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15 July 2004

Sandra Thompson
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By email to: CommentLetters@iasb.org.uk

Dear Sandra

Exposure Draft - The Fair Value Option

I am writing on behalf of the London Investment Banking Association (LIBA) to comment on the latest IASB Exposure Draft of amendments to IAS 39 – The Fair Value Option, which was published on 1 April. LIBA is, as you know, the principal UK trade association for investment banks and securities houses; a full list of our members is attached.

Financial instruments form a key component of the European business activities of the majority of LIBA members. We have therefore closely followed, and have in large measure supported, the IASB work on accounting for financial instruments and are very pleased to have the opportunity to comment on this important further Exposure Draft.

In our 14 October 2002 comment letter on the Exposure Draft of Proposed Amendments to IAS 32 and IAS 39, we strongly supported 'the Board's decision to allow an entity to designate any financial instrument as held for trading'. We are, accordingly, strongly supportive of the fair value option as incorporated by the Board into last December's final revised standard, and are very disappointed that the Board is now proposing to amend this accounting guidance.

LIBA considers the fair value option to be a key cornerstone of the revised IAS 39. To quote again from our 2002 comment letter, 'we believe fair value is the appropriate measure for many financial instruments and we applaud the Board's pragmatic solution to the current mixed measurement model'. We consider the fair value option to be a very progressive and innovative step forward in accounting for financial instruments and we are concerned that changing such a key component of the revised IAS 39 will trigger a range of knock-on consequences, including the appropriateness of the current definition of 'held for trading'.

We appreciate that the Board has been under considerable pressure from a number of bodies to make further changes to the revised standards and LIBA is sympathetic to, and supportive of, an iterative approach to accounting development, provided that this is constructive. However, some of the concerns that resulted in these most recent proposals appear to arise more from issues of corporate governance in an organisation, rather than from the drafting of the accounting standards themselves. If the fair value option is applied by organisations in a sensible and responsible manner, we believe it allows financial accounting to more closely reflect risk management and will result in reduced, not increased, volatility of earnings. We do not believe these concerns justify moving away from the Board's concept of a 'stable platform' for 2005. Making such changes at this late stage is, furthermore, causing most of our members significant difficulties in implementing their changed accounting framework for the end of this year.

LIBA and its members were also closely involved in advising on the redrafting of the fair value measurement considerations in the revised standard. Although we still have concerns about certain aspects of the drafting in the final standard, we believe there should not be two tiers of fair value measurement guidance, and that the guidance in the revised standard should be applied consistently to all financial instruments. Where organisations apply such accounting guidance appropriately, there should be no need for an additional standard of verifiability for the fair value of a financial instrument, just because it falls into a different financial reporting category.

Set out below are our responses to the specific questions raised in the Exposure Draft. Overall, LIBA is not supportive at all of the proposals in the Exposure Draft for Amendments to The Fair Value Option.

Q1 *Do you agree with the proposals in this Exposure Draft? If not, why not? What changes do you propose and why?*

As explained above, we do not support the proposals in this Exposure Draft.

The Fair Value Option allowed entities to ensure their financial reporting more closely reflected their risk management policies without having to apply a rigid application of the definition of 'held for trading', or the detailed hedge accounting requirements. As long as risk was being managed appropriately, the Fair Value Option provided entities with the opportunity to reduce earnings volatility caused by the accounting mixed measurement model. We do not see any benefit in restricting an accounting treatment that, if applied in a sensible way, produces a superior financial reporting result.

Q2 *Are you aware of any financial instruments to which entities are applying, or are intending to apply, the fair value option that would not be eligible for the option if it were revised as set out in this Exposure Draft? If so:*

(a) please give details of the instrument(s) and why it (they) would not be eligible.

(b) is the fair value of the instrument(s) verifiable (see paragraph 48B) and if not, why not?

(c) how would applying the fair value option to the instrument(s) simplify the practical application of IAS 39?

As covered in our response to Question 4, the ability under the current drafting of the exposure draft to fair value any financial instrument with an embedded derivative, irrespective of whether it is closely related to the host contract or not, should enable many financial instruments to still fall into the scope of the fair value option. The first two examples below have been included to reflect the hopefully unlikely situation that this exemption is restricted in any way in the final amendment, as in both scenarios the financial instruments will have embedded derivatives, but these derivatives may not require separation.

<u>Example 1</u>

An entity may choose to hedge elements of its credit exposure in a portfolio of loan receivables by entering into a series of credit default swaps that have an expected risk profile similar to the expected credit risk inherent in the loan portfolio. The Fair Value Option would have enabled these entities to fair value the loan receivables, thereby reducing the earnings volatility caused by the accounting mismatch of only being able to mark to market the derivatives. Although the intention of the hedging strategy will be to offset changes in the fair value of the loan portfolio, it is unlikely that this offset will be to a level that would meet the 'substantially offset' criteria in these proposals, or the effectiveness testing requirements of hedge accounting.

We do not understand what logic supports an accounting framework that allows either no or full earnings volatility, with no capacity to support partial earnings volatility that is reflective of the risk management policies that the entity is maintaining.

<u>Example 2</u>

Accounting for structured notes can be difficult, and trying to determine whether or not an embedded derivative requires separation often has a key bearing on the structuring of certain complex note issuances, such as range accrual notes. Under the original IAS 39, relatively arbitrary differences in the terms of the derivative caused note issuances to be accounted for in different ways, and significant analysis was required to determine what the embedded derivative actually was and whether it met the requirements for separation. Under the current fair value option, all structured note issuances can be accounted for at fair value, irrespective of the detailed terms of the financial instrument. As well as this being significantly easier to apply, this accounting treatment can result in consistent reporting for essentially similar instruments, which was not possible under the original standard.

<u>Example 3</u>

An entity may choose to hedge its risk on a more dynamic basis than would qualify for hedge accounting. For example, an entity may choose not to hedge exposures on a one on one basis at the outset of the transaction, in order to take advantage of current market conditions. The entity may consider it more beneficial to enter into derivative transactions to cover certain risks on a more combined basis, and/or to delay for a short time entering into derivative hedges rather than purchasing the instruments concurrently with the hedged transaction. Measuring all such financial instruments at fair value will truly reflect the risk management practices of the entity and will show more clearly any fair value risk that the entity is choosing to carry.

Q3 *Do the proposals contained in this Exposure Draft appropriately limit the use of the fair value option so as to address adequately the concerns set out in paragraph BC9? If not, how would you further limit the use of the option and why?*

We do not believe the fair value option should be limited in any way.

Q4 *Is the proposal in paragraph 9(b)(i) appropriate? If not, should this category be limited to a financial asset or financial liability containing one or more embedded derivatives that paragraph 11 of IAS 39 requires to be separated?*

As LIBA does not support any limitation on the use of the fair value option, we would support anything within these proposals that still enables some level of use of the option. We would therefore support not restricting the fair value option just to those instruments for which the embedded derivative requires separation. However, we would caution the Board that this proposal is likely to result in entities being able to take a very broad view of what a derivative actually is. For the majority of financial instruments (here specifically loans, receivables and liabilities), it could be deemed that an embedded derivative of some form exists. As mentioned above, identifying embedded derivatives can be difficult and determining whether or not such derivatives should be considered as closely related to the host contract or not can become very arbitrary. We do not support accounting requirements where arbitrary differences in the terms of a financial instrument result in different accounting results.

Q5 *Are (the) proposed transitional requirements appropriate? If not, what changes do you propose and why? Specifically, should all changes to the measurement basis of a financial asset or financial liability that result from adopting the amendments proposed in this Exposure Draft be applied retrospectively by restating the comparative financial statements?*

Applying restrictions to the fair value option on a prospective basis only is likely to cause significant issues. As the starting point for the new measurement basis of the debt host component will be the fair value of that component at the point of transition, this will result in a subsequent accretion of the discount or premium that is unlikely to bear any resemblance to the original terms of the instrument. There are also likely to be significant issues if the entity wants to revert back to, or establish, hedge accounting for the financial instrument. We would therefore support at least the option to apply any revised requirements on a fully retrospective basis.

Q6 Do you have any other comments on the proposals?

The Verifiability Test

LIBA strongly supports all the comments raised in paragraphs AV1-7 – the Alternative Views on the proposed amendments. In particular, we strongly agree with the view expressed in AV4 that it is not appropriate to have a dual standard for the determination of fair value for financial instruments, as would follow from the proposed new paragraph 48A.

Definition of Held for Trading

If the Board decides to implement the proposed amendment, we would also expect the Board to reconsider the definition of 'held for trading'. This definition had far less importance in the 2002 Exposure Draft of the Amendments to IAS 39, as any financial instrument at that stage could be designated as under this category. The proposed amendment to the fair value option would require entities to consider far more closely whether or not a financial instrument can or should be included within the held for trading category. This would not only cause significant practical difficulties for many of our members, but would also be likely to result in further differences between IAS and US GAAP.

Irreversible Designation

As the designation is irreversible, we see the potential for offsetting transactions that meet the requirement of 9b(iii) to be deliberately established and then one side of the transaction to be unwound at a later date, leaving the remaining financial instrument at fair value. This is unlikely to happen in an organisation with a strong risk management culture, but this would not prevent the concerns expressed by some that the fair value option could be used inappropriately to create volatility.

It is also unclear how the verifiable requirement links into this irreversible designation. At the inception of the transaction, it should be easier to prove that the fair value is verifiable, particularly given the existence of consideration paid or received. If, on a subsequent reporting date, the fair value can be reliably measured, but the fair value does not meet the stricter test of verifiable, how should the financial instrument be reported?

Prudential Supervisors

We strongly support the views expressed in AV7, believing that references to the requirements of prudential supervisors have no place in an accounting standard. Such requirements are best dealt with by the supervisors themselves, and any reference to the potential differences of certain requirements should, at most, be confined to the application guidance. We would also be extremely concerned if any prudential supervisors believed this reference gave them the ability to overrule accounting requirements for the purposes of financial reporting; we believe the oversight of application of these requirements is a matter for entities and their auditors, rather than for their prudential supervisor.

Substantially offset criteria
We struggle to understand how the substantially offset criteria will, in practice, be assessed any less rigorously than the onerous existing requirements for hedge accounting.

Conditions
The drafting of paragraph 9 is difficult to follow and potentially unclear. If it is the Board's intention (as indicated in AV 5) to only allow loans, receivables and liabilities to be carried at fair value if they meet one of the requirements in 9b (i) to (iii), it would be clearer to state this directly.

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I hope that the comments in this letter are helpful. We would of course be very pleased to expand on any particular points if there are aspects which you find unclear, or where you would like further details of our views.

Yours sincerely

Ian Harrison
Director

LONDON INVESTMENT BANKING ASSOCIATION

LIST OF MEMBERS

ABN AMRO Bank
Arbuthnot Latham & Co., Limited
Arbuthnot Securities Limited
BNP Paribas
Banc of America Securities Limited
Barclays Capital
Bear, Stearns International Limited
Bridgewell Group Limited
Cazenove & Co. Ltd
CIBC World Markets
Citigroup Inc.
Close Brothers Corporate Finance Ltd
Collins Stewart Limited
Commerzbank AG
Credit Suisse First Boston (Europe) Ltd
Daiwa Securities SMBC Europe Limited
Dawnay, Day & Co., Limited
Deutsche Bank AG London
Dresdner Kleinwort Wasserstein
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Goldman Sachs International
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15 July 2004