

BASEL COMMITTEE ON BANKING SUPERVISION

BANK FOR INTERNATIONAL SETTLEMENTS
CH-4002 BASEL, SWITZERLAND

THE CHAIRMAN

15 November 2000

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

Dear Sir Bryan,

The Basel Committee on Banking Supervision welcomes the opportunity to comment on the proposed IAS 39 Implementation Guidance (Batch IV). You will find in the enclosed note our comments on the draft issued for comment on 19 September 2000. The Basel Committee's Task Force on Accounting Issues, chaired by Dr Arnold Schilder, has prepared the note.

If you 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 (202-452-2741) or Bengt A Mettinger at the Basel Committee Secretariat (41 61 280 9278).

Yours sincerely,

A handwritten signature in black ink, appearing to read 'William J. McDonough', written in a cursive style.

William J McDonough

Enclosure

Proposed IAS 39 Implementation Guidance – Draft issued for comment on 19 September 2000 (Batch IV)

Paragraph 10

Question 10 - 11

Definition of originated loans and receivables

According to the suggested answer a debt security is to be classified as an originated loan if it is purchased at original issuance, unless the intent is to sell it immediately after the purchase or in the short term. The stated reason for this conclusion is that originated loans and receivables are defined in IAS 39.10 as: “financial assets that are created by the enterprise by providing money, goods or services directly to a debtor, other than those that are originated with the intent to be sold immediately or in the short term, which should be classified as held-for-trading”.

The significance of the suggested answer is that the standard’s strict criteria for classifying assets in the held-to-maturity category (necessary for measurement at cost for assets other than originated loans) would not apply to debt securities if they are bought at original issuance.

IAS 39 defines the term origination, but does not define the terms loans and receivables nor does it define (debt) securities. As IAS 39 uses both of these terms in different contexts, it would be inconsistent with the standard to determine that there is no difference between loans and debt securities. Moreover, despite differences in the legal definitions of securities and loans around the world, securities are fundamentally designed to be easily tradable, while loans are typically less so.

In addition, national accounting standards in countries that already have “held-to-maturity” and “available for sale” classification categories generally recognise this difference. Thus the suggested answer appears to move away from international harmonisation of accounting standards without any apparent benefit.

The suggested answer is also surprising when contemplating paragraph 39.19 in the standard, which elaborates on the definition of loans and receivables originated by the enterprise. This paragraph focuses entirely on when loans and receivables are originated or purchased. No mention is made that all debt securities purchased at origination should be classified as originated loans and receivables, unless the intent is to sell it immediately or in the short term.

Paragraph 39.10 and the suggested answer read literally could lead one to conclude that equity securities should also qualify for classification as an originated loan, which would obviously be contrary to rational accounting principles. In our view, the definition from IAS 39.10 quoted above should be read as a limitation on loans and receivables, clarifying when they qualify for classification as originated.

Finally, we believe that the suggested answer creates a significant potential for earnings management, as large securities portfolios can be classified as originated loans and carried at cost notwithstanding the relative ease with which they can be sold.

We recommend that the guidance should state that securities can not be classified as originated loans.

Paragraph 10

Question 10 - 13

Definition of amortised cost: debt instruments with stepped interest payments

The proposed answer is appropriate for instruments (with stepped interest features) that do not have any prepayment options. In the case of an embedded prepayment option, IAS 39.25 e states that it should not be separated from the host contract if the exercise price would not result in a significant gain or loss. We suggest that the Implementation Guidance Committee consider issuing additional guidance on how gain or loss should be determined in this situation, as well as explaining the interplay between IAS 39.25 e (on prepayment options) and IAS 39.24 c (on options to extend the term).

Paragraph 70

Question 70- 1

Reliability of fair value measurement

The suggested answer considers only IAS 39.70. However, it is not possible to answer the question without also considering both IAS 39.95 and IAS 39.96.

IAS 39.70 is not written as a strict rule with two exceptions (unquoted equity and derivatives linked to unquoted equities). Instead, it states that “there is a presumption that fair value can be reliably determined for most financial assets classified as available for sale or held-for-trading”. In addition, it enumerates the above exceptions as examples. As IAS 39.70 begins with the reference to a presumption, the list of exceptions can not be seen as exhaustive.

This is made clear in paragraphs IAS 39.95-102 that discuss in depth the issue of fair value measurement considerations. The basic ruling in IAS 39.95 is not a presumption of reliability, but instead a description of when a fair value is reliably measurable. The subsequent paragraph, IAS 39.96, describes situations in which fair value is reliably measurable. Of particular interest in this context is section b of paragraph 96, in which “a debt instrument that has been rated by an independent rating agency and whose cash flows can be reasonably estimated” is used as an example of situations in which fair value is reliably measurable. As written, the suggested answer to question 70 - 1 renders paragraphs 39.95 and 39.96 unnecessary. Furthermore, paragraph 39.96 b ceases to make sense, because there is a

“presumption” that the fair value of all instruments that are neither an unquoted equity instrument nor a derivative linked to such an instrument can be measured reliably.

We recommend that QA 70 - 1 should either be deleted or rewritten in accordance with the discussion above.

Paragraph 83

Question 83 - 6

Held to maturity investments: application of the “tainting” rule on consolidation

This question and answer discuss the application of the “tainting rule” “for held-to-maturity” investments in the consolidated accounts. We believe that the statements made in the suggested answer obscure the fact that sales of significant amounts may not necessarily preclude classification as held-to-maturity, namely if the exceptions (a) through (c) of paragraph 83 are applicable. We recommend that the answer be expanded to clarify this. Furthermore, it would be helpful if the QA also noted that what is “insignificant” is typically different at the group level than in the separate financial statements of a group company. It may also be helpful to refer to parent company and subsidiaries in the answer, to remind the reader of the way in which IAS 28 uses the term consolidation, as in some countries the term consolidation is also used to cover accounting for associates.

Paragraph 111

Question 111 - 4

Impairment: unallocated losses

The suggested answer notes that “Amounts that an enterprise has set aside for additional, possible impairment in financial assets, such as unallocated reserves that cannot be supported by objective evidence about impairment, are not recognised as impairment or bad debt losses under IAS 39”.

In our view the reference to unallocated reserves in the suggested answer may be read by some as a qualifying or limiting criteria, and others as an outright prohibition on unallocated reserves. We believe that it is important to avoid this potential misunderstanding. Therefore, we recommend that the suggested answer be rewritten to clarify that allowances (either allocated or unallocated) which meet the impairment criteria in IAS 39 and can be objectively supported should be recognised under IAS 39, while allowances (either allocated or unallocated) that can not be objectively supported may not be recognised under IAS 39.

Paragraph 122

Question 122 - 1

Hedging instrument: hedging using more than one derivative

In our view, the question and answer need to be somewhat more specific in discussing how the use of proportions of two or more derivatives to hedge an eligible asset or liability is inconsistent with IAS 39.

We assume that the purpose of the suggested answer is to clarify that hedge accounting can not be applied to the relationship between multiple derivatives. We suggest that language clarifying this be added to the suggested answer.

Paragraph 134

Question 134- 1- a

Offsetting internal derivative contracts used to manage interest rate risk

The suggested answer discusses hedge accounting criteria in IAS 39 and concludes that internal contracts may not be netted against each other in order to offset only the net exposure externally. The guidance as drafted states that the external offsetting must be done on a gross basis.

We believe that this is an important issue. Some enterprises use internal contracts in their risk management in order to transfer risk positions from operating divisions to a treasury division that is in charge of dealing with external counterparts on financial markets. This typically involves initiating the internal contracts at market conditions, establishing, settling, and documenting the transactions (with the same features as a third party transaction) between the operating divisions and the treasury. Through these processes an audit trail of the hedging transactions is established.

IGC Guidance (Question 134-1) has already clarified that internal contracts can be used in hedge accounting if the contracts are offset by derivative contracts with an external party. A requirement that the external offsetting must be done on a gross basis, however, provides no meaningful economic benefit. The result will however be that the number of external contracts increase, resulting in a corresponding rise in costs and risks (both credit and operational) to the enterprise.

The paragraph in the standard that deals with this issue, IAS 39.134, is, however, not written in the prohibitive way that the suggested answer claims. The paragraph does not state that “only a derivative with a party external to the enterprise can be designed as a hedging instrument”. It actually states that “...only derivatives that involve a party external to the enterprise can be designed as hedging instruments”. Of particular interest in this context is (a) the use of the plural form and (b) the term “involves”. We believe that the reasonable view of

a rule elaborated in this way is that an external transfer of the net position between offsetting internal contracts is sufficient for hedge accounting in accordance with the standard.

Paragraph 142

Question 142 - 5

Hedge accounting: identification of hedged forecasted transactions

The question and answer discusses the identification of hedged forecasted transactions. One of the most important conditions for a forecasted transaction to qualify as a hedged item is a high probability of the occurrence of this transaction. We suggest that the answer be expanded to remind the reader of this basic assumption for hedging of forecasted transactions.

Paragraph 172

Question 172- 9

Transition rules: internal hedging derivatives

The question and answer as currently worded actually imply that internal contracts can not be used in hedge accounting. As demonstrated in the guidance already provided, that is not necessarily true. We suggest that the QA be modified so as not to create any confusion about this.