

BASEL COMMITTEE ON BANKING SUPERVISION

BANK FOR INTERNATIONAL SETTLEMENTS
CH-4002 BASEL, SWITZERLAND

THE CHAIRMAN

10 July 2000

International Accounting Standards Committee
Att: IAS 39 Implementation Guidance Committee
166 Fleet Street
London EC4A 2DY
United Kingdom

Proposed IAS 39 Implementation Guidance – Draft issued for comment on 8 May 2000

The Basel Committee on Banking Supervision welcomes the opportunity to comment on the proposed IAS 39 Implementation Guidance.

As you know, the need for timely implementation guidance to IAS 39 has been a significant concern for the Basel Committee. We are therefore particularly pleased to note the speedy elaboration of high quality draft guidance in important areas from the Implementation Guidance Committee. In the enclosed note, you will find our detailed comments on the draft issued for comment on 8 May 2000. The note has been prepared by the Basel Committee's Accounting Task Force chaired by Dr Arnold Schilder.

Yours faithfully,



William J. McDonough

Enclosure

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Questions 14 – 3 and 14 – 4

IAS 39 is a standard on recognition and measurement on financial instruments. The black letter paragraph 6 also brings certain commodity-based contracts into the standard, namely those that give either party the right to settle in cash or some other financial instrument, with the exception of commodity contracts that (a) were entered into and continue to meet the enterprise's expected purchase, sale, or usage requirements, (b) were designed for that purpose at their inception, and (c) are expected to be settled by delivery.

The definition of derivative financial instruments in paragraph 10 makes a specific reference to "commodity price".

A special section of the standard (paragraphs 11 – 21) elaborates of the definitions. Paragraph 14 discusses commitments to buy or sell non-financial assets and liabilities.

We believe that this elaboration of the definitions shall be read and understood within the limits given by the definitions.

The draft implementation guidance suggested in Questions 14 – 3 and 14 – 4 however in effect considerably expands the coverage of the standard by making the word "commodity" mean all non- financial assets and liabilities. We do not support this guidance and suggests that it be deleted.

Question 23 - 1

Question 23 – 1 address the presentation of those embedded derivatives that according to the standard should be accounted for separately. The suggested answer is that the derivative part should be accounted for separately. It may not be a bad idea to do that, but we do not believe that this conclusion necessarily follows from IAS 39, which is a standard on recognition and measurement. Furthermore, as there is no IAS requirement to present stand-alone derivatives separately in the balance sheet, why introduce such a requirement for embedded derivatives? It should be noted that many banks currently present derivatives under Other assets and Other liabilities. We suggest that Question 23 – 1 is either deleted or, preferably, that the answer should be: those embedded derivatives that are to be accounted for separately should be presented in the balance sheet in the same way as the entity presents stand-alone derivatives.

Question 23 - 2

Question 23 – 2 discusses the accounting treatment of convertible bonds and states that they cannot be held- to maturity securities because that would be inconsistent with paying for the right to convert into equity shares before maturity. We suggest that the answer also should discuss the possible situation that a convertible bond can be converted only at maturity. In that

case it would be consistent with the standard to allow accounting for the embedded derivative separately at fair value, and for the remaining bond instrument as held to maturity, subject to the normal prerequisites for that classification.

Question 25 – 1

Question 25-1 discusses accounting for synthetic instrument. In the last paragraph, however, the answer discuss the possibilities for hedge accounting when hedging assets in the held - to - maturity category. The answer states that cash flow hedge accounting is not permitted for assets in this category. This controversial issue is however discussed in question 127 – 2 in Batch II. We therefore suggest that the last paragraph is deleted, and that the issue is discussed in question 127 – 2.

Question 35 - 1

Question 35 – 1 discusses the accounting treatment in Company A for a repo transaction in which the counterpart, Company B, is not expected to fulfil its obligations to resell the assets due to significant financial difficulties. The market price is higher than the repurchase price in the repo agreement. According to the suggested answer, company A should not derecognise the securities unless a competent legal authority has decided that company will not recover access to the securities. The answer does however indicate that company A will report an impairment loss.

We are not fully convinced about the merits of the suggested answer. It is of course clear that the size of the impairment loss is depending on the difference between the market value of the securities, the book value of the liability to Company B and Company B's ability to pay. Should the loss however initially be measured from the point in time when a competent legal authority decides, or when it becomes probable that the counterpart will not be able to return the assets? We believe that the later alternative is more meaningful and also is consistent with the position of IAS 39.111. The impairment is not impairment in the securities but on the claims on the counterpart. It is obvious that the company does not control the securities and cannot manage the securities exposure any longer. We suggest that the answer should be redrafted accordingly.

Question 57-2

Question 57 – 2 address the issue of the accounting for own debt securities that are bought back. It might be helpful for users of the financial statement if the financial statements include information about this kind of transactions, if material. We therefore suggest that the implementation guidance comment on the need for disclosure.

Question 66 – 1

Question 66 – 1 discusses the issue of transaction costs and provides guidance that is consistent with the standard. We do however believe that additional implementation guidance should be provided on what transaction costs are. That can be done as an expansion of question 66 – 1, or as a separate question and answer relating to paragraph 10.

Question 128 - 1

Question 128 – 1 addresses the hedging possibilities for financial assets if the issuer has the right to prepay. According to the suggested answer such right for the issuer severely restricts the possibilities for hedge accounting. Only if a comparable option exists in the hedging instrument would it be possible to designate the cash flows after the prepayment date as hedged item.

We strongly disagree with the suggested answer. It seems to try to bring additional specificity to the requirement for expectation of “highly effective”, but it instead introduces additional requirements. All the normal hedge accounting prerequisites in the standard may apply in this situation, but no additional ones should be introduced. In many countries, prepayment options may have significant differences in forms and terms and may for example cause penalties if exercised. If the hedge is expected to be highly effective, hedge accounting should be permitted even in the absence of a comparable formal option in the hedging instrument.

Other issues

The draft describes the status of final Q&A on page 4 where it is, correctly, stated that the final Q&A will not have the status of Standard or Interpretation. We note however that in the following sentence it is said that the “Q&A are intended to provide best practice guidance and the appropriate interpretation...”. As this might be read as a contradiction of the previous statement, we suggest that this sentence should be reworded.