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IASB Fair Value Option Public Roundtables

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In advance of the roundtables the IASB posed the following 2 questions:

1. Does the tentative proposal address all situations in practice in which entities are likely to want to use the fair value option? If not, why not and what changes would you propose? Are there other examples that meet the proposed criteria, which should be included in the Application Guidance?
2. Is the tentative proposal operational? Does it provide effective guidance on when the option is available and, equally important, when it is not? If not, why not and what changes would you propose?

Insurance Session (08:30am – 10:30am, chaired by Warren McGregor, IASB)

The big insurers at the first session all supported the tentative proposals, with many stating a preference for the existing full FVO, but all able to live with the new wording. Aviva did not want any further changes to the wording perhaps jeopardizing this conclusion. Concerns were raised around the status of the FVO in phase II of the insurance project, with the US insurers rejecting the option over the long-term (issues over comparability, optionality in IFRS, and abuse were cited), preferring instead a new category of instrument they called “available for settlement”. This approach was supported by representation from Nippon Life, who also warned against the appropriateness of the proposals for phase II. The insurance regulators all supported the IASB in their work; with the Australian’s requesting further assistance in “mandating” the option (apparently in Australia FV is mandated across life and general insurance products). The IASB felt that it would not be appropriate to address individual jurisdictional concerns. Other concerns raised included the likely interpretation of “at inception”, the extent of the policy documentation required, whether there was a need for further examples to be included, and also the effective date of the amendments (where in the EU some urgency was requested). See the Banking session below for detail on all these topics.

Banking Session (11:00am – 1:00pm, chaired by Bob Garnet)

The European Banking Federation began by offering support for the IASB’s tentative proposals, favouring a longer term review of issues around “own credit” and a “components approach”. The

EBF did not express a view on the unfettered FVO in existing IAS 39. The South African representative, who had been applying this full FVO did, and stated that in their view no example existed of transactions where companies who were applying the option would be restricted in doing so by the new proposals. The Danish Mortgage banks also supported the proposals and felt that they had a fair chance of adoption by the EU. The Danish supervisors find the proposals workable. Both UBS and HSBC put their weight behind the new proposals, with an emphasis on using the option for structured products, but would be grateful for a few clarifications (see below).

At this point, ISDA were able to thank and congratulate the IASB on their work on the FVO, and support the new “principles-based” proposal. We did however take the opportunity to remind the IASB of our support for the full FVO, and our continued work in persuading other standard setters of its merits (particularly in the US). Of the regulators present, both the UK FSA and the Basel Committee were confident they could work with the new proposals, and were concerned with the uncertainty currently associated with IAS 39, urging the IASB to “push this forward as quickly as possible”. Industry representatives agreed with the need for a speedy amendment (with some half-yearly reports due soon after June), but the IASB warned participants that even if they were to complete their work by the end of June, the ultimate decision, at least in Europe, would be left to the politicians.

Participants went on to discuss more detailed aspects of the proposals, under question 2, many of whom sought some sort of clarification from the IASB in terms of what their original intentions were. ISDA spoke in favour of allowing the FVO to be applied to “proportions” of assets and liabilities (where the instrument is divisible, e.g. a loan that is securitized), and therefore made consistent with the hedge accounting provisions (see AGX5). We explained that without this amendment, you could end up with 2 different accounting treatments (FVs?) for a single originated loan versus two similar loans made for the same amount? Initially the issue was confused with “a components approach” to the FVO, but the IASB went on to point out that the new proposal was drafted on an “instrument-by-instrument” basis, not applicable to part of an instrument, and therefore applying the option to proportions would not be allowed.

We were also able to seek clarity on when the option could be applied (“at initial inception”), and asked for assistance in firm’s discussions with auditors. The IASB were able to clarify that “a reasonable period of time” in which liabilities are taken on, with assets subsequently electing the option would be acceptable, application of the option would therefore need to be flexible (e.g. time it takes to build up a portfolio). ISDA requested some additional wording in the guidance to this affect to help in discussions with auditors. The IASB were also able to clarify that they intended to draft 3 ways in which firms could get the FVO, eliminating/reducing a measurement mismatch, managing on a FV basis (business/risk management strategy/documentation), and in certain circumstances where you have structured products with embedded derivatives [9(b) (i), 9(b) (ii), or 11]. Thus, if the embedded derivative cannot be separated out (e.g. clearly and closely related, under p.11), but you do manage the instrument on a FV basis (9(b) (ii)), you could still apply the FVO.

ISDA asked for clarification of how AG33B para (b) would be applied when the analysis of a complex embedded derivative has already happened. The IASB staff explained that the fair

value option would be prohibited (unless para 9(b) applies) only if it had previously required “little or no analysis” to determine that the embedded was closely related. In other words, if it required substantial analysis to determine that an embedded is closely related, the fair value option may be applied.

Finally, there was a discussion around the minimum documentation requirements envisaged under 9(b) (ii), how much documentation was required and at what level, and whether the IASB intended to require new additional information to be compiled? It was made clear by the IASB, more than once, that they had no intention to judge firms documented risk management strategies, and imagined this to be “a business as usual type scenario” (they did not intend to create additional “hoops”). The EBF and ISDA felt that it would be helpful to include additional wording (perhaps encompassing a reference to “portfolio” level documentation) in the application guidance to prevent an unnecessary and burdensome transaction-by-transaction requirement emerging. The IASB chair closed the roundtable with a summary of likely next steps, including, further comment & analysis, a possible re-drafting, leading to a vote at the April Board meeting, which could result in a final standard by the end of June.

* Note on effective date and transition (see attached).

The IASB discussed the effective date and transition requirements of whatever amendment to the FVO they decided upon at Tuesday’s Board meeting (March 15th) the day before the public roundtables. The discussion lasted for over 1 ½ hrs, with the majority of Board members seemingly unclear as to what had been voted on. Tricia O’Malley gave a clearer version of events at the Board meeting during the first Insurance roundtable, splitting the likely requirements for firms into (i) existing users and (ii) those who were first time adopters. However, no further decisions were taken at the roundtables, and ISDA hopes that the IASB will share draft proposals with members before anything is finalized.

ENDS.