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Basel Committee on Banking Supervision
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Monday 31st October, 2005

Supervisory guidance on the use of the fair value option by banks under IFRS

Dear Prof Dr Schilder,

ISDA appreciates this opportunity to comment on the Consultative Document “Supervisory guidance on the use of the fair value option by banks under International Financial Reporting Standards” published in July 2005.

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 work on accounting for financial instruments.

ISDA fully supported the fair value option when it was introduced by the IASB, and we have actively encouraged the FASB to introduce similar guidance into US GAAP. The fair value option alleviates the potentially misleading earnings impact stemming from the mixed measurement model and strict hedge accounting rules of IAS 39. Under the mixed measurement model some financial assets are fair valued through profit or loss and others through equity, whilst other financial assets and almost all financial liabilities are carried on an amortised cost basis. The fair value option is therefore necessary to reduce volatility resulting from this asymmetric accounting and enables adopters to align the accounting treatment of financial transactions with the underlying business and risk management practices.

We appreciate that some regulators could have concerns that should an entity use the fair value option inappropriately, it may lead to an increase in the volatility of their reported profits. However, it is important to emphasize that prudent management would not seek to introduce unnecessary volatility in their reported results unless it reflects the economic substance of the transaction and is in accordance with its risk management policy, as volatility in earnings could increase the cost of new debt issuance and lead

to a lower equity price. Misuse of the fair value option is likely to occur only where there are wider issues with the governance and control structures within an organisation.

Nonetheless, we do understand there is a need to provide guidance to supervisors to help them understand the implications of the fair value option and enable them to consider whether the financial statements need to be adjusted for regulatory purposes. We have outlined below our potential concerns with the draft guidance that we consider should be addressed before it is finalised:

- ISDA strongly believes that there should be only one set of accounting principles governing how you arrive at fair value measurement for a financial asset or financial liability. IAS 39 already provides guidance that should be followed to determine the reliable fair value of a financial instrument, including those under the option to fair value, and many of our members are in the process of implementing this standard for the first time. We do not therefore support the concepts outlined in Paragraphs 20 and 31 as we are concerned that this guidance introduces additional criteria to determine what constitutes a “reliable” or “reliably measurable” fair value where a bank designates a financial instrument at fair value. Furthermore, we do not support the apparent extension in paragraph 20 (d) of this additional “reliable” concept to all other areas of the bank.
- In amending IAS 39 to restrict the use of the fair value option, the IASB developed a fair value option that is based on a set of principles rather than prescriptive rules. We therefore consider the detailed guidance outlined in Principle 1 to be unnecessary as a bank will only be able to apply the fair value option where in substance it is appropriate to designate the financial instrument at fair value through profit or loss. The expansion of this point in paragraph 14 that implies that hedge accounting should be used where possible in preference to the fair value option is not, in our opinion, part of the “substance” of what was intended by the IASB.
- Although we appreciate that the guidance states that it is primarily for supervisors and that it is not intended to introduce additional guidance for financial reporting beyond that established by the IASB, we are concerned the current wording suggests otherwise. This could in practice result in the creation of additional accounting rules. In particular, it could be inferred that Principles 1 through 3 are intended to apply to non-regulatory financial reporting and so provide accounting requirements in addition to those included in IAS 39. We would therefore ask the Committee to set out more clearly the purpose of the document and where it sees its responsibilities versus those of the accounting bodies.
- Principle 5 in the draft guidance states that supervisors should evaluate whether a bank’s internal financial analysis of counterparties considers the impact of the counterparty’s use of the fair value option. As worded, this gives a disproportionate emphasis to one aspect of the counterparty’s accounting policies. In our view, a bank’s financial analysis should not look at the counterparty’s use of the fair value option in isolation but should consider all its significant accounting policies along with other information generally available. We therefore would not support inclusion of this principle, as worded, in the final guidance.

The appendix to this letter sets out more detailed comments on each of the eight principles included in the draft guidance. We would be pleased to discuss our comments with the Accounting Task Force or BIS staff. Please contact either Melissa Allen at Credit Suisse or Ed Duncan at ISDA on +44 (207)330 3574.

Yours sincerely

A handwritten signature in black ink that reads "Melissa Allen". The signature is written in a cursive style with a large loop at the end of the last name.

Melissa Allen
Chair of ISDA's European Accounting Committee and European Head of New Business &
Technical Accounting Support, Credit Suisse

A handwritten signature in black ink that reads "Ed Duncan". The signature is written in a cursive style with a large loop at the end of the last name.

Ed Duncan
Director of European Policy at ISDA

Appendix

We have set out below our comments on the eight principles contained in the draft guidance that establishes the supervisory expectations relevant to the use of the fair value option for regulatory purposes.

Principle 1 - Supervisors expect a bank's application of the fair value option to meet the criteria set forth in IAS 39 in form and in substance.

IAS 39, as amended in December 2003, allowed entities to designate irrevocably at inception any financial instruments at fair value through profit or loss. To address the concerns raised by regulators, the IASB amended the fair value option and added conditions to allow the option to be applied only where:

- (a) such a designation eliminates or significantly reduces an accounting mismatch; or
- (b) a group of financial assets, financial liabilities or both are managed and their performance is evaluated on a fair value basis in accordance with a documented risk management or investment strategy; or
- (c) an instrument contains an embedded derivative that meets certain conditions.

In making these amendments the IASB has developed a fair value option that is based on a set of principles rather than prescriptive rules. We therefore consider the fair value option will only be used by financial institutions when it results in a presentation that reflects the economic substance of the underlying transaction. Accordingly, in our view the guidance provided in Principle 1, paragraphs 13-17, is unnecessary.

Paragraph 14 states that “although the fair value option presents an alternative to hedge accounting in many circumstances, the use of the fair value option may not always be perfectly interchangeable”. The guidance suggests that where the bank is seeking to hedge only one component of risk of the hedged item and not all risks, then the bank should consider whether hedge accounting is preferable to using the fair value option. We are concerned that this introduces a principle that was not intended when the IASB amended the fair value option and so is not in accordance with the substance of the revised standard. Further, we are concerned that this may be seen as establishing additional accounting requirements that must be satisfied prior to the use of the fair value option and could prohibit the use of the option in situations that are entirely appropriate.

It is important to emphasise that the fair value option was introduced in part to reduce the need for hedge accounting and the resulting cost, complexity and administrative burden. In our view, the IASB see the fair value option as an alternative, and even preferable, to applying hedge accounting.

It is also worth clarifying that there will be economic hedging relationships where the bank is seeking to hedge a single risk component that may not qualify for hedge accounting. Take, for example, the situation where an entity purchases a loan asset and hedges the credit risk with a Credit Default Swap (“CDS”). The transaction may not qualify for hedge accounting if the

change in fair value of the loan asset for the hedged risk (ie, the credit risk) is not highly effective in offsetting changes in the fair value of the CDS trade. This may be where there is an option to transfer either the loan asset or substitute a similar bond issued by the same counterparty upon default. At the time of default, an educated party would transfer the financial instrument that is cheaper to deliver. In this situation, if the bank was unable to apply the fair value option it may result in an increase in volatility in the reported profits as the derivative will be recorded at fair value whereas the loan will be recorded at amortised cost.

Paragraph 15 states that supervisors reserve the right to consider the manner in which management has interpreted the criteria of the fair value option and/or the adequacy of its risk management and controls as they pertain to the fair value option. The paragraph uses an example where a bank may have a substantial volume of hybrid contracts with embedded derivatives that significantly modify the cashflows of the host contract. Whilst we agree that supervisors will need to understand the use of the fair value option and the adequacy of risk management and control procedures, we are concerned that the detailed guidance provided may discourage the use of the fair value option even when it is entirely appropriate to designate an instrument at fair value through profit or loss. As outlined above, the fair value option is based on a series of principles and to ensure the option was not misused the IASB included an “anti-abuse provision” in the final guidance which means that an entity cannot apply the option to an instrument containing one or more embedded derivatives if it is clear with little or no analysis that separation is not required. This should prevent the inclusion of a small embedded derivative into any host contract just to enable an entity to apply the option to a hybrid instrument.

If the Committee has particular concerns that the IAS 39 anti-abuse provisions are inadequate, then it would be helpful to document these in the guidance.

Principle 2 - Supervisors expect banks to have in place appropriate risk management systems (including related risk management policies, procedures and controls) prior to initial application of the fair value option for a particular activity or purpose and on an ongoing basis.

We agree with the principle that supervisors should expect a bank to have in place appropriate risk management systems to control and monitor the use of the fair value option. However, we are concerned that the detailed guidance introduces criteria, in addition to that contained in IAS 39, to determine what is a “reliable” fair value (see our comments on Principle 3).

We are also concerned that the guidance suggests that the fair value option may result in increased volatility in earnings. Although, the use of the fair value option could lead to an increase in volatility, in practice it is more likely to reduce volatility as it will allow banks to align the accounting treatment of financial transactions with the underlying business and risk management practices. It is important to emphasise that prudent management would not seek to introduce unnecessary volatility in reported results without a sound risk management policy as volatility in earnings could increase the cost of debt issuance and lead to a lower equity price.

There are several key uses for the fair value option that will better reflect the bank’s activities and the substance of the transaction. Take the situation where a bank selects the fair value option because the financial instrument is managed on a fair value basis but it is not eligible for the relatively narrow definition of what may be classed as held for trading. Another example is

where a bank holds a non trading asset together with a derivative as part of a long term arbitrage structure. The bank would choose to hold the non trading asset at fair value so as to align the accounting with the substance of the transaction and thus reduce the accounting mismatch created. We would encourage the Committee to include in the guidance these or similar examples so that regulators can better understand how the fair value is likely to be used in practice.

Principle 3 - Supervisors expect banks to apply the fair value option only to instruments for which fair values can be reliably estimated.

This Principle suggests that banks should only apply the fair value option to instruments for which fair values can be reliably estimated. Paragraph 31 states that “if fair values cannot be reliably estimated for the financial instruments concerned, the Committee would strongly discourage the use of the option”. The guidance goes on to say that it would encourage “banks to apply the fair value option only to instruments for which they can ensure that the variability in the range of reasonable fair values is low”.

ISDA strongly believes that there should be only one set of accounting principles covering how you arrive at a fair value measurement for a financial asset or financial liability. IAS 39 already provides guidance that should be followed to determine the reliable fair value of a financial instrument, including those under the option to fair value, and many of our members are in the process of implementing this standard for the first time. The IASB invested a considerable amount of time working with the industry on the concept of fair value and we consider the existing guidance should be consistently applied to all financial instruments and is strict enough to prevent abuse.

It is important to emphasise that if a bank were unable to apply the fair value option to a hybrid instrument because the fair value is not reliable, they would still be required to separate the embedded derivative. As a result, the entity would still have to determine the fair value of the derivative which will normally be the most subjective part of the valuation of the hybrid instrument. Consequently, if the valuation is not “reliable” it will most likely be due to the valuation of the component that IAS 39 will still require to be recorded at fair value even if the fair value option is not used.

ISDA would therefore not support the concept outlined in Paragraphs 20 and 31 as we are concerned this introduces additional accounting guidance to determine what would be considered a “reliable” or “reliably estimated” fair value where a bank designates a financial instrument at fair value through profit or loss. Further, we would not support the apparent extension in paragraph 20 (d) of Principle 2 of this “reliable” concept to all other areas of the bank.

We would, however, agree that where the fair value option is applied, and particularly with respect to illiquid instruments, supervisors should expect banks to incorporate fully best practice (including those within the G30 report “Enhancing public confidence in public reporting”) such as those pertaining to a model development and validation, price verification and both internal and external audit review. However, these practices should be followed equally whether an entity is applying the fair value option or holding an instrument at fair value because it has been designated as held for trading.

Principle 4 - Supervisors may require banks to provide supplemental information to assist them in assessing the impact of banks' utilisation of the fair value option.

We fully support the principle that supervisors should be able to require banks to provide supplemental information to assist them in assessing the impact of a banks' use of the fair value option. When the fair value option was introduced by the IASB, they acknowledged that for the purposes of determining what level of capital an institution should maintain, prudential supervisors may want to understand the circumstances in which the regulated financial institution has chosen to apply the fair value option.

Within IFRS 7, there will be a significant amount of new disclosure that will help to explain the impact of designating a loan or receivable or financial liability at fair value through profit or loss. This should be adequate for most purposes but it is important that supervisors maintain the right to ask for additional information where they believe it is necessary for them to fully understand an entity's annual financial report and accounts.

Principle 5 - Supervisors should assess whether a bank's internal financial analysis of counterparties evaluates the impact of the counterparties' use of the fair value option.

When a bank undertakes a credit assessment of a counterparty, we would expect them to carry out a full and thorough evaluation of all significant accounting policies of the entity to determine whether the counterparty meets their lending criterion. Clearly, as part of this review, it will be important to understand the use of the fair value option along with other accounting policies and the impact these have on the borrower's earnings, capital and other analytical ratios.

As worded, we are concerned that the guidance gives a disproportionate emphasis to one aspect of the counterparty's accounting policies. In our view, a bank's financial analysis of counterparty should not consider the use of the fair value option in isolation and therefore we would not support the inclusion of this principle, as worded, in the final guidance.

Principle 6 - Supervisors should evaluate a bank's risk management and control practices as they pertain to the use of the fair value option.

We agree with the guidance provided

Principle 7 - Supervisors should consider risk management and control practices related to the use of the fair value option when assessing capital adequacy.

We agree with the guidance provided

Principle 8 - Regulatory capital should be adjusted for gains and losses from changes

We agree with the guidance provided.