

**David Schraa**  
*Director, Regulatory Affairs*



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**Re: File reference No. 1810-100 Accounting for Financial Instruments  
and Revisions to the Accounting for Derivative Instruments and  
Hedging Activities**

Dear Mr. Golden:

The Institute of International Finance Senior Accounting Group appreciates the opportunity to comment on the Proposed Accounting Standards Update (ASU) on accounting for financial instruments. Accounting for financial instruments is a critical issue for the Institute's members and has major implications for financial institutions, regulators and the capital markets as a whole. The comprehensive set of changes set out in the proposed ASU could significantly change the banking industry. Hence, we believe that sufficient consideration is needed to prevent any detrimental long-term effects on capital markets.

Noting the significance of the proposed ASU and the range of topics it addresses (i.e., all aspects from scope, classification and measurement, impairment and provisioning to hedge accounting), we are concerned that the proposed comment period is insufficient for interested parties to develop detailed views on the areas addressed. We further note that the comment period is cut short by one month for parties who would like to participate in the FASB's October roundtable discussions.

As we would appreciate the opportunity to include the Institute's views at the October roundtables, we are submitting this letter as an initial response. We may submit further addenda to this initial response as discussions on the various topic areas advance between September 1 and the September 30 comment deadline; however, the major points developed here should be sufficient for round-table purposes. In addition, noting that IIF members are individually better placed to address specific questions posed in the proposed ASU, we focus on broad issues and overall concerns in this comment letter.

*Overall views*

The Senior Accounting Group welcomes the FASB's efforts to address issues relating to the accounting for financial instruments comprehensively and expeditiously. However, we do not believe that the proposed ASU responds to the G20's call for convergence in accounting standards. As emphasized in our previous submissions and meetings with the standard setters, we continue to believe that convergence should be a top priority. Convergence towards a set of high-quality accounting standards on the basis of clear principles would result in a significant improvement in global financial reporting. Failure to achieve such convergence would be a major setback for robust international financial markets and the financial stability goals of the G20 and FSB.

The proposed ASU does not respond to the Financial Stability Board's (FSB) expressed preference not to expand the use of fair value for lending activities; while of course the independence of the standard-setters' process is essential, nonetheless the strongly held views of the FSB must certainly be taken into account in order to achieve the ultimate goals of convergence on a single set of high-quality standards. The FSB's approach is in line with our expressed support for a balanced mixed-measurement attribute accounting model. Moreover, we believe the approaches suggested in this letter would provide a means of meeting the FSB's concerns in ways consistent with the traditional goals of accounting.

Moreover, considered in its entirety, we do not believe that the proposed ASU significantly improves financial reporting or achieves the FASB's stated objective "to provide financial statement users with a more timely and representative depiction of an entity's involvement in financial instruments while reducing the complexity in accounting for those instruments." On the contrary, some of the specific proposals would result in a misrepresentation of an entity's involvement in financial instruments as the proposals do not adequately consider the context in which financial instruments are used or the importance of the entity's business model.

In addition, many of the specific proposals would increase complexity in accounting for financial instruments. It should not be assumed that expansion of fair value accounting reduces complexity or subjectivity in financial reporting. Furthermore, it should not be assumed that all users of financial statements prefer the statement of financial position, reported equity and comprehensive income to be based on fair value. As acknowledged by dissenting FASB members and recent studies, views among users suggest otherwise.

We note the widely expressed concerns that the expansion of fair value accounting to traditional lending businesses could have severe unforeseen consequences including the dampening of origination of long-term loans, thereby impeding economic recovery, restricting the availability of credit, and increasing procyclicality in the financial system without, in fact, generating any countervailing benefits to investors or other users of financial statements.

Moreover, the ASU proposes some fair value changes to be recognized in other comprehensive income (OCI). We are concerned about the increased volatility in OCI and the resulting implications for regulatory capital. In addition, there would be an overall increase in volatility in net income with the increased use of fair value.

Furthermore, as noted on other occasions, we are concerned about the expansion of the use of OCI before a comprehensive theory of OCI is available, and without a good grounding in understanding the usefulness of OCI to users.

The remainder of this letter details our concerns on specific topics addressed in the proposals.

### *Classification and measurement*

As highlighted in the IIF Senior Accounting Group's response to the IASB exposure draft Financial Instruments: Classification and Measurement (attached), an appropriately balanced mixed-measurement attribute accounting model is the most appropriate classification and measurement scheme for financial instruments.

While fair value measurement has clear benefits to both preparers and users of financial statements for appropriate types of financial assets and liabilities, it does not always provide the most faithful representation of the reporting entity's operations and expectations of cash flows. For example, fair value accounting for debt instruments that are held for collection of contractual cash flows and non-trading liabilities of the entity itself would not reflect the expected realization of cash flows relating from those items and hence would not be the most relevant way to measure those items on statements of financial position and comprehensive income.

As a basic principle, the reporting entity's business model must be fully reflected in the classification and measurement attributes.

To provide users of financial statements with a clear understanding of the reporting entity's business, including potential risks and access to future cash flows, the economic substance of transactions in the context of separate business lines should clearly be reflected in the classification and measurement criteria. The entity's business model should be the primary driver for classification and measurement; variability and uncertainty of cash flows as well as other characteristics of the financial instrument should be assessed in order to determine whether or not the entity has the ability to manage a financial instrument in a particular manner.

The principle of consistency between the reporting entity's business model and the accounting outcome should be maintained so that the accounting for financial instruments reflects the businesses in which they are held. We firmly believe that an amortized cost classification provides the most appropriate mechanism to reflect this view with regard to traditional banking businesses. Although the ASU proposals consider an entity's business model in classification decisions, it is only considered in determining whether an instrument is measured at fair value through net income or fair value through OCI: this will result in confusion and less-than-representative reporting. As mentioned, a balanced mixed-measurement attribute model with amortized cost classification is needed to reflect the reporting entity's operations and expectation of cash flows.

In order to maintain consistency between the business model and the accounting, it is also imperative that the reclassification of financial instruments between measurement

categories be required, subject to appropriate controls and disclosure, should the business model change. The accounting will cease to reflect the economics of the instruments if reclassification is not required upon a change in business model.

Given our views above, we do not support the ASU's proposed classification and measurement approach. The proposals would not accurately reflect an entity's business models for various financial instruments.

We further note that under the ASU proposals, the income statement would reflect in some respects a mixed-measurement attribute approach while the statement of financial position would reflect a full fair value approach. This would be inconsistent with how an entity manages its business and needlessly add complexity to financial reporting as the income statement and statement of financial position would no longer share a mixed-measurement format. In our view, a consistent, mixed-measurement attribute approach should apply to all parts of the financial statements to ensure that the entity's business model is reflected consistently in all parts of its financial statements.

Moreover, we note the proposed ASU proposals would result in effectively six different classification and measurement categories for financial instruments. The introduction of new classification categories and measurement attributes does not reduce complexity in accounting for financial instruments.

With regard to classification and measurement, we encourage the FASB to review the approach adopted in IFRS 9 Financial Instruments. We believe that the two-category, amortized cost and fair value through profit or loss, approach proposed by the IASB vastly improves and simplifies current accounting while accurately reflecting the business models in which financial instruments are held. We urge the boards to work together on further developing and refining the classification and measurement principles in IFRS 9 to arrive at a converged approach to classification and measurement. This is of utmost importance as classification and measurement will subsequently drive decisions on impairment and hedge accounting. Failure to achieve convergence on these matters will effectively derail broader convergence due to the significant scope of these issues.

#### *Presentation of fair value information*

The ASU acknowledges that both fair value and amortized cost could provide useful information and proposes that both be provided on the face of the financial statements with reconciliation between these amounts for financial instruments measured at fair value with qualifying changes in fair value recognized in OCI. We do not support presentation of the same financial instrument under two different measurement attributes on the face of the financial statements. A measurement attribute should be consistent throughout the financial statements with regard to an individual financial instrument. That measurement attribute should be driven by the entity's business model.

The proposed presentation approach for the income statement and statement of financial information is confusing and results in the presentation of information that does not enhance the understandability for users. For example, for financial instruments held for collection or payment of contractual cash flows, amortized cost is the measurement attribute

that best represents how cash flows relating to such instruments are realized under the entity's business model. Fair value measurement for such instruments is not relevant as it is predicated on an exit value and necessarily implies that the entity does not intend to hold the instrument for collection and payment. Additionally, it recognizes changes in market value that will most often not be realized, and the effects of which may not be easy for users to identify and isolate for the purposes of analysis. Presentation of both relevant and irrelevant measurement attributes in the primary statements is confusing as it suggests alternative business models for financial instruments where there is not one.

Moreover, fair value measurement for debt instruments would certainly introduce increased subjectivity in the primary financial statements. Many debt instruments are not quoted in the market and their fair values are derived from non-observable inputs and subjective valuation methodologies.

In addition, we must object to the incremental operational challenges that would result from accounting for transactions at both amortized cost and fair value on an ongoing basis. This would require dual accounting for each transaction.

The ASU's proposed presentation approach would also require a significant level of detail on the face of the primary statements. Overly detailed primary statements will lead to information overload and detract from their usefulness. Such secondary information should be reserved for the notes to the financial statements. Disclosure of fair value information in the notes is more effective as it appropriately reflects the fact that such information is of interest only for purposes of comparison and analysis where it relates to non-trading and non-derivative financial instruments, and should not be taken as an operative valuation for most purposes. It also affords more space for the explanation of the information, particularly when fair values are derived from non-observable inputs and subjective valuation methodologies.

Presenting the most relevant measurement attribute (i.e., either amortized cost or fair value) that reflects the relevant business model on the primary statements and disclosing supplementary information in the notes would best ensure the clarity and understandability of information presented. Moreover, we note that the FASB has active projects on financial statement presentation and the disclosure framework. One of the objectives of the disclosure framework project is to seek better ways to integrate information provided in financial statements, MD&A, and other parts of a company's public reporting package. The proposed ASU should not preempt a more comprehensive discussion on the boundaries and purpose of the primary statements.

Under the ASU proposals, some fair value changes are presented in OCI. Prior to expanding the use of OCI, the FASB and the IASB should jointly develop a robust and consistent framework for the objectives and usage of OCI. It would be far more effective and conducive to the development of high-quality accounting standards for the boards to address the issues of OCI and recycling comprehensively and ensure that any guidance has a conceptual basis that is linked to the Framework. We are concerned about the increased use of OCI before a thorough discussion on the status of OCI within the financial reporting framework occurs. Furthermore, the ASU proposals would result in increased equity volatility that may be misleading to users and affect regulatory capital requirements.

On the whole, we understand that the basis for the FASB's decision to propose expansion of use of the fair value approach stems from the assertion that fair value information is useful to many users of financial statements. However, we believe there is a difference between recognition that such information may be useful in appropriate contexts and preferring that the statement of financial position, reported equity and comprehensive income be based on expanded fair value. It is far from clear that the majority of financial statement users prefer fair value over amortized cost in the statement of financial position for traditional banking products. A recent survey indicates the opposite, see footnote 1, as does the experience of members in dealing with their own investors.

Many groups, including the Corporate Reporting User Forum (CRUF), the US regulatory agencies, the European Financial Reporting Advisory Group (EFRAG) and the IASB, are seeking the views of users of financial statements, in order to understand their perspectives on the ASU proposals and how to enhance the quality of financial reporting. We believe that it is essential that the FASB take into consideration feedback from a wide and representative cross-section of users from such outreach efforts in addition to the FASB's and IASB's own outreach activities.

The FASB's decision to propose requiring fair-value information on the face of the primary statements, as opposed to the notes, is partly driven by the fact that notes are in some cases only available after the earnings statements and hence fair value information in the notes may not be timely. In our view, there is no sound conceptual justification for requiring fair value information in the primary statements to enhance its timeliness. If timeliness is an issue, it should be addressed as such, and not by substantially increasing the complexity of financial statements. Several members release disclosures in conjunction with their primary financial statements. It would be more appropriate for the FASB to consider jointly with the IASB, as part of the convergence process, the appropriate timing of disclosures to provide more meaningful information to users.

#### *Treatment of financial liabilities*

We are concerned about the treatment of liabilities under the ASU proposals. Under the proposals, deposits are distinguished between "core" and "non-core", and core deposits would be measured at the present value of the average core deposit balances discounted over the average estimated life at a rate equal to the difference between the cost of the next alternative available source of funding and the cost of providing services to the deposit holders.

Such an approach introduces a new measurement attribute that is conceptually questionable. The measure is purely hypothetical and not representative of the actual benefit attributable to the lower cost of funding provided by a core deposit base. More importantly, this measurement does not reflect how management views core demand deposits for internal reporting purposes, nor does it reflect the views of bank supervisors in analyzing the liquidity of banks' funding. Such an artificial remeasurement approach introduces unnecessary complexity. We further note that such a remeasurement approach would significantly rely on non-observable inputs and introduce additional subjectivity.

We are also concerned about the treatment of own-credit risk under the ASU proposals. As highlighted in our response to the IASB's exposure draft *The Fair Value Option for Financial Liabilities* (attached), we support exclusion of changes in own-credit risk on fair valued non-trading liabilities from net income. We believe the inclusion of such fair-value gains or losses is misleading and counterintuitive to users as those changes are unlikely to be fully realized and do not reflect the operating performance of the entity in the absence of extinguishment. Further, users have indicated their objection to recording own credit gains and losses in net income prior to extinguishment in comments and public feedback. We would generally support including these changes in OCI and reclassifying the amounts to net income when they are realized. In other words, recycling should not be prohibited (until further discussions on OCI take place). Separate presentation of significant changes in own-credit risk on the face of the statement of comprehensive income does not adequately address the issue of own-credit. The issue of own-credit is a significant one that we believe should be addressed expeditiously but separately.

Additionally, we are concerned that the proposed own credit approach of the ASU, excluding broader market changes, unnecessarily complicates the calculation of own credit changes. Unless the issuer realizes those changes, we do not believe the inclusion in net income is appropriate.

The proposed ASU permits the measurement of liabilities at amortized cost if (a) the liability is linked to an asset not measured at fair value, or (b) the liability is part of a segment or consolidated entity for which less than 50 percent of the segment's or entity's recognized assets are subsequently measured at fair value. Direct linkages between financial assets and financial liabilities at financial institutions are often difficult to identify as capital is often reallocated from one area or investment to another. Additionally, due to the expansion of fair value accounting under the proposed ASU, it is unlikely that any large financial institution with a large capital market practice will be able to meet either the segment or consolidated entity recognized asset criteria. This effectively precludes most large financial institutions from being able to carry any financial liabilities at amortized cost.

#### *Impairment and provisioning*

The IIF has a long-standing view that provisions should be forward looking. We have advocated this view since well before the crisis began. We generally support an expected-loss approach to impairment and provisioning. An impairment approach that incorporates expected credit loss information allows for more timely recognition of losses and allows users of financial statements better to assess management's view of expected losses.

We attach in Appendix A principles and criteria we submitted to the IASB on its exposure draft, *Amortized Cost and Impairment*. These principles and criteria are equally applicable to development of both international standards and US GAAP. We hope that a set of global industry views can form a basis for convergence between the standard-setters. Second, we think such principles and criteria can be used to assess the alternative models that have recently been developed by various groups including the IASB and FASB's Expert Advisory Panel (EAP). Given the complexity and differing interpretations of alternative approaches, we believe the principles and criteria can be used as a tool to build consensus

and clarify areas of contention. Any reasonable alternative should be consistent with these principles and criteria. Third, we note that so far the main focus of the EAP has been the operability of the IASB's model. We believe that principles and criteria could help highlight and address more conceptual issues. Thus, the FASB should align its proposals on impairment and provisioning with these principles and criteria and use them in advancing discussions with the IASB on the convergence of impairment and provisioning requirements.

With reference to the specific proposals on impairment and provisioning set out in the ASU, we are particularly concerned with the inability to take into consideration expectations about future economic events in determining the adequacy of the provision. In our view, the ability to form expectations should not be unduly restrictive but should allow for the incorporation of a broad range of credit information. We would support inclusion of reasonable and supportable risk information about economic conditions in determining expected credit losses to ensure expected losses reflect a broad range of forward-looking information. Such an approach would result in more timely and relevant reporting of expected credit losses that is decision-useful information.

Moreover, banks have invested heavily in such risk analysis for regulatory capital purposes and, while expected loss for regulatory purposes may not be the same as for impairment analysis, the rich methodological and data improvements made in that field should not be overlooked. We strongly support alignment of regulatory initiatives with accounting initiatives to the extent possible, in order to avoid unnecessary duplication of systems requirements, to maintain consistency with management's view of the business, and to minimize scope for a lack of clarity over the relationship between accounting and regulatory measurements, especially for such matters as impairment. However, we understand that prudential and financial reporting objectives may differ.

In addition, we are concerned with potential day-one losses on initial recognition under the ASU proposals. The proposals require an entity to recognize credit impairment immediately in profit or loss when the entity does not expect to collect all contractual amounts for originated financial assets and all amounts originally expected to be collected for purchased assets. This suggests the possibility of day-one (or day-two) losses when granting a loan. We do not believe it is reasonable for an entity to be required to recognize a loss when it originates or purchases a financial asset. While expected losses are implicit in any portfolio, the ASU proposals would suggest immediate recognition of such losses on recognition of the portfolio. This does not reflect the timing of the losses, the economics of a portfolio, or how the entity manages its lending activities. We believe users of financial statements might find automatically reporting losses on day one confusing and misleading, which would dilute the otherwise substantial value of a more forward-looking impairment model. We further note that mandatory recognition of day-one losses would make it difficult to start new lending businesses. This might be particularly problematic for emerging markets. Of course there may be specific situations where management would conclude that recognition of losses as of day one is in fact appropriate.

Given our concerns above, we do not support the ASU proposals for impairment and provisioning. We also do not support the IASB's current proposal as it does not achieve the goal of reducing complexity or contribute to reducing procyclicality. As noted elsewhere



in this letter, that convergence is highly important, particularly in regard to impairment and provisioning. As such, we urge the boards to continue to work on developing an expected loss concept to achieve a workable approach to more forward-looking impairment and provisioning.

We note that at present the IASB is moving ahead with its redeliberations yet the FASB is still to consider comments on this proposed ASU. We strongly urge the boards to align their timing in discussing any revised impairment and provisioning proposals. We previously expressed concerns about the lack of coordination between the boards in issuing the current proposals in writing. We are extremely concerned that the continued lack of coordination will result in diverged final requirements. Divergence in this very important area would greatly undermine the boards' stated convergence efforts.

### *Hedge accounting*

As a principle, the accounting should reflect the economic substance of a transaction. That is, hedge accounting should reflect how an entity manages its risks. In 2006, the IIF Senior Accounting Group developed several high-level principles on hedge accounting that were presented to the IASB. These principles provide our long-standing thoughts on hedge accounting and are set out in Appendix B. While developed in the IFRS context, the principles are generally applicable and analytically relevant. Hedge accounting that reflects how an entity manages its risks provides more relevant financial information to users of financial statements. Moreover, it is important that the standards not discourage companies that manage risks from applying hedge accounting. It is important that entities that hedge economically not be deterred from applying hedge accounting solely because of the restrictive and uneconomic nature of the current (or future) accounting requirements.

With regard to effectiveness testing, we support the replacement of the "highly effective" criteria (the so-called 80-125% test) with a "reasonably effective" criterion. Moreover, we are generally supportive of the proposed elimination of the short-cut and critical-terms match methods. These methods that assume perfect effectiveness are unreliable, have led to unnecessary restatements of financial statements in the past, and are not permitted under IAS 39. Replacement of the current quantitative effectiveness testing requirements with a qualitative assessment and a reasonably effective threshold would alleviate some of the long-standing problems in this area. However, we note that the ASU proposals would result in the recognition of ineffectiveness arising from cumulative changes in fair value from the hedge item being either higher or lower than cumulative changes in fair value from the hedging instrument for fair value and cash flow hedges. Although this might be a simplification to cash flow hedge accounting mechanics (through the elimination of the "lower-of" test), we do not think this treatment is appropriate. In order to avoid recognition of gains and losses on transactions that do not yet exist, e.g. highly probable forecast transactions, ineffectiveness in underhedging situations should not be recognized.

In addition, we are concerned with the ASU's proposal to restrict dedesignation of hedge accounting. If hedge accounting is to reflect how an entity manages its risks, the possibility for an entity to revoke the designation should be available if the entity changes its risk management strategy.

Although interest rate risk continues to be an eligible hedged risk under the ASU proposals, the definition of benchmark interest rate as set out in Topic 815 is very narrow and applied prescriptively. We would support expanding the definition of benchmark interest rate beyond the interest rate on direct US Treasury obligations and the LIBOR swap rate to include other rates.

We note that the IASB's proposals on hedge accounting are expected in the fourth quarter of 2010. We encourage the FASB to consider the IASB's proposals when they become available. We further note that one key difference between IAS 39 and the proposed ASU is the scope of hedge accounting. IAS 39 allows for portfolio hedge accounting in some circumstances, as is entirely appropriate and consistent with the business view of portfolios.

#### *Scope*

We do not support the change to the criteria for the use of the equity method of accounting for investments in associates. We do not believe that the accounting for investments in associates should be addressed within the scope of an ASU that addresses the accounting for financial instruments.

#### *Convergence*

As highlighted in our overall views, we believe that convergence of accounting standards is a top priority. We are concerned about the current and proposed divergence between the FASB and the IASB in the area of accounting for financial instruments. In our view, convergence toward a single set of high-quality financial reporting standards is an improvement on current GAAP.

As expressed in previous submissions and letters to the standard-setters, convergence should remain a top priority. We further recall the level-playing field debates that initiated many of the current discussions in early 2009. The Board of Directors of the IIF has recently reiterated that achievement of converged accounting standards is essential to future financial stability. We again recall the views expressed by the G20 leaders in their call on the accounting standard-setters to work urgently to improve standards on valuation and provisioning and achieve a single set of high-quality global accounting standards.

Although it is not uncommon for the boards to deliberate separately on joint projects and then subsequently reconcile any difference in their technical decisions, it is increasingly unclear how these differences can be reconciled within the proposed convergence timetable given the divergences between the boards in timing and approach. We would expect a joint set of proposals on accounting for financial instruments for public comment when the boards reconcile their differences on scope, classification and measurement, impairment and hedge accounting.

The IIF Senior Accounting Group appreciates the opportunity to comment on this crucial topic. We look forward to participation at the FASB's roundtables on accounting for financial instruments in October. Should you have any questions about this letter or the

views expressed, please contact the undersigned (dschraa@iif.com +1 202 857 3312) or Carol Wong (cwong@iif.com +1 202 857 3633).

Very truly yours,

A handwritten signature in black ink, appearing to read "David Schraa", followed by a long horizontal flourish.

Cc: David Tweedie, Chairman, International Accounting Standards Board.

Attachments

## Appendix A

This Appendix sets out the IIF Senior Accounting Group's working principles and criteria on impairment and provisioning. It addresses both general and some specific areas.

### *General*

- Provisions should be forward-looking. Forward-looking provisions need to capture expected losses.
- Incorporation of expected losses provides more valuable information to users.
- Provisions should reflect management's view of expected losses. They should reflect internal risk management practices.
- Provisioning should be consistent with the way entities manage their lending, securities, and other businesses; in particular, it is necessary for certain entities, notably banks, to manage provisions for most exposures on an open-portfolio basis.
- Provisions, based on impairment in portfolios, should reflect reasonably determinable changes in expected losses, plus actual charges on impaired loans as they emerge.
- Provisions must be usable in fact; i.e., it must be possible for entities to draw them down as impaired loans are identified and written off, without penalizing accounting or prudential treatment where the provisioning requirements have been complied with.
- Impairment approaches should contribute to reduced procyclicality insofar as earlier recognition of losses will reduce or avoid the volatility implied by a narrow interpretation of incurred loss. However, provisions should be determined by the appropriate measurement of expected losses and not be designed to act as macroprudential buffers.
- Any impairment approach proposed by the standard-setters should be a converged approach. A difference in classification and measurement approaches does not justify different approaches to impairment and provisioning, not least because the FASB's proposals require amortised cost to be presented.
- Any impairment approach should be applicable to a wide-range of financial assets including mortgages, corporate and government bonds in addition to originated loans.

### *Approach*

- The "too little and too late" objections of some in the official sector to incurred loss are unlikely to be addressed simply with improvements to the incurred loss approach. However, a final regime might well incorporate elements of incurred loss as well as expected loss.
- The impairment approach should focus on expected losses instead of expected cash flows as this is (i) operationally more efficient (i.e., would not require constant recasting of cash flows) and (ii) is in line with how credit risk is managed.
- An impairment approach should be applicable to both fixed and variable rate instruments without undue complexity.
- Initial expected losses should be addressed on a best-estimate basis taking the characteristics of the portfolio into consideration.

- The provision account should never be negative: any losses in excess should directly affect profit or loss for that period.
- Reassessment of expected losses should be required at every reporting date.
- Clear distinctions between incurred losses and expected losses are needed. This would preserve the alignment with current management practices and financial statement user needs.

#### *Portfolios*

- Consistently with the general principle stated above, any impairment approach must be applicable to portfolios including open portfolios, as entities, especially banks, manage their businesses on the basis thereof.
- Portfolios for accounting purposes should in principle be similar to portfolios used for internal risk management purposes i.e., determined using a management based approach. This is often the same basis as portfolios for regulatory capital purposes; supervisory oversight is applied to such portfolios. As the recent G20 and FSB statements point out, internal risk management procedures are essential to and closely supervised under, the prudential regulatory process. Some additional criteria could be considered in defining portfolios but a prescriptive approach should not be adopted.

#### *Interest revenue recognition*

- Interest revenue should continue to be recognized on the basis of the effective interest rate (EIR). On initial recognition the EIR should not factor in expected credit losses. The IAS 39 concept of EIR should be retained.
- There should not be a link between interest revenue recognition and allocation of expected losses. Decoupling is acceptable and necessary not only as a practical approach but to help distinguish between contractual factors reflected in the EIR and estimated expected losses reflected in credit expenses which are of different nature. The EIR should exclude expected losses.
- Decoupling meets the needs of many users who prefer to distinguish contractual interest for revenue recognition purposes and the allocation of expected losses. Moreover, decoupling helps to reflect that management do not manage interest risk and credit risk together.
- A simple EIR approach linked to contractual interest rates avoids complexities associated with variable rate instruments and should be retained.

#### *Forming expected loss estimates*

- The method used in forming estimates should not be overly prescriptive as banks use different methodologies grounded on historical experience in determining expected losses. The method used should be documented, verifiable and consistent with internal risk management processes for managing credit risk.
- As a fundamental principle for forming expectations, expected loss should be the best estimate of the most likely outcome.
- Both quantitative and qualitative factors should be taken into consideration in forming estimates; there should be linkage between observed changes and loss expectations.

- A good expected loss estimate should incorporate a broad range of credit information.
- There should be consistent treatment of initial loss estimates and subsequent changes in loss estimates.

*Transition*

- Restatement of comparatives should not be required as the use of hindsight in determining expected loss information has little value to users of financial information.
- Transition should be considered after an operational model is developed.

*Disclosures*

- There should be reassessment and alignment of the disclosure requirements proposed and of IFRS 7 or other required disclosures. Excessive and duplicative disclosures should be avoided. Such duplications are confusing to users.
- Disclosures that distinguish between expected and incurred losses and a reconciliation of the impairment allowance account are useful.
- Income statement disclosures such as reconciliations showing interest revenue based on contractual cash flows and adjustments for expected and incurred losses arriving at an interest revenue after credit loss figure may be useful.
- Segment information e.g., expected losses by business segment is useful and should be disclosed as a minimum requirement.
- Information comparing expected and incurred losses over time is useful.

## Appendix B

### Principle 1 – Hedge Designation

A hedging relationship qualifies for hedge accounting if it satisfies all of the following criteria:

- a) The hedged item and the hedging instrument share a risk (the designated risk) that gives rise to opposite changes in fair value that tend to offset each other.
- b) The designated risk is managed separately on a fair value basis in accordance with a documented risk management strategy.
- c) The fair value of the hedged item that is attributable to the designated risk and the fair value of the hedging instrument can be reliably measured.
- d) It eliminates or significantly reduces a measurement inconsistency (sometimes referred to as "an accounting mismatch").

### Principle 2 – Ineffectiveness Recognized in the P&L

All ineffectiveness should be recognized in profit or loss when it is incurred:

- a) The gain or loss from remeasuring the hedging instrument at fair value (for a derivative hedging instrument) or the foreign currency component of its carrying amount measured in accordance with IAS 21 (for a non-derivative hedging instrument) shall be recognized in profit or loss; and (refer to paragraph 89(a) of IAS 39)
- b) The gain or loss on the hedged item attributable to the designated risk shall adjust the carrying amount of the hedged item and be recognized in profit or loss. This applies if the hedged item is otherwise measured at cost. Recognition of the gain or loss attributable to the hedged risk in profit or loss also applies if the hedged item is an available-for-sale financial asset. (Refer to paragraph 89(b) of IAS 39.)
- c) Consequently, any ineffectiveness is recognized in profit or loss when it is incurred.

### Principle 3 – De-designation

De-designation of hedge accounting applies if:

- a) The hedging instrument expires or is sold, terminated or exercised (without being rolled over or replaced);
- b) The hedged item is sold, terminated or settled; or

- c) The entity revokes the designation.

#### Principle 4 – Disclosure

The required disclosures should include:

- a) A description of the documented risk management strategy, the specific hedging strategy and the expected effectiveness.
- b) Current period and cumulative changes in the fair value of (a) hedged items that is attributable to designated risks and (b) hedging instruments.
- c) If any hedging relationships are de-designated during the period, the carrying amount of the cumulative adjustment related to the hedged item that will be recognized in future periods.



**David Schraa**  
*Director, Regulatory Affairs*



July 16, 2010

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**Re: Exposure Draft: Fair Value Option for Financial Liabilities**

Dear Sir David,

The Institute of International Finance Senior Accounting Group appreciates the opportunity to comment on the Exposure Draft *Fair Value Option for Financial Liabilities* (ED/2010/4) (ED). The issue of measurement of credit risk, and in particular own-credit, has been a controversial topic that received increased attention and scrutiny during the recent financial crisis, particularly in the context of application to financial liabilities measured under the fair value option (FVO). We welcome the IASB's decision to address the financial liabilities portion of the classification and measurement phase of the Replacement of IAS 39 project in response to concerns expressed by respondents on the recognition in profit or loss of the changes in the credit risk of financial liabilities. The Senior Accounting Group had raised similar concerns regarding financial liabilities in its response to the IASB's exposure draft *Financial Instruments: Classification and Measurement* (ED/2009/7) in September 2009.

*Overall views*

The Senior Accounting Group supports the proposed approach to exclude from profit or loss changes in own credit risk on liabilities designated under the fair value option (FVO). We generally support including such changes in other comprehensive income (OCI). This is consistent with views expressed in our response to the IASB's exposure draft on classification and measurement and in our response to the Discussion Paper 2009/2 *Credit Risk in Liability Measurement* (DP). We recognize the complexities of some of the alternative approaches discussed in the ED and possible issues with creating additional types of measurement. Hence, on balance, we think the ED proposals are a reasonable way forward.

In fact, we would greatly support that the proposal be available for voluntary early adoption immediately without simultaneous adoption of other IFRS 9 requirements.<sup>1</sup> We note that own-credit has been a long-standing concern for both users and preparers of

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<sup>1</sup> The IASB could consider making a limited scope amendment to IAS 39 *Financial Instruments: Recognition and Measurement*.

financial statements. The effects of own-credit are counter-intuitive and misleading for users of financial statements. We note that this is an area where immediate change would significantly improve financial reporting.

### *Main concerns*

#### *Convergence*

We appreciate that the IASB is mindful of convergence and has asked its constituents to provide feedback to the FASB on the proposals in the FASB's exposure draft noting that this is a joint project with an objective of increasing international comparability.<sup>2</sup> However, we are extremely concerned with the deepening of divergence between the IASB and the FASB in proposals for reporting for financial instruments. As expressed in previous submissions and letters to the standard-setters, we believe that convergence must remain a top priority not only for the financial instruments project, but for all projects.<sup>3</sup>

We note significant differences in the IASB's and FASB's approaches to classification and measurement of financial instruments. In regard to financial liabilities, there is complete divergence as under the FASB's proposals, no bank will be able to account for any liability at amortised cost (as the criteria are unachievable) and due to the remeasurement approach introduced by the FASB for core deposits. We also note a fundamental difference in the boards' positions on reclassification from profit or loss to OCI i.e. 'recycling'. The FASB requires recycling of amounts in OCI upon sale, settlement, or impairment while the IASB prohibits recycling. Moreover, in regard to the issue of own-credit, unlike the ED proposals, the FASB proposes that changes in-own credit are recognized in profit or loss and separate presentation on the income statement only when the effects are significant.

We are extremely concerned that such differences have led and may lead to subsequent differences in proposals on impairment and hedge accounting. In line with our comments in our response to the IASB's proposals on impairment and provisioning (ED/2009/12), we hope to see a comprehensive joint set of proposals on accounting for financial instruments for public comment when the boards reconcile their differences on classification and measurement, impairment, and hedge accounting. We encourage the boards to continue to work closely together.

#### *Other comprehensive income (OCI)*

As expressed in our response to the DP, if an approach that uses OCI is to be adopted, the IASB ought also develop a robust and consistent framework for the objectives and usage of OCI. We think the discussion of whether or not 'recycling' from OCI to profit or loss should be permitted flows from what OCI is and how or whether it is different from profit or loss. The Senior Accounting Group is concerned with the increased use of OCI in the IASB's recent proposals (eg pensions and some investments in equity instruments) before a thorough discussion on the status of OCI within the financial reporting framework

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<sup>2</sup> Paragraph 17 of the ED.

<sup>3</sup> Please see the IIF SAG's response to the IASB's exposure draft on *Amortised Cost and Impairment* dated June 29, 2010.

occurs. BC27 states that “The proposals prohibit reclassification of gains or losses to profit or loss (on derecognition of the liability or otherwise). That proposal is consistent with the Board’s view that gains or losses on those liabilities should be recognized only once.” We question whether this view represents a principle that will be applied more widely to all OCI items in future. Our view is that this restriction (or rule) appears to be a means to penalize entities that use OCI. We believe it is inappropriate to adopt such blanket restrictions before further discussions and public consultation on the purpose of OCI takes place. We also note interactions with the financial statement presentation project and the IASB’s recent proposal on the presentation of OCI items. The exposure draft *Presentation of Items of Other Comprehensive Income* (ED/2010/5) however fails to address the fundamental issues relating to OCI.<sup>4</sup>

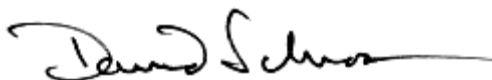
We would encourage the IASB to address the issues of OCI and recycling comprehensively and ensure that decisions made have a conceptual basis that is linked to the Framework. As a general principle, we believe that amounts that are ‘realizable’ and have cash flow effects should be recycled. Such amounts in OCI should be reclassified to profit or loss when the cash flow is realized.

#### *Scope*

There is currently still some uncertainty around which liabilities will be accounted for under IFRS 9 and which would be within the scope of the future IFRS on insurance contracts. This refers mainly to financial guarantee contracts, investment contracts with participation features and the extent to which unbundling would be required. The full impact of the proposals for insurers is difficult to assess. We encourage the IASB to align final proposals with its proposals on insurance contracts.

The Appendix to this letter sets out our responses to specific questions posed in the ED. The IIF appreciates the opportunity to comment on this ED. Should you have any questions about this letter or the views expressed, please contact the undersigned ([dschraa@iif.com](mailto:dschraa@iif.com); +1 202 857 3312) or Carol Wong ([cwong@iif.com](mailto:cwong@iif.com) +1 202 857 3633).

Very truly yours,



Cc: Mr Robert Herz, Chairman, Financial Accounting Standards Board

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<sup>4</sup> Consequently, some IIF Senior Accounting Group members believe that a disclosure alternative could serve as a temporary solution until a more comprehensive discussion on OCI takes place. Under this approach, changes in own-credit would be excluded from profit or loss. However, instead of presenting these changes in OCI, the amounts would be disclosed in the notes to the financial statements. Under this alternative we believe that recycling to profit or loss should be required of amounts realised when the liability is derecognized.

## Appendix

### Question 1

*Do you agree that for all liabilities designated under the fair value option, changes in the credit risk of the liability should not affect profit or loss? If you disagree, why?*

Please see our response to question 2.

### Question 2

*Or alternatively, do you believe that changes in the credit risk of the liability should not affect profit or loss unless such treatment would create a mismatch in profit or loss (in which case, the entire fair value change would be required to be presented in profit or loss)? Why?*

The ED stipulates that changes in credit risk of liabilities designated under the fair value option should be presented in other comprehensive income. Consistent with the definition of credit risk in IFRS 7, we understand that the intention of the proposal is to capture changes in fair value attributable to an entity's own-credit risk and not the 'liability's credit risk'. However, for the avoidance of doubt we suggest that the final standard specifically reference changes in own-credit. As mentioned in our overall views, we believe that changes in own-credit risk should be recognised outside profit or loss. We do not believe that changes in fair value related to credit risk should be taken out of profit or loss where a mismatch arises.

### Question 3

*Do you agree that the portion of the fair value change that is attributable to changes in the credit risk of the liability should be presented in other comprehensive income? If not, why?*

We generally agree that the portion of the fair value change that is attributable to changes in the own-credit risk of the liability should be presented in other comprehensive income.

### Question 4

*Do you agree that the two-step approach provides useful information to users of financial statements? If not, what would you propose instead and why?*

Please see our response to question 5.

### **Question 5**

*Do you believe that the one-step approach is preferable to the two-step approach? If so, why?*

We believe that the one-step approach is superior to the two-step approach from the point of view of transparency for users of financial statements. We note that the one-step approach provides the same information but with fewer line items, and restricts the information in each financial statement to the information that is relevant for that statement. Furthermore, the two-step approach may actually confuse users of the financial statements because it could suggest that the adjustments for movements in credit risk is relevant to measures of an entity's performance. The income statement line showing the total movement in the fair value of liabilities would not necessarily have the opposite sign to the adjustment for the movement attributable to changes in the own-credit risk of the liabilities because the total movement in fair value is affected by other factors in addition to own-credit. Users may wish to see this information in one place, and we believe that disclosure of such information would be more appropriate in the notes rather than on the face of the profit or loss statement, as this would afford more space to provide a clear explanation of the meaning of the different movements.

Moreover, we believe it is premature to require a two-step approach prior to a comprehensive discussion on other comprehensive income. The approach would appear to weaken the questionable argument that recycling should be prohibited because the fair value change has already flown through profit or loss. It is also noted that a two-step approach is not required for equity investments accounted for at fair value through other comprehensive income. However, in line with the treatment for financial liabilities under the fair value option, recycling is prohibited for such equity investments. We believe that a comprehensive discussion of other comprehensive income is needed before the appropriateness of a two-step approach is considered.

### **Question 6**

*Do you believe that the effects of changes in the credit risk of the liability should be presented in equity (rather than in other comprehensive income)? If so, why?*

No, we do not believe that the effects of changes in the credit risk of the liability should be presented in equity. We do not believe that these changes are equity. Moreover, we note that presenting these effects in equity might raise regulatory capital issues.

### Question 7

*Do you agree that gains or losses resulting from changes in a liability's credit risk included in other comprehensive income (or included in equity if you responded 'yes' to Question 6) should not be reclassified to profit or loss? If not, why and in what circumstances should they be reclassified?*

We believe that a fundamental discussion on other comprehensive income is needed before a decision on recycling can be made. (Please see our discussion on *Other Comprehensive Income* in our main letter). As a general principle, we believe that amounts that are 'realizable' and have cash flow effects should be recycled. Such amounts in OCI should be reclassified to profit or loss when the cash flow is realized in a clear arm's length transaction. We do not believe that the IASB has provided a strong basis for prohibiting recycling at this stage.

### Question 8

*For the purposes of the proposals in this exposure draft, do you agree that the guidance in IFRS 7 should be used for determining the amount of the change in fair value that is attributable to changes in a liability's credit risk? If not, what would you propose instead and why?*

Yes, we agree that the guidance in IFRS 7 should be used including the option to use a different method if it provides a more faithful representation of the changes in the fair value of the liability attributable to changes in its credit risk.

### Question 9

*Do you agree with the proposals related to early adoption? If not, what would you propose instead and why? How would those proposals address concerns about comparability?*

In requiring entities seeking to early adopt the ED's proposals to implement at the same time any requirements in IFRS 9 that they do not already apply, we believe that the IASB is missing an opportunity to achieve a more rapid improvement in financial reporting from the perspective of the users of financial statements, in an area that has been identified by users as one in urgent need of improvement. Moreover, we note that the issue of own-credit risk has been a long-standing issue that the IASB had begun to address separately in its 2009 DP.

### Question 10

*Do you agree with the proposed transition requirements? If not, what transition approach would you propose instead and why?*

We agree with the proposed transition requirements. We believe that robust transition requirements are needed to ensure that the most useful information is provided to users and to ensure comparability. We believe that retrospective application of the proposals to financial liabilities already designated under the fair value option is appropriate.

**David Schraa**  
*Director, Regulatory Affairs Department*



September 14, 2009

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**Re: Exposure Draft 2009/7 *Financial Instruments: Classification and Measurement***

Dear Sir David:

The Institute of International Finance Senior Accounting Group (SAG) appreciates the opportunity to comment on the Exposure Draft 2009/7: *Financial Instruments: Classification and Measurement*. The Institute is pleased to contribute comments on this important issue and, of course, stands ready to provide any additional comments or explanations that may be needed. Our response to questions requiring specific comment is included in the attached Appendix; in this section we highlight central aspects of our responses.

*Full reflection of the business model*

As a basic principle, the reporting entity's business model must be fully reflected in the classification and measurement attributes. To provide users of financial statements clear understanding of the reporting entity's business, including potential risks and access to future cash flows, the economic substance of transactions in the context of separate business lines should clearly be reflected in the accounting measurement system.

Although we acknowledge that it can be difficult to draw a universally-accepted line between fair value and amortized cost classification for financial instruments, we do believe that the dividing line chosen by the board needs to be refined and that certain additional exposures should be eligible for the amortized cost category. The business model – or the concept of managing a financial instrument to contractual yield, as the ED proposes – should be the primary driver for the classification scheme; variability and uncertainty of cash flows as well as other characteristics of the financial instrument should be included as part of the measurement framework so as to determine whether or not the entity has the ability to manage an instrument to contractual yield (and thus qualify for amortized cost classification).



As part of the application of the business-model notion to classification and measurement, it is important that the option to reclassify financial instruments between measurement categories be maintained. Reclassification should be required on conditions that would make it infrequent. It should not be expected to occur often. The defined eligibility criteria would need to be worked out, but some indicators would include, for example, a fundamental change in the reporting entity's business model (such as acquisition or divestiture of a line of business). We do not think that the accounting rule can be rigid so as to prohibit reflection of changes in the nature of the business; we caution that such rigidity might lead to future undue pressures for subsequent changes.

### *Insurance perspectives*

It is important that the board take into consideration the serious concerns that have been voiced by insurance industry members regarding the potential impact of the proposals on insurance companies, especially their investing activities. Consistent with the principle of reflecting accurately a firm's business models, it is important not to overlook the fundamental differences between the insurance and other business models, including those of banking institutions. Insurance firms are significant long-term investors in capital markets and only infrequently employ 'held-for-trading' as a strategy for investing in financial instruments. Rather, a key feature of the insurance business model is managing investment assets together with insurance and investment-contract liabilities. For the performance measurement of insurance firms, in advance of phase 2 of the insurance project, the current proposals would create undue volatility, as equity and complex fixed-income instruments would require fair value through profit or loss measurement without appropriate reflection of changes in the value of insurance liabilities. This volatility - created solely by accounting standards and not reflective of the underlying economic business model - will adversely affect the investment behavior of insurance entities as significant long-term investors. This would not only give a distorted view of the insurance business, but it would have financial-stability and market-liquidity implications as the ability of insurance firms to perform their traditional function in the market - based on their long-term investment needs - would be compromised.

A holistic accounting model - that reflects the particular nature of the insurance business - is urgently needed for the insurance industry.

The Institute fully supports the IASB's work in its project on insurance contracts. However, an isolated change in accounting for the asset side of the insurance business does not comprehensively address the accounting impact insurers face and might not support the overall objectives of the insurance accounting project. We urge the board to complete phase 2 of IFRS 4 expeditiously, in time for consistent implementation of the two revised accounting standards, or at the very least to provide appropriate transitional measures to avoid market and reporting distortions.

### *Convergence*

We note that, while this project is clearly defined as a converged project, the FASB has been discussing and developing substantially different views for the proposed amendments, views that may well result in quite a different classification and presentation

approach. This is troubling given the importance that the industry, the G20 and the regulatory community attach to convergence. At the very least, this threatens an inefficient approach to achieving a fully converged accounting standard. It will lead to increased uncertainty about the future of convergence efforts and will not serve to reduce existing confusion among investors and other users of financial statements. Furthermore, divergence in the standard will lead to significantly different balance sheets and related capital and leverage ratios. If one standard operates on a basis that substantially diminishes amortized cost on the face of the balance sheet, that will itself cause a diminution of reporting quality for those assets that would more appropriately be carried at amortized cost, in accordance with the principles being developed by the board and suggested in this note, and certainly exacerbate ongoing controversies. This is a highly undesirable outcome that should be avoided at all costs. We draw your attention to the IIF letter to the boards dated September 3, 2009 where these concerns are discussed in greater length.

While we realize that the scope of the project entails a comprehensive replacement of the accounting for financial instruments, we would like to note that certain urgent issues that have been highlighted by the crisis can and should be resolved in the short term without jeopardizing convergence and consistency with other standards.

The IIF appreciates the opportunity to comment on this important topic. We stand ready to provide additional comments or explanations on the views presented, as may be needed. Should you have any questions about this letter, please contact the undersigned ([dschraa@iif.com](mailto:dschraa@iif.com); + 1 202 857 3312) or Eran Meishar ([emeishar@iif.com](mailto:emeishar@iif.com); + 1 202 857 3633).

Very truly yours,

A handwritten signature in black ink, appearing to read "David Schraa", with a long horizontal flourish extending to the right.

Attachment

## Appendix A

IIF responses to questions asked in the exposure draft

### *Classification approach*

#### 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?

Yes, amortized cost is an important measurement attribute that provides decision-useful information. We believe that an appropriately balanced mixed-attribute accounting model is the most appropriate classification and measurement scheme for financial instruments. While fair value has clear benefits to both preparers and users of financial statements for some types of financial assets and liabilities, it does not always provide the most faithful representation of the reporting entity's operations and expectations of cash flows. The premise of consistency between the reporting entity's business model and the accounting outcome should be maintained so as to properly reflect management's view of the business; an amortized cost classification provides an appropriate mechanism to reflect this view.

#### 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?

Before we provide specific response on whether the ED provides sufficient operational guidance on basic loan features and management on a contractual yield basis, we would like to highlight to the board that the majority of SAG members support a two-criteria classification approach, with the business model (i.e. managing a financial instrument for contractual yield) being the primary driver for the classification scheme. Variability of cash flows and the characteristics of the financial instruments are important elements in the measurement framework for the ability of the reporting entity to hold an instrument for contractual yield.

Notwithstanding the paragraph above, we do not 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'. We further elaborate on our reasoning in each of the following paragraphs.

#### *Basic loan features*

Basic loan features are described as those contractual cash flows that represent principal and interest, where the interest portion represents a consideration for the time value of money and the credit risk of the instrument. There is some lack of clarity around the intended scope of application of paragraph B3(iii) of the ED to variable rate instruments with multiple reference benchmark interest rates. Specifically, paragraph B3(iii) provides an example of basic loan feature for "a variable return that, throughout the life of the instrument, is equal

to a **single** referenced quoted or observable interest rate (such as LIBOR)”(emphasis added). In practice, it is observed that many loan agreements may contain reference to two or more benchmark interest rates (such as LIBOR or Prime or different LIBOR tenors, such as LIBOR 3M or LIBOR 6M) whereby the debtor holds the ability to elect periodically the applicable benchmark rate. The application guidance in the ED does not address this situation and whether such loan arrangements would qualify for amortized cost classification on the basis of having a basic loan feature. We think that this issue should be clarified.

Furthermore, we have some significant concern about the application of the guidance in paragraph B1 and B3(c), as currently drafted, to financial liabilities held by the issuer. This matter is also related to embedded features in financial liabilities and addresses the interaction between basic loan features and “contractual terms that change the timing or amount of payments of principal or interest” which are, according to the proposed standard, deemed to not qualify as basic loan features (unless they are in the form of prepayment of principal). This is an issue of significant concern that is applicable to various types of financial liabilities that contain contingent provisions that have very low probability of occurrence, yet would result in the inability of issuers to classify such liabilities at amortized cost. It is unclear to us whether the board has sufficiently considered the impact of the proposed classification scheme on financial liabilities.

#### *Managed on a contractual yield basis*

As we noted above, it is the view of the majority of SAG members that managing a financial instrument for its contractual yield should be the primary driver in the classification decision, supplemented by the characteristics of the financial instrument. Making this distinction will most likely change the classification outcome from the current proposal for certain financial instruments. Subject to this view, we believe that the application guidance is not sufficiently operational. For example, we are unclear as to the application of ‘managed on a contractual yield’ guidance to liquid fixed-income instruments that are held to support the reporting entity’s liquidity position. That is, such instruments are held, and their performance is evaluated, on the basis of contractual cash flows, but may be used periodically to provide liquidity and funding. We would ask the board to clarify its intention with regards to the eligibility of these financial instruments to be classified at amortized cost.

#### **Question 3**

Do you believe that other conditions would be more appropriate to identify which financial assets or financial liabilities should be measured at amortised cost? 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 information that is more decision-useful 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 that those financial assets or financial liabilities should be measured at fair value? If not, what measurement attribute is appropriate and why?

Broadly speaking, we acknowledge that there is a difficulty in determining the appropriate “cutoff” between instruments eligible for amortized cost classification and those measured at fair value. However, as drafted we believe that the requirements in paragraph B8 of the ED appear to be rule-driven and excessively onerous for mezzanine tranches that exhibit low variability of cash flows and are held and managed by the reporting entity on a contractual yield basis; credit risk can be managed on a contractual yield basis as long as the yield is commensurate with the assumed credit risk. The proposed approach focuses on the legal form of the instrument without taking sufficient consideration of the entity’s ability to manage credit risk and hold the financial instrument on a contractual yield basis. It may also lead to significant structuring opportunities (for example, by repackaging junior notes into a single note that may be subsequently sold by originators to investors and qualify for the amortized cost classification). As currently drafted, we do not support the leverage characteristic argument for prohibiting such financial instruments from being eligible for the amortized cost classification.

Subordinated (e.g. mezzanine) tranches in securitizations should not be specifically excluded from the classification scheme for amortized cost. Classification should be predominantly based on the entity’s ability to manage the instrument on a contractual yield basis after assessing the level of variability of cash flows of the financial instrument. The level of variability of future cash flows should be determined by giving due consideration to factors such as leverage or other contractual terms.

### *Embedded derivatives*

#### **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 (ie 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 information about contractually subordinated interests?

Subject to swift and suitable solution of the presentation and reporting issues on changes in own credit for financial instruments classified at fair value under the fair value option (FVO), we would generally agree that amending the existing requirements for embedded derivative in hybrid contracts with financial hosts should aid in reducing complexity in accounting for financial instruments. However, some issuers believe that there will remain a need to maintain guidance on determining whether the contract has only basic loan features, to help issuers analyze the classification requirements for hybrid contracts.

If, however, the board determines that the current own-credit rules should be maintained, we believe that the current bifurcation requirements should not be changed. Financial

liabilities that will be measured at fair value will result in additional earnings volatility that is due to changes in own credit spreads, reducing the quality of reported results. For example, under the proposed classification regime, embedded features in convertible debt instruments could result in fair value classification for the entire financial liability, rather than a bifurcation of the embedded feature from the host financial contract and measurement of the host contract at amortized cost as would currently apply. This result gives greater importance to the decisions made by the board regarding the ‘own-credit’ discussion paper, so as to mitigate any potential earnings volatility that could obscure decision-useful information. As noted in the IIF comment letter on credit risk in liability measurements, we would generally support recognition of own-credit changes in OCI.

Vis-à-vis financial liabilities, the significant issues around embedded derivatives, own credit and basic loan features (including contractually subordinated interests where the issuer retains the entire liability) illustrate the need for the board to fully evaluate the scope of the proposed changes, the applicability and impact on financial liabilities.

With respect to the question regarding the proposed application of the proposed classification approach to contractually subordinated interests (i.e. tranches), we refer your attention to our response to Question 3.

### ***Fair value option***

#### **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?

In general, we agree that reporting entities should 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. However, we would like to highlight to the board the difficulty in providing meaningful feedback on the application of the fair value option until we know the outcome of any proposed changes to revisions for hedge accounting rules. Furthermore, any decisions on the application of the fair value option are also linked to the accounting standards for bifurcation of embedded derivatives which is intrinsically linked to own-credit reporting (i.e. any decision to remove existing bifurcation requirements will result in the application of the amortized cost category only to debt instruments – including embedded features – that have basic loan features and are managed on a contractual yield basis. The scope of application of the fair value option would then be limited only to such financial instruments).

#### **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?

As noted in our response to Question 5, we believe that it is difficult to provide meaningful feedback on the application of the fair value option until we know the outcome of any proposed changes to revisions for hedge accounting rules.

### ***Reclassification***

#### **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?

We do not agree that reclassification should be prohibited. It is critical to recognize that both the general business environment and the entity's own business model are dynamic and change over time. Although such changes are, as should be, infrequent, they do indeed occur in practice and to ignore them in the accounting measurement is to ignore business and economic realities. We caution against rigidity in accounting rules that may lead once again to undue pressures on the board in subsequent periods. This form of rigidity now appears to be driven by concerns over potential management of profits; however, it would be undesirable to have rules that attempt to achieve particular outcome. The case for reclassification further supports the importance of reflecting the business model in the accounting regime.

We believe that reclassification should be appropriately applied prospectively when there is evidence of a change in the entity's business model. Examples where the business model may change include portfolio acquisitions, mergers with entities in other lines of business, or strategic decisions to exist certain business segments. The board may wish to give full consideration to both endogenous factors (such as those mentioned above) as well as exogenous – perhaps market-related – factors as recommended in the Basel Committee's guiding principles. It is clear that a robust disclosure framework should be in place to support a transparent financial reporting of reclassification events to allow for market scrutiny and discipline.

### ***Investments in equity instruments that do not have a quoted market price and whose fair value cannot be reliably measured***

#### **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?

Given the complexities and uncertainty surrounding valuation measurements for non-listed equities, we do not believe that the removal of the cost exemption for non-listed equities is an urgent issue that needs to be resolved at this point in time.

### Question 9

Are there 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?

We are unable to provide specific examples on circumstances in which the benefits of improved decision-usefulness do not outweigh the costs of providing fair value information for equity instruments. We believe that individual financial institutions are better placed to provide examples.

### *Investments in equity instruments that are measured at fair value through other comprehensive income*

### 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?

Subject to the significant concerns expressed in the cover note for insurance enterprises, the IIF SAG would not object to the proposals to present changes in fair value for certain investments in equity instruments in OCI. However, we do not support reporting dividends received or realized gains and losses, in OCI without recycling into earnings. We believe that dividends should be recognized directly in profit or loss as income earned. Furthermore, since interest payments of the financial liabilities (i.e. funding costs) are presented in profit or loss, if the asset side is measured at fair value through OCI, a mismatch between investment side and funding side would appear.

We would like to highlight an important issue that may result in unintended consequences where the proposed accounting treatment for dividends (i.e. non-recognition in earnings) may actually lead to changes in business investment behavior for certain participants in the equity markets, namely insurance firms. This would be a highly undesirable case where the accounting treatment drives investment behavior for firms that are significant long-term investors in the equity markets. We believe that this matter should be avoided.

More broadly, given the perceived increase in prominence of the OCI category, we believe that the board should seek to explore the fundamental objectives and use of OCI in financial reporting. This is an inter-related issue with other ongoing projects, such as financial statements presentation, for example. It is unclear to us that there is a consistent approach to inclusion of certain measurement elements in OCI while others are reported in earnings. It would be beneficial if a robust conceptual approach for the use of OCI was developed.



### Question 11

Do you agree that an 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?

We understand that the board faced difficulties in defining strategic investments in order to appropriately “carve out” such investments from continuous recognition of changes in fair value in earnings. Therefore, we generally support the proposal that entities should be permitted to present in OCI changes in fair value of any investment in equity instruments. However, we also think that an entity should be able to recognize in earnings any realized gains or losses upon disposal of the equity investments. Clearly, exit and disposal activities should be subjected to disclosure requirements, to support transparency and market discipline. In addition, we reiterate our comment in the response to Question 10 regarding the objectives and use of the OCI category.

### *Effective date and transition*

### 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?

The additional disclosure requirements in IFRS 7 for entities that early adopt the proposed IFRS would require entities, among other things, to disclose the original measurement category and carrying amount, as well as the new measurement category and carrying amount. While we understand the critical need to maintain comparability, this requirement would be particularly onerous to issuers, especially given the short timeframe prior to year-end 2009. We would also note that a decision to early adopt would be impacted by several extraneous factors such as the future outcome on the proposed impairment revisions, hedge accounting and the direction of convergence efforts with the FASB. One example would be insurance entities that may decide not to early adopt the standard, given the near term prospects for finalization of the long-awaited insurance-contract measurement project.

### 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?

In general, we support retrospective application. We do however not support the requirement to restate comparatives and the related transition guidance as that is particularly burdensome and impractical for preparers and of limited relevance to users. We support a

similar approach to what was applied upon initial implementation of IAS 39, in which the requirements could be adopted retrospectively with a transition adjustment being recognized in equity at January 1 of the year of adoption, without restating comparatives.

### *An alternative approach*

#### **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?

We do not believe that the proposed alternative approach provides more decision-useful information. First, there is a level of duplication between the proposed approach and the alternative approach (i.e. it appears to us that Loans and Receivables would generally be a subset of financial instruments within the ‘basic loan features’ and ‘managed on a contractual yield basis’). Therefore, the scope of financial instruments for which the guidance would apply is unclear. For example, it is unclear whether the ED intends to allow the disaggregation of the changes in fair value only for financial instruments that are not Loans and Receivables, but would otherwise qualify for the amortized cost classification under the original proposal.

Second, the disaggregation of changes in fair value depends on the outcome from the deliberations on modifications to the impairment model. Presumably, an expected-loss impairment model would negate the need for such a disaggregation. It is difficult to provide meaningful feedback on this alternative given the ongoing discussion on impairment revisions.

#### **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?

We do not support either of the possible variants of the alternative approach. Presenting changes in fair value that are not attributable to amortized cost – that is, the credit component – issues in profit or loss would yield unnecessary earnings volatility and will not reflect reliably results of operations. Alternatively, reporting all financial instruments at fair value in the statement of financial position, when certain investments are not managed on a fair-value basis would not accurately reflect the entity’s business model and may lead to increased balance sheet volatility with unintended impact on regulatory capital and leverage ratios.



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