BASEL COMMITTEE ON BANKING SUPERVISION

cE n g

Chairman

VIA FACSIMILE

Sir David Tweedie
Chairman
International Accounting Standards Board
1st Floor
30 Cannon Street
London EC4M 6XH

23 August 2001

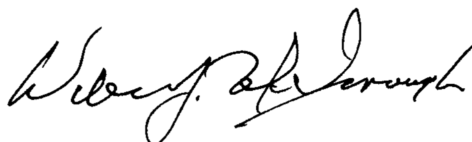
Dear Sir David,

The Basel Committee on Banking Supervision appreciates the opportunity to comment on the proposed IAS 39 Implementation Guidance (Batch VI). You will find our comments in the enclosed note. The Basel Committee's Task Force on Accounting Issues, chaired by Dr Arnold Schilder, Executive Director of De Nederlandsche Bank, has prepared the note.

Dr Schilder has drawn my attention to the topic of accounting for impairment of financial assets (question 112-3), an area of obvious importance to the Basel Committee. Specifically, as discussed more fully in the note, the suggested approach may cause a delay in loss recognition, resulting in an overstatement of assets and a reduction in the relevance of the accounting measure; as well as being contrary to a measurement methodology already accepted in major countries.

If you should have any questions regarding our comments, please feel free to contact Gerald A Edwards, Jr. at the Board of Governors of the Federal Reserve System (+1 202 452 2741) or Bengt A Mettinger at the Basel Committee Secretariat (+41 61 280 9278).

Yours sincerely,



William J McDonough

Enclosure

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Proposed IAS 39 Implementation Guidance – Draft issued for comment on 22 June 2001 (Batch VI)

Paragraph 18

Question 18-3

Liabilities held for trading: credit-linked note

Question 18-3 addresses whether an issued credit linked note can be classified as a liability held for trading in its entirety, “for instance, if it funds trading activities or is part of an arbitrage/customer facilitation strategy”. The suggested answer is no. The short answer even concludes in its final sentence that “Even if an enterprise has a policy of actively repurchasing issued credit-linked notes or other debt instruments, it cannot classify them as held for trading”.

In IAS 39.10, a financial asset or liability held for trading is defined as one that has been “acquired or incurred principally for the purpose of generating a profit from short-term fluctuations in price or dealer’s margin”. Additionally, IAS 39.18 states that “Liabilities held for trading include a) derivative liabilities that are not hedging instruments and b) the obligation to deliver securities borrowed by a short seller. The fact that a liability is used to fund trading activities does not make that liability one held for trading”.

IAS 39.10 identifies the purpose of a transaction as the main factor for determining when liabilities (as well as assets) can be classified as trading. IAS 39.18 illustrates this point by providing two *examples* of liabilities held for trading, namely non-hedging derivative liabilities and short positions. The question that remains to be answered is when liabilities other than those quoted may be seen as “acquired or incurred principally for the purpose of generating a profit from short-term fluctuations in price or dealer’s margin”.

We are far from convinced that it is impossible to issue credit-linked notes “principally for the purpose of generating a profit from short-term fluctuations in price or dealers margin”. Indeed, it seems entirely plausible that such an instrument issued as part of an arbitrage strategy (one of the possible purposes listed in the question) could meet the definition of a trading liability.

We also have concerns about the second part of the suggested answer. In effect, this part states that “a policy of actively repurchasing issued credit-linked notes or other issued debt instruments” can *never* provide sufficient evidence that the relevant instrument has been issued principally for the purpose of generating a profit from short-term fluctuations in price or dealer’s margin. We do not understand the basis for this conclusion and are not convinced that it is correct.

For these reasons, we would suggest that the Implementation Guidance Committee not issue the suggested guidance but instead revisit the question of when liabilities may be classified as trading.

Paragraph 112

Question 112-3

Impairment: portfolio of individually significant assets

Question: "If … an individual financial asset … specifically identified for evaluation for impairment, is found not to be impaired, may that financial asset be included in the assessment of impairment for a group of similar financial assets?"

Answer: "No."

Accounting for loan losses is one of the most important accounting issues relating to banks all over the world. This fact gives the international accounting guidance on impairment in financial assets considerable importance. Question 112-3 addresses one of the key issues in the area of accounting for impairment. The guidance in the suggested answer is, however, not satisfactory for a number of reasons.

The suggested answer does not promote good accounting

To account for impairment on an individually significant loan only when it can be measured in relation to that *specific* asset could well result in delayed loss recognition, overstated asset values and reduced relevance in the resulting accounting measure. Losses that are probable in the portfolio as a whole, but not identifiable in individual loans, would not be considered in the measurement. In effect, the guidance prescribes a measurement methodology that may well violate the measurement objective of the standard: to measure impaired loans and groups of loans at their recoverable amount. In contrast, the accounting regimes in major countries require or permit an additional group assessment for significant loans that have been individually evaluated but are determined not to be impaired.

Credit losses are caused by various individual factors and combinations of factors. The ability to identify impairment in an individual loan, however, often depends on an accumulation of factors that do not become evident until later in the credit deterioration process. For example, while the delinquency of contractually due principal or interest payments is clearly visible, the factors leading to a credit loss may well have occurred before that point. An illustration of this aspect would be when an insect infestation attacks a large agricultural area in which a lender has a number of loans outstanding. Although the lender may not have sufficient information to determine which of its borrowers will not be able to fulfil their obligations according to the loan contracts, the lender is likely to have sufficient quantitative information from similar past infestations to conclude that impairment exists within this group of loans and to estimate the amount which these borrowers collectively will not be able to pay. Consequently, while the Basel Committee believes that a careful individual review of significant loans is important in the measurement process (as well as for risk management purposes), the subsequent assessment of groups of similar loans not individually identified as impaired in the individual review is equally critical.

The suggested answer might also discourage sound risk management as probable losses in the portfolio in a number of cases would not affect the accounting measure. In addition, the differences in the accounting measure resulting from how the threshold for individual review has been determined could distort transparent reporting of underlying credit risk.

The suggested answer is not consistent with the standard

The suggested answer lacks consistency with the standard itself, especially after the changes made in October 2000 to IAS 39.112. As a starting point, it may be useful to repeat the measurement principle as outlined in IAS 39.109:

"An enterprise should assess at each balance sheet date whether there is any objective evidence that a financial asset or group of assets may be impaired. If any such evidence exists, the enterprise should estimate the recoverable amount of that asset or group of assets…"

Further, IAS 39.112, as revised, now states (the changes made October 2000 are marked below):

> "Impairment and uncollectability are ~~may be~~ measured and recognised individually for financial assets that are individually significant. Impairment and uncollectability may be measured and recognised on a portfolio basis for a group of similar financial assets that are not individually identified as impaired."

We believe that the last sentence quoted above actually answers the question asked in Question 112-3. **Group measurement is permitted** for loans that are **not individually identified as impaired.** The view taken in the Batch VI draft guidance would only make sense if this last sentence instead said that measurement on a portfolio basis is permitted for loans that are not individually **reviewed.**

Our view is also consistent with the Implementation Guidance Committee's earlier responses to Questions 112-1 and 112-2. These state that "Measurement of impairment on a portfolio basis under IAS 39.112 is applied when there is indication of impairment in a group of similar assets and impairment cannot be identified with an individual asset in that group" (Question 112-1) and "Recognition and measurement of impairment on a portfolio basis can only be made for groups of similar financial assets that are not individually identified as impaired" (Question 112-2). To revert to our insect infestation example above, no individual loan would be identified as impaired, but it would clearly be the case that the group of all such loans, taken together, is impaired. This seems to be precisely the sort of case contemplated in Questions 112-1 and 112-2 and we cannot reconcile that conclusion with the suggested guidance under Question 112-3, which would prohibit any adjustment to the carrying amount of the group of loans.

When the IASC Board decided in October 2000 upon the revised wording of IAS 39.112, it considered – but rejected – an initial suggestion for a final sentence in that paragraph to the effect that group assessment could be done for a group of similar financial assets that were **not individually significant**. Instead, the Board approved the wording quoted above: **"not individually identified as impaired**". The suggested guidance in Question 112-3 would clearly have complied with the wording that was suggested but not approved in October 2000. However, bearing in mind that the IASC Board rejected this alternative wording, it is especially difficult for us to understand how the draft guidance can be consistent with the version of revised IAS 39.112 that the Board actually approved.