

September 21, 2010

Mr. Russell G. Golden

Technical Director

Financial Accounting Standards Board

401 Merritt 7

P.O. Box 5116

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File Reference No. 1810-100 Accounting for Financial Instruments and Revisions to the Accounting for Derivatives and Hedging Activities

Dear Mr. Golden:

To develop a global perspective on the issues raised in the FASB Exposure Draft we solicited the opinions of the Macquarie bank analysts from around the world. Their opinions are explained in the research report we published on August 5, 2010 which is attached and should be considered part of this comment letter. Please note that in this report the opinions expressed by the individuals are in their roles as research analysts at various Macquarie entities and should not be considered the official opinions of Macquarie Group Limited, or any of its subsidiaries.

**The main point noted in the report is that the analysts are uniformly opposed to reporting bank loans at fair value and instead prefer amortized cost.** The chief reason cited by most of the analysts is that the business model of the banking industry is to intermediate between depositors and borrowers with profit resulting from the spread between the return of principal and the collection of interest and the cost of funds. With that model we do not see the merit in adjusting the carrying value of the loan for interest rate and liquidity risk if the loan is meant to be held to maturity. Conversely, if the business model of the reporting entity is to profit from changes in the price of the instruments, such as the trading portfolios of investment banks, then we believe fair value would be the preferred measure.

On the issue of loan loss provisioning, the analysts support the move to an expected loss basis from the present incurred loss approach. However, the analysts prefer the IASB approach of allowing companies to look at potential losses over the life of the loan rather than the FASB requirement that banks establish reserves based on corporate events and economic conditions as they exist at the reporting date.

**Even though from the perspective of an accounting theoretician I believe that fair value is more meaningful for understanding the value of an entity than any measurement approach driven by historical data I also believe that far more weight should be given to the opinions of the practicing analysts, particularly those that follow banks. And, those opinions are clear both in the attached report and in the commentaries of many others.**

Considering that the Boards are under pressure from the G-20 governments to converge their standards we believe a potential compromise lies in one of the alternative approaches discussed in the original IASB exposure draft in July 2009. Under this alternative, loans would be carried at amortized cost while all securities would be reported in the balance sheet at fair value. However, those securities that meet

certain criteria would have the change between fair value and amortized cost reported through other comprehensive income. This would result in some balance sheet volatility, but the impact could be mitigated by requiring both the fair value and amortized cost numbers to be presented in the balance sheet in a manner similar to that currently in the FASB proposal. Thus anyone wanting to back out the fair value changes could easily do so.

Thank you for the opportunity of allowing the Macquarie analysts to express their views. If you have any questions or comments please feel free to contact either me at 212 231 8081 or [Alan.Zimmermann@Macquarie.com](mailto:Alan.Zimmermann@Macquarie.com) or any other analysts who contributed to the report.

Alan Zimmermann

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## GLOBAL



# Financial Instrument Accounting

Macquarie global bank analysts prefer:

- Carrying bank loans at amortized cost versus fair value,
- Reporting impairments using the “expected loss” rather than the “incurred loss” method.

**Joining the debate.** While the FASB and the IASB share a common goal of simplifying financial instrument accounting, they currently differ on several key issues. We consider this to be an important debate both for bank stock performance and possibly for influencing the way the banking business is conducted in the future, so we asked the Macquarie bank analysts from around the world to weigh in with their views.

**Issue #1: Carrying value for bank loans.** Specifically, the FASB has proposed that all financial instruments be carried at fair value, while the IASB standard divides the instruments into two categories, amortized cost and fair value, based on certain criteria. The key difference is that bank loans would be carried at fair value under the FASB approach and amortized cost per the IASB. The Macquarie analysts prefer amortized cost.

**Issue # 2: How to report impairments.** Both Boards are eliminating the “incurred loss” approach to reserving and moving toward an “expected loss” model. However, a critical difference is that the FASB would have banks establish reserves based on corporate events and economic conditions as they exist today, while the IASB would allow companies to look at potential losses over the life of the loan. The Macquarie analysts favour the expected loss change and generally have a preference for the IASB methodology.

**Is there a middle ground?** Considering that the Boards are under pressure from the G-20 governments to converge the standards, it seems reasonable to look for a potential compromise. In our opinion, the natural meeting place between the two proposals lies in one of the alternative approaches discussed in the original IASB exposure draft in July 2009. Under this alternative, loans would be carried at amortized cost, while all securities would be reported in the balance sheet at fair value. However, those securities that meet certain criteria would have the change in value between fair value and amortized cost reported through OCI. Fair value changes on other securities would go through net income. This would result in some balance sheet volatility, but the impact could be mitigated by requiring both the fair value and amortized cost numbers to be presented in the balance sheet in a manner similar to that currently in the FASB proposal. Thus, anyone wanting to back out the fair value changes could easily do so.

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## Macquarie analysts express their views

For several years, the FASB and IASB have been working on a new model to simplify the reporting of financial instruments. The reason is that the current standards have become overly complex and have massive inconsistencies that were painfully evident in the latest financial crisis. As financial instruments became more complex, accounting standards did not keep up with the changes. Instead, the standards were continually revised in piecemeal fashion until they eventually became too convoluted to make sense.

While the FASB and IASB share the common goal of reducing complexity, they have reached different conclusions on the critical issues of classification, measurement and impairment. Specifically, the FASB has proposed that all financial instruments be carried at fair value while the IASB standard divides the instruments into two categories, amortized cost and fair value, based on certain criteria. The key difference is that bank loans would be carried at fair value under the FASB approach and amortized cost per the IASB.

Regarding impairment, both Boards are eliminating the “incurred loss” approach to reserving and moving toward an “expected loss” model. However, a critical difference is that the FASB would have banks establish reserves based on corporate events and economic conditions as they exist today, while the IASB would allow companies to look at potential losses over the life of the loan.

The Boards are under considerable pressure from the G-20 governments to converge the standards, but at this point it is hard to see how complete symmetry is possible, given the Boards’ differences on these issues.

In addition to different approaches for the various aspects of financial instrument accounting, the FASB and IASB have also approached the timing and sequencing of the project in different ways. The IASB has chosen to issue standards in segments while the FASB has issued a single exposure draft encompassing all the issues.

In November 2009 the IASB issued a standard (IFRS 9) on the first phase of its project on Classification and Measurement of financial assets and currently has outstanding two exposure drafts on Impairments and Financial Liabilities. Another exposure draft, on hedge accounting, is expected by year-end.

Rather than compartmentalize the project, the FASB has chosen to approach this as a single project and on May 26 issued an exposure draft covering all aspects of accounting for financial instruments.

### Where this report is going

The remainder of this report is divided into three sections:

- A brief discussion of the proposals in the FASB exposure draft,
- A discussion of the financial instrument standards issued to date by the IASB (IFRS 9) as well as the current IASB exposure drafts on impairment and financial liabilities
- Comments from the Macquarie analysts on the issues.

### FASB Exposure Draft on Financial Instruments

Following is a summary of the major proposals in the FASB exposure draft. When reading this discussion, keep in mind that in the standard-setting process there is a long way between an exposure draft and a final standard. Accordingly, there could be major changes to this exposure draft before getting to a final US standard, especially when considering the potential for compromises through international convergence.

#### 1. Financial instruments will be recorded at fair value.

Financial instruments including chiefly loans and debt securities on the asset side of the balance sheet and almost all financial liabilities will be recorded at fair value.

The change in fair value will be recorded either through

- a) Net income, or
- b) Other comprehensive income, if certain criteria are met.

Whether the change in fair value goes through net income or OCI depends on the cashflow characteristics of the instrument and the business strategy of the entity. Without going into the technical definitions, it is easiest to think of bank loans and debt instruments carried at FV-OCI, while investment banks and broker portfolios will be recorded at FV-NI. In many ways this resembles the treatment in the current “available for sale” and “trading” categories, although the criteria and definitions are different.

This is a completely new approach for carrying loans, although it is not much of a change for debt securities, since most are now carried on an AFS basis. Changes in the value of equity securities will go through net income.

The definition of fair value is unchanged. It remains “the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants.” Note that this is an exit price that asks the question at what price can the entity get out of the transaction?

Since there is limited marketability for bank loans these will almost always be Level 3 assets.

**2. Impairments on both loans and debt instruments will be recognized using single criteria: Does the reporting entity expect to collect all amounts due under the contractual terms of the instrument?**

In an effort to simplify the accounting, this will be the only impairment criteria. Gone are all references to the market price of an asset and the concept of other-than-temporary-impairment.

Also, the trigger for when a potential loss can be recognized will change so “expected losses” can be recorded rather than “incurred losses.” But the FASB does not go as far as the IASB in allowing companies to report future expected losses. Instead, the FASB would allow entities to consider all available information relating to past events and existing conditions, but not to project the future.

Bottom line is that impairments will probably be recorded earlier under the proposed accounting than with the existing standards but the pattern of annual changes will likely be more stable.

**3. Core deposit liabilities will no longer be recorded at face value, but instead at their net present value.**

The logic for this is that if loans are recorded at fair value then the funding sources for the loans should also reflect a degree of variability. However, it should be noted that the calculation of the value of the core deposits is not fair value since it is determined on an NPV basis not an exit price.

**4. Other liabilities will generally also be carried at fair value.**

(There are times when these can be carried at amortized cost if there is an accounting mismatch, but these situations are expected to be rare and are excluded for purposes of this discussion.)

Allowing liabilities to be reported at fair value has long been troublesome to investors because of the issue of what to do about a company’s own debt? The incongruent situation is simply that if a company’s credit standing deteriorates it would record a gain (because the fair value of the liability declines) and if its standing improves it would show a loss. Many people are uncomfortable with that result, especially since many financial companies posted gains in the midst of the financial crisis when the spreads on their debt deteriorated.

Having weighed these issues, the Board has determined that liabilities will be recorded using the same criteria as assets, meaning fair value with changes either through net income or OCI. Since, in most cases, the change in the fair value of the debt would go through OCI, the profit implications are minimized if not eliminated.

In conjunction with allowing the change in the fair value of a company's own debt to go through OCI (assuming it meets the same criteria as for assets), the following disclosures will be required

- a. The amount of the change in fair value that is attributed to the change in a company's credit standing will be required in the statement of financial performance, and
- b. The amortized cost of the debt will be required on the balance sheet. .

These are provided to allow users to clearly see the impact of the own debt changes on the entity's balance sheet.

**5. Interest income will now be calculated based on the net value of an instrument i.e. after any impairment allowance, rather than on the contractual amount.**

This will change the way net interest income is measured and creates some unusual accounting when the collected amounts exceed recorded income.

**6. Disclosures will be expanded.**

As an example, when reporting assets classified as FV-OCI entities will have to show the amortized value, the allowance for credit losses and the adjustment to fair value. In essence, the disclosures are designed so users can recreate the traditional balance sheet and income statement. It is almost as if companies will have to report the equivalent of two sets of financials.

**7. Other Comprehensive Income will now be presented in the same continuous statement as net income.**

Currently, comprehensive income can be shown either as a separate statement within the financials or in the footnotes. Earnings per share will continue to be based on net income, although net income will no longer be the bottom line in the new statement.

While net income will undoubtedly remain the focus of most investors there is no doubt this will enhance the prominence of items recorded through AOCI.

## **IASB Statement and Exposure Drafts on Financial Instruments**

To date the IASB has issued a statement (IFRS 9) on the classification and measurement of financial assets and two exposure drafts on impairment and financial liabilities. Another exposure draft on hedge accounting is expected by year-end.

Financial liabilities were originally to be part of the classification and measurement proposal but were dropped to allow the Board more time to consider the issue of own credit risk.

The following is summary of the standard and proposals to date.

**1. Financial asset classification uses mixed measurement attributes.**

The IASB standard uses two categories for financial assets, amortized cost and fair value through profit and loss, and the determination will be based on the business model of the entity and the cashflow characteristics of the asset.

The business model is the primary test for assets to qualify for amortized cost, and the entity's strategy must be to hold the assets to collect the contractual cash flows rather than be in the business of profiting from changes in fair values. In simple terms, this means that a bank making loans or an insurer with an investment portfolio designed to generate cash to pay off liabilities would qualify for amortized cost treatment while an investment bank would not. Thus, for entities in two lines of business, similar assets could be accounted for on different bases.

Regarding contractual terms, the asset must be one that gives rise to principal and interest payments. Essentially this means that loans and simple bonds could be carried at amortized cost, although as with most accounting issues, the overview can be simple but the details can get quite complicated. For example, a loan that provides for both fixed and variable interest would be viewed as a basic loan and interest rate resets based on changing rate criteria would not disqualify the loan from amortized cost status.

Instruments not falling into the amortized cost category will generally include all equities and many complicated types of structured or hybrid fixed-income products.

If an asset meets both criteria than it can be carried at amortized cost, although fair value could be chosen if such a designation would avoid an accounting mismatch.

As is the case with the FASB proposal, the IASB approach eliminates both the available-for-sale and held-to-maturity designations. While the criteria for amortized cost sounds somewhat like the HTM category, there are no "tainting" rules so the category will be more encompassing.

## **2. Impairments move to an expected loss basis**

As with the FASB, the IASB exposure draft proposes a change in the accounting for loan losses from an "incurred loss" basis to an "expected loss" basis. This will require banks to establish provisions for losses based on what they project losses will eventually be rather than waiting until the loss is actually incurred. In normal times this would require losses to be recognized earlier in an economic cycle, thus, requiring less provisioning in the downside of a cycle. The likely result would be to minimize the perceived procyclicality of provisioning by minimizing the need to add dramatically to loss reserves in difficult economic times. The result should be more stable provisions charged against earnings, and, thus, potentially more stable earnings.

Currently, under both US and international accounting standards losses on loans can only be recognized when it is probable that a loss has occurred based on the facts available at the reporting date. The key to this approach is that losses cannot be anticipated even if past experience suggests that losses will be incurred in the future. This approach was designed because it was believed that the requirement for a specific loss trigger would minimize the ability of reporting entities to manage earnings.

In practice, identifying when losses have incurred has proved difficult and this methodology is now seen as delaying loss recognition, thus, resulting in catch up provisioning in times of economic stress.

By contrast, the expected loss approach is based on the premise that losses are an integral part of the lending process and that loan pricing anticipates that defaults will occur. Thus, revenue recognition i.e. the interest income is not based on the gross price of a loan but on the net amount that ultimately is expected to be earned. This, in essence, allows for anticipatory loan loss recognition.

## **3. Modifying the fair value option for financial liabilities**

Currently, financial liabilities are recorded at amortized cost, although companies may utilize the fair value option for carrying their own debt, in which case changes in fair value would be recorded through profit and loss.

The exposure draft would allow companies to continue using the fair value option but the component of the change attributed to a deterioration or improvement in its own credit standing would go through OCI rather than income.

This would be done in two steps with the full change in fair value being recorded in income and the own credit portion reclassified to other comprehensive income.

**4. Other Comprehensive Income will now be presented in the same continuous statement as net income.**

The IASB has proposed essentially the same presentation of comprehensive as has the FASB. That is both net income and OCI in the same continuous statement with earnings per share based on net income even though that is no longer the bottom line in the new statement.

# Macquarie Analyst Comments

## **US Regional Bank Team**

In terms of fundamental analysis, we feel that recording a loan that is meant to be held to maturity at fair value is unneeded. The business model of the banking industry is to intermediate between depositors and borrowers and the profit results from the spread between the return of principal and the collection of interest and the cost of funds. We do not see the merit in adjusting the carrying value of loan for interest rate and liquidity risks if the loan is meant to be held to maturity. Also, since there is no active secondary market for bank loans, the fair values would have to be determined through internal models in which we have little confidence and which give managements far too much leeway in determining values.

Regarding impairments, we like the idea of having a consistent standard for impairment, as the current system has different approaches depending on the asset type. At the end of the day, credit risk should be measured and treated in the same manner for all asset classes.

Valuing core deposits at net present value rather than face is a slight offset for fair value of loans, but similar to loans, we do not see a lot of value in the measurement. The main purpose of marking core deposits to market is in a transaction (either selling branches or the whole bank). Deposits are not traded like securities and are the primary funding tool for the banks. We don't see the need for an interest rate mark on the deposits.

We believe that adopting fair value accounting for bank loans would be a negative for bank stock performance. Our initial take is that: 1) FV will create more volatility in comprehensive income which will likely become an investor focus and would lead to bank P/E multiple compression; 2) managing NIM will be more volatile/difficult (and there will be downward pressure in the near term); 3) based on our conversations with industry contacts, we do not believe these FV marks will be included in regulatory capital calculations. This will cause two sets of accounting for banks GAAP (FV) and regulatory (more historical cost); 4) P/B and P/TB multiples will likely rise in the short term as capital levels decline from FV marks; 5) a more forward looking reserving methodology is a plus, but reserves will now be for all cash flows (principal and interest) rather than just principal losses; and 6) potential offsets include the FV of debt and deposits, but this is likely only to have a minor impact.

## **European Bank Team**

Our thinking on this issue is largely the same as our US colleagues. We believe that the predominant consideration in carrying financial instruments should be the business strategy of the reporting entity. In the case of banks, this would result in loans being carried at amortized cost while for investment banks it would be fair value with changes through net income. Thus, we see ourselves on the side of the IASB in this debate.

We, like many others, see the current standards for impairments under either USGAAP or IFRS being unduly confusing and inconsistent. Therefore, we applaud the moves of the Boards to move to a single impairment standard and to eliminate the incurred trigger that undoubtedly allowed (required) banks to delay the recognition of losses.

Regarding the specifics of recording losses, we favour the IASB approach of reporting income based on the expected pricing.

## Japan

### Ismael Pili

In Japan, J-GAAP has loans being assessed on face value and securities at fair value. Unrealized gains/losses on AFS are booked against equity, and there's no disclosure on other comprehensive income (there's currently no concept of OCI under J-GAAP).

On loans, Japan may have little choice but for the IASB approach, largely led by the lack of secondary market and doubts over a bank's ability to measure clearly and implement credible internal models (especially in Japan, where banks defy the technology perception on the country with non-24hr ATMs that are not internationally linked). In the context of Japanese bank lending, where oftentimes there seems to be government influence if not directed lending, we're not comfortable giving too much leeway to managements that seem beholden to the social good.

On investments and equity holdings, the high portion of investments and equity holdings that these Japanese banks hold means anything related to MTM or a push to recognize everything through the P&L should add pressure on these institutions to unwind their cross holdings and/or discourage increasing their investments. The mega banks, for example, have hundreds of subsidiaries and have domestic holdings equivalent to roughly 40-80% of shareholders' equity. These investments and equity holdings have been a source of earnings volatility and uncertainty to the banks, both directly (through realized gains and unrealized losses) and indirectly (potential loss of reciprocal business from corporates that they own and are selling down). J-GAAP compels that unrealized losses on equity holdings exceeding 30-50% be booked in the 'gains & losses from equities' line in the P&L, while only realized gains on equity holdings are recognized in the same line.

On LLP, an "expected loss" basis is but logical on the theory that it'll help stabilize earnings. Still, in keeping with our cynicism that the greatest fudge factor for banks to meet guidance or consensus is the provisions line, we still see scope for manipulation on the recognition of expected losses. Even with the current classification, there is already a degree of forward-looking assessment in the provision charges that can be imputed (deterioration in economic conditions/business, for example, can be applied liberally, or a loan can be deemed not as bad). A bank can also increase their general provision (GP) beyond the prescribed ratio of say, 1%, under the banner of 'prudent' provisioning policy as we've seen done by banks in other countries.

## China

### Victor Wang

For China banks, we would prefer loans are booked at amortized cost. The reason behind is that this approach minimizes the workload required to regularly reassess loan value, which is not only difficult in China given its limited (or near nonexistent) asset transferring market but also can potentially increase operational risk, given China banks' enormous operational scale (we are talking about >10k branches for large names).

From the regulator's perspective, we would assume CBRC wants to have a simple, straightforward and consistent approach also.

## Korea

### Chan Hwang

Under Korean GAAP, we currently use the fair value for securities, while loans are booked at amortized cost. However, from 2011, Korean banks have to adopt IFRS.

Obviously, it is easier for us, banks, and regulators to book loans at amortized cost. In addition, practically, it will not be easy task to adopt the fair value method. However, making each bank evaluating their loans based on fair value is not a bad idea, in our view (as far as we know, fair value should be calculated by projected cash flow including commission income/expenses instead of secondary market pricing). From this practice, top management could be able to look forward and establish their strategy for the longer term. A critical issue in adopting the fair value (as many analysts indicate in this report) should be transparency. However, this should be judged by the market.

### **Singapore/Malaysia**

#### **Matthew Smith**

More generally, we tend to agree that implementation of fair value accounting for loans intended to be held to maturity is the wrong move. The irony is that the attempt to provide greater transparency will likely result in the opposite -- opaque model-based valuations will only increase the ability to manage earnings. If reported fair valuations are generated by regressing historical data to estimate future cash flows, this will be right only until it's wrong -- the "20 sigma, once in 4 billion years" event that occurs every few years. Or where such historical data doesn't exist, will estimates be done via ad-hoc guidelines by regulators? Or even worse, management making it up themselves? None of this inspires confidence, and we don't see how it helps us understand the businesses.

However, the argument that "determining fair value is too difficult for banks in Country X" is also not entirely convincing. This may be the reality today for much of our coverage (and, for example, it's also certainly true for many of the Taiwanese banks) and obviously there are costs involved that may not be justified. But from a purely theoretical perspective, it wouldn't be such a bad thing for banks to get a handle on their overall credit risks. Every individual micro-loan and credit card balance doesn't have to be audited individually -- presumably pools of such loans based on common characteristics would be looked at instead.

### **Taiwan**

#### **Jemmy Huang**

We have basically the same arguments for the Taiwan banks that amortization method may be preferred. There are no active secondary markets for loans to do the fair value assessment and the internal rating system is not complete for most of the banks. Also, the resulting earnings and book value volatility is not something regulators or banks would like to see, especially during the economic downcycle. One example is that insurance companies faced serious capital pressure during the financial crisis as their equities were undermined by the MTM losses and regulators had to come up with forbearance to allow them to recognize only 20% losses when calculating the solvency ratios. Therefore, we don't think the fair value methodology will be carried out any time soon.

## India

### Suresh Ganapathy

For Indian banks, we would also prefer loans being carried at amortised cost and think the regulators as well as banks would prefer the same. The key issue here is that all MTM hits (diminution in fair value) needs to be taken through the P&L in India and moving towards a fair value based accounting can create enormous P&L volatility which neither the banks nor the regulator would want. Moreover since 70% of banks in India are state-owned they clearly don't have the MIS to transition towards such an accounting system (they have already postponed implementation of IFRS for Indian banks from 2011 to 2013, citing system implementation issues) and similar to Indonesia we also don't have an active market for bank loans to effectively determine their fair value and banks don't have capability to develop internal models to assess the true impact. In fact, even in Basel –II, none of them have transitioned to an internal ratings-based approach for assessment of credit risk, citing that they don't have enough data/MIS to effect such a transition.

## Indonesia

### Ferry Wong

For Indonesian banks, we would also prefer loans are booked at amortized cost. Although the Central Bank has implemented IASB starting in 2010, only one bank so far has used this method in the 1Q2010 due to complex implementation. The implementation will be very difficult and time-consuming to reassess loan value using fair value methods in Indonesia. The loan portfolios primarily consisted of SMEs loan with a large amount of borrowers with relatively small size of loans. Furthermore the big number of micro lending loan (loan size of less than US\$1,000) in Indonesia will make this implementation difficult. This could potentially increase operational risk, given Indonesia's banks' enormous operational scale with thousands of branches.

We also do not see the value in adjusting the carrying value of loan for interest rate and liquidity risks if the loan is meant to be held to maturity. Furthermore, there is no active secondary market for banks loans, the fair value would have to be determined through internal models about which we have no idea of implementation, especially for the medium to smaller banks. The bigger market cap banks in Indonesia have been implementing a very conservative approach by aggressively accumulating provisions (over provisions) that cause the provision to NPL coverage to be more than 175% and more than 400% for some banks.

Since the Central bank is not allowing banks to put the impact of IASB into the profit and loss statement, this would lower credit cost of provision in this year and next year and will be accretive to book value and drive sector earnings higher as future provisions decline because the Indonesian banks will no longer overprovision. So Indonesian banks will not be as conservative as in the past. We would expect some delays in the IASB implementation in Indonesia this year, especially for smaller banks.

## Thailand

### Alastair Macdonald

#### Loans:

This is starting to sound rather one-sided from Asia, but we also have to support the IASB's approach to bank loans, i.e. amortised cost rather than fair value. The key impediments to the fair value approach in our view are:

- 1) Lack of transparency, given the limited secondary market for bank loans and uncertainty over choice of discount rates to value longer maturity loans
- 2) Practical hurdles in measurement - somewhat limited historical data that could be viewed as practically useful in a Thai context, and

- 3) Practical hurdles in implementation - some banks' IT systems may have the capacity to handle a fair value approach but we are not confident this could be done across the industry.

We would take the same approach to deposits and other interest bearing liabilities. To report additional income as a result of your own credit rating declining strikes us as barking mad.

However, we would support further evolution in applying the fair value approach to investments (in debt and equity securities). We are not very familiar with the "OCI", but we can see a case for including this below the income statement for banks to illustrate changes in valuations of investments for which transparent market valuations are available. At the moment, the Thai banks have a three-tiered approach to valuing investments:

- 1) Trading - marked to market, changes in valuation booked through the income statement;
- 2) Available for sale - marked to market, changes in valuation reflected in the balance sheet via changes in revaluation surplus (deficit); and
- 3) Held to maturity - amortised cost unless subject to impairment.

Realised gains or losses on disposal for all categories recognised in the income statement.

We find ourselves trying to strip out realised gains (losses) from the income statement and just keeping an eye on changes in AFS surpluses in the balance sheet. Putting all of these in an OCI, which is separate from the "core" income statement but clearly visible could offer a step forward. The lurking problem remains the HTM items - how do you set a standard which improves the accuracy of instruments which, by definition, do not have transparent and credible market prices?

#### **Impairments:**

We would also favor the IASB approach to loan loss provisioning. If banks can establish credibility with investors that they understand the potential for credit costs on different types of lending through an economic cycle, and reduce the volatility in provision charges, we think the market will reward them with higher ratings. We suspect there would likely be a disconnect between the accounting treatment of expected loss provisioning and the tax authorities' views on allowable expenses, as per the current Thai approach, in which the minimum required provisions set by the Bank of Thailand are allowable expenses for income tax computation whereas any additional discretionary provisions are not. But investors would probably understand this and forgive marginal inefficiency in tax minimisation in return for much reduced provisioning and earnings volatility through the cycle. A prime example would be HSBC, which booked "special general" provisions against lending in a number of Asian countries in response to the 1997/8 Asian financial crisis well in advance of being able to establish the actual losses.

#### **Fair value:**

We would view a presentation of the entire balance sheet based on "fair" values for all instruments as interesting but ultimately somewhat academic. We all know that assets trade below their theoretical fair values in times of stress (such as 4Q08/1Q09) so no amount of additional accounting disclosures is going to prevent that happening again. Similarly, in M&A, some managements and their advisors will always come up with creative arguments to overpay for acquired assets.

#### **Global Financial Coordinator**

##### **Alan Zimmermann**

Since I don't follow companies but just macro trends, I view the financial instruments issue from the perspective of an accounting theoretician rather than as an analyst. This I will concede is a classic ivory tower approach.

From this perspective, I believe that fair value is more meaningful for understanding the value of an entity than any measurement approach driven by historical data, simply because it represents a current rather than a past value. Also, exit values (what can I get for this instrument) seem more relevant than an entry value (what did I pay for it).

While I recognize that in illiquid markets determining the value of financial instrument might be challenging, I am willing to live with the fact that the values are determined largely by management assumptions. Since assets valued by internal models have to be fully disclosed as Level 3 assets, users can determine on their own how much credence to attach to the numbers.

While many observers make the case that fair value contributed to the last financial crisis, I would argue the opposite that fair value identified problems early and actually speeded up the recognition of the problems caused by illiquid markets and thereby contributed to a faster resolution.

Regarding loan loss provisioning, I have long believed that requiring a trigger event before a loss could be recognized is a flawed approach because it is extremely difficult to identify when a loss has been incurred. Also, I believe that the impairment of all instruments should be measured by the same criteria rather than the current standards which have a myriad of rules to determine impairment.

Therefore, the move to recognize losses on an expected basis is welcome as is the single criteria for measuring impairments. In general, though, I lean more toward the IASB approach of allowing losses to be recorded on a forward basis as I believe inherent in all lending decisions is an estimate of ultimate pricing which would be the key determinant of provisioning.

As a final point, I have long believed that there is useful information in other comprehensive income so I welcome the requirement to have OCI included in the same statement as net income even though I recognize that this is not new information but just a repositioning of the location of the numbers.

The Boards are making this change in OCI to enhance its prominence and I believe this will happen with the repositioning. Specifically, I believe financial statement users will begin to question why some items are included in net income and why others are in OCI. I believe they will inevitably conclude that OCI has been designed as a convenient dumping ground for some items that are inherently volatile.

It seems clear from the differences of opinion in the fair value/amortized cost debate that the issue can not be resolved to everyone's satisfaction. The FASB approach for both expanded disclosures and the use of OCI for many of the changes in fair values seem to be reasonable compromises. By expanding disclosures, the proponents on either side of the debate can see the data they prefer while allowing changes in fair value to be recorded through OCI rather than income allows for more stability in earnings than would be the case if income was affected.

**While I feel strongly about these opinions I also believe that far more weight should be given to the opinions of the practicing analysts, particularly those that follow banks. And, those opinions are quite clear in both this report and in the commentaries of many others.**

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Recommendation definitions	Volatility index definition*	Financial definitions																																
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<p><b>Recommendation proportions – For quarter ending 30 June 2010</b></p> <table border="1"> <thead> <tr> <th></th> <th>AU/NZ</th> <th>Asia</th> <th>RSA</th> <th>USA</th> <th>CA</th> <th>EUR</th> <th></th> </tr> </thead> <tbody> <tr> <td>Outperform</td> <td>50.55%</td> <td>64.29%</td> <td>54.41%</td> <td>45.63%</td> <td>65.08%</td> <td>50.26%</td> <td>(for US coverage by MCUSA, 4.58% of stocks covered are investment banking clients)</td> </tr> <tr> <td>Neutral</td> <td>35.16%</td> <td>17.15%</td> <td>38.24%</td> <td>47.91%</td> <td>30.69%</td> <td>35.16%</td> <td>(for US coverage by MCUSA, 5.56% of stocks covered are investment banking clients)</td> </tr> <tr> <td>Underperform</td> <td>14.29%</td> <td>18.56%</td> <td>7.35%</td> <td>6.46%</td> <td>4.23%</td> <td>14.58%</td> <td>(for US coverage by MCUSA, 0.00% of stocks covered are investment banking clients)</td> </tr> </tbody> </table>				AU/NZ	Asia	RSA	USA	CA	EUR		Outperform	50.55%	64.29%	54.41%	45.63%	65.08%	50.26%	(for US coverage by MCUSA, 4.58% of stocks covered are investment banking clients)	Neutral	35.16%	17.15%	38.24%	47.91%	30.69%	35.16%	(for US coverage by MCUSA, 5.56% of stocks covered are investment banking clients)	Underperform	14.29%	18.56%	7.35%	6.46%	4.23%	14.58%	(for US coverage by MCUSA, 0.00% of stocks covered are investment banking clients)
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