

ISDA

International Swaps and Derivatives Association, Inc.
One New Change
London, EC4M 9QQ
Telephone: 44 (20) 7330 3550
Facsimile: 44 (20) 7330 3555
email: isda@isda-eur.org
website: www.isda.org

September 5, 2001

The Secretary - General
International Accounting Standards Committee
166 Fleet Street
London
EC4A 2DY

Dear Sirs

Joint Working Group of Standard Setters – Draft Standard and Basis for Conclusions: Financial Instruments and Similar Items

The International Swaps and Derivatives Association Inc. (“ISDA”) is an international organisation whose membership comprises over 500 of the world’s largest commercial, merchant and investment banks and other corporations and institutions that conduct significant activities in swaps and other privately negotiated derivatives transactions. Additional information about ISDA can be obtained from our website, www.isda.org

ISDA appreciates the opportunity to offer comments on the Draft Standard “Financial Instruments and Similar Items,” proposed by the Joint Working Group of Standard Setters (“JWG”). ISDA welcomes the JWG’s initiative in seeking to achieve comparability in the accounting treatment of financial instruments and recognises that the publication of the Draft Standard is an important first step in that process. However, for the reasons discussed below, ISDA believes that more consideration needs to be given to the impact and effect of implementing full fair value accounting before a final pronouncement can be promulgated.

ISDA represents a wide-ranging constituency of members, primarily from the financial services sector. Consequently, its members hold a variety of views relating to the accounting treatment of financial instruments, reflecting the perspectives of their individual institutions. As a result, it has not always been possible to reach a consensus on the detailed matters discussed in the Draft Standard. Where this is the case, we have indicated this in the letter.

NEW YORK • LONDON • SINGAPORE • TOKYO

Incorporated as a Non-For-Profit Corporation with limited liability in the State of New York, United States of America

Most importantly, ISDA did not reach a consensus on whether a fair value accounting model is appropriate for all financial instruments. However, the group did strongly agree that if a fair value model were implemented based on the guidance contained in this draft, that the model would be significantly flawed. We discuss our comments on the nature of these and other concerns below.

Beyond comments on the technical aspects of the document, ISDA is concerned that the sheer volume of material covered in this draft has resulted in a flawed consultation process. It was not possible, in the limited time available, to address all of the topics in the level of detail necessary for a full understanding of the implications for preparers and users of financial statements. For example, in the U.S., our members have spent months considering the implications of accounting proposals on derecognition (SFAS 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*) let alone recognition, measurement, presentation, etc. Consequently, this letter only focuses on key matters of principle rather than each of the detailed questions raised in the preface to the paper.

Instead of trying to tackle all issues surrounding financial instruments in one document, we recommend the international standard setters consider developing separate projects addressing each of the major topics covered in the Draft Standard. We would visualize the following major project topics: measurement (including presentation), recognition and derecognition, liabilities vs. equity, and hedging. In addition, the consolidation guidance in SIC 12: *Consolidation – Special Purpose Entities*, generally requires consolidation of SPEs when there is any continuing involvement, rendering moot any guidance set forth in a standard on derecognition of financial instruments. As a result, we strongly urge that a simultaneous narrow -scope project on consolidations be undertaken to address this dilemma.

In summary, we believe an approach of addressing the issues through smaller, more focused projects would better enable respondents to consider and comment on the impact of implementation. ISDA will, of course, welcome the opportunity to provide a more detailed response to the specific issues raised at that stage and members of our Accounting Committee would be willing to participate in field testing sections of the proposals deemed necessary.

Our major comments on the draft document follow.

RECOGNITION AND DERECOGNITION

ISDA has concerns about several of the recognition and derecognition concepts set forth in the Draft Standard as they do not always reflect the practical and economic realities of the transactions discussed (e.g., accounting for repurchase agreements as sales). Moreover, the document does not always explain clearly either the rationale for the treatment or the implications of the approach. For example, it is counterintuitive that the Draft Standard requires recognition of the maximum liability assumed in a transaction as opposed to the fair value of the liability.

We believe the guidance would benefit greatly from additional examples that clearly describe the impact of the model on the accounting for many common transactions. For example, we would like to see some specific examples of how the standard would impact common SPE transactions. Similarly, it would be very useful to understand through a series of examples how the accounting for repurchase agreements would be accomplished when those instruments are treated as purchases and sales.

ISDA also believes that some focused field-testing would serve very well in this area. We suggest that the standard setters engage various constituents to field test narrow segments of the guidance, e.g., impact on SPE transactions, so that an understanding of the implications of the guidance can be fully grasped. We believe that taking the initiative to do this work early in the standard setting process will help greatly in providing rules that are clear and easy to apply to real business transactions. Otherwise, we would find ourselves in a situation similar to that being experienced with SFAS 133, *Accounting for Derivative Instruments and Hedging Activities*, SFAS 140 and IAS 39, *Financial Instruments: Recognition and Measurement*, where volumes of Q&As need to be written just so constituents can understand how to apply the rules.

Our specific comments follow:

Repurchase agreements

ISDA believes that further consideration needs to be given to the radical changes proposed in the Draft Standard for the treatment of repurchase agreements and stock lending transactions. Whilst some members supported this proposal, others were concerned that the proposed treatment in the Draft Standard would have a significant impact on those entities involved in such activities. All of our members agreed; however, that before such a change is made, it needs to be very clear that accounting for repurchase agreements as sales and purchases represents an improvement in accounting and reporting. ISDA members were concerned that the end-users of financial statements would think that this accounting actually misrepresented the nature of these transactions. After all, the nature and intent of repurchase agreements and stock lending is that of a secured lending transaction.

In addition, our members do not agree with the accounting for repurchase agreements where the transferee does not have the practical ability to transfer the assets. Under the proposed model, the transferee will record the assets rather than a receivable from the transferor. We believe that assets, regardless of characterization, should not be recorded on an enterprise's balance sheet unless they are controlled by that entity. Further, we do not support a model that would require two enterprises to record the same assets.

There also needs to be more intensive study of the impact on the repo and stock lending markets and its participants if this proposed treatment is to be adopted. Perhaps some focused field testing in this area would be helpful. Finally, before ISDA can provide firm views on this proposal, we would need to see detailed examples of how the cash flows from these transactions would actually be accounted for. Given that these transactions are truly secured lending arrangements, forcing the cash flows into a sales and purchases model can create very convoluted results.

Consolidations

The Joint Working Group explicitly states that consolidation issues are beyond the scope of its work. However, since many derecognition questions involve the transfer of financial assets to special purpose entities, guidance on derecognition cannot be meaningfully provided without consideration of consolidations guidance. This is particularly true since it is our understanding that application of SIC 12 often results in the consolidation of SPE where there is any continuing involvement. ISDA recommends that the impact of consolidation guidance, particularly SIC 12, be addressed in tandem with any standard on derecognition to ensure that sensible and consistent answers result.

Legal isolation

With respect to SPE transactions, ISDA recommends that further consideration be given to the requirement for the assets of an SPE to be legally isolated from the transferor as a prerequisite for derecognition. We do not agree that legal isolation should be required for SPEs and not other transactions. Rather, it is ISDA's view that the other guidelines for derecognition provide adequate tests to ensure that only transactions where control and significant future obligations have been relinquished will be derecognized. To require non-substantive entities like SPEs be legally isolated simply adds complexity to an area that is already difficult to apply in practice. For example, despite well-established laws and practice with respect to bankruptcy and receivership in the U.S., there has been and continues to be a significant amount of interpretation done in the area of legal isolation even to this day. We cannot even fathom the difficulties that would be encountered in trying to impose such a standard on a global basis, especially in situations where legal isolation does not exist as a legal concept.

Furthermore, we have found it very difficult in the U.S. to implement an accounting standard that is based on law. For several years following the issuance of SFAS 125 both the legal and accounting professions have struggled to conclude on what legal isolation means since overall business objectives for lawyers and accountants are very different. In our view, it is far superior to base accounting rules on solid principles of accounting and not require legal interpretation in applying those rules.

Put and call options

Members of ISDA struggled with the guidance provided in the document on put and call options. It appears that the guidance is inconsistent with the underlying components methodology. For example, one could interpret the guidance on put options retained by a transferee to require the transferor to recognize the maximum liability under that put option. We strongly disagree with this conclusion and again point out that such a conclusion is counter to a components and fair value model. Rather, consideration should be given to permitting a pure components approach in such cases, particularly where the option is event driven and outside the control of the transferor. Specifically, where the interest held by the transferor following the transfer of an asset consists solely of the put or call, ISDA believes that this interest should be recognised and valued as a stand-alone instrument at its initial fair value and that it should not prevent derecognition. In view of the complex nature of such transactions, ISDA strongly believes that more detailed examples should be given in this area and that extensive field-testing should be carried out before the proposals are finalised.

Trade date vs. settlement date accounting

ISDA believes that there should be reasonable exceptions to the application of the recognition and derecognition examples described in the Draft Standard. Its members welcome the pragmatic approach applied in respect of clean-up calls, which will not prohibit the derecognition of the assets transferred in a securitisation transaction. One area where we believe an exception is needed is in the proposed treatment of transactions between the trade date and the settlement date. ISDA does not agree that the delay between trade and settlement date should be classified as a forward. Such treatment of regular way transactions is neither practical nor cost effective for many preparers of financial statements. The accounting for trade date/settlement date time differences varies in practice depending on the type of transaction and the nature of the enterprise recording the transaction. For example, for broker/dealers, it is common to record regular way trades on the trade date.

However, other enterprises may not manage their positions in this fashion and do not have the systems to record transactions on the trade date. In summary, we do not believe a single model works well in the case of the trade date-settlement date time difference, since the economics of transactions from industry to industry vary greatly. ISDA believes the standard should be silent on this issue and allow practice to prevail.

VALUATION METHODOLOGY

As discussed above, regardless of whether ISDA members agree or disagree with the concept of fair value accounting, there is unanimous agreement among the members that the valuation methodologies proposed in the draft are significantly flawed.

Firstly, ISDA does not agree with the proposal for a strict hierarchy for valuation. The proposed hierarchy is too restrictive, and will not always result in the application of the most appropriate valuation methodology. For example, it may be more appropriate in some circumstances to refer to the market exit price for a similar asset on the reporting date, than attempt to adjust for an out of date market exit price for the same asset. Flexibility and judgement are paramount in making an appropriate fair valuation for an instrument. There are myriad scenarios that exist in practice that must be considered when determining what valuation methodology to use. For example, market quotes may be available for certain instruments; however, those quotes may be indicative quotes and not the amount at which instruments can actually be traded. Companies need to have flexibility to decide whether a different model for valuation makes more sense in such cases. Moreover, the hierarchy fails to recognise the extent to which models are used internally for valuation purposes. Models are the standard pricing mechanism for derivative valuations and for the majority of less liquid and thinly traded debt securities and loans. Valuation models often provide the most relevant values for financial instruments.

Secondly, ISDA questions the prohibition on recognition of blockage factors in valuing large holdings of instruments. Its members believe that, where the value of a large block of an instrument can be reliably determined, it should be used, even if it is different from the value of a smaller block scaled up. The aim should be to use the fair value *of the instruments that the entity holds* – and not the fair value of a smaller amount that the entity does not hold. It seems that standard setters have agreed with the misguided notion that a single price approach makes more sense because it increases comparability. We strongly disagree with this notion. There is a very significant difference between the economic impact of a firm owning one share of a stock and owning 10% of the outstanding shares of a given stock. The valuation of these positions necessarily needs to be different since one would expect that the 10% position could never be sold at the quoted market price. To value both positions at the market quote would greatly misstate the position of the company with the large position. This result does not achieve comparability.

An adjustment for a large block is particularly relevant for a trading book where the turnover of assets is higher and there is a view to sell. In fact, we are greatly concerned with not applying a blockage factor in such cases since the result would be to record gains or losses in one period only to have them reverse immediately in the next period when the trade is consummated. This is problematic when the trade crosses over a reporting period. A much better answer is to mark the position to the actual price at which the position will trade. If this includes a block discount or premium, the discount or premium should be included in the valuation. This would avoid recording fictitious gains and losses upon settlement of the trade. Of course, there will be circumstances where despite holding a large position, taking a block discount is not appropriate. If assets are acquired for other purposes, adjustment may be less relevant. The key point is that blockage factors and other restrictions are subjective and require judgement.

However, when applicable, they reflect economic reality and are more relevant than using a single unit price. We also note that while the Draft Standard objects to block discounts *per se*, there are a number of other sections of the report that seem to provide theoretical and conceptual support for such adjustments. One such example is that the JWG explicitly supports the need for factoring liquidity discounts to arrive at fair value. In practice a “block discount” is essentially the same as a liquidity discount. Therefore, if the JWG believes that the fair value of an instrument should take into account the liquidity of the instrument, we do not understand the objection to taking into account what amounts to one aspect of this liquidity factor.

Thirdly, ISDA strongly recommends that the issue of accounting for hybrid instruments be taken up in a separate project on liabilities and equity. There are significant and complex issues that arise when trying to determine the appropriate accounting and classification of hybrid instruments. For example, the convertible bond market is very complex, and the sum of the component parts do not necessarily equal the proceeds of the instrument as conventional option pricing methodology cannot be readily applied. Handling these issues in a separate project will allow constituents to focus on the unique issues that arise for these instruments and respond accordingly. It may also facilitate field-testing of the proposed guidance.

Finally, ISDA recognises in principle the validity of the arguments in favour of recognising a company’s own debt at fair value. However, its members are concerned that, in extreme circumstances where the company’s credit rating is deteriorating, the recognition of large gains in the performance statement is neither meaningful nor intuitive. In the context of a fair value model, ISDA supports the recognition of the interest rate risk in the fair value of a company’s own debt, but was unable to reach a consensus to support the inclusion of fair value adjustments resulting from movements in credit spreads (particularly in extreme credit deterioration). ISDA believes the views of financial statement users will be important in resolving these issues.

HEDGE ACCOUNTING

ISDA recognises that a full fair value accounting model will eliminate the need for hedge accounting in many cases. However, its members believe that the concept of hedge accounting remains relevant where financial instruments are used to hedge forecasted transactions like the future acquisition or disposal of non-financial items or forecasted foreign currency revenues and expenses. We strongly believe hedge accounting is warranted in such strategies to provide for an appropriate matching of hedge results with the hedged item as well as the accounting treatment with the economics of the transaction. In addition, ISDA strongly believes that hedge accounting should continue to be permitted where financial instruments are used to hedge the net investment in a foreign subsidiary. Again, as long as net investments in foreign subsidiaries continue to be revalued through equity, any hedges of such positions should be similarly accounted for. Net investment hedging is a significant and important risk management strategy, the accounting for which should mirror the economics.

In summary, we urge reconsideration of the proposed rules on hedge accounting in these two areas. We also recommend that a separate project on hedging be undertaken to provide guidance allowing these hedging strategies.

PRESENTATION AND DISCLOSURE

The topic of presentation and disclosure needs separate consideration once more detailed proposals have been developed in respect of the topics discussed above. Consideration will also need to be given to other disclosure requirements such as the current Basel proposals to ensure there is consistency. Overall, ISDA recommends that a primary objective should be to keep disclosure to a manageable level so as to provide the necessary level of information to users without over-burdening the preparer. Wherever possible, disclosure should be based on information firms use to manage their businesses in order not to impose dual reporting burdens. At the same time, the disclosures must be carefully considered to ensure that they do not reveal proprietary trading information to competitors.

Consideration should be given to information US SEC registrants currently report regarding risk sensitivities in Management's Discussion and Analysis ("MD&A"), which is intentionally placed outside the audited financial statements. Risk sensitive and historical financial statement information are fundamentally different, the former is hypothetical and forward-looking while the latter is intended to report the past. Including in the audited financial statements both risk sensitive and historical data may give users the misleading impression that the risk sensitive information is as reliable as the historical information. Additionally, to allow management to freely discuss historical information and forward-looking risk sensitive information without fear of potential legal ramifications associated with not meeting projections, certain "safe harbor" laws were enacted for disclosure of forward-looking information in MD&A.

While these disclosures are only encouraged in the proposals, we question whether audited financial statements are the appropriate vehicle for disclosing risk sensitive information and are concerned that mixing historical with forward-looking information would be misleading to financial statement users.

ISDA does not agree with the draft statement's requirement to record interest on a "fair value" basis. It is our view that interest on a fair value basis provides little informational value to users of the financial statements, while causing a significant process burden on the firm to produce these numbers. We strongly urge reconsideration of this requirement to one based on historical or contractual yields. For example, ISDA considers it very important to retain the disclosure of net interest margin on an historical cost basis. Such disclosures are currently used to report the performance of a bank's loan portfolio as this is a measure that is widely understood and is meaningful to those who wish to assess the performance of a bank.

Finally, ISDA strongly urges the standard setters to seriously consider the impact of any fair value requirement for financial instruments on companies with limited activity in those instruments. For example, the impact of the Draft Standard on manufacturing companies that use debt to finance property and equipment could be significant. We are not suggesting that they be excluded from the scope of the standard, but perhaps the manner of presentation could be flexible to accommodate their unique circumstances.

IMPLEMENTATION

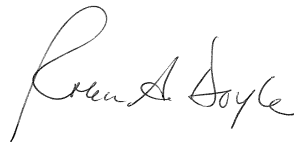
ISDA does not believe that a period of two years is adequate for the implementation of an accounting standard that fundamentally changes the way entities will account for financial instruments. The implementation of such a standard would demand considerable system changes and significant training for both preparers and users. ISDA also would not support a requirement for supplementary disclosures in the transitional period, since this would impose an additional burden on preparers without resolving the practical difficulties of implementation. Reporting entities must be given sufficient time to implement the necessary changes to ensure that their financial statements comply with the standard when it becomes effective. Moreover, as discussed above, ISDA believes that considerable additional research, consultation and field testing needs to be carried out before a standard can be finalised and the implementation period can begin.

If you have any questions concerning our comments, please contact Katia D’Hulster at ISDA European office.

Respectfully,



Robert Stevens
Managing Director
CSFB
Chair of the European
Accounting Committee



Robin Doyle
Vice President
JP Morgan Chase
Chair of the North American
Accounting Committee