RESERVE
BANK
OF NEW ZEALAND

Banking System Department

20 SEP 2002
RECEIVED

19 September 2002

Ms Lay Wee Ng
Director – Accounting and Professional Standards
Institute of Chartered Accountants of New Zealand
PO Box 11-342
WELLINGTON

Dear Ms Ng

IMPROVEMENTS TO IAS 32 AND 39

Attached are our comments on the proposed improvements to IAS 32 *Financial Instruments: Disclosure and Presentation*, and IAS 39 *Financial Instruments: Recognition and Measurement.*

Our comments are mainly restricted to the proposed improvements, taking the conceptual frameworks of both standards as givens. At this stage we reserve our judgement on these frameworks and the overall substance of the two standards.

We hope that our comments assist.

Yours sincerely

pp D. B. Bruce

Peter Ledingham
Head of Financial System Oversight

Ref #124795
2 The Terrace, PO Box 2498, Wellington, New Zealand

IAS 32 *FINANCIAL INSTRUMENTS: DISCLOSURE AND PRESENTATION*

Question 1 – Probabilities of Different Manners of Settlement

We support the proposed methodology for classifying financial liabilities set out in paragraphs 22A to 22D, but we also believe that if a financial instrument will clearly require the issuing entity to pay an above market rate of return for an instrument of similar risk and maturity at some stage during its life, for example, through an accelerating dividend on a preferred share, or through a large step-up of a dividend rate on a preferred share, then that financial instrument should also be classified as a financial liability.

In our view this structure is essentially equivalent to providing the instrument holder with a financial instrument of fixed maturity, and therefore meets the in-substance requirements of paragraph 18 for classification as a financial liability.

Question 2 – Separation of Liability and Equity Elements

We agree with the change in methodology proposed.

Question 3 – Classification of Own Share Derivatives

We support the proposed guidance on this issue.

Question 4 – Consolidation of IAS 32 and 39

Combining these two standards would probably create quite a large and unwieldy document. For the sake of simplicity and convenience, it may be preferable not to consolidate IAS 32 and IAS 39.

IAS 39 *FINANCIAL INSTRUMENTS: RECOGNITION AND MEASUREMENT*

Question 1- Scope: Loan Commitments

Conceptually we see no reason to exclude loan commitments from the scope of IAS 39.

In our view many of IAS 39's conceptual and practical problems with recognition could be more easily resolved if the definition of a derivative simply excluded contracts which are settled gross, such as forward commitments to provide finance or to purchase assets.

This approach would better align with the IASB's own conceptual framework outside of IAS 39, and would also better harmonise with common market understanding as to the nature of derivative contracts.

Question 2- Derecognition: Continuing Involvement Approach

Essentially it is proposed that an entity should continue to recognise an asset and recognise a liability to return proceeds when the transferor has an obligation that **will or could** involve repayment of all of the consideration received. We agree that where an entity has a repurchase obligation arising from an asset transfer, the asset should continue to be recognised and the obligation should also be recognised. However, where an entity has a contingent obligation arising from an asset transfer, the asset should be derecognised and the contingent obligation separately reported.

We are concerned that the proposals will result in an inconsistent recognition of assets underlying contingent obligations. Specifically, assets underlying contingent obligations will be recognised when the assets were once owned by the entity (and subsequently transferred), but will not be recognised when an entity establishes contingent obligations in respect of assets it never owned. "History should not matter." Our proposal will produce a consistent treatment – assets underlying contingent obligations will not be recognised.

Question 3 - Derecognition: Pass-Through Arrangements

We have no feedback on this proposal.

Question 4 – Measurement: Fair Value Designation

The Bank reserves its judgement on this issue at this point in time.

Question 5 – Fair Value Considerations

We note that reliability of measurement was an issue of concern for many respondents to the Joint Working Group's proposals on full fair value accounting, particularly where no open and liquid market exists. On this basis, we feel that some conservatism should be adopted in choosing the methodologies, which are considered to be permissible for the purposes of measuring fair values.
First, we suggest that the existing IAS 39 paragraph 69(c), 70, and 95 constraints on fair value measurements should be restored and applied to all financial instruments, not just equity instruments.

Second, we feel that there should be some restrictions on the use of valuation models. Again, the existing IAS 39 constraints are probably most relevant here (see paragraph 96), effectively limiting the use of valuation models to situations where data inputs to the model can be reliably measured because they come from active markets.

Question 6 – Collective Evaluation of Impairment

The Bank agrees that groups of financial assets measured at amortised cost should be collectively evaluated for impairment.

However, we do not agree with the methodology proposed for this valuation. Under IAS 39 concepts, we consider that the original contractual effective interest rate should be used for the purposes of determining the provisions (impairment allowances) associated with an asset group, and subsequently for calculating net interest income on the assets.

In our view these (general) provisions should be recognised on initial recognition, precisely because the contracted loan interest rate will normally include a margin built into it to cover expected losses on the assets involved. In accounting for collective impairment in the manner we propose, over time the performance of the asset group in covering its expected losses through its net interest income will therefore be better reflected in the statement of financial performance.

We do not agree that this approach is contrary to fundamental accounting principles – rather, it aligns perfectly well with the concept of a provision contained in the IASB's very own standard, IAS 37 *Provisions Contingent*

Liabilities and Contingent Assets. The key to the concept's acceptance is that the provisions relate to a group of loan assets, rather than to individual loan assets.

Our approach would require a slight adjustment to the methodology for accounting for actual losses on individual impaired assets set out in paragraph 111. In accordance with current bank accounting practice, we suggest that specific provisions should be allocated to each impaired asset from the pool of general provisions built up over time, rather than impairment losses on the individual assets being recognised directly in profit and loss.

Question 7- Impairment of Available-for-Sale Financial Assets

We agree that such an approach better aligns with the framework adopted in IAS 39.

Question 8 and 9 Hedges

We have some concerns with the IAS-39 approach for hedge accounting.

We agree with the IAS-39 principle that, in order to qualify for hedge accounting treatment, a hedging relationship has to be pre-designated and has to be met at the outset and continued to meet certain effectiveness criteria.
However, the IAS-39 requirements include a number of more detailed restrictions and specify accounting entries that should be made if hedge accounting is adopted. We believe consideration should be given to removing the specific hedge accounting rules with the general principle followed that effective hedge relationships can be accounted for using a consistent basis provided the hedging relationship is pre-designated, is effective at the outset and continues to meet the effectiveness criteria. We believe this approach will significantly simplify the IAS-39 hedge accounting rules, provide a framework for greater consistency with current hedge accounting arrangements while imposing a quality criteria that only effective and designated hedges can be accounted for on this basis.

Question 10 – Transitional Arrangements

This question is not relevant to New Zealand's circumstances.