



## BASEL COMMITTEE ON BANKING SUPERVISION

BANK FOR INTERNATIONAL SETTLEMENTS

Chairman

VIA EMAIL: [commentletters@iasb.org](mailto:commentletters@iasb.org)

Sir David Tweedie  
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30 Cannon Street  
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19 September 2008

### Discussion paper – Reducing complexity in reporting financial instruments

Dear Sir David

The Basel Committee on Banking Supervision (the Committee) welcomes the opportunity to comment on the IASB's Discussion Paper *Reducing Complexity in Reporting Financial Instruments*. The Committee has a strong interest in high quality financial reporting by banks and has carefully analysed the discussion paper noted above.

Below and in Appendix 1 the Committee sets out a number of general comments on your Discussion Paper. Our responses to each of the twelve questions posed by the IASB are set out in Appendix 2.

Much of the paper concerns possible wider use of fair value in accounting for financial instruments. Here the Committee's position remains as in our comments on the Joint Working Group of Standard Setters (JWG) proposal, which was issued for public comment by the International Accounting Standards Committee in 2001. As set out in more detail below, wider use of fair value might represent an improvement in banks' reporting of financial instruments if four preconditions were met, including development of active markets for the relevant assets and liabilities, and their management on a fair value basis. Our assessment is that these preconditions are currently not in place.

We suggest that the IASB gives priority to the recent recommendations relating to accounting standards made by the Financial Stability Forum. In particular, the recent market turbulence has highlighted the need for the IASB to focus on measurement issues, especially developing guidance on valuations in illiquid markets.

The Committee does not support mandatory increases in the use of fair values in the primary financial statements until substantial further progress on the above-mentioned preconditions is made and the yet-to-be developed valuation guidance is implemented. As a significant part the business of many banks, particularly smaller banks, is not managed on a fair value basis, financial statement users benefit from the supplemental fair value disclosures required

by IFRS 7. These disclosures provide valuable information such as the sensitivity of positions to market risk.

We agree that avoidable complexity should be removed from accounting standards. In our view, work to simplify IAS 39 should be focused on two aspects: (1) hedge accounting, and (2) editorial presentation of the standard.

These comments have been prepared by the Committee's Accounting Task Force, chaired by Sylvie Mathérat, Director of the Banque de France, and have been approved by the Committee. The Committee trusts that you will find its comments useful and constructive.

If you have any questions regarding our comments, please feel free to contact Sylvie Mathérat (+33 1 4292 6579), Ian Michael (UK FSA), who chairs the Financial Instruments Practices Subgroup of the Accounting Task Force (020 7066 7098), or Linda Ditchkus at the Basel Committee Secretariat (+41 61 280 8007).

Yours sincerely,

A handwritten signature in blue ink, appearing to read 'Nout Wellink', with a stylized flourish at the end.

Nout Wellink



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## Appendix 1

### General comments on IASB's discussion paper – Reducing complexity in reporting financial instruments

Below the Committee sets out a number of general comments on the IASB's Discussion Paper *Reducing Complexity in Reporting Financial Instruments*. Our responses to each of the twelve questions posed by the IASB are set out in Appendix 2.

#### Overview

We support the objective of removing avoidable complexity from IFRS financial instrument accounting. IAS 39 can probably be simplified by re-organising the standard, and making changes in certain areas such as hedge accounting. We are concerned that the IASB does not appear to have explored the option of addressing the perceived complexity of IAS 39 by improving the presentation of the material. These options include more sharply signposting the structure of the standard and reviewing whether some – or ideally much – of the implementation material could be deleted or moved (in suitably summarised form) into the main standard or its application guidance.

However, we do not agree with the idea that there is intrinsic merit in the use in primary financial statements of a *single* measurement attribute for financial instruments. We are of the view that the mixed-attribute model remains essential to proper representation of how earnings and cash flows are generated by banks, because many banks, particularly smaller ones, do not manage their business on a fair value basis.

Indeed, the notion of fair value as currently defined by the IASB is not easy to reconcile with the economic rationale for banks' non-capital markets business. Much financial intermediation takes place through banks precisely because the conditions for existence of a trading market are not in place – for example, in the cases of retail and small business loans. Secondary trading in these assets is not well developed in most jurisdictions.

Against that background, in our view the relevant issue is not whether IAS 39, its application and the use of accounts drawn up using that standard are 'complex' in some absolute sense, but rather whether or not there is more complexity than necessary to achieve fair presentation. As explained below, we do not believe that there is substantial excessive complexity on that criterion. That perhaps reflects the benefits of the extensive due process followed in the development of IAS 39 and the US standards on financial instruments.

Given the relevance of the standard to the financial sector, the impact of any change on the working of the financial system would need to be carefully evaluated. Close co-operation with the bodies responsible for global financial stability, and for financial stability in major regions and national markets, would be required.

## **A single measurement attribute, and fair value accounting**

The Discussion Paper states that full fair value accounting for financial instruments is the accounting standard-setting Boards' long-term objective. The Committee's views on that proposition were set out in their 2001 comment letter on the JWG proposal.

The Committee argued that the mixed attribute model remains appropriate, and identified four conditions which would need to be met before wider application of fair value to financial instruments might constitute an improvement in financial reporting.<sup>1</sup>

The Committee said that significantly greater use of fair value might be an improvement in financial reporting if:

- (i) the conceptual and practical issues associated with fair value are resolved,
- (ii) active markets develop for major aspects of banking book positions,
- (iii) bank risk management evolves to rely on fair value measurements, and
- (iv) a broad range of users of financial statements, including depositors and other creditors of banks, find fair value to be the best measure in the primary financial statements.

The Committee's assessment is that currently, although some progress has been made towards the latter two criteria, primarily in the context of larger banks in developed nations, these four conditions have not been met.

In our view there has not been significant progress in resolving a variety of long-standing conceptual challenges associated with fair value accounting, for example 'own credit risk' and 'core deposit intangibles'. Indeed, the scale recently of unrealized 'gains' from own credit risk – which in general do not appear to be gains in any conventional sense – has materially complicated the interpretation of financial statements and has led to a reputational risk to IFRS.

There has of course been further development in recent years of markets in products based on certain classes of bank loans originated by some – but far from all – banks based in certain jurisdictions, as well as credit derivatives and other forms of credit protection relating to these assets. However, some of these markets – notably for securitisation of credit exposures – are at the centre of the current market turbulence, and their future is at present uncertain.

There have also been changes in the use made of fair value information by sophisticated banks. This is partly related to developments in risk management, including those associated with the adoption of Basel 2. However, the linkages between risk management and accounting valuations remain very much work-in-progress, and are not currently a sound basis to justify the wider use of fair value accounting.

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<sup>1</sup> The Committee, in its April 2000 report to G7 Finance Ministers and Central Bank Governors on International Accounting Standards, established a set of criteria against which it evaluated the standards. In our view, these criteria also remain relevant and any change to IAS 39 should be consistent with them, in order that in particular the revised standard: (a) remains capable of representing the business models used in finance, (b) requires information which will attain a threshold level of reliability, and (c) is done in a way in which the costs to preparers (both initial and ongoing) could plausibly be judged to be outweighed by the benefits to users of accounts.

We are aware that particular groups of financial statement users have called for greater use of fair values in the financial statements of banks. However, we are not convinced that they are representative even of those who analyse the business of the largest, most complex banking organizations. Furthermore, those who focus on smaller banks may take a different position regarding the relevance of fair values.

The market turbulence during the past year was not created by the use of fair value in accounting, but it has emphasised a number of lessons directly relevant to the 'four tests' above. These include:

- there are important unresolved conceptual issues surrounding the definition and meaning of 'fair value' when markets are illiquid.<sup>2</sup>
- in illiquid markets, measurement of fair values can be very difficult, involve considerable subjective judgement, and require a high level of technical sophistication.
- disclosures concerning measurement methods and measurement uncertainty are typically limited. That is probably partly because they pose considerable technical challenges.<sup>3</sup>

We strongly encourage the IASB to work on these issues, for example in projects relating to fair value measurement, drawing on groups of experts such as the recently formed Expert Panel on valuation when markets have become illiquid. While it is clearly appropriate for the IASB to engage with leading edge experts, it is important that they also discuss these issues with 'typical' preparers.

## Complexity

We believe that the complexity of IAS 39 is sometimes exaggerated. For example, the standards for leasing (IAS 17) and employee benefits (IAS 19) are also lengthy yet deal with significantly more limited, albeit important, issues. In any case, much of IAS 39 is often not relevant to entities with positions only in straightforward financial instruments. Moreover, much of the complexity in IAS 39 relates to hedge accounting. This is something preparers may elect but are not required to use, although in some situations hedge accounting may be the only feasible way of avoiding accounting mismatches. Another area of complexity in IAS 39 arises from the derecognition criteria. However, the IASB already has a separate project underway, which addresses that area.

The IASB should take into account that the complexity of accounting depends not only on the standards per se, but also the difficulties (or otherwise) of practical implementation. Broader use of fair value would increase the complexity of application of IAS 39 by those banks – especially medium-sized and smaller banks, which represent the overwhelming majority of preparers by number – and which in general do not manage their exposures on a fair value basis.

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<sup>2</sup> We think the IASB particularly needs to do further work on: (1) the definition of fair value when either (a) a market is completely illiquid so that there is no observable information directly – or even indirectly – relevant to assessing the value of an instrument, or (b) there are some available indicators of value, but these appear to be strongly at variance with any reasonable assessment of economic fundamentals, and (2) the definition of an active market and the related issue of when a market price must be taken as indicating fair value.

<sup>3</sup> For example, aggregation of measures of valuation uncertainty across instruments is challenging, given the need to assess correlations between errors in measurement.

## **Market turbulence and the FSF**

We think it is essential that the IASB gives priority to the projects called for by the Financial Stability Forum, in particular enhanced guidance on estimating fair value in illiquid markets, the conceptual framework project related to measurements, consolidation/de-recognition and a review of implementation of – and possible enhancements to – the financial instruments disclosure standard (IFRS 7).

Moreover, it would not seem wise to propose significant changes to IAS 39 before it has been used for a longer period of time by most jurisdictions which have adopted IFRS, and over at least one full economic cycle. That is especially true given current conditions, as many insights as to what the current standard delivers are continuing to emerge as a result of the market turmoil. Once markets have returned to a more 'normal' state it will be possible to assess the extent to which accounts drawn up using IAS 39 have met the needs of investors and other stakeholders, and to take full advantage of the scope to learn lessons from the recent turbulence.

## **Simplification of hedge accounting**

Hedge accounting is an integral part of the mixed attribute measurement model. The detailed requirements in IAS 39 are almost universally regarded as excessively complex. While we agree with the standard setters that there is a need to address the potential scope for abuse, a balance should be struck between ensuring that only genuine hedges are eligible for 'hedge accounting' and facilitating hedge accounting treatment where appropriate.

In our view the IASB should work with the FASB to draw on the latter's recent work on hedge accounting, taking into account proposals that reduce complexity while promoting sound hedging and risk management. Further, the Committee's Accounting Task Force would be happy to work with the IASB on ways in which to simplify IAS 39 in this area. One aspect concerns the effectiveness requirements. In our view, these are clear candidates for simplification, bearing in mind that ineffectiveness is taken straight to profit or loss.

## **Other comments**

In Appendix 2 (response to Question 7) we set out a number of technical issues relevant to possible simplification of IAS 39, in addition to those set out in the Discussion Paper. These include the approach taken to impairment of different classes of assets, and the treatment of unit of account. In both cases, there may be scope to simplify practical implementation of the standard.

## **Appendix 2:**

### **Answers to detailed questions**

#### **Question 1:**

**Do current requirements for reporting financial instruments, derivative instruments and similar items require significant change to meet the concerns of preparers and their auditors and the needs of users of financial statements? If not, how should the IASB respond to assertions that the current requirements are too complex?**

We consider that there is substantial scope to enhance the accessibility of the standard. That could be achieved by, for example, reviewing the structure of the text, and investigating the scope to streamline some of the Application and Implementation Guidance. It may also be possible to simplify the requirements relating to hedge accounting.

Other than with respect to hedge accounting, the Discussion Paper does not provide complete details regarding which aspects of IAS 39 are asserted to be too complex. Without this information it is difficult to evaluate how the IASB should respond to these assertions. However, an important consideration is the need for the standard on financial instruments to ensure that all the different business models used in banking and finance are properly represented in the financial statements. If the IASB decides to simplify the structure of the text, we are prepared to assist in this process by identifying areas for consideration.

#### **Question 2:**

**(a) Should the IASB consider intermediate approaches to address complexity arising from measurement and hedge accounting? Why or why not? If you believe that the IASB should not make any intermediate changes, please answer questions 5 and 6, and the questions set out in Section 3.**

**(b) Do you agree with the criteria set out in paragraph 2.2? If not, what criteria would you use and why?**

**(a)** We do not support Approaches 1 and 2. We do, however, support examination of whether there is scope to simplify hedge accounting – please see our answer to Question 5.

On Approaches 1 and 2, our more detailed comments are as follows.

#### ***Approach 1***

In our view it is important to maintain the distinction between trading, the fair value option, and other accounting categories. These categories should reflect the different business activities in which banks engage and the differing ways in which these businesses and the resulting risks are managed.

#### ***Approach 2***

We do not believe that the IASB has made a convincing case for fair value to be the 'baseline' measurement attribute for financial instruments. We note that this would be a very major change. At present, for liabilities the baseline is amortised cost (subsequent to initial

recognition), with exceptions for trading, other derivatives and the 'fair value option'. For assets, there are significant categories which are required or permitted to be measured at amortised cost (in particular loans, receivables, and held-to-maturity securities). For most banks, by number, these amortised cost asset categories continue to represent a substantial majority of their assets.

We have considered the suggestion in the Discussion Paper that a distinction might be drawn between instruments according to the variability of their cash flows. We think this could lead to an increase in complexity, particularly if there were no 'bright lines' or other application rules established. Moreover, depending on how they were designed, the application rules themselves could add complexity. We are concerned that establishment of a fair value baseline with certain exceptions at the preparer's option could lead to: (1) a reduction in comparability; and (2) a situation in which much of banks' balance sheets was accounted for on an 'exception' basis – something which would call into question whether the right baseline measurement principle had been identified. In addition, if implementation of the distinction required some kind of 'bright line' to be established, there would be an inconsistency with the preferred 'principles-based' approach for IASB accounting standards.

Overall, it is not clear that the 'variability of cash flows' approach would reduce complexity in financial instrument accounting.

**(b)** We broadly agree with criteria (a), (c) and (d).

However, we do **not** agree with criterion 2.2 (b). As explained in our general comments, we do not believe that the use or otherwise of fair value as the measurement attribute is in itself an indicator of whether a change in IAS 39 would constitute a simplification in financial reporting.

### **Question 3:**

**Approach 1 is to amend the existing measurement requirements. How would you suggest existing measurement requirements should be amended? How are your suggestions consistent with the criteria for any proposed intermediate changes as set out in paragraph 2.2?**

Please see our general comments, and answer to Question 2.



## Question 4:

**Approach 2 is to replace the existing measurement requirements with a fair value measurement principle with some optional exceptions.**

- (a) What restrictions would you suggest on the instruments eligible to be measured at something other than fair value? How are your suggestions consistent with the criteria set out in paragraph 2.2?**
- (b) How should instruments that are not measured at fair value be measured?**
- (c) When should impairment losses be recognised and how should the amount of impairment losses be measured?**
- (d) Where should unrealised gains and losses be recognised on instruments measured at fair value? Why? How are your suggestions consistent with the criteria set out in paragraph 2.2?**
- (e) Should reclassifications be permitted? What types of reclassifications should be permitted and how should they be accounted for? How are your suggestions consistent with the criteria set out in paragraph 2.2?**

Please see our general comments, and answer to Question 2.

## Question 5

**Approach 3 sets out possible simplifications of hedge accounting.**

- (a) Should hedge accounting be eliminated? Why or why not?**
- (b) Should fair value hedge accounting be replaced? Approach 3 sets out three possible approaches to replacing fair value hedge accounting.**
  - i) Which method(s) should the IASB consider, and why?**
  - ii) Are there any other methods not discussed that should be considered by the IASB? If so, what are they and how are they consistent with the criteria set out in paragraph 2.2? If you suggest changing measurement requirements under approach 1 or approach 2, please ensure your comments are consistent with your suggested approach to changing measurement requirements.**

**(a)** We would be strongly opposed to the elimination of hedge accounting. We consider it to be an integral facet of the mixed attribute approach to financial instrument measurement, an approach we believe should be retained. In addition, because the use of derivatives and other financial instruments to hedge a variety of risks is an important component of many banks' business models, hedge accounting should continue to be recognised in the accounting standards for financial instruments to ensure a proper representation of their hedging activities.

While we encourage the IASB to look for ways to simplify the existing requirements, we agree with the standard setters' long held view that discipline is required in this area, given the scope for revenue and earnings to be made less transparent and the risk of abuse. That said, there is a need to balance the risks of non-hedging relationships being portrayed as hedges by preparers against the risk that overly tight requirements could prevent genuine hedges from being treated as such for accounting purposes. In this regard, the requirement

to recognise hedge ineffectiveness in profit or loss represents an important and sound control mechanism over hedge accounting.

**(b) (i)** Our comments on the three ways identified to replace current fair value hedge accounting are:

**(1) *Replacement by the fair value option.***

We do not believe that this would be appropriate since institutions may only hedge a portion of an instrument's risk, whereas the election of the fair value option would require institutions to fair value the entire hedged item. This would add complexity, and might reduce reliability, in cases where it is possible to determine the response of the hedged item to one or more specified valuation factors (eg a benchmark interest rate), but where the full fair value is significantly more difficult to determine. In such a situation, it would also be significantly more difficult to hedge effectively changes in the full fair value of the hedged item.

An example is hedging of fixed interest rate bank loans (back to a benchmark variable interest rate). The response of the value of fixed rate loans to the general level of interest rates is in some circumstances relatively straightforward to determine (especially if prepayments are not overly responsive to interest rates). By contrast, it may be difficult to determine full fair value if there is no market in the loans themselves or any other instrument with similar credit and liquidity characteristics.

In addition, unlike hedge accounting, the fair value option is available only at inception and is not revocable.

**(2) *Recognition of gains / losses on hedging instruments outside of earnings***

This might achieve some reduction in the perceived complexity of IAS 39 as fair value hedge accounting would become mechanically more similar to the cash flow variant. However, given the Board's assessment that this might not result in a significant reduction in complexity (paragraph 2.48), we see little advantage in this change.

**(3) *Recognition of gains/ losses on hedged items outside of earnings***

As described this option would seem to give preparers an excessive degree of flexibility regarding recognition of gains and losses on instruments other than derivatives and those classified as trading or subject to the fair value option. We agree with the Board that adding restrictions to this approach would then lead to little reduction in complexity, so we do not favour this approach.

**(b) (ii)** We think the effectiveness criteria for a hedge relationship to qualify for hedge accounting are overly restrictive. For example, bankers repeatedly say that these criteria prevent hedge accounting of credit exposures hedged with credit derivatives. At the margin, this may discourage banks from putting hedges in place, even where appropriate from a risk management point of view.

## **Question 6:**

**Section 2 also discusses how the existing hedge accounting models might be simplified. At present, there are several restrictions in the existing hedge accounting**

models to maintain discipline over when a hedging relationship can qualify for hedge accounting and how the application of the hedge accounting model affects earnings. This section also explains why those restrictions are required.

- (a) What suggestions would you make to the IASB regarding how the existing hedge accounting models could be simplified?
- (b) Would your suggestions include restrictions that exist today? If not, why are those restrictions unnecessary?
- (c) Existing hedge accounting requirements could be simplified if partial hedges were not permitted. Should partial hedges be permitted and, if so, why? Please also explain why you believe the benefits of allowing partial hedges justify the complexity.
- (d) What other comments or suggestions do you have with regard to how hedge accounting might be simplified while maintaining discipline over when a hedging relationship can qualify for hedge accounting and how the application of the hedge accounting models affects earnings?

(a) and (b) Bearing in mind that ineffectiveness is taken straight to profit or loss, we would support a less restrictive approach to effectiveness testing – for example, as outlined in the FASB's recent exposure draft.<sup>4</sup>

(c) We consider retention of partial hedges to be essential. That is because it is standard banking practice to hedge one or more clearly identified risks – for example interest rate or foreign exchange risk – while having no intention to hedge changes in the entire fair value of an instrument.

For instance, a bank with a variable rate funding base from retail and corporate deposits might hedge the interest rate risk on any fixed rate loans it advanced, but that does not imply that it would also hedge other risks, most notably credit risk relating to borrowers. Indeed, most often credit and other risks would not be hedged. 'Partial' hedge accounting is needed to portray such situations.

(d) Please see our answers to (a) and (b) above. We support the IASB's suggestion of removing choice regarding the treatment of cash flow hedges relating to non-financial items (see DP, paragraph 2.97).

More generally, it is important that the IASB is mindful of the advantages of taking a principles-based approach to hedge accounting, and that it continues to discuss this area with bankers and others who apply this technique in practice.

## Question 7:

**Do you have any other intermediate approaches for the IASB to consider other than those set out in Section 2? If so, what are they and why should the IASB consider them?**

In our view the requirements in IAS 39 relating to *impairment of available-for-sale assets* should be reviewed. We believe there may be scope to improve the standard in this area, and to achieve some reduction in complexity. We have two suggestions:

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<sup>4</sup> Accounting for Hedging Activities: an Amendment of FASB Statement No 133, June 2008.

(i) We question whether it is appropriate to require that where any of an unrealised loss is treated as impairment, then the entire loss is regarded as an impairment loss. That is not consistent with the approach to impairment of loans and receivables, and held-to-maturity instruments, where impairment relates to the reduction in expected cash flows discounted at the original effective interest rate.

The current approach to available-for-sale asset impairment has not worked well in recent market conditions, when the market value of many complex instruments has fallen for a range of reasons which go beyond lower expected cash flows, notably much reduced liquidity in many capital markets. It also creates an incentive for preparers to seek ways to delay recognition of any impairment for as long as possible.

(ii) It is not clear to us why the Board has not given further consideration to permitting the reversal of impairment charges against available-for-sale equities in certain limited instances – similar to the accounting for impairment charges in other aspects of IAS 39. If preparers are in a position to identify impairment losses, then presumably they are also in a position to identify any circumstances in which they have reversed. Again, the current approach creates incentives to delay recognition of impairment. In addition, asymmetries of this kind contribute to the impression that IAS 39 is overly complex.

It appears that there continues to be confusion – in practice – as to whether it is acceptable to measure positions on a portfolio basis. A more explicit treatment of the **unit of account** in this context would simplify the practical implementation of IAS 39.

## Question 8:

**To reduce today's measurement-related problems, Section 3 suggests that the long-term solution is to use a single method to measure all types of financial instruments within the scope of a standard for financial instruments.**

**Do you believe that using a single method to measure all types of financial instruments within the scope of a standard for financial instruments is appropriate? Why or why not? If you do not believe that all types of financial instruments should be measured using only one method in the long term, is there another approach to address measurement-related problems in the long term? If so, what is it?**

In our view, the Discussion Paper has not established that a single measurement method for financial instruments is the ideal approach – or is superior to the mixed measurement attribute approach. There are clearly more factors to consider than purely the fact that a single measurement method would simplify the text of IAS 39.

We believe that measurement should reflect the way in which instruments are used to generate earnings and cash flows, and whether or not active markets for the instruments in question typically exist.

Thus, we agree that fair value is appropriate for trading activities where cash flows are generated by active buying and selling – something which presumes the existence of markets.

However, we believe that the economics of conventional bank deposit taking and lending is better represented by the current amortised cost accounting approach. Here cash flows are typically generated by the spread between lending and deposit rates, and in general do not depend on the fair values of these instruments – because they are not being traded. While in some jurisdictions markets have emerged to sell certain bank loans and other receivables

through securitisation, use (or otherwise) of this technique varies considerably across countries and across banks, and in general is confined to larger, more sophisticated entities. Moreover, it is possible that private and official responses to the current market turbulence will lead to less deep and liquid securitisation markets than seen in recent years.

We do not believe that the mixed attribute measurement model, when accompanied with appropriate disclosures, is creating significant difficulties, other than in respect of certain aspects of hedge accounting and derecognition criteria (the latter being the subject of a separate IASB project).

### **Question 9:**

**Part A of Section 3 suggests that fair value seems to be the only measurement attribute that is appropriate for all types of financial instruments within the scope of a standard for financial instruments.**

- (a) Do you believe that fair value is the only measurement attribute that is appropriate for all types of financial instruments within the scope of a standard for financial instruments?**
- (b) If not, what measurement attribute other than fair value is appropriate for all types of financial instruments within the scope of a standard for financial instruments? Why do you think that measurement attribute is appropriate for all types of financial instruments within the scope of a standard for financial instruments? Does that measurement attribute reduce today's measurement related complexity and provide users with information that is necessary to assess the cash flow prospects for all types of financial instrument?**

**(a)** No – please see general comments, and answer to question 8.

**(b)** As noted above, we believe that the current mixed measurement approach best represents the way in which cash flows are generated in banking organisations. We do not think this is especially 'complex'. Broadly speaking, there are two measurement attributes (subsequent to initial recognition) – amortised cost (subject to impairment losses) and fair value – with the additional feature that unrealised gains and (non-impairment) losses for available-for-sale assets, which are measured at fair value, are recognised directly in equity rather than profit or loss.

Moreover, no extension of fair value measurement to liabilities should take place unless and until the conceptual and measurement implementation issues surrounding the fair value (eg 'own credit risk' and 'core deposit intangibles') are resolved.

### **Question 10:**

**Part B of Section 3 sets out concerns about fair value measurement of financial instruments. Are there any significant concerns about fair value measurement of financial instruments other than those identified in Section 3? If so, what are they and why are they matters for concern?**

The section sets out most of the issues relevant to accounting practice, though our emphasis and conclusions are rather different. In particular, the very limited discussion of 'difficulty in estimating fair values of financial instruments' (paragraphs 3.78-3.80) is hard to reconcile

with either the non-traded character of many risk factors which affect the balance sheets of banks, or the scale of valuation challenges which banks have faced during the current market turbulence.

There are also concerns about the reliability of fair values which are not established either by directly observing market prices, or through an industry-standard valuation technique which substantially uses only observable inputs. The current market turmoil has given rise to instances where the range of uncertainty regarding certain fair values is material in relation to the overall balance sheets of banks.

Further, we question the relevance of reporting fair value gains and losses in instances where there is not any mechanism for them to be realised. That applies to a large portion of bank lending worldwide (and would also apply to bank deposits, were these to be measured at 'fair value').

Insofar as any change would affect banks, it would be necessary also to consider possible impacts on global financial stability, including the interaction with prudential regulation, notably the Basel Framework ('Basel 2'), as well as the costs of a new approach.

Increased use of fair value would probably lead to increases in recognised unrealised gains and losses. These would be likely to affect the capital bases – and hence lending capacity – of banks. That could be a shift in the direction of procyclicality. The FSF has asked the Committee to investigate the issue of procyclicality further. This potential procyclical impact could not be addressed purely by further 'prudential filters' to remove certain unrealised fair value gains and losses. That is because there is evidence that markets focus on accounting, as well as regulatory, measures of bank capital. In addition, accounting measures of capital play a direct role in the dynamics of the financial system because of the existence of regulatory leverage ratios in a number of jurisdictions, including the US.

## **Question 11:**

**Part C of Section 3 identifies four issues that the IASB needs to resolve before proposing fair value measurement as a general requirement for all types of financial instruments within the scope of a standard for financial instruments.**

- (a) Are there other issues that you believe the IASB should address before proposing a general fair value measurement requirement for financial instruments? If so, what are they? How should the IASB address them?**
- (b) Are there any issues identified in part C of Section 3 that do not have to be resolved before proposing a general fair value measurement requirement? If so, what are they and why do they not need to be resolved before proposing fair value as a general measurement requirement?**

**(a)** A range of additional issues is highlighted in this comment letter. These would include the need for the IASB to demonstrate that a full fair value approach would better represent the economics of banking – something to which the four criteria listed on page 4 of this comment letter are directly relevant; extensive field testing regarding the practicality of greater use of fair value, especially by entities of a size below the largest global firms; assessment of the one-off and on-going costs of such a change; and dialogue with the Financial Stability Forum, and other relevant bodies, regarding the possible impact on the international financial system.

**(b)** The relevant issues include – but are not limited to – those set out in part C of Section 3.

**Question 12:**

**Do you have any other comments for the IASB on how it could improve and simplify the accounting for financial instruments?**

No.