



BASEL COMMITTEE ON BANKING SUPERVISION

BANK FOR INTERNATIONAL SETTLEMENTS

Chairman

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Sir David Tweedie
International Accounting Standards Board
30 Cannon Street,
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18 October 2002

**Re: Exposure Draft of proposed Amendments to IAS 32 and 39 on
Financial Instruments Accounting, Presentation, and Disclosure**

Dear Sir David,

The Basel Committee on Banking Supervision welcomes the opportunity to comment on the Exposure Draft of proposed *Amendments to IAS 32, Financial Instruments: Disclosure and Presentation, and IAS 39, Financial Instruments: Recognition and Measurement*, published for comment in June 2002. The Committee has a strong interest in promoting transparent and high quality financial statements by banks and believes that the Exposure Draft includes many useful proposals.

Please find our detailed comments in the attached note. The Committee's Accounting Task Force, chaired by Prof Arnold Schilder, Executive Director of De Nederlandsche Bank, has prepared the note. This note has been approved by the Basel Committee. The development of our comments was coordinated by an *ad hoc* subgroup on IAS 32 and 39 under the direction of Gerald A Edwards, Jr, Associate Director and Chief Accountant – Supervision, Federal Reserve Board. The Basel Committee trusts that you will find its comments useful and constructive.

If you have any questions regarding our comments, please feel free to contact Prof Schilder (+ 31 20 524 3360), Mr Edwards (+1 202 452 2741), or Mr Bengt A Mettinger at the Basel Committee Secretariat (+ 41 61 280 9278).

Yours sincerely,

William McDonough

Basel Committee Comments on IASB Exposure Draft of Proposed “Amendments to IAS 32, Financial Instruments: Disclosure and Presentation, and IAS 39, Financial Instruments: Recognition and Measurement”

Introduction

For over a decade, the Basel Committee on Banking Supervision¹ (Committee) has been issuing extensive guidance and policy papers on risk management activities of banks. These releases have included guidance and research studies on sound practices for managing credit risk, market risk (including interest rate and foreign exchange risk) and other banking risks arising from trading and derivatives activities and banking book exposures. In addition, in its work on the New Basel Capital Accord, the Committee is developing new rules and proposals for comprehensively relating capital adequacy to bank risk profiles. All of these efforts have involved extensive consultation with global banks and others, and have been designed to promote the adoption of sound risk management by banks around the world. In reviewing the proposal to amend IAS 32 and 39, the Committee has drawn upon its expertise in these areas.

Moreover, the transparency of banks – facilitated by sound accounting and disclosure – is a very important objective of the Committee. The Committee has developed a number of policy papers, surveys and supervisory guidance documents in support of this objective. Most notably, the enhanced capital framework that the Committee has proposed recognises the important role of transparency in effecting market discipline as a complement to effective banking supervision. In addition, since 1998 the Committee has been actively involved in important projects, with the IASB and its predecessor, on financial instruments accounting and disclosure. In all of these efforts, the Committee has been actively seeking to improve the overall quality of financial reporting in ways that will enhance transparency and market discipline, and facilitate financial stability. Thus, the Committee has brought these perspectives to bear in reviewing the proposal to amend IAS 32 and 39.

This note presents our comments in two sections. The first section provides our main comments on the proposal and focuses on the topics of the principles-based standards, fair value designation, impairment, hedging, derecognition and financial guarantees in IAS 39, and the presentation and disclosure guidance pertaining to IAS 32. The second section provides summary answers to the specific questions raised by the IASB in the exposure draft. The answers in this second section should be read in the context of our overall comments in the first section.

¹ The Basel Committee on Banking Supervision is a committee of banking supervisory authorities which was established by the central bank Governors of the Group of Ten countries in 1975. It consists of senior representatives of bank supervisory authorities and central banks from Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Spain, Sweden, Switzerland, the United Kingdom and the United States. It usually meets at the Bank for International Settlements in Basel, where its permanent Secretariat is located.

Section 1: Main Comments

The Exposure Draft represents an attempt to amend two very important International Accounting Standards and, in our view, has a number of positive aspects. For example, the Committee believes that the proposed guidance on impairment will enhance provisioning processes in many financial institutions. We note, however, that the IASB indicated in its introduction to the proposal that it does not intend to reconsider the fundamental approach to accounting for financial instruments that is established by IAS 32 and 39. While we understand the pressures on the IASB to finalise the project to improve these two IASB standards, the lack of time for field testing was unfortunate. We also believe that significant additional improvements could have been achieved had the IASB engaged in a more fundamental reconsideration of certain aspects of the IAS 39 guidance on financial instruments accounting and undertaken field tests of certain new approaches to determine their feasibility.

Principles-based Standards

We note that the IASB has repeatedly mentioned its commitment to a principles-based approach to its standards as opposed to a rules-based approach. The Committee strongly supports the IASB in its commitment to principles-based standards. However, in reviewing the exposure draft, the Committee notes that many aspects of the proposed guidance are essentially rules-based and do not appear to be consistent with the stated principles-based objective of the IASB. In particular, the guidance on impairment and hedge accounting could benefit considerably from a significant revision in a manner consistent with the IASB's principles-based-standards objective. Therefore, we recommend that the IASB revise the approach in the proposal in this manner when it issues its final standards.

We have attempted to provide suggestions in this note that should help the IASB to reflect a principles-based approach in its final IAS 39 guidance. However, since the proposal contains a number of rules-based amendments, this note also includes our technical comments on these proposed amendments.

Fair Value Designation and Measurement

In theory, there are certain benefits to a fair value designation through the exposure draft's guidance that would permit any financial instrument to be designated as a trading account item when initially recognised. For example, asset and liability positions in financial instruments that are managed together can receive a common accounting treatment that may not be currently available due to the mixed-attribute accounting model in IAS 39. In addition, this fair value treatment could potentially reduce the calculations and complexity associated with the IAS 39 hedge accounting rules, if the risk exposures and the derivatives that hedge them are designated as being held for trading purposes and accounted for on a fair value basis.

However, there are a number of potential problems associated with this approach. In fact, this designation could result in the same problems as the Committee noted in its previous comment letters about the potential adoption of full fair value accounting. For example, it could permit companies to report increased profits when their own creditworthiness deteriorates. For financial instruments without observable market prices arising from active markets, it may be difficult for companies to determine reliable fair values and for auditors to audit these estimates. Thus, if the fair value designation option is applied to financial instruments that are not traded in active markets and lack reliable fair values, this option may permit companies to manage earnings in ways that would not easily be detected by financial

statement users. For example, organisations could use potentially self-serving models to determine fair value for illiquid instruments in ways that improved their measured financial condition and performance. In addition, the relevance for decision making is questionable when the instruments purportedly reported at fair value are actually illiquid.

A related issue of particular importance to banks is the fair valuation of deposits on an ongoing basis. Banks clearly derive benefits from deposits beyond their contractual liability, which raises questions about the appropriate valuation approach. For example, should the measurement be based on maturity of current balances or should expected future inflows also be considered.

We also note that the proposed approach would essentially permit a further reporting option, which is contrary to one of the main objectives of the IASB improvement projects (i.e. to eliminate or simplify reporting options).

The Committee strongly recommends that the definition of “financial assets or liabilities held for trading” continue to include as a key characteristic that these instruments were “acquired or incurred principally for the purpose of generating a profit from short-term fluctuations in price or dealer’s margin” as in the original definition.

These issues – particularly the potential to allow companies to benefit from deterioration in their own credit risk – could seriously undermine the transparency of financial reports. Therefore, the Committee recommends that the IASB reconsider this proposed guidance.

While the IASB has taken some steps to include additional guidance on fair values in the exposure draft, we encourage the IASB to consider devising greater guidance for determining fair value. For example, we believe that, as a general principle, fair value accounting should not be permitted when the fair values are unreliable. We recognise that defining the boundaries of what constitutes reliable fair value information is a formidable task but it will pay dividends in enhancing the quality of financial reporting. We strongly caution against permitting fair value accounting that is based on potentially self serving valuations by some companies’ management that cannot be readily validated with objective market information.

In addition, as noted in our September 2001 comment letter to the IASB on the Joint Working Group’s (JWG) draft standard on fair value accounting for financial instruments, we recommend that the IASB consider the formation of an expert panel to: (i) examine best practices in the area of valuation techniques; and (ii) assess the feasibility and practicality of formulating reasonably specific sound practices guidance on appropriate methods for valuing illiquid instruments, such as bank loans.

The Committee would envision that such a panel should be comprised of experts representing both preparers and users of financial statements, as well as limited numbers of other interested parties, such as accounting standard setters, auditors, and regulators. As envisioned, such a group should ideally have a broad perspective of expertise encompassing such areas as risk management, financial modelling and valuation and auditing.

As noted in our comments below, the Committee believes that the IAS 39 hedge accounting framework is overly complex and burdensome. A streamlined approach might well obviate the perceived need for a fair value option.

Impairment

We commend the IASB for seeking to comprehensively update its guidance on provisioning. There are a number of positive aspects to the proposed guidance on impairment. For example, we welcome and strongly support the proposal to collectively evaluate groups of assets with similar credit risk characteristics, which include assets that were found to be unimpaired after being evaluated on an individual basis. In addition, based on discussions with IASB staff, we are pleased to see that the IASB has proposed that estimates of expected cash flows for groups of loans should be based on current events affecting the collectibility of the group as of the date of the balance sheet, as well as events expected to affect loan cash flows over the remaining lives of the assets in the group based on objective evidence.² These aspects of the guidance should enhance loan loss provisioning practices.

We encourage the IASB to ensure that its guidance on impairment truly follows a principles-based approach. An example here would be to establish a principle of impairment based upon the current guidance (which the IASB has proposed to delete) in paragraph 109 of IAS 39, “A financial asset is impaired if its carrying amount is greater than its estimated recoverable amount”. The guidance in the final standard could then build upon this important principle and may need to be less detailed as a result. Furthermore, we encourage the IASB to make clear that sound loss estimation techniques, the outcomes of which are in accordance with this principle, are permissible.

We agree with the IASB’s proposed discounting approach for measuring loan impairment. However, we see some practical problems and potential burdens for smaller banks in implementing this approach and more generally for banks when applying this approach to groups of smaller balance loans with similar credit risk characteristics (i.e. homogeneous loans). While the discounted cash flow approach to evaluating impairment in the proposal (and in current IAS 39) may lend itself readily to larger balance individually reviewed loans that are impaired, we are not certain that the benefits of this approach outweigh its costs for groups of homogeneous loans, particularly when the loans are smaller balance loans and of short duration. For groups of this type, we believe a more traditional approach of applying historic loss rates (adjusted for current credit conditions and trends that affect the collectibility of loan cash flows) to the current outstanding principal balance can be a sound proxy for estimating loss based on the present value of the estimated cash flows for a group of loans. We are not convinced that a loss estimate based upon the approach specified in the draft IAS 39 guidance for groups of homogenous loans would produce a materially different estimate than the more traditional approach described above.

The proposed text in paragraph 113D of IAS 39 seems to imply that expected losses are always covered by an appropriate risk premium included in the pricing. However, if the pricing is not adequate, it would result in a calculated effective interest rate that would be insufficient for use when calculating impairment. We recommend that the IASB address this matter in its final standard.

While we agree that objective evidence must be considered in sound provisioning processes, we also note that exercising expert credit judgement in evaluating this evidence is a crucial element of these processes. It is particularly essential when a financial crisis gives rise to credit losses that could not have been anticipated solely by consideration of historical loss rates or other observable data that typically form the basis for provisions. Moreover, it is important that the provisioning process cover impairment for all credit exposures carried at amortised cost based on consideration of the full range of an organisation’s internal credit

² This understanding concerning the estimation of expected cash flows for groups of loans is based on discussions with IASB staff and we encourage the IASB to make this point clearer in its final standard.

grades and not just the credit grades reflecting the most severe asset quality deterioration. We encourage the IASB to ensure that the final standards mention these important concepts, perhaps in the basis for conclusions or application examples.

Moreover, the guidance on impairment in IAS 39 should apply to lease receivables, loan commitments, financial guarantees and other credit risk exposures, even if they are otherwise outside the scope of IAS 39. This could to some extent be accomplished by modifying the scope exceptions in paragraph 1(b) and 1(i) of IAS 39, respectively.

Hedge Accounting

Hedge accounting remains one of the most challenging issues related to financial instrument accounting. On the one hand, it is not desirable to have standards that are so flexible that they open the door for companies to manipulate their reported financial results. On the other hand, it is similarly undesirable to have rules that are so complex that they stifle sound risk management. An approach to hedge accounting that strikes a better balance in terms of complexity and ease of application would be a welcome improvement to the current standards.

The Committee has long emphasised that banks should manage their risk exposures on a comprehensive basis. In this regard, the Committee has since 1999 been actively involved with the IASB and its predecessor in supporting efforts to develop hedge accounting approaches that support risk management on a portfolio basis in ways that are consistent with the intent of IAS 39. For example, these efforts resulted in IAS 39 Implementation Guidance 121-1 and 121-2 that outlined how many of the interest rate risk management activities of financial institutions could qualify for hedge accounting treatment under IAS 39.

We note that the hedging guidance in the proposal is very detailed and is not consistent with a principles-based-standards approach. We recommend that the IASB consider how to streamline the guidance on hedging so that this important objective is met in ways that will reduce reporting burden and improve transparency.

Obviously, a principles-based hedge accounting approach should recognise that hedges must be clearly defined when initiated, and that the strategies should be measurable, effective and adequately documented. The Committee continues to be concerned that burdensome rules for designation of derivatives as hedges of individual assets or liabilities or specific transactions and overly stringent requirements for correlation may deter banking organisations from undertaking prudent actions to manage risk exposures. In addition, it is well known that banks and other large companies seek to hedge net risk exposures, *i.e.* the remaining exposure when certain risks inherent in a group of assets are substantially offset naturally by the same risks embedded in a group of liabilities. We believe the IASB's focus on linking hedging derivatives individually with assets, liabilities, firm commitments or forecasted transactions is not consistent with many aspects of its previous implementation guidance for IAS 39 that effectively permitted cash flow hedges of net interest rate risk exposures on a portfolio basis.

The Committee recognises that there is a limited reference to hedging of net exposures in the proposed paragraph 150. This needs to be further explained and we therefore recommend that the final standard make a prominent reference to implementation guidance, such as 121-1 and 121-2, that illustrates how sound risk management practices on a portfolio basis can qualify for hedge accounting treatment under IAS 39.

As previously mentioned, the Committee recognises the importance of banks managing their overall risk profile. Many internationally active banks currently use derivatives hedges to

adjust their overall net exposures in the banking book on a dynamic basis and use internal transactions to reallocate risk exposures from the banking book to the trading book. Accounting standards should contribute to sound risk management practices and the Committee notes that the underlying principle of consolidation is a fundamental element of sound accounting practices. We recommend that the IASB improve its understanding of how banks use internal transactions to identify and hedge banking book risk exposures with derivatives contracts with external parties in order to determine whether additional hedge accounting guidance could be developed that could contribute to sound risk management and consolidation practices in this area.

Derecognition

It is clear to the Committee that the IASB is seeking to enhance its existing guidance on derecognition through the development of the proposed continuing involvement approach. However, the Committee is concerned that certain aspects of the IASB's proposal on derecognition are likely to result in reporting that is confusing to users of financial statements. We believe that additional work on derecognition and the related disclosures needs to be completed – including field testing -- before a suitable approach can be implemented. Derecognition, including the concept of pass-through arrangements, is a topic of great interest to banking supervisors and we would welcome an opportunity to discuss this further with the IASB in the short term.

Financial Guarantees

The accounting treatment of financial guarantees is of great importance to financial institutions and other companies, and to banking supervisors. Basically, financial guarantees that meet certain criteria are excluded from the scope of IAS 39. Thus, banks can take such guarantees to reduce the credit risks in their loan portfolios without having to measure them at fair value and try to apply the hedge accounting rules in IAS 39. Therefore, we strongly support the view that financial guarantees that meet the specified criteria should be excluded from the standard.

IAS 39 addresses the financial guarantee scope exception in paragraph 1(f) to which various amendments are proposed. We believe that further clarification is required because the language seems to be ambiguous.

The description of the guarantee contracts that qualify for the scope exception is the following: “. . . contracts . . . that provide for specified payments to be made to reimburse the holder for loss it incurs because a specified debtor fails to make payments when due under either the original or modified terms of a debt instrument”. We have two main questions about this language, the first of which concerns the meaning of “loss incurred by the holder”. When a credit exposure is impaired, the impairment loss suffered is, by definition, the difference between the carrying amount and the present value of expected future cash flows. A lender will normally be indifferent between a single payment of the present value and a stream of future payments matching those originally due from the debtor. Guarantee arrangements may take either of these forms and we assume that both are permitted under the definition. We recommend that this be made clear in the final standard.

A second related issue arises from restructuring clauses. Depending on the circumstances, banks may choose to restructure the contractual terms of a debt instrument in response to the borrower's financial problems. In effect, a new agreement is made in which the borrower's payment obligations are reduced or postponed. Such a restructured contract evidences that originally agreed payments will not be made. Needless to say, restructuring is

an important possible event for both banks and their borrowers. Some guarantee-type arrangements provide for compensating payments to be made either on a present value basis or as original payments fall due. The Committee believes guarantees that include restructuring clauses are very beneficial. Our reading of the proposed language in paragraph 1(f) ("original or modified terms") suggests that such clauses would not preclude these financial guarantees from falling within the scope exception, but we recommend that this be clarified in the final standard.

We would note that we assume that the scope exclusion relates to both guarantees given and guarantees taken although this is not entirely clear from the text. We also assume that the reference to a specified debtor means a debtor of the holder of the guarantee so that purchases and sales of credit risk by an entity that does not hold the underlying debt would not meet the definition of a financial guarantee.

Proposed Changes to IAS 32

Regarding the proposed changes to IAS 32, we note that the proposed change in the treatment of compound instruments with both liability and equity elements (under which an entity first measures the liability and assigns the residual amount to equity) conforms to the IASB's definition of a financial liability and an equity instrument. The Committee believes that the existing options for compound instruments under IAS 32 result in an understatement of liabilities and an overstatement of equity. The proposed treatment will help ensure that the liability element of a compound instrument is more properly measured.

In its September 2001 comment letter to the IASB on the JWG's draft standard on fair value accounting for financial instruments, the Committee recommended that fair value information could be enhanced through disclosure. Specifically, users of financial statements would benefit from information that would identify whether fair values were based on observable market prices or on other estimation techniques. We note that the proposed enhancements to fair value disclosures move in that direction by requiring disclosure of the extent to which fair values are determined directly from quoted market prices or recent market transactions or are estimated using a valuation technique. These and the other enhanced fair value disclosures should provide useful information to financial statement users, including supervisors, and should assist users in making judgements about the reliability of fair values presented in an entity's financial statements. We recommend that the wording of this proposed requirement be strengthened to indicate that quantitative information about the fair values (e.g. amount of fair values based on observable market prices versus fair values based on other approaches) and not just qualitative disclosure is expected. Moreover, we recommend disclosure of realised and unrealised changes in fair value and changes in fair value attributable to changes in valuation techniques. (We note that disclosures such as these are beginning to appear in some countries and are providing additional transparency in this area.)

The Committee notes that the IASB has a separate project to amend IAS 30, *Disclosures in the Financial Statements of Banks and Similar Institutions*. The IASB staff is being assisted in this endeavour by the Financial Activities Advisory Committee (FAAC) and the Committee participates in the FAAC through two observers. The Committee strongly supports the FAAC effort to enhance the risk disclosures about financial activities of banks and other companies. In view of the fact that the draft amendments to IAS 30 will supplement the risk disclosure requirements of IAS 32, we recommend that, as part of the IAS 30 amendment project, the IASB consider all of the risk disclosures in IAS 32 along with those proposed for IAS 30 to determine the best location for them. In particular, the IASB should consider whether to include all of the risk disclosures in IAS 32, to keep them in the two separate standards, or to create a new separate risk disclosure standard.

Section 2: Responses to Questions in the Exposure Draft

I. IAS 39

Question 1 – Scope: loan commitments (paragraph 1(i)) - Do you agree that a loan commitment that cannot be settled net and the entity does not designate as held for trading should be excluded from the scope of IAS 39?

We support the view that these loan commitments should be excluded from the definition of a derivative, as banks typically enter into these contracts as part of or an adjunct to their lending (banking book) activities, and such commitments are usually not traded. However, we suggest that the provisions of IAS 39 rather than IAS 37 be applied when determining the impairment of loan commitments that are not otherwise within the scope of IAS 39, as the credit risk underlying these types of commitments mirrors those of loan assets.

Question 2 – Derecognition: continuing involvement approach (paragraphs 35-37) – Do you agree that the proposed continuing involvement approach should be established as the principle for derecognition of financial assets under IAS 39? If not, what approach would you propose?

Please see the discussion of this topic in Section 1 of our comments.

Question 3 – Derecognition: pass-through arrangements (paragraph 41) – Do you agree that assets transferred under pass-through arrangements where the cash flows are passed through from one entity to another (such as from a special purpose entity to an investor) should qualify for derecognition based on the conditions set out in paragraph 41 of the Exposure Draft?

Please see the discussion of this topic in Section 1 of our comments.

Question 4 – Measurement: fair value designation (paragraph 10) – Do you agree that an entity should be permitted to designate any financial instrument irrevocably at initial recognition as an instrument that is measured at fair value with changes in fair value recognised in profit or loss?

Please see the discussion of this topic in Section 1 of our comments.

Question 5 – Fair value measurement considerations (paragraphs 95-100D) – Do you agree with the requirements about how to determine fair values that have been included in paragraphs 95–100D of the Exposure Draft? Additional guidance is included in paragraphs A32–A42 of Appendix A. Do you have any suggestions for additional requirements or guidance?

As the Committee noted in its comment letter to the IASB on the JWG's fair value accounting proposal, developing additional guidance for determining fair values (and their validation) is an increasingly pressing need. While the IASB has taken some steps to include additional guidance on fair values in the exposure draft, we encourage the IASB to consider devising greater guidance in determining fair value in ways that will reduce the potential for self-serving fair value estimates and other potential abuses. Please see our comments on fair value measurement in section 1 above.

Question 6 – Collective evaluation of impairment (paragraphs 112 and 113A–113D) – Do you agree that a loan asset or other financial asset measured at amortised cost that has been individually assessed for impairment and found not to be individually impaired should be included in a group of assets with similar credit risk characteristics that are collectively

evaluated for impairment? Do you agree with the methodology for measuring such impairment in paragraphs 113A-113D?

The Committee has long favoured early identification and recognition of loan impairment. Collective impairment is one of the significant elements that the Committee is adding to a revised version of its policy paper on Sound Practices for Loan Accounting, originally issued in July 1999, which the Committee expects to publish for comment soon after the IASB has issued the final amended IAS 39. Please see our comments in Section 1 above.

Question 8 – Hedges of firm commitments (paragraphs 137 and 140) – Do you agree that a hedge of an unrecognised firm commitment (a fair value exposure) should be accounted for as a fair value hedge instead of a cash flow hedge as it is at present?

We support the proposed amendment. The Basis for Conclusions explains that the amendment is proposed for both conceptual and practical reasons. Conceptually, a hedge of a firm commitment is a fair value hedge since the fair value of the firm commitment changes with changes in the hedged risk.

Question 9 – ‘Basis adjustments’ (paragraph 160) – Do you agree that when a hedged forecast transaction results in an asset or liability, the cumulative gain or loss that had previously been recognised directly in equity should remain in equity and be released from equity consistently with the reporting of gains or losses on the hedged asset or liability?

We believe that the proposed treatment of recycling on a period by period basis the gain or loss out of equity, in line with depreciation on the asset or other recognition in profit or loss of the consumption of the asset or reduction of the liability is burdensome. Moreover, it would make the effects of the hedge harder for users of financial statements to understand. In this regard, we do not perceive there to be a comparability issue with having different carrying amounts for two identical assets or liabilities – one whose acquisition was hedged and one whose acquisition was not hedged - as stated in paragraph C103. In our view, the difference in treatment is warranted by the corresponding difference in underlying transactions arising from the decision to hedge. The current treatment also provides more transparent information for the investor to see the success (or failure) of a hedging strategy. The proposal is based on the view that a gain or loss does not form part of an asset or liability. The problem with following this view is that hedge accounting, by definition, suspends the normal rules of recognition and measurement. We believe that the basis adjustment approach should be retained because the proposed amendment would place additional burden on preparers of accounts without improving the financial information..

Treating hedges of firm commitments as fair value hedges and retaining the basis adjustment approach also produces a more internally consistent accounting standard. Treating hedges of firm commitments as fair value hedges has the same effect as a basis adjustment when the firm commitment relates to an asset or liability.

Question 10 – Prior derecognition transactions (paragraph 171B) – Do you agree that a financial asset that was derecognised under the previous derecognition requirements in IAS 39 should be recognised as a financial asset on transition to the revised Standard if the asset would not have been derecognised under the revised derecognition requirements (i.e. that prior derecognition transactions should not be grandfathered)? Alternatively, should prior derecognition transactions be grandfathered and disclosure be required of the balances that would have been recognised had the new requirements been applied?

The proposal in paragraph 171B represents a conceptually pure approach that in some cases may be both burdensome and impractical. We therefore support a case-by-case

exemption that is accompanied by a disclosure requirement for specific transactions where undue cost or burden would result from following paragraph 171B.

II. IAS 32

Question 1 – Probabilities of different manners of settlement (paragraphs 19, 22, and 22A) – Do you agree that the classification of a financial instrument as a liability or as equity in accordance with the substance of the contractual arrangements should be made without regard to probabilities of different manners of settlement? The proposed amendments eliminate the notion in paragraph 22 that an instrument that the issuer is economically compelled to redeem because of a contractually accelerating dividend should be classified as a financial liability. In addition, the proposed amendments require a financial instrument that the issuer could be required to settle by delivering cash or other financial assets, depending on the occurrence or non-occurrence of uncertain future events or on the outcome of uncertain circumstances that are beyond the control of both the issuer and the holder of the instrument, to be classified as a financial liability, irrespective of the probability of those events or circumstances occurring (paragraph 22A).

The types of hybrid instruments affected by the change generally include elements of both equity and liabilities. As such, they are often difficult to categorise as either definitively equity or liabilities. Given the special nature of equity, especially for financial firms, it appears prudent to err on the side of classifying an instrument as a liability rather than equity. Moreover, the circumstances under which such instruments more typically resemble liabilities are during times of financial stress, which is exactly when financial institutions are most in need of a strong equity capital base.

Question 2 – Separation of liability and equity elements (paragraphs 28 and 29) – Do you agree that the options in IAS 32 for an issuer to measure the liability element of a compound financial instrument initially either as a residual amount after separating the equity element or based on a relative-fair-value method should be eliminated and, instead, any asset and liability elements should be separated and measured first and then the residual assigned to the equity element?

We agree that the options should be eliminated and replaced with a single method that separates and measures any liability elements first and then assigns the residual to the equity components.

Question 3 – Classification of derivatives that relate to an entity's own shares (paragraphs 29C - 29G) – Do you agree with the guidance proposed about the classification of derivatives that relate to an entity's own shares?

The Committee agrees with the broad thrust of the proposed guidance in this area.

Question 4 – Consolidation of the text in IAS 32 and IAS 39 into one comprehensive Standard – Do you believe it would be useful to integrate the text in IAS 32 and IAS 39 into one comprehensive Standard on the accounting for financial instruments? (Although the Board is not proposing such a change in this Exposure Draft, it may consider this possibility in finalising the revised Standards.)

The Committee is a strong proponent of useful disclosure and transparency in financial statements in support of market discipline. In fact, this is one of the three pillars of the new Basel capital accord. In this context, disclosure works best when it is tightly integrated with the principles underlying the financial elements of accounting standards. A combined IAS 32 and 39 text would perhaps be useful in reinforcing this link, and give the reader of the

standard a better sense of the interrelationships between disclosure and the financial principles of these two accounting standards. At the same time, the Committee believes that those companies that will need to adopt IASs for financial reporting purposes should be given sufficient time to prepare for this adoption. An effort to combine IAS 32 and 39 into a single standard as part of the IASB's current amendment process may delay the issuance of the amended standards. Thus, in the interests of time, the IASB should not integrate IAS 32 and 39 into a single comprehensive standard at present, but could consider doing so at a later date.