

29 June 2012

Mr Stefan INGVES
Chairman
Basel Committee
Email: Stefan.ingves@bis.org; Stefan.ingves@riksbank.se

Mr Hans HOOGERVORST
Chairman
International Accounting Standards Board
Email: hhoogervorst@ifrs.org

Dear Sirs,

We would like to address a matter of concern that has arisen recently as a result of current standard setting between the regulatory and accounting bodies. Specifically, we would like to highlight our concern over the potential removal of the AFS filter to determine regulatory capital and its interaction with the future accounting of Available for Sale (“AFS”) investment securities under US GAAP and IFRS.

OCI treatment under Basel III – removal of prudential filters

Basel III proposes that institutions, in determining their capital base, shall consider the unrealized gains and losses on AFS investment securities recorded in accumulated Other Comprehensive Income (“OCI”). The removal of the AFS filter will therefore result in unrealized gains and losses of any financial asset fair valued through OCI being included in regulatory capital.

While the Basel III framework envisaged that the Basel Committee will continue to review the appropriate treatment of AFS investment securities, national regulators should also take into account the evolution of the accounting framework before advancing with implementation of the Basel III provisions in question.

In some jurisdictions, the national implementation may result in a full deduction of unrealized losses on AFS investment securities from regulatory capital as of 1 January 2013

Potential amendments to IFRS 9 and inconsistency between the implementation date of the IFRS 9 and Basel III

Under current IAS 39, debt securities are classified into three categories. Assets classified in the AFS category are measured at fair value, with changes to fair value reported in OCI (a component of equity).

IFRS 9, as issued by the IASB in November 2009 for application by 1 January 2013, eliminated the AFS category. There are only two categories for debt securities; fair value through profit or loss and amortised cost. At the time the Basel III provisions were being developed, banks would have assumed that the elimination of the AFS filter would have no affect on banks’ capital since the AFS category would be eliminated from IFRS 9 at the same time as the filter would be removed. After the adoption of IFRS 9 by the IASB, the general view was that many simple AFS debt securities held for the collection of contractual cash flows would be measured at amortised cost under IFRS 9. As a result, IFRS banks made little objection to the Basel proposals at the time they were being considered.

However, the mandatory implementation date of IFRS 9 has been delayed by the IASB until 2015 and the standard is not yet endorsed for use in the EU. In our view, this results in significant unintended consequences in terms of volatility of capital since the AFS category will remain in use until at least 2015. The unrealized gains or losses of the AFS portfolio would be adding pro-cyclicality and volatility to the capital requirements of banks during a time window of at least 2 years. Therefore, there is a strong case for delaying the elimination of the AFS filter until the required implementation of IFRS 9.

The situation is further complicated by the recent decision of the IASB to reopen IFRS 9 and the tentative decision to include a third category for debt securities; fair value through OCI. Although there is much uncertainty at present as to what debt securities would be included in the category, we remain supportive of the principles in the issued version of IFRS 9 which in our view would result in relatively few (if any) portfolios of debt securities being included in the fair value through OCI category. In particular, we believe that liquidity and balance sheet management portfolios will need to be assessed against the business model criteria and, where appropriate, result in amortised cost accounting where sales of financial assets occur for credit reasons or to better match the changes in expected duration of asset/liability gaps. More than an infrequent number of sales result in the entity assessing whether and how such sales are consistent with the objective of collecting contractual cash flows rather than invalidating the previous amortised cost accounting. However, the current discussion of the IASB/FASB would suggest that liquidity and balance sheet management portfolios would be recorded at fair value through OCI. There needs to be harmonization as between IFRS and GAAP, such that different accounting regimes do not give rise to competitive inequities for some banking organizations relative to others. In addition, there also needs to be a reasonable, universal 'carve out' as to certain AFS debt securities for which the OCI filter is retained under Basel III. Such a filter should aid in minimizing conflict as between the Basel III capital rules and the Basel III liquidity rules relative to the LCR and the requirement to hold high quality, liquid assets under that ratio, as well as make sense for those AFS debt securities for which there is little to no credit risk but rather for which changes in value result principally from changes in benchmark interest rates.

If the IASB introduces a new third category in IFRS 9 but clarifies that most liquidity and balance sheet management portfolios may continue to be recorded at amortised cost, we currently anticipate that the removal of the filter in conjunction with a third category in IFRS 9 would result in less of a capital impact than the removal of the filter in conjunction with the continued application of IAS 39. It seems anomalous to introduce significant capital volatility under IAS 39 and then reduce it when IFRS 9 is adopted.

If the IASB introduces a new third category in IFRS 9 but makes it clear that most liquidity and balance sheet management portfolios would be recorded at fair value through OCI, removal of the filter will continue to give rise to significant capital volatility. In this scenario, we believe that the prudential filter should be retained at least for portfolios where regulators require there to be more than infrequent sales, in order to demonstrate liquidity. It should be noted that:

1. These portfolios will typically be comprised of high quality, usually government, bonds. As a result, there should be very low risk of default.
2. It is expected that if a third category is introduced by the IASB, this will be subject to an expected loss impairment provision, so that adequate recognition of credit losses would be reflected in capital, even while retaining the filter.
3. In certain cases, the level of sales of securities in liquidity management portfolios is as high as it is primarily because of regulatory requirements.

We therefore believe that (i) any proposal to remove the prudential filter should be delayed until the effective date of IFRS 9 and (ii) the period leading up to the implementation of the Basel Framework (if delayed) and IFRS 9, unrealised gains or losses shall remain under provisions equivalent to current national regulations. Such delay would allow for a closer examination of the possible impact that the removal of the filter may have on regulatory capital and the behavior of financial institutions that are likely to occur in different jurisdictions. Once IFRS 9 is in place, we believe the prudential filter removal

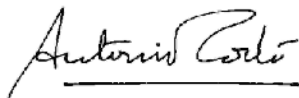
should follow the transitional arrangements as proposed in Basel III consistently across jurisdictions to ensure a level playing field, unless the IASB makes it clear that liquidity and balance sheet management portfolios would be required to be recorded at fair value through OCI. If this is the case, the potential filter should not be removed at all, at least for those portfolios where sales are mandated by regulators.

Treatment of accounting impairment allowance

Unless changes are made to Basel III it is expected that, to the extent the accounting allowance is larger than Basel EL for IRB approach portfolios, there will be an add back to Tier 2 capital up to a maximum of 0.6% of credit risk-weighted assets. For other regulatory approaches, it may be possible to add back bucket 1 allowance to Tier 2 up to a maximum of 1.25% of credit risk-weighted risk assets calculated under the standardised approach.

Neither approach is helpful for key regulatory ratios and are to some extent dependent on whether the accounting allowances are deemed to relate to unidentified losses. We recommend that Basel consider the interaction between the accounting changes and Basel III capital requirements to avoid any double counting as the extension of the scope of the expected losses resulting from the new impairment accounting principles must logically lead to a decrease in the amount of unexpected losses which is the basis of capital requirements for credit risk.

Yours sincerely,



Antonio Corbi
ISDA Risk and Research

Copy to:

Basel Accounting Task Force

Ms Sylvie Matherat, Chair (email: sylvie.matherat@banque-france.fr)

FASB

Ms Leslie Seidman, Chairman (email: lfseidman@fasb.org)

European Parliament

Mr Othmar KARAS, Rapporteur on CDR IV (email: othmar.karas@europarl.europa.eu)

Ms Sharon BOWLES, Chair of ECON Committee (email: sharon.bowles@europarl.europa.eu)

European Commission

Mr Jonathan Faull, Director General (email: jonathan.faull@ec.europa.eu)

Mr Mario Nava, Acting Director Financial Institutions (email: mario.nava@ec.europa.eu)

Mr Jeoren Hooijer, Head of Unit Accounting and Financial Reporting (email: Jeroen.Hooijer@ec.europa.eu)

Board of Governors of the Federal Reserve System

Ms. Jennifer J. Johnson Secretary (email: regs.comments@federalreserve.gov.)

Norah Barger (email: norah.barger@frb.gov)

Alan Adkins (email: alan.adkins@fsa.gov.uk)



Office of the Comptroller of the Currency

publicaffairs3@occ.treas.gov

Federal Deposit Insurance Corporation

Mr. Robert E. Feldman Executive Secretary,(Email: Comments@FDIC.gov)

EFRAG

Francoise Flores, Chairman (email: francoise.flores@efrag.org)

Cyprus Presidency

Mr Constantinos Trikoupis, Financial Attaché (email: ConstantinosTrikoupis@centralbank.gov.cy)

EBA

Mr Andrea Enria, Chair (email: andrea.enria@eba.europa.eu)

Mr Adam Farkas, Executive Director (email: CP50@eba.europa.eu)