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Sir David Tweedie
Chairman IASB
30 Cannon Street
London EC4M 6XH
United Kingdom

12 July 2004

Re : Adoption of IAS 39: "*Financial Instruments: Recognition and Measurement* The Fair Value Option".

Dear David,

We are pleased to provide our comments on the Adoption of IAS 39 "*Financial Instruments: Recognition and Measurement* The Fair Value Option".

Please find herewith attached EFRAG's draft reply to the IASB document together with the comments of the OIC.

Yours sincerely

Prof. Angelo Provasoli
(OIC – Chairman)

Question 1

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

Draft Response

In our comment letter dated 18 October 2002 EFRAG welcomed the fair value option in so far as it simplified the application of IAS 39 and facilitated the use of natural hedges. We note that the exposure draft, limiting the use of the fair value option, has been introduced to address the concerns of prudential supervisors and other regulators. We have studied the proposals to see whether they achieve their objective efficiently and if not what alternatives can be put forward.

One effect of the current proposals is that the criteria that need to be met if a change in fair value is to be recognised immediately in the profit or loss now vary depending on whether the item is *required* to be accounted for at fair value through profit or loss or whether it is *permitted* to be accounted for at fair value through profit or loss. EFRAG does not believe that a convincing case has been made in the exposure draft for such “double standards” and is concerned that this will lead to considerable confusion and difficulties of application in practice. For instance, it should be noted that the *verifiable* notion does not exist in other areas of measuring fair values in IFRS.

The proposed limitations introduce the *verifiable* notion which is explained as a stricter test than the *reliable* notion. The Basis for Conclusions (BC 25) explains that the notion *verifiable* has been proposed by analogy to its usage by other standard setters, for example the US standard setter FASB. We were unable to reconcile the IASB’s proposed definition of *verifiable*, which we do not support, with the FASB definition of the term and fail to see how the FASB definition would result in a stricter test than the reliable notion. Following the quoted definition from FASB’s concept statement, we believe that such verifiability would need to be applied to any fair value measurement. We are therefore not persuaded by the IASB’s reasoning for the introduction of the *verifiable* notion. Furthermore, we consider the three examples (a – c), illustrating when the fair value option can be used, redundant since they are merely a repetition of the existing application guidance in IAS 39 (see AG 74 and 76).
In general, we believe that the use of the word *verifiable* in the attempt to introduce a stricter test than *reliable* is not achieving its objective because it is generally accepted that if something is reliable, it should also be verifiable.

More fundamentally, it is our understanding that the objectives of the proposed amendments (to address the inappropriate use of fair values, reduce volatility in profit or loss and avoid recognition of gains or losses in profit or loss for changes in an entity’s own creditworthiness) will not necessarily be met. For instance, where a debt instrument contains an embedded derivative, it would still be possible to apply the fair value option. Similarly, the original fair value option allows (partially) offsetting assets and liabilities to be accounted for in the same way while the proposed limitations introduce criteria such as “contractually linked” and “substantially offset” thereby reinstating some of the stringent hedge accounting rules. As a result, an entity could be required to measure certain items at amortised cost while (partially) offsetting items would need to be measured at fair value, leading to full accounting volatility, despite the fact that from an economic point of view a partial offset exists. Finally, because IAS 39 often mandates the use of fair value, an inappropriate application thereof cannot be excluded.

It is our understanding that the five criteria for applying the fair value option (paragraph 9 (b)) need to be read sequentially. This means for instance that a loan (excluded by the

fourth criterion) could be eligible for the fair value option as long as it contains an embedded derivative (criterion i) or is part of a natural hedge (criterion iii).
The proposals limit the December 2003 improvement of IAS 28 *Investments in Associates* as regards the option to measure investments in associates at fair value in accordance with IAS 39, with changes in fair value recognised in profit or loss in the period of the change. Such a limitation seems in conflict with the underlying reason for the IAS 28 option that fair value information is considered by the Board to be often readily available because fair value measurement is a well-established practice in the venture capital entities, mutual funds and unit trusts (see BC 7 of IAS 28).

EFRAG does not support the reference to prudential supervisors and other regulators because such a reference could lead some to believe that regulators have authority to amend or overrule IFRS for the purposes of financial reporting. While we note that the IASB stresses in its Basis for Conclusions that this is not the case, we do not support the reference to supervisors because EFRAG strongly believes that there should be a clear dividing line between IFRS and prudential requirements.

We support the IASB's attempt to accommodate the concerns raised by prudential supervisors and other regulators while trying to retain the main thrust of the original intention of the fair value option. Therefore, taking into account our comments, we recommend the IASB to reconsider its approach in meeting the concerns in order to make IAS 39 acceptable to those regulatory organisations.

OIC Response

OIC also welcomed the fair value option in so far as it simplified the application of IAS 39 and facilitated the use of "natural hedges", noting the concerns raised by prudential supervisors and other regulators, which have led to the issue of this exposure draft restricting the original proposal.

We agree in finding the proposals "rules based" and not effective in meeting their stated objectives (i) to address the use of inappropriate fair values, (ii) reduce volatility in profit or loss and (iii) avoid the recognition of gains or losses in profit or loss arising from changes in an entity's own creditworthiness. We are as well concerned that the limitation of the use of the fair value option can have the effect of reintroducing artificial volatility in cases of "natural hedges".

OIC also agrees with the statement that the proposed limitations introduce the *verifiable* notion which is explained as a stricter test than the *reliable* notion. We do also agree about the difficulty to reconcile the IASB's proposed definition of *verifiable*, with the FASB definition of the term and fail to see how the FASB definition would result in a stricter test than the reliable notion. Following the quoted definition from FASB's concept statement, we agree that such verifiability would need to be applied to any fair value measurement. Therefore we are also not persuaded by the IASB's reasoning for the introduction of the *verifiable* notion in the attempt to introduce a stricter test than *reliable.*
Moreover, the original fair value option allows instead partially offsetting assets and liabilities to be accounted for in the same way while the proposed limitations introduce criteria such as "contractually linked" and "substantially offset" thereby reinstating some of the stringent hedge accounting rules.

Question 2

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

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

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

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

Draft Response

It is our understanding that certain financial institutions intend to apply the fair value option to their loans in order to reduce accounting volatility. Further, certain (other) financial institutions intend to apply the fair value option to asset and liability positions that offset each other partially in order to reflect economic exposures and reduce accounting volatility. Under the proposed amendments such a designation would become subject to the stringent hedge accounting requirement of “substantial offset”. If the IASB were to adopt the proposed amendments, the “substantially offset” requirement should be replaced by “partially offset”. After all, it is our understanding that the 80% - 125% prospective effectiveness test does not apply in the case of the fair value option.

(N.B. While EFRAG is seeking comments on all the points raised in this letter, as well as any other concerns commentators might have, we explicitly ask commentators to let us know 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 the exposure draft.)

OIC Response

OIC also believes that certain financial institutions intend to apply the fair value option to asset and liability positions that offset each other partially, in order to reflect economic exposures and reduce accounting volatility. Under the proposed amendments such a designation would become subject to the stringent hedge accounting requirement of “substantial offset”. If the IASB were to adopt the proposed amendments, the “substantially offset” requirement should be replaced by “partially offset”.

In some other cases, it is true that some entities might intend to apply the fair value option to financial instruments that would not be eligible for the option if it were revised as set out in the exposure drafts. For instance:

Hybrid Instruments: The Fair Value Option contributes to avoiding the need to bifurcate embedded derivatives and, furthermore, to reducing the administrative burden associated with hedge accounting. The current bifurcation rules are overly complex. The cost and administrative burden associated with maintaining hedge documentation and effectiveness testing (both prospective and retrospective testing) are significant.

If the “verifiable” requirement would be introduced it would become doubtful if it is possible to designate hybrid instruments that do not qualify for bifurcation at fair value. The perverse effect might be that bifurcation would be needed but that it would not be allowed to measure the host contract itself at fair value.

Internal contracts: Often when hedging risk, internal contracts are utilized to exploit the internal market maker expertise, thereby minimizing transaction costs and counterparty exposures. These internal contracts are then accumulated within the centralized department (Treasury) which in turn passes the risk onwards to external parties. Under the IAS 39 rules internal contracts do not qualify for the special hedge accounting treatment.

Instead, as part of the documentation requirements, banks would need to link the internal contracts to the external contracts transacted.

The use of the fair value option would avoid this problem to a large extent since there is no requirement to link the internal contracts to the external contracts. The Fair Value Option enables economic hedges (which are disqualified under current hedge accounting rules due to the inability to document the internal-external contracts linkage) to be properly accounted for in the financial statements. As a result, volatility to the financial statements is reduced to a considerable extent.

Question 3

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

Draft Response

EFRAG is content with the original fair value option, since it simplifies the application of IAS 39 and facilitates the use of "natural hedges". Our comments on the means used to limit its application are mostly made in our response to Question 1. We would, however, point out that the proposed amendments do not specifically address the concern of recognition of gains or losses in profit or loss for changes in an entity's own creditworthiness (see BC9 (c)). For instance, as long as a debt instrument contains an embedded derivative, it will be possible to apply the fair value option.

OIC Response

OIC welcomed the fair value option since it simplified the application of IAS and facilitated the use of "natural hedges". For comments on the means used to limit its application, please refer to responses to questions 1 and 2.

Question 4

Paragraph 9(b)(i) proposes that the fair value option could be used for a financial asset or financial liability that contains one or more embedded derivatives, whether or not paragraph 11 of IAS 39 requires the embedded derivative to be separated. The Board proposes this category for the reasons set out in paragraphs BC6(a) and BC16-BC18 of the Basis for Conclusions on this Exposure Draft. However, the Board recognises that a substantial number of financial assets and financial liabilities contain embedded derivatives and, accordingly, a substantial number of financial assets and financial liabilities would qualify for the fair value option under this proposal.

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

Draft Response

Since we are in general supportive of the current fair value option because it eases the application of IAS 39 and allows the reduction of accounting volatility we do not favour any (further) restriction. As regards our comments on the proposed limitations, we refer to our response to question 1.

OIC Response

As already pointed out, OIC is supportive of the current fair value option which eases the application of IAS 39, reducing volatility. Therefore, OIC does not favour any other restriction. As regards our comments please refer to response to question 1.

Question 5

Paragraph 103A proposes that an entity that adopts early the December 2003 version of IAS 39 may change the financial assets and financial liabilities designated as at fair value through profit or loss from the beginning of the first period for which it adopts the amendments in this Exposure Draft. It also proposes that in the case of a financial asset or financial liability that was previously designated as at fair value through profit or loss but is no longer so designated:

- *(a) if the financial asset or financial liability is subsequently measured at cost or amortised cost, its fair value at the beginning of the period for which it ceases to be designated as at fair value through profit or loss is deemed to be its cost or amortised cost.*
- *(b) if the financial asset is subsequently classified as available for sale, any amounts previously recognised in profit or loss shall not be reclassified into the separate component of equity in which gains and losses on available-for-sale assets are recognised.*

However, in the case of a financial asset or financial liability that was not previously designated as at fair value through profit or loss, the entity shall restate the financial asset or financial liability using the new designation in the comparative financial statements.

Finally, this paragraph proposes that the entity shall disclose:

- *(a) for financial assets and financial liabilities newly designated as at fair value through profit or loss, their fair value and the classification and carrying amount in the previous financial statements.*
- *(b) for financial assets and financial liabilities no longer designated as at fair value through profit or loss, their fair value and the classification and carrying amount in the current financial statements.*

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

Draft Response

EFRAG supports the pragmatic approach as regards the transitional requirements – i.e. no retrospective application when an entity changes the measurement from *at fair value through profit and loss* to amortised cost.

OIC Response

OIC agrees with EFRAG in supporting the pragmatic approach as regards the transitional requirements, i.e. no retrospective application when an entity changes the measurement from *at fair value through profit and loss* to *amortised cost*.

Question 6

Do you have any other comments on the proposals?

Draft Response

If, despite our comments expressed above, the IASB decides to move forward with the introduction of the *verifiable* notion, we recommend that it should require companies to disclose information on how they have met the verifiability test (e.g. by obtaining several independent estimates).

OIC Response

OIC also agrees with EFRAG that if the IASB, despite the comments expressed above, should decide to introduce the verifiable notion, disclosing information on how entities have met the verifiability test would be required.