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Mrs Svetlana Boysen
EFRAG
Avenue des Arts 41
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28 April, 2005

Re : "Adoption of Amendments to IAS 39 Financial Instruments: Recognition and Measurement – The Fair Value Option"

Dear Mrs Boysen,

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

IAS 39 is based on a mixed measurement model. The standard requires financial assets and financial liabilities to be measured at fair value or amortised cost according to the reason why they are acquired or incurred and their nature (i.e. equity or debt instruments, quoted or not quoted). Moreover, derivatives shall be measured at fair value through profit or loss.

As a consequence in IAS 39, without the Fair Value Option (FVO), the "consistent measurement of associated operations" rule can be applied only in case of Hedge accounting.

Hedge accounting, however, requires the respect of strict rules about effectiveness and the kind of instruments that can be designated as "hedging instruments" or "hedged items".

If these rules are not respected, different sides of a matched position should be measured according to different criteria. As a consequence, profit or loss can be affected by incomes or expenses that are not justified by the way financial instruments are managed.

The new proposal attempts to solve these problems allowing the use of "Fair value option" when:

1) it eliminates or significantly reduces an accounting mismatch;
2) a group of financial assets or liabilities are managed and evaluated on a fair value basis according to documented risk management and investment policies.

This proposal addresses one of the main concerns of the Regulators: the possibility, through the use of the option, to recognize profit or loss that are highly subjective.

Moreover, the information required in the notes allow disclosing the amount of change in fair value that is not due to interest rate risk.

At the same time, the new proposal does not restrict the use of the option to a series of identified financial instruments but, on the contrary, it defines principles that allow the representation of how financial institutions manage financial risks.

It must be observed, however, that fair valuation requires the recognition in profit or loss of every change in fair value, independently from the risk factor that caused them.

This means that when the fair value option is used to reduce or eliminate accounting mismatch, it must be recognized in profit or loss:

1) either the change due to the risk factor shared between assets and liabilities;
2) and the change due to risk factor that are not shared between assets and liabilities.

While the variations referred in 1) tend to offset, the ones addressed in 2) does not offset as they can be completely independent. In addition, these changes in fair value are very subjective as they are not based on quoted prices but on entity specific input.

For instance, assume that FVO is used to represent the effects of an economic hedge of a portfolio of retail loan with a portfolio of derivative instruments; according to the proposal, either the change in fair value due to interest rate risk and credit risk should be recognized on both loans and derivatives. Even if the interest rate risk is full offset, profit or loss will be affected by change in fair value due to credit risk.

This solution can be accepted if financial instruments are sold in the next future; however it is not acceptable if the instrument is kept for a long period of time or until maturity. In the last case, in fact, FVO is merely a substitute for hedge accounting, so it would not be appropriate to recognize incomes or expenses due to change in risk factor different from the one that is managed/hedged.

The new proposal doesn't address the "own credit risk" issue. We think that change in fair value due to change of own credit risk should not be recognized in profit or loss.

These concerns could be addressed only by the *component approach*. According to this approach only the change in fair value due to the managed risk factor would be recognized in profit or loss.

Conclusion

The new proposal on the Fair value option is an improvement from the ED issued in April 2004 as it allows to better reflect, in financial statement, the effect of matched position while avoiding, in the same time, an indiscriminate use of the option.

Even if the paper does not address some issues that can be solved only by the use of the *component approach*, we support the endorsement of the amendments to IAS 39 Financial Instruments: recognition and measurements – “The fair value option”.

Yours sincerely,

Prof. Angelo Provasoli
(OIC – Chairman)