Mr. Stefan INGVES
Chairman
Basel Committee
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26 February 2013

Dear Sir,

The International Swaps and Derivatives Association's (ISDA)[1] Accounting Policy Committee appreciates the opportunity to provide further comments and observations to draw your attention to the importance of examining the interaction between the regulatory and accounting frameworks. In particular the interaction between the Other-Comprehensive-Income (OCI) treatment under Basel III and the proposed Fair Value Through OCI classification for accounting purposes.

As agreed during the telephone call on Friday 8 February 2013 between members of the ISDA European Accounting Committee and representatives of the Basel Committee for Banking Supervision Accounting Task Force, we outline our main concerns regarding the introduction of a third asset category under IFRS 9 and the implications of the absence of a regulatory capital filter

*ED 2012 / 4 Amendment IFRS 9 Classification and Measurement - Impact on particular assets and business practices*

We believe that the number and value of financial assets held at Fair Value Through OCI (FVTOCI) will be greater than originally anticipated by the banks, due to the proposed guidance clarifying the IASB's narrow intention for what may be included in the amortised cost category. We therefore expect that the FVTOCI category will likely include more items that are moved out of the amortised cost category than out of the fair value through profit or loss category (FVTPL).

[1] Since 1985, ISDA has worked to make the global over-the-counter (OTC) derivatives markets safer and more efficient. Today, ISDA has over 800 member institutions from 60 countries. These members include a broad range of OTC derivatives market participants including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure including exchanges, clearinghouses and repositories, as well as law firms, accounting firms and other service providers. The buy-side represents 25% of ISDA's membership and continues to grow. Information about ISDA and its activities is available on the Association's web site: www.isda.org.

Items that we are currently considering for a potential FVTOCI classification include some originate-to-distribute portfolios and general loan portfolios subject to securitisation or other sales, which are derecognised from the banks' balance sheet. These products are often part of a banks' consumer finance, credit card or mortgage business. In addition loan syndication portfolios where an entity may retain a part of the syndication would likely be subject to the FVTOCI classification.

The other item that has been discussed at length within the industry is the liquidity portfolios. Under current IFRS 9's two category model, we anticipate that a significant part of the liquidity portfolio would be classified into the amortised cost category with the remainder classified as FVTPL. As banks are required to show the ability to turnover their liquidity pool and may periodically rebalance their portfolios for other reasons, it is difficult to classify the whole portfolio at amortised cost. The clarification of the Board's intention of what should be reported at amortised cost and the introduction of a new FVTOCI category provides a mixed purpose business model for hold and sale portfolios. This will enable banks to consistently show their liquidity portfolio in one balance sheet category, highlighting the nature and extent of the portfolios, thereby improving transparency and comparability.

However in its current format the capital treatment is a source of genuine concern since the absence of a filter will introduce significant volatility in regulatory capital. This is likely to reduce the ability and willingness of banks to classify their entire liquidity portfolio into the FVTOCI category.

As discussed during the call, we believe that the absence of a filter could give rise to unintended consequences for how liquidity portfolios are managed in future. We believe that it could result in liquidity buffers being split into long-term hold portfolios consisting of high quality assets which are held at amortised cost, and a short-term hold portfolio where sales are executed regularly to prove liquidity plus generate a higher-yield, which are held at FVTOCI.

The result of such a split portfolio might impact the composition especially of the long-term hold portfolios. We are concerned that only the highest quality sovereign bond issuances would be selected. Such a selection policy could present a risk of a market split with excessive demand for high quality issuers and low or negligible demand for lower quality issuers. At a time when in Europe especially, sovereign countries of all credit quality need to issue increasing volumes of debt to support their economic recovery, any measure which could limit banks' ability to hold such instruments may need to be reconsidered.

*ED 2012 / 4 Amendment IFRS 9 Classification and Measurement – Capital Filter*

As outlined during the call, we believe that the regulatory capital volatility that will be introduced through the FVTOCI model is mainly based on accounting driven timing differences rather than a reflection of changes in banks' long term capital strength. This is because the new impairment model under IFRS 9 will reflect expected credit losses to give a larger and earlier recognition of potential future impairment losses. All other fair value gains and losses that do not result in impairment but which relate to mark-to-market changes in credit spread and interest rate expectations for instruments that the bank does not sell, will by definition fully reverse through capital during the period to maturity.

Liquidity portfolios are held as a part of a bank's overall balance sheet management program and as such some sales and purchases are done to stabilise the balance sheet liquidity and to manage interest rate risk. We believe that to introduce capital volatility for the FVTOCI category would not be an appropriate  outcome as it has a potentially punitive effect on those banks that actively manage their balance sheet risks.

Additionally, when assets are initially recognised in the FVTOCI category, the interaction with the forthcoming impairment model introduces a capital charge on day 1 via the accounting requirements.  To illustrate this, consider an asset with an initial fair value of 100. Under the IASB's forthcoming expected loss impairment rules, impairment is recognised at initial recognition equivalent to the 12 month expected loss (assumed to be 10).

The journals for the initial recognition of the asset would be:

| | |
|---|---|
| Dr. Financial asset at FVTOCI | 100 |
| Cr. Cash | 100 |
| | |
| Dr. Impairment loss | 10 |
| Cr. OCI | 10 |

If the fair value of the asset at the end of day 1 is still 100 (equal to the purchase price), the carrying value of the asset must remain at 100 since it is classified as FVTOCI. The absence of an OCI filter causes an counterintuitive result at the initial date of asset recognition with the capital charge from the expected loss impairment model fully offset by an OCI gain, which enables the asset to remain at fair value.

Continuing the example, if on day 2 the fair value of the asset increases to 105 due to short term market conditions but all other factors including expected loss remain unchanged the journal entries would be as follows:

| | |
|---|---|
| Dr Financial asset at FVTOCI | 5 |
| Cr OCI | 5 |

In the absence of an OCI filter, the asset has contributed a life-to-date increase to regulatory capital of 5, arising purely from mark-to-market movements, whilst the expected loss impact is unrecognised. The gain of 5 will change in future to reflect market sentiment contributing further volatility to OCI and regulatory capital. This contrasts with the amortised cost value which shows a life-to-date loss of 10.

Our suggestion is therefore to create a filter for the FVTOCI category that aligns regulatory capital treatment with the accounting for amortised cost instruments. Any short term market factors which affect fair value and could be expected to reverse over time would not be reflected in capital unless they increase expected loss. This better reflects banks' long term capital position by removing the volatility in OCI from the FVTOCI classification whilst recognizing impairment under the expected loss model.

*Implications for IAS 39 Available for Sale Classification – Capital Filter*

Consistent with the above recommendation, we suggest that a similar capital filter under Basel III should be introduced for the Available For Sale (AFS) category in current IAS 39[2]. The AFS classification is widely applied by banks to large portions of their liquidity portfolios in particular, so many of the concerns raised above are equally relevant.

In Europe, the implementation of CRD IV is currently targeted from 1 January 2014, which does not align with the current mandatory effective date of IFRS 9. Furthermore, the IASB may postpone the IFRS 9 effective date to permit entities more time to implement the new requirements once they are finalised; expected by the end of 2013 or 2014. Two years is the expected minimum implementation time needed, which would result in the IFRS 9 mandatory effective date being put back to 1 January 2016 at the earliest.

If the IFRS 9 effective date is postponed to 2016 or beyond and CRD IV is implemented from 1 January 2014 at the earliest, without a suitable filter banks will be subject to regulatory capital volatility from fair value changes for AFS assets. If a regulatory capital filter is introduced for FVTOCI, a similar filter should be introduced for AFS under IAS 39, otherwise for the short period when IAS 39 and Basel III overlap, additional volatility in regulatory capital will occur, which would be unrepresentative and disruptive to banks' activities. Whilst these timings reflect the EU implementation of Basel III, we believe that such a filter should be applied at a Basel level to ensure a level playing field between EU banks and those domiciled in the rest of the world.

We hope the above information is helpful to you as you consider this topic. Should you require any additional information or wish to discuss the matter further, please do not hesitate to contact me.

Yours sincerely,

Antonio Corbi

Antonio Corbi,
ISDA, Assistant Director, Risk & Capital

Copy to:
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[2] This topic was raised by ISDA in the letter dated 29 June 2012 to the Basel Committee (Mr Stefan Ingves) and the IASB (Mr Hans Hoogervorst).