



LETTER OF COMMENT NO. 21



The voice of banking
& financial services

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Dear Mr Van Eperen,

Financial Crisis Advisory Group – request for comment

This is the British Bankers' Association's response to the Financial Crisis Advisory Group's request for comment issued on 10 March 2009.

We welcome the opportunity to comment and the decision by the IASB and FASB to establish the Advisory Group to coordinate their response to the financial turmoil. After their initial failure to identify the *seriousness* of the crisis and the importance of swift remedial action, the Boards, through the Advisory Group, have shown a willingness to respond to the mandate given to them by the G20 and Financial Stability Forum and to *discuss more openly with their constituents the changes which need to be made to IFRS and US GAAP.*

Whilst we look to the Advisory Group to advise the Boards on how they respond to the crisis, we look to the new IASB Monitoring Board and IASCF Trustees to ensure that the IASB conducts an open and interactive dialogue on its priorities and the direction of IFRS. The unambiguous demands from political leaders through the G20 that the IASB's governance be improved signals a clear warning that there is no longer the political willingness for the IASB to conduct its work inside an academic vacuum. The Board must have regard to market confidence and to the needs of its constituents and bring forward proposals to remedy weaknesses in standards. In particular, the Board must re-evaluate the scope of fair value and the merits of the mixed-measurement model for financial instruments and *reject its pursuit of full fair value.*

Our comments on the questions posed follow below.

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.

In our view, the sheer magnitude of the financial crisis and the failure of the tools and conventions designed to prevent and warn of such problems means that all aspects of the financial regulatory regime should be reviewed so that we can properly understand what, if any, contribution individual elements made to the financial crisis. We believe there are two key questions to consider when evaluating the role played by accounting in this regard: should general purpose financial statements have a financial stability objective and are elements of the accounting regime unduly pro-cyclical?

In response to the first, it could be argued that the damage caused by the current crisis is of such a nature that preventing a similar occurrence should be an absolute priority for any standard setter. On

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the other, many involved in the standard setting process believe that a better contribution to financial stability is achieved through financial reporting delivering a neutral and transparent account of an entity's financial position.

Whilst in our mind general purpose financial reporting should remain focused on the needs of shareholders and other capital providers and should not be confused with regulatory or prudential reporting; we believe that the market turmoil has shown that there is a clear need for standard setters to have regard to market confidence when drafting standards. An example of this would be responding to and accommodating regulatory authorities' requests for additional disclosures and having regard for financial stability considerations when evaluating reporting requirements.

With regard to the second question, and related to the first, is whether the IASB's standards themselves have contributed to pro-cyclicality and, if they have, whether the IASB should be placed under an obligation to give consideration to financial stability consequences in developing and/or reviewing its standards. It is clear, for example, that the accounting regime (and Basel II for that matter) placed insufficient emphasis on the relevance of market liquidity to valuation and there is a strong belief within the banking industry that this has exaggerated reported losses; recent events have also shed further light on concerns expressed in respect of proposals in hand on the process of calculating fair values.

Other areas of difficulty known to the Boards include the valuation and impairment of Available-For-Sale financial assets, the inability to reclassify instruments subject to the fair value option and issues concerning embedded derivatives.

- 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.**

We would summarise our current thinking on the merits of dynamic provisioning as follows:

- We would agree that there are grounds for regulators to consider whether to adopt a more dynamic provisioning approach whereby pro-cyclicality would be countered by raising an impairment provision on lending in healthy economic times for releasing as and when recession hits - in effect a rainy day fund.
- In determining whether to introduce such an approach, the starting point should be to consider how far expected loss provisioning (albeit with a 12 month probability of default time horizon) under Basel II takes us down that path.
- We do not believe that dynamic provisioning can be shoehorned into existing IFRS and remain of the view that incurred loss provisioning under IFRS serves a different purpose to the regulatory buffer under discussion.
- Recent economic experience, as opposed to the extended benign economic climate since the first time adoption of IFRS, provides a different backdrop for judgements about the appropriate level of provisions within the existing incurred loss model.
- Should it be considered that dynamic provisioning is relevant principally to the capital regime, and different in nature to IFRS incurred loss provisioning, then any regulatory buffer would still feed through to the accounting since the resulting change in capital would result in increased reserves in equity, and this could be separately disclosed.

- There are many practical issues around dynamic provisioning to which nobody at present has answers, including: how to identify the appropriate time in the economic cycle to commence provisioning (no bank would start setting aside provisions at this point without eroding capital further); the lack of consistency in the typical length of loan terms as compared to the length of the economic cycle; and the lack of any commonly agreed formula for calculating the formulae that would be applied, leading to loss of comparability and transparency.
- We would want to field test any proposal to ensure that it did not inadvertently add to capital requirements at the wrong point in the cycle if we were to head into recession in a deeper and more precipitous way than forecast.
- We would wish any new approach to be considered carefully by regulators, standard setters and industry in a coordinated way in order to ensure that accounting, regulation and business purpose remained integrated.

In terms of the options expressed above, we would strongly oppose the recognition of prudential provisions in earnings or OCI set out in options (1) and (2) and would marginally favour footnote disclosure (4) over appropriation of equity outside of earnings (3). We would not support general purpose financial statements not reporting the regulatory capital position (6) as we believe this information is useful to users and consistent with financial statements contributing to market confidence.

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?

We do not agree that the accounting for off-balance sheet items has been more contributory to the financial crisis than fair value, particularly in the context of IFRS. Whilst we welcome the medium-term objective of moving to a single consolidation principle set out in ED10, we do not believe the existing model is fundamentally broken and therefore that a revision is justified in the short-term. IFRS is superior to US GAAP in this area and does not contain the weaknesses that the Financial Stability Forum and G20 have directed the FASB to rectify. Furthermore, there are a number of flaws in the ED10 proposal which in our view will lead to greater inconsistency in application. The control principle is not always clearly articulated and may give undue emphasis to decision making powers where decisions are limited and there are seemingly a number of contradictions between the standard and the application guidance.

We fully accept and agree that the financial turmoil has demonstrated the need for better disclosure of the nature of activities with structured entities and acknowledge that the Board has been directed to move forward on this front at an accelerated pace by both the Financial Stability Forum and the G20, but we are very concerned that some of the disclosures proposed are voluminous and poorly targeted. Furthermore, we believe that many of the enhancements to the disclosure regime requested by the FSF and G20 more properly fit within the scope of IFRS 7 because they should be focused on the material risks the reporting entity is exposed to from structured and other entities (such as undrawn liquidity facilities or lending commitments) rather than all structured vehicles per se. Given the importance of enhancing the disclosure regime in the very short-term, we suggest that it could be sensible to divide the ED10 project into two. This will enable more resources to be focused on satisfying requests from the G20, Financial Stability Forum and other regulators for enhanced disclosure and will give more time for consideration of the single consolidation principle, which we do not believe to be an urgent priority. It will also enable the consolidation proposals to be considered together with the derecognition proposals.

With regard to fair value, we believe the IASB and FASB should conduct a review of the extent to which it may have played a part in the crisis and whether the valuations generated under IAS 39 are in any way pro-cyclical. As part of this review, the Boards should consider:

- The scope of fair value and the belief on the part of some IASB Board members that the long term objective should be to adopt *full* fair value for financial instruments.
 - The question of *how* to calculate fair value and whether the current financial crisis tells us anything about the circumstances in which 'exit values' and reliance upon a 'market participant' view for valuation may not be appropriate.
- 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?**

We continue to strongly favour the mixed-measurement model and oppose full fair value and urge the Boards to make an early announcement that the long term objective of full fair value set out in the reducing complexity discussion paper, and on occasions expressed as a principle, is no longer an option in view of the lessons learnt about the relevance and reliability of fair value in the absence of an intent and ability to trade or manage instruments on a fair value basis. In this context, we were disappointed that the IASB last month voted 9-5 in favour of maintaining full fair value as the long term objective, but we welcome Board members confirmation that the short-term review of IAS 39 should proceed on the assumption of a mixed-attribute measurement model.

In our view, a mixed-measurement model is superior to full fair value as it represents a principles-based approach to measurement by acknowledging that different entities may follow different business models. Instead of determining which measurement approach offers a superior model, standard setters should aim to accommodate the various business models and circumstances in which financial instruments are used. It is the business intent and risk position that should form the basis of financial reporting otherwise financial reporting could become as uniform as the difficulties in determining fair values in illiquid markets would allow but not provide relevant and useful information about what the business actually does and how it has performed. In addition, we believe that a single measurement base for the measurement of all financial instruments would lead to an increase in the complexity of measurement, presentation and disclosure.

- 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?**

We see a clear case for the adoption of a fast track procedure for resolving emergency issues in a timely manner. While an absence of any due process is clearly not the answer, there are clearly instances in which there is a need to introduce or amend standards without an extended consultative process over a period of many months. This is a major gap in the IASB's toolbox and it would seem unnecessary for the introduction of such a facility to await the outcome of the constitutional review. The Board variously used 15 and 25 day comment periods during the second half of 2008 for urgent measures and we would agree that there are circumstances in which the need for action outweighs the need for lengthy deliberation.

- 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?**

It is vitally important that the IASB and FASB coordinate their activities between themselves but also with the other international standard setters such as the Basel Committee on Banking Supervision and IOSCO through the Financial Stability Forum (FSF). We welcome the fact that the IASB has engaged with the working groups put in place by the FSF to progress and implement the recommendations made at the request of the G7 on enhancing financial stability and the more recent proposals from the G20. It is imperative in our view that the IASB continues to engage in this manner going forward. Issues that we would identify as being particularly important in this regard, include the discussion of mechanisms to counter-act the perceived pro-cyclicality of capital and accounting standards and the interaction of consolidation and derecognition standards with regulatory tools such as leverage ratios.

We also believe it would be helpful if the IASB interacted with regulatory authorities and others to understand the nature of additional disclosures about risks and exposures they are seeking. The IASB could then respond by introducing common disclosure requirements which are principles-based and mindful of materiality. By way of example, we would point to the interaction of the proposed disclosures in the ED10 Consolidation paper and the listing requirements in the US and EU to disclosure information about the nature of and risks associated with structured vehicles. It would be beneficial if these could be aligned as far as possible.

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

We have no further comments.

Yours sincerely

A handwritten signature in black ink that reads "Paul Chisnall". The signature is written in a cursive, flowing style.

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