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JPMorganChase

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Dear Ms Pryde

Exposure Draft (ED) 7 Financial Instruments: Disclosures

J.P. Morgan Chase & Co appreciates the opportunity to comment on the International Accounting Standards Board's ("IASB" or the "Board") Exposure Draft 7 Financial Instruments: Disclosures ("ED 7" or the "Exposure Draft").

We support the Board's objectives for issuing the Exposure Draft, namely removing onerous or duplicative disclosures and locating in one place all disclosures relating to financial instruments. In particular we support the Board's conclusion (see paragraph BC 22 of the Exposure Draft) that disclosure about an entity's exposure to risks arising from financial instruments should be based on how the entity manages those risks. We do however have three overall concerns with the Exposure Draft which we consider contradict this conclusion; these relate primarily to the "Nature and Extent of Risk Arising from Financial Instruments" section contained in paragraphs 32 to 48 of the Exposure Draft (the "Risk Management Section") and are detailed below.

Minimum Disclosures

We appreciate the Board's attempt to make disclosures comparable by requiring minimum disclosures, but we consider that these requirements will not provide relevant information when they do not reflect the way an entity views and manages its risk. As a result, both sophisticated and simple users of financial instruments could be adversely burdened by the "one size fits all" approach proposed by the Exposure Draft. We recommend that the disclosure requirements in the Risk Management Section of the Exposure Draft be more principles-based and allow more flexibility in how an entity discloses its exposure to, and management of, risk arising from financial instruments. We consider that the minimum disclosures, plus a more extensive set of examples would be more appropriately located in the Implementation Guidance and should support and illustrate the disclosure principles contained in the Standard.

Scope of the Exposure Draft

We support applying the provisions of the Exposure Draft to all entities based on exposure to risk rather than type of entity. However, such disclosure should only be made when the information produced is relevant to users of financial statements. In particular, at a subsidiary level some of the disclosures in the Risk Management Section of the Exposure Draft may not provide relevant information about the way risk is managed. This is because financial institutions generally manage risk at a business unit level which in many cases may cut across legal entities. As a result disclosures that are required to be made at a subsidiary level may not meaningfully reflect the way risk is managed.

In addition, we consider that disclosure is only relevant where significant external users of financial statements exist. A subsidiary's performance under its obligations is generally guaranteed by the subsidiary's ultimate parent and therefore creditors rely on the consolidated financial statements rather than those produced by the subsidiary. Regulators are able to access information irrespective of whether it is disclosed in the financial statements. Accordingly, we recommend that the Board exclude from the scope of the Risk Management Section a wholly-owned subsidiary of a group that publishes comparable risk disclosures in its consolidated annual report.

Credit Risk Disclosures

We have concerns regarding the credit risk disclosures in paragraphs 39 to 41 of the Exposure Draft. In particular we believe that disclosures representing an entity's exposure to credit risk should always reflect the impact of netting of derivatives receivables and derivatives payables under legally enforceable master netting agreements. Further, disclosing the fair value of collateral held against retail or commercial loan portfolios in isolation is not necessarily appropriate because it is only one element to consider when evaluating credit exposure. Our position is discussed in more detail in the body of the letter in our response to Question 2 of the Exposure Draft.

In addition to the overall concerns raised above, we have several specific comments which we have detailed by addressing the questions raised in the Exposure Draft below.

Question 1 – Disclosures relating to the significance of financial instruments to financial position and performance

The draft IFRS incorporates disclosures at present contained in IAS 32 Financial Instruments: Disclosure and Presentation *so that all disclosures about financial instruments are located in one Standard. It also proposes to add the following disclosure requirements:*

(a) financial assets and financial liabilities by classification (see paragraphs 10 and BC13).

(b) information about any allowance account (see paragraphs 17 and BC14).

(c) income statement amounts by classification (see paragraphs 21(a), BC15 and BC16).

(d) fee income and expense (see paragraphs 21(d) and BC17).

Are these proposals appropriate? If not, why not? What alternative disclosures would you propose?

We agree with the Board's decision to move all financial instrument and risk disclosures into one Standard.

We are however concerned that the disclosure requirements in paragraph 21(d) could require separate disclosure of fees incorporated in the cashflows of financial assets and financial liabilities that are fair value through profit and loss. Fee income would be extremely difficult to separate from mark-to-market gains and losses and would provide little additional information as this would already be incorporated in the disclosures required under paragraph 21(a) of the Exposure Draft. We do not think the Board intended that this information be separately disclosed since the analogous disclosure on interest income or expense in paragraph 21(c) specifically excludes interest arising from assets and liabilities held at fair value through profit or loss. We would therefore recommend that the Board removes assets and liabilities at fair value through profit and loss from the scope of paragraph 21(d) of the Exposure Draft.

Question 2 – Disclosure of the fair value of collateral and other credit enhancements

For an entity's exposure to credit risk, the draft IFRS proposes to require disclosure of the fair value of collateral pledged as security and other credit enhancements unless impracticable (see paragraphs 39, 40, BC27 and BC28).

Is this proposal appropriate? If not, why not? What, if any, alternative disclosures would you propose to meet the stated objective?

We agree that an entity should disclose information about the fair value of collateral held against derivative receivables, securities borrowed and securities purchased under resale agreements. This information is in line with the manner in which these instruments and their related collateral are managed.

We would however question whether the disclosure of the fair value of collateral pledged against loans in isolation provides relevant information. Where the asset is not managed on a fair value basis, information about the fair value of collateral would provide little information about credit risk management or exposure. For example, control over collateral pledged on retail and commercial loans is generally not given to the lender. Unlike collateral taken against derivatives or securities lending activities, the lender cannot repledge the collateral or use it in any way to generate earnings. Also unlike derivatives and securities lending arrangements, where collateral is generally adjusted with the fair value of the underlying receivable, the lender has no direct ability to either preserve the value or control the amount of collateral on loans.

In terms of credit exposure, the expected loss on a commercial loan is a product of two factors: the probability of default and the loss given default. Probability of default is determined by the assessed creditworthiness of the borrower and loss given default is determined by collateralization and other credit enhancements. Therefore, two loans with very different profiles – one with a low probability of default and a higher loss given default, and a second loan with a high probability of default and a lower loss given default – may have the same calculated expected loss. The principle described above is also true for consumer loans, in that the expected loss is a function of both the creditworthiness of the borrower and the quality and level of collateral. Therefore, to provide disclosures about the level only of collateral is to present only part of the picture. Information about the fair value of collateral is only relevant if presented along with information about the credit quality of the related borrower. For large loan portfolios, the level of detail required to make this disclosure would be unsuitable for financial statements.

We note that paragraph 39(b) the Exposure Draft provides that an entity need not disclose the fair value of collateral where obtaining such information is impracticable. Paragraph BC28 suggests that this exception can be invoked when the fair value is not readily available (e.g. residential property which is not appraised regularly or floating charges against the borrower's assets). The information available to value collateral received against many loans would be based on information of varying quality. It is questionable that the fair value would not meet the observable or reliable standards of IAS 39 *Financial Instruments: Recognition and Measurement*. Accordingly, we suggest the Board provide clearer guidance in the body of the standard as to the circumstances to which the impracticable exception may apply. Based on this paragraph, we consider that the "impracticable exception" could apply to many instances where collateral is not controlled by the holder or managed on a fair value basis.

Paragraph IG14(b) of the Exposure Draft specifically provides that disclosure of the carrying amount (net mark-to-market value) of derivative receivables will meet the minimum credit disclosure requirements of paragraph 39(a). Further, paragraph IG13(a) provides that maximum exposure to credit risk is the gross carrying amount net of amounts offset in accordance with IAS 32 *Financial Instruments: Presentation and Disclosure*. IAS 32 does not allow offset of derivative balances under master netting agreements. Where a master netting agreement is in place, an entity is only legally exposed to loss on a net derivative receivable position in the event of credit default by its counterparty. Accordingly we strongly disagree that gross carrying values of derivatives prior to netting under master netting agreements is a correct representation of maximum exposure to credit risk. We recommend that paragraph 39(a) and IG13 is amended to specifically allow for the impact of master netting agreements for derivatives where the entity has a legally enforceable right to set off the recognized amounts.

Also in respect of derivatives, it is unclear how financial institutions may interpret the term “maximum exposure to credit risk without taking into account collateral” in paragraph 39(a) of the Exposure Draft. A financial institution is unlikely to use the carrying value of derivatives to measure its credit exposure as it only gives management a current view. Measures that capture potential future variability, after adjusting for the impact of netting and collateral, are more likely to be used by a financial institution to assist it in managing its credit risk (for example Derivative Risk Equivalent). We would request that the Board clarify what is meant by maximum credit exposure in respect to derivatives.

Question 3 – Disclosure of a sensitivity analysis

For an entity that has an exposure to market risk arising from financial instruments, the draft IFRS proposes to require disclosure of a sensitivity analysis (see paragraphs 43, 44 and BC36 - BC39).

Is the proposed disclosure of a sensitivity analysis practicable for all entities?

If not, why not and what, if any, alternative disclosures of market risk would you propose to meet the stated objective of enabling users to evaluate the nature and extent of market risk?

We were concerned when we first read paragraphs 43 and 44 of the Exposure Draft as it is not clear that a value-at-risk (“VAR”) methodology would meet the minimum sensitivity analysis disclosure requirements. This only becomes apparent in paragraph IG35 of the Implementation Guidance. Given that this methodology is a key measure of market risk for many financial institutions we would request that the Board make it clear by providing an example in the Implementation Guidance using VAR for the purposes of this disclosure.

In addition, we are of the view that a sensitivity analysis would not be simple to prepare. In light of this and based on our view as previously discussed that disclosures should convey information which is relevant to users of financial statements, we would question whether this disclosure should be required in the financial statements of wholly-owned subsidiaries. Further we consider that a market risk sensitivity analysis would be of little relevance where an entity only holds assets as long term investments i.e. assets classified as loans and receivables, held to maturity or available for sale. We would therefore recommend that the Board consider flexibility in applying the disclosures in paragraphs 43 to 45 of the Exposure Draft.

Question 4 – Capital disclosures

The draft IFRS proposes disclosure of information that enables users of an entity's financial statements to evaluate the nature and extent of its capital. This includes a proposed requirement to disclose qualitative information about the entity's objectives, policies and processes for managing capital; quantitative data about what the entity regards as capital; whether during the period it complied with any capital targets set by management and any externally imposed capital requirements; and if it has not complied, the consequences of such non-compliance (see paragraphs 46-48 and BC45 - BC54).

Is this proposal appropriate? If not, why not? Should it be limited to only externally imposed capital requirements? What, if any, alternative disclosures would you propose?

We agree that a certain level of disclosure about an entity's capital and the way it is managed provides useful information about an entity's risk profile. However, we disagree with the specific requirements in sub-paragraph 47(b), (d) and (e) of the Exposure Draft. These provisions require entities to disclose quantitative information about internal capital targets set by management and non-compliance with both internally and externally imposed capital limits. We recommend that the Board remove the disclosure requirements in these paragraphs for the following reasons:

- Internal capital targets are set by management to achieve a number of objectives including the promotion of good performance (akin to setting a budget) and setting a buffer between actual performance and any externally imposed capital limits. In addition given that these targets are internal, the basis on which they are calculated will lack commonality between entities. A breach of an internally imposed capital requirement serves as an early warning and ensures investigation and remedial action prior to the occurrence of a more serious capital breach. It is for this reason that internal capital targets tend to be set at conservative levels. Disclosure of these internally set capital requirements and any breaches thereof could fundamentally alter the use and level of internally set targets as a monitor and manager of capital related performance.

- For similar reasons we do not agree that a breach of an externally set capital requirement should be disclosed. The current relationship between a Regulator and firm does not generally lead to public disclosure. The exception to this is when the Regulator considers the matter of sufficient importance to require a public disclosure as the Regulator is generally responsible for the administration of capital rules in the local market. These disclosures could potentially undermine that responsibility by forcing disclosure where the appropriate body has deemed it unnecessary. The reporting of capital exceptions should remain the responsibility of the empowered Regulator alone.

Question 5 – Effective date and transition

The proposed effective date is for periods beginning on or after 1 January 2007 with earlier adoption encouraged (see paragraphs 49 and BC62 - BC67).

Entities adopting IFRSs and the draft IFRS for the first time before 1 January 2006 would be exempt from providing comparative disclosures for the draft IFRS in the first year of adoption (see Appendix B, paragraph B9).

Are the proposed effective date and transition requirements appropriate? If not, why not? What alternative would you propose?

The proposed effective date and transition requirements seem appropriate.

Question 6 – Location of disclosures of risks arising from financial instruments

The disclosure of risks arising from financial instruments proposed by the draft IFRS would be part of the financial statements prepared in accordance with International Financial Reporting Standards (see paragraph BC41). Some believe that disclosures about risks should not be part of financial statements prepared in accordance with IFRSs; rather they should be part of the information provided by management outside the financial statements.

Do you agree that the disclosures proposed by the draft IFRS should be part of the financial statements? If not, why not?

We consider that the disclosures regarding the significance of financial instruments for financial position and performance (paragraphs 9-31) are appropriately located in the financial statements.

However, we consider that the disclosures in the Risk Management Section and those concerning capital should be located outside the financial statements. Much of the information required by these sections is based on management's view and judgment. Because of this, the audit of such disclosures could be costly and provide little extra comfort. In the U.S. much of this information is disclosed in the Management Discussion and Analysis (MD&A) and we consider this has the benefit of allowing management flexibility in the way their risk management practices are disclosed. We understand that given the IFRS framework it is difficult for the Board to require disclosure of information outside of financial statements, but we urge the board to investigate other means of achieving influence in this area, bearing in mind the different jurisdictions in which IFRS is applied.

Question 7 – Consequential amendments to IFRS 4 (paragraph B10 of Appendix B)

Paragraph B10 of Appendix B proposes amendments to the risk disclosures in IFRS 4 Insurance Contracts *to make them consistent with the requirements proposed in the draft IFRS. The requirements in IFRS 4 were based on disclosure requirements in IAS 32 that would be amended by the draft IFRS. The Board's reasons for proposing these amendments are set out in paragraphs BC57 - BC61.*

Do you agree that the risk disclosures in IFRS 4 should be amended to make them consistent with the requirements proposed in the draft IFRS? If not, why not and what amendments would you make pending the outcome of phase II of the Board's Insurance project?

We have no comment.

Question 8 – Implementation Guidance

The draft Implementation Guidance accompanying the draft IFRS suggests possible ways to apply the risk disclosure requirements in paragraphs 32-45 (see paragraphs BC19, BC20 and BC42 - BC44).

Is the Implementation Guidance sufficient? If not, what additional guidance would you propose?

As highlighted in our opening discussion we consider that the body of the Standard, in particular as it relates to the Risk Management Section, should contain a series of disclosure principles with the minimum disclosure being moved to the Implementation Guidance as examples. In addition we would encourage a broader array of examples (simple to complex) so as to better illustrate these disclosure principles.

If the Board decides to retain the concept of minimum disclosures, we would continue to encourage more extensive examples. In particular, given the simplicity of the minimum disclosures, it is not always clear whether more sophisticated risk management techniques used by financial institutions would satisfy the minimum disclosure criteria (refer above to our discussion on VAR and the sensitivity analysis).

Question 9 – Differences from the Exposure Draft of Proposed Statement of Financial Accounting Standards* Fair Value Measurements *published by the US Financial Accounting Standards Board (FASB).

The FASB's Proposed Statement of Financial Accounting Standards Fair Value Measurements, *which is open for public comment at the same time as this Exposure Draft, proposes guidance on how to measure fair value that would apply broadly to* *financial and non-financial assets and liabilities that are measured at fair value in accordance with other FASB pronouncements.*

Do you agree that the requirements in the draft IFRS provide adequate disclosure of fair value compared with those proposed in the FASB's Exposure Draft? If not, why not, and what changes to the draft IFRS would you propose?

We refer to our comment letter to the FASB on its Fair Value Measurement Exposure Draft dated 3 September 2004. Our most significant concern with the FASB's proposed fair value disclosures related to the requirement to separately disclose unrealised gains and losses for the period as we do not believe that this disclosure would not provide meaningful or useful information to readers of financial statements.

We also recommended that the Board require entities to provide a clear and transparent description of the control processes in place for fair valuing assets and liabilities. The Board could consider the disclosure principles outlined in the 2003 Group of Thirty Report on "Enhancing Public Confidence in Financial Reporting"[1].

Further, we noted that in the prior year, we had considered providing a sensitivity analysis of the parameters that were used to estimate fair value (similar to the requirements under paragraph 31(c) of the Exposure Draft). However after considerable effort, we found it difficult to compute the analysis (as it relied on many assumptions), as well as how to aggregate the results in a way that would provide meaningful information to the reader of our financial statements. This was not surprising since we were not using that metric as a way to manage our business. In light of our practical experience, the Board may want to reconsider the requirements in paragraph 31(c) of the Exposure Draft.

Question 10 – Other comments

Do you have any other comments on the draft IFRS, Implementation Guidance and Illustrative Examples?

Paragraphs 11 and 12

The disclosure principle underlying paragraph 11 of the Exposure Draft is unclear. If the Board intention was that this disclosure provides information about the impact of changes in an entity's own credit spread, then we consider that this will not always be clearly reflected in the disclosure required. Take the example of a financial institution that issues structured notes (i.e. debt with an embedded derivative) which it elects to fair value through profit or loss. If the financial institution is required to disclose changes in the fair value of these notes not attributable to changes in a benchmark interest rate, that change will include not only changes attributable to its credit worthiness, but will also include changes attributable to the embedded derivative. We therefore recommend that the Board clarify the purpose of the disclosure.

[1] See Chapter Three of the G-30 Report for a listing of the eight recommended disclosure principles.

In addition, we consider that paragraph 12 of the Exposure Draft should not be located in the body of the Standard and would be more appropriately located in the Implementation Guidance.

* * *

We appreciate the opportunity to submit our views and would be pleased to discuss our comments with you at your convenience. If you have any questions, please contact either myself on +1 212.270.7559 or Shannon Warren, Head of Accounting Policies – Wholesale, on +1 212.648.0906.

Sincerely,

Joseph Sclafani, EVPCC
J.P. Morgan Chase