



BASEL COMMITTEE ON BANKING SUPERVISION

BANK FOR INTERNATIONAL SETTLEMENTS

Chairman

VIA EMAIL: iasb@iasb.org

Sir David Tweedie
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

14 September 2009

Exposure Draft – ED/2009/7 ‘Financial Instruments: Classification and Measurement’

Dear Sir David

The Basel Committee on Banking Supervision (the Committee) welcomes the opportunity to comment on the IASB’s exposure draft (ED) *Financial Instruments: Classification and Measurement*. The Committee has a strong interest in high quality financial reporting by banking organisations and has carefully considered this proposal, in particular, since in April 2009 the G20 Leaders called on “accounting standard setters to work urgently with supervisors [...] to achieve a single set of high-quality global accounting standards”.

The Committee welcomes the IASB’s attempts to improve and simplify the accounting requirements for the classification and measurement of financial instruments. Given the importance of this work, the Committee strongly encourages the IASB and the Financial Accounting Standards Board to work together in order to achieve a high-quality converged accounting standard for financial instruments.

Our general comments and specific responses to 12 of your 15 questions are included in the attached Appendix, and they build upon the Committee’s *Guiding principles for the replacement of IAS 39* (high-level guiding principles) that were sent to you in July 2009.¹ The G20 Finance Ministers and Central Bank Governors, following their meeting on 4-5 September noted: “*within the framework of the independent accounting standard setting process, the IASB is encouraged to take account of the Basel Committee guiding principles on IAS 39 . . .*”.

The ED proposes two primary categories for measuring financial assets and liabilities. These categories are fair value and amortised cost. As noted in the high-level guiding principles, we believe the new standard should ensure banking transactions are portrayed in a robust and consistent manner. Furthermore, the new two-category approach for financial instruments should not result in an expansion of fair value accounting, in particular through profit or loss for institutions involved in credit intermediation. For example, deposits and lending instruments, including loans, should not end up in the fair value category under the

¹ These principles can be found on the Committee’s website (www.bis.org/press/p090827.htm).

proposed approach. Were they to do so, a significant gap would open up between the accounting for bank activities and their economic substance. Specifically, it is important that instruments managed on a contractual yield basis are accounted for at amortised cost, and not fair value.

Further, providing the information necessary for investors and other financial statement users can be better achieved by enhancing the impairment model to incorporate a broader range of credit information that results in earlier identification and recognition of credit losses, such as in an expected loss model. This revised impairment model for the amortised cost category would be consistent with providing financial statement users with improved transparency into changes in credit trends without expanding the use of fair value.

We are not convinced that the proposed conditions for allocating financial assets and liabilities into the ED's two primary classification and measurement categories would meet the key high-level guiding principles cited above. The principles also mention that there should be "a strong overlay reflecting the entity's underlying business model as adopted by the Board of Directors and senior management, consistent with the entity's documented risk management strategy and its practices, while considering the characteristics of the instruments". A greater emphasis by the IASB on the business model, which is founded in sound governance, control and internal documentation, could assist the IASB in improving the conditions for the proper classification of financial instruments in a manner consistent with the high-level guiding principles and the information needs of investors. This recommendation is further explained in the general and detailed comments sections of the Appendix attached to this comment letter.

The Committee finds it difficult to opine on certain specific elements of this ED in the absence of concrete proposals relating to the revision of other aspects of IAS 39. This includes, for example, proposals relating to impairment and hedge accounting presently under development. This ED potentially interacts with these proposals that are not yet available. Accordingly, the views expressed in this comment letter might need to be reconsidered once the IASB proposals to revise or replace other aspects of IAS 39 are known.

These comments have been prepared by the Committee's High Level Working Group (HLWG), co-chaired by Sylvie Mathérat, Director of the Banque de France and Chair of the Committee's Accounting Task Force (ATF), and Jerry Edwards, Senior Advisor, ATF. The Committee has approved these comments and trusts that you will find them useful and constructive. If you have any questions regarding our comments, please feel free to contact Sylvie Matherat (+33 1 4292 6579), Jerry Edwards (+41 61 280 8055), or Xavier-Yves Zanota or Rob Sharma at the Basel Committee Secretariat (+41 61 280 8613 or 8007).

Yours sincerely



Nout Wellink



Appendix

General comments on IASB's Exposure Draft on Financial Instruments: Classification and Measurement

The Committee sets out below a number of general comments before answering the more detailed questions in the exposure draft (ED).

The ED first proposes conditions for requiring financial assets and liabilities to be measured at amortised cost. When instruments have only basic loan features and are managed on a contractual yield basis, such instruments are to be measured at amortised cost. Otherwise, these financial instruments would be measured at fair value. The Committee welcomes that the IASB is proposing that amortised cost measurement is appropriate for key aspects of banking activities and will result in more relevant financial information for market participants.

However, in practice, we believe that the fact that fair value becomes a default category may lead to more financial instruments being measured at fair value than at present under IAS 39 as the conditions for the amortised cost category are overly restrictive. This means that certain transactions would be portrayed in a manner inconsistent with banks' business models, ie the way in which banks are managed internally. These conditions need further clarity so as not to give rise to significant differences in interpretation. We note that the conditions will require the following instruments to be measured at fair value through profit or loss:

- host instruments where embedded derivatives are currently bifurcated, which would now have to be fully fair valued;
- assets representing tranches other than the most senior tranche issued by a special purpose entity (SPE) and related liabilities; and
- some available-for-sale (AFS) and held-to-maturity (HTM) debt securities.

We question the relevance of fair value measurements for an entity that manages such instruments on an amortised cost basis in accordance with its business model.

Many of our concerns with the conditions for the amortised cost category could be addressed, as set forth in the high-level guiding principles, by having a strong overlay reflecting the entity's underlying business model as adopted by its board of directors and senior management, consistent with the entity's documented risk management strategy and its practices, while also considering the characteristics of the instruments (eg liquidity). The business model concept should be carefully defined by the IASB along these lines to avoid abuse. We note that objective evidence of the business model is to be found in, for example, documented strategic and risk management policies and reports to the Board and senior management as well in the entity's practices. Thus, the "business model" set forth in the high-level guiding principles is something capable of verification.

We are also concerned that the conditions for classification could result in different accounting based on the manner in which an entity acquires financial assets. In cases where an entity acquires financial assets at a discount due in part to credit deterioration, under the proposal the assets must be measured at fair value on an ongoing basis. If an entity's

business model is to manage the acquired assets in a manner consistent with other similar assets it has originated and measures at amortised cost, then the proposed criteria would result in less than optimal accounting.

Furthermore, the ED permits certain investments in equity instruments (and associated dividends) that are not held for trading to be measured at fair value through other comprehensive income (OCI). When such investments are sold, the gains or losses that are realised continue to be recognised in other comprehensive income (with no recycling through profit or loss). We question this approach as the sale of investments would represent the culmination of an earnings process for that strategic purpose, which should result in recognition of the related gains or losses. Furthermore, this approach is inconsistent with the matching principle as operating expenses incurred to support the strategic equity investments are charged to the income statement, while the associated dividends, in particular, are permanently accounted for in OCI. This is the case particularly for a financial or investment holding company whose main revenue source is dividend income from its strategic investments. Having dividend income in OCI may also mean that these companies will report losses as there are little or no other revenues against which the operating expenses can be matched. This may have implications for ratings and/or covenants.

In addition, the classification and measurement proposal – in combination with the ED on fair value measurement – does not seem to address the issue of significant valuation uncertainty associated with illiquid instruments measured at fair value and take into account the lessons learned from the crisis. These concerns have been expressed by the G20 and the Financial Stability Board, and most recently in the Committee's high-level guiding principles (principle 10). For financial instruments that are either not actively traded, or have insufficient market depth, or rely on valuation models using unobservable inputs, there is considerable valuation uncertainty. IASB standards should provide for valuation adjustments to avoid misstatement of both initial and subsequent profit or loss recognition when there is significant valuation uncertainty. The size of the adjustment could be based on the degree of uncertainty created by the weakness in the data or underlying modelling approach. This could possibly be addressed by drawing from the existing guidance on valuation adjustments in the IASB's report of the Expert Advisory Panel on valuation, October 2008, and expanding it so as to address this issue and include appropriate references in the IASB's final standards on fair value measurement and on classification and measurement, including in the basis for conclusions. Another possible solution could be to include financial instruments with significant valuation uncertainty in fair value through OCI. The Committee's comment letter on the fair value measurement ED will discuss these issues in more detail.

Answers to detailed questions

Classification approach

Question 1

Does amortised cost provide decision-useful information for a financial asset or financial liability that has basic loan features and is managed on a contractual yield basis? If not, why?

The Committee believes that amortised cost provides decision-useful information for instruments that are managed on a contractual yield basis. The information associated with the amortised cost basis that would be presented in an entity's financial statements is the necessary information for an entity to manage these kinds of financial instruments. This information would also be useful and relevant for financial statement users, including investors and banking supervisors, to evaluate how well the entity has managed these instruments and related cash flows. As noted in the general comments above, we are concerned that certain kinds of financial assets and liabilities, including loans and other debt instruments, will end up in the fair value category due to the restrictive nature of the conditions proposed in the ED for the amortised cost category. We ask the IASB to carefully reconsider its approach.

The proposed amortised cost conditions do not allow banking transactions to be faithfully portrayed in a robust and consistent manner in line with their economic substance. As noted in the high-level guiding principles, there is a need for a strong overlay reflecting the entity's underlying business model as adopted by the Board of Directors and senior management, consistent with the entity's documented risk management strategy and its practices, while considering the characteristics of such instruments. We offer some recommendations for further improvements in our answers to the questions below.

Question 2

Do you believe that the exposure draft proposes sufficient, operational guidance on the application of whether an instrument has 'basic loan features' and 'is managed on a contractual yield basis'? If not, why? What additional guidance would you propose and why?

For most liabilities for banking organisations other than trading and derivatives, there is a rebuttable presumption that such positions represent "funding", and accordingly the use of amortised cost should be mandatory because this is likely to be closer to the contractual amount (being managed by the organisation) than fair value. As noted in our comments below, use of the fair value option could be permitted to deal with certain "mismatch" situations.

For assets, if a loan is characterised by advancing principal, receiving interest on it, and also with principal repayment in some manner – all subject to the credit risk of non-payment – then it is not obvious why amortised cost accounting should be restricted just to those with basic loan features. Moreover, in general a loan does not cease to be a loan just because one or more derivatives are embedded. Depending on the business model, the way to deal with this may be bifurcation (as currently required or permitted in IAS 39 – see answer to Question 4).

The Committee believes that the IASB could enhance the operational guidance in the ED in a number of ways. First, we encourage the IASB to review the characteristics of securitisations to see whether some of these instruments with subordination features could

qualify for amortised cost treatment (eg due to lower risk profiles). The IASB should consider developing further guidance for structured products in addition to paragraphs B7 and B8.

We generally agree with the IASB that the highest tranche of a securitised asset is a basic loan, and that the lowest tranche due to the presence of extensive credit protection should be measured at fair value through profit or loss. However we believe that, for all other tranches, the accounting treatment should depend on whether the cash flow characteristics are similar to those of the most senior tranche or those of the lowest tranche. In this regard, we would encourage the IASB to develop this concept into a principle based on the expected variability of the financial instrument's cash flows at origination together with a strong business model overlay (as described in our earlier comments, which include reasonable documentation). Regardless of how they compare to the senior and lowest tranches, instruments that are not the most senior tranche with significant expected variability of cash flows at origination would not be eligible for amortised cost.

In addition, the application guidance should specifically explain how the waterfall structure of these products would affect their classification. The IASB should clarify whether the assessment of the subordination of tranches is performed only at the inception of the contract (as in the case of derecognition under ED 10) or, having regard to the typically sequential nature of these products, whether the subordination should be periodically reassessed over the life of the contract. In this regard, when the most senior tranche is paid in full, the next tranche normally becomes the most senior tranche. If an entity purchases this newly senior tranche, it does not seem appropriate to preclude the purchaser from classifying the tranche in the amortised cost category if it meets the relevant conditions.

The guidance in paragraph B8 unduly constrains certain tranches of a structured investment vehicle from being measured at amortised cost. We are also not convinced by the reasoning in paragraphs BC26 and BC27 of the Basis for Conclusions that support a different treatment for structured investment vehicles than for the institution itself. We encourage the IASB to consider developing further guidance for structured products whereby greater emphasis is placed on how an entity manages those products and the instrument's expected cash flow characteristics. We would caution that determinations based solely on structural elements (such as seniority of payment) could be subject to manipulation (eg by way of resecuritisations).

Also, it is not clear how the "basic loan features" condition is to be interpreted in relation to more complex instruments. Notably, we are concerned that the features and covenants usually included in commercial loans and some retail loans may not meet this condition, which would prevent these loans from qualifying for amortised cost measurement. For instance, the ED addresses the treatment of a prepayment option but it does not explicitly outline how loans with options to extend the maturity while keeping the same other characteristics will be treated. A consistent accounting treatment for these traditional lending instruments should be required.

As noted above in our general comments, the Committee believes that the amortised cost measurement conditions are overly restrictive and will be subject to differences in interpretation. For instance, according to paragraph B13(b) of the ED, a financial instrument that is acquired at a discount that reflects incurred credit losses does not meet the "managed on a contractual yield basis" condition. It is not clear whether this exclusion depends on the fact that the expected cash flows from the acquired financial asset that will generate the income on the asset are not "contractual" interest cash flows. If so, it is unclear how originated loans would be treated under the ED if the concept of expected credit losses is introduced in the IASB's planned new impairment standard that replaces IAS 39. Financial assets that are acquired at a discount or at a premium according to paragraph B13(b) should be eligible for measurement at amortised cost, given that discount and premium can be

amortised to the extent appropriate over the life of the assets until maturity. The discount or premium does not change the basic loan features, and the asset can still be managed on a contractual yield basis. Acquisition at a discount or at a premium should result in the same classification since the contractual characteristics of the instruments remain unchanged in both cases.

Furthermore, it is unclear from the proposals how hedge accounting would work on financial instruments that are reclassified on transition. Further guidance is needed to address these transactions in the final standard.

Question 3

Do you believe that other conditions would be more appropriate to identify which financial assets or financial liabilities should be measured at amortised cost? If so,

- (a) what alternative conditions would you propose? Why are those conditions more appropriate?*
- (b) if additional financial assets or financial liabilities would be measured at amortised cost using those conditions, what are those additional financial assets or financial liabilities? Why does measurement at amortised cost result in information that is more decision-useful than measurement at fair value?*
- (c) if financial assets or financial liabilities that the exposure draft would measure at amortised cost do not meet your proposed conditions, do you think that those financial assets or financial liabilities should be measured at fair value? If not, what measurement attribute is appropriate and why?*

As noted in our cover letter, our general comments and our responses to Questions 1 and 2 above, we believe Principle 2 of the high-level guiding principles, which calls for faithful representation by reflection of the business model, should be a significant condition to appropriately identify financial instruments at amortised cost. This principle stresses the need for banking transactions to be portrayed in a robust and consistent manner in line with their economic substance. Using the approach set forth in the high-level guiding principles the business model will strongly reflect the entity's underlying business as adopted by the Board of Directors and senior management, consistent with the entity's documented risk management strategy and its practices. We believe the use of the business model overlay (with these attributes) on the consideration of the characteristics of the instrument will provide more meaningful information to users of financial information.

However, in order to ensure that the boundaries between fair value and amortised cost are consistent and comparable across entities careful consideration needs to be given in the final standard to the definition of the business model and the characteristics of the instruments.

Furthermore, the manner in which the entity engages in business activities with financial instruments measured at amortised cost or fair value needs to be considered. When an entity uses either amortised cost or fair value as the measurement basis for managing its financial assets and liabilities, and uses the same measurement basis for making decisions to allocate resources and assess performance, it is more likely than not that the measurement basis is consistent with the underlying business model and is consistent with the entity's documented risk management strategy.

Question 4

- (a) *Do you agree that the embedded derivative requirements for a hybrid contract with a financial host should be eliminated? If no, please describe any alternative proposal and explain how it simplifies the accounting requirements and how it would improve the decision-usefulness of information about hybrid contracts?*

The ED proposes that embedded derivatives will no longer be separated from the host contract and some hybrid instruments will be measured at fair value through profit or loss. Today, many financial instruments embed a derivative, and it is necessary that the reporting for such instruments be consistent with the entity's business model. We would recommend that bifurcation is retained as an option in certain cases. That is, we are in favour of maintaining the requirement to separate embedded derivatives when they are not economically closely related to the host contract. We believe it is more useful to financial statement users for an entity to reflect the different nature and effect of each component of hybrid instruments that have significantly different features. Continuing to separate hybrid instruments will not lead to excessive complexity as entities already have the necessary systems and processes to bifurcate under the current requirements and these requirements are well understood.

- b) *Do you agree with the proposed application of the proposed classification approach to contractually subordinated interests (ie tranches)? If not, what approach would you propose for such contractually subordinated interests? How is that approach consistent with the proposed classification approach? How would that approach simplify the accounting requirements and improve the decision usefulness of information about contractually subordinated interests?*

As noted in our response to Question 2, the Committee disagrees with the assertion that all contractually subordinated interests do not have basic loan features and that only the most senior interest could be eligible to the amortised cost category. Some subordinated interests could be senior (but not the most senior) and have features regarding expected cash flows and credit risks similar to those of any collateralised loan. Hence, measuring them at fair value may be inappropriate. We encourage the IASB to consider developing further guidance for subordinated interests with an emphasis on the business model of the entity and the instruments' expected cash flow characteristics.

Fair Value Option

Question 5

Do you agree that entities should continue to be permitted to designate any financial asset or financial liability at fair value through profit or loss if such designation eliminates or significantly reduces an accounting mismatch? If not, why?

Question 6

Should the fair value option be allowed under any other circumstances? If so, under what other circumstances should it be allowed and why?

The Basel Committee worked very closely with the IASB as the IASB developed the June 2005 amendment to the fair value option rules, and this amendment, coupled with the Basel Committee's supervisory guidance based on the revised accounting treatment was supported by the European Central Bank and the European Commission (EC), resulting in

the elimination of the EC's carve-out. It is very important, therefore, that the substance of the fair value option accounting treatment be maintained in the final IASB standard.

To the extent the IASB's hedge accounting rules will be sufficiently simplified, the fair value option could possibly be eliminated. Therefore the future application of the fair value option would need further consideration as part of the development of the amendment of the hedge accounting rules.

The Committee has raised concerns in past comment letters to the IASB regarding the recording of gains arising from changes in the fair value of liabilities accounted for at fair value through profit or loss due to the deterioration of an entity's own credit risk. This has also been addressed in the Committee's comment letter in September 2009 on the IASB's Discussion paper *Credit Risk in Liability Measurement*.

The Committee also considers that those financial instruments held for trading should be disclosed separately from the rest of the financial instruments classified at fair value through profit or loss.

Reclassification

Question 7

Do you agree that reclassification should be prohibited? If not, in what circumstances do you believe reclassification is appropriate and why do such reclassifications provide understandable and useful information to users of financial statements? How would you account for such reclassifications, and why?

The Committee is of the view that financial statements should portray banking transactions in a consistent manner in line with their economic substance and believes reclassification should be allowed in very rare circumstances where the business model has clearly changed (ie from a sell-for-profit business model to a business model whereby instruments are managed on a contractual yield basis). As we have learned from the financial crisis, business models can and of necessity do change as economic events and situations significantly change. A business model change is not done lightly or easily so any such changes should be a rare event.

We believe it is important to retain the flexibility in current International Financial Reporting Standards to enable entities to reclassify financial instruments from fair value to amortised cost when economic events cause markets to become dislocated and an entity's management responds to this dislocation by changing its business model. Any reclassification should be irrevocable and should be done in rare circumstances only.

As the reclassification of a financial instrument can have a significant effect on the financial statements, it is important that such assessments are not made on an instrument-by-instrument basis and that comprehensive disclosures are provided to users.

Unquoted Equity instruments

Question 8

Do you believe that more decision-useful information about investments in equity instruments (and derivatives on those equity instruments) results if all such investments are measured at fair value? If not, why?

Question 9

Are there circumstances in which the benefits of improved decision-usefulness do not outweigh the costs of providing this information? What are those circumstances and why? In such circumstances, what impairment test would you require and why?

Our recommended classification condition that would be based on the business model should be applied also to equity instruments other than controlling interests (IAS 27), joint-ventures (IAS 31) and associates (IAS 28). These are equity instruments held for several reasons (trading, strategic investments etc.) Entities should be allowed to measure these instruments according to their economic use – at fair value (eg when held for trading) or at amortised cost (eg when held as long-term investments in non-listed companies). As noted in our earlier comments, the emphasis on the business model, which is set forth in the high-level principles, is founded on sound governance, internal control and documentation practices, which means business models should not change repeatedly. Therefore, under this approach a business model change would not be done lightly and would be a rare event.

In some cases – ie interests in non-listed companies (eg investments in start-ups and venture capital investments) – it could be very difficult and onerous to estimate a reliable fair value. Often it could be a Level 3 fair value. Valuing equity investments in these companies is likely to be highly resource intensive, judgmental, and unlikely to be comparable across institutions. From a cost-benefit perspective, it remains unclear whether the benefit of having unreliable fair value information will exceed the cost required to produce such Level 3 fair value estimates. In this regard, we believe there is merit to retain the cost exemption that IAS 39 currently provides for such unquoted equity investments, with supporting disclosure in the notes.

The impairment test for unquoted equity investments measured at cost could follow the same approach as in IAS 36. In order to avoid the well-known implementation problems posed by current rules on AFS assets, the new IAS 39 could clarify that equity investments should be classified as “impaired” when they relate to entities with identified solvency problems/financial difficulties.

Investments in equity instruments that are measured at fair value through other comprehensive income

Question 10

Do you believe that presenting fair value changes (and dividends) for particular investments in equity instruments in other comprehensive income would improve financial reporting? If not, why?

Question 11

Do you agree that an entity should be permitted to present in other comprehensive income changes in the fair value (and dividends) of any investment in equity instruments (other than those that are held for trading), only if it elects to do so at initial recognition? If not, (a) how do you propose to identify those investments for which presentation in other comprehensive income is appropriate? Why? (b) should entities present changes in fair value in other comprehensive income only in the periods in which the investments in equity instruments meet the proposed identification principle in (a)? Why?

As noted in our general comments above, we question the approach taken in the ED under which realised gains and losses on sales of certain investments in equity instruments continue to be recognised in OCI with no recycling through profit or loss and dividends on these investments also are recognised in OCI rather than in profit or loss.

Furthermore, as a principle for sound accounting standards, the Committee believes that arbitrary rules (such as no recycling, no reversal of AFS equity impairment, and the held to maturity tainting rule) which do not have any justification in the economic substance of transactions should be avoided. This is consistent with principle 3(c) of the high level guiding principles. Therefore, the Committee is not convinced by the rationale for prohibiting the recognition of realised gains and losses in profit or loss.

Question 14

Do you believe that this alternative approach provides more decision-useful information than measuring those financial assets at amortised cost, specifically:

- (a) in the statement of financial position?*
- (b) in the statement of comprehensive income?*

If so, why?

The alternative approach aims at measuring some quoted debt instruments at fair value through OCI by adding a third condition to the amortised cost category. We are strongly opposed to this approach that will reduce the scope of the amortised cost category and expand the use of fair value.