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The International Accounting Standards Board
1st Floor
30 Cannon Street
London
EC4M 6XH

Ref.: IAS 39 replacement project

Dear Sir,

The European Accounting Policy Committee of the International Swaps and Derivatives Association[1] ("ISDA") would like to provide the following comments with respect to the IAS 39 replacement project following the IASB's discussions on 1st June 2009 and ahead of its follow up discussions on 5th June 2009.

The views expressed in this letter represent those of a majority of our members however, it should be noted that some members do not share all these views.

We fully support of the IASB's objective of reducing the complexity of financial instruments in an accelerated timeframe. We believe that the business model and intent should have more emphasis in the classification criteria than appears from the business overlay currently being proposed. However, our comments here are principally in relation to specific aspects of the model being discussed by the Board. We focus on matters that we believe need to be addressed by the Board in its imminent discussions and prior to the issuance of the Exposure Draft (ED). We would anticipate making further comment upon the release of the ED.

[1] ISDA has over 820 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.

a) Embedded Derivatives:

We understand the IASB's objective of restricting the use of the amortised cost classification for items with derivative characteristics. The forthcoming IFRS for small and medium-sized entities (SMEs) does appear to allow host financial instruments with the most common closely related embedded derivatives to be measured at amortised cost. However, given the extent of the guidance on embedded derivatives within IAS 39, the fact that this has been in use for a reasonable length of time and user familiarity, we suggest that the Board incorporates the current guidance in IAS 39 on embedded derivatives. We recommend that those hybrid instruments containing embedded derivatives that would require separation under the existing requirements in IAS 39 should be recorded at fair value in their entirety, whereas those hybrid instruments with embedded derivatives that meet the characteristics of being 'clearly and closely' related to the host contract should be eligible to be measured at amortised cost in their entirety.

We believe this is an important point to avoid unintended consequences, for example, if all hybrid instruments were required to be classified at fair value, then issued liabilities with vanilla call options, issued structured notes and loans with prepayment provisions would have to be classified as fair value through profit or loss.

In due course, possibly as a fourth stage of the IAS 39 replacement project, the rules on whether embedded derivatives are closely related should be re-examined, but this should not be addressed in the classification and measurement stage because it would add significant complexity to the project.

b) Vanilla fixed income instruments:

We are concerned that certain Board members believe that it should not be possible to apply the amortised cost category to debt instruments with embedded net written or asymmetrical options, such as loans with vanilla caps or floors. These do not expose an entity to loss of principal (other than due to credit risk which is true for all loans), nor to interest attributable to current or prior periods or leverage. As noted above, the use of the current IAS 39 derivative bifurcation rules would provide a reasonable and compelling basis for determining which hybrid financial instruments may be accounted for at amortised cost.

We note that if the term "debt instrument" is used in the exposure draft, it will need to be defined from the holder's (as opposed to the issuer's) perspective.

We also recommend retention of the current requirement of IAS 39 for loans and receivables subject to prepayment so that debt instruments that can be prepaid or settled in such a way that the holder will not recover substantially all of its initial investment (other than because of credit deterioration) would be excluded from the amortised cost category. Examples include interest-only strips, residual interests in securitization transactions, or other assets that can be contractually prepaid or otherwise settled at less than par.

c) Investments in asset-backed securities (securitization tranches):

We understand that certain members of the Board are concerned that some securitization tranches for which there would be no separable embedded derivative could qualify for the amortised cost category. Should the Board decide to restrict the application in this manner, we would suggest the following approach.

For securities whose cash flows are based on the cash flows of an underlying pool of assets, we believe that where the variability of the cash flows the entity is exposed to via the security is similar to or less than that which the entity would be exposed to were it to hold the underlying pool of assets directly, the same accounting classification should apply to the security as would be permitted for the underlying assets.

d) Loan commitments

We also point out that the SME rules provide guidance on loan commitments received but are silent on loan commitments issued. As many of our members issue loan commitments, guidance needs to be provided on this issue. Our preference would be presentation and measurement of loan commitments consistent with the accounting treatment of the loan or the business intent of the loan when originated.

e) Transition requirements:

We have two concerns about the transition requirements:

- Firstly, given the significant work that would be required to comply with the proposals, the new standard should not require mandatory adoption for 2009 calendar financial periods, although, as always, early adoption should be permitted. Some entities have an obligation to present a five year table and hence this would require the restatement of four years of history, potentially reopening IFRS transition balance sheets. Additionally, there is almost no time to deal with the implications on hedge accounting.

- Secondly, significant further consideration and industry discussion needs to take place before a decision can be reached on the most appropriate transition provisions. The full retrospective application will be extremely difficult to execute and will prevent quick adoption if any amended standard. However, full prospective application is also problematic because it will prevent comparability. Therefore, the Board should work with preparers and users to develop an appropriately balanced solution.

f) Impairment testing of AFS instruments:

We strongly recommend the Board consider bringing forward an element of the proposals by allowing the use of the current IAS 39 amortized cost impairment model for 2009 interim period reporting for those assets that would be permitted to be recorded at amortised cost under the new proposals. This could also potentially allow the amendments to classification to be implemented over a more realistic timeframe.

We fully appreciate the tight timeframe that the IASB is operating to and therefore have focused on a small number of key messages. If you would like further clarification or to discuss any of the points made here please do not hesitate to contact the undersigned.

Yours faithfully,

Charlotte Jones
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Chair, European Accounting Policy Committee

Antonio Corbi
International Swap and Derivatives Association
Risk and Reporting