ANNEX

CL 150

Comments of the Subcommittee on Accounting and Auditing (the Subcommittee) established under the aegis of the Banking Advisory Committee (regulated by Articles 57-59 of the Directive 2000/12/EC) on the International Accounting Standards Board's Exposure Draft of Proposed Amendments to IAS 32 and 39

General Comment

A number of issues dealt with in the Exposure Draft have been identified as being of major importance to the banking sector. The IASB appears to have undertaken no field testing of the proposed changes in relation to fair value designation, derecognition and impairment and the Subcommittee questioned whether all the implications of the proposed changes can be fully understood in the absence of such work.

Hedge accounting

The majority of Members supported a move to principles-based hedging rules (the relevant principles being that the hedge is clearly defined from the outset, measurable, effective and adequately documented). The existing hedging rules should be reviewed in the light of these principles and, to the extent that they are not required by or consistent with these principles, amended or deleted.

It is widely recognised that the hedging of net interest rate positions should meet the requirements for hedge accounting and that sound risk management practices adopted by banks may provide a basis for demonstrating documentation and effectiveness of such hedges. The principles of the Implementation Guidance Q&A 121-2 (dealing with hedge accounting considerations when interest rate risk is managed on a net basis) have been considered as useful in this respect; they could either be included in the Standard or given greater prominence to help clarify when hedge accounting may be used under the current rules.

The Subcommittee recommended that the IASB develops a better understanding of how internal hedging contracts are used by banks in practice in managing their financial exposures in order to assess whether they should be eligible for hedge accounting in certain conditions.

The reasons for not allowing non-derivatives to qualify as hedging instruments (except in relation to foreign currency risk) and the hedging of interest rate risk on held-to-maturity assets appeared to be (at best) unclear. The Subcommittee recommends the IASB to reconsider these reasons.

In conclusion, a proper review of the hedging rules in the light of the overriding principles is widely seen as the best way forward.

Fair value designation

While recognising that fair value designation has some potential advantages (at least in theory), the majority of Subcommittee Members considered that those advantages are more than outweighed by the practical disadvantages.

These disadvantages (which were highlighted in 2001 in the comment letters of the European Commission and others on the Joint Working Group's proposals) include:

- allowing all liabilities to be fair valued, with changes in value taken to profit/loss, will allow entities to report increased profits as their creditworthiness deteriorates;
- it may not be possible to determine sufficiently reliable fair values for certain financial instruments not traded on deep and liquid markets (such as originated loans and core deposits); and
- allowing entities to choose whether or not to measure a financial instrument at fair value might offer opportunities for "cherry picking" and result in less comparability between the financial statements of different entities.

There was unanimous agreement that an adequate analysis by the IASB of problems such as issues relating to reliability and own credit risk is needed.

Fair value designation is not seen as an answer to the problems associated with the current hedging rules. If fair value designation is to be allowed, it should be irrevocable to prevent entities reclassifying items to manipulate their earnings.

Impairment

There was agreement on the fact that individually assessed loans which are found not to be impaired should be included in a collective evaluation of impairment. The proposed methodology, involving discounting expected cash flows, is considered conceptually attractive but likely to give rise to some practical difficulties (for example, smaller banks may have problems estimating the amount and timing of future cash flows since they do not all use a discounting approach for pricing purposes). Therefore, to ease implementation difficulties, a majority of the Subcommittee is of the view that a short-cut non-discounted method for certain portfolios should be allowed.

Other points arising are:

- there is a need for greater clarity as to the definition of "effective interest rate" and more guidance on how to calculate it for different types of loan contracts. In particular, the now different definitions of effective interest rate laid down in IAS 32.61 and 39.10 should be aligned;
- whether there are any differences with the treatment under US GAAP which can be eliminated (for example, foreclosure costs would be taken into account in measuring impairment but are expensed as incurred under US GAAP);
- whether the issue of underpriced loans needs to be dealt with in some way (for example, the inclusion of additional guidance on calculating impairment for such loans).

Derecognition

The continuing involvement approach proposed by the IASB is an improvement on the existing provisions in IAS 39 in that it is based on a clear principle and will therefore be easier to apply. It was noted that the IASB will continue to consider the conceptual issues related to derecognition as part of future projects (paragraph C47 of the ED).

The principal concerns arising are:

- the examples in paragraph A9 appear to demonstrate that applying the approach will allow large portions of assets to be derecognised in circumstances where all, or substantially all, the risk is retained by the transferor. The level of risk associated with the portion of the asset remaining on the balance sheet will therefore be much greater than that associated with the original asset and the provisioning rules will need to reflect this. In addition, derecognition will give rise to immediate recognition of profits;
- the emphasis on the contractual provisions relating to the transfer, as opposed to the economic substance of the transaction, may give scope for the development of schemes designed to remove assets from the balance sheet when the spirit of the requirements indicates that they should not be derecognised;
- a legal transfer of assets may be necessary in certain jurisdictions in order for assets to be derecognised and legal isolation therefore needs to be addressed before the revised Standard becomes effective.

This is a complex area and the Subcommittee recommended that some field-testing is carried out to establish what the effect of the new approach is likely to be in practice before major changes are introduced.

Other issues

The following additional points have been raised:

- lease receivables and finance lease assets should be brought within the impairment provisions of IAS 39 (by amending paragraph 1(b) in the scope section);
- credit derivatives that meet the criteria set out in ED IAS 39.7, in relation to contracts to buy or sell non-financial items, should also be brought within the scope of the Standard;
- the status of the extant IGC guidance (summarised in an Appendix at the back of the ED) needs to be clarified. In particular, it should not be necessary to refer to such guidance to understand what is and is not permitted under the standard (one example is given above in relation to hedge accounting where arguably this is the case at present).