

ISDA

International Swaps and Derivatives Association, Inc.
One New Change
London EC4M 9QQ
United Kingdom
Telephone: 44 (20) 7330 3550
Facsimile: 44 (20) 7330 3555
email: isda@isda-eur.org
website: www.isda.org

EFRAG Secretary General
Patrick Mommens
Project Manager
EFRAG
Avenue des Arts 41
1040 Brussels
Belgium
E: patrick.mommens@efrag.org

Friday 2nd July 2004

EFRAG's PRELIMINARY VIEWS ON THE IASB's EXPOSURE DRAFT OF PROPOSED AMENDMENTS TO IAS 39 FINANCIAL INSTRUMENTS RECOGNITION AND MEASUREMENT: THE FAIR VALUE OPTION

Dear Patrick,

The International Swaps and Derivatives Association (ISDA) appreciates the opportunity to comment on the European Financial Reporting Advisory Group's (EFRAG) preliminary views on the IASB's Exposure Draft (ED) of proposed amendments to IAS 39 Financial Instruments Recognition and Measurement: the fair value option.

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 the IASB's work on accounting for financial instruments.

ISDA is in the process of finalising a more detailed comment letter on the Fair Value ED to meet the July IASB deadline, however in the meantime we wanted to contribute our thoughts to the European process and comment on the preliminary views put forward by EFRAG on May 19th.

ISDA, like EFRAG, supported the fair value option when it was first introduced by the IASB in July 2002; the intent was to alleviate the potentially misleading earnings impact of asymmetric accounting resulting from the mixed measurement model inherent in IAS 39. We also appreciate the regulators' concerns over the volatility in profit or loss that would follow from the inappropriate use of the fair value option. However, the restrictions proposed to prevent this abuse have also, perhaps inadvertently, prohibited the use of the fair value option in situations that are entirely appropriate. ISDA believes the fair

value option aligns the accounting result with the underlying economic substance and will not only reduce volatility but along with appropriate disclosures will increase transparency. We therefore agree with EFRAG that the ED will not be effective in meeting the stated objectives of the IASB.

Key messages

In particular and most importantly we disagree with the introduction of the “verifiable” fair value concept. ISDA invested a considerable amount of time working with the IASB on the concept of, and controls surrounding fair value measurement, and we consider the existing standard to be both robust and strict enough to prevent abuse. In particular, the standard is very specific on the use of market quotes and restricts the use of valuation techniques to only a limited number of circumstances. We would suggest that the provisions of IAS 39 already designed to determine the fair value measurement of derivative and other financial instruments should also be considered appropriate for the application of the fair value option. We therefore do not think that a second-tier, “stricter test” for fair value measurement is necessary and would agree with EFRAG that the “verifiable” test is a repetition of existing application guidance.

ISDA also supports EFRAG in its analysis of the “substantially offset” criteria. Many of our members had considered applying the fair value option to asset and liability positions offsetting each other, where hedge accounting could not be applied. Although the term “substantially offset” is not defined in the proposals the Basis for Conclusions (BC6, BC10) suggests the Board considers this to be a lower hurdle than required for effectiveness testing under hedge accounting. However the term ‘substantially’ is used on three other occasions in IAS 39 and is normally interpreted in those circumstances as a very high percentage of the total amount (perhaps even greater than the 80% - 125% likely to be applied in the prospective and retrospective hedge effectiveness tests). This could lead to the market applying a much stricter test than had been envisaged by the Board. Furthermore, the documentation required to support the use of the condition may be interpreted to be similar to that required for hedge accounting. ISDA considers that the ‘substantially offset’ principle does not provide an appropriate condition to determine whether the fair value option may be applied, as the size of offset, whether relative or absolute, is irrelevant. However should the IASB continue to include this criteria, we recommend that the standard allow the use of the fair value option where a financial instrument forms part of an economic hedging relationship with another financial instrument (or portfolio of instruments) and where fair value would provide a more appropriate reflection of the true risks involved.

Finally, ISDA supports EFRAG in its objections to Paragraph 9, as revised in the ED. This includes the statement that for entities subject to prudential supervision, the powers of the prudential supervisor may include oversight of the application of the accounting requirements and of relevant risk management systems and policies. We consider this wording unsatisfactory since it has the potential to take the process of determining appropriate accounting policy away from accounting standards setters and reporting entities and, potentially, give it to regulators. This might not only lead to accounting treatments which are inconsistent with the overall conceptual framework but also result in inconsistency between the treatment of similar instruments by entities governed by different regulators.

The ISDA comment letter to the IASB will also raise industry concern around the definition of “held for trading”, more practical issues with applying the “substantially offset” criterion and recommend appropriate disclosures around the use of the fair value option. We will also present a number of examples of financial instruments to which entities were intending to apply the fair value option that may not now be eligible under the revised proposals.

In the meantime if you have any further queries regarding our work on the fair value option ED please do not hesitate to contact Ed Duncan, at ISDA on (020) 7330 3574.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Ed Duncan', with a large, sweeping underline stroke below it.

Ed Duncan
ISDA