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International Accounting Standards Board
30 Cannon Street
London
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By email to: CommentLetters@iasb.org.uk

Re: Exposure Draft of Proposed Amendments to IAS 32, Financial Instruments: Disclosure and Presentation, and IAS 39, Financial Instruments: Recognition and Measurement

We appreciate the opportunity to comment on the Exposure Draft of Proposed Amendments to IAS 32, *Financial Instruments: Disclosure and Presentation*, and IAS 39, *Financial Instruments: Recognition and Measurement* ("the Exposure Draft"). Goldman Sachs is a leading global investment banking and securities firm that provides a wide range of financial services worldwide to a substantial and diversified client base that includes corporations, financial institutions, governments, and high-net-worth individuals.

Through our involvement with The Bond Market Association, the London Investment Banking Association, the International Swaps and Derivatives Association, and the European Securitization Forum we participated in the development of their comment letters on the Exposure Draft. We urge the Board to give careful consideration to the complex issues and recommendations contained in those letters. Accordingly, we have limited the scope our letter to comments on broad, principles-based matters.

We would appreciate an opportunity to participate in one of the roundtable discussions the Board plans to hold the week of March 10, 2003, on a date most convenient for the Board. We attach particular importance to the following topics, which we would be prepared to comment on at the roundtable:

- *Derecognition of financial assets*. The accounting for financial asset derecognition is a complex area (as evidenced by the myriad implementation issues faced in the United States under FAS 140 and in the United Kingdom under FRS 5). We believe the continuing involvement model is likely to create a similar set of implementation issues. Rather than impose an unfinished accounting model for financial asset derecognition, we urge the Board to work together with national standard setters in countries with well-

developed securitization markets to develop a single, global model for financial asset derecognition. As an interim step, we believe the Board should eliminate the conceptual inconsistencies in IAS 39 and re-expose the Exposure Draft if the Board rejects the continuing involvement model as we suggest.

- *Fair value measurement considerations*. Rather than promulgate temporary rules for determining fair value, we suggest the Board work with other national standard-setting bodies to coordinate the efforts in this area to promote global convergence of accounting standards. Specifically, the FASB currently has on its agenda a project to replace FAS 107 with a new Statement that would describe more specifically how to determine fair value for financial instruments and improve the form and content of the disclosures. We believe financial statement users and preparers would be best served if the Board and FASB devoted their resources to developing a consistent set of guidelines for determining fair value.

- *Hedge accounting ¾ assumption of perfect effectiveness*. We believe there is diversity in practice concerning the assumption of perfect effectiveness in a hedging relationship. If the critical terms of a hedging instrument and the hedged item are perfectly matched, we believe an entity should be permitted to assume no ineffectiveness. We see no reason to require an entity to perform time consuming and costly exercises of proving hedge effectiveness when the critical terms match. Inclusion of an assumption of perfect effectiveness would not only promote convergence between IAS 39 and FAS 133, but importantly would make hedge accounting more accessible to entities applying IAS and encourage entities to use "perfect" hedges.

- *Hedge accounting ¾ embedded derivatives*. The Exposure Draft implies that if the holder of a debt instrument writes a call option on that debt instrument to an investment bank, this affects the accounting by the issuer of the same debt instrument. The issuer then must determine whether there is an embedded derivative in the original debt instrument. The FASB has posted clear guidance in DIG Issue B13 on this matter. This guidance has been successfully applied in the US and has also been applied under IAS in the absence of guidance to the contrary. Convergence is an issue high on the Board's agenda and in this particular case we believe it would be easy to achieve by converging to the FASB model.

IAS 32, *Financial Instruments: Disclosure and Presentation*

Question 1¾ Probabilities of different manners of settlement (paragraphs 19, 22, and 22A). *Do you agree that the classification of a financial instrument as a liability or as equity in accordance with the substance of the contractual arrangements should be made without regard to probabilities of different manners of settlement?*

We believe a fundamental element of a substance-based approach is the use of judgment based on all relevant information. To preclude consideration of the probabilities of the manners of settlement of a liability will result, in certain circumstances, in the classification of an instrument based on its contractual form instead of its economic substance.

For example, consider a redeemable share with the redemption element set such that it is unlikely redemption will occur. Under the Exposure Draft (IAS 32 paragraphs 19 to 22), the share would be treated as a liability. However, based on the improbability of the share's redemption, judgment would suggest it should be classified as equity. Another example is the application of paragraph 22B to mutual funds. The residual interest in such entities generally is puttable by the interest holder. Although in substance the interests are residual beneficial interests, they would be classified as liabilities in the financial statements of the fund under

the Exposure Draft. This would result in the mutual fund reporting all of its residual beneficial interests as liabilities—a result we consider to be unreasonable.

The FASB has a well-advanced project on its agenda to address the accounting for financial instruments with characteristics of liabilities, equity, or both. We suggest the Board work with the FASB to develop a single model for the classification of financial instruments as liabilities or equity and remove the requirement to disregard probabilities of different settlement in paragraph 19 of the Exposure Draft.

Question 2 ¾ Separation of liability and equity elements (paragraphs 28 and 29). *Do you agree that the options in IAS 32 for an issuer to measure the liability element of a compound financial instrument initially either as a residual amount after separating the equity element or based on a relative-fair-value method should be eliminated and, instead, any asset and liability elements should be separated and measured first and then the residual assigned to the equity element?*

We believe the value of multiple embedded derivative features in a compound financial instrument should be included in the liability element of the instrument and the options in IAS 32 for an issuer to measure the liability element should be eliminated. However, we are concerned the example in paragraph A24A contradicts this principle and achieves an inappropriate result. This is illustrated by re-examining the example:

> *Assume that the proceeds received on the issue of a callable convertible bond are 60. The value of a similar bond without any call or equity conversion option is 57. Based on an option-pricing model, it is determined that the value to the issuer of the embedded call feature in a similar bond without an equity conversion option is 2 and that the value to the counterparty of the equity conversion option in a similar bond without an embedded call feature is 12. In this case, the value allocated to the liability element under paragraph 28 is 55 (57 - 2) and the value allocated to the equity element is 5 (60 - 55). This allocation ensures that the joint value between the liability and equity elements attributable to interdependence between the embedded call and equity conversion features of 7 (12 - 5) is included in the liability element.*

This example can be analysed by comparing the proceeds on issuance of each of the hypothetical bonds:

Bond	Proceeds
Vanilla bullet bond	$57
Callable bond	55
Convertible bond	69
Callable convertible bond	60

Following the guidance in the example, the issuer initially records a liability at 55. We disagree with this treatment for a callable convertible bond because it represents the value of a bond with an embedded interest rate call when the callable convertible bond does not have a pure embedded interest rate call. Simplification for accounting purposes results in creating a financial instrument that never existed in the original bond. The accounting reflects a bond that will be called by the issuer based on interest rate levels, while the issuer's call decision is not simply based on interest rate levels.

Alternatively, consider how to hedge the interest rate risk of the bond using the above bifurcation principle. Economically the best hedge would be a receive fixed/pay floating interest rate swap that is cancelable if the bond is called or converted. If the bond is called or converted, the issuer is left with an interest rate swap it may be forced to close out. The best hedge of the interest rate risk of the bond should consider the uncertain tenor of the bond. This uncertain tenor is driven by two factors: interest rates and equity prices. The issuer is *not* hedging the equity call option when using an equity contingent swap. Rather, the issuer is hedging the interest rate risk of a liability with an uncertain tenor and this uncertain tenor is matched by the terms of the swap. This is similar to hedging the fair value interest rate risk of a callable fixed rate bond under IAS 39 with a swap containing a mirror call option that ensures the swap is cancelled when the bond is called or converted.

However, this equity contingent swap would not be a good hedge for the bond were it accounted for using the bifurcation approach above. The Exposure Draft would have the issuer account for a bond that has an embedded interest rate call. Under that approach, the best hedge would be a receive fixed/pay floating interest rate swap that mirrors the interest rate call. However, this could result in the swap being cancelled based on interest rate levels when the bond has not been called or converted or, conversely, the swap not being cancelled when the bond has been converted. This is because the bond's tenor is driven far more by equity prices than by interest rates. In effect, the Exposure Draft would measure ineffectiveness on a perfect hedge and no effectiveness on an ineffective hedge.

Various approaches could be adopted to achieve an accounting result that more accurately reflects the economics of the bond—specifically, its uncertain tenor. For example, assume an issuer issues a five-year convertible bond that is callable after year three. This could be accounted for as:

- A five-year equity warrant that is callable by the issuer after year three, plus
- A five-year bond with an equity price driven knock-out.
- The equity-price-driven knock-out may then be bifurcated and accounted for separately as a derivative.

Based on the overriding principle of substance over form, we disagree with the example because it creates artificial liability and equity instruments, neither of which reflects the substance of the components underlying the callable convertible bond. We believe the Exposure Draft should eschew a conceptually simple model if the model results in creating fictitious instruments.

Other IAS 32 Comments

- **Offsetting of a Financial Asset and a Financial Liability (paragraphs 33-41).**

  We are concerned about the impact of paragraphs 33 to 41 on the presentation of derivatives portfolios transacted under master netting arrangements. We believe net presentation of fair value derivative balances with a single counterparty under a master netting arrangement is the most appropriate presentation because it correctly reflects the credit risk exposure with that counterparty as well the legal positions of the counterparties in bankruptcy; i.e., gross presentation overstates assets and liabilities. Further, such a presentation would conform with banking regulatory and United States generally accepted accounting principles. Accordingly, we recommend that fair value derivative amounts transacted under master netting arrangements be offset when the requirements of paragraph 33(a) are met.

- **Disclosures ¾ Fair Value (paragraph 77B).**

  We believe high-level information regarding significant methods and assumptions applied in determining fair values of financial instruments is useful to users of financial information. However, the extent and nature (i.e., qualitative, quantitative) of the disclosure requirements in paragraph 77B are unclear. Further, we believe the complexity of many valuation models inhibits the usefulness of detailed disclosure and in some cases may require disclosure of proprietary information. In addition, the words "the extent to which" in paragraphs 77B(b) and (c) and "effect on the fair value" in paragraph 77B(d) suggest quantitative disclosures are required.

  Further, paragraph 77B(e) requires disclosure of the total amount of the change in fair value recognised in profit or loss during the period estimated using a valuation technique. We question the benefit to financial statement users of quantifying the effects of valuation techniques on profit and loss. In fact, we are concerned such disclosure could provide misleading information as it may imply that gains or losses using valuation techniques lack validity.

  Finally, financial instrument portfolios generally are valued based on market prices, valuation techniques, or a combination of both. Given the size of financial instrument portfolios, classifying and quantifying revenue or losses arising from valuation techniques, in whole or in part, would not be practicable for large financial institutions like Goldman Sachs.

- **Insurance Contracts (paragraphs 1(c), 3, and 43).**

  We agree that contracts in the form of insurance that principally involve the transfer of financial risk should be within the scope of IAS 39. This will promote consistency of accounting for insurance contracts across industries. However, given the complexity and array of contracts that will be within the scope of this provision, more specific guidance would be helpful. In particular, the criteria for determining when a contract that bears insurance risk together with financial risk should or should not be classified as an insurance contract need to be clearly set forth.

IAS 39, *Financial Instruments: Recognition and Measurement*

Question 1¾ Scope: loan commitments (paragraph 1(i)). *Do you agree that a loan commitment that cannot be settled net and the entity does not designate as held for trading should be excluded from the scope of IAS 39?*

We strongly support including loan commitments within the scope of IAS 39 when those commitments can be settled net in cash (or by delivery of some other financial instrument), by selling the resulting loans shortly after origination, or when the loan commitment has otherwise been designated as held for trading.

While we believe a loan commitment meets the definition of a derivative from a lender's perspective, such a commitment does not meet the definition of a derivative from a borrower's perspective. This is because the borrower does not have the lender's ability to realise the economic value of the commitment by assigning its rights and obligations to others. From the borrower's perspective there are no net settlement characteristics—the commitment must be physically settled by the borrower incurring a liability that is not readily convertible into cash.

For example, consider a circumstance in which a borrower's credit deteriorates and it has an outstanding loan commitment. The borrower must decide whether or not to borrow. If it borrows, the underlying loan's fair value may be less than its book value, but the borrower cannot realise this value unless it can repurchase the loan at fair value. However, a troubled company typically does not have the ability to finance the repurchase.

We believe this asymmetry between lenders and borrowers makes sense because the economic consequences of the loan commitment are different for lenders and borrowers: Lenders can readily transfer their positions while borrowers cannot. Therefore, we believe borrowers should not be required to account for loan commitments as derivative financial instruments. We suggest this point be made explicit in the standard.

Question 2 ¾ Derecognition: continuing involvement approach (paragraphs 35-57). *Do you agree that the proposed continuing involvement approach should be established as the principle for derecognition of financial assets under IAS 39? If not, what approach would you propose?*

We disagree with the proposed continuing involvement approach to derecognition of financial assets. The accounting for financial asset derecognition is a complex area (as evidenced by the myriad implementation issues faced in the United States under FAS 140 and in the United Kingdom under FRS 5). We believe the continuing involvement model is likely to create a similar set of implementation issues. In fact, many such issues are raised in the LIBA, ISDA, and ESF letters we referred to in the introduction to this letter. Rather than reiterate those implementation issues, we urge the Board to consider carefully those issues when re-deliberating the Exposure Draft and to assess whether the continuing involvement model is sufficiently superior to existing models to justify global accounting standard divergence and the inevitable implementation issues it will create.

The Board acknowledges in paragraph C47 that the "proposed amendments are not intended to preclude longer-term debate about whether additional or different criteria should be applied in determining when a financial asset should be derecognised. The IASB will continue to consider the conceptual issues related to derecognition as part of future projects."

Rather than impose an unfinished accounting model for financial asset derecognition, we urge the Board to work together with national standard setters in countries with well-developed securitization markets to develop a single, global model for financial asset derecognition. As an interim step, we believe the Board should eliminate the conceptual inconsistencies in the current IAS 39 and re-expose the Exposure Draft if the Board rejects the continuing involvement model as we suggest.

Question 3 ¾ Derecognition: pass-through arrangements (paragraph 41). *Do you agree that assets transferred under pass-through arrangements where the cash flows are passed through from one entity to another (such as from a special purpose entity to an investor) should qualify for derecognition based on the conditions set out in paragraph 41 of the Exposure Draft?*

We believe it is not possible to address derecognition without simultaneously addressing consolidation of special purpose entities ("SPEs"). We believe a standard on derecognition of financial instruments that does not address consolidation of SPEs in an integrated manner cannot be complete. The Board has on its agenda a project on consolidations (including special-purpose entities), and we urge the Board to consider the interaction of financial instrument derecognition and consolidation as a matter of urgency. In particular, we wish to emphasise that we do not believe the "pass-through" rules in IAS 39 are an acceptable alternative to a comprehensive consolidation model that encompasses SPEs.

If the Board proceeds with the pass-through rules we suggest the Board clarify what the assets and liabilities of a pass-through conduit would be. Assuming the requirements of a pass-through arrangement are satisfied, and the assets are transferred to an SPE that issues securities collateralised by the transferred assets, we understand the SPE would reflect no assets or liabilities. If the transferor has derecognised the assets, the pass-through SPE does not recognise the assets, and the investor accounts for its SPE security investment, it is our understanding the transferred assets are not recorded by any party to the structure. This does not appear conceptually sound. We suggest additional guidance on pass-through arrangements be provided, preferably in the form of a comprehensive example to assist entities in preparing financial statements.

Question 4 ¾ Measurement: fair value designation (paragraph 10). *Do you agree that an entity should be permitted to designate any financial instrument irrevocably at initial recognition as an instrument that is measured at fair value with changes in fair value recognised in profit or loss?*

We support the principle that an entity can designate any financial instrument at initial recognition as held for trading and thus measure it at fair value recognising any changes in profit or loss. We consider fair value to be the most appropriate measure of financial instruments and support movement to a full fair value model.

Question 5¾ Fair value measurement considerations (paragraphs 95-100D). *Do you agree with the requirements about how to determine fair values that have been included in paragraphs 95 ¾100D of the Exposure Draft? Additional guidance is included in paragraphs A32 ¾A42 of Appendix A. Do you have any suggestions for additional requirements or guidance?*

Similar to our comments on the derecognition provisions of the Exposure Draft, rather than promulgate temporary rules for determining fair value, we suggest the Board work with other national standard-setting bodies to coordinate the efforts in this area to promote global convergence of accounting standards. Specifically, the FASB currently has on its agenda a project to replace FAS 107 with a new Statement that would describe more specifically how to determine fair value for financial instruments and improve the form and content of the disclosures. We believe financial statement users and preparers would be best served if the Board and FASB devoted their resources to developing a consistent set of guidelines for determining fair value.

Should the Board not choose to follow this approach, we have the following comments on the Exposure Draft's positions.

Fair value hierarchy. The Exposure Draft's proposed guidance regarding fair value is based on a pricing hierarchy that asserts the best evidence of fair value first is a published price quotation in an active market, next a recent market transaction between knowledgeable, willing parties in an arm's length transaction and, finally, a valuation technique. We believe the Exposure Draft's proposed fair value hierarchy is too prescriptive because there are circumstances when accurate pricing involves judgment and market knowledge. In these cases, the use of the hierarchy could result in the estimation of an inappropriate fair value.

The objective of fair value is to determine an estimated price that would have been received or paid if positions had been sold, exchanged, or settled on the measurement date in a current transaction between willing parties, other than in a forced or liquidation sale. For many financial instruments, listed prices such as those quoted for equity securities on exchanges do not exist. However, participants in the capital markets often are able to obtain market information about recent transactions and model inputs through a variety of means:

- Exchange or listed markets ¾ Financial assets are traded in an auction market and prices are readily available.
- Dealer markets ¾ Dealers stand ready to trade for their own account.
- Brokered markets ¾ Brokers attempt to match buyers and sellers but do not stand ready to trade.
- Principal to principal markets ¾ Negotiated independently with no intermediary and little if any public information is released.

Through these market structures most price discovery occurs. In the derivatives market, valuation is most appropriately performed on a portfolio basis, and market convention is to quote market inputs (e.g., bid-ask spreads for a given forward curve) rather than quote the actual price of the instrument. Entities then incorporate the quoted inputs into valuation methodologies and modeling techniques for purposes of deriving fair value. Critical to this approach is a practice of applying these model inputs throughout the portfolio so valuation is done on a consistent basis.

Current accounting literature recognizes the use of valuation models. In the United States, FAS 107 provides examples of procedures for estimating fair value that include estimation when there are no quoted prices and indicates the use of pricing models is appropriate. Paragraph 25 specifically provides valuation guidance for the more complex, "custom tailored" financial instruments. FAS 140, paragraph 69, elaborates on these concepts stating: "If quoted market prices are not available, the estimate of fair value shall be based on the best information available in the circumstances."

Derivative contracts are typically valued based on models. This is because valuation methodologies based on multiple market inputs are deemed more reliable than subjectively adjusting quotes obtained for similar instruments. These models estimate fair value using forward curves that are based on interest rates and other relevant indices/prices observable in the market. Variables include current price levels, credit worthiness of the counterparty, liquidity and size of the transaction, complexity, dealer margin, value of similar contracts, observable economic factors and implied inputs (e.g., volatility) from recent representative transactions.

Listed prices for specific derivative contracts may not be available. However, the fact that valid market inputs and market information are available for estimating fair value should not be discounted. In fact, market participants observe current market transactions with similar terms and counterparties and observe market inputs for use in valuation models.

Portfolio valuation methodology. Following is a suggested approach to determining portfolio valuation. However, underlying this approach is the principle that the best information available should be used to arrive at the entity's estimate of fair value. Thus, the following should not be interpreted as a strict hierarchy if there is evidence to suggest that one approach is superior to another in determining fair value.

- Prices or inputs observed in liquid, active markets always should be the primary source for valuation; e.g., electronic quotations or published prices.

- When prices or inputs cannot be discovered from liquid, active markets, prices or inputs observed in less liquid markets should be used; e.g., broker quotes or market transactions.

- When prices or inputs cannot be discovered from the above approaches, prices or inputs from similar instruments should be used, with adjustments for identifiable differences

between the reference valuation and the similar instrument; e.g., observed spreads between similar markets.

- When prices or inputs cannot be discovered from the above approaches (e.g., because the portfolio includes long-dated contracts), prices or inputs may be constructed if supported by historical observations or statistical analyses that are rational and reasonably expected to persist (e.g., correlations between components of the term structure, seasonal patterns).

- When prices or inputs cannot be discovered or constructed from the above approaches, the price or input implied from the most recent transaction is likely to be the best indicator of fair value, taking into account the size of the transaction and absent observable market movements that could reasonably be expected to impact the price or input.

Blockage factors. We disagree with the proposition in paragraph 99 that "[t]he fair value of a portfolio of financial instruments is the product of the number of units of the instrument and its quoted market price." The implication of this amendment would be that when an entity holds a large block of an otherwise unrestricted security for which a quoted market price on an active market is available, it would be precluded from discounting the market price of that security for the purposes of determining the fair value of its holding. Such discounts are commonly referred to as "block" or "liquidity" discounts.

We believe block discounts are necessary to appropriately reflect the fair value of a large block of shares because an attempt to sell the entire position at once would significantly affect the security's quoted market price. In an exchange market the quoted market price of a security actually is the last sale price for the quantity traded, which typically was not a block of shares. By virtue of the basic economic principles of supply and demand, an institutional block trade will move the price of a stock. Such "price impact" occurs because the seller has to move the market away from its last sale to find the price at which demand exists for the full size of the block.

Our institutional experience demonstrates that liquidating a large block over a relatively short period of time will depress the market price. Perhaps the clearest example of this is a situation in which, in our capacity as a broker-dealer, we enter into a block trade as facilitation for a customer who wants to sell a large block of securities and will avail itself of our ability to place the block to our institutional customers. Based on our experience, purchases and sales of block trades can be at prices that are significantly different from the quoted market price for the security.

Thus, in valuing the block of securities prior to liquidation, we believe it is appropriate to factor in the discount to the quoted market price. If we were to do otherwise, we would write the block up to quoted market value, and realise an immediate gain on acquisition, only to incur a loss shortly thereafter when the position is sold to our institutional customers.

We understand one of the Board's concerns with block discounts may center on the perceived subjectivity of the discount. However, we take issue with an approach that would require entities to value a security at a price they know is not indicative of fair value, merely for the sake of objectivity. To do so would be misleading to investors.

Question 6 ¾ Collective evaluation of impairment (paragraphs 112 and 113A-113D). *Do you agree that a loan asset or other financial asset measured at amortised cost that has been individually assessed for impairment and found not to be individually impaired should be included in a group of assets with similar credit risk characteristics that are collectively*

evaluated for impairment? Do you agree with the methodology for measuring such impairment in paragraphs 113A- 113D?

We agree with this approach because it brings IAS 39 in line with FAS 114 and its supplementary guidance.

Question 7 ¾ Impairment of investments in available-for-sale financial assets (paragraphs 117-119). *Do you agree that impairment losses for investments in debt and equity instruments that are classified as available for sale should not be reversed?*

We agree with this approach because it brings IAS 39 in line with FAS 115.

Question 8 ¾ Hedges of firm commitments (paragraphs 137 and 140). *Do you agree that a hedge of an unrecognised firm commitment (a fair value exposure) should be accounted for as a fair value hedge instead of a cash flow hedge as it is at present?*

We agree with the Exposure Draft because it brings IAS 39 closer in line with FAS 133. However, we believe an entity should be permitted to account for a foreign currency hedge of a firm commitment either as a cash flow hedge or as a fair value hedge. This would then be fully consistent with FAS 133.

Question 9 ¾ 'Basis adjustments' (paragraph 160). *Do you agree that when a hedged forecast transaction results in an asset or liability, the cumulative gain or loss that had previously been recognised directly in equity should remain in equity and be released from equity consistently with the reporting of gains or losses on the hedged asset or liability?*

We agree with this approach because it brings IAS 39 in line with FAS 133.

Question 10 ¾ Prior derecognition transactions (paragraph 171B). *Do you agree that a financial asset that was derecognised under the previous derecognition requirements in IAS 39 should be recognised as a financial asset on transition to the revised Standard if the asset would not have been derecognised under the revised derecognition requirements (i.e. that prior derecognition transactions should not be grandfathered)? Alternatively, should prior derecognition transactions be grandfathered and disclosure be required of the balances that would have been recognised had the new requirements been applied?*

If a financial asset was derecognised in accordance with accounting rules that existed at the time, the entity may not have retained the information required to identify and accurately rerecognise those assets in their financial statements. Accordingly, we believe prior derecognition transactions should be grandfathered.

Other IAS 39 Comments

- **Assumption of perfect effectiveness (paragraph 151).**

  In our experience, paragraph 151 has created diversity in practice. One interpretation assumes there is no perfect effectiveness, even when the critical terms of the hedging instrument and hedged item are perfectly matched.

  We suggest paragraph 151 be amended to permit such an assumption. If the critical terms of the hedging instrument and the hedged item are perfectly matched, we believe an entity should be permitted to assume no ineffectiveness. We see no reason to require an entity to perform time consuming and costly exercises of proving hedge effectiveness when the critical terms match. Inclusion of an assumption of perfect effectiveness would

not only promote convergence between IAS 39 and FAS 133, but importantly would make hedge accounting more accessible to entities applying IAS and encourage entities to use "perfect" hedges.

In addition, paragraph 151 has an example of hedging with a forward contract when assuming perfect effectiveness. This has been interpreted to mean other hedges (e.g., of interest rate risk) are not eligible for similar treatment. This is partly founded in IGC 147-1, which states an entity may not assume perfect effectiveness. This IGC thus contradicts paragraph 151 of IAS 39. We suggest the Board clarify what conditions are required to assume perfect effectiveness. We suggest the IGC be amended to permit the assumption of perfect effectiveness and incorporated into the body of IAS 39.

- **Financial Guarantee Contracts (paragraph 1(f)).**

We believe using IAS 39 to initially measure a financial guarantee and using IAS 37 to subsequently measure such a guarantee raises implementation issues. The measurement guidance in IAS 37 is not consistent with the fair value measurement guidance provided in IAS 39. We suggest the Board provide an example of the accounting for a financial guarantee contract in the appendix to IAS 39, both from the view of the holder of the guarantee as well as the issuer.

- **Embedded derivatives (paragraph 22, A4).**

Paragraphs 22 and A4 appear to refer to puttable reset securities. In these structures an issuer issues a bond to a holder with an embedded put option. Simultaneously with the bond issue, the bondholder writes a call option to an investment bank. The terms of the call option and the put option may be identical (i.e., same maturity date, strike rate, underlying). The effect of the options is as follows:

- If market interest rates increase, the fair value of the bond (absent the effect of the put option) will decrease. The put option is in the money; therefore, the investors will put the bonds to the issuer.
- If market interest rates decrease, the fair value of the bond (absent the effect of the call option) will increase. The call option is in the money; therefore, the investment bank will call the bonds from investors and resell the repriced bonds in the market at a premium.

Paragraph A4 implies that if the holder of a debt instrument writes a call option on that debt instrument to an investment bank, this affects the accounting by the issuer of the same debt instrument. The issuer then must determine whether there is an embedded derivative in the original debt instrument. We have two concerns with this treatment.

Firstly, it contradicts the definition of an embedded derivative. To determine whether the issuer has an embedded derivative in the bond that it has issued, the issuer should apply paragraph 22:

> *… A derivative that is attached to a financial instrument but is contractually transferable independently of that instrument, or has a different counterparty from that instrument, is not an embedded derivative, but a separate financial instrument.*

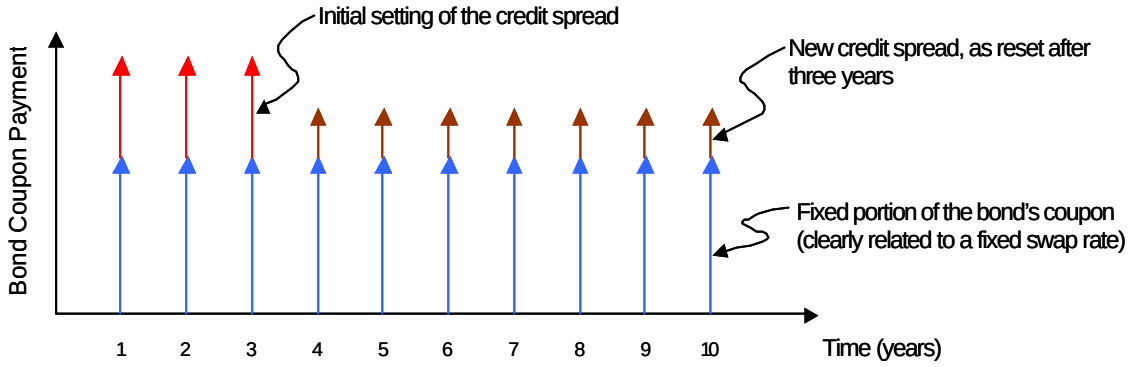
The call option meets the criterion in the above paragraph and hence cannot be included in the definition of an embedded derivative. That is, the new paragraph contradicts the definition of an embedded derivative. The new paragraph may result in the issuer

accounting for a bond with an embedded call option when the issuer is not a party to the call option. The accounting treatment is conceptually incorrect, as it requires the issuer to account for a call option to which it is not a party.

Secondly, if one views the bond as a credit spread floater, it becomes clear the call option written by the holder to the bank has no impact on the issuer. This is best illustrated in an example. The example will show how a simplified puttable reset security, from the issuer's perspective, is simply a puttable bond with a floating interest rate.

Consider an example of a 10-year puttable reset security, puttable after year 3, and callable by the investment bank at the same time as it becomes puttable. Assume there is only one reset date – the first put date. The same principle holds for multiple reset dates. The structure can be depicted as follows:

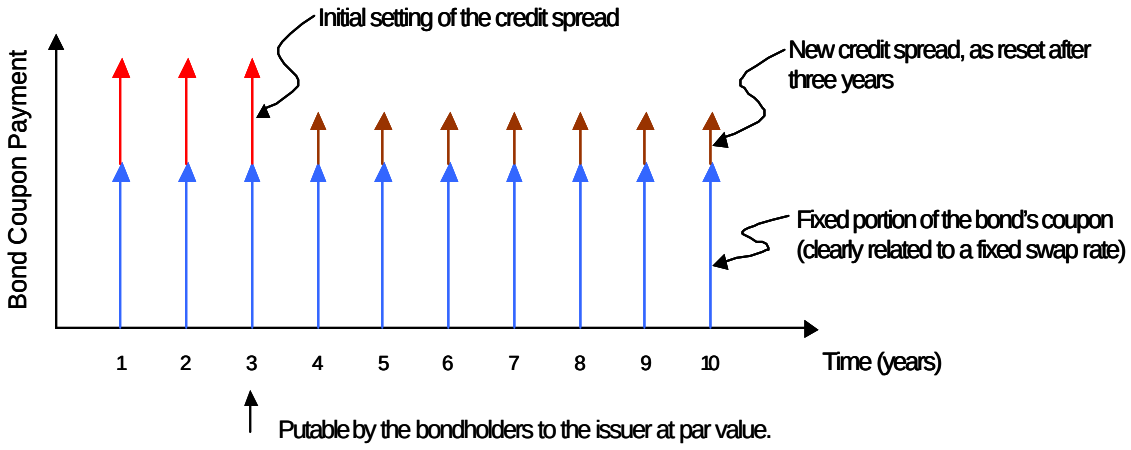
STEP 1: Start with a 10-year bond whose credit spread resets at the end of year 3:



Economically, the coupon is set at a fixed rate for the first 3 years and at the end of year 3 the coupon will reset to a new rate based on the issuer's credit spread at year 3.

Accounting analysis. This is a bond with a stepped interest coupon, the coupon contingent on the credit spread of the issuer at the time of reset. There are no embedded derivatives in this bond (because the reset is based on the issuer's own credit and hence is closely related) and it is accounted for in the same manner as any bond that has coupons contingent on some closely related factor.

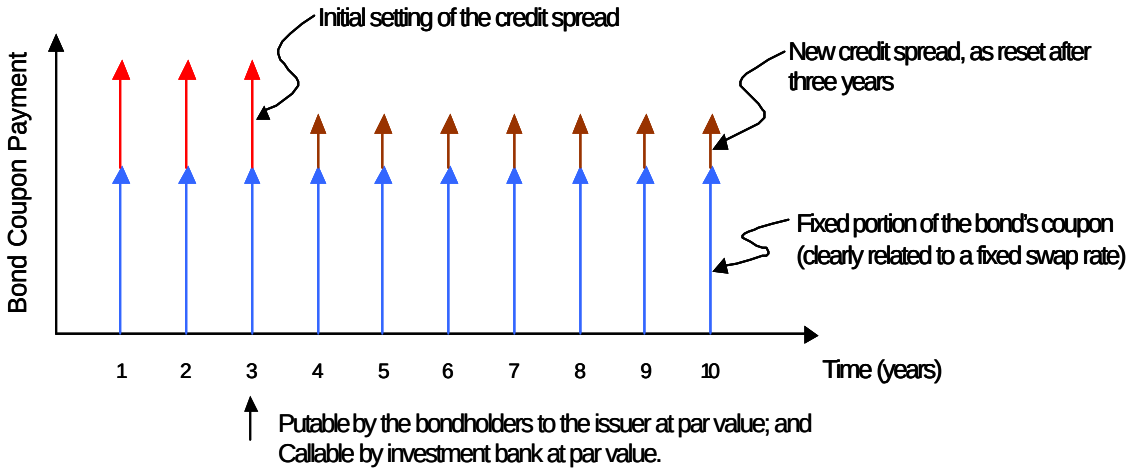
STEP 2: A 10 year bond whose credit spread resets at the end of year 3 AND the bond is puttable by the holder at year 3:



Economically, the coupon is set at a fixed rate for the first 3 years and at the end of year 3 the coupon will reset to a new rate based on the issuer's credit spread at year 3. If market interest rates increase by year 3 the fair value of the bond (absent the effect of the put option) will decrease. The put option is in the money; therefore, the investors will put the bonds to the issuer. Alternatively, if market interest rates decrease by year 3, the fair value of the bond will increase. The put option is out of the money; therefore, the investors will not put the bond back to the issuer. The bond will remain outstanding until year 10 and have a coupon based on the issuer's credit spread at the reset date

Accounting analysis. This is the same bond as in STEP 1 but it is now puttable. The put option needs to be evaluated under IAS 39 to determine whether the bond is puttable at an amount significantly different from its accreted amount. This example assumes the bond is puttable at par (which is generally how such bonds are structured in practice). Thus the bond will have a carrying amount of par at the put date. Hence there is no embedded derivative that requires bifurcation by the issuer as there is no substantial difference between the carrying value of the bond at the put date and the amount at which the bond is puttable. The accounting would thus be the same as for the bond in STEP 1; i.e., there are no embedded derivatives that require separate accounting.

STEP 3: A 10 year bond whose credit spread resets at the end of year 3 AND the bond is puttable by the holder at year 3 AND is callable by a bank at year 3



Economically, the coupon is set at a fixed rate for the first 3 years and at the end of year 3 the coupon will reset to a new rate based on the issuer's credit spread at year 3. If market interest rates increase by year 3 the fair value of the bond (absent the effect of the put option) will decrease. The put option is in the money; therefore, the investors will put the bonds to the issuer. Alternatively, if market interest rates decrease, the fair value of the bond (absent the effect of the call option) will increase. The call option is in the money; therefore, the investment bank will call the bonds from investors and resell the repriced bonds in the market at a premium. The bond will thus remain outstanding until year 10, and have a coupon based on the issuer's credit spread at the reset date.

Accounting analysis. This is the same bond as in STEP 2 but it is now callable on the put date by the investment bank. The call option is not an embedded derivative from the perspective of the issuer, as it is not party to the call option. The call option also has no effect on the issuer. At the put date, if the holder does not put the bond back to the issuer, it will be called by the investment bank and remarketed. The remarketing will result in the coupon on the bond resetting to the same rate to which it would have reset in STEP 1 and STEP 2. Hence nothing has changed from the issuer's perspective from STEP 2, and

hence the accounting should be the same as for STEP 2 (where we have previously illustrated that there is no embedded derivative).

It is thus very difficult to understand why the issuer has a term extension option in the bond that may be required to be bifurcated. Furthermore, it is difficult to see why the Board would develop a model different from that developed by the FASB to account for such securities.

The FASB invested resources in researching this accounting issue and has posted very clear guidance in DIG Issue B13. This guidance has been successfully applied in the US and has also been applied under IAS, in the absence of any guidance to the contrary. If the FASB has already developed a model that is conceptually sound and easy to implement, we find it difficult to understand why the Board would post difference guidance. Convergence is an issue high on the Board's agenda and in this particular case it would be easy to achieve by converging to the FASB model.

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Thank you for the opportunity to provide you with our feedback. If you have any questions regarding our comments, please do not hesitate to contact either Stephen Davies in London at 0207-774-3804 or me at 212-357-8437.

Sincerely,

/s/ Matthew L. Schroeder
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Managing Director
Director of Accounting Policy

/s/ Stephen Davies
Stephen Davies
Managing Director
European Controller

Cc: Russel Botha
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