LIBA

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22 October 2004

Andrea Pryde
Assistant Project Manager
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30 Cannon Street
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To: CommentLetters@iasb.org.uk

Dear Ms Pryde,

ED 7 Financial Instruments: Disclosures

I am writing on behalf of the London Investment Banking Association (LIBA) to comment on the IASB Exposure Draft ED 7 Financial Instruments: Disclosures, which was published on 22 July. LIBA is, as you know, the principal UK trade association for investment banks and securities houses; a current list of our members is attached.

Financial instruments form a key component of the European business activities of the majority of LIBA members. We have therefore closely followed, and have in large measure supported, the IASB work on accounting for financial instruments, and we are very pleased to have the opportunity to comment on this further Exposure Draft.

Overall we support the Board's reasons for issuing this Exposure Draft: removing "unnecessarily onerous or duplicative disclosures" and locating "in one place all disclosures relating to financial instruments". We believe, however, that the proposed IFRS does not achieve these objectives. Our general concerns are summarised in the next few paragraphs, and are followed by more detailed responses to the questions listed in the "Invitation to Comment" section of the Exposure Draft.

We believe the Board should make the proposed IFRS more principles-based by including an overall disclosure objective in each section and by moving as much as possible of the detail to the Implementation Guidance. Minimum disclosures are fine for a simple entity, but they can be misleading and/or superfluous when combined with the additional information appropriate for a complex organisation. The disclosure objective should contain sufficient information to make it clear to the preparer what the disclosure should tell the user, so that he can produce meaningful disclosures without losing transparency and/or comparability across entities. This will provide the entity with more flexibility in determining the appropriate level of disclosure to meet the objectives and to reflect the way risk is managed in the business. We believe this is preferable to the "one size fits all" approach of the Exposure Draft, which the prescriptive nature of much of the drafting in any case makes hard to follow, while maintaining consistency with the overall disclosure principle set out in paragraph 8.

In determining the disclosure objectives we ask the Board to consider what information is most relevant to the users of the accounts. Many of the minimum disclosures are consistent with those required by Basel Pillar III, but the level of detail required by a regulator will generally be different from that required by other users. While the users are of course a diverse group, we do not think the accounts should be required to include additional information for one specialised class of users (such as regulators) if there are other reasonable means for them to obtain that information. We appreciate that many of the disclosure rules were written with regulated entities in mind and we generally support the close link to Basel, but we would request that decisions yet to be made by Basel are not pre-empted and not enforced on entities that may not have to comply with Basel.

We also believe that the location of some of the proposed disclosures within the audited financial statements, particularly the sensitivity analysis requirements and the capital disclosures, is inappropriate. Firstly, the preparation of the sensitivity analysis will include subjectivity and estimation which could be seen to undermine the basis of the fair value of financial instruments included in the financial statements, and potentially pose a significant audit challenge. Secondly, we do not believe the financial statements should be used to ensure that companies comply with external regulatory capital. We recognise that the IASB is catering for multiple jurisdictions, and that its remit is restricted to the financial statements, but we would ask the Board to consider whether it could provide guidance for the disclosure of certain information <u>outside</u> the audited financial statements: a possible route might be to issue one or more statements of best practice for disclosures which would be better located elsewhere in the accounts, such as in the Operating and Financial Review. We believe these disclosures should only be included in the audited Financial Statements in jurisdictions where there is no other appropriate place.

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?

Overall we agree that the proposed disclosure requirements for financial assets and liabilities on the balance sheet and on the income statement will provide useful information for users of the financial statements.

We understand why paragraph 21(a)(i) distinguishes between "financial assets and liabilities classified as held for trading and those designated by the entity as at fair value through profit or loss". We believe, however, that this could cause practical difficulties: as explained in our 15 July letter on the Fair Value Option we think the present definition of held for trading needs to be revisited to ensure that it does not create such difficulties for our members and create additional GAAP differences between IAS and US GAAP.

Paragraph 21(a)(v) provides an example of where it would be helpful to include a more principles-based statement of the intention of the disclosure. We believe the paragraph could be read much more broadly than the Board seems to have intended: it may have been the intention to require disclosure of the net interest expense of a Company's financing activities, but "net gains or losses on … financial liabilities measured at amortised cost" would also appear to catch non financing activity. This could for example include financial liabilities such as repo balances which may be linked to reverse repos as part of a matched book, and where disclosing the net gain or loss on the repo position only would only produce meaningless figures. Another example is structured notes where the Fair Value Option through P&L is not used, the debt host would be held at amortised cost, and the balance disclosed would again be meaningless as it is only a component of the total gain or loss on the instrument.

Finally, we are concerned that the paragraph 21 classifications will be too inflexible for more complex trading businesses. In particular, there will be issues regarding how to break out the various components of a trading profit and loss in a meaningful way; we suggest it may be sensible to aggregate all trading book net gains or net losses.

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 do not believe this proposal is appropriate: the disclosure requirements are voluminous, are not supported by any disclosure principle with respect to credit risk, and are likely to result in the disclosure of quantitative information that is of no use, and could indeed be misleading to users of the accounts. Some specific concerns and proposed solutions are set out below:

- We feel the qualitative disclosure of an entity's use of collateral and credit enhancements in managing the risk of the business, as suggested in paragraph IG15, would be sufficient for users. We do not see how the fair value of the collateral will be of use to the user of the financial statements, and believe that quantitative information should therefore be provided only when the collateral is being relied upon. Certain of our members will, furthermore, have significant portfolios of collateralised loans, such as mortgage portfolios, where there may be material practical difficulties in determining a reliable fair value for the collateral for all loans on an ongoing basis.

- We are concerned that the proposed requirements will not lead to a meaningful disclosure of credit risk, since the minimum disclosures do not permit the ability to reflect master netting agreements, which provide important credit protection in the event that a counterparty cannot meet its obligations. This is a result of IG13 requiring disclosure in accordance with the offset rules in IAS32, which presents balances with a liquidity risk focus. This does not appear to meet the objective of the disclosure, which is to disclose information on credit risk; one would expect, if a master netting agreement is in place, to be able to look at financial assets and liabilities on a net basis. The proposed consequential amendment (in paragraph B2 of the Exposure Draft) to paragraph 50 of IAS32 suggests that this was the objective of this disclosure, since it states that "when financial assets and financial liabilities subject to a master netting agreement are not offset the effect of the arrangement on an entity's exposure to credit risk is disclosed in accordance with paragraph 39 of IFRS X". As stated in our 14 October 2002 letter on the IAS32 Exposure Draft, we do not believe the gross presentation of these balances provides meaningful information to users as it is de-linked from the credit exposure. We would request that IG13 be amended to make it consistent with the approach suggested.

- We believe that basing the definition of "past due" on contractual due date makes it impractical to produce an age analysis of any assets past due but not impaired, as it would require the inclusion of any late payment, regardless of how it occurred. For example, an amount may appear to be outstanding because of operational delays in allocating cash received. We propose that companies should be permitted to define their own policy in respect of when assets are past due, which would include policies for when the assets are considered for impairment. For practical reasons this would probably be different to the contractual due date and would depend on the type of asset. A past due policy for trading assets such as foreign exchange contracts would, for example, be different from the policy for lending assets such as mortgage loans.

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?

As stated in our general points on page 2 of this letter, we do not believe it is appropriate to include the sensitivity analysis within the audited financial statements. We support the Board's attempt to align these disclosures more closely with the way the business is managed, but believe these disclosures fit better in the unaudited sections of the annual report. More specifically:

- One concern is that these disclosures require significant levels of judgement and estimation, and that the information could therefore be difficult to audit. For example the disclosure required by paragraph 36 will require judgement by the preparers to assess whether the risk disclosures at the year end were representative of the risk throughout the period, and these judgments would need to be audited. IFRS preparers could in consequence be at a competitive disadvantage as against preparers who include this information only within their unaudited financial statements, such as US GAAP preparers who would include the information in the MD&A. We propose that these disclosures should be included within the unaudited sections of the annual report.

- The inclusion of market risk data in the audited financial statements could be misleading, as it represents a market risk view of the world rather than an accounting view. We are concerned that by disclosing a range of fair values this could be seen to undermine the fair value disclosed on the balance sheet and the changes in fair value taken through P&L or reserves. We propose that the existing disclosures on fair value should be sufficient for the audited financial statements, and that this type of sensitivity analysis should also be disclosed in the unaudited sections of the annual report.

We are not clear what level of aggregation or detail would be considered adequate to meet the minimum disclosure requirements, and are concerned that the necessary detail may result in voluminous disclosures. As with the credit risk disclosures, we suggest that a more qualitative assessment of how market risk is managed within the business would be more appropriate in most cases.

Finally, we believe it is inappropriate to require this level of disclosure for all entities within a group. This volume of detailed information is much less relevant for wholly or substantially owned subsidiaries, particularly where they have no listed securities and where this information is already provided as a part of the parent entity's consolidated financial statements. It may furthermore prove practically difficult to produce this information at the intermediate levels where the risks are managed by the business on a group basis.

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?

Our general remarks on page 2 of this letter make it clear that we do not support this proposal: we do not consider that the financial statements should be used to ensure that companies comply with external regulatory capital requirements. We suggest that this proposal be removed.

The relevance of these disclosures to this Exposure Draft is in any case unclear. An entity's own capital is not a financial instrument and for non financial institutions the capital of the entity will in the main be supporting non financial assets and liabilities. Furthermore, regulated entities will be far more accustomed to thinking about capital requirements in the manner proposed, while non regulated entities outside the financial institutions will see capital very differently.

The capital disclosures are required to be based on information that is “provided internally to the entity’s key management personnel” and require the disclosure of any breach in management’s capital targets (paragraph 47(e)). Internal capital requirements could be very disparate across different companies, and their different roles within the overall control structure may result in some companies setting themselves significantly more challenging internal targets than others. We have concerns that the requirement for breaches to be disclosed may lead to lower or less detailed limits being set internally to ensure that these are not breached, and that this may also lead to lack of comparability across financial statements.

A further concern is that some jurisdictions may have legal restrictions on disclosing breaches of external regulatory capital as proposed in the Exposure Draft. Where such disclosures are permitted, moreover, the potential impact on the company could be disproportionately damaging (for example, where there has been a minor breach that has been remedied, to the satisfaction of the regulator, by the time the financial statements are filed), and could put regulated entities at a comparative disadvantage to non regulated. If this requirement is maintained we suggest that such disclosures should be limited to breaches that are publicly disclosed by the entity’s regulator.

Finally we would like further clarification of the level of detail required for paragraph 47(a)(ii), which asks for qualitative information on the nature of external capital requirements. Although we are sure that the Board did not intend for a multinational group to append the rule books for each regulated entity within its group, further guidance would be helpful in this respect.

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?

We suggest the Board amend the wording of the transition rules to permit, rather than to encourage, early adoption. In addition, the Standard would be clearer if the transition rules relating to the exemption from providing prior year comparatives in the first year (if the draft IFRS is adopted before 1 Jan 2006), were moved from the Basis for Conclusions into the Standard itself.

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?

As stated within our general remarks on page 2 of this letter, and in our response to Question 3 above, we do not believe it is appropriate to include all the risk disclosures relating to financial instruments within the audited financial statements.

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 on this question.

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?

Consistent with our opening comments, we propose that much of the detailed requirements in the draft Standard should be moved to the Implementation Guidance as examples of possible disclosures, and that clearer objectives and principles for the disclosures be included within each section of the Standard. We also believe the Implementation Guidance provided within the Exposure Draft is not sufficient to provide additional clarity on application of the draft Standard, and would strongly recommend that additional illustrative examples should be provided for both financial and non financial institutions.

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. That Exposure Draft proposes disclosure of information about the use of fair value in measuring assets and liabilities as follows:*

(a) For assets and liabilities that are remeasured at fair value on a recurring (or ongoing) basis during the period (for example, trading securities)

(i) the fair value amounts at the end of the period, in total and as a percentage of total assets and liabilities,

(ii) how those fair value amounts were determined (whether based on quoted prices in active markets or on the results of other valuation techniques, indicating the extent to which market inputs were used), and

(iii) the effect of the remeasurements on earnings for the period (unrealised gains or losses) relating to those assets and liabilities still held at the reporting date.

(b) For assets and liabilities that are remeasured at fair value on a non-recurring (or periodic) basis during the period (for example, impaired assets), a description of

(i) the reason for remeasurements,

(ii) the fair value amounts,

(iii) how those fair value amounts were determined (whether based on quoted prices in active markets or on the results of other valuation techniques, indicating the extent to which market inputs were used), and

(iv) *the effect of the remeasurements on earnings for the period relating to those assets and liabilities still held at the reporting date.*

Disclosures similar to (a)(ii) above are proposed in paragraph 31 of the draft IFRS (and are currently required by paragraph 92 of IAS 32) and disclosures similar to (a)(iii) are proposed in paragraph 21(a).

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?

Although we support convergence with US GAAP, we believe there are too many existing differences between IAS/IFRS and US GAAP on the accounting for financial instruments at fair value for identical disclosures to be appropriate at this stage. We therefore encourage the IASB to work with the FASB on harmonising financial instrument disclosures in the future.

Question 10 – Other comments

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

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Paragraphs 11 and 12

Paragraph 11 appears to require companies to determine the impact on their P&L of fair value movements relating to their own credit. The approach prescribed in paragraph 12 will however not always result in this being the impact disclosed. Many financial liabilities will have unrelated factors, other than benchmark interest rates, that impact their fair value, including embedded derivatives (whether or not clearly or closely related). As a result of these factors the balance disclosed would not allow the users of the accounts to determine the impact of own credit changes that is included in P&L. In line with our comments above, we suggest the draft Standard be revised to include an objective for each section and that the more prescriptive detail be moved to the Implementation Guidance.

It is not clear what would be disclosed under paragraph 11(b) in respect of the amount to be paid at maturity. Again this may make more sense for a simple financial liability such as fixed rate debt, however for structured debt (linked to equity, for example) the maturity payment would depend on the performance of equity prices over the period, which could not be predicted with any certainty.

Paragraphs 19 and 20

We would encourage the Board to provide more guidance on what is intended to be disclosed relating to defaults, as we are concerned that disclosure of information sensitive to the company could be misleading if misinterpreted by the users of the Financial Statements. Consistent with our comments on the capital disclosures, we would encourage the Board only to require disclosure where the information has already been disclosed publicly.

Paragraph 31

We believe the fair value disclosures within this paragraph need revising, as they are not consistent with the existing fair value hierarchy in IAS39 (revised): paragraph 31(d), for example, refers to fair values determined in "active markets or estimated using a valuation technique", whereas the revised IAS39 hierarchy recognises a distinction between active and non active markets. We would be delighted to assist the IASB in redrafting these requirements if that would be helpful.

Paragraph 37

This paragraph would appear to imply that a company would use risk management methodologies that did not produce the most relevant and reliable information on risk exposures. Companies should be expected to, and do, use the technique that is most appropriate to the risk inherent in the financial instrument. We therefore believe this paragraph, if required at all, should be within the Implementation Guidance rather than the Standard.

"Key management personnel"

The term "key management personnel" is used at several places in the Exposure Draft, but there is no further explanation of what is envisioned. We note that IAS24 includes a definition of this term which we believe is too broad to be the key personnel within an organisation who have responsibility for managing risks across that organisation. We would however encourage the Board to retain sufficient flexibility within any definition to ensure that it can be applied across most complex group structures. We also recommend that a different term be used to that in IAS24, so that there is a clear distinction between the two Standards.

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I hope that the comments in this letter are helpful. We would of course be very pleased to expand on any particular points which you may find unclear, or where you would like further details of our views.

Yours sincerely

Ian Harrison

Director

LONDON INVESTMENT BANKING ASSOCIATION

LIST OF MEMBERS

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Arbuthnot Securities Limited
BNP Paribas
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Barclays Capital
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Brewin Dolphin Securities
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22 October 2004