International Accounting Standards Board

30 Cannon Street

London EC4M 6XH

28th March 2013

Ref.: Exposure Draft ED/2012/4 Classification and Measurement: Limited Amendments to IFRS 9, Proposed amendments to IFRS 9 (2010)

Dear Board members,

ISDA's European Accounting Policy Committee members represent leading participants in the privately negotiated derivatives industry that rely on over-the-counter derivatives to manage efficiently the financial market risks inherent in their core economic activities. Collectively, the membership of ISDA[1] has substantial professional expertise and practical experience addressing accounting policy issues with respect to financial instruments and, specifically, derivative financial instruments.

We are writing to you to comment on the International Accounting Standards Board's ('IASB' or 'the Board') above referenced Exposure Draft ('ED'). ISDA welcomes the opportunity to comment on this important issue that has an impact on many different jurisdictions across the globe.

In this letter we outline our key messages in response to the ED and in the Appendix we provide our more detailed responses to the specific questions along with a number of more detailed concerns that we have regarding the proposals.

Key messages:

- Overall, our members are grateful that the Board has sought to amend IFRS 9 so as to address better those assets that are held both to sell as well as to collect the contractual cash flows. However a majority of our members believe that rather than introduce the new fair-value-through-other-comprehensive-income ('FVOCI') category, the Board

[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.

International Swaps and Derivatives Association, Inc.
One Bishops Square
London E1 6AD, United Kingdom
P 44 (0) 20 3088 3550 **F** 44 (0) 20 3088 3555
www.isda.org

NEW YORK WASHINGTON
LONDON BRUSSELS
HONG KONG SINGAPORE
TOKYO

should instead amend the business model criteria so as to permit more financial assets to be recorded at amortised cost. Not to do so would result in many loans that are now recorded at amortised cost under IAS 39 in future being recorded at fair value, which we do not believe was the objective of most users, regulators or the G20.

- Only if the Board decides not to broaden the business model criteria to permit more financial assets to be recorded at amortised cost would the majority of our members support the introduction of a FVOCI category. However, other members would support the introduction of the FVOCI category as their first choice solution. Notwithstanding the above, we agree that FVOCI would better reflect a business model that is to both 'sell and collect' than fair-value-through-profit-or-loss ('FVPL').

- While our members are supportive of improvement in the guidance as to what financial assets would meet the 'characteristics of the asset test', they believe that the new criteria are still too narrow. This includes products in rate regulated markets, for which they agree with the Board that more work needs to be done.

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	Antonio Corbi
HSBC Bank plc	International Swaps and Derivatives Association
Chair of Accounting Policy Committee	Risk and Capital

Appendix – Responses to specific questions raised in the exposure draft.

Appendix: Answers to the specific questions

Contractual cash flow characteristics assessment: a modified economic relationship between principal and consideration for the time value of money and the credit risk

> Question 1:
> Do you agree that a financial asset with a modified economic relationship between principal and consideration for the time value of money and the credit risk could be considered, for the purposes of IFRS 9, to contain cash flows that are solely payments of principal and interest? Do you agree that this should be the case if, and only if, the contractual cash flows could not be more than insignificantly different from the benchmark cash flows? If not, why and what would you propose instead?

We support the principle that 'plain vanilla' financial assets should not be disqualified from being measured at amortised cost just because of minor modification features. However some of our members believe that the 'more than insignificantly different' concept proposed in the ED requires interpretation and guidance as to its application. It would also be helpful for examples to be provided to show how the application might work, including whether cash flows should be discounted.

In addition, it is also peculiar how the Standard can continue to have a stated principle that financial assets should have cash flows that are 'solely' principal and interest to qualify for amortised cost and then permit modifications. In our view, it would be easier to understand the principle if it were to refer to financial assets whose cash flows are 'substantially' principal and interest.

Some of our members also believe that the 'double-double-test', or a quantitative assessment akin to that test, which is retained for the assessment of whether embedded derivatives should be separated from liabilities in paragraph B4.3.8 of IFRS 9, would be easier to apply to financial assets, as it is a more familiar test. This would also result in more consistency between the requirements for financial assets and financial liabilities.

Also, our members are concerned that the proposals are too narrow and would require many common assets that are managed on an amortised cost basis to still be recorded at fair value through profit or loss. For instance, we support the Board's intention to deliberate further instruments issued in rate-regulated environments, as indicated in paragraph 44 of the Basis for Conclusions.

We believe that a common feature of many of the instruments that would not qualify for amortised cost measurement under the proposed amendments is that the interest rate is less variable than a market-driven floating rate. This would be the case, for instance, for any instrument that pays a rate based on a period longer than the interval between interest rate resets, such as a constant maturity bond. Longer term interest rates are usually less volatile than those in the short term. As a result, such instruments behave (in terms of both sensitivity to changes in fair value and cash flows) somewhere between a conventional fixed rate instrument and a normal floating rate instrument. In effect, they have less leverage than a conventional floating rate instrument. Given that the IASB has already accepted that capped and floored floating rate instruments – which also have features intermediate between those of conventional fixed and floating rate instruments - may qualify for amortised cost, it would seem reasonable to permit these regulated rate instruments to do so as well.

As another suggestion, the Board could consider allowing more flexibility in the definition of time value of money, which would allow more products to be accounted for at amortised cost. This would also address concerns as to how margins for the lender's profit and liquidity risk should affect the assessment, since they are additional to the 'time value of money and credit risk'.

Question 2
Do you believe that this Exposure Draft proposes sufficient, operational application guidance on assessing a modified economic relationship? If not, why? What additional guidance would you propose and why?

Please see our response to Question 1.

It is not clear to our members how the 'significant modification' guidance in paragraph B4.1.9 A to E should be applied to financial assets containing caps, collars, and extension and prepayment options. In our view, it would not make sense for a significance threshold to be introduced solely for the assessment of whether interest represents consideration for the time value of money and credit risk.

Also, it is unclear how to combine the guidance for assets that are both modified and have caps, floors, or extension or prepayment options. Should the 'comparable' asset in paragraph B4.1.9 B also have this feature, or should the entire asset, including this feature, be treated as a modified asset?

Similarly, it is not clear to our members what the benchmark instrument would be against which to compare the cash flows of an asset that, say, pays six monthly interest, reset three monthly; should a three month contract be used as the benchmark instrument? Alternatively, in these circumstances, an asset that pays six monthly interest, which is reset every six months would appear to be an equally acceptable benchmark instrument.

Question 3:
Do you believe that this proposed amendment to IFRS 9 will achieve the IASB's objective of clarifying the application of the contractual cash flow characteristics assessment to financial assets that contain interest rate mismatch features? Will it result in more appropriate identification of financial assets with contractual cash flows that should be considered solely payments of principal and interest? If not, why and what would you propose instead?

See our response to Question 1.

Business model assessment: the 'fair value through other comprehensive income' measurement category for financial assets that contain contractual cash flows that are solely payments of principal and interest

Question 4: Do you agree that financial assets that are held within a business model in which assets are managed both in order to collect contractual cash flows and for sale should be required to be measured at fair value through OCI (subject to the contractual cash flow characteristics assessment) such that: (a) interest revenue, credit impairment and any gain or loss on derecognition are recognised in profit or loss in the same manner as for financial assets measured at amortised cost; and (b) all other gains and losses are recognised in OCI? If not, why? What do you propose instead and why?

Our members agree that classification of financial assets should follow from the business model, and believe that this is an improvement over IAS 39. However, the majority of our members believe that the way IFRS 9 applies the business model could be significantly improved. In particular, they consider that the accommodation of a business model that involves selling as well as collecting contractual flows would be better achieved by amending the existing IFRS 9 business model criteria to widen the scope of financial assets that may be classified at amortised cost rather than by introducing a new FVOCI category.

Our members believe that the amortised cost business model criteria are too narrow for the following reasons:

1. The business model for banks is increasingly to hold financial assets both to collect contractual cash flows and to sell those assets. Virtually all assets of a bank may be sold 'if the price is right'. Although the extent to which this is the case varies from bank to bank, given increases in capital requirements it is likely to become much more common for banks to extend loans that may be subsequently securitised or sold. The consequence is that many traditional banking assets, which are currently accounted for at amortised cost under IAS 39, will not qualify for such treatment under IFRS 9. We do not believe that the recording of such assets at fair value best meets the requirements of users or regulators.

2. The loans that will be required to be recorded at fair value will often not be traded or capable of being measured at fair value without undue cost or effort.

3. While a bank may sell securities held for asset and liability management, this will often be for reasons other than to make fair value gains, such as to reflect changing liquidity needs, in response to depositor activity, loan draw-downs and repayments, to manage the bank's exposure to interest rate risks, to reduce capital requirements or to manage concentrations of credit risk. Our members believe it should be 'the reasons for selling', rather than 'the frequency of sales' that should drive the classification assessment. In particular, if sales are required by a regulator

(rather than being made at the choice of the entity) our members do not believe that this should determine the entity’s business model.

4. The Key Performance Indicators (KPIs) used by banks to manage loans and securities held for asset and liability management purposes include yield and return on capital, but not changes in fair value. Many of these assets will be held to maturity and, hence, the fair value gains or losses on such assets are not an indicator of future cash flows. Therefore, these members believe it is inappropriate to report the performance of a bank by introducing a business model and a metric that the bank’s management (and regulators) would not recognize and which does not feature in the bank’s strategy, budgets, internal performance reporting or compensation calculations; this would also give rise to more use of non-GAAP measures to communicate with shareholders. It is agreed that fair value information is useful to users of financial statements, and that these should be given prominent disclosure, but that, in certain circumstances, it is less useful than amortised cost information. We believe there should also be specific reporting of gains and losses resulting from sales of assets in the amortised cost category on the face of the income statement.

5. Some of our members also have a number of concerns about the FVOCI category, which are detailed below:

a) The introduction of the FVOCI measurement category would add unnecessary complexity to IFRS 9, which would be contrary to the original objective of replacing IAS 39 with IFRS 9. Further, the mechanics of recycling coupled with the application of the expected loss impairment model to the FVOCI measurement category is not straightforward and will make the financial statements more complex and less easy to understand. Also, two different FVOCI models, one for equity instruments without recycling and another for debt instruments with recycling, will not improve the quality of financial reporting.

b) The FVOCI category would only partially address the concerns raised about the interaction between the accounting for insurance contract liabilities and the accounting for financial assets backing those liabilities, due to the inconsistencies in other parts of the Standard with the requirement to recycle gains and losses when assets are sold.

c) The boundaries of the FVOCI model proposed by the IASB differ significantly from those proposed by the US Financial Accounting Standards Board (‘FASB’). As a consequence, a FVOCI category under IFRS will be confusing to users of financial statements seeking to compare the performance of entities reporting under the two different accounting bases.

If the Board decides not to amend the IFRS 9 criteria to permit financial assets held both for collection and sale to be measured at amortised cost, our members consider that the next best option would be to introduce the FVOCI category, as proposed but taking into account the concern raised in question 5.

Question 5:
Do you believe that the Exposure Draft proposes sufficient, operational application guidance on how to distinguish between the three business models, including determining whether the business model is to manage assets both to collect contractual cash flows and to sell? Do you agree with the guidance provided to describe those business models? If not, why? What additional guidance would you propose and why?

See our response to Question 4.

Some of our members are concerned that the distinction between FVOCI and FVPL is not clear. This is in part because 'managing assets both to collect and sell' overlaps with 'managed on a fair value basis' i.e., not all assets managed on a fair value basis or held for trading will be sold before maturity. Moreover, the distinction between opportunistic sales to maximise yield and to maximise profit is subtle, somewhat arbitrary, and difficult to apply. This is another reason why a majority of our members would prefer to draw the line between amortised cost and FVPL, as set out in our response to Question 1, since they believe that the simplest criterion to understand and operate is to distinguish between the trading book (measured at FVPL) and other debt instruments (measured at amortised cost).

As noted in our response to the previous questions, the application guidance in the FASB's proposal for the types of business activities and sales that would qualify for the amortised cost and FVOCI classifications appears to differ from that in the IFRS 9 ED. In the FASB's ED, FVNI is a residual category, for financial assets held only for sale. Unlike the proposed amendments to IFRS 9, the FASB's proposal makes no reference to "maximizing cash flows" or "managing on a fair value basis" as activities that would support a FVNI categorization. Furthermore, the fair value option is wider in scope under the FASB's proposals, since it includes assets managed on a fair value basis. Thus, if the IASB does decide to introduce a FVOCI category, we strongly encourage it to work with the FASB to seek to harmonize the boundary between the FVOCI and FVPL categories, along with the scope of the fair value option.

Paragraph B4.1.3 allows assets recorded at amortised cost to be sold if their credit quality has deteriorated. It would be helpful if the guidance made it clear that this provision does not require the asset to have already met the 'significant deterioration' threshold for expected losses to be measured on a life-time basis, so that sales can be made from the amortised cost category to avoid credit losses as well as in response to them. Furthermore, in our view, permitted sales from the amortised cost category should include sales made to reduce the level of an entity's exposure, such as those made to avoid excessive concentration of risk.

Example 1 of paragraph B4.1.5 refers to circumstances where the entity "will sell financial assets and re-invest the cash in financial assets with a higher yield..." This guidance could be better worded, as it is unlikely that an entity would do this. What it should perhaps say is "will sell financial assets and re-invest the cash in financial assets with a higher yield relative to their assessed risks...." There is similar wording in example 2 in paragraph B4.1.4B. In our view, one of the reasons that the current wording is unhelpful is that a sale in order to invest in an asset with a higher yield would, absent this clarification, be more likely if interest rates have risen, in which case the sale will normally result in a realised loss.

Question 6: Do you agree that the existing fair value option in IFRS 9 should be extended to financial assets that would otherwise be mandatorily measured at fair value through OCI? If not, why and what would you propose instead?

Our members support extending the fair value option in IFRS 9 to financial assets that would otherwise be measured at FVOCI. However, as mentioned in our response to question 5, we encourage the Board to work with the FASB to converge the criteria for the fair value option.

Early application

Question 7: Do you agree that an entity that chooses to early apply IFRS 9 after the completed version of IFRS 9 is issued should be required to apply the completed version of IFRS 9 (i.e. including all chapters)? If not, why? Do you believe that the proposed six- month period between the issuance of the completed version of IFRS 9 and when the prohibition on newly applying previous versions of IFRS 9 becomes effective is sufficient? If not, what would be an appropriate period and why?

Our members support the proposal to require early adopters of IFRS 9 to apply the completed version of IFRS 9 once issued, for the reasons specified in the Basis for Conclusions to the ED. They also agree with the six-month transition period proposed in the ED.

Presentation of 'own-credit' gains and losses on financial liabilities

Question 8: Do you agree that entities should be permitted to choose to early apply only the 'own credit' provisions in IFRS 9 once the completed version of IFRS 9 is issued? If not, why and what do you propose instead?

Our members welcome the proposal to allow early application of the 'own credit' requirements in IFRS 9. However, they believe the changes to the requirements for reporting 'own credit' should be made as an amendment to IAS 39 rather than being incorporated in IFRS 9, to enable them to be adopted as soon as practicable. Otherwise this amendment will only become available once IFRS 9 is completed and, for EU-based reporters, once it is endorsed. Given that there appears to be broad agreement with this proposal, it should be possible to expose it as an amendment to IAS 39 with only a short period for response.

In addition, our members believe that recycling to 'P&L' should also be required for 'own credit' gains and losses recorded in OCI. While most changes in fair value due to own credit will never be realised – which is why our members agree that they should ordinarily be recorded in OCI – it would, in our view, be appropriate to recognize such gains and losses in profit or loss if debt is repurchased at an amount that differs from the contractual amount and the gain or loss is realised. We understand the original decision not to require recycling was taken to ensure consistency with the treatment of equity instruments (see BC5.53) and as the overall objective of the use of OCI had not yet been established (see BC5.55). However, given the Board's proposal to require recycling of gains and losses for assets classified as FVOCI, our members believe that this reasoning would now need to be revised.

First-time adoption

Question 9
Do you believe there are considerations unique to first-time adopters that the IASB should consider for the transition to IFRS 9? If so, what are those considerations?

Our members support the Board's intention to reconsider the transition requirements of IFRS 9 for first-time adopters, to ensure that first-time adopters of IFRS are not at a disadvantage in comparison to existing preparers. They agree with the Board's concern (set out in paragraph BC113 of the ED) that retrospectively applying some aspects of the completed version of IFRS 9 (especially impairment) would be impracticable, due to the risk of applying hindsight, if those requirements were not actually applied during the reporting periods covered by the first IFRS financial statements. They also believe that the considerations that led the Board to give existing IFRS preparers relief from restating prior periods upon first applying IFRS 9 are equally applicable to first-time adopters.