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International Accounting Standards Board
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30 Cannon Street
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13th July 2010

Ref.: Exposure Draft "Fair Value Option for Financial Liabilities"

Dear Sirs,

The International Swaps and Derivatives Association ("ISDA") is pleased to provide the following comments with respect to the above mentioned submission exposure draft.

ISDA has over 840 member institutions from 56 countries on six continents. These members include most of the world's major institutions that deal in privately negotiated derivatives, as well as many of the businesses, governmental entities and other end users that rely on over-the-counter derivatives to manage efficiently the financial market risks inherent in their core economic activities. As such, we believe that ISDA brings a unique and broad perspective to the work of the IASB.

Key Messages

- ISDA welcomes and supports the key proposals in the exposure draft.
- We believe the definition of 'own credit' needs to be tightened to focus only on the credit risk of the reporting entity. In some circumstances the credit risk of a liability relates not to the entity but to the risks of assets which the entity holds. An example would be a legally isolated loan securitisation vehicle, which the reporting group is required to consolidate, but does not guarantee the performance of the notes it issues. In these circumstances, we believe that changes in own credit of such financial liabilities should be recorded through profit or loss, so as to avoid an accounting mismatch.
- Since the proposals are unconnected with IFRS 9, we believe that it should be possible to apply the proposals independently of IFRS 9 and for entities to be permitted to revoke or exercise the fair value option anew when they are first applied.

- Recycling of gains and losses to profit or loss should be permitted for early redemption or repurchase of financial liabilities.

Our responses to the specific questions in the submission are included in the Appendix to this letter.

We hope you find ISDA's comments useful and informative. Should you have any questions or would like clarification on any of the matters raised in this letter please do not hesitate to contact the undersigned.

Yours faithfully,

Tom Wise
HSBC Bank plc
Chair of Accounting Policy Committee

Antonio Corbi
International Swaps and Derivatives Association
Risk and Reporting

Attachments:
Appendix – Responses to specific questions raised by the IASB

Appendix – Responses to specific questions raised by the IASB

Question 1

Do you agree that for all liabilities designated under the fair value option, changes in the credit risk of the liability should not affect profit or loss? If you disagree, why?

Yes. Our members agree that, in principle, changes in the credit risk of a liability resulting from changes in the credit standing of the reporting entity (*own credit*) should not be reported in profit and loss. However, we believe the term *own credit* needs to be more tightly defined by IAS 39 such that it focuses only on the credit risk of the reporting entity.

As currently defined, *own credit* could capture more than changes in the credit standing of the reporting entity. In these instances, it may be appropriate to report changes in credit risk of a liability in profit or loss, where those changes are not associated with changes in the credit standing of the reporting entity. Please note our response to question 2 where this is explained in more detail.

Question 2

Or alternatively, do you believe that changes in the credit risk of the liability should not affect profit or loss unless such treatment would create a mismatch in profit or loss (in which case the entire fair value changes would be required to be presented in profit or loss)? Why?

As noted in Question 1, we understand that there is a difference between own credit risk and a 'liability's credit risk' and therefore believe that changes in fair value of certain financial liabilities due to changes in credit risk should be recorded through profit or loss, if the change in credit risk does not reflect the credit standing of the entity (own credit) but the risks of assets held by the entity, as may be the case with, for example, securitisation vehicles and asset repackaging special purpose entities. We would therefore ask the IASB to tighten the own credit definition contained in IAS 39.

To illustrate the issue, consider a legally isolated loan securitisation vehicle which holds a portfolio of loans and vanilla interest rate swaps transacted with a third party. The entity issues liabilities which are contractually linked to the loans held. The bottom tranches of the securitisation structure are initially held by the sponsoring bank and so the entity is consolidated by the banking group. Assume that the loans in the securitisation are classified as trading by the group since it is expected the entity will be deconsolidated in the short term through the sale of the bottom tranches of notes to a third party. The loans are consequently recorded at fair value through the P&L. The swaps are also recorded at fair value through P&L since they meet the definition of derivatives. The group decides to designate the contractually linked liabilities issued externally by the entity at fair value under the fair value option since the liabilities are managed and their performance evaluated on a fair value basis. The net effect on the banking group's recorded P&L is the change in fair value of the bottom tranches which it holds.

The liabilities are not exposed to the credit risk of the banking group since the SPV is legally isolated. However, it could be interpreted that a change in the fair value of the liabilities changes due to movements in the credit spread, arising from changes in the risks of the loans held by the vehicle, would represent a movement in fair value due to credit risk. This, according to the ED, would be posted to OCI. We believe this is inappropriate due to the accounting mismatch it would create, since the corresponding risks on the reference assets are recorded through P&L. We believe that such a movement in fair value is more appropriately regarded as being due to market risk factors.

Question 3
Do you agree that the portion of the fair value change that is attributable to changes in the credit risk of the liability should be presented in other comprehensive income? If not, why?

Yes, except as noted in our response to Question 2.

Question 4
Do you agree that the two step approach provides useful information to users of financial statements? If not, what would you propose instead and why?

No – see Question 5

Question 5
Do you believe that the one step approach is preferable to the two step approach? If so, why?

Yes. No information is lost by this but it would simplify the reporting.

Question 6
Do you believe that the effects of changes in the credit risk of the liability should be presented in equity (rather than in other comprehensive income)? If so, why?

No.

Question 7
Do you agree that gains or losses resulting from changes in a liability's credit risk included in other comprehensive income (or included in equity if you responded 'yes' to Question 6) should not be reclassified to profit or loss?

The gain or loss on derecognition of the liability should be recycled to profit or loss. While there may not be an expectation that a liability designated at fair value will be repurchased, if it happens then the gain or loss will have been realised and there would appear to be no conceptual reason why it should not be reported in profit or loss. It would be inconsistent and counterintuitive for the gain or loss on decrecognition of a liability recorded at amortised cost to be recorded in profit or loss but not the same gain or loss just because the liability has been designated at fair value through profit or loss.

Question 8

For the purposes of the proposal in this exposure draft, do you agree that the guidance in IFRS7 should be used for determining the amount of the change in fair value that is attributable to changes in a liability's credit risk? If not, what would you propose instead and why?

Yes, except as noted in response to Question 2.

Question 9

Do you agree with the proposals related to early adoption? If not, what would you propose instead and why? How would those proposals address concerns about comparability?

No. As the proposed amendment makes no reference to phase 1 of IFRS9, the amendment could be adopted in isolation. The majority of our members support the ability to adopt the proposed amendment early for existing liabilities where the reporting entity has previously elected to account for those liabilities using the fair value option.

Question 10

Do you agree with the proposed transition requirements? If not, what transition approach would you propose instead and why?

Yes. However as outlined in our response to question 9 the majority of our members support the ability to early adopt as outlined. A minority also believe that if early adoption is permitted it would be equitable to also allow reconsideration of the use of the FVO for items already on the Balance Sheet at that time. This is mainly because entities may have been inhibited from using the fair value option in the past because of the potential impact on profit and loss of changes in fair value of the own credit element. Given that this amendment solves this issue it would be helpful to allow these entities to take advantage of the new rules to apply the FVO for instruments which were previously bifurcated.