Guiding principles for the replacement of IAS 39

Fundamental principles

1. Usefulness and relevance

The replacement of IAS 39 should improve the decision usefulness and relevance of financial reporting for stakeholders, including prudential regulators. Information is useful to users if it enables them to assess amounts, timing, and uncertainty of future cash flows of the reporting entity and stewardship and accountability of the entity's management.

The new two-category approach for financial instruments should not result in an expansion of fair value accounting, in particular through profit and loss for institutions involved in credit intermediation. For example, lending instruments, including loans, should not end up in the fair value category.

The proposals should enhance the quality of information available about firms' risk profiles, risk management practices and related gains or losses. This should be addressed through enhancements to both the accounting and disclosure requirements where necessary. By doing so, accounting and disclosures should enhance market confidence.

2. Faithful representation: reflecting the business model

The new standard should allow banking transactions to be portrayed in a robust and consistent manner in line with their economic substance. 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.

3. Avoid undue complexity

The new standard should:

(a) limit the use of options and need for interpretations;

(b) be practical in terms of its use and application by financial institutions across all jurisdictions, regardless of size or complexity;

(c) avoid arbitrary rules (such as no recycling, no reversal of AFS equity impairment, or the held to maturity tainting rule) which have no justification in the economic substance of transactions, particularly when a transaction represents the culmination of an earnings process. That is, the new standard should include only essential anti-avoidance rules;

(d) incorporate significantly simplified hedge accounting rules that are consistent with the business model of the reporting unit;

(e) be reasonably simple (ie avoid undue complexity) and include relevant Application Guidance that should address common as well as more sophisticated situations where appropriate. The standard should incorporate a practical approach that reduces excessive burden to financial institutions and improves the ability of auditors to verify and supervisors to assess fair value and provisioning practices.

4. Accounting lessons from the financial crisis

The new standard should:

(a) reflect the need for earlier recognition of loan losses to ensure robust provisions;

(b) recognise that fair value is not effective when markets became dislocated or are illiquid;

(c) permit reclassifications from the fair value to the amortised cost category; this should be allowed in rare circumstances following the occurrence of events having clearly led to a change in the business model;

(d) promote a level playing field across jurisdictions.

5. Transparency and Disclosure

The new standard should increase transparency including on sources of estimation of uncertainty and be accompanied by appropriate and robust comparable disclosures. Consequently, IFRS 7 should be revised to deliver a framework of meaningful disclosures to users of financial reports and not just a layering on of additional required disclosures. More standardised formats for reporting would enhance comparability.

6. Implementation

The IASB should carefully consider financial stability when adopting the timing of the implementation of the final standard.

Fair value related principles[1]

7. Fair value should not be required for items which are managed on an amortised cost basis in accordance with the firm's business model;

8. Fair value is an appropriate measurement for trading activities, stand alone derivatives[2] (subject to the need to avoid unintended consequences of the new hedging rules), and potentially other instruments managed on a fair value basis;

9. The current restrictions on use of the fair value option should not be relaxed.[3] Thus, the fair value option treatment should continue to reflect the approach carefully

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[1] The Committee intends to comment separately on the issue of own credit risk as part of comment letter to the discussion paper recently published on this matter.

[2] Embedded derivatives which, in current IAS 39 language, are not closely related to the host contract should also be measured at fair value.

[3] See also the Basel Committee's *Supervisory guidance on the use of the fair value option for financial instruments by banks*, June 2006.

worked out with the Basel Committee in 2005 and reflected in the amendment to IAS 39.

10. The new standard should provide for valuation adjustments to avoid misstatement of both initial and subsequent profit or loss recognition when there is significant valuation uncertainty. 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. A solution could be to partially de-link the valuation process (in mark-to-market) from certain aspects of income and profit recognition when significant uncertainty exists. The size of the adjustment could be based on the degree of uncertainty created by the weakness in the data or underlying modelling approach.

11. Fair value measurement should be supported by appropriate disclosures.

Provisioning and impairment related principles

12. Loan loss provisioning should be robust and based on sound methodologies that reflect expected credit losses in the banks' existing loan portfolio over the life of the portfolio. The allowance or provision should be presented separately from total loans. The accounting model for provisioning should allow early identification and recognition of losses by incorporating a broader range of available credit information than presently included in the incurred loss model and should result in an earlier identification of credit losses. For the purpose of these principles, expected credit losses are estimated losses on a loan portfolio over the life of the loans and considering the loss experience over the complete economic cycle.

13. The provisioning approach should allow for the exercise of professional judgement while using leading economic indicators, changes in underwriting standards and collection practices, and other relevant information when estimating provisions or allowances. Judgement related to these provisions should be well evidenced.

14. The new standard should allow for provisions for groups of loans with similar risk characteristics.

15. The new standard should utilise approaches that draw from relevant information in banks' internal risk management and capital adequacy systems when possible (eg approaches that build upon or are otherwise consistent with loss estimation processes related to bank internal credit grades may be useful).

16. The approach should encourage provisioning to address credit losses across the entire range of bank internal credit grades for loan portfolios.

17. The new standard should apply the same impairment approach to all financial assets measured using amortised cost.