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Secretariat of the Basel Committee on
Banking Supervision
Bank for International Settlement
CH-4002 Basel
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Our ref MT
Contact Mary Tokar

22 April 2010

Dear Sirs

Comment letter on Consultative Document – *Strengthening the resilience of the banking sector*, December 2009

We appreciate the opportunity to comment on the Basel Committee on Banking Supervision's ("the Committee") Consultative Document – *Strengthening the resilience of the banking sector*, December 2009. This letter expresses the views of the international network of KPMG member firms.

We support the Committee's effort to address the lessons of the recent economic crisis as part of the G-20's initiatives to strengthen the global financial architecture. We have submitted this response in our role as auditors of supervised entities and our comments focus on the interaction of the Committee's proposals with accounting requirements and do not offer views on the merits of the proposed changes to the regulatory capital requirements. To the extent that our comments in this letter relate to the potential audit and accounting implications of the proposals, we assume that a supervised entity is reporting using International Financial Reporting Standards (IFRSs) and that auditors are reporting under International Standards on Auditing (ISAs).

The proposals are likely to increase the regulator's reliance on the published financial statements of banks. We support the Committee's efforts to minimise the need for additional information by maximising the use of existing financial reporting. Such an approach is efficient and would reduce the cost of developing parallel regulatory calculations. However, ultimately, the primary purpose of the financial statements is to serve the needs of investors for transparent financial information and so it may not always align with the prudential interests of supervisors. In our view, when there are such conflicts, the needs of the investors should prevail.

Unlike investors in capital markets, prudential regulators do not have to rely solely on published financial statements and have the ability to compel supervised entities to provide required information. However, there may be areas in which prudential supervisors have information needs that could be satisfied by relatively small amendments to IFRS disclosure requirements, even if the financial statements are prepared using an approach to recognition, measurement or disclosure that differs from the approach that prudential supervisors will use. In our detailed comments we have noted where additional IFRS disclosures might be helpful to support proposed adjustments to calculate capital for prudential supervisory purposes.

The Committee also has proposed a published reconciliation of regulatory capital and net assets as reported in audited financial statements, although it is not clear whether the Committee intends for this disclosure to be included within the audited financial statements. Requiring this disclosure to be within the audited financial statements would bring the calculation of regulatory capital within the scope of the audit and in some jurisdictions this could result in significant additional audit costs. Issues that should be considered in deciding whether such a reconciliation should be subject to audit include measuring the expected increase in audit cost against the benefit of the enhanced reliability that would result.

We also note that greater reliance on audited financial information would result in an enhancement to the consistency of global regulation if it is based on a common financial reporting framework. Therefore we encourage the global adoption of IFRSs not just for listed companies but for all supervised entities. Adoption of a single set of accounting standards should remove opportunities that exist today for accounting arbitrage between different sets of accounting standards.

Accounting standards and their interpretation change over time. This places an onus on supervisors to consider the implications of such changes for regulatory purposes. We would welcome the opportunity to discuss periodically with the Basel Accounting Taskforce the current accounting developments and share our views on proposed and final changes and their interaction with the Committee's capital, leverage and liquidity requirements.

Please contact Wienand Schruff at +49 30 2068 1480 or Mary Tokar at +44 (0)20 7694 8871 if you wish to discuss any of the matters raised in this letter.

KPMG IFRG Limited

Yours sincerely
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Appendix

1. Accounting matters

In several sections of the Committee's proposals it is not clear whether the proposed adjustments are intended to align with the IFRS requirements, or whether they are to be made to the amounts calculated in accordance with IFRS. We provide further details of these areas below. It would be helpful for the Committee to clarify its intentions in this respect.

1.1 Investments in own shares

The proposal at paragraph 100 to deduct from a bank's capital its investments in its own common shares is consistent with the general requirements in IAS 32: *Financial Instruments: Presentation* (IAS 32 paragraph 33). However, the proposed requirement to look through holdings of index securities to eliminate the portion that relates to a bank's own shares goes beyond the requirements of IFRSs and may be very complex to implement.

1.2 Cumulative gains and losses due to changes in own credit risk

We note that the proposals at paragraph 105 extend the requirements for a capital deduction in respect of changes to own credit risk to cover all liabilities that are subject to measurement at fair value through profit or loss, not just those that are so measured as a result of the application of the fair value option. Other liabilities measured at fair value include liabilities that are held for trading. We note that currently IFRS 7 *Financial Instruments: Disclosures* requires disclosure of changes in own credit risk only for liabilities designated using the fair value option as at fair value through profit or loss. Therefore the current IFRS disclosure requirements may not fully support the expanded regulatory requirements.

The International Accounting Standards Board (IASB) are expected to issue shortly an exposure draft revising the recognition and measurement principles for financial liabilities and the Committee may wish to raise the potential disclosure gap noted above as part of that consultation.

1.3 Defined benefit pension fund assets

The Committee proposes at paragraph 106 to deduct from Tier 1 capital defined benefit pension fund assets, unless the entity has "unrestricted and unfettered access" to these assets. IAS 19 *Employee Benefits* and its interpretation IFRIC 14 *The Limit on Defined Benefit Asset, Minimum Funding Requirements and their Interaction* set the criteria for recognition of a defined benefit pension fund asset. IAS 19 limits recognition of such asset to "the present value of economic benefits available in the form of refunds from the plan or reductions in future contributions to the plan" plus unrecognised gains and losses. It is not clear whether it is the Committee's

intention to restrict further the circumstances under which deduction from capital is not required, or whether a surplus recognised under IAS 19 would meet the "unrestricted and unfettered access" test. If the Committee wishes to exclude assets whose realisation depends on reductions in future contributions then it would be setting aside one of the bases in IAS 19/ IFRIC 14 for recognition of a pension asset.

The Committee also may wish to clarify the meaning of the requirement that: "Such offsetting assets should be given the risk weight they would receive if they were owned directly by the bank." It is not clear whether "assets" refers to the amount that would be recoverable from the fund or portions of the underlying assets in the fund.

The IASB are expected to publish shortly proposals to amend IAS 19 to remove deferral of the recognition of actuarial gains and losses. This will enhance comparability between different entities in terms of recognition of pension fund assets and liabilities. Also, current disclosure requirements under IFRSs do not provide an analysis of pension assets by the basis of recovery (eg refund vs future contribution reduction). The Committee may wish to consider if there is any disclosure gap that it wishes to raise as part of this consultation.

1.4 Offsetting of financial instruments

The Committee discusses at paragraph 206 its proposal to introduce a new prudential ratio of leverage, which would measure the ratio of an entity's capital to its exposures. It appears that, under the proposals, on-balance sheet items would be included in such a ratio on the basis of the accounting measure, except for netting for which special treatment would be developed.

IAS 39 sets out the requirements relating to when a financial instrument is recognised and when it is derecognised. The requirements for derecognition of financial instruments are complex and currently are subject to a comprehensive revision by the IASB; the current requirements under IFRSs regarding derecognition also have some significant differences from comparable requirements under current US generally accepted accounting principles. As we noted in our comment letter to the IASB dated 30 July 2009, responding to their April 2009 exposure draft on derecognition, we believe that the shift away from the risk and rewards approach should be reconsidered. For example, we encouraged the IASB to consider the risk and rewards overlay to the control-based model currently under consideration by them. The IASB currently is reviewing its timetable for the derecognition project.

The proposals discuss in more detail (paragraph 222) the approach to securitisations but this is only one type of transaction that may result in financial assets being removed from an entity's balance sheet. Understanding of the derecognition requirements and their application to a wide range of products and structures will be particularly important in ensuring that the regulatory objective in this area is achieved.

In addition, many of the IASB ongoing projects will affect the measure of equity and hence the starting point for the calculation of the regulatory capital.

1.5 Unrealised gains

We note that the Committee proposes at paragraph 96 that no adjustment should be applied to remove from Tier 1 capital unrealised gains or losses on investments including those in debt instruments, loans and receivables, equities, own use properties and investment properties recognised in the statement of financial position. The Committee also notes that it will continue to review the treatment of unrealised gains. To the extent that this reconsideration results in adjustment only for unrealised losses, it may be helpful for the financial statements to include a disclosure of gross unrealised gains and gross unrealised losses to support such a regulatory requirement.

Also, it is unclear whether the Committee's proposals at paragraph 96 focus only on items measured at fair value through other comprehensive income (e.g. investments classified as available for sale) or also extend to items measured at fair value either because they are classified as held for trading or through using a fair value option. In addition, the IASB's new standard on measurement of financial instruments (IFRS 9) precludes investments in debt securities and loans and receivables from being measured at fair value through other comprehensive income.

1.6 Cash flow hedge reserve

The Committee proposes at paragraph 104 to remove the positive and negative cash flow hedge reserve from Tier 1 capital. The IASB currently are revising its requirements for hedge accounting and it may be that the cash flow model will be the main hedge accounting model.

1.7 Deferred tax assets

The Committee proposes at paragraph 98 that deferred tax assets that rely on future profitability of a bank for realisation should be deducted from the Common Equity component of Tier 1 capital. The amount to be deducted would be net of deferred tax liabilities.

The accounting requirements in IAS 12 *Income Taxes* include offsetting requirements which are described in paragraph 74 of that standard. They require offsetting of deferred tax assets and deferred liabilities only when:

- The entity has a legally enforceable right of set off; and
- The asset and liability relate to income taxes levied by the same taxation authority and either the same entity or different entities which settle tax net.

We note that there may be a possible inconsistency between the stated objective of ensuring that assets of a regulated entity provide protection to depositors in a period of stress, and allowing deferred tax assets that rely on future profitability to be offset against deferred tax liabilities. Netting beyond that required in IAS 12 may, for example, result in netting of amounts

recoverable from tax authorities in the United States against liabilities to tax authorities in France, even though in practice such netting could not be achieved. Therefore, for financial statements prepared under IFRSs, netting recognised deferred tax assets against recognised deferred tax liabilities to calculate the adjustment to Tier 1 capital would mean that not all deferred tax assets whose realisation depends on future profitability would be deducted. If the Committee's intention was to permit or require offset of deferred tax assets and deferred tax liabilities only to the extent required in IAS 12 then it may wish to state this in its final document.

The IASB have been exploring a convergence project with the US Financial Accounting Standards Board (FASB) on accounting for income tax. However, we do not expect any immediate significant reconsideration of the recognition and measurement requirements in this area.

2. Auditing matters

The Committee proposes at paragraph 108 "a full reconciliation of all regulatory capital elements back to the balance sheet in the audited financial statements." It is not clear whether this proposal would require such a reconciliation to be included in the audited financial statements, or whether it would require only that the reconciliation be made available publicly. Requiring this disclosure to be within the audited financial statements would bring the calculation of regulatory capital within the scope of the audit and in some jurisdictions this could result in significant additional audit costs. Issues that should be considered in deciding whether such a reconciliation should be subject to audit include measuring the expected increase in audit cost against the benefit of the enhanced reliability that would result.