BASEL COMMITTEE ON BANKING SUPERVISION

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Chairman

Sir David Tweedie
Chairman
International Accounting Standards Board
1st Floor, 30 Cannon Street
London EC4M 6XH

30 September 2001

Dear Sir David,

The Basel Committee on Banking Supervision appreciates the opportunity to comment on the discussion paper and draft fair value accounting standards issued for comment last January by the International Accounting Standards Board (IASB) and the other members of the Joint Working Group of Standard Setters. You will find our comments in the enclosed note.

The Basel Committee's Accounting Task Force (ATF), chaired by Prof Arnold Schilder, Executive Director of De Nederlandsche Bank, has prepared the enclosed note. This note has been approved by the Basel Committee. The ATF has dedicated significant resources to analysing the key issues associated with fair value accounting and to the preparation of our comments to the IASB. These activities were coordinated by an *ad hoc* subgroup on fair value accounting under the direction of Gerald A Edwards, Jr, Associate Director and Chief Accountant – Supervision, Federal Reserve Board. The Basel Committee trusts that you will find its comments useful and constructive.

If you have any questions regarding our note, please feel free to contact Prof Schilder (+31 20 524 3360), Mr Edwards (+1 202 452 2741) or Mr Bengt A Mettinger of the Basel Committee Secretariat (+41 61 280 9278).

Yours sincerely,

WJ McDonough

Enclosure

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The Basel Committee on Banking Supervision

Comments on

Draft Standard & Basis for Conclusions

Prepared by the Financial Instruments Joint Working Group of Standard Setters

Issued for Public Comment by the International Accounting Standards Committee

30 September 2001

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1. Executive summary

1.1 The Basel Committee on Banking Supervision (the Committee)[1] expresses its strong support for transparency. The Committee highlights the need for the International Accounting Standards Board (IASB) and other accounting standard setters to improve the standards for loan loss provisioning and credit risk disclosures in the short term, since this is the critical need of the moment. While fair value accounting has some conceptual appeal (and is appropriate for trading activities), the Committee has specific concerns about the conceptual and practical issues that are associated with this proposed accounting model. In particular, considerable difficulties exist in reliably estimating the fair value of bank loan portfolios, even when internal credit grading systems exist.

1.2 Moreover, apart from their trading and derivatives activities and certain asset sale activities, most large banks do not use fair value measurement internally to manage their risks. While some generate certain types of present value calculations or fair value-based information (such as value-at-risk) for their banking book activities, fair value measurement is not the basis for their risk management practices for the banking book.

1.3. In addition, discussions with bank analysts indicate that most do not see a need for fair value accounting in the primary financial statements at this time. Moreover, the current supplemental fair value disclosures of those banks that provide them under national or international standards ordinarily do not provide information that forms an important part of the analysts' evaluations of banks' condition and performance. This leads to questions about whether a move to fair value accounting in the primary financial statements is consistent with users' information needs.

1.4. Therefore, the Committee does not believe that the time is right to prescribe full fair value accounting in the primary financial statements for all financial instruments of banks. Instead, new, improved supplemental disclosure of enhanced fair value information in financial statement footnotes by major firms in a manner that is useful to financial statement users, coupled with the development of reasonably specific standards for the valuation of loans and other assets for which active markets do not exist and bank liabilities such as deposits, could be a useful way of improving the quality of information available to users of financial statements. In this regard, the Committee recommends that a working group of risk management and valuation experts should be appointed with the goal of researching and, where possible, developing reasonably specific sound practices guidance on appropriate methods for valuing illiquid instruments, which comprise the vast majority of bank assets.

1.5. The Committee recognises that in years to come financial markets for banking book instruments may evolve to become more active in many parts of the world and that risk management practices and user information needs may further evolve in a manner consistent with these market developments. Over time, if (i) the conceptual and practical issues associated with fair value accounting are resolved, (ii) active markets develop for major aspects of banking book positions and their credit risks, (iii) bank risk management approaches evolve further to internally rely on fair value measurements, and (iv) users of financial statements find fair value to be the best measure in the primary financial

[1] The Basel Committee on Banking Supervision is a committee of banking supervisory authorities which was established by the central bank Governors of the Group of Ten countries in 1975. It consists of senior representatives of bank supervisory authorities and central banks from Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Spain, Sweden, Switzerland, the United Kingdom and the United States. It usually meets at the Bank for International Settlements in Basel, where its permanent Secretariat is located.

statements, then fair value accounting might represent an improvement in financial reporting in the future.

2. Development of our comments

2.1. During the last decade, the Committee has issued extensive guidance and policy papers on risk management activities of banks. These releases have included guidance and research studies on sound practices for managing credit risk, market risk (including interest rate and foreign exchange risk) and other banking risks arising from trading and derivatives activities and banking book exposures. In addition, in its work on the New Basel Capital Accord, the Committee is developing new rules and proposals for comprehensively relating capital adequacy to bank risk profiles. All of these efforts have involved extensive consultation with global banks and others, and have been designed to promote the adoption of sound risk management by banks around the world. In reviewing the proposal on fair value accounting, the Committee has drawn upon its expertise in these areas and has sought to determine the implications of the proposal on risk management practices.

2.2. Moreover, the transparency of banks – facilitated by sound accounting and disclosure – is a very important objective of the Committee. The Committee has developed a number of important policy papers, surveys and supervisory guidance documents in support of this objective. Most notably, the enhanced capital framework that the Committee has proposed recognises the important role of transparency in effecting market discipline as a complement to effective banking supervision. In addition, the Committee has been actively involved in important projects, with the IASB and other standard setters, on financial instruments accounting and disclosure. In all of these efforts, the Committee has been seeking to improve the overall quality of financial reporting in ways that will enhance transparency and facilitate financial stability. Thus, the Committee has brought these perspectives to bear in reviewing the fair value accounting proposal.

2.3. The Committee, through its Accounting Task Force (ATF), has devoted significant resources, time and effort to analysing the Joint Working Group of Standard Setters' (JWG) proposal on fair value accounting. This effort has included the establishment of an ad hoc subgroup on fair value accounting under the ATF to specifically analyse the proposal. The subgroup was comprised of chartered/certified public accountants, financial analysts, senior economists and others with accounting expertise, and it consulted with other specialists within the Committee to ensure that the proposal was assessed in a manner consistent with our latest findings on risk management, valuation, and transparency.

2.4. In order to ensure that the Committee's comments and views on fair value accounting are informed by the everyday practical considerations of the industry and other relevant parties, the subgroup has, among other things, surveyed and met with bankers, analysts, auditors and other market participants in a number of key countries around the world. Consistent with a practical focus, these meetings and surveys paid close attention to banks' risk management, valuation, and disclosure practices and the use and potential usefulness of fair value information by banks and analysts. With auditors, the discussions and surveys focused on their ability to adequately test the reliability of fair value estimates during external audits. In addition, the subgroup conducted independent research in certain areas addressed in the fair value accounting proposal, including fundamental issues associated with the valuation of bank loan portfolios. The major findings of these meetings, surveys, and research are included as supporting commentary within the relevant sections of this note.

2.5. In addressing international accounting and auditing issues, the Committee has always been careful to understand current practices and emerging trends as a background to its assessment of proposals. At the same time, the Committee has been committed to maintaining its independence and objectivity in evaluating the complex aspects of the fair value accounting proposal. The views expressed in this note reflect the Committee members' unique objectives, as central banks and bank supervisors, in encouraging the adoption of sound risk management and transparency practices that will contribute to the safety and soundness of banking systems around the world.

3. Conceptual and practical issues

3.1. The Committee recognises that fair value accounting for financial instruments has some conceptual appeal, and believes that it is clearly appropriate for the trading activities of banks and other companies. The Committee, however, has specific conceptual and practical reservations and concerns about extending fair value as a measurement and presentation basis in the primary financial statements to instruments, such as illiquid loans, for which there are not observable market prices. Moreover, while there is movement toward the use of more present value-based and fair value-based information for risk management purposes at larger banks, fair value is not yet the approach that most banks are using to manage their loan portfolios and active markets do not currently exist in most countries for most bank loans. In view of these and other concerns, the Committee does not believe that the time is right to prescribe full fair value accounting in the primary financial statements for all financial instruments of banks. A move to fair value accounting at this time would not improve the quality of overall financial reporting by banks.

3.2. In particular, the Committee is troubled by the draft standard's lack of specific guidance on approaches for valuing illiquid financial instruments, such as bank loans. Without reasonably specific valuation guidance, the Committee is concerned that the subjectivity of valuations could increase, and the auditors' work to validate such valuations would be difficult at best.

3.3. In the Committee's expert judgement, the stated assumption of the JWG that internal ratings systems can provide the necessary valuation architecture for reliably estimating the fair value of non-traded instruments, such as bank loans, may overestimate the utility of such systems for this purpose. Internal credit rating systems have great promise for improved risk management, provisioning, and capital measurement. However, experience tells the Committee that current internal ratings systems are not designed to estimate the fair values of banking book loans since fair value measurement is not the basis upon which banks manage their banking book loans. Therefore, these systems may not provide the full range of information that would be required under a fair value accounting approach for the loan portfolio. These issues should be explored in greater detail before reliance is placed on these systems under a fair value accounting approach.

3.4. While there is conceptual appeal for all enterprises holding an asset to arrive at the same value for financial reporting purposes, the practical reality may well be that the value of even an actively traded asset will depend, in part, upon who holds it and their intentions. For instance, it is currently common practice for financial reporting purposes for banks to measure financial instruments in their trading account at mid market (i.e., the mean of the bid and the ask price) when they are market makers. In contrast, when banks hold other trading account financial instruments, it is common practice to measure positions for financial reporting purposes at the bid price on long positions and the ask price on short positions. Similarly, banks and other financial institutions typically make undisclosed measurement adjustments in their trading portfolios for factors such as liquidity, model risk and esoteric

structure that are calculated based on quantitative and judgmental considerations. The Committee believes that, while disclosure of these measurement adjustments would be an enhancement to transparency, it would not like to see these practices, where they represent appropriate prudence and industry best practices, supplanted in the trading book by a more restrictive valuation regime.

3.5. A fundamental difference between banking book and trading activities is that banking book assets tend to be held to maturity, while most trading assets are implicitly turned over frequently. Another difference is that active markets do not exist for the vast majority of bank loans. These loans tend to be highly customised, and banks have developed a large amount of proprietary financial information on their customers (especially for small and medium enterprises that do not issue debt instruments to the markets). In the absence of an active market for such loans or for their credit risks, it would be difficult to reliably value these loans using an exit value concept for fair value. In effect, the JWG proposal would replace the current mixed accounting model with a model that mixes mark-to-market and mark-to-model accounting. The Committee recommends that standard setters reconsider alternative valuation definitions to exit price for instruments, such as bank loans, when the intention is for an entity to hold the asset to maturity and when market price information is not readily available.

3.6. Some other areas of concern, which are manifest most prominently in the banking industry, are the valuation of core deposits and the effect of reflecting a company's own credit risk in the valuation of its liabilities. The first issue arises from the fact that bank deposits, especially retail deposits, do not function strictly speaking on their contractual terms. The persistence of depositors in renewing time deposits and maintaining deposits that are payable on demand over long periods of time is one of the reasons why such deposits can be sold in some jurisdictions for substantial premiums. On the one hand, the Committee has significant reservations about valuing deposits on the basis of what they could be sold for because doing so might inflate reported capital by including the essentially intangible value of customer relationships. On the other hand, valuing deposits solely on their contractual terms, especially those that are payable on demand, would in effect cause certain liabilities to be presented essentially at historical cost, while financial assets would be presented at fair value. The JWG's proposal that demand deposits should be measured on the basis of gross expected outflows is problematic both in practical terms and because it will create artificial volatility as explained below. Through its meetings and surveys, the subgroup found that many banks are currently developing statistical models to estimate customer deposit behaviour and manage their deposits. These types of statistical models and underlying approaches may be a worthwhile avenue of exploration for standard setters in resolving how best to fair value core deposits. Valuation issues, such as this, underscore the need for further constructive dialogue between standard setters and the industry, and related research.

3.7. The issue of a firm fair valuing its own liabilities presents the counterintuitive situation that a bank or other enterprise could recognise profits as its condition (credit rating) deteriorates and losses should its condition subsequently improve. Also, this approach may not be consistent with the legal frameworks for profit and loss reporting in many countries.[2] This issue is not only part of the larger issue of performance reporting under fair value but it also raises questions about the relevance of such information (i.e., about the potential earnings impact of liability revaluation) to users of the financial statements. In view of this

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[2] It is also often mentioned that this approach may affect legal frameworks that addresses the balance between creditors' claims and shareholders' rights.

and other significant issues arising from the fair value accounting proposal, the Committee recommends that the IASB undertake further work in these important areas.

3.8. More generally, there is the potential concern that significant volatility could be introduced to annual accounts under a fair value framework. The Committee would be concerned about any volatility that was in a sense "artificial," i.e., volatility that arises solely from the specified accounting treatment and not from a change in a company's risk profile. For example, the JWG's proposal to measure demand deposits on a basis which ignores expected replacement inflows would create an accounting mismatch between assets and liabilities (which would be different than the mismatch measured by most banks today for risk management purposes). Unresolved, this and similar issues and anomalies could lead to volatility in reported earnings and capital that in the Committee's judgement is not reflective of a bank's underlying risk profile.

3.9. Ideally, accounting standards should impartially and objectively report the underlying condition and business results of an enterprise. In practice, accounting and tax considerations often affect business decisions. The Committee believes that insofar as full fair value accounting represents a significant change to the structural framework and underpinnings of accounting theory and practice, due consideration must be given to the potential micro- and macro-economic effects. In particular, the Committee notes the importance of bank and other financial company lending and investment activities to the prosperity and growth of national economies. In this context, while the Committee has not yet evaluated these issues, the Committee believes that it is particularly important for standard setters to consider whether the adoption of full fair value accounting might have unintentional effects on the activities of bank and non-bank companies.

4. Fair value, a longer-term project

4.1. As many standard setters, users and preparers have noted, the various mixed attribute accounting models currently in use in most parts of the world, where certain financial instruments are reported at cost and others at market or fair value, are far from perfect. Moreover, the complex accounting rules for hedging instruments that have evolved to bridge the two reporting bases do not necessarily lead to more transparent financial statements.

4.2. The Committee recognises that many accounting standard setters view development of a full fair value standard as the single best way to address the shortcomings of current mixed accounting systems, as well as an opportunity to enhance harmonisation of accounting standards around the world. Setting aside, for a moment, the relative merits of this view, and in consideration of the conceptual and practical issues noted above, possible development of a full fair value standard for financial instruments can only be viewed as a longer-term project. It is too early to say whether this can be fully achieved. Therefore, and also for the short-term reasons that we explain in section 5 below, it is important that the IASB does not abandon efforts to enhance the current international mixed model accounting standard.

4.3. In this regard, the Committee notes that many basic elements of a comprehensive fair value accounting standard, such as performance reporting, have yet to be developed. Moreover, the Committee believes that due consideration must be given to the significant implementation challenges that banks and other enterprises would face in converting their primary accounting statements to a fair value presentation. Such implementation issues include reconfiguring their core financial reporting and control systems, and hiring additional specialised expertise in areas such as financial modelling and valuation. Auditors would also

face similar challenges to ensure that they were adequately prepared to evaluate the valuation approaches, including rating systems and models, that will likely increase the complexity of balance sheet valuations under a fair value accounting framework.[3]

4.4. A change in financial reporting to full fair value accounting from the mixed attribute models currently in use would also require a period of adjustment for analysts and other users of financial reports. In evaluating and trying to understand changes in reported financial results, analysts today can draw upon a rich and vast wealth of historical data that would become considerably less relevant in a paradigm shift as significant as the introduction of full fair value accounting in the primary accounting statements. The Committee believes that standard setters need to think in terms of a rather lengthy transition period for any contemplated shift to full fair value accounting. The Committee envisions that during such a transition period, both fair value and historical cost information would need to be presented in one form or another (primary financial statements or supplemental disclosure) to allow analysts to become comfortable with the nuances of financial statements presented on a fair value basis.

5. Critical issues that need current attention

5.1. In the context of considering the adoption of full fair value accounting as a long-term project, the Committee feels it is important that standard setters do not abandon efforts to continue to enhance the current accounting standards in the nearer-term. In this regard, greater use of expected loss approaches for provisioning purposes, consistent with sound internal risk ratings and methodologies, and better disclosures of credit risk and business segment information could enhance reporting by banks and other lenders, and provide information that is very relevant to the users of their financial statements. In the subgroup's recent discussions with banks, analysts and auditors around the world, most indicated that these areas, rather than the adoption of fair value accounting in the near-term, should be the short-term focus of the IASB as it seeks to improve the transparency and usefulness of financial reporting. Such a focus would also be consistent with the Committee's efforts to encourage banks to adopt stronger practices for managing credit risk and for maintaining appropriate capital in relation to their credit risk profiles.

5.2. The Committee would also like to point out that one of the concerns heard from virtually every bank analyst with whom the subgroup spoke was the lack of guidance on asset quality reporting in the JWG's proposal. Fair value reporting would, per se, eliminate loan loss provisioning and charge-off practices that currently provide highly useful information to analysts on trends in an institution's loan quality. Without a suitable reporting and disclosure methodology in place, changes in credit quality could be difficult or impossible to segregate from an overall change in fair value that encompasses, among other things, general changes in the overall level of interest rates. In the Committee's view, it is likely that any work standard setters undertake now to improve current asset quality disclosures, by more closely aligning them with risk management practices, will have applicability in any full fair value accounting standard that might be implemented in the future.

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[3] While the IASB does not have responsibility for international auditing standards, it is important, from a bank supervisory perspective, to recognise the need for auditors to be adequately prepared to perform their attestation roles under a fair value accounting model. Most bank auditor practitioners with whom the subgroup spoke in countries that do not have extensive loan sales expressed apprehension at their ability to evaluate fair value measurements for banking book loans in the absence of market prices. Most agreed that extensive training programs and more specific standards for valuation and related audit procedures would be needed if fair value accounting were adopted for the primary financial statements.

6. Recommendations to enhance fair value disclosure and valuation guidance

6.1. Increasingly, larger banks and other financial entities are devoting significant resources to estimating current values and risks of financial instruments in order to more effectively manage their businesses. These efforts include estimating current values for banking book exposures. While not necessarily conforming strictly to the draft standard's definition of fair value, these risk management initiatives nonetheless represent an important trend toward the greater use of present value-based information in the management of financial enterprises.

6.2. From its meetings and surveys, the ATF sees the trend of banks making greater use of present value information in managing their banking book risks continuing. However, at present, apart from their trading and derivatives activities and certain asset sale activities, fair value measurement is not the basis upon which banks are managed. In addition, for the banking book, when fair values are calculated internally, they are only one type of information that banks use for risk management purposes. Furthermore, there does not appear to be any particular consensus as to the valuation methodologies employed across the industry when fair values are estimated for internal purposes.

6.3. In light of banks' increased use of fair value-type information in managing their businesses, and recognising the unsettled and emerging state of the art, the Committee is of the view that enhanced fair value disclosure (i.e., disclosure that goes beyond current standards, such as IAS 32) coming initially from major firms could benefit the transparency and usefulness of published financial statements. For example, transparency could be enhanced by identifying financial instrument fair values that are based on active market prices separately from those that are based on estimates derived from similar instruments or models. Over time, such supplemental disclosures could provide a vehicle for both resolving many of the current performance reporting and valuation issues surrounding fair value accounting and testing the conceptual underpinnings of this potential accounting model. The Committee, through its ATF, would be available to discuss with the IASB such potential disclosure enhancements in more detail.

6.4. In tandem with supplemental disclosure, the Committee recommends that standard setters consider the formation of an expert panel to: (i) examine best practices in the area of valuation techniques; and (ii) assess the feasibility and practicality of formulating reasonably specific sound practices guidance on appropriate methods for valuing illiquid instruments, such as bank loans.

6.5. The Committee would envision that such a panel should be comprised of experts representing both preparers and users of financial statements, as well as limited numbers of other interested parties, such as accounting standard setters, auditors, and regulators. As envisioned, such a group should ideally have a broad perspective of expertise encompassing such areas as risk management, financial modelling and valuation and auditing.

6.6. An often stated goal of accounting standard setters is for accounting statements to reflect the results of an enterprise in a manner consistent with how managers actually run their companies, so that users of financial statements can have a perspective similar to management’s when evaluating a company. Consistent with this goal, the Committee believes that a change as significant as the adoption of fair value accounting should not be contemplated without meaningful input from the industry and user groups. The Committee encourages standard setters and bankers to work together in establishing a constructive dialogue with one another focused upon conceptual and practical considerations of fair value accounting.

7. Conclusions

7.1. While the Committee does not believe that the time is right to prescribe full fair value accounting for all financial instruments in the primary financial statements, it acknowledges that fair value is clearly appropriate for reporting on trading activities, and could be more broadly appropriate in the future. In particular, the Committee would need to see the important conceptual and practical issues, discussed above, resolved before it could consider supporting a full fair value standard for all financial instruments. In large part, resolution of these issues is unlikely to occur before more active markets develop for banking book positions and their credit risks, i.e., markets that are sufficiently deep as to permit the accurate validation and calibration of financial valuation models, particularly if an exit price approach is used to define fair value. The Committee also sees the acceptance of fair value as a reporting standard by preparers and users of financial reports as being largely dependent on risk management relying to a greater extent in the future on fair value measurement, particularly for the banking book.

7.2. The Committee encourages the IASB and other standard setters to continue their long-term work on resolving the conceptual and practical issues relating to fair value accounting. As mentioned previously, the Committee further believes that this work would benefit from ongoing and enhanced dialogue between the banking industry and standard setters.

7.3. The Committee, through its ATF, would be pleased to meet with the IASB to discuss these recommendations in more detail.