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2nd April 2009

Financial Crisis Advisory Group
c/o Adam Van Eperen
ajvaneperen@fasb.org

Ref.: Financial Crisis Advisory Group (FCAG) Written Submissions from Constituents

Dear Sirs,

The International Swaps and Derivatives Association ("ISDA") is pleased to provide the following comments with respect to the above referenced submission issued by the Financial Crisis Advisory Group ("FCAG").

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:

- During the recent market turmoil, we believe that reporting or disclosing the fair value of financial instruments has been instrumental in putting the spotlight on issues early – it has helped with transparency and the quick identification of risk exposures.

- The objective of financial statements is to provide decision useful information about an entity's financial position and performance to a wide range of users although the principal users are investors. Users have different needs and objectives and so differing information requirements and it is not always possible to meet all these needs. At times therefore, it may be necessary for certain users such as regulators to adjust the information provided in the financial statements or require additional information to meet their needs.

- There is a need for a framework to be applied to the development of any new disclosures and a holistic review is required to assess the relevance of existing disclosure requirements. We believe clear, focused, risk based, relevant disclosures are more useful than the current voluminous financial statements.

- Any new disclosures for special purpose entities and similar items should be developed as part of a holistic review of the existing disclosure requirements. Simply adding to the already voluminous disclosures is likely to overburden users with disjointed and unfocused information.

- It is important that any amendments to accounting standards help to rebuild investor confidence in financial statements. Investor confidence will be improved by coordinated and consistent responses to issues by the IASB and the FASB to ensure that there is a truly level playing field. We are strongly supportive of converging accounting standards between the FASB and IASB.

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 sincerely,

Charlotte Jones
Deutsche Bank AG
Chair, European Accounting Policy Committee

Antonio Corbi
International Swap and Derivatives Association
Risk and Reporting

Attachment:
Appendix – Responses to specific questions raised by the FCAG

Appendix – Responses to specific questions raised by the FCAG

Question 1

From your perspective, where has general purpose financial reporting helped identify issues of concern during the financial crisis? Where has it not helped, or even possibly created unnecessary concerns? Please be as specific as possible in your answers.

Fair Value

The principal users of financial statements are investors. In deteriorating markets, fair value accounting (whether through measurement or disclosure) has been instrumental in putting the spotlight on issues – it has helped with transparency and the quick identification of risk exposures.

In our submission to the International Accounting Standards Board (IASB") on the discussion paper *Reducing Complexity in Reporting Financial Instruments* we noted that most of our members support a mixed measurement model, with an appropriate use of fair value for the measurement certain financial instruments, and specifically those held for trading purposes. Notwithstanding this, some of our members continue to support the use of fair value for the measurement of all financial instruments.

Although we believe the use of fair values did not create unnecessary concern, the fixed connection by many regulators between financial reporting and regulatory capital requirements, contributed to many banks having to recapitalize or liquidate holdings of financial assets, thereby putting additional pressure on the financial system. In our view, regulators need to adopt a more flexible approach to setting regulatory capital requirements to help reduce procyclicality. While in general we are in favour of harmonization of regulatory and accounting requirements to reduce costs and operational challenges, we believe it is appropriate for there to be differences where the needs of investors and regulators are not the same.

The difficulties involved in determining fair values for financial instruments in illiquid markets means that there is a need for guidance on this subject. Our members therefore found the advice of the IASB Expert Advisory Panel on *Measuring and disclosing the fair value of financial instruments in markets that are no longer active* helpful. We note the recently released draft FASB Staff Positions FSP 157-e, *Determining Whether a Market is Not Active and a Transaction is Not Distressed* (FSP 157-e). ISDA already responded to this FSP and will be writing separately to the IASB's recently requested comments on this matter. A key concern is that there should be a consistency of guidance under US GAAP and IFRS and the FASB and IASB should work together to ensure this is achieved.

AFS Impairment

Under a mixed measurement model it is necessary to have a robust model for impairment and we welcome the joint IASB and FASB commitment to examine loan loss accounting, including the incurred and expected loss models as part of their work towards a common standard of financial instruments. Many of our members believe in the short term there is a need for entities to be able to record impairment of available-for-sale securities on a basis consistent with the impairment rules for other debt financial instruments. That is, when an AFS debt security is impaired, the profit or loss impairment charge should be consistent with the cash flow expected to be received, and not the entire decline in market value of the security, if the instrument is not expected to be sold. Application of this principle would have enabled entities to report financial instruments at their fair values without reporting, in their profit or loss, losses that are unlikely to be realised. In this regard, we note the proposed FSP No. FAS 115-a, FAS 124-a, and EITF 99-20-b *Recognition and Presentation of Other-Than-Temporary Impairments*. It would be possible to make this revision to IFRS relatively quickly and would not require the import of the rest of the FASB impairment literature. As with fair value measurement guidance, disparity between IFRS and US GAAP would not be helpful in dealing with the issues our members currently face in the market. We therefore encourage the IASB and FASB to work together to ensure consistency of accounting approach for this issue.

Disclosures

We believe that where general purpose financial reporting has not helped is in the overall length and complexity of corporate reports. In many cases, the volume and level of detail of disclosures, both in the financial statements and in other sections of the annual report, are such that the key information and risks are obscured, and overall, the corporate report does not present a clear and coherent picture of the entity's performance. In addition, reports are so long and complex they have become less useful to investors and other users and therefore the most important information is not identified when reading the reports. In this regard, we believe there is not necessarily a demand for more disclosure, but instead a need for a more holistic, principles-based approach to all disclosure requirements that concisely highlight the key information.

Question 2

If prudential regulators were to require 'through-the-cycle' or 'dynamic' loan provisions that differ from the current IFRS or US GAAP requirements, how should general purpose financial statements best reflect the difference: (1) recognition in profit or loss (earnings); (2) recognition in other comprehensive income; (3) appropriation of equity outside of comprehensive income; (4) footnote disclosure only; (5) some other means; or (6) not at all? Please explain how your answer would promote transparency for investors and other resource providers.

The credit crisis has demonstrated there are problems with the incurred credit loss model in that impairment losses are established only once it is reasonably probable that those losses will arise.

Alternative approaches should be explored, including the use of an expected loss approach and considering what elements of the loan loss reserve should be reflected in regulatory capital and accounting profit. These alternative approaches should be considered against a general purpose accounting framework.

If additional amounts are reserved for regulatory capital purposes over and above the amount recognized in accounting profit, it may be helpful for this to be disclosed in the notes to the financial statements or as an appropriation of equity. However, more work would be needed to confirm whether this would be useful for investors as opposed to just another way to introducing further complexity.

Question 3

Some FCAG members have indicated that they believe issues surrounding accounting for off-balance items such as securitizations and other structured entities have been far more contributory to the financial crisis than issues surrounding fair value (including mark-to-market) accounting. Do you agree, and how can we best improve IFRS and US GAAP in that area?

We do not believe that the decision whether to consolidate particular structured entities, contributed significantly to the financial crisis, since balance sheet size is not itself a direct reflection of the risk faced by an institution. However, we are aware that some entities may have developed more complex structures in order to reduce their regulatory capital requirements. In this regard, general purpose financial accounting may not have always been appropriate for regulatory capital purposes.

A much more important issue was that the risks of certain structures, especially in stress conditions, were not fully understood by financial institutions and/or communicated clearly to investors. Disclosure about off balance sheet risks has already been significantly improved by banks in response to regulatory and investor demands. As has already been mentioned in out response to Question 1 above, there would be value in the development of common disclosures across the industry, and so accounting guidance would be helpful in this area. It is important, as with all disclosures, that the guidance should be focused and principles-based. We believe the best way to achieve this is to reassess all disclosure requirements on a holistic basis to ensure overall disclosure is focused on key risks and presents a clear picture of the position and performance of an entity in a concise fashion. Also, this is an area which should be developed consistently by the IASB and FASB, working together.

Question 4

Most constituents agree that the current mixed attributes model for accounting and reporting of financial instruments under IFRS and US GAAP is overly complex and otherwise suboptimal. Some constituents (mainly investors) support reporting all financial instruments at fair value. Others support a refined mixed attributes model. Which approach do you support and why? If you support a refined mixed attributes model, what should that look like,

and why, and do you view that as an interim step toward full fair value or as an end goal? Whichever approach you support, what improvements, if any, to fair value accounting do you believe are essential prerequisites to your end goal?

We draw your attention to our earlier submission to the International Accounting Standards Board on the discussion paper *Reducing Complexity in Reporting Financial* Instruments dated 19 September 2008. In that submission, we provided the following key messages:

- ISDA believes that fair value measurement is the most appropriate measurement basis for many financial instruments, in particular those held for trading or managed on a fair value basis. However, where an entity is holding the instrument to benefit from its long term cash-flows, the majority of our members believe a cost based measure is more appropriate and is opposed to the longer term objective of measuring all financial instruments at fair value. This view is not shared by all members, but we would recommend that efforts are focused, in the short to medium term, on simplifying the current mixed measurement model rather than moving to a full fair value model.

- ISDA strongly believes that there is an opportunity to simplify some of the current accounting literature relating to classification and measurement of financial instruments. By their nature, financial instruments are often complex and therefore there will always be a degree of complexity inherent in financial instrument accounting standards. However, in our view, many of the current issues arise as a result of the unnecessarily complex accounting rules within extant standards on financial instruments contained within both US GAAP and IFRS. We would therefore encourage the IASB and FASB to focus their efforts on striking a better balance between rules and principles to reduce complexity in financial reporting and simplify the current mixed attribute measurement model.

- Hedge accounting provides a valuable tool for financial statement preparers to communicate to financial statement readers how a business manages the various financial risks it is exposed to. ISDA supports the Board's objective of reducing some of the complexities associated with hedge accounting though it will be critical that any amendments do not restrict the use of some of the most simple and effective hedging strategies that are used in practice. In particular, it is important that entities retain the ability to apply hedge accounting for part of its cash flows or for specific risks. The majority of our members would also encourage the IASB to explore the proposals set out in our response to *Reducing Complexity in Financial Reporting* to modify fair value hedge accounting to allow the effective portion of a fair value hedge relationship to be recorded in equity. In our view, this may assist financial statement users as it would remove the existing hybrid measurement model. Further, we would encourage replacement of the notion of "highly effective" to allow hedge accounting for "reasonably effective" hedging relationships and simplification of the current rules to assess hedge effectiveness. We have expressed these views in more detail in our comment letter to the FASB on *Accounting for Hedging Activities, an amendment to FAS*

133 and we strongly believe that collectively these proposed changes would both simplify and reduce the operational burden of using hedge accounting.

Question 5

What criteria should accounting standard-setters consider in balancing the need for resolving an 'emergency issue' on a timely basis and the need for active engagement from constituents through due process to help ensure high quality standards that are broadly accepted?

Our members believe there needs to be enough time to respond to each issue but support an accelerated due process in certain circumstances where it is really necessary.

The IASB and FASB need to be able to respond appropriately to any genuine emergency issues, but such issues should be extremely rare. These issues will be, by their nature, unexpected and unpredictable; therefore attempts to place too many rules or processes around this may be ineffective. Additionally, the IASB and FASB should consider an arrangement whereby a group of constituents can be called on at short notice to review and provide input on any emergency issues.

In general, the comment period needs to reflect the length and complexity of the proposed change. It is unlikely that a consultation period of less than 90 days would be sufficient for complex issues, such as the introduction of a new standard. For more focused issues, in an emergency, less consultation time would be necessary. However, in our opinion, a comment period of less than 10 working days would not generally allow constituents sufficient time to consult and comment on accounting issues.

Further, we believe that amendments to accounting standards, where at all possible, should be made consistently by the IASB and FASB working together.

Question 6

Are there financial crisis-related issues that the IASB or the FASB have indicated they will be addressing that you believe are better addressed in combination with, or alternatively by, other organizations? If so, which issues and why, and which organizations?

There have been a number of calls for the IASB and FASB to address financial stability as part of its remit in setting financial reporting standards. We believe that standard setters should be mindful of financial stability, rather than it being the primary driver when developing new standards. The main aim of financial reporting is to provide transparent information to users (principally investors) in order to assist them in their investment decisions. A financial stability objective may not necessarily sit comfortably alongside this aim, because financial statements need to portray a transparent picture of the underlying economic reality.

Question 7

Is there any other input that you'd like to convey to the FCAG?

We believe in the continued independence of the accounting standard setters in order to balance the conflicting demands being made of them by different constituents.