LIBA

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International Accounting Standards Board
30 Cannon Street
London
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By email to: CommentLetters@iasb.org.uk

Dear Sir

Exposure Draft of Proposed Amendments to
IAS 32 Financial Instruments: Disclosure and Presentation
IAS 39 Financial Instruments: Recognition and Measurement

I am writing on behalf of LIBA (the London Investment Banking Association) to comment on the above Exposure Draft. LIBA is, as you know, the principal UK trade association for investment banks and securities houses; a full list of our members is attached.

Dealing in financial instruments is a core part of the business of many LIBA members, and in most of these cases our member's UK broker/dealer operations form part of a global operation. We therefore have a particular interest in the development of these two IASs and are very pleased to have the opportunity to comment on this important Exposure Draft.

Except where otherwise noted, the comments below follow the structure of the questions set out in the "Invitation to Comment" sections of the Exposure Draft.

IAS 32 Financial Instruments: Disclosure and Presentation

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?

LIBA is supportive of the overall requirement, in paragraph 18, for an issuer to classify a financial instrument "as a liability or equity in accordance with the substance of the contractual arrangement". We are however concerned that without being able to apply judgement and to consider the probabilities of different manners of settlement, it will not be possible for an entity to properly consider the full substance of an arrangement. If all aspects of an instrument are not considered in determining its classification, the form of the instrument could override the substance, and it would be possible for clauses to be structured for an instrument solely to drive the accounting. For example, an instrument could be considered a liability because it is redeemable, but the redemption price could be so far removed from commercial possibility that it would be better considered an equity instrument.

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?

LIBA is strongly opposed to the separation of compound financial instruments into liability and equity elements, as proposed in paragraphs 23-29. We believe that presenting such instruments as separate components will result in misleading financial reporting, as it ignores the legal standing of a holder of convertible debt prior to exercise of the embedded option and also presents a number of issues in relation to the valuation of each component.

Typically, these financial instruments do not trade separately in the marketplace and, as compound financial instruments continue to become more and more complex, the ability to apply the Board's recommended valuation approach will become increasingly difficult and could result in different outcomes for similar instruments.

Initially, the separation of convertible instruments was required in order to better present the interest cost of a convertible bond offering and remove the benefit of the equity option premium from the determination of net income. This requirement has generally resulted in the liability component being substantially understated (due to the fact that if the bond were to default the next day, the original par amount would be a creditor claim, not the accreted value) and the equity component being initially overstated. The equity component would then disappear over time as the incremental discount on the debt is recognized as an expense. For example, it is of interest to note that Enron issued a convertible bond in January 2001 for $1,250 million. If the equity component had been separated out, $650 million of the bond would have been presented in equity. Investors relying on the balance sheet would have been surprised to find that this $650 million of equity did not exist once Enron was in default.

As an alternative to the measurement proposals put forward by the Board, LIBA would like to propose the following, which would require the identification of 'interaction' features in complex convertible structure that have calls and puts. This approach could be applied to all convertible instruments and has the added benefit of being simple to apply with results that are readily understandable.

At issuance, the convertible debt would be recorded on the balance sheet at its fair value. No portion is attributed to the equity option because, in reality, the premium for the equity option is paid over time and the carrying value of the option increases accordingly. In order to accrue interest, the normal borrowing cost for a debt instrument without the equity option would be determined based on the puts and calls in the debt. This higher level of interest would be accrued each period as interest expense. The difference between the actual coupon and the calculated interest amount would be credited to equity, to represent the implied payment of the equity option premium.

This treatment has the benefit of appropriately recording interest expense commensurate with the entity's borrowing rate. It also records the liability at its settlement amount and does not overstate equity, but rather reflects the pattern in which the premium on the equity is received. If a convertible was exercised at maturity, the full option value would be reflected in equity and the full interest cost reflected in retained earnings.

Question 3 – Classification of derivatives that related 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?

IAS 39 appropriately excludes derivatives on own shares from its scope and we believe that IAS 32 similarly should not be extended to derivatives on own shares. If IAS 32 is to include guidance on these instruments, we believe all derivatives on own shares that provide the issuer the right and ability to share-settle should be classified as equity. We believe that each instrument should be considered on its own merit and that past practice should not be a factor in determining the appropriate accounting in the future. Accordingly, we believe the table in paragraph B27 of the Basis for Conclusions should exclude the column headed "Issuer choice (no past practice of physical settlement)", and should also make no reference to past practice in the preceding column.

The proposals may result in certain transactions involving equity derivatives, which are ultimately settled by the issuance of a company's own shares, being reported as a liability, with changes in fair value reported in earnings. As financial intermediaries and advisers in the equity capital markets, we are concerned that the proposals may adversely impact corporate behaviour with respect to capital management strategies.

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?

LIBA believes it will ultimately be beneficial to combine the accounting requirements for financial instruments into one accounting standard. However, we believe that the other matters raised in this letter are of more urgent importance, and would therefore suggest that the integration of the text is deferred until a longer term solution is found for derecognition. We also note that the Application Guidance in Appendix A of IAS 32 does not form part of the standard, while the equivalent appendix in IAS 39 does. This inconsistency would also need to be addressed, preferably with both appendices outside the standard.

Other comments on IAS 32 Financial Instruments: Disclosure and Presentation

We have a number of other comments on IAS 32 which do not fall easily into the structure of the IASB's specific questions:

1. Insurance Contracts (paragraph 3)

Paragraph 3 provides guidance on when an insurance contract should be included within the scope of both IAS 32 and IAS 39. LIBA believes it is appropriate to include insurance contracts that are in substance no different from other financial instruments included within scope, as this helps to ensure a level playing field for all participants in this business area. However, we believe that the Board needs to be more definitive in its requirements and to reinforce the reference in the last sentence of this paragraph, which requires entities only to "consider the appropriateness of applying the provisions of this Standard".

2. Treasury Shares (paragraphs 29A-B)

LIBA is concerned that the proposals for the accounting of treasury shares do not take into account situations specific to market making activities, where recognising such amounts in equity does not appropriately reflect the business activity being undertaken. For example, an entity may be quoted on a major equity exchange and may also actively trade in equity index product linked to that exchange. In order to properly hedge its exposure on an index contract, the entity would be required to frequently buy and sell all the shares represented in that index, including those related to the entity itself. All other positions in relation to the index and its hedge would be accounted for as trading inventory and reflected at fair value. Separately extracting the component relating to the entity's own shares would result in distorting the risk position of the trading book and imply that shares had been repurchased for capital management activity. We believe it is more appropriate to account for such equity instruments through the trading book, but to disclose at each reporting date the amount of these instruments and the purpose for which they are held.

3. Offsetting a Financial Asset and a Financial Liability (paragraphs 33-41)

Paragraphs 33-41 allow an entity to offset financial assets and liabilities where the entity has a legal right of set-off and the entity intends either to settle on a net basis, or to realise the asset and settle the liability simultaneously. We do not agree with the requirement that an entity must have an intention to settle net. We consider that all that is required is that the entity has the unconditional ability and legal <u>right</u> to settle net. This is because where an entity has ability to settle net in all circumstances, its maximum credit exposure is the net amount of its obligations with the counterparty.

As a result, we are deeply concerned about the impact that the proposals in paragraphs 33-41 would have on the presentation of our derivatives portfolios transacted under master netting arrangements. These arrangements entitle us to terminate where our counterparty fails to make one payment under the arrangement. Upon termination we can demand net settlement of <u>all</u> derivative contracts with that counterparty, even though in normal business situations we would normally only net settle by individual contract. We consider that net presentation of our fair value derivative balances with a single counterparty under a master netting arrangement is the most appropriate, because it correctly reflects the credit risk exposure we have with that counterparty. Accordingly, we recommend that even if the requirement to have an intention to settle net is retained, provided the legal requirements for offset exist, the offsetting of fair value derivative amounts transacted under master netting arrangements should be permitted.

We note in this context that under US GAAP, where there is an equivalent requirement to have an intention to settle net in order to offset (FIN 39, paragraph 5(c)), fair value amounts under derivatives contracts transacted under master netting arrangements are specifically exempted from the requirement of FIN 39 paragraph 5(c).

4. Disclosures – General Comments

We consider that the overriding principle in disclosing information about risk is that the disclosure should reflect the way in which the reporting entity manages its risk. Corporate groups tend to manage risk on a group basis, in order to take advantage of natural risk offsets and to utilise designated trading, hedging and liquidity functions that may exist within the group. As a result we are concerned that many of the disclosures required by IAS 32 will be of little relevance to users if provided at an individual entity level. In fact, disclosure of risk exposures at an entity level could potentially be misleading as it may suggest the existence of exposures that are in fact actively hedged or offset at a consolidated level. Accordingly we strongly recommend that the IASB specifically exempt entities from the disclosure requirements of IAS 32 where the entity is a member of a consolidated group that publishes financial statements in accordance with IAS or with another comparable regime.

We commend the Board in recognising in paragraphs 44 and 45 of IAS 32 that disclosing information requires judgement and flexibility. This enables an entity to disclose what it considers to be the most useful information in the most appropriate format. It also enables an entity to disclose relevant information, whilst protecting confidentiality.

5. Disclosures - Interest Rate Risk (paragraphs 56-65)

The interest rate disclosure requirements in IAS 32 require an entity to disclose information about its exposure to interest rate risk by reference to contractual repricing or maturity dates and effective interest rates. Paragraphs 64 to 65 envisage that entities that have a significant number of financial instruments should disclose information about exposure to interest rate risk in the form of either an interest rate gap analysis or scenario analysis.

As noted under 4 above, we consider that the overriding principle in disclosing information about risk is that the disclosure should reflect the way in which the reporting entity manages its risk. Currently, the primary methodology used by financial institutions to manage interest rate and market risk in the trading book is Value at Risk ("VaR"). This methodology is not considered in paragraphs 56 to 65.

Accordingly, we propose that VaR information on interest rate risk is specifically included as an option for disclosing interest rate exposures for those items held or designated as trading. This will ensure that disclosure follows management practice and therefore would be of greater relevance to users of the financial statements. In addition, with a view to convergence, disclosure of VaR to explain market risk, including interest rate risk, is in line with current disclosure requirements in the UK under FRS 13 and those required by the SEC in the US.

6. Disclosures - Fair Value (paragraph 77B)

Although we believe high-level information regarding significant methods and assumptions applied in determining fair values of financial instruments could be useful to users of financial information, we are unclear as to the extent and nature of the disclosure requirements in paragraph 77B.

We would argue that the complexity of many valuation models inhibits the usefulness of detailed disclosure and may require disclosure of proprietary information.

In addition, the language in paragraph 77B, such as "the extent to which" in sub-paragraphs 77B(b) and (c) and "effect on the fair value" in sub-paragraph 77B(d), suggests that quantitative disclosures are required. In particular, paragraph 77B(e) specifically requires that an entity disclose the total amount of the change in fair value estimated using a valuation technique that was recognised in profit or loss during the period. We are puzzled as to the purpose of quantifying the effects of valuation techniques on the profit and loss and are unclear what extra useful information it provides. In fact we are concerned that such disclosure could provide misleading information, as it may imply that gains or losses using valuation techniques are somehow inferior or lack validity. This seems an unfair result, given that the proposed IAS 39 encourages the wider use of fair value.

On a practical point, our portfolios contain a mixture of fair values obtained by market prices, valuation techniques or a combination of both. Given the sheer volumes and mix involved, looking to source pricing information in order to classify and quantify revenue or losses arising from valuation techniques, in whole or in part, would be almost impossible.

Accordingly, we suggest that the level of disclosure required by paragraph 77B should be limited to a qualitative discussion as described in paragraph 77B(a).

7. Disclosures – Continuing Involvement (paragraph 93A(b))

As noted in our response to Question 2 on IAS 39, we have serious concerns about the continuing involvement model in IAS 39. We have similar concerns to those expressed above regarding the disclosure proposals which relate to the continuing involvement model.

IAS 39 Financial Instruments: Recognition and Measurement

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?

As outlined below, LIBA is generally supportive of this proposal. One of our members has however expressed serious reservations over the point, believing that all loan commitments should be excluded from the scope of IAS 39, irrespective of their nature. This member is concerned that including net settled loan commitments in the scope of IAS 39 will present a number of operational difficulties and that the results would not reflect the economics of its lending business, where loan commitments are typically not settled in cash and are rarely traded either via assignment or by offsetting trades. This member considers loan commitments to be an extension of credit to a customer, rather than a true derivative, because the entity would always be long the credit risk.

With the exception of the concerns raised in the previous paragraph, we support the inclusion of loan commitments within the scope of IAS 39 where those commitments can be net settled, including by selling the resulting loans shortly after origination, or where the loan commitment has otherwise been designated as held for trading.

All loan commitments fall within the definition of a derivative contained in paragraph 10 of IAS 39 as (a) their values change in response to specified variables (interest rates), (b) they require no initial investment and (c) they will be settled at a future date. As acknowledged in paragraph C10 of the Basis for Conclusions, a loan commitment is in effect "a written option to the potential borrower to obtain a loan at a specified interest rate".

Where an unfunded loan commitment falls within the scope of IAS 39, it is appropriate to treat it as a derivative, recognising it on balance sheet at fair value. It is industry practice for investment banks to fair value loan commitments and as a result these entities believe they properly reflect interest rates, credit ratings and the probabilities of draw down.

We believe the fair value of a loan commitment best reflects the lender's exposure to credit risk compared to the rate or spread reflected in the commitment. To the extent that a lender's portfolio of loan commitments becomes more or less risky, changes in the market value of the commitments would inform the reader of the financial statements about the credit change and about the fact that the lender's commitments do not reprice for changes in credit risk. Further, to the extent that the fair value of such commitments is less than the book value, this would also be highlighted by mark-to-market accounting treatment.

However, we understand that unless an entity can realise the economic value of the commitment, recording the obligation at fair value would provide little useful information to a user of financial statements. Accordingly, we agree that loan commitments where there is no ability for the lender to settle the commitment net in cash or by some other financial instrument, including by selling the resulting loans shortly after origination, should be scoped out of IAS 39.

We consider that the crucial element that must be considered is the lender's effective ability to realise the economic value of a loan commitment, as distinct from past practice or contractual provisions that allow for net settlement. However, if past practice is retained in the standard, we believe that the definition needs to be refined to ensure that the term "entity" is not applied across a global group irrespective of the loan commitment activity a particular segment of an entity may have. For example, it would be excessive if an entity's US operations developed a practice of selling assets from loan commitments shortly after origination and this change then resulted in the entity's very different European operations needing to consider its loan commitments as falling within the scope of IAS 39.

Finally we wish to bring to your attention the position of a borrower under a loan commitment. Given that an unfunded loan commitment is effectively a written option, it could be inferred that the borrower holds a purchased option. Although we do not think it is contemplated that borrowers' rights under unfunded loan commitments should fall within the scope of IAS 39, we consider that a specific statement to this effect should be included in the standard.

In support of this proposition, the rights of a borrower under a loan commitment are significantly different to that of the lender. Importantly, a borrower has no ability to net settle the contract since a loan commitment is rarely assignable by the potential borrower. Accordingly, on the same basis that certain loan commitments are scoped out of IAS 39 on the basis that the lender cannot realise the economic value of the loan commitment via net settlement, an equivalent concession should be applied to borrowers.

Question 2 - Derecognition: continuing involvement approach (paragraphs 35-57)

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?

We believe the proposed continuing involvement approach is fundamentally flawed. The approach seems to be based on the premise that an accounting principle that does not have any exceptions is a good principle – a premise with which we disagree. Accounting standards should be based on the stated accounting building blocks set out in the IASB Framework, where the four principal qualitative characteristics of financial information are identified as understandability, relevance, reliability and comparability. Financial information derived from an approach developed specifically to have no exceptions will result in financial information that fails on all four fronts since, by its nature, it ignores the economic substance of the transaction. The continuing involvement approach results in the recognition of assets and liabilities that do not meet the definitions of assets and liabilities in the IASB Framework. We fail to see how inclusion of these fictitious assets and liabilities will enhance public confidence in financial reporting. The Board believes that these amendments to IAS 39 result in a "workable approach to the derecognition of financial instruments". We believe that the proposals, particularly those in relation to measurement, promote an accounting model that is both meaningless and difficult to implement in practice.

LIBA is aware that the Board is under significant pressure to produce a revised standard as soon as possible, and we appreciate the effort that has gone into addressing the issues presented by the current IAS 39. Although we are unable at this time to propose a fully thought-through alternative to the continuing involvement approach as drafted, LIBA would be more supportive of the approach as an interim solution if amendments were made to take into account the nature and economics of any continuing involvement.

In the following paragraphs, we have outlined some of our concerns with the recognition and measurement aspects of the continuing involvement proposal.

Continuing Involvement - Recognition
We understand paragraph 37b includes situations where an asset may be reacquired as the result of a security pledge. For example, an entity may transfer an asset to a counterparty that meets the derecognition requirements and concurrently enter into an interest rate swap agreement that meets the requirements of paragraph A9(p) of Appendix A. Due to the credit standing of the transferee, the transferor may require collateral to be pledged back to the transferor in order to provide security for the transferee's obligations under the interest rate swap arrangement. The transferor would only be able to benefit from the original asset in the event that the transferee defaulted on the swap contract. However, because the transferor "may…reacquire control of its previous contractual rights", the transferor would be unable to derecognise the transferred asset. We fail to understand how the continued recognition of such an asset, from which benefits may only flow to the entity contingent on events outside its control, provides meaningful information to users of accounts.

Similarly, even in a fairly basic securitisation transaction, it is common for the securitisation vehicle to have a derivative contract, usually an interest rate swap, as well as the underlying asset. The transferor of the asset is frequently also the swap counterparty. Where the swap contract is a standard vanilla contract, following the guidance in Paragraph A9(p) derecognition would initially appear to be appropriate. However, in a securitisation, the securitisation vehicle will only be able to look to its own assets to meet its obligations both to the noteholders and to the swap counterparty. Consequently, if the underlying asset transferred defaults, the securitisation vehicle will have no other assets from which to meet any obligations it may have under the swap contract. This would appear to conflict with the strict requirements of paragraph A9(p), that "payments on the swap are not conditional on payments being made on the transferred asset". If this conclusion was intended, we do not believe that it would be appropriate in these circumstances to otherwise preclude derecognition of the asset.

The majority of the proposed standard appears to focus on the accounting requirements of the transferor, rather than the transferee. Paragraph 28 requires the accounting treatment for the transferee to reflect the accounting treatment that the transferor is required to follow. We presume the cross reference here to paragraph 56 should actually be to paragraph 57, which explains that, where the transferor does not have a right and an obligation to reacquire control of the transferred asset, yet has been unable to achieve derecognition, the transferee would create a receivable balance classified as held for trading, available for sale or held to maturity. Given that the transferor needs to consider its accounting by reference to "agreements" it may have both with the transferee and with third parties (paragraph 37), it is difficult to understand how the transferee would know whether or not the asset had been derecognised by the transferor. Secondly, it is not clear how the transferee would then continue to reflect the receivable it has been required to recognise. Is the intention that the transferee and transferor will need to continue to reflect mirror accounting for these created assets and liabilities? If so, what happens if the transferee subsequently sells the asset? Alternatively, does the guidance for the transferee then shift back to paragraph 56 and require the transferee to consider a control based approach in addition to that of the transferor's continuing involvement? Or does the reference to classification mean that the transferee would carry the asset at an amount that reflected its own intentions for holding the asset that it is precluded from recognising?

We note that the objective of having no exceptions in IAS 39 has resulted in the need for an exemption to be added to the netting requirements in paragraph 33 of IAS 32. In our opinion, this only emphasises the fact that the continuing involvement approach is flawed. This also means that the entity will be reflecting assets that are not available to the general creditors of the entity.

As the proposals fail to take into account the economics, the accounting for a transaction will be driven instead by its structure. This will mean that transactions that are economically the same will be accounted for differently, which could also enable an entity to change the structure of a transaction in order to reflect a more preferable accounting treatment. For example, a structure where an entity transfers a readily available instrument at fair value and enters into a fair value call on the transferred asset, would not result in derecognition of the asset. If, however, the same transfer took place without the fair value call, yet the entity subsequently decided to buy back the instrument from the market at fair value, this would result in derecognition of the transferred asset. It is inconsistent to have different accounting treatments for two transactions that are in substance the same.

Continuing Involvement - Measurement

In contrast to the Board's belief that these proposals will result in a "workable approach", we believe the measurement proposals will result in an operational nightmare. For example, entities do not generally track the time value of options as a separate component of the fair valuation of an options portfolio, making it impossible to implement the measurement proposals outlined in paragraph A8 of Appendix A without significant systems changes. Similarly, the gain on sale calculation is very convoluted and, whilst it might provide good guidance to an entity with only a few derecognition transactions every year, certain entities would need to do a detailed different analysis for hundreds of transactions every day.

The proposals fail to take into consideration the complex valuation issues of a derivative, including the credit risk of an OTC contract. This is because the measurement proposals are based on the exercise price included in the contract, rather than the fair value of the contract itself. This will mean that an entity would, for example, recognise a bond underlying a call option contract as if it already owns the bond, whereas in reality, if the counterparty defaulted on the call option contract, it would never own it through this contract. It will also mean that contracts with the same terms will be recognised differently depending on whether they are linked to an asset transfer or not. Interestingly, this also appears to contradict the Board's proposals in the Measurement section of the proposed revised standard, where there is an assumption that the same contract should be valued in the same way for all entities.

Of greater concern is the fact that by disregarding the fair value of the contract, an entity would be able to manipulate its assets and liabilities by, for example, entering into a call option contract that has an exercise price significantly higher than the expected fair value of the underlying asset and, as a result, significantly inflating its reported assets and liabilities. This "ballooning" of the balance sheet would then presumably reverse when the contract expired, although we find the guidance in this area to be unclear. We do not understand how this representation of a call option contract would provide users of the accounts with meaningful information.

We also understand that the measurement proposals can intentionally result in double counting of assets. This appears to arise in two situations:

Firstly, where an entity has some continuing involvement in an asset, for example through the holding of a subordinated tranche issued through a securitisation of the asset, the Board's proposals will result in the continued recognition of the original asset, as well as the recognition of a new asset, which is in fact a component of the original asset. This results in the creation of assets on the transferor's balance sheet that will never be realised into cash and liabilities that will never be met. It is unclear how these fictitious assets and liabilities are then to be measured. If an event occurs that affects both the original asset and the asset in which the transferor continues to have an interest, does the impact of this get reflected against the new asset, the original asset, or both and, if both, is the impact on the income statement reduced by an equal and offsetting change to the fictitious liability? We fail to understand how such accounting fits within the accounting framework of the IASB and we also believe such information will be difficult to track and meaningless to users of accounts.

Secondly, where an asset has been transferred in exchange for cash, but the transfer for some reason fails the derecognition criteria, an additional asset and liability are created across the two entities involved in the transaction – generally reflected on the transferor's balance sheet. We believe that the Board has overreacted to concerns that assets may have been derecognised inappropriately in the past and, as a result, these proposals will result in a significant overstatement of assets in the marketplace.

We find the principle behind these measurement proposals unclear, which will therefore make it impossible to follow when dealing with non-standard transactions. Is the intention to recognise a derivative contract on a grossed out basis using fictitious assets and liabilities, rather than on a net basis, as it would be settled? For example, the guidance in paragraph A8 of Appendix A does not make it any clearer how to treat an instrument such as an option contract with a moving exercise price, a combination of a put and a call option, and a collar. New financial instruments will always be developed and it is important that any accounting standard dealing with financial instruments provides a framework in which the accounting for new instruments can be determined.

Because the proposals fail to consider the economics of transactions, entities will need to maintain separate books and records to those used for external financial reporting, in order for management to appropriately risk manage the business. We fail to understand the benefit of financial reporting which does not reflect the way in which an entity risk manages its business.

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?

We believe the pass-through arrangement is appropriate for many situations. For example, the sub-participation of a loan should result in the derecognition of the related underlying loan asset, even if legal title has not passed. We also believe it is appropriate to be able to apply the pass-through arrangement for consolidated reporting purposes, where SIC 12 (in its current form) requires consolidation of a special purpose entity by a transferor and the original asset transfer to that special purpose entity has already met the derecognition requirements of IAS 39.

However, we do have concerns that the proposals will result in financial reporting for the special purpose entity itself that will show no assets or liabilities. We believe that, particularly in the current environment, requiring such reporting will be both misleading and concerning for investors and we are also concerned that, under the forthcoming EU Regulation on IAS, these proposals will directly impact many listed European issuance entities. We also find it interesting that the Board, from paragraph C50, has relied on its interpretation of the framework to get to this result, which in this case results in no assets or liabilities but, in the case of continuing involvement, results in new assets and liabilities.

Finally, we believe the current drafting of the pass-through arrangement requires some refinement. This includes clarifying whether the activities permitted in a pass-through arrangement are only those for the benefit of the beneficial interest holders and that it is only activities for the benefit of the transferor which may prevent an arrangement meeting the pass-through requirements. In addition, we do not believe the requirement in paragraph 41(c) to remit cash flows "without material delay" was intended to preclude arrangements where all cash collected on the underlying assets is passed through to the transferee in accordance with predetermined coupon payment schedules, even if the cash may be collected over a coupon period. We suggest the wording is amended to make this point clear.

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?

Yes. We strongly support the Board's decision to allow an entity to designate any financial instrument as held for trading. We believe fair value is the appropriate measure for many financial instruments, and we applaud the Board's pragmatic solution to the current mixed measurement model. As noted in the Basis for Conclusions, the mixed model causes numerous difficulties that this classification choice will address including, *inter alia,* complex hedge accounting and the separation of complex financial instruments.

However, since the other categories of financial instruments will remain, we feel the prohibition from reclassifying a financial asset into or out of the held for trading category is incorrect. The definition of a financial asset or financial liability held for trading requires that certain financials assets are designated as held for trading based on the objective for initially acquiring them. This approach ignores the possibility that the purpose of holding a financial instrument may change. While we do not think it is appropriate for financial instruments to be moved frequently between trading and available-for-sale, the standard should permit financial instruments to be reclassified when the principal purpose for holding the financial instrument has substantially changed and those conditions are expected to prevail for the foreseeable future. In other words, when the substance and economic reality behind holding an asset has changed, this change should be reflected in the financial statements. For example, some of our members have both trading subsidiaries and corporate subsidiaries. The corporate subsidiary may include the treasury function that manages a liquidity portfolio that is classified as available for sale. Assets for the liquidity portfolio would ideally, and most efficiently, be purchased from the trading subsidiary rather than directly from the market. However, if the treasury function purchases an asset from the trading subsidiary, under this proposal, it would be prohibited from classifying the asset as available for sale since the asset had originally been held in the trading book. We do not accept that this is the appropriate result. If the Board is concerned about the potential for reclassifications being too frequent, a caveat could be added that such reclassifications should be rare, or perhaps include a limit of only one reclassification per financial instrument.

Question 5 – Fair value measurement considerations (paragraph 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?

In general, LIBA believes that an accounting standard based on the fair value of financial instruments must explicitly acknowledge that the use of estimates, assumptions and judgement are an inevitable and indeed essential part of such a standard. The hierarchy for valuation set out in paragraphs 95-100D is too prescriptive and would change the valuation methods of dealers in financial instruments in a number of areas.

Specifically, we disagree with the phrase inserted in the first sentence of paragraph 99 that effectively requires that a quoted market price be used if one is available. While we agree that a quoted market price is in many situations the best indicator of fair value, this is not always the case, particularly for derivative financial instruments or for large holdings of financial assets, as discussed below. We therefore strongly recommend that the Board reinstate the first sentence in paragraph 99 as it currently exists in IAS 39. This would correctly recognise that quoted market prices are "normally" the best evidence of fair value but allow entities the flexibility to depart from the quoted price when it is industry practice, as for derivatives, or when the quoted price is unlikely to be realisable, as for large holdings of financial assets.

Valuation of derivatives

The Board should be aware that for most derivative instruments, under current valuation approaches used in practice, values are derived using objective market inputs as a starting point but are ultimately valued by using various modelling techniques. Such models are the primary pricing tools used by dealers for a wide variety of instruments, and we therefore believe the valuation hierarchy should allow the flexibility to continue their application, rather than mandate another approach.

For example, although many plain vanilla swaps could theoretically be priced by obtaining a quote from another dealer, in practice, they are regularly valued using valuation models, because it would be impractical and operationally burdensome, given the size of their portfolios, for dealers to obtain dealer quotes for every single swap. Prices derived using such models are typically verified by regularly testing the market inputs used in the models and by comparing the models' prices to quotes for similar instruments that give an indicative value for the instruments. However, the model is the primary pricing tool, and the comparison to quoted prices for similar instruments is merely a secondary model testing technique. Furthermore, a requirement that dealers obtain price quotes for all their swaps would be circular, since all dealers arrive at their quotes by reference to their models. We therefore propose that the standard allow greater flexibility in determining the most appropriate valuation method.

These valuation methods should also be transparent to readers of financial statements, since they will be set out in the accounting policies note as required by IAS 32.

Valuation of large holdings of financial assets

We are also extremely concerned with the addition in paragraph 99 of the sentence, "The fair value of a portfolio of financial instruments is the product of the number of units of the instrument and its quoted market price."

This sentence will prohibit an entity's ability to adjust the market price of a block holding of financial instruments to take into account the fact that the size of the holding is likely to impair its realisable value. In a trading environment, dealers often trade large blocks of securities that are purchased and sold at a discount from the quoted price as a means of efficiently transferring large positions and managing risk. For these securities, dealers must take into account market liquidity in arriving at fair value. The adjustments to the quoted price are commonly referred to as "block discounts". LIBA has considerable concerns over the prospect of being required to record a position at a price that the firm is reasonably certain it will <u>not</u> be able to realise. This prescriptive approach appears, moreover, to be inconsistent with the requirement in the Exposure Draft of IAS 1 for financial statements to present fairly the financial position and performance of an entity.

We understand that a primary concern with block discounts may be the perceived subjectivity and the lack of market information available to estimate the adjustment. However, we take issue with an approach that would require institutions to value a security at a price they know is not indicative of fair value, merely in the name of objectivity. We believe that it is better to be subjective in a reasonable attempt to arrive at a true fair value, than to be objective but wrong. Furthermore, if dealers were required to use a quoted price of a security where management did not truly believe that it could realise such a price, such a valuation would be misleading to investors.

It is our experience and that of academic research that liquidating a large block of a security over a relatively short period of time will depress the market price. The quoted market price of a security is really the quote for a marginal share, that is, the quote for the last share bought or sold, rather than a large block of shares. By virtue of the basic economic principles of supply and demand, the seller of a large block of stock has to move the market away from its last sale price in order to find the price at which demand exists for the full size of the block. Accordingly, we believe that an adjustment to the listed price is necessary in order to reflect accurately the fair value of a large block position.

In addition, we note that dealers often purchase large blocks of securities from customers in a competitive bidding environment at a discount from the quoted market price. Thus, when determining the fair value of such a block of securities held by the dealer, we believe it is appropriate to include the discount to the quoted market price. If we were to do otherwise, we would end up writing the block position up to quoted market value and realising an immediate gain on acquisition, only to incur a loss thereafter when the position is sold.

Further, we find it inconsistent that paragraph 99 prohibits such block discounts when paragraph 5 of IAS 32 defines fair value as "the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction". For a large block of securities, application of this definition results in pricing at a value that represents some discount to the quoted market price. Paragraph 99 also seems at odds with paragraph A17(g), which explains that marketability is a factor that should be taken into account when valuing a financial instrument using a valuation model. We fail to see why marketability is considered relevant in one case but not the other.

Pricing services

We note that paragraph 99 suggests an institution should, *inter alia*, take into account information that is readily available from a "pricing service" in determining the market exit price for some securities: for fixed income securities, this could be interpreted as constituting the "published price quotation" that must then be used as the fair value of the securities. However, we consider such pricing services to provide reliable market data for only a relatively small portion of fixed income securities that trade in the marketplace – specifically, the top 50 or so high-grade corporate issuers. Beyond this top tier, the breadth and depth of the market falls off so dramatically that we believe the information provided by the pricing service should only be used as a reference or benchmark against which to compare management's independent calculation of fair value.

Use of mid-market prices

Paragraph 99 allows mid-market prices to be used as a basis for determining fair values "when an entity has matching asset and liability positions". LIBA is concerned that, where this is applied to OTC contracts that are nevertheless quoted in an active market, this approach would not properly reflect other risks specific to that contract. For example, an entity may have two vanilla interest rate swap contracts that equal and offset from a market risk perspective. Using mid-market prices for these positions without further provisioning may fail to capture the credit risk associated with these contracts.

Question 6 – Collective evaluation of impairment (paragraphs 112 and 113A-113D)

Do you agree that a loan asset or other financial asset measured at amortized 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?

Generally, we agree with the proposed approach but we do have significant concerns regarding the impact of such an approach as drafted, including reservations regarding the methodology for measuring impairment.

We do not believe that the fact that losses are expected (as in paragraph 110(g)), is in itself reason enough for establishing a collective loan provision, when there is no change in the credit rating of the borrower. The proposed approach to charge <u>expected</u> losses rather than <u>incurred</u> losses is another deviation from US GAAP and we do not understand the rationale for introducing further GAAP differences in this area.

In the example in B33-34, an impairment charge is recognised even though the risk of the group of loans does not change. This occurs because the estimated expected cash flows remain unaltered over the life of the loan. In the example, when the year 2 present value is determined, the loss rate from years 2-10 is unchanged, and the entity ends up recognising an impairment loss even though an impairment event has not occurred. We would propose that the expected cash flow should be updated, i.e. using the years 1-9 cumulative loss rate (not 2-10) which would mean that if the risk profile of the loan did not change, no impairment charge would be recognised. To extend the example further, if there was no impairment event throughout the life of the loans then the loss rate applied in year 10 would be the same loss rate applied in year 1. We recognise that adjusting the cumulative loss rates to take into consideration the passage of time would result in a mark to model concept. Although we do not believe that a mark to model concept should be implemented before there is adequate field-testing, we believe it is theoretically more appropriate than the methodology currently included in these proposals.

We agree with the principle outlined in paragraph 113A, that financial assets should be grouped on the basis of similar credit risk for the purposes of a collective review for impairment. This grouping of loans is possible for a retail portfolio, however we do not believe it is possible to apply this for a corporate client portfolio where the number of counterparties with similar credit characteristics would be small. Since almost every credit in a corporate portfolio is unique, most financial institutions would be unable to group loans, and therefore the collective loan impairment for a corporate would likely be based on an individual client basis anyway. In addition, historical loss experience factors applied to a collective pool of financial assets will typically result in a range of estimated impairment losses for the pool. The guidance provided in the Exposure Draft does not address this issue, so it is unclear whether the entity should utilise the high, middle, or lowest point of the range of estimates calculated.

Finally, we do not believe the pooling approach adequately considers other mitigating factors. For example, the proposals do not consider the impact of hedging strategies on the historical loss experience factors applied to the collective pools. An entity may enter into credit derivative transactions to minimise losses arising from a specific financial asset or group of financial assets. We believe the historical loss experience factors applied to a group of financial assets should consider the hedges applicable to those assets within that group. Similarly, an entity may have obtained collateral against the risk of default on a specific loan or pool. In these cases, an impairment reserve may not be required, as the estimated recoverable amounts from the liquidation of the collateral may support the value of the impaired loan. Including this loan in a collective pool for impairment will result in the recognition of an unnecessary reserve and contradicts the guidance in paragraph 113 relating to collateral.

Question 7 – Impairment of investments in available-for-sale financial assets (paragraphs 117-119)

Do you agree that impairment losses for investments in debt and equity instruments that are classified as available for sale should not be reversed?

Although the proposed approach is consistent with US GAAP, we do not agree that impairment losses on available-for-sale investments should not be reversed through profit or loss.

Impairment losses are based on estimates of potential losses considering current economic and market conditions. Should these conditions change, and become favourable in the future, the ability to reverse previously recognised impairment losses should be permitted. We believe that impairment losses recognised in profit or loss on financial instruments that are classified as available for sale should be reversed through the profit and loss account. This would be consistent with the treatment of a reversal of an impairment loss related to a revalued asset under IASs 2, 8, 16, 36 and 38. It is inconsistent to recognise a loss in profit or loss, but to recognise its subsequent reversal in equity. We are not persuaded by the Board's argument that it is difficult to determine when an impairment exists and therefore when it reverses.

In addition, when an available-for-sale debt security has been evaluated to be impaired, the amount of cumulative net loss to be removed from equity is the difference between the acquisition cost and the recoverable amount. The recoverable amount is defined as the present value of expected future cash flows discounted at the current market rate. We do not support this methodology and we also note that it is not consistent with the fair value measure considerations in paragraphs 95-100. Impairment loss calculations for debt securities should be determined in the same way as equity securities, using current fair value.

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?

In the interests of international convergence we support the move to treat a hedge of an unrecognised firm commitment as a fair value hedge, rather than as a cash flow hedge as it is at present. However, in the interests of eliminating all differences with US GAAP in this respect, we believe that IAS should also allow hedges of foreign currency commitments to be considered as either a cash flow hedge or a fair value hedge.

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?

In the interests of international convergence we agree with elimination of basis adjustments. In certain respects, we do not consider this a significant change as the proposal results in the same net income statement presentation over the period of the hedge as that which exists in the current version of IAS 39.

We note however that this change will result in an entity having to maintain extensive records over the life of the hedged item to ensure that the rate of release from equity of the cumulative gain or loss on the hedging instrument is consistent with the rate by which the hedged item is recognised in profit or loss. These changes may well be onerous on entities because there is no net difference in income statement presentation, yet the entity will have to maintain separate records to monitor the hedged item and the hedging instrument.

General comments on hedging
In addition to our responses to Questions 8 and 9, we have some general comments regarding the proposed guidance on hedge accounting.

We do not believe that the current rules based approach is the most effective way of applying hedge accounting. The accumulation of many rules from both the original version of IAS 39 and the interpretations from the Implementation Guidance Committee, many of which are now included in the current exposure draft, makes the practical application of hedge accounting unnecessarily complex. Entities enter into many transactions that are economically hedged, yet they cannot always apply hedge accounting because the rules are so prescriptive. The consequence of not being able to apply hedge accounting, is that many transactions where entities have eliminated risk are presented in their accounts as if they are still exposed to that risk. In addition, new products, structures and hedging techniques are continually evolving and a set of prescriptive rules will never be able to capture all the possibilities that may arise. We do agree with the general principle that hedges must be effective in order to qualify for hedge accounting, but the application of hedge accounting should follow a more substance-based approach, which looks at the economic exposure of the entity and not at whether the entity has passed a detailed set of hedging rules. We believe the current proposal to allow an entity to designate any financial instrument as trading with gains and losses recognised in profit or loss is a positive step forward as this allows an entity to achieve a hedged position in its income statement without the need to apply detailed hedging rules.

We also have significant concerns over some other specific aspects of the proposals, which we believe represent arbitrary rules and result in unnecessary complexity. In particular, we believe an entity should be able to reflect the benefit of economically hedging on a net portfolio basis. We also believe it is inappropriate to restrict the use of non-derivative financial instruments to hedging only foreign exchange risk. Finally, we believe IAS 39 should allow entities to follow more simplistic hedging requirements where the hedging relationship is considered straightforward. This will significantly reduce unnecessary burdens of hedge accounting for many entities and will also bring the IAS 39 hedging requirements closer to US GAAP.

To conclude, a more substance-based approach to hedge accounting for all GAAPs would eliminate the complexity and ultimately reduce potential inconsistencies between various GAAPs. Consequently, in the longer term, we hope that the IASB will be able to re-examine the practicalities and relevance of the current rules-based approach to hedge accounting, and to consider moving to a more appropriate substance-based approach.

Question 10 – Prior derecognition provisions (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 recognition transactions be grandfathered and disclosure be required of the balances that would have been recognised had the new requirements been applied?

We believe that there should be an undue cost or effort exemption for the proposal in paragraph 171B that prior derecognition transactions should not be grandfathered. The derecognition requirements proposed in the IAS 39 Exposure Draft are incredibly complex and each transaction will require a comprehensive analysis in order to determine the accounting proposed for both asset/liability recognition and gain on sale. Given the significant number of transactions that organisations such as those represented by LIBA undertake, the volume of work required in going back and reanalysing all previous transactions, even if the information was available, would be extremely onerous and would not, in our opinion, result in more meaningful information for users of financial statements. Indeed, because of the difficulties expected in being able to identify all transactions that should now be accounted for differently, LIBA has significant concerns that the information could be so incomplete that it will actually be misleading.

We note in this context that the existing transition provisions of paragraph 172(h) of IAS 39 prohibit the retrospective restatement of securitisations, transfers or other derecognition transactions.

Other Comments on IAS 39

As with IAS 32, we have a number of additional comments on IAS 39 which do not fall easily into the structure of the IASB's specific questions:

1. Entities held for disposal (paragraph 1(a))

Paragraph 1(a) refers to those investments that may otherwise be subject to IASs 27 or 28, but which are to be accounted for in accordance with IAS 39. The specific requirement referred to in this paragraph is for those entities "acquired and held exclusively with a view to (their) subsequent disposal within twelve months from acquisition". Consistent with the comments we submitted on the recent Exposure Draft of Proposed Improvements to International Accounting Standards, we strongly believe that the key consideration is the intention to dispose of an investment, and the addition of a fixed time criterion is both unnecessary and arbitrary. Also consistent with our comments on the proposed changes to IAS 27 and IAS 28, where fair value is used as an established industry practice for investments, we believe IAS 39 should be used for all such investments, irrespective of whether they would otherwise be considered as subsidiaries. For all other situations, investments should be considered on a case by case basis, rather than by category of investment, and IAS 39 should be applied where this is appropriate to the purpose for which that specific investment is held.

2. Scope Exemptions (paragraph 1)

Paragraph 1 provides a number of exemptions from the scope of IAS 39. As noted in the first of our "other comments" on IAS 32, we believe the IASB could be clearer in defining those insurance contracts that should be included within the scope of these standards. In addition, we believe that the scoping in permitted in paragraph 1(i), for "loan commitments that the entity elects to designate as held for trading under this Standard", should also be incorporated into paragraphs 1 (f) and (h), for those financial instruments otherwise exempted through these paragraphs, but which an entity may want to designate as held for trading.

3. Initial Recognition (paragraphs 27 and 29)

Paragraph 27 states that "an entity shall recognise a financial asset… when the entity becomes a party to the contractual provisions of the instrument". It is unclear how broadly this should be interpreted. For example, if an entity enters into a total return swap arrangement with a third party, under which it will receive all of the underlying cash flows of a reference asset, does this mean that the entity needs to recognise the asset in its entirety, rather than its true economic exposure, which is the fair value of the swap contract only? If the former approach is correct, how would the related double entries follow through, as this would create an increase to the entity's assets and liabilities?

Paragraphs 27 and 29 require assets and liabilities to be recognised when an entity becomes a party to a contract, with the exception of regular way purchases of financial assets. It is not clear whether this exemption is intended to also cover repurchase and securities lending contracts that, given they are considered secured financing activities, are recognised only on settlement date when the cash passes.

4. Derecognition of a financial liability (paragraph 60)

Paragraph 60 requires an issuer of a debt instrument to "extinguish" that instrument if it is repurchased, even if the entity is a market maker in that instrument. It is not clear whether the IASB is here imposing a legal requirement to extinguish the debt, or whether the IASB is intending to put forward specific accounting requirements for the treatment of debt considered "extinguished" from an accounting perspective, although a legal contract still exists. We do not believe it is appropriate for the Board to dictate when debt is legally extinguished. We also do not believe it is appropriate or practical for a market maker to be effectively precluded from temporarily repurchasing its issued debt. However, we do recognise that where an entity holds its own debt, particularly as a result of this market making activity, it is appropriate for users of accounts to be aware of this fact. By analogy with our comments on IAS 32 relating to treasury shares, we believe this can be better achieved through appropriate disclosure in the accounts.

5. Measurement of Financial Assets (paragraph 72A)

Paragraph 72A provides very specific guidance on the accounting for commissions. The convention in markets globally varies significantly as to whether or not the quoted bid/offer spread includes the broker's commission. We therefore believe it is both misleading and confusing to apply the guidance in paragraph 72A to different markets. In addition, we believe it is appropriate, particularly for trading book activity, to reflect the potential costs of selling an asset in determining its fair value.

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I hope that our comments are helpful. We would of course be very pleased to expand on any particular points if there are aspects which you find unclear, or where you would like further details of our views.

Yours faithfully

Ian Harrison

Ian Harrison
Director

LONDON INVESTMENT BANKING ASSOCIATION

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