CL 125

October 30, 2002

Sir David Tweedie
Chairman
International Accounting Standards Board
30 Canon Street
London
ECM4M 6X H
United Kingdom

Proposed Amendments to IAS 32 and IAS 39 Financial Instruments

Dear Sir David:

J.P. Morgan Chase & Co. appreciates the opportunity to comment on the Exposure Draft of Proposed Amendments to IAS 32 Financial Instruments: Disclosure and Presentation and IAS 39 Financial Instruments: Recognition and Measurement (collectively referred to herein as the "ED").

We welcome a number of the amendments that the IASB has proposed to its standards. Accordingly, we have only commented where we have conceptual differences with the standard and in response to certain questions posed by the Board. We understand that the Board does not intend to revisit at this time the fundamental approach to certain aspects of these standards. However, given the drive to harmonize International and U.S. accounting standards, and the current status of the FASB in its deliberations of certain of its standards, we feel that certain concepts should be reconsidered. Addressing these conceptual issues now will facilitate the transition toward a uniform set of global standards and, most importantly, avoid unnecessary disruption and inefficiencies in the capital markets.

Our substantive concerns are summarized below and in more detail in Appendices I and II. Our responses to the specific questions posed by the IASB regarding IAS 32 and IAS 39 are also contained in Appendices I and II.

IAS 32 Summary of Comments:

- We strongly disagree with the principle of separation of certain financial instruments that include both equity and liability components. Under the proposed rules commonly understood compound financial instruments, such as convertible debt, will be split into two or more instruments and reported in both the liability and equity sections of the balance sheet. We are not convinced that providing separate information on the components of these compound instruments will improve the usefulness of financial information. In fact, there is a distortive impact on the financial statements as a convertible instrument bifurcated between debt and equity would be reported as a discounted, possibly deeply discounted, debt instrument with a corresponding equity component that may never materialize. Additionally, the operational requirements to bifurcate complex instruments will prove difficult in practice and will place a significant burden on companies.

- We agree that the classification of a financial instrument should be based upon the substance of the instrument. However, we do not conceptually agree with the following:

1. The concept that only those derivative contracts that result in an exchange of a fixed amount of cash or other financial asset for a fixed number of an entity's own equity instruments should be classified as equity.
2. The concept that all net settling contracts to deliver shares of a company's own equity would not be considered equity instruments.
3. The application of historical experience in determining the classification of gross physically settled contracts.

By narrowly defining when an instrument can be equity and excluding net share settling contracts, the ED will result in inconsistent accounting results for a whole class of financial products. We discuss specific examples of these inconsistencies in Appendix I. We generally believe that if an instrument will be gross or net settled in an entity's own shares, and settlement is within the issuer's control, the financial instrument should be classified as equity both upon issuance and settlement of the financial instrument. Also, we disagree with the application of historical experience as it brings an element of probability into the accounting assessment, which is an apparent contradiction to the removal of probability and economic compulsion. It also restricts those with no history and creates lack of comparability between companies. Past experience is not always a good indication of future actions especially with complex financial instruments, which vary significantly in their terms.

- The proposed changes, which remove the concepts of probability and economic compulsion, could mean that for certain transactions form would override substance. The IASB should at least introduce wording to ensure that clauses which have no genuine commercial possibility do not drive the classification of a financial instrument.

Each of these points is discussed in more detail in Appendix I of this letter.

IAS 39 Summary of Comments:

- We agree that loan commitments not designated as held for trading should be excluded from the scope of IAS 39. However, we believe the guidance can be further simplified by basing the exclusion on the creditor's intent and not whether the commitment can be settled net.

- The fair value methodology proposed in the ED is too prescriptive and does not allow for the appropriate judgment needed to estimate the fair value of financial instruments. Instead of providing detailed rules on how to fair value, we believe it would be more beneficial for the Board to provide best practices on appropriate valuation methodologies and processes and controls to ensure valuations are done in a consistent fashion.

- We have a significant concern with the derecognition model in IAS 39. The Board appears to be implementing "quick-fixes" to a flawed derecognition model because of the upcoming EU convergence deadline. We believe it would be more appropriate for the Board to develop a principles-based derecognition model rather than create a model with the expectation of changing it as standards converge.

- We do not agree with the proposed discounting methodology to measure impairment of a pool of loans from both a conceptual and practical standpoint. We are concerned that adjusting the original contractual interest rate for the expected loss premium would cause impairment not to be recorded when the expected cash flows are less than contractual cash flows. Furthermore, adjusting the original contractual interest rate for the expected loss premium for each loan in a portfolio would pose significant operational difficulties.

- Financial guarantees should not be recognized as liabilities until the recognition requirements of paragraph 14 of IAS 37 have been met.

Each of these points is discussed in more detail in Appendix II of this letter.

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We would be pleased to discuss our comments with you at your convenience. Please do not hesitate to contract me at 212.270.7559.

Sincerely,

Joseph Sclafani, EVPCC
J.P. Morgan Chase

APPENDIX I: IASB'S SPECIFIC QUESTIONS ON IAS 32

Question 1-Probabilities of different manners of settlement.

Do you agree that the classification of a financial instrument as a liability or 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 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 financial liability, irrespective of the probability of those events or circumstances occurring.

We agree with the notion that classification of a financial instrument should be based upon the substance of the instrument and that the spirit of the standard remains intact with the removal of the probability element for classification of a financial instrument. Further, we support a non-probabilistic model for classifying financial instruments. The most comparable literature in the U.S. is Emerging Issues Task Force Issue No. 00-19: *Determination of Whether Share Settlement Is Within the Control of the Issuer*. We have found that EITF 00-19 model is workable and provides increased clarity and consistency in financial reporting.

However, we do acknowledge that the proposed changes which remove the concepts of probability and economic compulsion could mean that for certain transactions form would override substance. Along these lines the IASB should at least introduce wording to ensure that clauses that have no genuine commercial possibility do not drive the classification of a financial instrument.

Question 2- Separation of liability and equity elements:

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?

We strongly disagree with the principle of separation of certain financial instruments that include both equity and liability components. Under the proposed rules many commonly understood compound financial instruments, such as convertible debt, will be split into two or more instruments and reported in both the liability and equity sections of the balance sheet. We are not convinced that providing separate information on the components of a compound instrument will improve the usefulness of financial information.

In fact, there is a distortive impact on the financial statements as a convertible instrument bifurcated between debt and equity would be reported as a discounted, possibly deeply discounted, debt instrument with a corresponding equity component. Based on our interpretation of IAS 39, interest payments should be charged so as to give a constant effective rate and the initial amount vs. maturity amount should be brought into this calculation. Accordingly, the debt component will be amortized into income under IAS 39, via interest expense, distorting the cost associated with this instrument. Also, the debt component would be reported as plain vanilla debt, without presenting the favorable conversion feature. The equity component on the other hand would have no offsetting income statement effect and may be held out as permanent equity when in fact it might never be converted into equity.

Not only would the information not be meaningful but the operational requirements to bifurcate these complex instruments will prove difficult in practice and would place a significant burden on companies. Bifurcation of compound financial instruments is a complicated task, as noted by the implementation problems encountered with US GAAP literature relating to derivatives (Statement 133). We expect that companies would experience difficulty in determining the value of interrelated components that do not typically trade separately in the marketplace.

To alleviate these concerns, we have worked with ISDA to propose an alternative accounting model for convertible debt, which we believe, would more accurately reflect these instruments in the financial statements. This solution is discussed in detail within the ISDA comment letter to the IASB dated October 14, 2002. In summary, the convertible debt would be recorded on the balance sheet at fair value and no portion would attributed to the equity option at issuance. 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 coupon or stated accretion on the convertible would be credited to equity as the installments of the equity option premium are "paid." We strongly urge the IASB to embrace this approach as it has many benefits of providing appropriate expense recognition, recording liabilities at their settlement amount and not overstating equity.

Notwithstanding the objections noted above, if the Board proceeds with the separation model, we agree that there is a need to eliminate the alternative methods of measurement and agree with the proposal that the residual amount should be assigned as the equity component.

Question 3 –Classification of derivatives that relate to an entities own shares:

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

We agree that the classification of a financial instrument should be based upon the substance of the instrument. However, we do **not** conceptually agree with the following:

- The concept that only those derivative contracts that result in an exchange of a fixed amount of cash or other financial asset for a fixed number of an entity's own equity instruments should be classified as equity.
- The concept that all net settling contracts to deliver shares of a company's own equity would not be considered equity instruments.
- The application of historical experience in determining the classification of gross physically settled contracts.

Each of these points is described in more detail below.

The concept that only those derivative contracts that result in an exchange of a fixed amount of cash or other financial assets for a fixed number of an entity's own equity instruments should be classified as equity.

We agree with the notion that financial instruments, which could require settlement by delivering cash or other financial assets should be classified as financial liabilities providing the occurrence or non-occurrence of uncertain future events causing this means of settlement are beyond the control of the issuer. We further believe that an obligation solely to deliver a variable number of shares to pay a fixed dollar liability should always be considered a liability (e.g. "debt payable in stock"). However, that does not mean an obligation to deliver a variable number of shares is always a liability.

Numerous contracts exist which allow the issuer to deliver a variable number of shares for equity-like pay-outs (i.e., where the change in value of the contract is positively tied to the equity price movement). Some examples would include forward sales for floating indexed payments and variable share delivery contracts, which are described in more detail below.

Forward sale for floating indexed payments

The Issuer sells a fixed number of shares forward for the receipt of a notional amount that accrues at a floating rate. The only difference from a fixed share, fixed price forward is that the forward price is determined using a floating rate of interest. In both forwards, the issuer delivers a fixed number of shares. In the fixed price version the counter-party delivers a fixed dollar amount X (where X is a premium to the spot price typically figured using a cost of carry analysis: X = Spot x (1 + Rate x time). In the floating price version the counter-party delivers a notional that accretes at a floating rate, e.g., Y = Spot x (1 + (Libor + spread) x time).

The ED would cause the entire floating price contract to be considered a liability while the contract with a fixed receipt is an equity instrument. Again, neither contract has any obligation for the issuer but to deliver a fixed number of shares, only the counter-party amount that the Issuer receives is different. It seems illogical to suggest the receipt of a fixed amount of value or a floating amount of value is the turning point for an analysis of whether the issuance of stock is an equity instrument or a liability.

We believe that equity forward sales are equity instruments whether the payments received are fixed or floating based on cost of carry. The FASB recently concluded that *"Fair value changes in the consideration the issuer would receive from the holder would not include changes in the amount of functional currency cash that the issuer would receive due to costs of carry as described above (for example, in a variable-rate forward sales contract)."* We concur with the FASB and feel that convergence on this topic is critical.

Variable share delivery contract

Irrevocable contract between Company and investors specifying the future sale by a Company of a variable number of its common shares in exchange for a fixed dollar amount in three years (the "Face Amount"). The Face Amount is based upon the price of Company common stock at the pricing date. The Purchase Contract may only be settled by investors with cash. The number of shares deliverable to holders per XYZ Contract will be equal to the settlement rate, as determined by the average trading price of the common stock over a 20-day period ending on the third date prior to the forward contract maturity date. The settlement rate will be determined in Year 3 as follows:

Avg. stock price at or below $[34.00]/share:	0.74 shares issued
Avg. stock price between $[34.00] - $[40.80]/share:	0.74 – 0.61 shares issued
Avg. stock price above $[40.80]/share:	0.61 shares issued

The instrument described above can be broken down into the following components, a purchased put on .74 shares at $34, a written call on .61 shares at $40.8 and a right and obligation to sell a variable number of shares equal to $34 when the average price is between $34 and $40.8.

In table B27 of the ED: *"Overview of the proposed Accounting For Derivatives Indexed only to the value of the Entity's Own Shares,"* the Board indicates that a forward to sell shares should be classified as equity and we concur. However, based on our interpretation of the ED, a variable forward as described above would result in a liability or mark-to-market derivative.

The mechanics of the example above could result in a variable number of shares issued to satisfy a fixed monetary amount. The purchased put and the written call if issued separately would qualify under IAS 32's definition of an equity instrument since the fair value of the contract is equal to the change in a fixed monetary amount for a fixed number of shares below and above the strike prices of the options. The right and obligation to sell $34 worth of stock at fair value would meet the IASB's definition of a derivative but has no fair value if bifurcated. We do not believe that the difference in the number of shares in the two options and the derivative that links the two, which has no fair value at any time, should disqualify the entire transaction from being an equity instrument of the issuer. Thus, we would bifurcate the forward sale at market (i.e. zero fair value upon sale) from the instrument and treat it as a derivative. The remaining put and call would be treated as equity instruments.

We believe it would be misleading to ignore the overwhelming equity characteristics of this contract and treat it in its entirety as a mark-to-market derivative solely because (1) there is a derivative component that has no fair value in the contract and (2) at different price levels the number of shares to be delivered changes commensurate with the terms of components that would otherwise meet the requirements to be equity instruments of the issuer.

The concept that all net settling contracts to deliver shares of a company's own equity would not be considered equity instruments.

As currently drafted, all net share settlement contracts would be treated as derivative assets or liabilities and held at fair value. We generally believe that if an instrument is required to be or at the issuers discretion can be gross or net settled in an entity's own shares and has predominately equity characteristics, the financial instrument should be classified as equity both at issuance and at settlement. An instrument would have predominately equity characteristics if the change in value of the contract is correlated to equity price movements. If an obligation can be satisfied with the deliverance of an equity instrument in lieu of an asset, then the issuer has the ability to permanently keep the proceeds or assets it received in exchange for the instrument and the contract should therefore be classified as an equity instrument. Following is an example of a net settled derivative with the same economics as a gross physically settled contract:

<u>A net settled call (the same concept would apply to a net settled forward)</u>

Issuer sells a fixed strike price call option on its own shares, which it can settle by delivering the net share amount of the in-the-money value at maturity. This option has the same economics, and has identical fair value, as a gross physically settled call option. The net settlement feature recognizes the counter-party could deliver <u>**its**</u> obligation in shares (meaning the issuer receives a fixed dollar amount in a variable number of shares). Decomposing the call option into an obligation to deliver shares for the receipt of a fixed amount of value, we see the net settlement feature is the sum of an equity instrument (delivery of fixed shares by issuer) and an asset (receipt of fixed value by issuer), not as a derivative liability as the ED would dictate.

The application of historical experience in determining the classification of gross physically settled contracts.

We believe that the paragraph 32.29e criteria (b) and (c) should be eliminated. Considering experience in classification introduces an element of probability in to the accounting assessment, an apparent contradiction to the removal of probability and economic compulsion as discussed in question 1. Its use further restricts those with no history and also creates lack of comparability between companies. Additionally, by requiring the conditions in (b) and (c) to be met the accounting would be trumped by past experience. Past experience is not always a good indication of future actions especially with complex instruments, which vary significantly in their terms.

Additional concerns

We have additional concerns that there are a number of standard contractual provisions such as merger events, anti-dilution events (stock split, spin-off, recapitalization), ordinary or extraordinary dividends, borrow rate or recall protection or other unwind events, regardless of the remoteness of the protection or unwind that result in liability or derivative treatment when an instrument contains overwhelming equity characteristics.

We are aware that the FASB Staff is contemplating clarifying its definition of equity to allow contracts to include the standard provisions noted above. The FASB Staff is also in the process of reviewing the classification for a broad class of variable delivery contracts (e.g., callspreads, variable forwards, etc.). We feel that both the IASB and the FASB should work toward convergence on this topic. The FASB's October 11 update on their liability and equity project included language carving out dividend, credit and cost of carry adjustments for forwards:

"*When comparing the monetary value of the obligation with the fair value changes of the underlying shares, any costs of carry (for example, the time value of money, counter-party default risk, and dividends on the underlying shares) implicit in a forward sales contract denominated in the functional currency of the issuer would be ignored. Similarly, adjustments to the number of shares that maintain the contract's value in response to a stock split or dividend of the underlying stock would not affect equity classification.*"

In conclusion, by narrowly defining when an instrument can be equity and excluding net share settlement contracts, the ED will result in inconsistent accounting results for numerous complex derivative structures as described above.

APPENDIX II: 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?

We agree that loan commitments that are not designated as held for trading should be excluded from the scope of IAS 39. However, we disagree with the provision that a loan commitment should be excluded from the scope of IAS 39 only if it cannot be settled net. We believe that the exclusion should not be based on whether the loan commitment can be settled net, but rather does the entity plan to designate the loan as trading after the commitment has been drawn upon. If the entity does not plan on designating the loan as trading after the commitment has been drawn upon, then the commitment should be excluded from IAS 39.

Paragraph C14 of the ED states if the value of the loan commitment can be settled net in cash or by some other financial instrument, including by selling the resulting loan assets shortly after origination, the loan commitment should not be excluded from the scope of IAS 39. There are two problems with this. First, there may be loan commitments where the resulting loan can be sold shortly after origination (because there is an active market), but the entity has no intent to sell the loan. For example, certain banks in the U.S. enter into conforming residential mortgages. These mortgage agreements contain standard wording and have certain requirements that enable banks to sell loans in a relatively short time frame. Although many of the banks that issue conforming mortgages do not intend to sell the loan agreement, they use these types of agreement because they are the industry standard. With no intent to sell; the resulting loan will be accounted for on an amortized cost basis. Second, there has been significant debate in the U.S. regarding the determination of whether a loan commitment can be net settled, as discussed in more detail below.

The FASB decided on a scope exception for loan commitments for several reasons, including the difficulty of defining a market mechanism that facilitates net settlement for loan commitments and practical concerns (e.g., review of each loan agreement to see if can be assigned, cost to develop systems to fair value loan commitments, and the accounting implications of a mixed attribute model.) We believe that the same concerns will exist under IAS 39 and also believe that the IASB should be concerned that there may be a lack of comparability as different entities may have the same loan commitment, but interpret the requirement for net settlement differently. We strongly urge the IASB to consider the FASB's rationale for excluding loan commitments from the scope of SFAS 133 and not base the decision solely on whether the commitment can be net settled.

Furthermore, we are concerned with the proposed guidance that states that an entity which has a past practice of selling the assets resulting from a loan commitment shortly after origination, shall apply IAS 39 to all of its loan commitments. Specifically, we are concerned that the use of the term "entity" implies that if there is one specific operating unit of a financial institution that sells loans shortly after origination, then all operating units in the entity, even if they do not sell loans, would have to apply IAS 39 to all loan commitments. This poses a problem for financial institutions that have different operating units that operate in different markets with different loan portfolio strategies. We believe that each of these operating entities should be viewed separately when applying the guidance in IAS 39.

As noted in the summary of changes to IAS 39, "the objective of the proposed amendment is to simplify the accounting for entities that grant or hold loan commitments that will result in the origination of a loan asset and, in the absence of a specific scope exclusion, would be accounted for derivatives under IAS 39." To achieve this objective, we recommend that the classification of loan commitments be consistent with the classification of loans. Therefore, if the loan will not be classified as trading, then the loan commitment should not be classified as such. It simplifies the application of the guidance and does not burden entities that may have loan commitments that can be net settled, but have no intention of selling the loans once the commitments have been drawn.

Additionally, we assume that the ability to net settle refers to the creditor only since in typical lending arrangements, the borrower does not have the ability to net settle a commitment. The Board should clarify that there will be asymmetrical accounting between the creditor and debtor for the same contract.

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?

Continuing Involvement vs. Control

We do not agree that the proposed continuing involvement approach should be established as the principle for derecognition of financial assets under IAS 39 for several reasons. Firstly, the continuing involvement approach may result in an entity continuing to recognize the assets (or a portion thereof) even though it has surrendered control over those assets to the transferee. For example, it may be interpreted that the transferor's retained residual interest in a securitization constitutes a right to receive subsequent increases in the value of its previous contractual right of the assets and results in the transferor's continuing involvement. Under the ED, this would preclude derecognition for a portion of the transferred assets, even though the transferor has given up control of, and legal rights to, the asset. It would reduce the transparency of financial statements to have a transferor include assets that it does not legally own or control, or liabilities that it may not be responsible for in its financial statements.

Secondly, the concept of continuing involvement may lead to certain cash flows being recorded twice as assets (double counting of rights). As proposed, a retained subordinated piece of a securitization will be recorded on the balance sheet at its fair value. However, since the subordination effectively provides a credit guarantee for a portion of the assets transferred, a portion limited to the subordinated interests does not qualify for derecognition, resulting in an additional amount recognized on the balance sheet as loans and the associated amount of sale proceeds received being recorded as a secured borrowing. The Board needs to reconsider the impact of recording the secured borrowing for continuing involvement and provide further guidance that would not result in the recognition of the same rights to cash flows twice.

Paragraph 39 of the ED states that a transfer does not qualify for derecognition to the extent that there are contractual provisions related to the transfer that require payments to be made by or to the transferor based on subsequent changes in the value of the transferred asset. However, if the transferor retains the residual interest in the pool of assets, there may be no cap to the amount of changes in the value of those assets (and the transferor's retained residual interests). In this case, it is unclear what amount of derecognition may be applied.

Thirdly, the ED proposal may also result in inconsistent accounting for the same interest in a transferred pool of assets. For example, if the entity is a transferor and retains the residual in a pool of transferred assets, then the transferor would recognize both the residual interest at its fair value, along with the portion of assets and related sales proceeds (limited to the residual interest value) as a secured borrowing. However, an entity that is not the transferor would carry the exact type of subordinated interest on its balance sheet at its fair value, without any secured borrowing being recorded.

We support the financial-components approach to recognition and derecognition of financial assets and liabilities, since it reflects the economic consequences of contractual provisions underlying financial assets and liabilities and is consistent with the way participants in the financial markets deal with financial assets, including the combination and separation of components of those assets. The approach analyzes a transfer of a financial asset by examining the component assets (controlled economic benefits) and liabilities (present obligations for probable future sacrifices of economic benefits) that exist after the transfer. Each party to the transfer recognizes the assets and liabilities that it controls after the transfer and no longer recognizes the assets and liabilities that were surrendered or extinguished in the transfer.

Examples illustrating our concerns with the continuing involvement model follow.

Call Options

In securitizations, it is common for the servicer (which may be the transferor) to hold an option to purchase the remaining transferred financial assets, or the remaining beneficial interests if the amount of outstanding assets or beneficial interests falls to a level at which the cost of servicing those assets or beneficial interests becomes burdensome in relation to the benefits of servicing (e.g., clean-up calls). Under the ED, any clean up call level would result in precluding derecognition of assets up to the clean up call amount. Similar to Statement 140, the IASB should exclude clean up calls from precluding derecognition to give the servicer (which may be the transferor) the flexibility to clean up and terminate deals that are inefficient to service due to low levels of balances in the securitizations.

In addition, certain types of call options and Removal of Account Provisions (ROAPs) that are held by the transferor and are based on events or "triggers" outside the control of the transferor do not convey control over those assets until such events or "triggers" are met. Under the ED, assets subject to these call options and ROAPs will be recorded as a secured borrowing. However, since the transferor does not control the assets until such event or trigger is met, it should be able to achieve derecognition and not be required to reflect the assets on its balance sheet until such event or trigger has been met. The IASB should implement guidelines which permit the derecognition of assets under such call options and ROAPs until such event or trigger is met. Also for some ROAPs it may not be possible to identify which assets will be subject to the ROAP creating difficulties in determining the amount that is a secured borrowing.

Put Options

The ED states that if the financial asset can be put back by the transferee, it has not been transferred to the extent of the amount of the transferred asset that is subject to repurchase upon exercise of the put option. The ED argues that the transferee's contractual ability to require the transferor to repurchase the asset may result in the transferor regaining control of the asset, and therefore the transferred asset does not qualify for derecognition. We disagree with this conclusion. A put option held by the transferee only provides the transferee with control over the right to put the asset back to the transferor. Further, in most cases, the put option is driven by events outside the control of the transferor (e.g., defaulted assets). Since the transferor does not control the occurrence of the triggering events and has no control over the transferee's exercise of the put option, the transferor should be able to achieve derecognition of the financial asset.

Guarantees

Derecognition is precluded to the extent of the amount that the transferor could be required to pay under a credit guarantee the transferor issues in relation to a transfer of financial assets. Again, this is not consistent with the financial component approach. In this case, the transferor will not have control over the transferred financial assets. Consequently, the transferor should derecognize the financial assets and recognize the fair value of the guarantee on its books.

Following the financial component approach will result in consistent derecognition standards for assets and liabilities. In the derecognition of liabilities as proposed in the ED, if the debtor is no longer primarily liable for the obligation, the debtor will derecognize the liability and recognize the guarantee on its books instead.

Limit on Gains

The ED limits gain to the extent gain would be recognized on whole loan proceeds if there are no price quotes or recent market transactions to support the fair value of any residual interest. This would not allow the positive arbitrage that may result from an efficient securitization execution when illiquid or non-traded securities are retained by the transferor. The ED should allow transferors to estimate the fair value based on the best information available using valuation techniques such as present value of cash flows using assumptions that market participants would use in their estimates of fair value.

Question 3-Derecognition: pass-through arrangements (paragraph 41)

Do you agree that assets transferred under pass-through arrangements were 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 IASB needs to clarify the proposed tests for the pass-through arrangement to ensure that they can be of practical use to securitization and similar transactions, specifically those between the special purpose entity and the noteholders. The following examples are used to highlight some of the issues in applying the proposed tests.

- In a simple repackaging, the special purpose entity is expected to pay the noteholder a combination of cash earned on the asset and an amount received under the swap. The ED should be revised to require the asset and the swap be viewed on a combined basis for purposes of applying the proposed tests. This would reflect the economics of a pass-through arrangement, in which the special purpose entity transfers to the noteholders the contractual rights to the cash flows that constitute a financial asset.

- In a commercial paper conduit, the commercial paper will be repaid via a rollover, from the receivables, or by a liquidity advance from the liquidity provider. As currently drafted, the ED would unintentionally preclude derecognition of financial assets in a commercial paper conduit. A commercial paper conduit is a special purpose entity designed to effect the transfer of the contractual rights to cashflows of the underlying receivables. Therefore, we recommend that the proposed tests be clarified to permit the transferor of assets to a commercial paper conduit to derecognize the assets transferred.

- In a credit-linked note structure, the special purpose entity's obligation to pay the noteholder is contingent upon the reference asset(s) under the credit default swap not defaulting. Similar to the repackaging example above, to reflect the economics of a pass-though arrangement, the asset and credit default swap should be viewed on a combined basis. The ED should clarify that the contingent nature of the cashflows would meet the requirements of a pass-through arrangement.

- A pass-through arrangement requires a transferor to remit any cashflows it collects on behalf of the transferee "without material delay." It is common that in a securitization transaction, cash collected from the assets is passed onto the noteholder at the next payment date. We, therefore, recommend that the "without material delay" requirement be replaced by a “market standard” concept so as to accommodate the various remitting arrangements currently existing in the securitization market.

The proposed derecognition rules would apply to securitizations, which involve the transfer of financial assets from an originator to a special purpose entity. It is possible for certain transactions to qualify for derecognition under the proposed derecognition rules, even where SIC 12 requires the special purpose entity to be consolidated. In order to achieve a consistent accounting framework for securitization and similar transactions, we recommend the derecognition rules be established in tandem with guidance on consolidation.

Question 4- Measurement: fair value designation

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 recognized in profit or loss?

We agree that an entity should be permitted to designate any financial instrument irrevocably at initial recognition as an instrument that is held for trading with changes in fair value recognized in profit or loss because providing this choice will (i) alleviate problems of earnings distortions that result from the current mixed measurement model, and (ii) eliminate the burden of bifurcating financial instruments with embedded derivatives.

In addition to the benefits as described in paragraphs C58-C62, we also believe that fair value provides the most relevant measure for trading instruments and strategies because this is how transactions are risk monitored and managed. We also believe that the ability to designate financial instruments as trading will provide enhanced transparency to readers as management reporting and external reporting would be on the same basis. Finally, permitting entities to designate financial instruments as trading will provide a foundation for further development of fair value accounting.

Since the designation of a financial instrument is not mandatory, we expect that there would be some concern with the lack of comparability among entities. However, we believe that the disclosure requirements as described in IAS 32 and paragraph 18A of IAS 39, coupled with the inability to transfer to or from the trading classification, should mitigate this concern.

Question 5- Fair value measurement considerations

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 A15-A25 of Appendix A. Do you have any suggestions for additional requirements or guidance?

We disagree with the fair valuation methodology proposed in the ED as the pricing hierarchy is too prescriptive and does not allow for the appropriate level of judgment needed to estimate the fair value of financial instruments. Companies must be allowed the flexibility to determine whether market prices or models that include market parameters provide the best estimate of fair value. The ED's de-emphasis on the use of models is a concern since derivatives and many cash instruments are valued using models. Furthermore, we are concerned that the ED does not allow for adjustments to be taken to a quoted market price when an entity holds a large position.

Pricing Hierarchy

We recommend that the presumed hierarchy that is described in paragraphs 95-100D be eliminated. Instead, we recommend that the ED state that a primary principle of fair valuation is to require, whenever possible, the use of quoted market prices or *quoted market parameters* (yield curves, volatilities, etc.) when fair valuing financial instruments. We are concerned that the guidance on sources of market price information implies that quoted market *prices* must be obtained for positions in active, over-the-counter (OTC) markets. While it is common for electronic services to provide quoted market prices for very liquid securities; there are multitudes of transactions that do not fall into this category, including derivatives. It is not practical and would be cost prohibitive for an enterprise to regularly get quoted prices for the great majority of its OTC positions. We believe that valuation models are efficient tools to estimate fair value, including actively traded financial instruments, since they rely heavily on market-based, objective inputs for valuations. Robust models coupled with a comprehensive internal control process can ensure an appropriate fair value is achieved. We believe that best practices can be established to ensure that appropriate controls are in place, including establishing reliable models, using market data, price testing, back-testing, and independent reviews of the valuation process.

Blockage Discounts

We disagree with the conclusion in the ED that prohibits adjusting the market price of a financial instrument for the effect of holding a large block in such an instrument. We believe blockage adjustments are necessary to derive the true fair value of an instrument and should be taken into consideration when determining its fair value. In addition, we do not believe that blockage adjustments cause a lack of comparability between firms. Rather, the key to comparing different firms is evaluating their positions in the context of management’s strategy and performance.

To illustrate this point, assume Company X holds 1,000 shares of Investment A and Company Y holds 1,000,000 shares of the same investment. The price per one share of Investment A at December 31, 2001 is $100. For Company X, the total estimated fair value of their investment is $100,000. However since Company Y owns a significant block in Investment A, the price that can be realized in the market for 1,000,000 shares of Investment A would be $90,000,000, or $90 per share. If the $100 market price of a single share was used versus the true exit price of $90 to value Company Y’s investment, it would be overstated and therefore misleading to the financial statement users since that price of $100,000,000 cannot be realized in the current market. Taking this further, assume Company Y sells their entire investment on January 2, 2002 for $90,000,000. Based on the accounting prescribed in the document, a loss of $10,000,000 would be recorded on January 2, 2002. We believe the fair value of $90,000,000 should have been recorded at December 31, 2001 since that was the true fair value at that date. Because Company Y holds a significantly larger position than Company X, different values *should* be used to compare the results of their respective investing strategies. Using the same price would actually cause financial statement users to compare each company's investment in the same manner, even though they are significantly different. After adjusting the price of Company Y's investment, a more meaningful comparison can be made.

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?

We 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 and agree with the Board's basis of conclusions as described in paragraph C72. Impairment may not be identified for a specific loan but may be probable when assessing impairment on a portfolio of loans with a similar credit risk profile. We also agree that there is a time lapse between the occurrence of an event that affects the ability of a borrower to repay a loan and the time when a borrower actually defaults. Furthermore, a requirement for objective evidence to exist to recognize and measure impairment in specific loans will result in delayed recognition of loan impairments that has already occurred.

However, we do not agree with the discounting methodology proposed in paragraph 113D of the ED from a conceptual standpoint. We do not believe that the proposed discounting methodology results in an appropriate measurement of impairment for a pool of loans. In the example in paragraph C91, the expected cash flows for a pool of similar loans is less than the contractual cash flows. Therefore, we believe that impairment should be recognized on the pool in this example, even if there are loans that were recently originated within the pool. We do not think it is appropriate to adjust the weighted-average original contractual effective interest rate for the expected loss rate to ensure no impairment is recognized.

On origination, we would expect that the expected cash flows for each *individual* loan is the same as the contractual cash flows. However on a *portfolio* basis, we know from historical experience that losses are inherent in the portfolio and thus the expected cash flows will differ from the contractual cash flows based on historical default experience. There is a probability that certain loans in a portfolio will default, based on historical experience, even though no individual loan is apparently impaired. The historical loss experience is reflected in the loan's credit risk rating. The credit risk rating of the pool does not consider origination dates, nor should it. Thus, we believe that impairment should be measured based on the weighted-average original contractual effective interest rate.

We also do not agree with the discounting methodology from a practical standpoint. We believe that it would be extremely difficult to derive an effective interest rate that is adjusted for expected loss rate for each loan in a portfolio. There can be thousands of loans in a portfolio within commercial and consumer loan businesses. To calculate the original effective loss rate (default premium) for each individual loan in the portfolio would result in an impairment calculation for each individual loan versus the portfolio. In addition, applying the discounting methodology to consumer loans would be unworkable since estimating the anticipated cash flows and yields of such loans is impossible given they are constantly changing due to market, economic, and other factors. The example in paragraph C91 overly simplifies the calculation by assuming the loans were all originated on the same day with exactly the same terms (principal, interest, and maturity). In reality, there will be different origination dates included in the portfolio as well as loans with varying contractual terms.

In addition to the above, the methodology described in paragraphs 113D, B32-B36, and C91 is inconsistent with the impairment measurement calculation for an individually assessed loan as described in paragraph 113. Paragraph 113 requires impairment be measured using the financial instrument's original effective rate and not a rate that is adjusted for the default premium. We do not understand the conceptual rationale for why there should be a different measurement methodology for loans that are individually impaired and for loans that are evaluated in a pool.

We strongly believe that the Board should reconsider the guidance in paragraph 113D, and instead prescribe the same methodology as described in paragraph 113 to measure impairment in a portfolio of loans. This would be consistent with the Accounting Standards Executive Committee of the American Institute of Certified Public Accountants proposed Exposure Draft on allowance for credit losses (the AcSEC Proposal). The AcSEC Proposal requires the use of the composite effective interest rate of loans to measure loan impairment on a portfolio of loans. The AcSEC Proposal also acknowledges that many financial institutions may calculate the present value of expected future cash flows indirectly. Under the indirect approach, creditors calculate credit losses in a pool by applying a historical charge-off rate and a loss emergence period to the pool's loan balance. For creditors that calculate their collective loan impairment components this way, the historical charge-off experience component will be equal to the pool's loan balance, times the pool's historical charge-off rate, times the pool's loss emergence period. Because the pool's loan balance is already a discounted amount (the present value of the contractual future cash flows), further discounting is unnecessary. We agree with the indirect approach as described in the proposal, and we strongly recommend the Board consider this an appropriate alternative.

Question 8 – Hedges of firm commitments (paragraphs 137 and 140)

Do you agree that a hedge of an unrecognized 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?

We agree that an unrecognized firm commitment should be able to be accounted for as a fair value hedge. However, we see benefit in permitting both approaches for foreign currency hedges of firm commitments and note that US GAAP also allows either approach.

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 recognized directly in equity be released from equity consistently with the reporting of gains or losses on the hedged asset or liability?

We agree that the accounting for a hedged forecasted transaction should be that the gain or loss accumulated in equity remain in equity and be released to earnings as the forecasted transaction impacts earnings.

Question 10—Prior derecognition transaction (paragraph 171B)

Do you agree that a financial asset that was derecognized under the previous derecognition requirements in IAS 39 should be recognized as a financial asset on transition to the revised Standard if the asset would not have been derecognized under the revised derecognition requirements (i.e. that prior derecognition transactions should not be grand-fathered)? Alternatively, should prior derecognition transactions be grand-fathered and disclosure be required of the balances that would have been recognized had the new requirements been applied?

As stated earlier in our letter, we do not support the continuing involvement model as a long-term solution and believe that the Board should work towards a model that better presents the portion of the assets and liabilities retained and the assets sold and liabilities assumed. However, if the literature is adopted in its current form, we recommend that the derecognition standard not be applied retrospectively, since restating the information would require undue cost and effort on the part of the preparers. Also, we would not support a requirement for supplementary disclosures, since this would impose an additional burden without resolving the practical difficulties of implementation. Moreover, preparers should be given sufficient time to implement the necessary changes to ensure that their financial statements comply with the derecognition standard when it becomes effective.

OTHER COMMENTS

Financial guarantee contracts

Paragraph 1f of the ED would require that a guarantor record a financial guarantee at inception at fair value. Furthermore, paragraph C16 states that this amendment clarifies that an issued financial guarantee contract meets the definition of a liability and should be recognized as such. We disagree with the Board's conclusion that a financial guarantee meets the definition of a liability from the issuer's perspective. Per paragraph 10 of IAS 37, "a liability is a present obligation of the enterprise arising from past events, the settlement of which is expected to result in an outflow from the enterprise of resources embodying economic benefits." Paragraph 18 of IAS 37, also says that a contingent liability "is a possible obligation that arises from past events and whose existence will be confirmed only by the occurrence or nonoccurrence of one or more uncertain future events not wholly within the control of the enterprise." While we agree that a financial guarantee represents a present obligation for the issuer, the existence of the obligation is contingent upon the occurrence of an uncertain event (e.g., default by a borrower) and settlement of the contingent obligation is based on the occurrence of that uncertain event. We therefore believe that a financial guarantee should be considered a <u>contingent</u> liability in accordance with IAS 37. Accordingly, no liability should be recorded at initial recognition, unless the requirements of paragraph 14 of IAS 37 are met.

In addition, paragraph 1f of the ED states that subsequent to initial recognition, an issuer should apply paragraphs 36-39 of IAS 37 to measure the financial guarantee. Paragraph 36 of IAS 37 requires that the amount of provision recognized should be the best estimate of the expenditure required to settle the present obligation at the balance sheet date. If the Board does not consider our comments above, it is unclear what the subsequent accounting should be when it is not probable that an outflow of resources will be required to settle the obligation. Based on IAS 37, no obligation would be recorded. Thus, would there be a reversal of the liability that was recorded at initial recognition on Day 2? We recommend the Board clarify this.

<u>Classification of loan receivables</u>

We agree that an entity should record and measure originated loans on an amortized cost basis, unless the loan is designated as trading. However, we disagree with the distinction the Board has made between loans originated by an entity and loans purchased by an entity. It is unclear to us why there should be a different accounting model for loans solely based on the method of acquisition, if the intent is to hold the loan to maturity under both circumstances. In paragraph C20, the Board stated it is more appropriate to measure a loan at amortized cost without consideration of the entity's intention and ability to hold the asset until maturity because there is no liquid market for the asset. In addition, the Board states that it is less appropriate to extend the category to debt securities traded in liquid markets. The problem is that a loan may be assigned to an entity from the original creditor, but that does not mean there is a liquid and active market for that loan as defined in paragraph 99 of the ED. For example, Entity A loans $100 to Entity B. Entity C also loans $100 to Entity B. Entity B has no additional debt obligations trading in the market. Entity A decides it no longer wants the credit exposure to Entity B and Entity C is willing to buy Entity A's loan to B. Entity C intends to hold both loans for the longer term. There is no broker or dealer that regularly provides quotes on Entity C's loan. It appears from our understanding of the ED that the loan purchased from Entity A would be classified as available-for-sale by Entity C (paragraph 20), while the loan originated would be measured on an amortized cost basis. We believe it would be more appropriate for Entity C to classify and account for the two loans to Entity B in a consistent manner.

<u>Transaction Costs</u>

Paragraph 66 requires capitalization of transaction costs in connection with recognition of financial asset. Transaction costs are not part of the basis for subsequent measurements of fair value. *Transaction costs that are directly attributable to the acquisition or issue are included in the initial measurement of the financial asset or financial liability.* All transaction costs should be expensed as incurred – there is no basis for capitalizing the costs.