosure of the amount of unrealized gains or losses associated with fair value measurements be removed, as this does not provide useful information and could be misleading to financial statement users.

It is important to note that disclosures required by this FASB Exposure Draft would be supplemented by the qualitive disclosures that are already made regarding fair value measurements. Currently, much of this qualitative information regarding valuation and valuation techniques is disclosed within many banks' and broker-dealers' critical accounting estimate disclosures in the Management's Discussion & Analysis section of their public filings, which sit outside the audited financial statements.

> *Question 10 – Other comments*
>
> *Do you have any other comments on the draft IFRS, Implementation Guidance and Illustrative Examples?*

In addition to our comments to questions one to nine, we have detailed below several concerns with the detailed proposals that should be addressed prior to finalising the standard. The Board should consider these matters in the context of our comments above and ensure it is clear from the implementation guidance in the final standard the type and extent of the suggested disclosures.

Paragraph 11 – Financial liability at fair value through profit or loss

An example where the ED is overly prescriptive as opposed to principles-based, is that paragraph 11 states a disclosure requirement, without explaining why it is required. We assume that the objective of paragraph 11 is for the reader of the financial statements to understand the extent to which profits or losses booked in any year arise from changes in the entity's own credit risk. If this is the case, then the Standard will need to state this. As worded, the information provided will not be sufficient to enable a reader to understand the effect of changes in own credit risk, since there could be other factors involved in an instrument's change in fair value unrelated to the benchmark interest rate, such as the effect of an embedded derivative.

Also, while we agree that the information required by paragraph 11(b) is necessary, it is not clear how entities are expected to determine the amount contractually required to be paid at maturity. In cases where a bond is issued with the principle linked to, say, equity prices, all that would be capable of being disclosed would be the amount that would be required to be paid if equity prices do not change, plus any further information to ensure the reader understands that the number could, and will, be different at maturity.

Paragraph 19 – Defaults and breaches

As with our comments on capital, above, we are concerned that the information will not always be in the public domain and the information may not be useful.

Paragraph 23(b) – Accounting policies

It is not clear why there should be criteria for designating financial assets as Available For Sale, since this will normally be the default category. The only discretion is if a firm (for instance) decides that loans should be classified as AFS, in which case the suggested disclosure should be amended to make this clear.

Paragraph 23(f) – Accounting policies

We consider this paragraph requires rewording. By definition, an item is “past due” until it is paid. Therefore whether an item is still past due or not is a matter of fact, rather than an issue of policy. We presume that it is intended that disclosure should be made of the policy for determining if loans are no longer impaired and when provisions can be released.

Paragraph 24 – Hedge accounting

The hedge accounting disclosure should also include disclosure of the change in the value of the items being hedged. This will then provide the user with an overview of the entity’s hedge accounting transaction.

Paragraphs 31(b) and (c) – Fair value

As worded, this could be answered “yes” or “no”. The requirement should presumably not be “whether”, but “the extent to which”, making it clear that a quantitative response is expected.

We would also encourage the Board to revise the fair value disclosure required under paragraph 31 (c). We are concerned the proposals, in requiring reasonable alternative fair values to be disclosed, would be inconsistent with the fair value hierarchy prescribed in IAS 39. We would be pleased to assist the Board in developing alternative guidance.

Paragraph 40(b) – Financial assets past due or impaired

As currently worded it is not clear as to what level of detail is expected in relation to this paragraph. For a non-financial institution this might only require a few lines but the information, for a bank, could run to many pages. As with a number of the other requirements in ED 7, an entity should disclose sufficient information to enable readers of the financial statements to understand adequately the risks of the entity.

Paragraph 41 – Collateral and other credit enhancements obtained

For a bank, the information required by paragraph 41 would be far too detailed unless provided only in aggregate. Further clarification should be provided in the final standard as to the objective of this disclosure.

September 2, 2004

Suzanne Q. Bielstein
Director - Major Projects and Technical Activities
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, Connecticut 06856-5116

Re: File Reference No. 1201-100, Proposed Statement of Financial Accounting Standards, *Fair Value Measurements*

Dear Ms. Bielstein:

The Bond Market Association ("TBMA"), the International Swaps and Derivatives Association ("ISDA") and the Securities Industry Association ("SIA") are pleased to offer the following comments in response to the Financial Accounting Standards Board's ("FASB") above referenced Exposure Draft (the "Exposure Draft"), *Fair Value Measurements*.

The comments that follow were developed and are being presented jointly by a working group (the "Joint Industry Working Group") composed of representatives of the respective accounting policy committees of TBMA, ISDA and SIA. Collectively, the membership of these committees have substantial professional expertise and practical experience addressing the accounting policy issues and questions raised by this tentative guidance with respect to financial instruments. A description of our organizations is contained in Attachment I.

The Joint Industry Working Group is supportive of the FASB's objective of developing a framework clarifying the fair value measurement objective and its application, and would like to take this opportunity to comment on a few matters in the Exposure Draft, including certain matters for which the Board specifically solicited comments. The Joint Industry Working Group believes that certain clarifications would enhance the usefulness of a final Statement and improve its application. In addition to those clarifications, we believe that it is critical that the Board field test the provisions of the fair value guidance before the issuance of a final Statement. Our comments cover the following key areas:

- Offsetting positions
- Significant subsequent events
- Most advantageous market/transaction costs
- Block discounts
- Marking to one's own credit spread
- Application of EITF 02-3
- Disclosures
- Fair value option

<u>FAIR VALUE PRINCIPLES</u>

The first three topics – Offsetting positions, Significant subsequent events and Most advantageous market - are principles that appear to only apply to assets and liabilities estimated under Level 1 of the Exposure Draft. We strongly believe that these three concepts should be broadly applied across all levels of the hierarchy as further described below.

OFFSETTING POSITIONS

For estimating fair value, paragraph 17 of the Exposure Draft indicates that for Level 1 estimates of "offsetting positions, mid-market prices shall be used for the matched portion." We support the offsetting concept for estimating fair value as articulated in paragraphs 17 and C53, although we believe a broader application across the hierarchy is appropriate to ensure that all fair value estimates are consistent with trading and risk management practices of dealers.

Dealers provide liquidity and make trading in cash securities and derivative instruments possible. When an entity wants to change its risk profile, it needs to find a willing counterparty with an acceptable credit standing. Dealers stand ready to act in this capacity and make risk exchange possible by having the expertise to structure a product that meets the client's risk profile, the willingness to accept the offsetting risk position and manage it, and the liquidity to unwind or restructure positions when clients wish to subsequently change their risk profile.

Consistent with this business model, dealers maintain large portfolios of client transactions. As a fundamental principle, dealers manage the underlying risks (such as interest rate risk or credit risk) of transactions. Some of the risks of client transactions naturally offset each other and do not create an "open" risk position for the dealer to manage. Other risks do not naturally offset and may be economically hedged (or "closed out" by entering into an offsetting position) with a combination of cash and derivative instruments. For example, assume that a dealer has executed a one-year, 2 million notional pay 5%, receive-LIBOR interest rate swap with a counterparty and a two-year, 2 million notional receive 5%, pay-LIBOR interest rate swap with a different counterparty. The dealer does not have an open interest rate position in year one but does have an open 2 million notional interest rate position in year two. To offset the interest rate position in year two, the dealer may decide to enter into an offsetting interest rate swap or a series of Eurodollar futures. A dealer's success is dependent upon its ability to close out risk in the most efficient manner through optimal access to markets (cash and derivative). Consistent with this risk management approach, the effect that a potential transaction may have on the aggregate risk position (for example, whether it will create a market risk position or reduce an existing market risk position) is one of many factors considered when determining the pricing offered to a client.

The conceptual basis for applying the offsetting provisions to fair value measurements is to accurately reflect the way that marketplace participants price and manage risk. Therefore, consistent with that approach, the offsetting provisions should not be linked to levels of the hierarchy, but rather should be linked to the way in which marketplace participants price and manage risk. The language in paragraph C53 and International Accounting Standard 39 Financial Instruments: Recognition and Measurement, appears to support a risk management approach as the focus of paragraph C53 is on fair value reflecting the risk retained in the instrument or portfolio of instruments (cash and/or derivative products). We believe using mid-market prices to value offsetting positions is a general principle that should not be restricted solely to Level 1 estimates, as it is appropriate to apply it to each level of the hierarchy as well as across levels of the hierarchy, in order to accurately reflect the risk management position of the company and the economics of its positions. Valuing offsetting positions using mid-market prices provides more relevant information because an offsetting position locks in the net cash flows from the asset and liability positions and potentially could be traded as a matched position without incurring certain transaction costs (i.e., the bid-ask spread).

To illustrate, a common transaction is one in which a company executes an over-the-counter ("OTC") equity option on a single stock which is hedged by a listed equity option on the same single stock. Although we believe that the listed option is a Level 1 instrument and the OTC option is a Level 3 instrument, the positions offset each other's market risk. Since the company has offset the risk of market exposure associated with the options, using the observed mid-market volatility to price the OTC contract would seem appropriate. The same concept would apply to a portfolio of exchange traded and OTC options.

Furthermore, many marketplace transactions combine instruments and evidence the way that the market prices offsetting risk. Consider a credit default swap ("CDS") bond basis package trade whereby a company purchases a bond from the dealer (a Level 1 instrument) while simultaneously buying credit protection from the dealer through a CDS indexed to the credit of the issuer of the bond (a Level 3 instrument). Although the CDS is referenced to the same entity that issued the bond, a basis position exists due to supply and demand factors; the ability of the company, upon default of the issuer, to deliver other obligations of the issuer in exchange for par under the settlement terms of the CDS; and, differing default scenarios. For such transactions, the bid-offer spread is paid on the basis position (the net open position) and would be less than the bid-offer spread paid if each leg of the transaction were priced separately. We believe it is appropriate in this case to value the offsetting credit positions at a mid-market price and the remaining net long basis position at bid, consistent with the observed market pricing.

The simplified examples above are designed to illustrate the application of the offsetting concept that is consistent with current trading and risk management practices. Numerous other examples exist, each with its own complexities. However, the general concept is that risks should be valued using mid-market pricing to the extent risks offset each other, regardless of the level of hierarchy used to categorize instruments. If the mid-market valuation concept for offsetting positions is not permitted across all levels of the hierarchy, then positions with similar underlying risk will be valued differently resulting in inconsistent and incorrect fair value measurements.

In addition, it is our understanding that the purpose of footnote 8 is solely to clarify that the offsetting guidance in the Exposure Draft applies to estimating the fair value of offsetting risk positions and is not intended to provide guidance about netting for balance sheet presentation purposes in the financial statements. We do not believe it was the Board's intent to limit the offsetting position provisions in the Exposure Draft to only those transactions that achieve balance sheet setoff under other relevant pronouncements such as FASB Interpretation No. 39, *Offsetting of Amounts Related to Certain Contracts*, and to depart so fundamentally from how the market values risk. We strongly urge the Board to clarify this point.

SIGNIFICANT SUBSEQUENT EVENTS

The Exposure Draft also indicates that entities should establish and consistently apply a policy for determining how significant subsequent events should be considered in determining estimates of fair values under Level 1 of the hierarchy. We believe that adjusting fair value for significant subsequent events is a general principle of fair value measurement and entities should have policies for determining the effect of significant subsequent events on instruments measured under all levels of the hierarchy.

Again consider market-traded debt, valued under Level 1 of the hierarchy, and a CDS (indexed to the credit of the issuer of the debt), valued under Level 3 of the hierarchy. We believe that entities should have policies in place to address an event that affects both instruments, such as events regarding the credit of the issuer. For example, if a subsequent credit event occurs that affects the fair value of both instruments, the provisions of the Exposure Draft would permit the bond’s price to be adjusted for the effect of the event. However, as written, the Exposure Draft does not clarify whether it permits the CDS to be adjusted for the same event. If a credit event that affects fair value occurs after the last quoted trade is done but before the end of the reporting period, an entity’s policy should address how the event factors into its estimates of fair value under all levels of the hierarchy.

MOST ADVANTAGEOUS MARKET/TRANSACTION COSTS

We support the provision of the Exposure Draft that indicates that when an entity has access to multiple markets, the Level 1 reference market should be the most advantageous market to which an entity has immediate access. We also agree with the Board that in general the goal of most entities is to maximize profit. For example, a dealer may enter into a transaction with a retail client and, in order to maximize profit, enter into an offsetting position by accessing the more advantageous wholesale market thereby recognizing a profit.

The most advantageous market is defined as the market that maximizes the net amount received taking into account the cost to transact in the respective markets. However, the Exposure Draft also states that the price used to estimate fair value should not be adjusted for the costs to access the reference market. As highlighted in the example below, we believe that the prohibition against adjusting for such transaction costs will produce anomalous results.

Consider a common marketplace example, in which a company purchases a barrel of oil. The spot price of a barrel of oil at Location A where the company intends to execute any future sale is $35 and the company would incur no transaction costs to execute at Location A. The company determines that the spot price of a barrel of oil at Location B is $40 and the related transportation costs are $4. If the company were to actually transact at Location B, the company would have to arrange for transportation of the oil. Assuming the company has made these arrangements and, therefore, has immediate access to the reference market at Location B, the company would mark the barrel of oil to $40, the spot price of oil at Location B. Under the provisions of the Exposure Draft the company would recognize an immediate gain of $5, of which $4 represents transaction costs. This provision will have the effect of causing an entity to record unrealized gains in one period and related expenses or realized losses in another period.

The example above illustrates the anomalous results associated with requiring a company to recognize a gain that primarily represents the transaction costs of executing in a particular market. We recognize the Board's concerns regarding consistency in fair value measurement; however, relevance of the fair value measurements is of equal importance. We believe that the most advantageous market provision as currently contemplated in the Exposure Draft may force companies to recognize gains that will merely be expensed in a later period. Therefore, while we support the concept of the most advantageous market, we have concerns regarding the prohibition against adjusting the estimated fair value for transaction costs that would be incurred.

In addition, the Exposure Draft appears to be internally inconsistent with regard to treatment of transaction costs for a Level 1 instrument versus treatment of such costs for a Level 3 instrument. Paragraph B9 of the Exposure Draft emphasizes that fair value shall not be adjusted to take into account Level 1 transaction costs whereas paragraph 23(f) states that "a price might need to be adjusted for difference in the unit of account, condition, or location, or to reflect the appropriate valuation premise." We are unclear as to whether it was the Board's intent to differentiate the treatment of transaction costs depending on where within the hierarchy a position is categorized. However, we believe that, in order to ensure the relevance of a fair value measurement and to achieve consistency across levels of the hierarchy, the Board should include a provision similar to that of paragraph 23(f) in **all** levels of the hierarchy. In addition, given paragraph 23(f), it is unclear what costs may be deemed transaction costs for purposes of applying the most advantageous market provisions of the Exposure Draft.

Clarifying the applicability of offsetting, significant subsequent events and most advantageous market concepts to all levels of the hierarchy as indicated above would ensure that meaningful, relevant information is provided in the financial statements and improve the operationality of a final Statement.

* * *

Our comments related to the remaining topics – Block discounts, Marking to one's own credit spread, Application of EITF 02-3, Disclosures, and Fair value option – relate to specific provisions of the Exposure Draft or to issues that we believe should be addressed in the Exposure Draft.

BLOCK DISCOUNTS

We support the decision of the Board as articulated in the Exposure Draft that for large positions of securities held by broker-dealers and certain investment companies a fair value estimate would include a block discount. Including such a discount enhances the relevance of financial statements and provides representationally faithful information. Since block traders transact in the block market, the application of such a discount produces a value that accurately reflects the business activities of the entity. The block discount provisions of the Exposure Draft will prevent the income statement distortion that could occur if entities that purchased a large position at a discount were required to recognize a gain that may never be realized due to the size of the block.

MARKING TO ONE'S OWN CREDIT SPREAD

Footnote 4 of paragraph 5 and paragraphs A23 to A27 indicate that, in determining the fair value of liabilities, the effect of the entity's credit standing should be considered. We understand the reasons for considering the effect of an entity's credit standing in estimating the fair value of liabilities. However, practice is currently mixed with regard to whether the effect of an entity's own credit standing is included in fair value estimates of trading liabilities.

FASB Statement of Concepts No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements*, states that including changes in an entity's own creditworthiness in fair value measurements provides the most relevant information; however, existing higher level GAAP has not clearly addressed this issue in a consistent manner. In FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, the Board acknowledged its pronouncements to date have not broadly addressed whether it is appropriate to reflect changes in creditworthiness in fair value measurements, but decided not to provide additional guidance.

In the absence of clear guidance for derivatives, practice has developed two views. Certain constituents agree with the view in the Exposure Draft. They believe that including the effect of a change in an entity's own creditworthiness in fair value measurements for liabilities is consistent with the widely accepted view that the asset side of the balance sheet must be adjusted for credit risk in determining fair value. This approach ensures that the credit risk component of a valuation methodology is consistent for both assets and liabilities and that fair value measurements include all risks related to the contractual agreement. These constituents believe that the market considers the effect of an entity's creditworthiness in the fair value measurement of derivative liabilities and, therefore, the entity has the ability to realize the effect.

However, the majority of constituents believe that there is little market transparency or conclusive research indicating that derivative transactions in the marketplace consistently reflect the creditworthiness of the "issuer." These constituents believe that including an entity's own creditworthiness in the determination of fair value may not be appropriate as the entity does not typically have the ability to realize gains or losses arising from the changes in its own creditworthiness. It is also worth noting that the Basel Committee on Banking Supervision (the "Committee") decided that the potential inclusion of gains and losses arising from the changes in an entity's own creditworthiness in Tier 1 or Tier 2 capital raises significant supervisory concerns, and therefore, the Committee is of the view that such gains and losses should be excluded from regulatory capital. These constituents believe that this is a factor that the FASB may want to consider when concluding on the issue of marking for one's own credit spread.

Both groups of constituents believe it is appropriate for an entity to include the effect of changes in an entity's own creditworthiness in fair value estimates where the effect is contemplated in the marketplace and when the entity has the ability to realize the effect. This approach is consistent with the concept of fair value being the amount at which an asset or liability could be exchanged between unrelated willing parties as defined in the Exposure Draft.

Including the effect of changes in an entity's credit standing in fair value measurements of liabilities when the entity does not have the ability to realize the effect results in fair value information that is less relevant to financial statement users. For example, there may exist a case in which an entity's credit rating has deteriorated significantly. However, in this situation, it is unlikely that the entity would be able to extinguish its liabilities and thus realize the gain, as it is probable that (in the case of a significant credit deterioration) the entity needs the funding. In that case, even if the liability can be extinguished, the entity would have to replace it by refinancing at a higher effective interest rate. We offer this example to illustrate that there may be cases where an issuer is unable to realize gains resulting from changes in its credit. Without the ability to realize the value, the effect of an entity's credit standing on the value of its liabilities would be inappropriately included in the fair value measurement of the liabilities. Furthermore, this could result in fair value information related to the liability that is less relevant to the readers of financial statements.

Regardless of how the Board ultimately concludes on this matter, the Board should consider a requirement that an entity disclose its accounting policy regarding whether or not fair value measurements of liabilities contemplate changes in the entity's own credit spread. Such a disclosure would clarify an entity's approach to fair value measurements and would provide users of financial statements with the information needed to understand the nature of those fair value measurements.

EITF 02-3
We support the Board's objective of a single fair value hierarchy as provided in the Exposure Draft. However, we believe further clarification is needed in regard to the potential interaction between the Exposure Draft and EITF Issue No. 02-3, "Issues Involved in Accounting for Derivative Contracts Held for Trading Purposes and Contracts Involved in Energy Trading and Risk Management Activities" ("EITF 02-3"). The fair value hierarchy in the Exposure Draft requires that preparers "estimate an exchange price for the asset or liability being measured in the absence of an actual transaction for that asset or liability" and provides guidance on how valuation inputs should be derived in arriving at that fair value estimate. However, it appears that EITF 02-3 may preclude a preparer from applying certain provisions of the Exposure Draft as it relates to Level 3 estimates.

For example, consider a 10-year written OTC equity option on a single name stock where only two years of observable data is available. Under the Exposure Draft, the entity would supplement the two years of market data with entity-derived data to arrive at a fair value estimate under Level 3 of the hierarchy. However, under EITF 02-3 this value would be adjusted to transaction price regardless of the value estimated under the provisions of the Exposure Draft. Thus, the fair value estimated under the Exposure Draft and the fair value resulting from the application of EITF 02-3 would not be compatible.

For financial institutions that are in the business of buying and selling financial instruments, EITF 02-3 has been an issue of critical importance. We do not believe that delaying discussion of EITF 02-3's relevance to the issue of fair value will improve financial reporting. As a result, we would strongly encourage the Board to consider adding this issue to the scope of the final standard. Due to the significance of this topic, we believe that any decisions reached with regard to this topic should be exposed for comment.

DISCLOSURES
We support the general concept behind the Exposure Draft's required disclosures. However, we believe the requirement to disclose the amount of unrealized gains or losses associated with fair value measurements does not provide useful information and may provide misleading information to financial statement users. This is because this is not a means by which management evaluates its business. Consider an at-the-money written option with a premium received of $100. Subsequent changes in the fair value of the option may include both realized and unrealized gains. The periodic time value decay (of the original $100 premium received) will, over time, result in realized gains; other changes in value are considered unrealized gains or losses. Segregating the accounting for the instrument in this manner for disclosure purposes does not add transparency to the valuation process. Furthermore, the effort to produce this type of disclosure for a given reporting period is significant and should not be underestimated, as it will require modifications to companies' systems and reporting processes.

We do however understand that users of financial statements may desire additional information regarding fair value measurements estimated using significant entity inputs. Therefore, for estimates that use significant entity inputs we propose requiring entities to disclose total gains and losses (realized and unrealized). The total gain or loss could be presented as a percentage of total earnings for the period.

It is important to note that disclosures required as part of this project would be supplemented by the qualitative disclosures that are already made regarding fair value measurements. Currently, qualitative information regarding valuation methodology and techniques is disclosed within many banks' and broker-dealers' critical accounting estimate disclosures in the Management's Discussion & Analysis section of their public filings.

FAIR VALUE OPTION
The Joint Industry Working Group notes that the Board has recently undertaken a separate project to determine the scope and application of a "fair value option" for financial instruments. We would like to take this opportunity to reiterate our support for a fair value option which would be applied broadly, to any financial instrument, and to suggest that the Board's separate project be incorporated into this one. While we understand that the purpose of the Exposure Draft is to address how to measure fair value and not when to measure at fair value, we believe that a discussion of the fair value option is particularly relevant to this project. However, should the Board decide to handle the fair value option as part of a separate project, we believe that the fair value option should be subject to the same fair value hierarchy that is ultimately developed via this Exposure Draft. That is, we do not support the proposed approach that the IASB has put forward in its recent exposure draft of amendments to The Fair Value Option, which introduces a verifiability requirement for applying the fair value option. We believe that it is critical that all financial instruments that are measured at fair value be subject to a single standardized fair value hierarchy.

CONCLUSION
In addition to the technical comments above, we believe it is critical that the Board field test the fair value guidance before the issuance of a final statement. The field test should apply the proposed fair value measurement guidance to marketplace transactions estimated using each level of the hierarchy (e.g., listed equity securities, plain-vanilla interest rate swaps, high yield bonds, exotic derivatives). An analysis of the field test should focus on both the valuation results and the operationality of the guidance. The Joint Industry Working Group is available to assist with this field test.

Again, the Joint Industry Working Group appreciates the opportunity to provide the foregoing comments in response to the Exposure Draft. In addition, the Joint Industry Working Group would like to express its desire to participate in the scheduled fair value measurement roundtable. Should you have any questions or desire any clarification concerning the matters addressed in this letter or if you would like to discuss our participation in the scheduled roundtable, please do not hesitate to contact any of the undersigned at the telephone numbers provided, or George Miller, Senior Vice President and Deputy General Counsel of TBMA at 212.440.9403, Robert Pickel, Director and CEO of ISDA at 212.901.6020 or Jerry Quinn, Vice President and Associate General Counsel of SIA at 212.618.0507.

Sincerely,

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Attachment I

The Bond Market Association represents securities firms and banks that underwrite, distribute and trade debt securities, both in the United States and abroad. The Association's members are active participants in the securitization market, collectively accounting for the vast majority of primary issuance and secondary market trading in U.S. mortgage-backed and other asset-backed securities. More information about The Bond Market Association may be obtained from its Internet website, located at www.bondmarkets.com.

ISDA is the global trade association representing leading participants in the privately negotiated derivatives industry. ISDA was chartered in 1985, and today has more than 600 member institutions from 46 countries on six continents. These members include most of the world's major institutions that deal in privately negotiated derivatives, 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. Information about ISDA and its activities is available on the Association's web site: www.isda.org.

The Securities Industry Association, established in 1972 through the merger of the Association of Stock Exchange Firms and the Investment Banker's Association, brings together the shared interests of nearly 600 securities firms to accomplish common goals. SIA member-firms (including investment banks, broker-dealers, and mutual fund companies) are active in all U.S. and foreign markets and in all phases of corporate and public finance. According to the Bureau of Labor Statistics, the U.S. securities industry employs 790,600 individuals. Industry personnel manage the accounts of nearly 93-million investors directly and indirectly through corporate, thrift, and pension plans. In 2003, the industry generated $213 billion in domestic revenue and an estimated $283 billion in global revenues. (More information about SIA is available on its home page: www.sia.com.)