



BASEL COMMITTEE ON BANKING SUPERVISION
BANK FOR INTERNATIONAL SETTLEMENTS



LETTER OF COMMENT NO. 52

Chairman

Restricted

Via e-mail: ajvaneperen@fasb.org

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Financial Crisis Advisory Group's Request for Comment

Dear Mr Van Eperen

The Basel Committee on Banking Supervision welcomes the opportunity to provide its views on the questions raised by the Financial Crisis Advisory Group (FCAG). It is our understanding that our responses will help inform FCAG's evaluation of the accounting and reporting matters related to the financial crisis and thereby assist you in making recommendations to the IASB and the FASB. The Committee has a strong interest in high quality financial reporting by banks and has carefully analysed the questions posed by FCAG. We trust that you will find our comments useful and constructive.

These responses have been prepared by the Committee's Accounting Task Force and have been approved by the Committee. If you have any questions regarding our comments, please feel free to contact Mrs Sylvie Mathérat, Director at the Banque de France and the Basel Committee's representative on the FCAG (+33 1 4292 6579; sylvie.matherat@banque-france.fr), or Xavier-Yves Zanota of the Basel Committee Secretariat (+41 61 280 8613; xavier-yves.zanota@bis.org).

Yours sincerely

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1. From your perspective, where has general purpose financial reporting helped identify issues of concern during the financial crisis? Where has it not helped, or even possibly created unnecessary concerns? Please be as specific as possible in your answers.

The Committee is of the view that fair value accounting has reflected the decline in asset values due to the worsening of the financial and economic environment. Fair value has also been a significant factor in the contagion mechanism by reflecting in some cases irrational price changes at each phase of the cycle (in good and bad times). Deficiencies of markets in providing users with reliable information, due to inactive and illiquid situations, or liquidity shortage, have exacerbated the crisis of confidence by raising uncertainty levels among market participants lacking points of reference on the value of some financial products.

The Committee also notes that the varying degrees of information available in general purpose financial reports on assets, whose measurement and ongoing realisation potential is judgmental, has not helped during the financial crisis. Information about potential risks confronting financial institutions (eg liquidity risk and risks associated with off-balance sheet vehicles) has not always been appropriately presented in financial reporting. The Committee is of the view that a return to confidence will imply more transparency through improved accounting standards and enhanced disclosures.

The crisis has also highlighted that accounting relating to consolidation and de-recognition (see question 3), recognition of deferred tax assets and impairment of available-for-sale securities needs to be improved. The application of the fair value method to liabilities, especially to own debt of entities, is also an area of concern. Finally, the current model for loan loss provisioning has resulted in a delayed recognition of credit deterioration which may have reduced confidence in general purpose financial reporting (see question 2).

2. If prudential regulators were to require 'through-the-cycle' or 'dynamic' loan provisions that differ from the current IFRS or US GAAP requirements, how should general purpose financial statements best reflect the difference: (1) recognition in profit or loss (earnings); (2) recognition in other comprehensive income; (3) appropriation of equity outside of comprehensive income; (4) footnote disclosure only; (5) some other means; or (6) not at all? Please explain how your answer would promote transparency for investors and other resource providers.

The Committee is of the view that transparency for investors and other users of financial statements is best achieved when loan provisions reflect the accumulation – or “build up” – of credit risk in a portfolio of loans. In the Committee’s view, the current incurred loss model under both IFRS and US GAAP does not achieve this objective. The current model relies heavily on the identification of a loss event as a condition for setting aside a provision against such loss. In practice, the identification of a loss event for a particular loan, or pool of loans, has proven to be a difficult process that results in making a provision that does not track the build up of credit risk in a portfolio. Until now the current model does not appear to have been effective in recognising incurred losses based on management’s judgement. As a consequence, there has been a tendency to under estimate, in provisions, the latent credit losses and the inherent credit risks in loan portfolios.

Committee members agree that a provisioning approach which addresses the risk and uncertainty embedded in the loan portfolio "over the cycle" would provide greater transparency in financial statements. Among the six alternatives proposed in the question, only (1) *recognition in profit or loss*, and (3) *appropriation of equity outside of comprehensive income*, are deemed appropriate. However, those two options may cover different objectives.

Based on the fact that provisioning reflects future cash-flow reduction with a direct impact on the income statement, most members would recommend option (1) in the sense that provisions should be recognised over the cycle as an expense in the income statement. That is justified as risks are accumulated over the cycle of the loan, even if losses are materialised all at once. Option (3), which has an income neutral impact, is analysed as a reserve, or an economic cycle reserve, movements in which should be disclosed at the bottom of the income statement.

In the view of many members, options (1) and (3) are not exclusive, but rather, complementary. Option (1) addresses the provisioning issue, whereas option (3) deals with reserves which some consider to be of a different nature. Therefore, the Committee would recommend having a comprehensive approach from loan provisioning to building up reserves in order to capture all risks and uncertainty attached to loans, as reflected in the terms and conditions (eg interest rates) that vary from one loan to another. Implementation of both options (1) and/or (3) would definitely increase transparency because risk and uncertainty do not arise at a particular point in time and users and providers of resources should be informed about the accumulation of risks. They should not be caught by surprise when losses materialise. The quality of the loan portfolio should be not only reported but also recorded in the financial statements.

3. Some FCAG members have indicated that they believe issues surrounding accounting for off-balance items such as securitisations and other structured entities have been far more contributory to the financial crisis than issues surrounding fair value (including mark-to-market) accounting. Do you agree, and how can we best improve IFRS and US GAAP in that area?

The Committee believes that the question of whether issues surrounding accounting for off-balance-sheet items have been far more contributory to the financial crisis than issues surrounding fair value accounting is a very important and difficult one.

The Committee highlights the importance of disclosures and transparency of financial information in order to eliminate potential inconsistencies in the treatment of complex financial instruments. In this regard, the Committee believes that the principles set out in IAS 27 and IASB's Standing Interpretations Committee's Interpretation 12: *Consolidation - Special Purpose Entities* (SIC 12) are clear and changes to the latter should be carefully considered and focused solely on areas of concern. US GAAP on the contrary may offer more room for arbitrage. The definition of common rules for de-recognition and consolidation in IFRS and US GAAP should be given priority.

As indicated in its comment letter to the IASB on "*Exposure Draft 10 – Consolidated financial statements*" of 20 March 2009, the Committee is concerned with the possibility that fewer entities will be consolidated under the proposed

approach set out in the exposure draft than under current guidance because of the lack of consideration for risks and rewards in the proposed control assessment approach. Such a result would be inconsistent with the general findings of the Financial Stability Forum and others indicating that off-balance-sheet treatment for certain types of structured finance activities was inappropriate and was a contributing factor to the current financial crisis. The Committee recommends that the IASB give prominence to the role of risks and rewards in identifying control, particularly with respect to structured entities.

4. Most constituents agree that the current mixed attributes model for accounting and reporting of financial instruments under IFRS and US GAAP is overly complex and otherwise suboptimal. Some constituents (mainly investors) support reporting all financial instruments at fair value. Others support a refined mixed attributes model. Which approach do you support and why? If you support a refined mixed attributes model, what should that look like, and why, and do you view that as an interim step toward full fair value or as an end goal? Whichever approach you support, what improvements, if any, to fair value accounting do you believe are essential prerequisites to your end goal?

The Committee's position on this question was communicated to the IASB in response to the discussion paper "*Reducing complexity in reporting financial instruments*", in September 2008. In our response we expressed support for the objective of removing avoidable complexity from IFRS financial instrument accounting, and particularly in this case, IAS 39 (specifically the approach to hedge accounting, and editorial presentation of the standard).

We support a refined mixed-attribute model for accounting and reporting of financial instruments in order to represent as adequately as possible how earnings and cash flows are generated by banks. Indeed, the notion of fair value, as currently defined by the IASB, does not reconcile easily with the economic rationale of banks' business outside of capital markets. Much financial intermediation takes place through banks precisely because the conditions of existence of a trading market are not in place. This is for example the case for retail and small business loans. Secondary trading in these assets is not well developed in most jurisdictions.

The financial crisis could be seen as a field test for fair value which has revealed its limitation and weaknesses in case of turmoil and illiquid markets. In one sense, there was an accounting failure to tackle disturbed situations. Fair value cannot be considered as a universal system and cannot be a one-size-fits-all model measuring all assets and liabilities. We support a refined mixed-attribute model that should be considered as our ultimate goal and not as an intermediary step towards a full fair value model.

Regarding improvements to be brought to fair value measurement, we are of the opinion that the Experts Advisory Panel guidance on "*Measuring and disclosing fair value of financial instruments in markets that are no longer active*", and the subsequent modification of IFRS 7 were important steps and that the classification, for reporting purposes, in three levels – similar to US GAAP – was an improvement.

5. What criteria should accounting standard-setters consider in balancing the need for resolving an 'emergency issue' on a timely basis and the need for active engagement from constituents through due process to help ensure high quality standards that are broadly accepted?

By letter dated 31 March 2009, the Committee responded to an invitation by the International Accounting Standards Committee Foundation (IASCF) to comment on matters related to the IASCF's Constitution. As noted in our response, we appreciate that in cases of great urgency the IASB may need to modify an accounting standard more expeditiously than through the normal due process, and a "fast track" process may be a good way to address these occasions. If such a procedure is developed, we recommend it include the following elements. The procedure should: (1) be used only in rare circumstances, (2) be temporary (ie until a more rigorously vetted solution has been implemented), (3) include some transparent due process, even if on an accelerated basis, and (4) not result in expedited decisions on issues deserving full-deliberation and due process. Further, we believe this initiative should be seen as an opportunity for standard setters and regulators to reinforce their collaboration and to liaise with auditors.

6. Are there financial crisis-related issues that the IASB or the FASB have indicated they will be addressing that you believe are better addressed in combination with, or alternatively by, other organisations? If so, which issues and why, and which organisations?

The standard setters should work together to the greatest extent possible, and liaise closely with financial regulators on issues likely to have a material impact on the financial sector. On all significant projects, the Committee believes it is important that the IASB conducts adequate field testing and cost-benefit analysis, including dialogue with the major accounting firms and representative preparers, before issuing documents for formal public comment. The Committee encourages the IASB to collaborate with other organisations such as the International Auditing and Assurance Standards Board (IAASB). This liaison could facilitate the consistent interpretation and application of accounting and auditing standards.

7. Is there any other input that you'd like to convey to the FCAG?

The Committee would like to reiterate that issues identified by the FCAG should be dealt with as a matter of urgency as they are key in enhancing market confidence and therefore should help the resolution of the crisis. In our view, these urgent tasks cover provisioning, consolidation and de-recognition, measurement, and disclosures (valuation methodologies and exposures to risk). In doing so, both boards should take into account the reality that, as a matter of fact, we do not have liquid markets which would allow every financial item to be credibly fair valued directly, or even indirectly using observable inputs and standard models.