B A S E L C O M M I T T E E O N B A N K I N G S U P E R V I S I O N

BANK FOR INTERNATIONAL SETTLEMENTS
CH-4002 BASEL, SWITZERLAND

THE CHAIRMAN

August 2000

Via Facsimile

Sir Bryan Carsberg
Secretary General
International Accounting Standards Committee
166 Fleet Street
EC4A 2DY London
UNITED KINGDOM

Dear Sir Bryan,

The Basel Committee on Banking Supervision welcomes the opportunity to comment on the proposed IAS 39 Implementation Guidance, which was issued for comment on June 12, 2000. In this regard, please find enclosed our comments prepared by the Basel Committee's Accounting Task Force, chaired by Dr. Arnold Schilder.

Should you have any questions regarding the enclosed suggestions, please do not hesitate to contact Jerry Edwards of the Board of Governors of the Federal Reserve System at (202) 452-2741 or Bengt A. Mettinger of the Basel Committee Secretariat at (41) 61 280 9278.

Yours sincerely,

W.J. McDonough

Enclosure

TELEPHONE: +41 61 / 280 80 80 TELEFAX: +41 61 / 280 91 00 E-MAIL: baselcommittee@bis.org

Proposed IAS 39 Implementation Guidance -
Draft issued for comment on 12 June 2000 (Batch II)

The nature of the questions and answers in the suggested guidance illustrates the complexities of the issues that the Implementation Guidance Committee is dealing with and underlines the importance of issuing additional guidance on IAS 39. We note that, in spite of the attention paid in Batch II to the derecognition issues, further guidance may be necessary in this complicated area.

Q 35 – 2

It would be helpful if the answer to this question also made reference to IAS 39.42.

Q 86 – 2

Question 86 – 2 discusses the scope in the standard for the sale of held-to-maturity assets, when the sale is due to a significant increase in entity-specific capital requirements imposed by regulators. The suggested answer takes a restrictive view, stating that only in rare cases, may an enterprise not be able to reasonably anticipate an increase in entity-specific capital requirements. We are of the view that this may not necessarily be true.

The Basel Committee is currently reviewing the 1988 Capital Accord and has brought forward in a consultative document a concept including not only a rule based regulatory requirement for calculating a bank's capital adequacy, but also a supervisory review of whether such a capital requirement is sufficient for individual banks. Such a review may take into account a more differentiated view of the bank's risk exposures, risk management, internal controls and management. As a consequence of this review, banks may be required to hold additional capital. It may well be possible to anticipate some components of such increased capital requirements, especially as the supervisor's policy becomes better known and understood over time. Other components, however, may be much more difficult for a bank to anticipate. We believe that the issue concerns what can be anticipated at the time an asset is classified as held-to-maturity, a point in time which might be well before the supervisory conclusions or the facts and conditions upon which they are based become known to the bank's management.

Q 100 - 1

Question 100 - 1 discusses how to determine the fair value in a situation where there is a "control premium" associated with a large holding. The use of the term "control" in this context may create some problems, as the term is defined in international accounting standards and has important accounting effects. The example would benefit from a comment explaining why IAS 28 would not be applicable.

Q 127 - 2

Question 127 – 2 discusses the permissibility of hedge accounting for assets classified as held-to-maturity. It concludes that for such assets not only fair value hedges but also cash flow hedges are prohibited for interest rate related risks. In our view, the suggested answer to this question is at odds with the actual text of IAS 39 and also creates an inconsistency with IAS 32.

Paragraph 127 of IAS 39 explains the limitation on hedging of held-to-maturity assets in the following way: "Unlike originated loans and receivables, a held to maturity investment cannot be a hedged item with respect to interest-rate risk because designation of an investment as held-to-maturity involves not accounting for associated changes in interest rates." We interpret this language to specifically preclude the use of fair value hedges but not cash flow hedges.

The suggested answer, notwithstanding the plain language of IAS39.127, explains the prohibition on cash flow hedges by asserting that IAS 39 uses the term "interest rate risk" in a more general manner than IAS 32 to include the risks associated with changes in both fair value and cash flows due to changes in interest rates. The rational for modifying as fundamental a term as "interest rate risk" is puzzling to us, and the suggested answer introduces an inconsistency between IAS 39 and IAS 32. We are of the view that this is undesirable, as both of these standards are strongly linked to one another, having been developed from the same initial project, and representing the two comprehensive international standards on accounting for financial instruments.

While IAS 39 did amend some aspects of IAS 32, it did not specifically alter the definition of interest rate risk. The use of this term as discussed in the suggested answer to this question goes beyond IAS 32.43(a)(ii), which defines interest rate risk as the risk that the fair value of a financial instrument will fluctuate due to changes in interest rates. Based on the IAS 32 definition, a floating rate held-to-maturity instrument is not exposed to interest rate risk because its fair value is not affected by changes in interest rates. However, such an instrument could contain cash flow risk.

We are of the view that cash flow hedging should be permitted for held to maturity investments, and believe that IAS 39 actually permits it. The current text of Q 127 – 2 should be deleted or rewritten to clarify this.