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

Ref.: Exposure Draft / ED/2009/7 / Financial Instruments: Classification and Measurement

Dear Sirs,

The International Swaps and Derivatives Association ("ISDA") is pleased to provide the following comments with respect to the above mentioned Exposure Draft (ED) issued by the International Accounting Standards Board ("IASB").

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.

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.

Key Messages:

- The majority of our members believe that amortised cost provides decision-useful information for financial instruments which have basic loan features and which are held in accordance with an appropriate business model (herein referred to as the 'two criteria approach'). However, they have concerns with how these principles have been expressed in the ED, specifically with respect to securitisation tranches. The attached appendix (Questions 2 and 4) provides alternative approaches for the Board to consider.

- In regards to embedded derivatives, while most members agree that the embedded derivative rules in IAS 39 are overly complex and in need of revision, the majority of our members have expressed an alternative view to retain the option to bifurcate embedded derivatives, in particular if changes in own credit continue to be recognised in profit or loss.

- The majority of members believe that reclassification should be required when the business model changes. In our view there should be greater emphasis on the business model for determining whether an instrument can be measured at amortised cost. A natural consequence of this principle is that if the business model subsequently changes, this should trigger a mandatory reassessment of whether the portfolio of financial instruments can continue to be accounted for in the same manner or whether it should be reclassified.

- While we agree in principle that the proposals should be applied retrospectively, if it is the intention of the Board to encourage early adoption of the ED, we believe there should be some relaxation of this principle. Specifically, we do not believe it is appropriate to require comparative figures to be restated for entities early adopting the new requirements. Instead, we would advocate the same approach as was used to apply IAS 39 when entities first adopted IFRS in 2005, in which comparative information was not required.

- Finally it is of paramount importance that there be only one standard on classification and measurement for financial instruments applied by both IFRS and US GAAP reporters. Our members are concerned that the differences in the approaches currently being pursued by the IASB and FASB may lead to divergence in accounting. We urge the IASB and the FASB to work together to avoid this. Our members are also concerned about the piecemeal nature of the new proposals, to the extent that we are being asked to comment on the classification and measurement for financial instruments without any knowledge of the plans for hedge accounting or impairment.

- Therefore the majority of our members would support extending the date at which the IASB has set for completion of the classification and measurement amendment from 2009 to 2010. This would allow the IASB and the FASB to jointly develop a robust high quality standard, which addresses all aspects of financial instrument accounting, including hedge accounting, own credit and impairment.

We hope you find ISDA's comments useful. 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,

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Deutsche Bank AG
Chair, European Accounting Policy Committee

Antonio Corbi
International Swap and Derivatives Association
Risk and Reporting

Appendix – Responses to specific questions raised by the IASB

Appendix – Responses to specific questions raised by the IASB

We set out below our comments relating to the specific questions in the invitation to comment.

Question 1

Does amortised cost provide decision-useful information for a financial asset or financial liability that has basic loan features and is managed on a contractual yield basis? If not, why?

The majority of our members have long held the view that amortised cost does provide decision useful information for certain types of financial instrument. This view was most recently expressed in September 2008 when responding to the IASB's request for comment on the *Reducing Complexity in Reporting Financial Instruments* discussion paper. These members agree that the use of amortised cost should be limited to those instruments held in accordance with an appropriate business model, but have some concerns about the terms 'basic loan features' and 'managed on a contractual yield basis', both of which are further detailed below in our response to Question 2.

Question 2

Do you believe that the exposure draft proposes sufficient, operational guidance on the application of whether an instrument has 'basic loan features' and 'is managed on a contractual yield basis'? If not, why? What additional guidance would you propose and why?

The majority of ISDA members support a mixed measurement model and the two criteria approach (e.g., they agree that the amortised cost category should be limited to those instruments that have 'basic loan features' and are held in accordance with an 'appropriate business model'). However, they have some concerns with how these principles have been expressed in the ED, which are described in the following paragraphs.

<u>Basic loan features</u>

Paragraphs 4 and B1

Our members believe that the criterion for 'basic loan features' should be more clearly expressed as a principle, in the main body of the Standard. This would have two components: the right to receive (or obligation to pay) principal and interest (where interest is the consideration for the time value and the credit risk) and that the loan is not levered. Therefore the wording in B1 should be moved to the forepart of the standard.

In addition, we note that the concept of leverage is only referred to in the Basis for Conclusions and not in the main body of the standard. As such we recommend that paragraph B1 make specific reference to the requirement regarding 'non leverage'. For example, paragraph B1 could be restated to say: 'Basic loan features are **non leveraged** contractual terms that give rise on specified dates to cash flows that are payments of principal and interest on the principal outstanding'. However there are differing views amongst our members as to what constitutes leverage (see our response to Question 4).

Paragraph B3(c)
Paragraph B3(c) of Appendix B discusses contractual provisions "that permit the issuer (the debtor) to prepay a debt instrument (e.g. loans or bonds) or permit the holder (the creditor) to put a debt instrument back to the issuer before maturity and are "not contingent on future events" (emphasis added) as an example of basic loan features. In our experience, a significant majority of loans include a redemption feature if the lender is subject to a successful taken over. In our view, contingent events of this nature should not preclude a financial instrument from exhibiting basic loan features. Therefore, we believe that paragraph B3(c) of the ED should be amended to accommodate takeovers and similar triggers to be consistent with the basic loans features concept.

Paragraph B3
In addition it would be helpful if the following examples, which are common features in financial instruments, could be added to the application guidance as further clarification of the basic loan features concept:

1. Options which permit the issuer to extend the maturity of a debt instrument, provided they are not contingent on future events (to allow symmetry between the treatment of prepayment and extension options);
2. Indexation to inflation as long as it is measured in the same currency as the instrument's contractual terms;
3. A perpetual coupon which constitutes compensation for the holder in respect of both time value of money and credit risk of the issuer, and repayment of the holders initial investment; and
4. Cumulative preferred shares which contain terms whereby the issuer delays payment of interest as long as interest is accrued in any arrears and they are settled upon maturity

Paragraphs B6 to B8
The majority of our members are in strong disagreement with paragraphs B6 to B8 relating to the subordination and the waterfall features. Our detailed comments to the treatment of securitisation tranches is contained in Question 4.

Managed on a contractual yield basis

The members who support the two criteria approach believe that greater priority should be assigned to the business model and that reclassifications should be required if the business model changes (see Question 7). A significant number of our members would also prefer to retain the principle of bifurcating a host instrument (managed in accordance with one 'traditional banking' business model) so that it is measured at amortised cost and any embedded derivative (managed in accordance with another business model) measured at fair value through profit or loss (see Question 4).

The term 'managed on a contractual yield basis' is not self evident as a principle and the reference to 'contractual yield' is misleading as it implies that it is different from managed on an effective yield basis or that the yield basis for financial instruments cannot be altered through hedging. Specifically ISDA has the following drafting suggestions to the ED in regards to the 'managed on a contractual yield basis' concept.

Paragraphs 4 and B9
Consistent with our comment in regards to basic loan features above, our members believe that the criterion of managed on a contractual yield basis should be expressed as a principle contained in the main body of the standard rather than in the application guidance in B9. Therefore we suggest that the concept (as amended for the below drafting changes) be moved to the forepart of the standard.

We believe that it is the Board's intention to capture within the term 'managed on a contractual yield basis' those 'financial instruments held predominantly for the collection of interest and principal or funding instruments held which result in the payment of contractual cash flows'. Whether or not a financial instrument is held predominantly for the receipt or payment of contractual cash flows should be determined by the business model. The majority of our members believe that the business model is driven by both the types of activities an entity engages in order to create shareholder value and the way such value is created. Specifically, the activity where the cash flows inherent in the instruments are primarily realised through the collection of interest and principal is separated and distinct from activity where the cash flows are primarily realised through the various forms of trading financial instruments or acting as a financial intermediary.

As such we recommend that the ED be amended (specifically paragraphs 4 and B9) to reflect the views above.

Paragraph B10
The ED does not explain the level at which financial instruments are assessed as being managed on a contractual yield basis. It is unclear as to the whether the test applied to the individual financial instrument, a portfolio of similar instruments, trading desk by trading desk, or across the reporting entity as a whole. One reading of the ED paragraph B10 would be that a bank would have perhaps two businesses: a 'trading' and a 'banking' business, but we believe that the ED should be amended to make it clear that there could be a number of businesses (or portfolios) within one entity.

The possibility of some financial instruments managed on a contractual yield basis being sold or repurchased before maturity is only discussed in paragraph 33 of the Basis of Conclusions and we believe it should be addressed in the Application Guidance. It needs to be made clear that the sale or repurchase of a pool of assets held or liabilities issued to enable the management of interest and credit risk, to respond to business acquisitions and disposals and/or changes in liquidity needs, would not invalidate the classification of the portfolio as a whole as long there has not been a change in the business model (see Question 7). Our members support the proposal in the ED to require separate disclosure of gains or losses realised by selling or repurchasing financial instruments recorded at amortised cost.

Paragraph B13(b)
A majority of our members disagree with the approach outlined by the IASB requiring loans acquired at a discount to be measured at fair value. Specifically, they disagree with the rationale expressed in paragraph B29 of the Basis for Conclusions that loans acquired at a discount do not contain basic loan features and should therefore always be measured at fair value. These members believe that appropriate consideration should be given to the business model when classifying loans acquired at a discount. For example, loans acquired as part of a business combination that have already experienced incurred losses, but if the acquirer's business model continues to be to hold those loans primarily to collect the principal and interest they should, in our view, be able to be accounted for on an amortised cost basis. Similarly, organizations may acquire portfolios of loans with a view to collecting the principal and interest because they believe that they have better processes to do so than the seller, or because the seller is exiting the market. On the other hand, there are undoubtedly business strategies in which the purpose of acquiring deep discounted loans will be motivated by the desire to realize a higher value on subsequent sale and therefore should be recorded at fair value through profit or loss.

Therefore these members recommend that paragraph B13(b) be removed.

Question 3

Do you believe that other conditions would be more appropriate to identify which financial assets or liabilities should be measured at amortised costs? If so,

(a) What alternative conditions would you propose? Why are those conditions more appropriate?
(b) If additional financial assets or financial liabilities would be measured at amortised cost using those conditions, what are those additional financial assets or financial liabilities? Why does measurement at amortised cost result in more decision useful information than measurement at fair value?
(c) If financial assets or financial liabilities that the exposure draft would measure at amortised cost do not meet your proposed conditions, do you think those financial assets or financial liabilities should be measured at fair value? If not, what measurement attribute is appropriate and why?

See our responses to Questions 2 and 4.

Question 4

(a) Do you agree that the embedded derivative requirements for a hybrid contract with a financial host should be eliminated? If not, please describe any alternative proposal and explain how it simplifies the accounting requirements and how it would improve the decision usefulness of information about hybrid contracts.

(b) Do you agree with the proposed application of the proposed classification approach to contractually subordinated interests (i.e. tranches)? If not, what approach would you propose for such contractually subordinated interests? How is that approach consistent with the proposed classification approach? How would that approach simplify the accounting requirements and improve the decision usefulness of the information about contractually subordinated interests?

Question 4(a) - Embedded derivatives

Our members agree that the section of IAS 39 dealing with embedded derivatives is too complex and in need of revision.

A number of our members agree with the proposal outlined in the ED to eliminate the concept of embedded derivatives for hybrid contracts with a financial instrument host, on the basis that it will significantly reduce complexity in the reporting of financial instruments.

However, the majority of our members wish to retain the option to bifurcate a derivative embedded in a financial host contact and account for that derivative as a separate financial instrument if changes in own credit continue to be recognized in profit or loss.

These members are concerned that the ED would lead to many more financial liabilities being recorded at fair value through profit or loss because they contain non-basic loan features, such as hybrid debt contracts. They are concerned with the volatility of profit or loss created by the own credit component inherent in such instruments, where those instruments are typically held for funding purposes. In our response to the *Credit Risk in Liability Measurement* Discussion Paper some of our members expressed a preference for the effects of the changes in the price of own credit for instruments which are recorded at fair value but are not held for trading, being reported in other comprehensive income. If this recommendation is adopted by the Board, eliminating the concept of embedded derivatives would be less of a concern.

Finally, there are members who believe bifurcation should be retained to accommodate hedging strategies which rely on bifurcation, as the embedded derivative is designated as a hedging instrument. Hedge accounting for such strategies would not be possible going forward unless the whole hybrid instrument is permitted to be designated as a hedging instrument. It is difficult to fully assess the impact of removing the ability to bifurcate a derivative embedded in a financial host contract until our members have seen the proposed IASB exposure draft on hedge accounting.

Not withstanding the above, our members who wish to retain the concept of separation of embedded derivatives would propose that the guidance on this subject be simplified so that any feature which would not be a basic loan feature would be regarded as a separable embedded derivative. This would achieve most of the simplification benefits of eliminating the concept of embedded derivatives.

Question 4(b) -Securitisations

The section of the ED set out in paragraphs B6 to B8 on subordination and waterfall features does not properly reflect the principle of basic loan features, being excessively focused on the legal form of the instrument. As currently drafted, with no opportunity or requirement to look through to the underlying risks of the securitisation SPE, the proposal is both unduly strict and creates structuring opportunities:

i) As there is no requirement to look through to the assets held by an SPE, amortised cost accounting may be afforded to senior tranches whose repayment is dependent on the performance of underlying assets with highly variable cash flows. While we believe that to do so would not be consistent with the basic loan feature principle, paragraph BC 28 of the Basis for Conclusions appears to create a conflicting principle that it is not appropriate to look through such structures;

ii) even a BBB rated tranche could be ‘converted’ into a financial asset having only basic loan features if it were put into a further securitisation structure and new notes issued, one of which would be the most senior. Again, while this would seem to conflict with the general basic loan features principle, it follows logically from the approach set out in paragraphs B1 to B8;

iii) entitlement to cash flows which would be similar to a contractual waterfall could be created by establishing a series of SPEs, each of which would have differential entitlement to the cash flows of a pool of assets but which would issue separate debt instruments that do not explicitly refer to the waterfall;

iv) meanwhile, highly rated but not the most senior tranches of securitisations of conventional debt with only basic loan features, whose variability in possible cash flows is less than would be the case if the holder invested in the underlying assets, would be required to be recorded at fair value through profit or loss.

Our members have expressed various views about possible alternative approaches that could be taken, as described in the following paragraphs.

Look Through Approach

As expressed in our letter to the IASB dated 4 June 2009, the majority of ISDA members believe that a more sophisticated test is required for securitisation structures. Rather than adopting the simple basic loan features test for such structures, some ISDA members believe it is more appropriate to 'look through' to the underlying pool of assets. Specifically, for debt securities whose cash flows are based on the cash flows of an underlying pool of assets, these members 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. Having 'looked through' to the underlying pool of assets, security would be classified based on the classification options available to the underlying pool of assets e.g. if the underlying pool of assets are equities, the security would be measured at fair value through profit or loss. The concept of variability in cash flows is not new and has precedent in SIC 12 and also FIN 46R *Consolidation of Variable Interest Entities,* issued by the FASB.

To the extent that the securitisation vehicle has entered into derivatives, provided that the derivatives are designed to align the cash flows between the underlying assets and the instruments issued and they are not entered into for the purpose of creating additional leverage, these members believe that the securitisation tranches should not be precluded from being measured at amortised cost.

We note that in paragraph BC28 of the Basis of Conclusions, the Board has rejected a 'look through' approach because it is too complex. These members believe that a degree of complexity is inevitable when accounting for financial instruments. However, if 'looking through' a particular structure is not possible, we propose that the financial instrument would by default be measured at fair value. This, in these members' view, should not preclude looking through securitisation structures to the extent it is practical, to determine whether the underlying assets exhibit basic loan features.

Other Possible Approaches

ISDA members share the view of the Board that the 'look through' approach is too complex. The alternative approaches proposed by these members differ to that proposed by the Board in the following respects:

- Other members believe the approach proposed in the ED draws an artificial split between structured and non structured entities which is not clear and was highlighted in the ED 10 discussions. Rather, they believe that a basic loan should be re-defined as an instrument that provides for the payment of principal and interest cash flows - with interest defined as compensation for the time value of money and any credit risk associated with the principal amount outstanding, including direct risk of issuer and any 3rd party. This would provide a consistent principle for instruments with similar risks regardless of entity type. They understand that this new basic loan definition would increase the scope of instruments with basic loan features but believe the entity's business model will ensure appropriate classifications are achieved. If accrual accounting is desired it will be important for the entity to prove that there is sufficient certainty over the cash flows to be received to ensure the entity can manage those cash flows on a contractual yield basis. As an alternative they would support retaining the current IAS 39 bifurcation rules.

- Other members propose a combination of criteria to determine classification of asset backed security ('ABS'). Specifically, those members believe that a combination of a) the nature and risk profile of the underlying assets in the securitisation vehicle; b) the level of subordination of the instrument being analysed; and c) whether the credit risk of the instrument in question is greater or less than that of the underlying assets. This approach looks to the substance of the funding arrangements within the SPE and combines aspects of the look through approach and the approach proposed in the ED.

Question 5

Do you agree that entities should continue to be permitted to designate any financial asset or financial liability at fair value through profit or loss if such designation eliminates or significantly reduces an accounting mismatch? If not, why?

Yes, our members support retaining the ability to designate any financial asset or financial liability as fair value through profit or loss if such designation eliminates or significantly reduces an accounting mismatch.

Question 6

Should the fair value option be allowed under any other circumstances? If so, under what other circumstances should it be allowed and why?

In our response to Question 4 we stated that certain of our members believe that the requirement to separate embedded derivatives be retained. These same members believe that the fair value option should be retained for contracts that contain one or more embedded derivatives, as is currently permitted by IAS 39.11A.

Some of our members support unrestricted fair value election.

Question 7

Do you agree that reclassification should be prohibited? If not, in what circumstances do you believe reclassification is appropriate and why do such reclassifications provide understandable and useful information to users of financial statements? How would you account for such reclassifications, and why?

The members who support a mixed measurement model believe that reclassification should be required if the business model subsequently changes.

As outlined in our response to Question 2, in our view there should be greater emphasis on the business model for determining whether an instrument can be measured at amortised cost. Indeed, an instrument must be managed on a contractual yield basis before it can be measured at amortised cost. A natural consequence of this principle is that if the business model subsequently changes, this should trigger a mandatory reassessment of whether the portfolio of financial instruments can continue to be accounted for in the same manner or whether it should be reclassified. To be consistent, our members acknowledge that changes in business model would consider the appropriateness of reclassifications from FVTPL to amortised cost category and vice versa.

We anticipate that the circumstances where a portfolio of financial instruments is reclassified because of a change in business model would be infrequent. It would necessitate a more significant and demonstrable change than just a change in the intention of management as regards to the assets.

If the standard were to require a reporting entity to reclassify a portfolio of financial instruments from amortised cost to FVTPL (or vice versa) because of a change in business model, we believe this should be accompanied by an appropriate level of disclosure to allow users to understand the drivers and the impacts of the change in business model as at the date of the reclassification.

Question 8

Do you believe that more decision-useful information about investments in equity instruments (and derivatives on those equity instruments) results if all such investments are measured at fair value? If not, why?

Yes our members believe that fair value provides the most decision useful information for investments in equity instruments.

Some of our members do not believe that fair value is the most relevant measurement basis for all equity instruments, particularly when the investment is not held for sale or risk managed on a fair value basis, for example strategic investments.

Question 9

Are there any circumstances in which the benefits of improved decision usefulness do not outweigh the costs of providing this information? What are those circumstances and why? In such circumstances, what impairment test would you require and why?

From the perspective of our membership there would be no circumstance where the cost of obtaining the fair value of an equity instrument that does not have a quoted price would outweigh the benefits of obtaining that information.

Question 10

Do you believe that presenting fair value changes (and dividends) for particular investments in equity instruments in other comprehensive income would improve financial reporting? If not, why?

The majority of our members do not believe that presenting fair value changes (and dividends) for particular investments in equity instruments in other comprehensive income would improve financial reporting. Those members do not understand the accounting principle supporting this proposal and further, note that it is inconsistent with the accounting treatment of any other financial or non-financial asset.

The majority of members believe that dividends on equity investments, where fair value changes are reported in other comprehensive income, should be reported in profit or loss. Additionally, they believe that any gain or loss on disposal of such investments should be recycled through profit or loss. It is acknowledged that if these options were adopted, the IASB would have to address the scope of application and impairment, including the treatment of reversals of impairment.

Question 11

Do you agree that the entity should be permitted to present in other comprehensive income changes in the fair value (and dividends) of any investment in equity instruments (other than those that are held for trading), only if it elects to do so at initial recognition? If not,

(a) How do you propose to identify those investments for which presentation in other comprehensive income is appropriate? Why?

(b) Should entities present changes in fair value in other comprehensive income only in the periods in which the investments in equity instruments meet the proposed identification principle in (a)? Why?

Please refer to our response to questions 7 and 10.

Question 12

Do you agree with the additional disclosure requirements proposed for entities that apply the proposed IFRS before its mandated effective date? If not, what would you propose instead and why?

Yes, we agree with the additional disclosure requirements.

Question 13

Do you agree with applying the proposals retrospectively and the related proposed transition guidance? If not, why? What transition guidance would you propose instead and why?

While we agree in principle that the proposals should be applied retrospectively, if it is the intention of the Board to encourage early adoption of the ED, we believe there should be some relaxation of this principle. Specifically, we do not believe it is appropriate to require comparative figures to be adjusted. Instead we would advocate the same approach as was used to apply IAS 39 when entities first adopted IFRS in 2005, in which comparative information was not required to be amended. In addition to being an impediment to early adoption, we question how meaningful those comparatives would be in providing decision-useful information to investors, especially as hedge accounting relationships cannot be retrospectively designated and there may not have been the accounting mismatches in earlier years which led to the use of the fair value option on initial application. The work required to determine impairment on assets disposed of before the start of the year of implementation would be particularly disproportionate to its value and it is also not clear how to apply the current business model approach to businesses which were disposed of in prior years.

Question 14

Do you believe that this alternative approach provides more decision useful information than measuring those financial assets at amortised cost, specifically:

(a) In the statement of financial position?
(b) In the statement of comprehensive income?

If so, why?

No, the majority of our members do not believe the alternative approach provides more decision-useful information.

A minority of our members believe the alternative approach may have merit but would need to see more comprehensive details of it before confirming this view.

Question 15

Do you believe that either of the possible variants of the alternative approach provides more decision useful information than the alternative approach and the approach proposed in the exposure draft? If so, which variant and why?

The majority of members do not believe either variant provides more decision-useful information. However, certain of our members would like to see more detail on the alternative proposals before confirming this view.