

BASEL COMMITTEE ON BANKING SUPERVISION

Chairman

Sir David Tweedie  
Chairman  
International Accounting  
Standards Board  
166 Fleet Street  
London EC4A 2DY  
UNITED KINGDOM

19 February 2001

Dear Sir David,

Re: Proposed IAS 39 Implementation Guidance (Batch V)

The Basel Committee on Banking Supervision welcomes the opportunity to comment on the referenced draft guidance issued for comment on 20 December 2000. The Basel Committee's Task Force on Accounting Issues, chaired by Dr Arnold Schilder of De Nederlandsche Bank, has prepared the enclosed note.

If you have any questions regarding our comments, please feel free to contact Gerald A Edwards, Jr of the Board of Governors of the Federal Reserve System (+1 202 452 2741) or Bengt A Mettinger of 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 20 December 2000 (Batch V)**

## **Paragraph 10**

### **Question 10- 15**

#### ***Definition of held for trading: purpose of acquisition***

The question and answer discuss the criteria for classifying non-derivative financial assets as held for trading. The Standard's focus is on whether the assets are acquired "principally for the purpose of generating a profit from short term fluctuation in price or dealers margin". The suggested answer explains that "short-term refers to an intended holding period generally measured in hours or days rather than months or years".

The emphasis of the suggested answer on "hours or days" seems too narrow, considering the wide variety of potential trading strategies that may be pursued by an organisation. We recommend that the answer should be expanded to clarify that an intended holding period of hours or days is clearly indicative, but not the sole determinant factor that an instrument should be properly classified as held for trading. A longer holding period may be appropriate, so long as the underlying strategy employed by the organisation relies on price fluctuations to generate profits.

## **Paragraph 110**

### **Question 110-1**

#### ***Impairment: future losses***

The question and answer deals with the permissibility of an enterprise establishing an allowance for future losses at the time a loan is originated. The suggested answer states that it is inconsistent with IAS 39 to reduce the carrying amount of a loan at initial recognition through the recognition of an immediate impairment loss.

We do not dispute that the suggested answer is consistent with the standard. However, we should like to mention that the Basel Committee's Task Force on Accounting Issues is currently studying how banks should appropriately account for credit losses in ways that also are consistent with modern credit risk management. Appropriate accounting for loan losses is necessary for banks' financial statements to portray their financial position and financial performance fairly and realistically.

## Paragraph 113

### Question 113-1

#### ***Impairment: consideration of the value of the collateral***

This question addresses the role of collateral in the estimation of the amount recoverable on an impaired loan. The answer states that "the estimation of the recoverable amount of a collateralised financial asset reflects the cash flows that may result from foreclosure whether or not foreclosure is probable". It goes on to say "if foreclosure is probable, impairment is measured based on the fair value of the collateral".

We recommend that the answer be expanded to clarify that to the extent cash flows from collateral are expected to form a part of the cash flows to the bank of the loan, those cash flows should be considered on the basis of the fair value of the collateral.

Additionally, the fair value of the collateral should consider on a discounted basis the estimated costs to the bank of realising the collateral value in measuring the recoverable amount.

We also recommend that the guidance should explicitly note that the fair valuation should be as of the balance sheet date.

### Question 113-3

#### ***Impairment: observable market price***

This question discusses the circumstances in which a creditor may measure impairment based on an observable market price. The suggested answer concludes that the standard permits the use of an observable market price in determining impairment only in the case of variable interest rate financial instruments.

The standard in our view offers somewhat more latitude. The basic reference is that observable market price may be used "as a surrogate for such a fair value calculation". However, there is no fair value calculation mentioned in paragraph 113.

To bring this issue into a practical context, it should be noted that the question of whether the contractual interest rate is fixed or variable has limited effect in cases where the borrower is not able to fulfil his contractual obligations.

Furthermore, the use of an observable market price may, in cases where such prices are available, be a way to establish the recoverable amount that is easier and more cost effective than other methods.

We recommend that the answer be rewritten to clarify that use of observable market price is an acceptable method for measuring impairment for both fixed and variable interest rate financial assets.

## **Paragraph 127**

### **Question 127- 6**

#### ***Hedge of prepayment risk of a held-to-maturity investment***

The suggested answer states that a held-to-maturity investment may not be classified “as a hedged item in a hedge of interest rate risk,” and then goes on to conclude that prepayment risk is a function of interest rates. Prepayment risk can however be both a component of interest rate risk and affected by changes in interest rates, but there can be a number of other factors affecting prepayment risk. This is especially true for mortgages.

We believe that hedging of prepayment risk of a held-to-maturity investment is in accordance with the standard, and recommend that the answer be amended accordingly.

## **Paragraph 134**

### **Question 134-3**

#### ***Internal contracts: single offsetting external derivative***

This question and answer further elaborate on the issues relating to the use of internal contracts in hedge accounting. In our comments on Batch IV we explained our views on the issue of netting of internal contracts prior to external risk transfer. As you may remember, we do not believe that netting should necessarily disqualify hedged gross positions from receiving hedge accounting treatment. So as not to repeat ourselves, we only note the importance of all efforts being made by the Implementation Guidance Committee in developing reasonable approaches compatible with the substance of banks' risk management activities.