# CL 22A

Commonwealth Bank of Australia
ACN 123 123 124

**Financial & Risk Management**
**Group Finance**

| | | | | |
|---|---|---|---|---|
| Level 8 | GPO Box 2719 | Telephone | (02) 9378 5036 | **Gary Thursby** |
| 48 Martin Place | Sydney | Facsimile | (02) 9378 3303 | **Group Financial Controller** |
| Sydney | NSW 1155 | | | |
| NSW 1155 | | | | |
| Australia | | | | |


11 October 2002

Sir David Tweedie
Chairman
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
UNIITED KINGDOM

Dear Sir

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

Thank you for the opportunity to provide comment to the IASB for consideration in its deliberations on adopting IAS 32 and 39 as Australian Accounting Standards.

The proposals in IAS 32 and 39 are very complex and would represent a major change in Australian accounting if the proposals were adopted. The Commonwealth Bank of Australia (CBA) acknowledge the IASB’s underlying premise to have all financial instruments on balance sheet and to provide recognition and measurement guidelines. However, the proposals are driven by rules rather than principles. The CBA’s preference is to maintain hedge accounting on an accruals basis, and not have the fair value of hedge derivatives reflected on the balance sheet. That is, the accounting treatment for the hedge should follow the accounting treatment applied to the underlying item being hedged.

We believe certain of the requirements are too far reaching at this stage and create business consequences beyond the domain of accounting. In particular, the new hedging proposals, when applied to the Commonwealth Bank, adopt a very simplistic approach to risk management. This will lead to a backward step, from the current level of sophistication of portfolio risk management, to one that largely operates on an individual matching of hedge transactions. The result will be a very simplistic, cumbersome and costly approach to risk management that would be more applicable over 20 years ago when risk management techniques were in their infancy.

We have suggested a possible alternative approach under the hedge accounting section which follows.

Our principal concerns lie with the retrospective nature of the proposals, the capital implications of IAS 32, the hedge accounting provisions of IAS 39 and the clarity of the recognition principles and guidelines, particularly as they impact securitisation.

*Retrospective Implementation*

We consider the requirement to apply the Standards to the earliest prior period presented as if the Standards had always been in use, to be onerous and costly and to have unintended business consequences. In particular, we wish to draw to the attention of the IASB that the impacts on the equity balance may have unintended impacts upon the debt convenants of some Australian corporates. Some Australian corporates in adopting this standard in 2005 will be required to adjust their comparatives back to 2003.

The CBA recommends the introduction of the standards with application only from the beginning of the current financial period for which the proposals are adopted. We consider that current financial instruments classified as equity balances should be "grandfathered" under the new proposals, at least for a two year period to allow time for reorganisation of existing hybrid equity issues.

*Capital Implications*

In determining the capital adequacy of banks, central banks look to the classification of equity in the accounting standards and how instruments and reserves are reported in financial statements to determine Tier 1 capital. Whilst there is the opportunity to agree alternative treatments with central banks, it is likely that the proposed accounting standards will have a significant impact on future issues of complex financial instruments and the level of equity reserves. There is a potential for a very material impact on bank's capital positions flowing from these new equity classification requirements. It is imperative that there is a close liaison between the IASB and central banks regarding the capital implications of instruments and new equity reserves. Central banks rely on accounting classification for equity recognition.

*Securitisation*

The CBA supports the proposed concept of recognition rules based on legal form and continuing involvement. In general, we consider these to be easier to interpret and apply over Australia's existing "substance over form/risks and rewards" principle. However, we request the IASB to provide clarity over the application of the proposals particularly as they apply to transactions such as securitisation. There is an industry concern that such transactions may be unintentionally adversely impacted by the proposals. Should the rules on options not be amended to consider probability of exercise, then from a business perspective, the CBA would prefer to move to a full components approach based on control.

In supporting the proposed "continuing involvement" approach, we draw to the attention of the IASB that this would create an inconsistency in the recognition framework. We believe that the IASB should consider the impacts of such an inconsistency, particularly as regards to the consolidations standard IAS 27,which relies more on a risks and benefits, control demonstration basis, before these proposals are adopted.

*Provisioning*

Loan loss provisioning by its nature involves a significant degree of subjectivity and judgement. The introduction of a requirement for discounting expected cash flows adds an unnecessary level of complexity for little benefit. Australian banks currently determine the amount they expect to lose on the current performing portfolio over the remaining term to maturity. This is a commonly accepted approach in the Australian Banking Industry and to date has aligned credit, accounting (including tax) and regulatory regimes in a common outcome. We view current methodologies as providing a level of provisioning for impairment to meet identified risks, and see little value in having an accounting approach which is radically different to current practice. We request the IASB to review the proposed methodology in line with current credit practices.

*Hedge Accounting*

The CBA's preference is to maintain hedge accounting on an accruals basis, and not have the fair value of hedge derivatives reflected on the balance sheet. That is, the accounting treatment for the hedge should follow the accounting treatment applied to the underlying item being hedged.

The new proposals, when applied to banks, adopt a very simplistic view and approach to risk management. A comparison can be drawn with the original Basle capital accord that adopted a very simplistic approach to capital management, when numerous banks did not have a formal internal process. A new capital accord is now proposed that recognises varying levels of sophistication in determining capital requirements. This proposed standard for banks (large banks in particular), means a backward step from the current level of sophistication of portfolio risk management to one which largely operates on an individual matching of hedge transactions. This is a very simplistic, cumbersome and costly approach to risk management that would be more applicable over 20 years ago when many risk management techniques were in their infancy.

The hedging proposals in IAS 39 represent a major change to Australian GAAP. We believe the proposals have not adequately considered the business dynamics of hedging arrangements and corporate governance protocols. The hedging proposals may unintentionally influence risk management decisions and outcomes. The result is a loss of symmetry and an injection of volatility into the balance sheet and profit and loss account that is unrelated to the economic substance of the transaction in question.

We acknowledge the IASB's desire to have all hedge derivatives on balance sheet at fair value. However, the CBA believe that the accounting rules for the hedging instrument should follow the hedged item during the life (and ongoing effectiveness) of the hedge. This is opposite to the position for a fair value hedge in IAS 39, where the accounting treatment for the hedged item has to follow that of the hedging instrument. The current IAS 39 approach results in groups of assets and liabilities being partially carried at fair value and partially carried at amortised cost.

A possible alternative is that hedge derivatives be valued at fair value, the hedged item be carried at amortised cost, but the change in the fair value of the derivatives be taken to an equity reserve to be transferred to profit and loss when the gains or losses on the hedged item are recognised in profit and loss. In the normal course, where the hedge is effective, the revaluation of the hedge derivative at each reporting period will gradually adjust the equity reserve and profit and loss such that at maturity the hedge derivative will be at zero value.

This possible alternative solution eliminates the distinction in the accounting for fair value hedges and cash flow hedges, and consequently would make hedge accounting more akin to the economic substance, especially when accompanied by appropriate disclosures. It would significantly reduce the number of adjustments to the carrying amounts of the hedged items, while reporting clearly the amount of gains or losses deferred during the life of the hedges.

The above alternative is similar to that being put forward by the European Financial Reporting Advisory Group.

The taking of all fair value movements on hedge derivatives through an equity reserve serves to provide consistency of reporting and comparability of accounts for users. This proposal also provides for simpler more cost effective procedures for reporting entities.

Current hedge accounting arrangements allow the use and recognition of hedge transactions where there is a transfer of risk between an entity's balance sheet and its trading book and such risk is subsequently demonstrably transferred to the external market. The CBA continues to support this approach based on management protocols to isolate risks and operations. Continued allowance of such arrangements would avoid any potential for artificial transactions to arise.

*Short Comment Period*

Given the radical change in accounting proposed for most financial institutions, the shortness of the commentary period does not allow sufficient time for our detailed review of all the issues. The implementation of similar accounting standards in the USA identified many issues after the implementation of the standard. The CBA is disappointed sufficient time has not been given to comment and help identify such issues for discussion before finalisation of an accounting standard. We ask the IASB give detailed consideration to the issues raised prior to finalising the proposed standards.

Please find our detailed consideration of these and other issues set out in the attachments.

The CBA would be happy to provide further clarification of these issues if required. Please contact Geoff Steel or myself if you would like further input. Geoff's contact details are:

Geoff Steel
Executive Manager, Group Accounting
Commonwealth Bank of Australia
Level 8, 48 Martin Place
Sydney NSW 2000
Australia

Phone: 61 2 9378 3636
Fax: 61 2 9378 3303

Email: steelg@cba.com.au

Yours sincerely

Gary Thursby
Group Financial Controller

**Attachment**

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

The following more detailed comments are provided:

## IAS 32 “Financial Instruments: Disclosure and Presentation”

### Background

Australian Accounting Standard AASB 1033 Presentation and disclosure of financial instruments generally conforms to the current international standard IAS 32 Financial Instruments: Disclosure and Presentation. The proposed changes to IAS 32, primarily with regard to the classification of financial instruments between liability and equity, could have a significant impact on Australian banks on initial restatement and into the future.

### Proposed changes

We would like to draw the IASB's attention to the impact the following changes will have on bank financial statements.

### Financial instruments with contingent settlement provisions

Under the proposed standard, a financial instrument that an entity could potentially be required to settle with cash or other financial assets depending on uncertain future events or on the outcome of uncertain circumstances that are beyond the control of both the issuer and the holder should be considered as a financial liability because the issuer does not have discretion to avoid settlement. The proposed standard specifically mentions circumstances such as the existence of future profits and debt/ to equity ratios as circumstances that of themselves would not remove the issuer's obligation to settle.

Australian banks currently have financial instruments on issue that allow distributions not to be made where, for example, the entity has insufficient profits. It has been common practice to classify such instruments as equity on the basis that there was no obligation to make distributions as the obligation was contingent on such circumstances. Clearly there will be an impact on classification of existing instruments if the proposed standard is accepted in its current form. Whilst we agree that the classification of a financial instrument should be recognised in accordance with the substance of the contractual arrangement, we do not agree that the classification should be made without regard to the probability of settlement.

### Instruments that can be redeemed for a fixed amount

Financial instruments that can be settled with the entity's own equity instruments will only meet the definition of equity if the holder of the instrument is entitled to receive a fixed number of equity instruments. Where the instruments are redeemed for cash or a fixed amount the holder does not have a residual interest in the entity and therefore the instrument cannot be considered as equity.

Where a unit trust provides unitholders with a right to redeem their units at any time for cash equal to a proportion of the current value of the net assets of the entity, the trust should recognise the instrument as a liability rather than equity as there is an obligation to pay the unitholder.

Both of these circumstances may cause items traditionally disclosed as equity, such as resetting preference shares, to be reclassified to liabilities. The materiality of the effect on capital levels of financial institutions of this change should not be understated.

**Impact on Australian banks and corporates**

In general, the tightening of the classifications of equity and liability in the proposed international standard will cause some instruments that are currently classified as equity to be re-classified as liabilities. This may have a significant impact on bank's statements of financial position. The current international proposal is that all the changes will be applied retrospectively. This will not only cause a significant reclassification of instruments from equity to debt on adoption, but would also have a significant profit effect as amounts previously shown as equity distributions will have to be reclassified as interest in the statement of financial performance.

Financial statements of corporate clients may also be affected by the proposed classification changes. Where debt covenants exist, these will be impacted by the reclassification of instruments from equity to debt. This is of particular concern during the transition as existing covenants will be immediately affected.

The transitional section of IAS 32 requires retained earnings to be restated in the earliest period that is presented and other comparative amounts to be restated as if the standard has always been in use. We ask that the IASB consider the impact of the transitional provisions in this regard.

The CBA supports the introduction of the standards with application from the beginning of the current financial period for which the proposals are adopted. We consider that current financial instruments classified as equity balances should be “grandfathered” under the new proposals, at least for a two year period to allow time for the reorganisation of hybrid equity issues.

## Central Banks

In determining the capital adequacy of banks, central banks look to the classification of equity in the accounting standards and how instruments are reported in financial statements to determine Tier 1 capital. Whilst there is the opportunity to agree an alternative treatment for instruments with central banks, it is likely that the proposed accounting standard will have a significant impact on future issues of complex financial instruments.

In order to maintain bank capital adequacy levels as currently described we believe that it would be appropriate to recognise that contingent settlement provisions do negate the issuer's obligation to make payments to the holder under the terms of the instrument and as such, holders of these instruments are exposed to changes in the underlying value of the issuers equity instruments.

***Rating agencies and analysts***

In general we accept that rating agencies and analysts will make an assessment of complex financial instruments based on specific information disclosed about those instruments and that a change in classification will not pose a problem to those users of the financial statements.

# IAS 39 "Financial Instruments: Recognition and Measurement"

### Effective Date – Retrospective Implementation

Paragraph 171 of IAS 39 and paragraph 96 of IAS 32 require the proposed standards to be implemented retrospectively, applicable to the earliest prior year presented in the accounts, as if the standard had always been in place. The proposals allow for an exemption, if restatement of the proposals would require undue cost or effort.

There is a high degree of cost and effort in restating information retrospectively. Therefore, there is a possibility that some organisations will elect not to restate information leading to an inconsistency of information presented across industries. Comparability of companies and usefulness of information is then compromised and the degree of information reported and the cost and time incurred by some companies would be incurred unnecessarily.

We draw to the attention of the IASB, that the retrospective implementation of these proposals may lead to the unintentional breach of debt covenants by some corporates. This result could lead to unexpected contractual financial impacts on these corporates as a result of an accounting change.

The CBA supports the introduction of the standards with application only from the beginning of the current financial period for which the proposals are adopted. We request the IASB to take this into consideration.

## Recognition and Derecognition

The CBA supports the proposed concept of recognition rules based on legal form and continuing involvement. In general, we consider these to be easier to interpret and apply over Australia's existing "substance over form/risks and rewards" principle. However, we request the IASB to provide clarity over the application of the proposals particularly as they apply to transactions such as securitisation. There is an industry concern that such transactions may be unintentionally adversely impacted by the proposals. Should the rules on options not be amended to consider probability of exercise, then from a business perspective, the CBA would prefer to move to a full components approach based on control.

Currently, securitisation programs contain a time based call option which allows the repurchase of the outstanding securitised loan balances, generally at the end of seven years. Due to the normal prepayment of home loans, the outstanding balance at year seven is less than 10% of the original principal. It is highly probable (greater than 95%) that such a level of prepayments will occur in the Australian market. However, if there were no prepayments then theoretically on a 25 year home loan, the balance outstanding at year seven would still be in excess of 80% of the original value. The existence of the option under the proposed rules without recognition of the probability of prepayments adversely impacts the commercial viability of securitisation in Australia. Similar recognition issues exist with the provision of liquidity facilities, guarantees and other items in securitisation programs. The CBA believes that proposed continuing involvement concept be extended to include consideration of the probability of outcomes such as prepayment levels on securitisation transactions.

In supporting the proposed "continuing involvement" approach, we also draw to the attention of the IASB that this would create an inconsistency in the recognition framework. We believe that the IASB should consider the impacts of such an inconsistency, particularly as regards to the consolidations standard IAS 27, which relies more on a risks and benefits, control demonstration basis, before these proposals are adopted.

### Provisioning

Loan loss provisioning by its nature involves a significant degree of subjectivity and judgement. The introduction of a requirement for discounting expected cash flows adds an unnecessary level of complexity for little benefit. Australian banks currently determine the amount they expect to lose on the current performing portfolio over the remaining term to maturity. This is a commonly accepted approach in the Australian Banking Industry and to date has aligned credit, accounting (including tax) and regulatory regimes in a common outcome. We view current methodologies as providing a level of provisioning for impairment to meet identified risks, and see little value in having an accounting approach which is radically different to current practice. We request the IASB to review the proposed methodology in line with current credit practices.

## Hedge Accounting

The CBA's preference is to maintain hedge accounting on an accruals basis, and not have the fair value of hedge derivatives reflected on the balance sheet. That is, the accounting treatment for the hedge should follow the accounting treatment applied to the underlying item being hedged.

The new proposals, when applied to banks, adopt a very simplistic view and approach to risk management. A comparison can be drawn with the original Basle capital accord that adopted a very simplistic approach to capital management, when numerous banks did not have a formal internal process. A new capital accord is now proposed that recognises varying levels of sophistication in determining capital requirements. This proposed standard for banks (large banks in particular), means a backward step from the current level of sophistication of portfolio risk management to one which largely operates on an individual matching of hedge transactions. This is a very simplistic, cumbersome and costly approach to risk management that would be more applicable over 20 years ago when many risk management techniques were in their infancy.

The hedging proposals in IAS 39 represent a major change to Australian GAAP. We believe the proposals have not adequately considered the business dynamics of hedging arrangements and corporate governance protocols. The hedging proposals may unintentionally influence risk management decisions and outcomes. The result is a loss of symmetry and an injection of volatility into the balance sheet and profit and loss account that is unrelated to the economic substance of the transaction in question.

We acknowledge the IASB's desire to have all hedge derivatives on balance sheet at fair value. However, the CBA believe that the accounting rules for the hedging instrument should follow the hedged item during the life (and ongoing effectiveness) of the hedge. This is opposite to the position for a fair value hedge in IAS 39, where the accounting treatment for the hedged item has to follow that of the hedging instrument. The current IAS 39 approach results in groups of assets and liabilities being partially carried at fair value and partially carried at amortised cost.

A possible alternative is that hedge derivatives be valued at fair value, the hedged item be carried at amortised cost, but the change in the fair value of the derivatives be taken to an equity reserve to be transferred to profit and loss when the gains or losses on the hedged item are recognised in profit and loss. In the normal course, where the hedge is effective, the revaluation of the hedge derivative at each reporting period will gradually adjust the equity reserve and profit and loss such that at maturity the hedge derivative will be at zero value.

This possible alternative solution eliminates the distinction in the accounting for fair value hedges and cash flow hedges, and consequently would make hedge accounting more akin to the economic substance, especially when accompanied by appropriate disclosures. It would significantly reduce the number of adjustments to the carrying amounts of the hedged items, while reporting clearly the amount of gains or losses deferred during the life of the hedges.

The above alternative is similar to that being put forward by the European Financial Reporting Advisory Group.

The taking of all fair value movements on hedge derivatives through an equity reserve serves to provide consistency of reporting and comparability of accounts for users. This proposal also provides for simpler more cost effective procedures for reporting entities.

**Internal Hedging**

Paragraph 126B of IAS 39 requires that internal hedges be fully eliminated on consolidation and outlines that only derivatives that involve a party external to the entity can be designated as hedging instruments.

The CBA believes the proposals fail to reflect the detailed risk management structures of large financial institutions to manage banking and trading risks independently. Banks have corporate governance procedures in place to ensure that any internal transactions are entered on an independent arms length basis at current market prices and recognised in separate responsibility centres. Financial Institutions operate in a sophisticated environment that is at the leading edge of theory and process. Counterparty and other risk limits ensure that material risks are not held within the entity.

We request the IASB to review this request.

**Hedging of Held to Maturity Investments**

Paragraph 127 of IAS 39 disallows the hedging of interest rate risk on Held to Maturity Investments.

The CBA appreciates the IASB's view that held to maturity investments do not generate interest rate risk if indeed the investments are held to maturity. Held to maturity investments nevertheless form part of the interest rate risk mix in a bank's balance sheet. Interest rate risk may arise from holding fixed interest rate Held to Maturity Investments that are funded by floating rate liabilities. The ability of an entity to consider various hedging and funding arrangements which best suit the economic business of the entity should not be jeopardised by the accounting rules to record such business transactions. In reality, it is imperative that a Held to Maturity Investments may be hedged where a more effective hedge can be identified and effectiveness tested. This does not contradict the requirements for the intent and the ability of an entity to hold the Held to Maturity Investment to maturity.

We request the IASB to review the allowance of hedging of Held to Maturity Investments.

### Hedging of Leases

Paragraph 1 (b) of IAS 39 excludes Leases from the application of this proposal.

Fixed interest rate leases generate interest rate risk and form part of the interest rate risk mix in a bank's balance sheet. The ability of an entity to consider various hedging arrangements which best suit the economic business of the entity should not be jeopardised by the accounting rules to record such business transactions. It is imperative that a lease may be able to be hedged as effectiveness will be more readily proved against this lease asset rather than the funding liability.

The CBA requests the IASB confirm that for purposes of hedge accounting, a lease may be considered similar to an originated loan and therefore, hedge accounting may be applied in accordance with the proposals.

## General Hedge Portfolio

The hedge accounting proposals allow a portfolio hedge or a hedge of a net asset/liability risk position by identifying the underlying assets or liabilities to be hedged. The requirements for hedging such positions are very onerous and may prove cost inhibitive. The CBA believes that a general portfolio hedge of assets or liabilities with similar risk characteristics, although not individually identified and documented can be an effective hedge. We request the IASB review this requirement in their finalisation of the proposed standard.

### Hedging Examples

The hedge accounting requirements of IAS 39 are very complex and will require detailed product and accounting systems to enable an entity to comply with the requirements. The proposed standard has limited examples of how to apply hedge accounting under IAS 39. For the sake of clarity, should this standard be adopted in its current form, the CBA requests the IASB include further detailed examples of how hedge accounting could be applied given the sophisticated risk management techniques of large financial institutions.

## Other Issues

Other aspects of the standard that have been criticised include:

- Strategic investments in equity securities have no fixed maturity date and will therefore, be classified as ‘available-for-sale’ under IAS 39. As a result they will be measured at fair value with gains and losses recognised in the Statement of Changes in Equity during the period. Investments of this nature, however, are usually held for continuing use in the business as part of a longer term strategy. It would therefore, be more appropriate for them to be measured at cost less provisions for any permanent impairment in value.

- Only loans originated by an enterprise and not held for trading are permitted to be measured at amortised cost ‘without regard to the enterprise’s intent to hold them to maturity’. While purchased loans can be measured at amortised cost, it requires them to be classified as held-to-maturity and precludes their being fully assimilated into the acquirer’s mainstream loan book.

**APPENDIX**

**Invitation to Comment (IAS 32)**

**Question 1 - Probabilities of different manners of settlement (paragraphs 19, 22, and 22A)**

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

*Whilst we agree that the classification of a financial instrument should be recognised in accordance with the substance of the contractual arrangement, we do not agree that the classification should be made without regard to the probability of settlement. By including the statement 'without regard to probabilities of the manner of settlement' in paragraph 19, we believe that the assessment of classification of the instrument based on substance is diminished. Where there is low or remote probability that redemption will be required, the substance of the instrument may best be represented by classifying the instrument as equity.*

**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?

*No. The CBA believes the existing options within the standard are appropriate given the complex nature of these instruments.*

**Question 3 - Classification of derivatives that relate to an entity's own shares (paragraphs 29C 29G)**

Do you agree with the guidance proposed about the classification of derivatives that relate to an entity's own shares?

*The proposed guidance on share based derivatives appears consistent with the classification of liabilities and equity. We note that it is illegal to trade in 'own' shares under Australian corporations law.*

**Question 4 - Consolidation of the text in IAS 32 and IAS 39 into one comprehensive Standard**

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

*No preference.*

**Invitation to Comment (IAS 39)**

**Question 1 – Scope: loan commitments (paragraph 1(l))**

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?

*No Comment.*

**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?

*Yes.*

*The CBA supports the proposed concept of recognition rules based on legal form and continuing involvement. In general, we consider these to be easier to interpret and apply over Australia's existing "substance over form/risks and rewards" principle. However, we request the IASB to provide clarity over the application of the proposals particularly as they apply to transactions such as securitisation. There is an industry concern that such transactions may be unintentionally adversely impacted by the proposals. Should the rules on options not be amended to consider probability of exercise, then from a business perspective, the CBA would prefer to move to a full components approach based on control.*

*Currently, securitisation programs contain a time based call option which allows the repurchase of the outstanding securitised loan balances, generally at the end of seven years. Due to the normal prepayment of home loans, the outstanding balance at year seven is less than 10% of the original principal. It is highly probable (greater than 95%) that such a level of prepayments will occur in the Australian market. However, if there were no prepayments then theoretically on a 25 year home loan, the balance outstanding at year seven would still be in excess of 80% of the original value. The existence of the option under the proposed rules without recognition of the probability of prepayments adversely impacts the commercial viability of securitisation in Australia. Similar recognition issues exist with the provision of liquidity facilities, guarantees and other items in securitisation programs. The CBA believes that proposed continuing involvement concept be extended to include consideration of the probability of outcomes such as prepayment levels on securitisation transactions.*

*In supporting the proposed "continuing involvement" approach, we also draw to the attention of the IASB that this would create an inconsistency in the recognition framework. We believe that the IASB should consider the impacts of such an inconsistency, particularly as regards to the consolidations standard IAS 27, which relies more on a risks and benefits control demonstration basis, before these proposals are adopted.*

**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?

*The CBA agrees that where contractual cash flow arrangements have been transferred from the transferor to the transferee and there is no continuing involvement in the cash flows by the transferor, other than the passing through of the cash flows from the underlying borrower to the special purpose securitisation entity that has acquired the securitised assets, then derecognition by the transferor is appropriate.*

*We believe there are many situations where the "pass-through arrangement" tests would be met, however, in substance and legally, the transferor should still have a financial asset and a financial liability.*

*The Basis of Conclusions makes it apparent that these rules were intended to apply where special purpose entities were involved. As currently written, the proposals appear to have wider application and could be open to abuse. For example, many non-recourse debt liabilities and the related assets in a special purpose securitisation entity might be derecognised, whereas legally investors have a right to the financial assets in the securitisation entity.*

*The Basis of Conclusions seem to imply that the financial assets and financial liabilities arising from securitisation transactions may often be derecognised. However, the "pass-through arrangement" tests would not be met in practice by most 'generally accepted' securitisation transactions. For example, in a typical Australian securitisation transaction:*

- *the SPE does not transfer the underlying financial assets or issue beneficial interests in the underlying financial assets; it issues beneficial interests in the SPE*

- *similarly, the SPE will often enter into derivative transactions (eg swaps) to convert cash received to a basis consistent with the SPE's liabilities; hence again the noteholders (ultimate transferees) will not be paid directly from the amounts collected from the financial assets*

*The thrust of the proposals is that an SPE that qualifies as a "pass-through arrangement" would record no assets or liabilities. However, we believe the investors in the SPE would be looking to their financial statements (as a reporting entity) for useful information.*

**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?

*The CBA appreciates the flexibility it enables and the reduction in documentation for fair value hedges that would eventuate. However, we consider it likely to lead to inconsistency in accounting treatments applied between like financial institutions. The comparability and useability of financial accounts could be compromised.*

**Question 5 – Fair Value measurement considerations (paragraphs 95 – 100D)**

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

*Yes. The CBA believes the hierarchical methodology provided is a sound basis for determination of fair value on a consistent basis.*

*We note however, that the methodology values individual financial instruments and does not take into consideration that from a large financial institution perspective, financial instruments may be transacted in various sizes and circumstances and that the majority of a large financial institution's financial instruments may never be sold. The valuation methodology does not take into consideration or provide for valuation of customer relationships, portfolio benefits, etc which would be taken into normal business considerations in an arm's length exchange. While we believe the methodology will provide a consistent basis of reporting, it may not establish what the transaction price would have been on the measurement date in an arm's length exchange motivated by normal business considerations. In this regard, we request the IASB to take this into consideration and provide more guidance on portfolio valuations, if appropriate.*

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

Do you agree that a loan asset or other financial asset measured at amortised cost that has been individually assessed for impairment and found not to be individually impaired should be included in a group of assets with similar credit risk characteristics that are collectively evaluated for impairment? Do you agree with the methodology for measuring such impairment in paragraphs 113A – 113D?

*The CBA agrees that a loan asset or other financial instrument not found to be individually impaired should be included in a group of assets for collective evaluation for impairment. This is similar to the current Australian approach used to determine the level of the general provision for impairment.*

*We do not agree with the methodology for impairment as proposed. Loan loss provisioning by its nature involves a significant degree of subjectivity and judgement. The introduction of a requirement for discounting expected cash flows adds an unnecessary level of complexity for little benefit. Australian banks currently determine the amount they expect to lose on the current performing portfolio over the remaining term to maturity. This is a commonly accepted approach in the Australian Banking Industry and to date has aligned credit, accounting (including tax) and regulatory regimes in a common outcome. We view current methodologies as providing a level of provisioning for impairment to meet identified risks, and see little value in having an accounting approach which is radically different to current practice. We request the IASB to review the proposed methodology in line with current credit practices.*

**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?

*No. Financial institutions will assess the credit risk of a counterparty in its entirety, this is not related to an accounting classification. Impairment losses should be treated consistently across all financial instruments. Should an available for sale financial instrument return to a non-impaired status, write-backs of any impairment provisions should be considered similarly to an originated loan.*

**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?

*Yes. The accounting treatment applied to the hedge instrument should follow the nature of the risk being hedged.*

**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?

*Yes.*

**Question 10 – Prior derecognition transaction (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 (ie that prior derecognition transactions should not be grandfathered)? Alternatively, should prior derecognition transactions be grandfathered and disclosure be required of the balances that would have been recognised had the new requirements been applied?

*No Comment.*