



BASEL COMMITTEE ON BANKING SUPERVISION

BANK FOR INTERNATIONAL SETTLEMENTS

Chairman

VIA EMAIL: director@fasb.org

Mr. Russell G. Golden
Technical Director
Financial Accounting Standards Board
401 Merritt 7
PO Box 5116
Norwalk, CT 06856-5116
United States

22 September 2010

Re: Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities (Topic 815) and Comprehensive Income (Topic 220)¹

Dear Mr Golden

Based on the IASB's request for comment, the Committee welcomes the opportunity to comment on the FASB's proposed Accounting Standards Update (ASU) *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities*.² This comment letter also addresses the related proposal on the amendments to *Comprehensive Income*.

The Committee has a strong interest in high quality financial reporting by banking organisations and has carefully considered this proposal as well as the concurrent projects being developed by the IASB, in particular, since in April 2009 the G20 Leaders called on "accounting standard setters to work urgently with supervisors [...] to achieve a single set of high-quality global accounting standards". We strongly encourage the FASB to work with the IASB and supervisors to achieve this objective.

The Committee strongly supports a mixed attribute model for the classification and measurement of financial instruments. The Committee also strongly supports an Expected Loss (EL) approach for financial instruments measured at amortised cost. An EL based approach when combined with amortised cost measurement for financial instruments such as those associated with lending activities is likely to facilitate greater alignment between an institution's internal risk management approaches and incentives, its risk-taking behaviour, and the measurement of its performance in its financial statements.

The Committee is concerned that these FASB proposals raise some fundamental issues that, if not satisfactorily resolved, would reduce the possibility of convergence between IASB and FASB financial instrument accounting standards

¹ File reference numbers: 1810 -100 and 1790-100.

² This is referred to hereafter as the "FASB proposal".

and would also diminish the quality of financial reporting and information available for investors. The Committee's position on these key issues builds on comments made to accounting standard setters on several occasions in the past. These include the Committee's comment letters in September 2001 on the Joint Working Group of Standard Setters' *Draft Standard and Basis for Conclusions – Accounting for Financial Instruments and Similar Items* and in September 2008 on the IASB's *Discussion paper – Reducing complexity in reporting financial instruments*.³

The Committee would also like to bring to the FASB's attention the *Guiding Principles for the replacement of IAS 39*, published by the Committee in August 2009 and endorsed by the G20 Finance Ministers and Central Bank Governors.⁴ Prior to their publication these principles were shared with the IASB in July 2009 to assist them in their efforts to simplify and refine IAS 39. We strongly encourage the FASB to consider these Guiding Principles as it considers how to finalise its proposed ASU on financial instruments and develops other financial instruments proposals.

The Committee believes that these *Guiding Principles* should facilitate continued, necessary coordination among standard setters, supervisors and regulators in their respective efforts to implement the G20 recommendations.

Under the Committee's *Guiding Principles* any new financial instruments standard should faithfully represent the business model of the entity.⁵ Specifically, the new standard should allow banking transactions to be portrayed in a robust and consistent manner in line with their economic substance. There should be a strong overlay reflecting the entity's underlying business model as adopted by the Board of Directors and senior management, consistent with the entity's documented risk management strategy and its practices, while considering the characteristics of the instruments. Moreover, the standard should also incorporate a practical approach that reduces excessive burden to financial institutions and improves the ability of auditors to verify and supervisors to assess fair value and provisioning (impairment) practices.⁶

The FASB proposal results in an inappropriate application of fair value measurement, for example, for lending and deposit activities and liabilities. This raises significant financial stability issues. Consistent with current market practice, the Committee believes that fair value measurement for actively traded financial instruments and derivatives is appropriate. However, fair value measurement for instruments that are not actively traded but are held for the long term collection or payment of interest and principal is not appropriate.

In addition, the Committee recognises that there can be considerable measurement uncertainty associated with many financial instruments that makes fair values for such instruments unreliable. Many of these instruments do not have quoted prices readily available and are not managed based on changes in fair

³ These comment letters are available from the BIS website (www.bis.org).

⁴ These principles can be accessed by visiting www.bis.org/publ/bcbs161.pdf?noframes=1. Hereafter, these are referred to as the "Guiding Principles".

⁵ Refer to fundamental principle 2 of the *Guiding Principles*.

⁶ Refer to fundamental principle 3 (e) of the *Guiding Principles*.

value. One of the lessons learned from the crisis was the lack of reliability and relevance of certain fair value measurements. As a practical matter, with many financial instruments the application of fair value measurement is highly subjective and complex. We do not recommend expanded use of fair value measurement for such instruments. We also do not see how the benefits of this proposal outweigh its costs. The proposal also raises questions about the transparency of the due process associated with the cost benefit analysis being followed to justify these fundamental accounting changes.

Also, the Committee notes that the FASB is proposing amendments to the Statement of Financial Position that have significant detrimental implications for bank financial statement users, including supervisors. The Committee does not agree that there is intrinsic merit in the use in primary financial statements of a *single* measurement attribute (ie fair value) for financial instruments. Additionally, we are concerned with the proposal for the dual presentation of amortised cost and fair value measurements for financial instruments in the statement of financial position. 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. The primary financial statements are intended to provide a clear view of the performance and financial position of an entity – that objective will not be achieved if ‘two versions of the truth’ are presented with such a dual presentation approach.⁷ We set out our more detailed comments on these key issues in Appendix A.

These comments have been prepared by the Committee’s Accounting Task Force chaired by Sylvie Mathérat, Director of the Banque de France, and the Committee’s High Level Working Group jointly chaired by Sylvie Mathérat and Jerry Edwards, Senior Advisor. The Committee has approved these comments and trusts that you will find them useful and constructive. If you have any questions regarding our comments, please feel free to contact Sylvie Matherat (+33 1 4292 6579), Jerry Edwards, (+41 61 280 8055), or Rob Sharma 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, flowing script.

Nout Wellink

cc: Sir David Tweedie

⁷ This aspect is explained further under the heading “Dual presentation on the balance sheet” in Appendix A. Dual presentation of fair value and amortised cost information in the notes to the financial statements is not precluded.

Appendix A

Key issues

The following key issues are commented upon in this Appendix:

- (i) Inappropriate Application of Fair Value Measurement
- (i) Impairment
- (i) Hedge Accounting (and Netting)

(i) Inappropriate Application of Fair Value Measurement

The FASB proposal would require that most financial instruments be measured at fair value in the statement of financial position in each reporting period.

This proposal would result in an inappropriate application of fair value measurement for instruments utilised in core banking operations, particularly those involving credit intermediation. For example, lending instruments, including loans, would end up in the fair value category. In most cases, for the reasons set out below, fair value is not appropriate for measuring these kinds of instruments.

First, there is likely to be considerable measurement uncertainty associated with many financial instruments (eg loans) that would be measured at fair value. Furthermore, there is typically a lack of a market for these financial instruments, making fair value measurement unreliable and subjective. Measurement uncertainty is one of the factors resulting in unreliable fair value measurement and there is inadequate guidance in existing or proposed accounting standards to address measurement uncertainty. Also, the subjective fair value measurements used for such financial instruments are difficult to audit. These instruments are currently measured at amortised cost. The recent financial crisis has demonstrated that amortised cost measurement remains appropriate in instances where fair values measures have been shown to be unreliable.

Second, the proposal also raises significant financial stability issues. As the current crisis has shown, the inappropriate use of fair value measurements for banks can be highly destabilising. In times of market stress, such as seen recently, credit and liquidity spreads typically widened sharply. This led to a significant reduction in the fair values of many financial assets even when there was no evidence of impairment. If this proposal would have been operational during the recent crisis, many banks on such a full fair value basis would have wrongly appeared to be insolvent and investors would have been misled.

Third, the proposed requirements for fair valuing financial instruments have significant cost-benefit implications for a variety of financial statement preparers and users, including for smaller nonpublic entities for which a four-year delay in the implementation of certain elements of the proposal would be provided. It is unclear how the cost benefit criteria are being met by this proposal. Similarly, unless a report describing the findings of the confidential field visits for which the ED solicits volunteers is made available to both the FASB Board and the public, it is unclear how a series of such visits would meet the objectives of transparency and open due process in such a key area of accounting.

The Committee therefore has fundamental concerns with this proposal. The Committee's reasons for not supporting this proposal are detailed below.

Overarching Issues

The Committee believes that the mixed attribute model (such as set forth in IFRS 9 *Financial Instruments*) is appropriate. Moreover, in cases where fair value might be the appropriate measurement attribute, the Committee has identified four conditions that would first need to be met to enhance the decision usefulness of fair value information for users of financial reports:

- (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 although currently some progress has been made toward the latter two criteria, primarily in the context of some banks in developed nations, doubts remain whether all of these four conditions can be satisfactorily met in the future. As noted above, the recent financial crisis has shown that fair value is not the appropriate measurement attribute for many financial instruments. Also, with respect to the last criteria noted above, recent surveys and comments from many investors indicate that many investors do not wish to see loans and certain investments in debt securities measured at fair value in the primary financial statements.⁸

Conceptual challenges with fair value measurements

Alignment with an entity's business model

The notion of fair value as currently defined is not easy to align 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 around the world and appropriate, reliable inputs for fair value determinations are either non-existent or not easily available.

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 recent market turbulence, and their future remains uncertain. There have also been changes in the use made of fair value information by banks. This is partly related to advances in risk management. However, the linkages between risk

⁸ For example, the survey published by PricewaterhouseCoopers, *What investment professionals say about financial instrument reporting*, June 2010, shows that a majority of those surveyed indicated that amortised cost was the preferred measurement basis for loans held for the long term and for debt securities held to maturity.

management and accounting valuations remain very much a work-in-progress, and are not currently a sound basis to justify the wider use of fair value measurements.

The Committee believes that there are numerous other specific challenges with fair value measurements today. These challenges are more fully explained below.

Own credit risk and core deposit liabilities

There has not been sufficient progress in resolving a variety of long-standing conceptual challenges associated with fair value measurements, such as consistently and reliably measuring “own credit risk” and “core deposit liabilities”. Faithful representation of these aspects in the context of fair value is crucial to avoid creating interpretative issues with financial statements that could undermine market confidence, mislead investors and lead to financial instability.

Own credit risk

The IASB and FASB have recognised that unrealised “gains” from own credit risk do not appear to be gains in any conventional sense. We would encourage consistency between the IASB and FASB approaches to the measurement of own credit risk: it should include both an entity’s own credit risk and the pricing of this risk. However, both the IASB and FASB do not prescribe a single measurement method to be used when measuring own credit risk. Instead, a method that results in a more faithful representation of the changes in the liability’s own credit risk is preferred.⁹ This form of guidance suggests that: 1) practices in this area are diverse and evolving; and 2) there is no single way to address this key conceptual challenge with fair value measurements.

We oppose the recognition of a change in an entity’s own creditworthiness due to a change in the fair value of its own outstanding debt in income. Allowing an entity to increase its net worth based on an amount that is unlikely to be realised misrepresents its earnings performance. It is our understanding that such recorded gains and losses as currently required are often not considered relevant and are often ignored by many financial statement users, including those analysts that generally favour fair value.

Core deposit liabilities

We believe that amortised cost is the most appropriate measurement attribute for core deposit liabilities. This is because it represents the amount that an entity would forego upon settlement of the obligation with the depositor, which is payable on demand.

The FASB proposal uses management judgement to distinguish between demand deposits that are “core deposit liabilities” and those that are not.¹⁰ These “core deposit liabilities” are to be initially measured using a current value based remeasurement approach. Subsequent remeasurement would occur at each balance sheet date. Management judgment is used to determine the appropriate inputs and assumptions to determine the value of the core deposit liabilities.¹¹

⁹ The IASB uses this kind of language in their *Fair Value Option for Financial Liabilities* Exposure Draft. Refer to paragraph BC40.

¹⁰ Refer to the FASB proposal, paragraph IG22.

¹¹ Paragraph 31 of the FASB proposal states that an entity shall measure its **core deposit liabilities** at the present value of the average core deposit amount during the period discounted at the difference between the

The FASB proposal also acknowledges that the current value based measurement approach for core deposit liabilities potentially creates a new measurement attribute (ie current value). Users presently relate to amortised cost as the appropriate measurement attribute since it reflects the value expected to settle the liability. In addition, the current value measurement attribute is sufficiently different from the concept of fair value and not well defined which will likely result in widespread confusion about what these attributes are meant to represent.¹²

Reclassifications

The FASB proposal should draw on one of the accounting lessons from the crisis that supported financial stability; thus it should permit reclassifications within a mixed attribute model from the fair value to the amortised cost category. Such reclassifications should only be allowed in rare circumstances following the occurrence of events having clearly led to a change in the business model of an entity. These reclassifications should be coupled with transparent disclosures.

Amortised cost for financial assets and financial liabilities

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 greater use of fair value measurement is appropriate for any bank.

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

- there are important unresolved conceptual issues surrounding the benefits of use of 'fair value' when markets are illiquid or non existent.
- in illiquid markets, measurement of fair values can be very difficult, involve considerable subjective judgement, and require a high level of technical sophistication to address valuation uncertainty.
- disclosures concerning measurement methods and measurement uncertainty are typically unreliable because they pose considerable technical challenges.

In summary, while we acknowledge that the IASB and FASB have made progress to overcome some of these challenges as part of their *Fair Value Measurements* project (including guidance issued in 2008 and 2009), we believe significant conceptual and practical implementation challenges remain. Therefore, an expansion of fair value measurements is not justified at the present time.

The Committee believes that amortised cost remains the appropriate measurement attribute for financial assets such as loans, and for virtually all financial liabilities such as core deposits and long term liabilities.

Dual presentation on the balance sheet

The FASB proposal requires dual presentation of amortised cost and fair value in the statement of financial position when specific eligibility criteria are met and management

alternative funds rate and the **all-in-cost-to-service rate** over the **implied maturity** of the deposits (the core deposit liabilities remeasurement approach). In contrast, IFRS 9 *Financial Instruments* and current U.S. generally accepted accounting principles (GAAP) use amortised cost for core deposit liabilities.

¹² Refer to the FASB Proposal, paragraphs BC66 - BC68.

elects to report the qualifying portion of a financial instrument's fair value changes in other comprehensive income rather than in net income. Furthermore, the proposal also recommends the inclusion of both amortised cost and fair value information when determining net income and comprehensive income for financial instruments.

The role of accounting standards is to set out the most appropriate measurement attribute for different business objectives and activities, and that is what attention should be focused on in the primary financial statements. The Committee does not believe that this proposed accounting standard meets that role.

In the case of financial instruments where the business model and instrument characteristics mean that amortised cost is the most appropriate measurement attribute, additional presentation of fair value numbers – which could be very different – would potentially be misleading. Specifically, by definition such numbers would be out of line with the business model. Related to that point, where an entity manages instruments on a 'cost' basis, and there is not an active market for them, then its estimates of fair value are of unavoidably limited reliability. For example, for a bank that primarily takes deposits and makes loans and is managed on the basis of the interest spread between assets and liabilities, but with separate management of credit risk, full fair value accounting is not representative of that bank's business model.

Furthermore, as noted above, there remain very difficult conceptual issues regarding the application of fair value to liabilities (other than trading, derivatives, and in the hedging context). These include the approach to be taken to deposit liabilities, and to 'own credit risk'. That said, because some users regard fair value information on financial instruments accounted for at amortised cost as having analytical value, there is already a requirement to disclose that information in the notes.

(ii) Impairment

Using fair value as the primary measurement attribute for financial assets and liabilities, the FASB has also proposed a revised credit impairment model.¹³

The revised FASB credit impairment model is a variation of the current incurred loss model. Under the revised credit impairment model, an entity would no longer wait until a credit loss is probable to recognise a credit impairment. Credit impairment occurs when an entity does not expect to collect all of the contractual cash flows.¹⁴ The credit impairment would be recognised in net income.

The FASB believes that "the model in the proposed guidance is different from an expected loss model because it would require entities to consider the effects of past conditions and existing events in estimating the cash flows it expects to collect in future periods that make up the remaining life of its financial assets but it would not allow an entity to forecast future events or economic conditions in developing those estimates as would occur in an expected loss model".¹⁵

¹³ The starting point of the FASB model is fair value measurement. On the other hand, the IASB uses amortised cost measurement. This makes comparisons between the two approaches difficult.

¹⁴ Paragraph 43 of the FASB proposal sets out some of the factors to be considered when evaluating whether a credit impairment exists.

¹⁵ Refer to the FASB proposal, paragraph BC175.

Theoretically, the FASB proposal may result in an earlier recognition of credit losses than the current incurred loss model (eg due to the elimination of the probability threshold). However, we believe that the proposed impairment model could be enhanced through a more explicit recognition of expected credit losses with amortised cost measurement.

The lack of clarity in the proposal's impairment requirements raises some concerns. First, the scope of the proposed guidance does not provide a specific requirement for how an entity should identify financial assets that are to be evaluated individually for collectability. For banks, the Committee favours a portfolio approach (that would be applied to pools of assets with similar risk characteristics) while not ignoring a specific review of large exposures and related loss estimates (including provisions¹⁶ already created). Although some loans are evaluated on a collective basis, removal of these loans from the collective pool and evaluation on an individual basis is appropriate in some circumstances. For example, individual loans (including related loss estimates and provisions already created) should be considered for specific review when:

- The exposures are large; and/or
- The loans require close monitoring. This is especially relevant when, for example, there are potentially higher credit losses than typically expected, rare events occur or there is a concentration of risks (eg investment bank and corporate loans that have loss distributions with "fat tails").

It would also be beneficial for banks to differentiate between performing and non-performing loans when utilising a portfolio approach as non-performing loans are currently treated differently from performing loans within banks' internal risk management and Basel II capital systems and typically experience higher loan losses.

In addition, the proposal's emphasis on "current conditions" is unclear in terms of defining the information boundary between "current conditions" and forecasts of future conditions. As currently written, the wording could be subject to a variety of interpretations and could have negative consequences for financial statement preparers, users, and supervisors. The impairment proposal with its emphasis on "current conditions" would result in provisions being recognised early (on Day 2) while not allowing a more systematic build-up of provisions. Although the FASB's intent is for provisions to be recognised early under the proposed impairment model, the emphasis on "current conditions" when narrowly interpreted may not result in the full range of management's expectations being factored into the credit impairment assessment and could result in inadequate provisions being recognised on a bank's balance sheet. The final FASB standard needs to allow banking transactions to be portrayed in a consistent manner in line with their economic substance and the entity's business model, while not overstating net income over the loan's life and ensuring provision levels on the balance sheet remain adequate at all times.

The Committee strongly supports an expected credit loss (EL) approach as this will improve the decision usefulness and relevance of financial reporting for users, including prudential regulators.

Given the importance of this work, the Committee strongly encourages the IASB and the FASB to work together to achieve a high-quality converged impairment accounting standard for financial instruments based on expected losses and amortised cost using a mixed attribute model.

¹⁶ The term 'provisions' in this submission has the same meaning as 'allowance for credit losses' in the FASB proposal.

The Committee has developed and approved an EL provisioning proposal in response to a request by the Central Bank Governors and Heads of Supervision (GHOS), which is the Committee's governing body. The Committee's proposal builds on the *Guiding principles* and does not expand the use of fair value accounting. The 11 January 2010 GHOS press release stated,

"It is essential that accounting standards setters and supervisors develop a truly robust provisioning approach based on expected losses (EL). Building on the Basel Committee's August 2009 Guiding Principles for the replacement of IAS 39, a sound EL provisioning approach should achieve the following key objectives: 1) address the deficiencies of the incurred loss approach without introducing an expansion of fair value accounting, 2) promote adequate and more forward looking provisioning through early identification and recognition of credit losses in a consistent and robust manner, 3) address concerns about procyclicality under the current incurred loss provisioning model, 4) incorporate a broader range of credit information, both quantitative and qualitative, 5) draw from banks' risk management and capital adequacy systems and 6) be transparent and subject to appropriate internal and external validation by auditors, supervisors and other constituents. So-called "through-the-cycle" approaches that are consistent with these principles and which promote the build up of provisions when credit exposures are taken on in good times that can be used in a downturn would be recognised."

The Committee's EL provisioning proposal addresses the key objectives outlined above. The key elements of this proposal are set out in Appendix A of the Committee's June 30, 2010 Impairment ED comment letter submitted to the IASB.¹⁷

(iii) Hedge accounting and netting

Hedge accounting is an integral part of the mixed attribute measurement model. The detailed requirements in the FASB literature and IAS 39 are almost universally regarded as excessively complex. We welcome the FASB's approach to simplify hedge accounting requirements. In our view, both the FASB and IASB should continue to work together towards developing a hedge accounting approach that reduces complexity while promoting sound hedging and risk management.

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.

We also note there are different requirements for netting arrangements under both IFRS and US GAAP. We are encouraged by the IASB and FASB decision to work together to develop a proposal that draws on the best elements of their accounting literatures, and thereby take steps towards a converged solution. This would help ensure a level playing field around the globe.

¹⁷ This comment letter can be found on the Committee's website (<http://www.bis.org/bcbs/commentletters/iasb27.pdf>).