

THE CFO NETWORK

30 September 2010

Accounting Rules and Business Models

We, CFOs of the twenty largest banks in Europe, welcome the opportunity of providing the FASB with our thoughts regarding the use of fair value in accounting.

The objective of financial reporting should be to help investors estimate the value of the reporting entity. Internally, it guides management for decision making but it is pointless to oppose management's needs and investors' needs: management works for the shareholders and makes decisions designed to increase the value of the company. External and internal information should therefore naturally reflect this fact.

But, in a company's ordinary life, before any asset can be purchased or any liability entered into, plans and decisions must be made. By definition, the performance of business activities resulting from these decisions requires intellectual and physical inputs. This highlights a critical fact of financial reporting: business activities involve more resources than can be reflected by assets and liabilities on a balance sheet. **Consequently, the value of a company does not equal the sum of the values of its assets minus the sum of the values of its liabilities.** Business activities involve a dynamic interplay between resources in the context of a predetermined, deliberately organized process. The key lies in the process that is specific to each type of business activity. It is the process, and its organization, **the "business model"**, that determines whether or not a combination of resources is successful.

Each business activity has an economic logic, specific to that activity. Different business activities have different business models, each based on a different economic logic. The value of a resource to an activity depends on the way it contributes to net cash inflows, in context of the economic logic of the activity in progress (i.e. depending on its function and use).

Trading or not trading: that is the question

An asset can produce benefits in different ways. To simplify, an asset's contribution to net cash inflows can be broken down into two basic forms of logic: contribution by use and contribution by exchange. Contribution by use refers to an economic logic in which an asset's value is derived through the use of a resource, either alone or in conjunction with other assets and liabilities. Conversely, when a resource contributes to net cash inflows by exchange, the cash flow contribution under this model is achieved by giving up the resource.

Because an item can be used in those two ways, financial reporting must recognize the differences inherent in those business models and reflect them in the financial statements. Let us call "trading" a business creating value primarily by exchange and "cash flow activity" a business creating value primarily by use.

The following example, detailing two companies that use trucks in different capacities, demonstrates how the value of an asset may differ depending on the entity holding it.

Used truck dealers buy and sell trucks. The current values of the trucks it owns are of major importance for the shareholders and investors, as the entity can realize value only by the sale of the trucks. Therefore, the entity generates profit based on changes in the fair market values for the trucks. If the price of trucks goes up, it is an important and positive parameter for an increased value of the company itself.

Delivery companies will use their trucks in the long term to generate profit by delivering goods. What matters to shareholders and investors is the gap between delivery revenues and costs, and the key element of costs is the amortization of the trucks' acquisition price over the life of the trucks. Reflecting the fair value changes of the trucks in the financial statements would distort the representation of the company's performance. If the price of trucks goes up, it does not have a significant impact in the operating profit. Marginally, it is even a negative parameter as it will cost more to replace old trucks and the company may become less competitive, compared to other delivery means (rail, sea,)

Financial activities are not different and can be carried out under two business models.

- **Trading activity** involves actively buying and selling financial instruments, just as one would do with trucks or buildings. This business model implies high turnover and active hedging or arbitraging. The primary objective of this business model is to realize value through the exchange of items.

Examples of trading activities include broker/dealers' business, mutual funds' management, hedge funds' arbitrage.

- **Cash flow activities** consist of lending and borrowing money, holding and issuing securities, and gathering deposits in order to derive earnings from the cash flows that they generate. It may involve selling assets occasionally, but not with significant frequency.

Examples of cash flow activities with financial instruments include industrial companies' funding, insurance companies' general fund management.

Banks tend to do both, in separate divisions, often referred to as "trading desks" and "banking book" respectively.

One example of a "Cash Flow" activity in the financial industry: The Banking Book Business model

The banking book business model involves acting as an intermediary between economic agents that are either depositors, investors, or borrowers. These economic agents have different needs and risk appetites depending on the roles that these agents play at a given point in time.

For example, an individual customer may be both a depositor and a borrower. As a depositor, this economic agent is primarily interested in being able to withdraw deposits on demand to satisfy liquidity needs. As a borrower, the economic agent needs to be able to forecast its future payments on loans. He therefore desires predictability in long term cash flows. Banking book activity is providing the right service at both ends and is left with a liquidity risk, which is managed with market instruments like treasury bills and bonds, and issued securities and derivatives.

This business model also provides borrowers with protection from fluctuations in market rates. The bank transforms short term resources into long term loans and transforms floating rate deposits into fixed rate assets. Then it has to hedge the interest rate risk of the banking book, and financial institutions are therefore obliged to use derivative instruments.

The business model of the banking book activity can therefore be described as three basic portfolios:

Customer relationship portfolio: includes deposits, medium to long term borrowings, and loans granted to clients. This portfolio creates liquidity risk due to the timing differences of cash flows related to these instruments, as well as interest rate risk caused by differences in returns on both sides of the balance sheet.

Liquidity risk hedging portfolio: this portfolio consists of assets and liabilities that the bank holds to manage the liquidity risk created by maturity mismatches generated by the customer relationship portfolio. The purpose of this portfolio is to complement the asset or the liability side to mitigate risk arising from maturity differences on both sides of the balance sheet. For example, it includes currency swaps in order to create funding in one currency out of an issue denominated in another one. It is, however, also a portfolio that allows the bank to hedge its interest rate risk.

Interest rate risk portfolio: This portfolio is composed of financial instruments that are primarily derivative instruments used by the bank to hedge the residual interest rate risk left over from the first two portfolios.

It is obvious, from an economic point of view, that the existence of the three portfolios in this organizational scheme make sense only when they are used simultaneously. Therefore, a banking institution can only realize value by holding financial instruments for the long term.

How to differentiate between the two activities?

There is a very clear difference between the two kinds of activities of a bank :

- they follow different management practices and different prudential rules
- they are easily identifiable by management and auditors.

The separation between the two books is easily auditable. Only in exceptional circumstances it may occasionally make sense for the entity to transfer an asset or a liability from one book to the other. It may be a trading book asset, whose market becomes suddenly illiquid, due to a financial crisis. As it is now impossible to sell it, the bank will keep it in the banking book. Conversely, it may be a banking book asset that the bank decides exceptionally to sell and it is expedient to transfer it to the trading division's relevant teams and ask them to sell it in the market at the optimal price. Financial reporting should recognize these exceptional transfers and allow the entity to reflect and disclose them in the reporting of the entity's performance. These transfers are easy to control and justify. In terms of difficulty, this is much simpler and more transparent in comparison to controlling the fair value of an instrument that is no longer traded on an active market.

Accounting and business model

As previously stated, management works to add value for investors. It is also true that investors rely on financial reporting to determine the performance of the entity and the effectiveness of management decisions.

Consequently, it is clear that there is an interaction between the financial reporting framework and decisions made by management. If accounting rules are not adaptive to the entity's business model, and if these rules do not provide a relevant representation of the effects of management decisions, it will naturally lead management to run the business differently in order to present the entity's performance more favorably.

What market participants need is a mixed measurement accounting framework that allows companies to implement their business model appropriately. The separation between fair valuing and cost accounting should be driven according to the business model and not by the nature of the instrument: fair value should be limited to trading activities. Amortized cost should apply to long term "cash flow" activities, be it banking books, insurance companies investments or corporate funding.

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For this reasons, we don't support the FASB proposed single fair value measurement approach. As a consequence, we don't support several key aspect of FASB proposals :

Own credit risk – We believe that own debt should be measured at fair value only where the fair value option (FVO) has been used to reduce accounting mismatches and that the effects of changes in own credit risks in respect of FVO liabilities should not be recognized in the income statement.

Hybrids/Embedded derivatives – We do not support the FASB's approach whereby hybrid financial instruments containing such embedded derivatives previously bifurcated are classified at FV to income statement as this is not consistent with the mixed measurement approach and introduces further complexity to the accounting for financial instruments.

Core deposit liabilities – We do not support the FASB's proposed measurement model for core deposit liabilities as the measurement basis neither represents fair value nor amortised cost. In our view, introducing alternative measurement bases introduces undue complexity and is a departure from a principle-based approach to classification and measurement.

Reclassification – We do not agree with the FASB's proposal to prohibit reclassification of financial instruments after their initial recognition. Under a mixed measurement approach, reclassification should be permitted (maybe even required !) when there are clear indications that the business model for a particular instrument has changed.

Impairment – As a consequence of our preference for a mixed measurement model, we do not support the FASB's proposals regarding immediate recognition of credit losses. We also believe that including a consideration of future events and conditions provides more relevant decision useful information. We are therefore supportive of the objective of the IASB's expected loss approach where losses are recognised on an expected basis using all available credit-related information.

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We suggest that, rather than sticking to its full fair value approach, the FASB should work in cooperation with the IASB towards a converged, business model based, mixed measurement approach to accounting for financial instruments.

The recently inaugurated CFO Network is a high-level discussion group formed and attended by the CFOs of the top 20 banks by total assets within the European Union. It seeks to present a common and technically well-informed position on behalf of Europe's largest banks to policymakers, regulators and others on the key issues faced by the banking sector and the financial system.

The CFO Network members are:

<i>- Barclays Bank:</i>	<i>Mr Chris Lucas</i>
<i>- BBVA:</i>	<i>Mr Manuel Gonzalez Cid</i>
<i>- BNP Paribas:</i>	<i>Mr Philippe Bordenave</i>
<i>- BPCE:</i>	<i>Mr Nicolas Duhamel</i>
<i>- Commerzbank AG:</i>	<i>Dr Eric Strutz</i>
<i>- Crédit Agricole:</i>	<i>Mr Bertrand Badré</i>
<i>- Danske Bank:</i>	<i>Mr Lars Andreasen</i>
<i>- Deutsche Bank:</i>	<i>Mr Stefan Krause</i>
<i>- Dexia:</i>	<i>Mr Philippe Rucheton</i>
<i>- DZ Bank:</i>	<i>Mr Albrecht Merz</i>
<i>- HSBC:</i>	<i>Mr Douglas Flint</i>
<i>- ING Groep:</i>	<i>Mr Patrick Flynn</i>
<i>- Intesa Sanpaolo SpA:</i>	<i>Mr Carlo Messina</i>
<i>- Lloyds Banking Group:</i>	<i>Mr Tim Tookey</i>
<i>- Nordea:</i>	<i>Mr Fredrik Rystedt</i>
<i>- Rabobank:</i>	<i>Mr Bert Bruggink</i>
<i>- Royal Bank of Scotland:</i>	<i>Mr Bruce van Saun</i>
<i>- Santander:</i>	<i>Mr José Antonio Alvarez</i>
<i>- Société Générale:</i>	<i>Mr Didier Valet</i>
<i>- Unicredit SpA:</i>	<i>Mrs Marina Natale</i>