Federation of Bankers Associations of Japan (ZENGINKYO)

4th October 1999

To: The Chairman, the Joint Working Group of Standard Setters on Financial Instruments

From: The Joint Working Group of Banking Associations on Financial Instruments

ACCOUNTING FOR FINANCIAL INSTRUMENTS FOR BANKS

The enclosed papers have been prepared by the Joint Working Group of Banking Associations on Financial Instruments (JWGBA) as a basis for discussion with the Joint Working Group of Standard Setters (JWGSS). Together they constitute the international banking community's position on the proposed application of fair value accounting to banks.

- The first paper - Accounting for Financial Instruments for Banks - has been prepared on a "first principles" basis and seeks to explain why the banks believe that modified historical cost provides the optimal basis on which to report banking book performance in the primary financial statements. The paper takes as its framework the four prime characteristics that standard setters have set down as defining the usefulness of information in financial statements – relevance, reliability, understandability and comparability.

- The second paper - Financial Instruments: Issues Relating to Banks – responds directly to the issues raised in the 31st August JWGSS paper. The paper includes a schedule illustrating the banking industry's response to previous consultation papers on fair value, an analysis of the research referred to by the JWGSS and a summary of user group surveys and other useful source material.

At the outset, we should reiterate that we are not arguing in favour of wholesale exemption from fair value for the banking industry. Far from it: the banks were instrumental in pushing for fair value measurement for transactions undertaken in a short-term trading environment. We are of the view, however, that banking book transactions are better represented on a historical cost basis.

Our response has been prepared in detail because of the growing perception within the banking industry that standard setters have not recognised the depth of concern over their radical proposals on accounting for financial instruments. Banks do not accept the working premise of the standard setters – that fair value measurement is always 'superior' – and do not believe that there is a demand from users, whether public or professional, for this radical agenda.

The JWGBA comprises representatives of the banking associations of the United States, Australia, Canada, Japan, and the European Union. The European Union is represented collectively by the Federation Bancaire and individually by the British, Dutch, French and German associations. A list of representatives is enclosed.

The bank association group has been formed specifically to engage in discussion with the standard setters on this important issue. It is uniquely placed to represent the views of the international banking community. It looks forward to entering into a dialogue with the JWGSS. It also provides an appropriate mechanism for the IASC to involve the banking industry in its planned review of IAS 30 on disclosures within bank financial statements.

This letter and the enclosed papers are copied to the IASC and national standard setters with a request that they post it to their websites as the response of the banking industry to the JWGSS paper.

Signed on behalf of the constituent associations of the JWGBA
4th October 1999

Federation of Bankers Associations of Japan (ZENGINKYO)

ACCOUNTING FOR FINANCIAL INSTRUMENTS FOR BANKS

Joint Working Group of Banking Associations on Financial Instruments
October 1999

Executive Summary

"Accounting for Financial Instruments for Banks" sets out the position of the Joint Working Group of Banking Associations on Financial Instruments (JWGBA) (the banking associations of the United States, Australia, Canada, Japan and the European Union) on the measurement of financial instruments by banks in the primary financial statements. The paper concludes that the mixed measurement system provides the optimal means of reporting financial performance. A separate paper has been prepared in response to the Joint Working Group of Standard Setters' paper "Financial Instruments – Issues Relating to Banks" dated 31 August 1999.

Both the mixed measurement and fair value accounting models are considered in relation to the qualitative characteristics that make information "useful". It is concluded that:

- users of bank financial statements do not support the proposed change to full fair value accounting. This is because a full fair value system does not provide a sound basis for predicting banking book net cash flows and lacks relevance.

- banking book income is earned on an ongoing basis over time and not from taking advantage of short term fluctuations in prices; the accruals accounting method provides a dynamic and faithful representation of both this earning process and the manner in which a bank's management operates. It, therefore, provides a more relevant and reliable representation of this earning process. A notional fair value snapshot taken at a historic balance sheet date fails to achieve this.

- fair value accounting is perceived by the standard setters as solving problems with issues relating to hedging and management intent. The reality is that fair values for a banking operation are significantly more subjective than values derived under the mixed measurement accounting model and this would reduce both the reliability and comparability of financial statements.

- financial statements prepared using the mixed measurement method of accounting are well understood by users who have developed sound and extensive financial management processes that rely on this information as a basis for economic decision-making. A move to a full fair value measurement basis would represent a radical change to those analytical processes. This should not be undertaken as the case for such a radical change has not been made with sufficient conceptual justification.

Within any given accounting measurement model, it is not possible to encapsulate in a single measure everything that an investor needs to know. Both fair value and historical cost accounting need to be supplemented by appropriate risk-based and other disclosures in order to provide investors with a complete picture.

The JWGBA believes that the needs of the users of bank financial statements are already being met by the existing accounting measurement and disclosure practices of the banking industry. If there are areas where users' needs are not being met, the JWGBA would welcome the opportunity to discuss how current practices could be improved.

It is important that a full and open debate on this important subject now takes place with contributions from all interested parties.

1 The objectives of financial reporting

1.1 The objectives of financial reporting for all entities, including banks, are to provide information:

- that is useful to present and potential investors, creditors and other users in making rational investment, credit and similar decisions;

- to help current and potential investors, creditors and other users in assessing amounts, timing and uncertainty of prospective cash receipts from dividends or interest, the proceeds from the sale, redemption or maturity of securities or loans, the entity's capital transactions and other factors that affect liquidity;

- about the economic resources of an entity, the claims to those resources and the effects of transactions, events and circumstances that change resources and claims to those resources;

- about an entity's financial performance given by measures of earnings and its components in order to help in assessing the prospects of an entity;

- about how management has discharged its responsibility to shareholders for the stewardship of the entity's resources; and

- that is useful to management in making decisions in the interest of shareholders.

1.2 Of the above, usefulness for investor decision making is perceived as the key objective. In common with the frameworks of accounting standard setting bodies, it is envisaged that the objectives above can only be satisfied if the information included in financial statements possesses the following qualities:

- relevance (section 2);
- reliability (section 3);
- understandability (section 4); and
- comparability (section 5).

1.3 This paper concludes that, against each of the criteria in 1.2, the objectives outlined in 1.1 are best met for a commercial bank by use of the mixed measurement approach with additional disclosure, where appropriate, of fair values.

1.4 The consideration of all proposed accounting policies must include a review of the likely costs and benefits of changing the current policy. Introduction of a fair value accounting measurement system would almost certainly result in banks having to maintain two separate accounting systems. Accounting records would still have to be maintained on a historical cost basis to meet the needs of management information and of customers as it is inconceivable they would wish to receive fair value bank statements. A second system would be required to produce fair values for the financial statements. Such a requirement would represent a significant and unjustifiable cost for the banking industry in the light of any perceived benefit to be gained from reporting fair values for all financial instruments.

2. Relevance

2.1 Fundamental question

The fundamental question that requires consideration is:

"For a commercial bank, are the external primary financial statements more relevant if prepared using a full fair value measurement basis than if prepared under the existing mixed measurement framework?"

2.2 Capable of influencing decisions

2.2.1 For information to be relevant, it must be capable of influencing economic decisions made by users by helping them to evaluate past, present or future events or confirming, or correcting, their past evaluations. Such decisions include whether to purchase, sell or continue to hold equity and/or debt positions in a bank. These decisions are made by reference to the bank's financial performance together with specific performance ratios such as earnings per share and return on capital. Fair values alone are not sufficient to influence decision making.

2.2.2 Information about a bank's risk profile is also important in the assessment of its financial position and prospects. Supporters of fair valuing all financial instruments have, to date, seemingly been influenced by an interest in market risk and the desire to use fair values as a proxy for providing information on that risk albeit that the fair value will be historic and, therefore, not useful for prediction given the time that elapses between the balance sheet date and that when the financial statements are approved and subsequently distributed to shareholders.

2.2.3 Market risk, however, is only the prime risk with regard to a bank's trading activities where the bank stands to gain or lose through short-term movements in rates or prices and engages in transactions with that short-term objective. Such business is, generally, conducted against a backdrop of openly quoted changing market values and it is widely recognised that fair value is the most appropriate measurement basis for recognition.

2.2.4 However, fair values tell the reader little about a bank's risk profile and that adoption of a fair value measurement basis for trading activities has not obviated the necessity for extensive supplementary disclosures on banks' market risk profiles.

2.2.5 In the non-trading or banking book, the principal risk is not general market risk but credit risk. Credit risk is managed over time; for the majority of loans, credit risk does not result in any loss despite fluctuations in the perceived credit rating of the borrower over the period of the loan. Financial information based on the historical cost of the loan is more relevant to users as it is the amount which the bank stands to lose if the borrower defaults.

2.2.6 Income earned from banking book transactions and other income, such as commissions, reward banks for assuming risks that are mitigated through active management on a portfolio basis – a process known as asset and liability management. Asset and liability management utilises transactions with customers

wherever possible but will also involve loans and deposits in the wholesale markets, the issue and purchase of debt securities and the use of derivatives where appropriate. Its purpose is to ensure that any potential adverse effect on liquidity and structural interest rate risk is reduced and a margin is earned over the life of the portfolio in line with the risks being borne. Historical cost measurement provides the most appropriate accounting information required to manage inherent portfolio risks and is, for that reason, the most relevant basis to report information on which to assess management's performance. Banks' management of structural interest rate risk is best explained in supplementary information to the financial statements by way of, for example, a table illustrating repricing intervals for non-trading financial instruments or by sensitivity analysis.

2.2.7 Users do not favour replacing the current mixed measurement system because it provides them with information that is useful in understanding the business and identifying trends and in valuing a business by projecting earnings and cash flows. It, therefore, gives access to the core financial information that shapes users' decisions.

2.3 Predictive value of information

Future prospects

2.3.1 To be relevant, the information presented should have a predictive value and be considered to make a useful contribution to the predictive process, even though it is not the information itself that is judged to be a prediction of future outcomes. Relevant information will reduce uncertainty, thereby enhancing its predictive value.

2.3.2 In assessing the financial performance and future prospects of a commercial bank, there is no evidence that users such as investors and practising analysts would prefer fair value accounting to be used to measure banks' non-trading or traditional banking activities in the primary financial statements, as opposed to disclosure of this information. Many banks already make additional fair value disclosures in the notes to their financial statements; few questions are ever asked about this data. Fair value data is perceived to be of limited usefulness as future net cash flows in a banking book cannot be predicted from fair values. The investor community bases its decision making on transaction-based measurements. This data is reliable and represents the 'hard' values that analysts and investors can depend on to pay dividends, repay loans and invest in growth. By contrast, fair values are 'soft' and detached from the underlying transactions and there is no demand from users for its use as the measurement basis for the primary financial statements of banks.

2.3.3 Reporting market values at a historic point in time has little predictive value since markets are, by their nature, volatile. For this reason, the balance sheet value of non-trading assets should not be based on short-term price movements. Where banks report fair values of non-trading items, use of these for comparative analysis is discouraged by those banks because they do not represent the value of certain financial instruments to the bank as a going concern. Rather they are an opportunity cost valuation at a point in time based on the key assumption that liquid markets are available. Furthermore, these fair values are likely to be out of date not only when they become available to users, but also shortly after they are prepared.

2.3.4 Application of a fair value measurement basis to a bank's non-trading book would result in reporting information that is unrelated to the economic substance of the transactions which gave rise to the amount being "fair valued" and which, therefore, has limited predictive value. One of the principal factors affecting profits and losses, therefore, would not be whether the bank achieved a margin on the principal advanced but whether there had been incremental changes in the unrecognised gains or losses arising from unhedged changes in market rates. This is not useful for measuring banks' performance as it is an inappropriate basis for judging the performance of lending and other non-trading activities, whether externally or internally by bank management.

Risk profile

2.3.5 Additional qualitative and quantitative information about banking risks can significantly assist users in understanding the risk profile of a bank and in making predictions on future performance. This profile cannot be properly represented in a balance sheet measured at fair value. Many of the assumptions concerning the various risks and their effect are necessarily based on highly subjective assessments of the consequences of future events or events that have not yet fully unfolded.

2.4 Effect of management intent on performance

Transfers between portfolios

2.4.1 One common criticism of the currently used mixed measurement system for bank accounting is that it relies on management intent resulting in information that is subjective and difficult to verify. However, no evidence has been produced to demonstrate that this concern is valid.

2.4.2 This argument assumes that management categorisation between trading and non-trading books is entirely subjective, whereas in reality the different books result from essentially different business activities – trading books from banks' dealing operations in the financial markets and their non-trading books from their retail and commercial banking business. For both internal management and external reporting purposes, a clear division is required to be made between trading and banking book activities. These rules govern both the initial allocation of the trade to a book and transfers between the banking and trading books, with disclosure required of gains and losses arising on the disposal of banking book assets. These transfers are required to be made at market value. In addition, the banking/trading split is clearly disclosed in the financial statements to enable the user to evaluate the impact of management's actions in this area.

2.4.3 Management intent is already a feature of other accounting measurement principles. For example, the classification between fixed assets and current assets is effectively determined by intention relating to use within the business and different accounting policies apply to the two categories. It is, therefore, an accepted accounting convention that different values can appear in the balance sheet for similar items depending on the nature of their use.

2.4.4 It has also been alleged that the existence of investment portfolios permits management to cherry-pick assets for disposal to enhance earnings. Banks generally disclose investment gains or losses recognised in their financial statements and the level of these gains reported as a proportion of their profits is comparatively low reflecting the strict rules that govern disposals out of non-trading books. The difference between the carrying value and the market value of accruals accounted investments is also disclosed. Accordingly users of the financial statements have relevant supplementary information to assess the possible impact on the bank's financial position should it liquidate its portfolios in an economic and market environment identical to that existing at the historic balance sheet date.

Hedge accounting

2.4.5 Supporters of a comprehensive fair value approach cite the difficulties of accounting for hedges as a key problem caused by using a mixed measurement approach. However, hedging is an economically sound activity in that it allows an entity to manage the variability of cash flows. Accounting treatments that recognise the fair values of hedging items do not report an entity's result faithfully. A framework for the proper reporting of hedging activities has already been developed using a mixed measurement model.

2.5 Application of the 'relevance' criteria

Loans and advances to customers

2.5.1 In order to be useful to investors, the financial statements of a bank should include information that enables a user to make decisions regarding the future profit-generating capacity and cash flows of that bank. For this purpose, information required for loans includes the principal amount lent, the interest being generated from those loans and the amount of the loan principal expected to be recovered. Extensive disclosures are, therefore, provided in a bank's Operating and Financial Review about the nature and concentration of credit risk. Users also require an assessment of the potential for future loan growth and an understanding of management's strategy for developing that business.

2.5.2 It has been argued that the development of securitisation and credit derivatives means that management can realise loan fair values readily. However, outside the USA these markets are miniscule compared with the overall stock of bank loan assets. Furthermore, securitisation is rarely identical to the sale of an asset and the value realised by a securitisation is not the equivalent of a fair value. The securitising bank normally retains a residual interest in the assets or supplies credit enhancement. Credit derivatives markets are in their infancy and are currently little used by banks to adjust credit risk profiles within their banking books.

2.5.3 Notwithstanding the development of securitisation techniques and credit derivatives, it remains the case that customer loans are generally held to maturity by banks without variation of the original contractual terms of the loan. Accounting for these loans on an historical cost basis, therefore, most closely reflects the economic substance and cash flows, namely, that income is earned over the period of the loan. The bank is exposed to risk on the non-repayment of the principal advanced.

2.5.4 It has been argued that the fair value of a customer loan provides relevant information about the current credit quality of that loan; as a borrower's credit standing deteriorates, the credit spread demanded rises and therefore the fair value falls and a loss occurs. However, this loss is theoretical because the widening of the spread neither has an impact on the existing loan contract nor on the ultimate repayment of the loan in the majority of cases.

2.5.5 The converse arises in the case of an entity's own debt where a gain results. Higher credit spreads are usually charged to less creditworthy borrowers, but changes in credit spreads can be driven by factors that are totally unrelated to a change in a particular borrower's credit standing such as supply and demand or market illiquidity. Therefore, the credit quality of a bank's loan book and user information demands about risk concentrations are best met through risk-based disclosures and not through the single measure of fair value.

2.5.6 Furthermore, it must be understood that it is neither practicable nor realistic to assume that a large commercial bank could realise the difference between carrying value and fair value of its loan book as deep and liquid markets for such assets do not exist globally. Even if this could be achieved by selling these loan assets, this is not the purpose for which these assets are held and runs contrary to these banks' business role. There is limited scope for hedging or modifying credit risk by using credit derivatives as markets are thin and restricted to the larger corporates in a very small number of markets.

2.5.7 The historical cost of the loan book represents useful information as it is the maximum amount that the bank could lose if the borrower defaults as well as the principal amount on which interest is charged. By contrast, the fair value of the loan book provides less relevant information as it is a function of the current credit spread and prevailing interest rates.

Retail deposits

2.5.8 Determination of a fair value for retail deposits illustrates the irrelevance of fair value measurement for banking book items. Retail deposits provide banks with a cheaper and more stable source of funds than the wholesale markets. Interest paid is not the only cost of the deposits. In order to attract deposits, a bank must advertise and provide branches and support services. Nonetheless, the total cost of retail deposits is generally less than the cost of borrowing in the wholesale markets at often volatile market rates.

2.5.9 If a bank were required to fair value its retail deposits, the difference between the 'real' costs and the cost of alternative funding would result in the recognition of an asset because the difference represents a saving to the bank. This asset is sometimes referred to as the "core deposit intangible". Inclusion of such an asset in the balance sheet results in the recognition of internally generated goodwill on the balance sheet which is not generally permitted in financial statements.

2.5.10 Such an asset represents an 'opportunity benefit' for the bank. It will never be realised other than through the sale of the business as a going concern. Internal

management systems are not concerned with such opportunity benefits but rather the funding potential of these deposits. Therefore, of more value to a user when making decisions is the historical cost of the deposit base and the interest paid on it. Extensive average balance sheet and interest margin and spread information is already provided in the Operating and Financial Review section of banks' Annual Reports and Financial Statements.

2.5.11 In a similar manner to the interest rate charged to its customers for borrowing (see paragraph 2.5.5), the interest rate paid by a bank to its depositors is also affected by the credit standing of that bank. On a fair value measurement basis, as the creditworthiness of that bank deteriorates, the credit spread demanded by depositors increases and the bank records a gain as the current value of its liabilities falls. This would be misleading.

2.6 Conclusion

A full fair value system for the measurement of financial instruments in the primary financial statements of the banking industry would not be an improvement on current practice with reference to the relevance criteria outlined in paragraphs 2.2.1 and 2.3.1 above. Fair valuing a bank's non-trading items in the primary financial statements at an historic date does not improve the quality of information available to users of financial statements and may be misleading to those making economic decisions. Furthermore, where such information is provided in the notes to the financial statements it is not perceived by users as possessing attributes that contribute greatly to the predictive process. This is borne out by the emphasis placed on the use of the contractual future cash flows for traditional banking activities in preference to fair values in this area, even when the latter are provided, because measurement at fair value will not change the cash flows the bank will actually generate.

3 Reliability

3.1 Fundamental question

The fundamental question that requires consideration is:

"Does a full fair value accounting model faithfully represent the commercial effect of a bank's non-trading transactions and would the results be free from material error and bias?"

3.2 Faithful representation

Revenue recognition

3.2.1 It is important that the framework used by management for decision making is reflected in the financial statements so that the user can assess the performance of an entity in the context of the objectives of management. Furthermore, this framework should recognise revenues and profits on a basis that is consistent with the fundamental profit-earnings process that is occurring in the business. For a bank, that profit-earnings process is different for banking and trading activities.

Banking activities

3.2.2 At its simplest level, banking consists of raising funds and investing these funds in assets. Banks aim to make a profit by earning a margin between the amount received on interest-earning assets and the amount paid on interest-bearing liabilities. In undertaking these activities banks act as intermediaries between their customers, on the one hand taking deposits and on the other making loans on terms that meet customers' needs. These activities are best measured on a historical cost basis because revenue is earned by the accrual of interest on a daily basis and not by taking advantage of short term fluctuations in fair value.

3.2.3 Central to this function is the customer relationship that the bank enters into on a long-term basis. The focus of management when entering into both lending and deposit taking activities is the margin that the transaction is expected to generate together with any related fee income arising from cross-selling other products or services. For example, the provision of a current account would be expected to provide both incremental net interest income (from the low interest or interest-free nature of the account) and fee income, either from service charges levied on the running of the account itself or from other facilities, such as the provision of foreign currency or from the sale of other products such as residential mortgages, credit cards or household insurance. The same relationships also hold for corporate business as banks increasingly focus on the totality of income earned from a customer relationship when determining pricing for any one product.

3.2.4 It follows that a bank's management is not interested in either the current value of the banking assets or liabilities at a point in time, because it does not reflect the nature of the transactions that have been entered into, or the completed set of income streams likely to result. There is no intention to dispose of the assets or liabilities in question; indeed in many cases the bank would not be able to do this. The transactions are part

of a long-term customer relationship under which income accrues over time and fair value measurement would fail to reflect this.

3.2.5 Applying fair values to the banking book would result in transactions being depicted in a manner that is entirely unrelated to their commercial substance. Gains and losses would be recognised following changes in theoretical market rates and not when income has been earned or a loss incurred. This is not a faithful representation of the earnings streams that are generated from banking book transactions.

Non-banking (or trading) activities

3.2.6 A bank's trading activities are fundamentally different in substance from banking activities. The objective of management when trading is to profit from short-term fluctuations in market prices. In a trading environment, where active decisions are taken to hold financial instruments as well as dispose of them, a fair value basis of measurement better represents the transactions entered into and management performance.

3.3 Freedom from material error and bias

3.3.1 Advocates of the fair value basis of measurement argue that robust fair values suitable for inclusion in a set of financial statements are available for many financial instruments. Examples in support of this are cited as:

- the existence of active and liquid markets for many financial instruments;
- the use of current values for internal risk management purposes;
- for many financial instruments, cost is likely to be a reasonable approximation of fair value;
- companies reporting in accordance with US GAAP are already reporting fair value information for all financial instruments; and
- models have been developed by financial institutions and others to value financial instruments for which there is no active market.

3.3.2 Although it is acknowledged that, in some cases, fair values will not be readily available and estimates and assumptions will need to be made, this is not regarded by standard setters as undermining the integrity of the approach. It is acknowledged that assumptions and estimates play an important role in the mixed measurement system and that fair value estimates should be evaluated in relation to the range of estimates accepted in other areas.

3.3.3 This grossly underestimates the fundamental difficulties associated with arriving at fair values for many of the most common financial instruments. Given the high level of gearing in a bank's balance sheet, the effect of errors or inaccuracies in the calculation of fair values will be greatly magnified. In these circumstances it is hard to envisage how the directors will satisfy themselves that they have fulfilled their legal obligation to prepare financial statements showing a true and fair view. In addition, discussions about auditability have concentrated on the difficulty of auditing the range of possible model outcomes and serious concerns were expressed about how models subject to a wide range of management discretion could be audited. Given that for many financial instruments there is no readily available market value, and

that, therefore, widespread use of internal models developed by management would be required for external financial reporting, it is questionable whether the resulting fair values will be capable of being audited and a "true and fair" view audit opinion expressed.

3.3.4 The "fair values" calculated using discounted cash flow techniques and credit spreads determined by management will not be a "fair value" within the definition used for financial reporting, that is, the amount at which those loans could be sold in an arm's length transaction between informed and willing parties.

3.3.5 The introduction of an accounting measurement framework based on fair values would lead to an unacceptable level of subjectivity. Opponents of the existing mixed measurement system contend that it allows management to manipulate disclosed earnings, either by the selective realisation of gains or the establishment of excessive provisions. Given the probable dependence of the models required to arrive at fair values for many non-traded instruments upon the underlying assumptions made by management, in our view a full fair value system is likely to offer more opportunity for "creative accounting" than is currently the case. There will not be any reduction in the degree of subjectivity necessary for determination of loan loss provisions but the assessment of credit spreads by management will only serve to increase subjectivity in measurement.

Active and liquid markets

3.3.6 Whilst active and liquid markets exist for a number of financial instruments, principally debt securities of various kinds, equity shares and certain derivative products, there is no market of any substance for loans and deposits. In 1998 the volume of loans traded on the secondary market in Europe totalled approximately US$30 billion. This represents 0.66 per cent of the estimated US$4,500 billion of total outstanding lending.

3.3.7 As stated in 2.5.2, securitisation remains in its infancy outside the US market and is unknown for many classes of asset. Furthermore, in some jurisdictions, legal constraints limit the possibility of effective sales of loans.

Internal risk management

3.3.8 Knowledgeable users of financial instruments have well developed internal risk management functions. These functions use a number of different risk management techniques reflecting both the underlying nature of the transactions and all the inherent risks. In this process, fair value information is not used for traditional banking operations (other than for assets held as part of the asset and liability management process).

US reporting

3.3.9 A number of banks reporting under US requirements already provide fair value information for financial instruments. However, the provision of this information by way of a note to the financial statements is generally accompanied by "health warnings" as to its reliability. This is because the level of assumptions and estimates

that have been made would not be considered acceptable for financial reporting in the primary statements.

Models

3.3.10 Whilst some models exist for valuing financial instruments, these are generally only available to support trading activities. New models would need to be developed to deal with the lending and deposit portfolios and much work has recently been done on credit risk models. However, the paper published by the Basel Committee in April 1999 "Credit risk modelling, current practices and applications" noted the significant problems that still need to be overcome before these models are conceptually sound, empirically validated and comparable across banks. Because models vary owing to the assumptions used in creating the model and the sensitivity of the variables input, they cannot be considered reliable. This weakness could be addressed by requiring the use of a standard model with a pre-determined range of variation allowed in the inputs. However, banks operate in evolving markets, sensitive to external change, for example, in the economy, and, therefore, any such restrictions would quickly become out of date rendering the model irrelevant.

3.4 Loans and deposits

3.4.1 The balance sheets of most commercial banks are dominated by lending to, and deposits from, customers. To measure these balances reliably on a fair value basis would cause particular problems as set out below.

Loans

3.4.2 Loans can be classified into two broad groups comprising non-homogeneous (for example, commercial and larger personal loans), and homogeneous loans. For the former, credit quality may be monitored individually for each loan whilst for the latter, credit quality may be measured on a pooled basis for a collection of similar loans (for example, credit card and personal loans). Homogeneous loans are typically classified into pools of loans with similar characteristics that will be affected by similar factors and to a similar extent when those factors change. The credit quality of such loans can accordingly be assessed on a collective rather than an individual basis.

Non-homogeneous loans

3.4.3 There is virtually no market for non-homogeneous loans. Therefore, fair value can only be estimated using discounted cash flow techniques that employ, for example, forward rates from the zero coupon yield curve for loans with the borrower's existing credit rating. However, there is no published or reliable data available on the current credit spread for most borrowers and only very limited alternative sources in the form of prices of traded debt securities. Any estimate of credit spread would need to be made using internal pricing guides and/or the prices offered by other finance providers. Internal pricing guides provide only a general indication of the rate to be charged and this rate will be determined having regard to the bank's relationship with the individual customer and the range of products and services provided. In addition,

the range of products in the market renders any precise comparison with other lenders impossible.

3.4.4 The credit spreads applicable to many of these loans will reflect different levels and types of security held as collateral. A high degree of subjectivity would also be inherent in such valuations owing to the range of estimates available for the discount rates and other parameters applied in the discounted cash flow calculations used in such models. This would become increasingly significant as the term of the loan increases.

3.4.5 An upgrade or downgrade in the borrower's creditworthiness will result in a change in the fair value of the loan (see paragraph 2.5.5). Fair value will also change if there is a shift in the credit spread caused by, for example, competition or volatility in the lending market, as the current rate for the loan will differ from the rate charged under contracts with existing borrowers.

3.4.6 Stock and bond prices exhibit considerable randomness or 'noise' unrelated to identifiable economic fundamentals. This includes exaggerated price swings caused by disproportionate changes in market sentiment and speculative activity. Recent examples of market movements provide ample evidence of the extent to which market prices can move, particularly in thin markets, without economic justification. Any attempt to adjust for perceived abnormality in the markets will add more subjectivity to the reporting process. Full fair value measurement may exhibit volatility that does not reflect an institution's underlying economic value.

3.4.7 Impairment could be factored into the discounted cash flow calculations on an individual basis. However, this will introduce further subjectivity into the valuation process because estimates of the recoverability of future cash flows will need to be made and will often be complicated by the requirement to take account of the value of the collateral held.

Homogeneous loans

3.4.8 The fair value of homogeneous loans would also be determined using discounted cash flow techniques that suffer from many of the problems experienced with non-homogeneous loans. Under this method, the cash flows from the loans in a pool are aggregated into different time buckets based on their due date, and discounted at the forward rates derived from the zero coupon curve applicable to the loans in the pool. As for non-homogeneous loans, the discounted cash flows will become increasingly subjective as the terms of the loans increase.

3.4.9 For certain loan products such as fixed rate loans, using the contractual due dates in the valuation model will be inappropriate since this ignores the existence of the embedded option for the borrower to prepay, with or without penalty. Therefore, any estimate of future cash flows will be based on a model that captures both future interest rates and consequent borrower behaviour. As borrowers often do not exercise their embedded option on a rational basis, any resulting valuation will be highly subjective and not comparable between banks other than in established securitisation markets, most notably the US mortgage market. Similar problems will also be encountered for pools of loans such as credit card receivables with no fixed maturity.

Retail deposits

3.4.10 The retail deposit base represents a core source of funds for many banks. There is no market for retail deposits and it is not possible to determine a sufficiently reliable fair value for such instruments for financial reporting. Valuation of retail deposits also presents other difficulties as it will require an understanding of the behavioural patterns of a bank's customers. For example, current accounts and some deposit accounts can be withdrawn without notice. However, in practice a large element of these deposits may remain in place for the long term and often form the basis of a bank's relationship with its customers. Any estimates of fair value will, therefore, need to incorporate an estimate of the average maturity of such deposits which will be subjective and will also include an element of goodwill reflecting the future value of the customer relationships.

3.4.11 The valuation of fixed term savings accounts presents similar problems. Many accounts of this kind will earn interest at a sub-market rate, reflecting the nature of the product and size of the deposit. Consequently, a fair value measurement basis would result in a gain being recognised at the inception of the transaction. This is inappropriate because the gain crystallises over a period of time as the bank invests the funds received at a higher rate of interest, thereby securing its return.

3.5 Conclusion

3.5.1 The mixed measurement basis faithfully represents the earnings process in banks for both the banking and trading books. For the banking book, income is earned on an ongoing basis through the intermediation period, not from gains or losses arising from short term holdings of positions in the expectation of market changes which is undertaken in the trading book. The reporting is also free from bias as banking book transactions are recorded at their cost at acquisition which is unbiased by subsequent judgement and market changes except in instances of impairment.

3.5.2 Fair valuing items in the banking book does not link to the earnings process. In addition, such a measurement basis would be highly subjective in its determination of amounts to be recognised in the balance sheet. This arises from the lack of tradability and trading of the underlying instruments. Establishing value will require significant assumptions concerning liquidity, credit worthiness, collateral realisability, optionality and expected customer behaviour. Extensive subjective judgement seriously undermines the reliability of fair value accounting as a basis of measurement.

4 Understandability

4.1 Introduction

The fundamental question to be addressed is:

4.1.1 "For a commercial bank, does measuring all financial instruments at fair value result in a presentation of information in the financial statements which is more understandable and thus enables users to make economic decisions better than under the existing framework?"

4.1.2 First, changing the way in which financial instruments are measured also changes the way the resulting values need to be presented in a bank's financial statements. This issue does not arise in the same way for non-financial entities whose use of financial instruments is more incidental to their core activities. Secondly, it is also the case that behind any decision to choose between different models for measuring financial instruments will lie value judgements about what is significant.

4.1.3 Imposing fair value accounting for financial instruments held in the banking book creates inherent presentational problems and difficulties in understanding for even relatively sophisticated users. Additionally, and more seriously, it reflects an unbalanced view of what is significant not only for this area in a bank's financial statements but also for a bank's financial statements as a whole. Understandability would thereby be reduced.

4.2 Presentation

4.2.1 The existing mixed measurement system is well understood by users. Any change to a full fair value measurement basis represents a radical recasting of financial reporting. Attendant problems are more fundamental than those associated with educating users in a new accounting policy. The manner in which financial performance is to be presented must be articulated fully. The impact on users and their related financial processes also requires consideration. Proposals for measuring banking book financial instruments at fair value have not addressed presentation issues in the primary financial statements.

4.2.2 Users of bank financial statements have well developed processes that utilise the existing historical cost information for the banking book. These processes include assessing the future cash flows that can be generated by the bank's business. A fundamental change to the underlying accounting model will impact significantly on decision making processes of investors and should not be undertaken without full consideration of the implications for the investor community.

4.2.2 Lack of a specific framework in which the fair value movements of banking book financial instruments could be presented contrasts with the current reporting model which is well understood by users and is consistent with mixed measurement systems used by other businesses. Additionally it reflects the way in which the entity reports internally and assists management to communicate performance and financial position in a manner that most users understand.

4.3 Significance

4.3.1 The confusing recasting of banks' reporting framework that a move to full fair value accounting would entail is said to be justified by standard setters on the grounds that it will provide users with better quality information about banks' performance and financial position. This view is completely at odds with the view which exists amongst banks in this area and the lack of demand for change from users. Furthermore, to make such a change will obscure what is significant while highlighting that which is incidental.

4.3.2 Using fair values as a measurement basis implies that it is the management of the various risks (for example, credit risk and interest rate risk) assumed by a bank when it sells a financial product to a customer that is of prime significance in considering its performance and financial position. This is because performance in a period will be based on changes in the fair value. The banking industry would agree that this is the correct approach for trading books.

4.3.3 Commercial banking transactions such as loans and deposits are not entered into with a view to profiting from movements in market rates or changes in a customers' credit risk; rather banks are seeking to earn a margin over the life of the transaction. Banking book risks are managed to secure this margin. Accordingly, measuring banking book transactions at fair value obscures more relevant and reliable information on performance which is provided by a historical cost measurement basis.

4.3.4 This is illustrated by examining the reporting of a bank's interest-earning activities under the current framework. Net interest income that a bank earns is determined by the rate of interest it earns on its interest-earning assets, the volume of these assets, the interest rate it pays on its interest-bearing liabilities and the volume of its net free funds. It is one of the key sources of a bank's income. Management uses certain key ratios to monitor trends in net interest income and provides users of the bank's financial statements with extensive discussion on how net interest income has changed. These ratios are:

- interest spread – defined as the difference between the interest earned on average interest-earning assets and the interest paid on average interest-bearing funds; and

- net interest margin – being net interest income expressed as a percentage of average interest-earning assets.

Future cash flows that a bank can generate from interest income will, therefore, be determined by each of these factors. Analysts review closely how a bank's margin changes over time, the volume of growth in interest-earning assets and how these may change going forward as these are key drivers of revenue growth prospects. These key ratios are calculated using historical cost data because this best reflects how a bank actually charges and pays interest.

4.3.5 By contrast, a fair value model would show net income including interest received and fair value changes and report interest-earning assets and interest-bearing liabilities at fair value. The relationship, therefore, between net income and interest-earning assets would bear little relation to the way in which income is earned. The net interest

margin derived under the fair value model by dividing net income by average interest-earning assets would have no meaning and would display trends that would be complex to explain and would have no predictive value. Hence, analysts in the absence of additional disclosures on an alternative basis, would be unable to assess key business drivers from the financial statements, such as the capacity of a bank to generate future cash flows from one of its major income streams. This is a serious weakness arising from the use of fair values as the primary basis for measuring banking book items in the financial statements.

4.4 Conclusion

The mixed measurement basis is well understood by the users of financial statements who have developed extensive financial management processes which rely on the information as a basis for decision making. Any change to fair value accounting for banking book will lead to financial statements being significantly more difficult to understand and will impair the understandability of financial statements.

5 Comparability

5.1 Fundamental question

The key issue to be considered is:

"Are financial statements prepared under a fair value basis more or less comparable from period to period, or between entities, than those prepared using a mixed measurement approach?"

5.2.1 Information provided by financial statements needs to be comparable. Comparability is desirable as it allows users to compare:

- an entity's financial information over time in order to identify trends in its financial performance and financial position; and
- the financial information of different entities in order to evaluate their relative financial performance and financial position.

Comparability requires the consistent application of a reporting entity's accounting policies both within each accounting period and from one period to the next. In order to compare the results of different entities, disclosure is required of the accounting policies used together with changes, detailing particulars, effects and reasons for the changes.

5.2.2 The mixed measurement system is a known and tried basis of accounting which aids comparability. It faithfully represents both the profit-earning process and management's approach to the business. The level of subjectivity involved in the determination of profits under this system is limited to a small number of critical areas, for example, loan loss provisions. Resulting figures, and their limitations, are well understood by users of accounts.

5.2.3 Proponents of a fair value measurement basis claim that the mixed measurement approach is flawed because identical items have different carrying values if recognised at different times (in the banking book) or if acquired for different purposes (i.e. trading or banking). However, the different values are integral to an important element of comparability in banks' financial statements. The mixed measurement approach distinguishes trading from banking activities and measures performance in both areas using different, but more relevant, measures.

5.2.4 Supporters of a full fair value model maintain that it provides greater comparability from the use of a common accounting policy – "fair value". In practice, however, greater subjectivity will be involved because the underlying assumptions necessary to value the banking book are capable of wide variation. Adoption by entities of assumptions that differ, albeit only slightly, would significantly reduce comparability.

5.3 Conclusion

5.3.1 The existing mixed measurement system is well understood by users of accounts and provides a satisfactory degree of comparability. A move to full fair value accounting

would reduce, rather than increase, comparability. This would represent a radical change, the need for which has not been proven.

6 Overall conclusion

6.1 The mixed measurement system which reports the banking book at cost and the trading book at market values continues to provide the most appropriate basis for communicating financial information to investors, lenders, creditors and other users for use in making economic decisions and assessing management stewardship. It continues to be both relevant to users and reliable. It is well understood and allows for comparison between entities.

6.2 This system has been integrated into the financial markets and their related processes encompassing analysis, decision making and ascribing overall value to equity as well as reporting forming the basis of financial management. A change is, therefore, a change in the essential financial management model and should not be viewed merely in the context of financial reporting.

6.3 Fair value does not provide a conceptually sound basis for the measurement of a bank's financial position and performance as it will not provide useful information to the users of financial statements in accordance with the qualitative characteristics of relevance, reliability, comparability and understandability.

Federation of Bankers Associations of Japan (ZENGINKYO)

FINANCIAL INSTRUMENTS - ISSUES RELATING TO BANKS
Comments on the JWGSS paper

Overview

We are disappointed at the consistent lack of even-handedness displayed within the paper:

- Opposing views are not represented or analysed in any depth before being dismissed.
- There is little in the way of reasoned justification in support of fair value measurement.
- The supporting material has been selectively represented and occasionally misrepresented.

If an open and constructive debate is to take place on the way in which banks should measure and disclose information about financial instruments, it must be based on a dispassionate

evaluation of users needs and the relevance of the various alternatives in meeting these. In this respect the JWGSS paper is a missed opportunity.

Introduction

The impression that an independent reader would gain from the opening paragraphs of the JWGSS paper is that the standard setters have established the case for full fair value measurement and that this has been the subject of a thorough dialogue with the banking industry. The opposite is the case. As our Attachment 1 shows, the overwhelming message given in the banking papers and response letters listed in Appendix A to the JWGSS paper was that the banking industry is critical of the rationale and support for the proposal that all financial instruments, including those in the banking book, should be measured on a fair value basis. Doubts about the fair value initiative have also been expressed in the meetings referred to in the JWGSS appendix.

Even the quotation from the British Bankers' Association is misrepresented. Its 31 March 1999 letter commented:

"It would be in all our interests if the next stage of consultation could adopt a more constructive approach than the negative terms in which we have been obliged to respond to IAS 39. The banking industry in recent years has sought to improve the quality and transparency of its published financial information. We would be pleased to advise the IASC of these developments and to establish an agreed conceptual framework for banks."

This is very different from the interpretation given in the JWGSS paper. Substantial progress has been made in improving the transparency of bank accounting and this has been achieved in the full understanding that the market has a high expectation of the information that it expects banks to provide. Hence the industry itself has constantly evolved measurement and disclosure practice. In Australia, for example, banks fair value trading securities, though there is no statutory or accounting requirement for them to do so, while in the UK, the development of a disclosure standard for banks on financial instruments largely involved the standard setter capturing developments that were already taking place within the industry.

Paragraph 1.4 comments that the paper reflects the result of "analysis and evidence" developed by accounting standard setters over many years and the paper later states, at paragraph 2.6, that "the case for the superior relevance of fair value measurement is supported by a growing body of market-based research". This, in our view, is questionable. The market-based research listed in Appendix C at best presents a case for some fair value disclosures and, in some instances, points to the superiority of the present modified historical cost basis. It is also US-dominated. Our analysis of the research is given in Attachment 2 to this response.

The research material selected also overlooks studies that support the contrary view, including the user-orientated 1994 American Institute of Certified Public Accountants study "Improving Business Reporting", studies on fair value conducted by KPMG and the 1997 Federation des Experts Comptables report "Accounting treatment of financial instruments: a European perspective". A summary of these and other available reference material is given at Attachment 3.

The JWGSS paper is based on supposition and makes no attempt to show how full fair value measurement would actually work for assets and liabilities in the banking book, ie how fair value changes from the opening balance sheet to the closing balance sheet would be reflected in the profit and loss account and statement of movement of reserves. It therefore fails to analyse whether the resulting P&L account would have any meaning for users of accounts. Conceptual issues have not been discussed with any thoroughness; highly significant practical difficulties are not considered adequately; and no consideration is given to whether disclosure may be a more appropriate response to the perceived demand for information.

The body of the JWGSS paper is divided into three parts, with sections devoted to relevance, reliability and feasibility, and issues relating specifically to the banking book. This response follows the same sequential order.

Part 1: General relevance of fair value in comparison with cost-based measures of financial instruments

We do not believe that the JWGSS has adequately considered the conceptual issues concerning relevance. It makes the assumption that relevance considerations should be interpreted only in terms of measurement in the primary financial statements and not through supporting disclosures.

Our conceptual paper, "Accounting for Financial Instruments for Banks" gives an account of the reasons why we consider that relevance criteria support the use of the modified historical cost measurement base. Our task here is to address directly some of the unsupported assertions made by the JWGSS:

Para 2.5 – the effect of current economic conditions is reflected under both fair value and the present cost-based measurement models. The difference is that, under cost-based measurement, recognition better reflects economic substance and what management is trying to achieve as earnings are accrued over the life of the transactions in question. This is in contrast to fair value movements reflecting short-term price changes that are often irrelevant to the management of the transactions in question and the underlying profit-earning process.

The assertion that fair values aid comparability and cost-based values impede comparability is unproven. This view is based on research material from which firm conclusions cannot be drawn. It is also relevant to note that banks reporting under SFAS 107 continue to advise users that differences in the assumptions and parameters used in reaching the fair values given mean that comparative analyses between institutions are not meaningful.

The JWGSS has also been working under the misapprehension that making adjustments to a loan portfolio for credit risk, market risk and prepayment risk results in a fair value that would be achieved in an open trade. The reality, however, is that the value of any banking portfolio will also include the value of the existing and future customer franchise and potential synergies with other business streams. In, for example, the two purchases of banking portfolios in Australia in the past three years, the premium paid over book value reflected the future benefits that the buyer expected to achieve from access to the customer base and distribution network obtained. Any comprehensive measure of fair value, therefore, would need to place a value on the internally generated goodwill associated with a loan portfolio.

Our fundamental position is that were it the case that "fair values provide a superior basis for prediction", then they would be a standard reference point for management and analysts and there would be a market expectation for fair values to at least be disclosed. Yet the reality is that management as a rule do not use fair values to measure financial performance in respect of the banking book and the market places little weight on fair value disclosures. This, we believe, reflects the understanding that it is inappropriate for decisions about long-term business to be driven by short-term factors.

We believe the scope for "income management by selective realisation and settlement of financial assets and liabilities" is unfounded and is not supported by market practice or the evidence provided by the academic research appended to the JWGSS paper. Moreover, preparers in practice have not experienced difficulty in coping with the "complex hedge accounting" described by the standard setters as resulting from the mixed measurement base. Rather, they consider that the blueprint it provides constitutes the optimal means of reflecting the economic substance of the underlying transactions.

The conceptual case set out in Chapters 5 and 6 of the 1997 IASC Discussion Paper has already been commented upon in detail by the banking industry. As can be seen from Attachment 1, it failed to command support the first time round.

Para 2.6 - the case made by the research material summarised in Appendix C is far from compelling and does not support the conclusions drawn. In many instances, the JWGSS has unreasonably extrapolated the research to financial instruments other than those that were the subject of the research, has failed to reflect doubts expressed by 'pro' fair value authors and has not reflected the views of those that see no case for fair value measurement. Whether the conclusions merit disclosure rather than measurement has not been explored. As explained above, we also consider that useful user surveys and other material have been overlooked; a summary of these is given at Attachment 3.

Paras 2.7, 2.8, 2.9 – it is not credible for the JWGSS to take reports written by its constituent standard setters and cite these as adding to the "weight of evidence" pointing to the appropriateness of fair value measurement. In the case of FASB, changes to the accounting rules for banks may have been published, but the fundamental issues relating to fair value measurement cannot be said to have been resolved. The 1997 IASC discussion paper has a common heritage to the JWGSS paper and IAS 39 achieved IASC Board support by a narrow majority and is regarded as flawed by many, including the international banking community. The Canadian, UK and Australian Accounting Standards Boards have so far not won domestic support for the introduction of comprehensive fair values. Finally, as Attachment 1 shows, the response from other interests has been far from conclusive. Even where support has been expressed amongst the investor community, for example, there is evidence of opinion being divided and instances where the depth of analysis is extremely thin.

Para 2.11 – we do not agree that the case for the general relevance of fair value measurement of financial instruments "has been thoroughly made and documented". The banks' conceptual paper - Section 2 in particular - and the attached analysis of the research material explain why. In addition, the responses to the 1997 discussion paper remain germane and are publicly available.

Areas of misunderstanding

The JWGSS paper next turns its attention to trying to clear up "misunderstandings" that have come to light during previous consultation exercises. Each of the issues considered by the JWGSS is commented upon below.

Para 2.14 – capital markets and rational investor decision models – as explained above, we do not agree that the body of capital markets research "demonstrates the superior relevance" of fair value over cost-based measurement. It is precisely because banking book assets and liabilities are normally held to maturity that cost-based data provides more relevant information about expected future cash flows than fair value-based data.

We have seen no analysis from the JWGSS on why fair values are more relevant than the underlying cash flow streams and risk attributes; we would welcome the opportunity to review what the JWGSS proposes in this area.

We accept that banking supervisors are placing greater emphasis on transparency and that they view this as an important market discipline. It would be wrong to suggest, however, that the Basel Committee on Banking Supervision believes that fair value measurement for financial instruments can and should be introduced. The juxtaposition of the comment on their views with the comment on securities regulation is therefore misleading.

We agree that the capital markets extract a high price where full and fair information is not disclosed; however, we reject entirely any suggestion that existing disclosures made by the major banks currently trigger such penalties from the capital markets or are likely to do so in the foreseeable future.

Paras 2.15 - 2.18 – user demand, evidence of information value, and understandability of fair values of financial instruments – as explained in our comments on paragraphs 1.4 and 2.6, we do not regard the research cited in Appendix C as being conclusive.

While some user groups may have expressed support for fair value, others have presented a detailed case against its adoption. This includes the highly relevant AICPA and KPMG studies summarised in Attachment 3.

As for the results of the focus group survey conducted by independent consultants on behalf of AIMR, it is not convincing to be able to say that users defined by the consultants as being knowledgeable and informed about financial instruments were "evenly divided" between those favouring fair value measurement and those that did not. Only a minority of participants were regarded as being knowledgeable about fair values and financial instruments; and it must also be self-evident that those regarded as less informed would want more and better information. At best, the conclusion of the 1998 survey supports the need for more fair value information, not *fair value measurement*.

Paras 2.19 – 2.22 – the volatility of fair values – our prime concern is relevance, though lack of reliability also weighs heavily and is commented upon in the following section. Any suggestion that SFAS 133 (or IAS 39) will improve transparency would not be shared.

The JWGSS will appreciate that, in the absence of information about how changes in fair values of financial instruments will be presented in a performance statement, we are unable to comment on whether alternative methods would constitute an improvement to existing financial reporting.

Paras 2.23 – 2.24 – management intention - we do not agree that the fair value of, for example, a bank's loan book represents the relevant measure of management's success. For example, in the situation where loans are initiated and are held to maturity, the fluctuations in fair value of these loans does not represent the relevant measure of management's performance. The interest margin achieved and level of bad debt provisions experienced, together with other income earned from the customer relationship, are more meaningful measures of financial performance.

Paras 2.25 – 2.26 – current realisability and liquidity considerations – we do not accept that fair value offers a better basis for decision-making in respect of long-term funding issues and have fundamental concerns about the potential for premature profit recognition.

Paras 2.27 – 2.31 – shortcomings of a mixed-attribute model - we would not claim that the mixed model is perfect and, therefore, accept that it has shortcomings. It is considered, however, that the mixed model provides an accounting base that allows banks to present their financial statements in a way that most closely matches the way in which they organise their business, manage their risks and earn profit. It is also well understood by users.

The paper states that "a basic objective of financial accounting is that like things be recognised and measured in like ways". This has traditionally been interpreted as relating to the classification of items in the balance sheet, for example, between fixed and current assets. It does not mean that two identical assets must be recorded in the balance sheet at the same value.

As we will discuss more in relation to the JWGSS's section on reliability, it is a misconception to believe that all financial instruments are near-cash in nature and hence single facetted. The reality is that, in market terms, a corporate loan looks very different from an exchange-traded equity or derivative. The basic objective to which the JWGSS refers therefore is best served by creating an accounting framework that permits banks to recognise those differences. We have long held that the justification for the mixed model is based on the differing characteristics of the financial instruments in question and believe that rules governing the distinction can be devised without making the arbitrary distinctions embodied in SFAS 133 or IAS 39. This has been achieved in many major banking and commercial centres and has been documented, for example, in the BBA's Statements of Recommended Practice.

The IASC Discussion Paper (pages 96 to 100) discusses perceived shortcomings of a mixed measurement approach. We do not regard these shortcomings as being so severe that they cannot be overcome and would welcome the opportunity to discuss the points raised with the JWGSS. We do not believe that the income management concerns represent a justifiable criticism of current bank accounting practices and most certainly do not consider that they warrant the imposition of an accounting model on banks that bears no relation to the way in which they manage their business.

The overwhelming majority of bank loans <u>are</u> held to maturity; in Europe, for example, the secondary loan market stands at only 0.66% of outstanding loans. Other investments in the banking book are realised in limited circumstances and any resulting gains or losses disclosed.

The significant mismatches referred to in the final bullet point of paragraph 2.28 do not occur under properly formulated hedging rules. Hedge accounting can be controlled through appropriate documentation, need not be complicated and does not require complex accounting rules.

The views expressed by JP Morgan and UBS are not representative of the banking sector – which, as Appendix 1 shows, should be evident to the JWGSS from the response to the 1997 discussion paper and E62. In any event, the valuation of the non-trading book is largely irrelevant to the business mix of JP Morgan, which is predominantly trading in nature; and the UBS response draws attention to the many unresolved issues.

It is misleading to quote Alan Greenspan, Chairman of the US Federal Reserve Board, in a positive light given that the main purpose of his letter – the abandonment of SFAS 133 – was ignored. An interesting question for the SEC to consider would be whether it can really justify saying that market prices can be calculated objectively in the near-absence of a market.

Furthermore, our concerns about the relevance of fair value measurement in the banking book have not been alleviated by the suggestion in correspondence by the IASC (IASC-BBA, 14 April 1999) that the answer may lie in parallel financial statements:

> *"An answer might lie in having parallel financial statements, one set which would match management's perception of reporting which is consistent with the way banks organise their business and manage their risks, the other incorporating fair values."*

This, it would seem to us, simply confirms the view that the measurement of the banking book on a fair value basis would bear no relationship to the underlying fundamentals of the business. We believe it would undermine banks' financial reports.

Part II : Feasibility of reliable fair value measurement

It is difficult to comment on much of this section of the paper as, in most areas, the JWGSS is not able to present its findings as much of its work is still being completed. It is far from clear that the JWGSS will gain support for its conceptual advocacy of fair value or manage to resolve the substantial practical problems associated with estimating fair values and establishing appropriate controls.

We agree that fair values should not be required to be measurable within a narrower range than is accepted for cost-based measurement of the same instruments, but would expect an equivalent standard of reliability to that provided by transaction-based measurement. Without this, fair value would not represent progress. We understand the distinction between reliability and volatility and in this context are concerned about reliability. Concern also exists about volatility, but is seen as a relevance issue, since the question is whether short-term market movements should be given a relevance that might impact on how the business is managed in the long-term.

1. Conceptual basis for the fair value measurement of demand deposit liabilities

We need to understand how the JWGSS's thinking has progressed before we can comment.

2. Loans for which there is no active market value

The introduction of fair value accounting for loans will increase, not decrease, the degree of subjectivity. Currently, the only relatively subjective area is the determination of the quantum of loan loss provisions required whereas under fair value accounting the subjective element would be extended to include management's perception of credit risk, market risk and prepayment risk.

Banks are as concerned as anyone else about seeking to improve the process by which they set their provisions and model their credit risk. This is undertaken as part of their on-going business process. They do not, however, believe that fair value would improve this. Nor do banking supervisors. As recentlys its July 1999 paper "Sound Practices for Loan Accounting and Disclosure", the Basel Committee on Banking Supervision expressed doubts, commenting that:

"Without prudent and balanced standards for the estimation of fair values, particularly when active markets do not exist (such as is often the case for loans), the use of a fair value model could reduce the reliability of financial statement values".

The Basel Committee's subsequent paper "Credit Risk Modelling : Current Practices and Applications" comments more specifically on the present state of credit risk modelling techniques:

"At this time, significant hurdles, principally concerning data availability and model validation still need to be cleared…and the Committee sees difficulties in overcoming these hurdles in the timescale envisaged for amending the Capital Accord".

The banking industry believes that these hurdles can be overcome and that we will reach a point where credit risk modelling and internal ratings can be brought into the determination of regulatory capital. It needs to be appreciated, however, that it may be some time before such developments impact on banks.

The Basel Committee also observed a range of practices in the conceptual approaches to modelling:

"Different approaches to the measurement of credit loss. Most banks employ either of two conceptual definitions of credit loss: the default-mode paradigm, in which a credit loss arises only if a borrower defaults within the planning horizon, and the mark-to-market (or more accurately, mark to model) paradigm, in which credit deterioration short of default is also incorporated. Banks may also choose to adopt different time horizons for monitoring credit risk."

It is, therefore, inappropriate to suggest that the development of credit risk models will necessarily lead to banks developing systems for fair valuing rated loans as some banks are developing models which are not based on a mark-to-market approach.

Credit Metrics is openly available in the marketplace and is an example of a model using a mark-to-market approach, but is used only by a small proportion of banks. While it is undoubtedly valued by those banks which utilise it, no single credit modelling system can be applicable to the broad difference in the business mix that exists between banks. Credit

Metrics is one of a number of tools that may be used by management to inform lending decisions and does not constitute a foundation for financial reporting measurement. Moreover, it applies only to rated loans and therefore offers no assistance in respect of the larger proportion of the loan market.

We believe that the JWGSS has seriously underestimated the difficulties associated with developing and interpreting statistical bases to underpin fair values for the majority of loans and advances.

3. Behavioural aspects of certain loan arrangements

Liquidity and interest rate risk management is an on-going process in which banks constantly reevaluate and reposition their exposures in light of current and forward market movements. While it is right that the financial statement disclosures encompass liquidity and interest rate risk management, it does not provide a basis for measurement in the primary financial statements.

4. Reliability survey

We look forward to reviewing the replies to the JWGSS's survey, particularly since the constituent national surveys have in some cases been completed without reference to the most relevant preparers within the ing industry and, we understand, in some instances have achieved only a minimal response – which in itself provides evidence of the lack of support for extending fair value beyond the trading book. We consequently believe that the JWGSS should take great care in interpreting the responses and in drawing conclusions from the survey.

The implication of paragraph 3.14 is that the JWGSS believes that it can unlock expertise that the accounting function within banks cannot. This is simply not the case. It also implies that Boards are incapable of managing their businesses given that opposition to comprehensive fair value measurement in the primary financial statements exists at the most senior levels within the industry. In any event, the JWGSS is working on the incorrect assumption that fair values are generally used in the management of the banking book.

The JWGSS is the principal advocate for change and the onus is on it to prove beyond doubt that full fair value measurement is conceptually sound and reliable in comparison to the current mixed measurement basis. The banks' case against adopting fair values for the banking book is principally conceptual – they do not believe that it constitutes the appropriate base on which to measure performance in this area. However, the practical difficulties are also significant and are widely recognised.

It is surprising to read that the JWGSS is willing to contemplate such a radical change to bank accounting without having succeeded in resolving all the outstanding issues. There are too many unanswered questions relating to fair value and the issues are of such critical importance that they cannot be 'left to sort themselves out' as the JWGSS implies. To accept such an approach would expose banks to having to publish their financial statements using a measurement framework that suffers from severe practical difficulties and is flawed. This would certainly impair the reliability assigned to the financial statements by the capital markets. Comparability between banks would be reduced and, similarly, year-on-year assessments in respect of individual banks would be impaired.

The JWGSS has not yet presented a convincing case for change and most certainly has not demonstrated how the main problems associated with comprehensive fair value could be overcome. Until it has, it would be inappropriate and ill-conceived to introduce such radical change. Piecemeal introduction of fair value to the banking book would not attract market confidence and is rejected because it would introduce a form of accounting that bears relationship to the way in which the underlying business is managed – one of the key objections expressed in opposition to SFAS 133 and IAS 39.

Part III : Banking differences

Para 4.3 – the principal key difference between the banking industry and other sectors is that a bank's financial instruments earn revenue from both trading and traditional banking activities. The mixed measurement basis reflects the fact that the earnings process for the two areas is entirely different. Fair value therefore has greater significance for the banks and the introduction of an unproven measurement basis would potentially have a much more damaging effect.

Banking book management practices

It is disappointing that, notwithstanding presentations made on asset and liability management, the JWGSS still believes that the banking book is only managed on a "net gap" basis. These presentations made it clear that gap analysis was still used by some banks as a management tool but that most larger banks use different, more sophisticated approaches. Earnings-at-risk and balance sheet modelling techniques do not use a "net gap" approach and give management a deeper insight as to how future cash flows may be affected by assets and liabilities, which may behave in a different manner from the contractual characteristics. Risk management techniques may also be different for liquidity risk and interest rate risk. In places, this section of the JWGSS paper seems to confuse the two risks referring to "cash flow gaps" when seeming to discuss interest rate risk.

The banking community's objections to fair value measurement are not based on the use of any particular ALM tool. The JWGSS's analysis in paragraph 4.7 seems more to do with how and what risk management disclosures should be made rather than the correct accounting model to be adopted. It should be noted that where credit derivatives are used to hedge risk in the banking book they are carried at cost and not fair value.

The reasons why banks believe that fair value would reduce rather than improve transparency are set out in the accompanying conceptual paper and include the non-utilisation of fair values in the management of the banking book, the lack of economic relevance and the subjective nature of the estimations.

We do not believe that it would be a major task to define the trading and banking books with the certainty needed to achieve consistency between institutions and over time; and it most certainly should be less contentious than the attempted imposition of an unproven measurement base.

Banks are continually upgrading their risk management techniques and analyses used would include credit risk and interest rate risk models. That, however, is not to say that the certainty that can be placed on the resulting data is such that it is the sole information used in

managing the book or that it constitutes an appropriate base for measurement in the primary financial statements.

Demand-type deposits

It is difficult for us to provide comments in the abstract in this area. We would therefore prefer to discuss the question of demand deposits once we have a better understanding of where the JWGSS's thinking currently stands.

Broad implications for financial stability

We believe that the view that bankers and regulators believe that "prudent smoothing of market volatility is essential" has been overstated and object to the implication that banks have systematically misstated their financial performance. In our view the JWGSS has seriously misinterpreted the industry's position on this.

It is our view, however, that the measurement system should not result in short-term fluctuations having an undue bearing on decisions about long-term funding. This is one of the key drivers in our belief that the measurement of transactions in the banking book should reflect their long-term nature. Loans overall are not interchangeable trading instruments; the introduction of a measurement base that implies otherwise cannot be justified.

The banks have expressed concern about valuing their banking book assets and liabilities using market prices (where available) which bear no relationship to the pattern of cash flows. Those market prices can contain significant amounts of "noise", can be highly volatile and can move in ways that are not determined by underlying economic conditions. The evidence provided by the drastic swings in market prices during the Asian crisis of late 1997 is persuasive in this regard: a large element of the price changes arose from immediate sentiment and other short-term factors and was largely unconnected with economic fundamentals.

We are also not aware of any research that supports the view that fair value information about the banking book is instrumental in users being able to make rational economic decisions.

In response to the comment in paragraph 4.30, we would add that we do not believe that management is seeking to "second guess" the market; rather it is ensuring that short-term market volatility does not influence its decision-making processes about long-term funding.

Relationship to banking regulation and capital adequacy

It would seem self-evident to us that confidence in the integrity of banks' reporting systems dictates that the banks' own measurement techniques, the regulatory regime and financial reporting requirements should be developed in harmony. While safeguarding depositors' monies may determine that the regulator should have access to more regular - and sometimes more detailed - information, the basic building blocks should be the same. To develop financial reporting on a separate track from business use and regulation would cast doubts on the usefulness of the published financial information.

Definition of banks and banking activity

We do not consider this to be a significant issue. If an institution is providing a banking service, then it should account for that service on a basis compatible with its nature. This holds for a non-bank undertaking banking activity and for a bank undertaking a non-bank activity. The only exception would potentially be where management practice and materiality determined that a single measurement base should prevail.

We should add that, in any event, banks operating outside the US are not subject to Glass-Steagall type restrictions and have for some time provided brokerage, investment banking and insurance services.

Attachment 1

Comment letters on IASC Discussion Paper, *Accounting for Financial Assets and Financial Liabilities*, March 1997

	Support fair value	Against fair value	Other	Comment
ABN AMRO Bank		✔		"Nevertheless we would like to emphasise our objection to your proposal to measure all financial assets and liabilities at fair value"
American Bankers Association		✔		"… the ABA strongly objects to a fair value accounting model for financial instruments because it would misrepresent the financial condition and operating performance of most enterprises."
Association Francaise des Banques		✔		"We do not think that measurement at fair value subsequent to initial recognition of all financial assets and liabilities is always the approach which best reflects the economic reality of transactions."
Australia and New Zealand Banking Group		✔		"…, we do not currently support the fair value measurement of financial instruments that are not traded in an active market."
Australian Bankers' Association		✔		"We understand the reasons for the move to fair value accounting for financial instruments, but on balance do not support it."
Australian Financial Institutions Commissions	✔			"We support the concept proposed in the discussion paper suggesting a fundamental change in the method of accounting for financial assets and liabilities from the current historical cost based reporting to reporting at fair value."
Bank of Montreal		✔		"In addition to our concerns about the CICA working with the IASC rather than FASB, we do not support the specific proposal made in the Discussion Paper to adopt full fair value accounting."

Basel Committee on Banking Supervision		✔		“While many of the goals of the fair value approach are desirable, we have serious reservations about IASC going ahead with the proposals as currently constituted on comprehensive fair valuation in the balance sheet and income statement at the present time.”
British Bankers Association		✔		“The UK banking industry is vehemently opposed to the application of fair value to the non-trading activities of banks and similar financial institutions.”
Bundesverband deutscher Banken		✔		“An application of fair value accounting in non-trading areas would lead to misinterpretations of accounts since in traditional banking fair values do not represent an adequate basis for the determination of distributable profits.”
Canadian Bankers Association		✔		“In addition, we have fundamental concerns with the direction in which the Discussion Paper would take Canadian accounting standards, and we do not support the proposals that would require the fair valuing of all financial instruments.”
Chase Manhattan Corporation		✔		“However, Chase does <u>not</u> support fair value accounting because it will create unnecessary earnings volatility for the overwhelming majority of financial institutions and commercial and industrial companies around the world.”
Canadian Western Bank		✔		“I have a fundamental concern with the concept of marking the balance sheet to market or fair value as the primary accounting principle.”
Citibank		✔		“Until further development and experience changes both the reality and perception of unreliability, fair values cannot be used as the primary measurement basis.”
Commonwealth Bank of Australia		✔		“The Commonwealth Bank of Australia does not support the current proposals to account for all financial assets and financial liabilities on a fair value basis.”

Danish Financial Supervisory Authority	✔			"We agree that financial assets and liabilities should be measured at their fair value subsequent to initial recognition."
Deutsche Bank AG		✔		"… the German banking sector totally rejects the reporting of non-dealing activities at market values."
Dresdner Bank		✔		"The case against fair values for financial instruments of the non-trading book in the balance sheet is further supported by the fact that the balance sheet represents the actual cash flow situation of the instruments."
Federation Bancaire de l'Union Europeenne		✔		"The Federation would like to emphasise in this respect that it does not agree with the argument used in the discussion paper to reject the use of forms of mixed measurement…"
Federation of Bankers Associations of Japan		✔		"…the scope of transactions subject to fair value evaluation…should be limited to financial instruments in mature markets with which the management intends to seek short-term capital gains."
Hang Seng Bank		✔		"We do not agree that fair value accounting should be applied to non-trading financial assets and liabilities."
HSBC Holdings		✔		"We fundamentally disagree with the proposal to carry all financial instruments at fair value since this will not address the stated objectives and concerns of the IASC."
ING Bank		✔		"Furthermore valuing instruments at fair value, which are considered to be held to maturity, while taking evaluation differences to the profit and loss account, does not give a fair view of a banks results."
J P Morgan	✔			"Overall, we support a fair value accounting model for financial assets and liabilities." "…the timing issue is more complex and would benefit from more discussion on what is useful financial information. We suggest using disclosure as a first step to full integration of fair value accounting into the basic financial statements."

London Investment Banking Association		✔		"We do not agree that all entities should necessarily measure all financial instruments at fair value subsequent to initial recognition."
Marine Midland Bank		✔		"Specifically, utilization of fair value as the principal basis of financial statement measurement will in our opinion perpetuate one of the very problems that IASC is attempting to address. That being inconsistency and abuses in accounting treatment."
Mitglied des Vorstandes der Deutsche Bank		✔		"In contrast to these ideas, the German banking sector totally rejects the reporting of non-dealing activities at market values."
National Australia Bank		✔		"National Australia Bank does not support the current proposals to account for all financial assets and financial liabilities on a fair value basis."
Netherlands Bankers' Association		✔		"Therefore the NVB disagrees with the Steering Committee's proposal that all financial assets and liabilities should be measured at fair value subsequent to initial recognition."
New York Clearing House		✔		"However, the Clearing House does <u>not</u> support the fair value accounting approach being advocated in the Discussion Paper at this time."
Office of the Superintendent of Financial Institutions (Canada)	✔			"As a result, fair values should be used, at this time, to measure all financial instruments on the balance sheet."
Rabo Securities		✔		"We prefer a mixed accounting model which reflects the fact that financial instruments are used by banks for different economic purposes and that the accounting treatment of those instruments should reflect that underlying economic reality."
Rabobank Nederland		✔		"Therefore I disagree with the Steering Committee's proposal that all financial assets and liabilities should be measured at fair value subsequent to initial recognition."

RMA – Association of Lending and Credit Risk Professionals		✔		"The APC believes that fair value data provide useful information, but that it is inappropriate to consider them as a replacement for the historic cost as it is used in today's mixed attribute accounting measurement model."
Robeco Effectenbank		✔		"Therefore we disagree with the Steering Committee's proposal that all financial assets and liabilities should be measured at fair value subsequent to initial recognition."
Schretlen & Co		✔		"Therefore we disagree with the Steering Committee's proposal that all financial assets and liabilities should be measured at fair value subsequent to initial recognition."
Societe Generale de Belgique		✔		"We believe that obliging all companies in all types of activities to account at fair value for all financial assets and liabilities is fundamentally inappropriate."
Swiss Bank Corporation	✔			"Swiss Bank Corporation remains firmly of the view that fair value accounting as recommended by the Steering Committee is the correct way for financial institutions to account for their activities in financial instruments."
The Bank of Nova Scotia		✔		"I do not believe measuring all financial instruments at fair value in the core financial statements is the correct answer."
Union Bank of Switzerland	✔			"…but we do not underestimate the many definitional problems and unresolved implementation issues."
World Bank	✔			"We appreciate the IASC's effort to improve the accounting requirements for financial assets and liabilities and agree with the theoretical correctness of the fair value approach for financial instruments."

Comment Letters on IASC Exposure Draft E62, *Financial Instruments: Recognition and Measurement*, June 1998

	Support fair value	Against fair value	Other	Comment
ABN AMRO Bank (Netherlands)		✔		Argues that it should be axiomatic for accounting principles to support commercial practice and explains that for banks this means making a distinction between the banking and trading books.
American Bankers Association (USA)		✔		“While the ABA supports the IASC’s efforts to harmonize the accounting for financial instruments, the ABA does not support E62 because it represents a major step towards measuring financial instruments at fair value.”
Association Française des Banques (France)		✔		“The AFB considers that fair value measurement method is totally unsuitable for commercial banking activities, and that its application to this activity could have serious consequences, in particular from a regulatory point of view.”
Australian Bankers’ Association (Australia)		✔		“… we oppose the adoption of fair value measurement for non-trading financial instruments.”
Bank of Baroda (India)			✔	Principally concerned about the recognition of unrealized gains.
Basle Committee on Banking Supervision (Switzerland)		✔		“Our main concerns are that too broad an application of fair value accounting, including many banking book assets, would be inappropriate at the present.”
British Bankers’ Association (UK)		✔		“The BBA disagrees fundamentally with the assertion that fair value is a better method of accounting for banks’ traditional retail and corporate banking activities than the current accruals basis.”
Bundesverband deutscher Banken (Germany)		✔		“This conforms largely with our view to apply Fair Value only to instruments held with an intention to sell them. Fair Value Accounting of traditional banking activities is, therefore, excluded.”

Dutch Association of Insurers (Netherlands)			✔	"… we strongly recommend to defer the applicability of E 62 and any other standards on financial instruments until the definitive standard for Insurance companies is in force."
Fédération Bancaire de l'Union Europeenne (European Union)		✔		"The proposed interim standard clearly takes as its starting point the fair valuation of financial instruments and liabilities. Its implementation would create insurmountable application difficulties for the European Banking industry, which cannot, therefore, associate itself with the draft in its present state."
Federation of Bankers Associations of Japan		✔		"Derivatives on transactions other than trading (hereinafter banking transactions) should not be measured at their fair value."
ING Bank (Netherlands)			✔	Principally concerned about ensuring that the appropriate held-to-maturity investments can continue to be valued at amortised cost.
Italian Banking Association (Italy)		✔		"… attribute a value of exchange (fair value) to the non-trading book means a significant increase in the subjectivity of the process of evaluation."
London Investment Banking Association (UK)		✔		"It cannot, however, be in anyone's best interests to publish a standard at all unless it is conceptually well-founded, a proper reflection of commercial reality and enjoys the broad support of the financial community at large. We have had to conclude that E62 meets none of these tests."
Netherlands Bankers' Association		✔		See ABN AMRO Bank
World Bank	✔			"Over the last several years the World Bank has noted through its interactions with the IASC's, the committee's recognition that fair value was the best measure for financial instruments."

The IASC has advised that the following institutions listed as replying to E62 in fact replied only to the 1997 discussion paper:

- Australia and New Zealand Banking Group (Australia)
- Australian Financial Institutions Commission (Australia)
- Commonwealth Bank of Australia (Australia)
- Danish Financial Supervisory Authority (Denmark)
- Dresdner Bank (Germany)
- Fédération Française des Sociétés d'Assurances (France)
- Hang Seng Bank (Hong Kong)
- Mitglied des Vorstandes der Deutsche Bank (Federal Association of German Banks) (Germany)
- National Australia Bank (Australia)
- New York Clearing House (USA)
- Rabo Securities (Netherlands)
- Rabobank Nederland (Netherlands)
- Robeco Effectenbank (Netherlands)
- Schretlen & Co (Netherlands)

Attachment 2

SELECTED EMPIRICAL AND POLICY STUDIES, STANDARD SETTER PUBLICATIONS AND OTHER REFERENCES

Introductory remarks

The implication of identifying extensive empirical and policy studies must be that the JWGSS considers that independent research supports its drive for the preparation of the primary financial statements of banks on a full fair value basis. From our reading of the research material, however, it is evident that no such conclusion can be drawn.

In considering the relevance of the research material, it needs to be borne in mind that the banks are not saying that fair value is never appropriate. Rather, they are questioning the circumstances in which it is appropriate and whether its relevance and reliability is such that it merits primary statement recognition. Key to understanding the banks' analysis of the available research is appreciating that instruments held in trading books are already measured on a fair value basis. In addition to this, banks recognise the benefit of providing fair value information in support of the primary financial statements, but not in circumstances where the value would have to be manufactured in the absence of a market price. Typically, this would mean that banks disclose the fair value of market-based investment securities, but do not believe that a fair value should be placed on untraded investments or loans.

In preparing our own analysis of the research material attached to the JWGSS paper, we are not in any way questioning the veracity of the research undertaken. There are many instances, however, where we question the conclusions that can be drawn from the research and the relevance of the material to the fair value measurement debate. While each of the papers is commented upon in turn below, key themes emerge from our analysis:

- On the issue of whether fair valuation constitutes better accounting or provides a better reflection of the economic substance of the transactions within the banking book, Barth, Landsman and Whalen concluded that their findings "were consistent with investors perceiving volatility in historical cost earnings to be a better measure of economic risk than volatility in fair-value earnings".

- While some studies find that fair value estimates of loans, securities and long-term debt provide significant explanatory power for bank share prices, others – notably Eccher, Ramesh and Thaigarajan, and Nelson – find no such relationship.

- The findings supporting a correlation between fair values and share price are principally limited to investment securities, with Petroni and Whalen pointing towards the correlation applying only to the fair value of securities traded in active markets.

- Even the 'pro' fair value surveys raise question marks over the reliability of the estimated fair value. Disclosure rather than measurement may be a more appropriate solution and Barth suggests that the key policy issue may be the design of the supervisory regime.

- To reflect the appropriate economic value of the assets and liabilities, fair values would need to include an element for internally generated goodwill.

- Mengle concludes that the subjectivity of fair value accounting may simply mean that "one problem would be replaced with another problem" and that the cost of market value accounting may not be justified.

- Barth/Wayne/Landsman/Wahlen, Cordell and King, and McAnnally find that contrary to the public perception, derivatives are not associated with increased levels of risk.

- Factors other than historical cost accounting played a pivotal role in the US Savings and Loans crisis – poor management, poor regulation and the copper-bottomed deposit insurance scheme.

Empirical studies

Ahmed, Anwar S. and Carolyn Tadeka: "Stock Market Valuation of Gains and Losses on Commercial Banks' Investment Securities: An Empirical Analysis" (1995)

The authors argue that balance sheet changes are needed if investors are not to overlook unrealised gains and losses. They find that changes in unrealised gains and losses have a positive effect on bank stock returns and consider that their findings are "*potentially relevant for evaluating some of the arguments forwarded in the market value accounting debate and provide some insights into how investors view managerial discretion over accounting choices.*"

While some comfort can be drawn from the fact that the recognition of unrealised gains and losses may have a positive effect on share price, the paper makes no comment on the accounting principles underpinning the measurement of investment securities. In concluding with an open remark about how investors view managerial discretion, the paper indirectly raises one of the banks' key questions: which constitutes the greater source of management discretion – disclosed gains and losses on investment securities or the freedom to determine the assumptions and parameters for placing market values on non-traded assets in the absence of a market?

Barth, Wayne, Landsman and Wahlen: "Fair value accounting: Effects on Banks' Earnings Volatility, Regulatory Capital, and Value of Contractual Cash Flows" (1995)

This study concludes that the banks' three main concerns over measuring investment securities on a fair value basis are not supported, in that: the increased volatility of earnings does not necessarily represent increased economic risk; the more frequent regulatory capital breaches may help predict future violations, are not perceived to be material and may warrant a change in the regulatory framework; and investment securities values associated with changes in interest rates are already reflected in bank share prices through the earnings multiple on interest revenue.

The authors close by admitting that they "*cannot be sure whether bankers' concerns have merit until investment securities' fair values are recognized in the financial statements and we observe the actions regulators and investors take in response to those data.*"

The principal author also observes that she is *"convinced that the key policy issue is the correct implementation of the Basle Accord"* including issues such as *"the number of risk*

categories, appropriate risk weights and covariances among various components of risk." She also refers to the conclusion drawn in work by Cordell and King, that off-balance sheet categories are associated with significantly lower bank asset risk on average, observing that given recent scares about derivatives, this is *"both important and powerful"*, but also *"politically unpopular"*. She cites the US Savings and Loans crisis as causing many to question the usefulness of historical cost accounting. Hence fair value is favoured because changes in fair values, i.e. unrecognised gains and losses, are recognised, in contrast to historical cost where changes in value are typically not recognised until realised.

The study is limited to investment securities and does not concern itself with accounting policy from a conceptual viewpoint. We comment as follows on the above extracts from the paper:

- The key policy issue is the proper operation of the Basle Accord – the accord is currently undergoing a substantial review and hence the author's stated main concern would appear to have been met.

- The public perception about the riskiness of derivatives is unfounded – Europe, so far, has stepped back from introducing inappropriate measures to overcome the perceived risk posed by derivatives. Others, however, have introduced incoherent accounting measures to counter what may be a mythical risk. Bank failures in which derivatives have been a factor have not resulted from accounting policy shortfalls, but fraud, poor internal control and inappropriate pricing.

- The suggestion that fair value accounting would have caused regulators and others to address institutions' difficulties earlier is not substantiated and it would seem clear that other factors were involved.

Barth: "Fair Value Accounting: Evidence from Investment Securities and the Market Valuation of Banks" (1994)

The paper concludes that the fair valuation of investment securities is reliably reflected in share price, but that gains and losses are not. The author observes that this may result from the combined effect of estimation errors or the fact that securities' gains and losses are offset by unrecognised correlating gains and losses. She adds that supplemental analyses give more credence to the first explanation.

The author's main conclusion suggests that reliability doubts exist specifically in respect of the fair valuation of investment securities once gains and losses are added. This leads us to conclude that disclosure rather than measurement would seem the appropriate application of fair value. Her final concluding remarks are not included in the JWGSS summary:

"The estimation error interpretation is particularly important to the fair value accounting debate because critics cite the questionable reliability of fair value estimates as a major reason against using fair value accounting. Fair values of investment securities are among the most reliably estimable of all bank asset and liability fair values. Even so, reliability of the securities gains and losses amount appears to be an issue. This raises the question of whether less reliable fair value estimates are appropriate to include in earnings."

The paper also observes that the data-gathering costs for fair valuing investment securities would be small as the banks have been disclosing fair value estimates for many years. This, however, is a secondary issue and is only true in the case of quoted securities.

Barth, Beaver and Landsman: "Are Banks' SFAS No. 107 Fair-Value Disclosures Relevant to Investors?" (1197)

(Untraced.) Paper summarised as concluding that fair value disclosures, most notably for loans, have a greater correlation to share price than book values.

Barth, Landsman and Whalen: "How Does Fair-Value Accounting for Investment Securities Affect Earnings Volatility, Regulatory Capital, and Value of Contractual Cash Flows?" (1995)

We would summarise the researchers' findings as follows:

- Bank earnings calculated using fair value estimates of investment securities gains and losses are 'significantly' more volatile than earnings using the historical cost model. The authors "*use the term significant in the statistical sense, indicating statistical significance at less than the 5% level*".

- Regulatory capital requirements would be breached more frequently, though investors "*do not perceive the potential increase in regulatory risk to be material*". Indeed, the authors confirm that their findings "*indicate that the only risk associated with regulatory capital violations under historical cost is reflected in bank share prices*".

Neither factor would have a bearing on share price. As the authors observe, "*This is consistent with investors not perceiving fair-value earnings volatility as a better proxy for risk than historical cost earnings volatility*".

The authors additionally observe that their findings *"are not consistent with increased volatility arising from using fair-value accounting for investment securities directly affecting capital allocation decisions by investors. They are consistent with investors perceiving volatility in historical cost earnings to be a better measure of economic risk than volatility in fair-value earnings"*.

They conclude from this that the banks' concerns about fair value generating uncertainty are unfounded. An alternative conclusion would seem possible:

- that as far as investment securities are concerned the differences generated between the two accounting bases are immaterial; and,

- investors regard historical cost as a more appropriate basis against which to judge economic risk.

Barth, Beaver and Stinson: "Supplemental Data and the Structure of Thrift Share Prices" (1991)

The study examines the disclosure of credit default risk and interest rate risk by thrifts and concludes that the significance of the disclosures on share price is lower in the case of thrifts than banks. It also draws the conclusion that thrifts that do not disclose the default risk variable appear to be valued at a discount to those that do.

Our assessment of the main findings of the study is that financial information generated by large financial institutions is more closely scrutinised by the analyst community. This is only to be expected. On the second conclusion, we would comment that the banking industry has long been aware that the quality and extensiveness of the disclosures made by individual institutions has a substantial bearing on the market's perception of their financial management. Hence the constant priority given to evolving credit and market risk management and the on-going development of disclosure practices.

Barth, Beaver and Landsman: "Value-Relevance of Banks' Fair Value Disclosures under SFAS No. 107" (1996)

This study provides evidence that fair value estimates of loans, securities and long-term debt disclosed under SFAS 107 provide significant explanatory power for bank share prices beyond that provided by related book values.

The study finds, however, that:

- Core deposits command a premium of 5 to 7 cents on the dollar, supported by prices typically paid for the acquisition of banks and thrifts.

- Fair values of loans for less healthy banks may be more difficult to estimate than for healthy banks, resulting in more estimation error. This possibly results from managers of less healthy banks having a greater incentive to overstate unrealised gains and to understate unrealised losses.

We comment as follows:

- The finding on core deposits supports the view that any fair value would need to include an element for internally generated goodwill.

- The implication of a distinction being drawn between a 'healthy' and an 'unhealthy' bank is that there are control issues rather than measurement issues.

- Other studies – Eccher et al (1996) and Nelson (1996) – find no explanatory power.

Barth, Beaver and Wolfson: "Components of Earnings and the Structure of Bank Share Prices" (1990)

The study shows that earnings before securities gains and losses play an important role in explaining bank stock prices, suggesting that investors perceive reported gains and losses in banks' investment securities are timed by bank managements to offset losses and gains in other earnings.

The study also finds that: "*Insofar as their marginal impact on share prices is concerned, greater than expected realized securities gains and losses are "bad news" rather than "good news"*.

This suggests to us that the market is perfectly capable of placing an appropriate interpretation on the information before them and that opportunist profit manipulation is penalised.

Beaver, Eger, Ryan and Wolfson: "Financial Reporting, Supplemental Disclosures and Bank Share Prices" (1989)

Results suggest that supplemental disclosures with respect to various characteristics of the loan portfolio do possess incremental explanatory power beyond that provided by allowance for loan losses and that the capital market's assessment of the market value of loans is below the reported book value.

The study concludes that: "*The results are consistent with the contentions supporting the decision to mandate the disclosure of these supplemental data."*

Bernard, Merton and Palepu: "Mark-to-market Accounting for Banks and Thrifts: Lessons from the Danish Experience" (1995)

The study finds that mark-to-market accounting in Denmark is not susceptible to manipulation, including *"the major realized and unrealized gains and losses on investments and some off-balance sheet positions."* The study finds *"no affirmative evidence"* that the mark-to-market system is used to avoid regulatory intervention and that Danish mark-to-market accounting produces numbers that are more reliable indicators of value than for US banks or US thrifts. It also finds that "in contrast to the US experience, banks sold as a result of regulatory intervention have typically fetched prices close to or higher than final reported book value."

We would suggest that one could also draw the conclusion that during the period in question Danish banks were in a healthier state than US savings and loans institutions. Also, we note that the authors observe, in footnote 3, that *"Many observers of the US thrift crisis point to flaws in the deposit protection system as its most underlying cause."*

The paper describes the Danish "mark-to-market" regime as follows:

"*The Danish system requires a provision for loan losses that is sufficient to cover "both known and foreseeable losses". The regulations provide no explanation of this rule; those who we interviewed – including representatives from auditing, banking, and the Supervisory Authority – interpreted the rule to indicate that the loan balance, net of provisions, should approximate current market value."*

Hence it can be seen that the Danish concept of market value does not equate to the fair value concept advocated by the JWGSS.

Carroll and Linsmeier: "Fair Value Accounting: Evidence from Closed-End Mutual Funds" (1996)

(Untraced.) The study finds a value relevance for the fair value of investment securities held by closed-end mutual funds and an association between stock prices and fair value estimates of securities gains and losses.

Eccher, Ramesh and Thiagarajan: "Fair value disclosures by bank holding companies" (1996)

The paper concludes that "*fair value disclosures for financial instruments other than securities are value- relative only in limited settings*".

It further observes that "*the value of the going concern (i.e. present value of the expected future cash flows) is likely to be greater than the sum of the reported fair values of individual assets minus liabilities due to the omitted value of 'goodwill'. Consequently, fair value estimates provided under SFAS 107 are incomplete due to the omission of important intangible assets representing the present value of expected future rents (e.g., value of trust department, value of trading activities, core deposit intangibles*".

And that: *"The evidence on the new disclosures under SFAS 107 is mixed. We find that the fair value of net loans has a weaker association with market-to-book ratio than does the fair value of securities. While the off-balance-sheet instruments are value-relevant in limited settings, we find no significance for the fair value of deposits. The lack of significance for deposits could be due to the exclusion of core deposit intangibles".*

"In contrast, the relative success of the traditional historical cost financial ratios indicates that the present value of expected future rents ('goodwill') is a significant component of firm value. This finding is important for standard setters examining the relative merits of switching to a market value accounting system".

The paper finds that, given that the fair value disclosures apply to the bulk of banks' assets and liabilities, their explanatory power is "*rather modest*".

Eccher et al consider their basic empirical findings to be compatible with those of Barth, Beaver and Landsman, the difference being the change in specification to take account of the intangible component. They note, however, that the Nelson study (1996) finds statistical significance solely for the fair value of securities and only for one of two years studied.

The Eccher et al paper concludes: *"The results of our incremental analyses…suggest that historical cost variables provide more value-relevant information compared to fair value disclosures in both an absolute and an incremental sense."… "Since switching to a fair value accounting system could eliminate some value-relevant historical cost information, these findings should be germane for regulators who are evaluating alternative accounting regimes for banks".*

Levites: "Mark-to market: Freddie Mac's Fourth Financial Statement" (1990)

The paper comments: "*Management believes that the disclosure of MTM information for Freddie Mac [the Federal Home Loan Corporation] was both possible and necessary to provide a complete picture of corporate performance*". It adds that in its case "*market value information was readily available*".

The paper also explains that Freddie Mac regarded users attempting to compare the net market value presented in the MTM balance sheet to the aggregate value of Freddie Mac's publicly traded stock as "*the single biggest risk*" and that "*the comparison would be inappropriate.*" This results from MTM not placing a fair value on future business opportunities or franchise potential, both of which are reflected in the company's stock value.

McAnally: "Banks, Risk and FAS 105 Disclosures" (1996)

The study examines whether FAS105 footnote disclosures of off-balance sheet instruments and derivatives provide risk-relevant information. The empirical tests of the model revealed that the disclosures do provide risk-relevant numbers but that the results are not uniformally strong. Interestingly, it finds that "*Stronger evidence …shows that certain controversial classes of derivatives are* <u>*not*</u> *associated with increased levels of market and industry-level risk*".

It concludes that "*This latter evidence stands in contrast to the idea, seen in the popular press and manifested in the new risk-based regulations, that derivative contracts, especially interest rate and currency swaps, increase overall bank riskiness.*"

Mengle: "Market Value Accounting and the Bank Balance Sheet" (1990)

While the study concludes that fair values would have a significant effect on income statements, and that this yields information about the solvency of a bank, it also makes the following observations:

- "*Market value accounting would eliminate obfuscation over differences between (objectively determined) historical and (subjectively determined) current values, but it would introduce new obfuscation over criteria for determining market value. Thus one problem would be replaced with another problem.*"

- "*The costs of market value accounting may not be justified.*"

Nelson: "Fair Value Accounting for Commercial Banks: an Empirical Analysis of SFAS No. 107" (1996)

This study finds that "*only the reported values of investment securities have incremental explanatory power relative to book value. No reliable evidence of incremental explanatory power is found for the value disclosures of loans, deposits, long-term debt or net off-balance sheet financial instruments*". Moreover "*After controlling for two competing indicators of value captured by the accrual accounting system, ROE and growth in book value, the fair value of securities no longer exhibits a significant association with market value*".

The difference between this and earlier studies is that Nelson models not only the difference between market and book values of equity as a function of the current market information reflected in the SFAS 107 disclosures, but also the value attributable to banks' future growth opportunities. She concludes that "*the value-relevance of investment securities fair value noted in earlier research is driven by the omission of proxies for future profitability from the model*".

Olsen: "SFAS No. 107: The Challenge of Disclosing Fair Values" (1992)

Ronald Olsen, at the time a member of the FASB's Financial Instruments Task Force, comments that fair value disclosures may have a silver lining and that they are likely to "*force bankers and others to learn more about the realities of marketplace transactions and assist them to manage complex risks*" and that they will "*force decision-makers to react to problems, not delay*".

The paper acknowledges that fair value modelling would involve banks making "*many subjective decisions*", but considers this to be an acceptable price for the listed paternal achievements. The tenor of the article seems to be that fair value disclosures are needed to deal with incidences of bad management.

Petroni and Wahlen: "Fair Values of Equity and Debt Securities and Share Prices of Property-Liability Insurers" (1995)

The study analyses the relation between fair values of equity and fixed maturity debt securities and share prices of equity property-liability insurers. It finds that property-liability share prices can be explained by fair values of equity investments and US Treasury investments. It also finds that fair value disclosures of other investment securities, such as municipal and corporate bonds do <u>not</u> explain share prices beyond historical cost. It therefore concludes that fair values of only "*certain categories of investments, such as equities and U.S. Treasury securities, which are more likely to be traded in active markets, are valuation relevant*".

Pfeiffer: "Market Value and Accounting Implications of Off-Balance-Sheet Items" (1998)

The paper is solely concerned with the value relevance of off-balance-sheet originated mortgage service rights. It also looks at whether firms enter into transactions designed to manage their reported income and financial position.

The paper concludes that they are priced "*even when they are not reported in financial statements*" and that "*liquidity is a stronger motivation for entering into sales of servicing rights than an earnings-management-based incentive*".

Pozdena: "Danish Banking: Lessons for Deposit Insurance Reform" (1992)

The report argues that a consequence of Danish banks adopting marking-to-market accounting is that banks facing difficulties are forced into closure at a point where they still have positive net worth, unlike American banks which struggle on and then require bailing out by the deposit insurance scheme.

We would comment as follows:

- The Danish regime does not constitute market-based fair value.
- The paper does not prove a cause/effect relationship between fair value and the cost of closure.

Robb: "Market Value Accounting in Financial Institutions" (1996)

The paper examines the feasibility of estimating bank loan market values through the development of an empirical model that adjusts reported historical cost values to market. The approach used views a loan as a bond and adjusts historical cost for changes in both default and interest rate risk in order to estimate fair values. The paper finds a difference between the book and market value and concludes that bank balance sheets may be inflated.

The paper uses a methodology in which "*fair values are imputed from unambiguous, market determined assertions of overall bank values*". "*If a relatively low cost model such as the one suggested in this paper is feasible, the market can make its' own evaluation of loan market values, eliminating the need for costly analysts' evaluations and (subjective) manager representations of value.*" The message, therefore, seems to be that there is no need to use fair value as a basis for the financial statements and, indeed, that there are good reasons for not permitting its use.

The paper also observes: "*It is widely believed that valuing bank assets at their current market values, rather than historical cost, is necessary in order to avoid another savings and loans debacle*" and adds that "*it has often been claimed that the use of historical cost accounting as required under GAAP has hindered supervisors in recognising or closing insolvent institutions on a timely basis*". The author explains that this at least implies that market values can be credibly estimated and disclosed at a reasonable cost for both thickly traded and non-traded assets and that the disclosure of the information is value-relevant.

This raises the question of whether FASB's pursuit of a fair value regime is grounded in it trying to deal with a past, high profile and expensive US problem with an inappropriate solution – the appropriate solution being better management, better supervision and a deposit protection scheme that avoids moral hazard.

Simonson, Donald and Hempel: "Running on Empty: Accounting Strategies to Clarify Capital Values" (1990)

(Untraced). The paper regards market value accounting as essential if regulators are to effectively monitor financial institutions. It claims that market values provide greater information about the prospects for future earnings than do historical values, removes the incentive for bankers to 'ride losers' and is a prerequisite for comprehensively measuring institution's interest rate risk.

We comment as follows:

- Supervisors have not demanded fair value information on the banking book.

- Historical cost provides a better base for calculating trends in key performance indicators and hence gives a better insight into future prospects.

- Bankers do not believe that market valuation constitutes a useful management tool for untraded assets and liabilities.

- Interest rate risk can and is calculated without fair values.

Sweeney, Warga and Winters: "The Market Value of Debt, Market Versus Book Value of Debt, and Returns to Assets" (1997)

The paper documents how book value measurements of debt distort debt-equity ratios and cost of capital ratios. It concludes that book value sometimes, but not always, seriously mismeasures the market value of debt and that this mismeasurement is associated with changes in bond-market yields.

White: "The S & L Debacle: Public Policy Lessons for Bank and Thrift Regulators" (1991)

(Untraced.) Sets out the case for change in light of the savings and loans debacle.

Policy studies

Cates: "The Case for a New Model of Financial Performance" (1997)

(Untraced.) The author, a banking consultant, argues that banks are managed on a mark-to-market basis but publish historical cost based financial statements. He concludes that this violates two basic rules of good investor policy relations policy: that the public corporate story should be lived internally; and the main themes of corporate strategy should be clearly visible.

We agree with the two guiding principles of investor relations as stated by the author, but disagree with the premise. Banks manage their banking books on a historical cost basis – this is currently reflected in their financial statements and should continue to be the foundation on which long-term business decisions are made.

Clarke and Mattson: "FASB No. 107: Why It Is More than Just a Compliance Issue"

(Untraced.) Argues that market value *"is one of the more useful tools management can employ to both accurately monitor and improve the bank's performance"*.

Our reasons for disagreeing with this are set out in the JWGBA conceptual paper.

Clarke and Mattson: "Why Market Value Accounting Could Be Good for Banks" (1992)

(Untraced.) Argues that knowledge of market values is critical to the successful management of a bank.

Our reasons for disagreeing with this are set out in the JWGBA conceptual paper.

Mengle: "The Feasibility of Market Value Accounting for Commercial Banks" (1989)

(Untraced.) The paper argues that depository institutions should adopt market value accounting because of the relevance of economic values to decisions and to reduce the incentive for gains trading and income management.

We neither believe that market values are relevant to the management of the banking book, nor accept that perceived income management justifies its imposition.

Merrill Lynch Accounting Bulletin 10: "Fair Value Disclosure Required: Bad News for Weak Financial Institutions" (1992)
Merrill Lynch Accounting Bulletin 12: "Mark-to-Market Accounting for Banks: Accounting and Valuation Implications (1992)

(Untraced.) *"In Accounting Bulletin No.10, 'Fair Value Disclosure Required: Bad News for Weak Institutions', we took the position that the 1992 fair value disclosures required by FAS 107 will:*

- *Lead to the disclosure of valuation relevant corporate information not previously available to the public. These data will be useful to investors seeking to identify both strong and weak financial institutions.*

- *Provide opportunities for knowledgeable and creative financial analysis to gain new insights into the strategies, operations, and value of corporations.*

- *Be impounded in stock prices. Its influence on valuation will vary from company to company.*

- *Change corporate behavior, since managements can no longer hide behind non-disclosure to keep private its financial instrument mistakes, excessive risk taking, and dubious public valuations. Detecting corporate behavior changes will be important to investors, since shifts in corporate behavior may lead to valuation changes."*

"Any future requirement by the FASB to require in a company's primary statements mark-to-market accounting for marketable securities and related liabilities will further ensure that these consequences will occur, since many managements and investors appear to take information on the face of primary statements more seriously than when the identical information is only disclosed in notes. Astute investors know this is a mistake, but then not every investor is astute."

Merrill Lynch's assessment of the relevance the SFAS 107 disclosures has patently not been borne out by experience. It provides a poor basis for calling for fair value measurement.

Morris and Sellon: "Market Value Accounting for Banks: Pros and Cons" (1991)

The article argues that market value accounting is conceptually attractive because it provides a more accurate measure of a bank's health. It adds, however, that market value accounting would be expensive to implement and that it may not provide an accurate measure of bank capital until better valuation models are developed.

National Commission on Financial Institution Reform, Recovery and Enforcement: "Origins and Causes of the S&L Debacle: A Blueprint for Reform" (1993)

(Untraced.) *"Accounting issues played a major role in creating the perverse incentives which produced the S&L debacle."*

As stated earlier, so did poor management, poor regulation and a structurally flawed deposit insurance scheme.

U.S. General Accounting Office: "Bank Insurance Fund: Additional Reserves and Reforms Needed to Strengthen the Fund" (1990)

(Untraced.) *"Reliance on bank financial reports may hinder early warning of problem banks. Regulators' efforts to strengthen both on-site and off-site monitoring systems are hindered by unreliable information in the quarterly reports of financial condition that banks prepare for regulators. GAO found instances where banks' reports did not reflect their true financial condition; their accuracy seemed to be dependent on whether there had been a recent on-site examination by the bank regulators."*

It is unclear from the extract whether the point was made that the problems related to the measurement base.

Attachment 3

Fair Value Accounting – User Surveys and other Research Material

"Improving Business Reporting – A Customer Focus: Meeting the Information Needs of Investors and Creditors", Comprehensive Report of the Special Committee on Financial Reporting, American Institute of Certified Public Accountants, 1994.

The AICPA undertook a comprehensive study to determine the information needs of users to identify the types of information most useful in predicting earnings and cash flows for the purpose of valuing equity securities and assessing the prospect of repayment of debt securities or loans. The Committee designed the study to ensure that the findings were representative of a broad group of users and to distinguish between the types of information users really need and the types that are interesting but not essential. It also considered how users' needs for information might change over time.

To help ensure representative results, the study focused on direct input from users and rejected speculative data (page 4).

The study found that:

- users do not want fair value measurement; instead, they would retain the current mixed accounting model because it provides a stable and consistent benchmark that is highly useful for evaluating a business and is reliable. The study found that users do not want to replace the current accounting model with a fair value model and recommended that standard setters continue to follow a mixed-attribute model.

  "Users do not favor replacing the current accounting model, which is largely based on historical costs determined in market transactions, with a value-based accounting model. They would retain the current model because:
    - It provides users with a stable and consistent benchmark that is highly useful for understanding the business, identifying trends, and valuing a business by projecting earnings and cash flows.
    - It provides information that is reliable because the amounts are based on market transactions" (page 94).

- users <u>oppose</u> fair value accounting, because it is not relevant with respect to how they evaluate companies, predicting earnings or cash flows is not dependent on fair values, it would introduce an unacceptable level of volatility which is not useful in assessing future performance, it often does not reflect the nature of an ongoing business, it may be stale information by the time it is released, it lacks sufficient reliability, there are differing uses and definitions of fair value, and benefits do not exceed costs.

  "… users oppose a value-based accounting model because:
    - The model is inconsistent with the manner in which most users value companies or assess credit risk. It is not the purpose of the balance sheet to provide an estimate of a company's value. Users value continuing operations based on their future earnings or cash flow, which is usually the dominant driver of a company's value. Predicting earnings or cash flow usually is not dependent on or greatly assisted by knowing the value of individual assets or liabilities used in the business.

- It would introduce an unacceptable level of volatility or noise into the income statement and/or stockholders' equity which is not useful to users in assessing a company's future performance and prospects. A value-based accounting model often does not reflect the nature of an ongoing business.
- Because of volatility of markets, value information would be stale by the time it is released.
- Value information lacks sufficient reliability to replace historical costs in financial statements. Estimates of value may be subjectively determined by management or based on thin markets or models of hypothetical markets. Even for marketable assets, users often doubt whether a value at a point in time is representative of ongoing value.
- Users do not agree on the appropriate definition of value. Creditors, for example, are generally interested in liquidation values, perhaps in distressed situations. In contrast, investors are usually interested in longer term value.
- The benefits of reporting value information do not exceed costs" (page 94).

- Fair values should only be used in footnotes or in supplementary disclosures. If fair values are disclosed, they should be in the notes to the financial statements, and should not be used as the primary measurement.

  "Fair or market values, if disclosed, should be in the notes to the financial statements or in accompanying schedules… Users are willing to accept less reliability in the context of supplementary disclosures than in the context of measurement in the balance sheet or the income statement" (page 94).

  Although fair value disclosures may be conceptually more applicable to financial industry activities than manufacturing, users question fair value disclosures that fail to reflect matching of financial assets and liabilities.

  "Users view fair value as conceptually more applicable to financial industry activities than manufacturing activities, although they question fair value disclosures that fail to reflect matching of financial assets and liabilities" (page 95).

- External financial reporting should be better aligned with management's reporting. Fair value is not the primary measurement used to manage the businesses of most banking institutions.

  "To meet users' changing needs, business reporting must… better align information reported externally with the information reported to senior management to manage the business" (page 5).

- Existing papers and research do not provide sufficient knowledge about users' needs. The study dismisses some of the research that the JWGSS paper relies upon as empirical evidence. The study recognized that there is a considerable body of research on the effects of financial information and the impact on pricing in the capital markets; however, it states that such research does not provide sufficient knowledge about users' information needs.

  "The committee is aware of a considerable body of research that provides important evidence about the effects of financial information and changes in that information on securities prices in capital markets. That research includes work on the efficiency of capital markets and accounting event studies. Although useful, those research results measure behavior and do not provide sufficient knowledge about users' information

needs for the Committee to use them to develop and support its recommendations" (page 10).

"High-quality research on users' needs for information has been limited. Much of what is written about users' needs for information is speculative - that is, the author speculates about what would or would not be useful to users, not testing the speculative ideas with empirical data or with direct observations or otherwise working with users. Most of the empirical research on users' needs that has been done is not intended to support standard-setting activity and, as a result, is too broad or narrow to be helpful to standard setters. The Committee decided to conduct and sponsor new research because of the scarcity of relevant research" (page 114).

- The study suggests that comparability may not be as important as the JWGSS suggests.

  "Many users believe they can handle differences in accounting among companies, even in the same business, if they can obtain information that enables them to understand the differences and interpret them as clearly as possible. Differences in the way companies apply accounting rules should be allowed as long as there is disclosure of the application methods.

  Many users value information that is consistent over time more highly than information that is comparable among companies because they consider themselves capable of adjusting information to compensate for non-comparabilities resulting from the use of alternative accounting procedures and the many differences in companies" (page 34).

- National and international standard setters should focus on user needs rather than reconciling different countries' accounting standards. The study recommends that international standard setters increase their focus on user needs. It recommends that U.S. standard setters work with international setters to develop international accounting standards, providing the resulting standards meet users' needs for information.

  "National and international standard setters and regulators should increase their focus on the information needs of users, and users should be encouraged to work with standard setters to increase the level of their involvement in the standard-setting process" (page 113).

  "U.S. standard setters and regulators should continue to work with their non-U.S. counterparts and international standard setters to develop international accounting standards, provided the resulting standards meet users' needs for information."

  "This approach, which is different from attempting to reconcile differences among the standards of different countries, should enable international standard setters to arrive at standards that serve the information needs of users. It should also allow standard setters to identify instances… where international standards are not possible because information needs among different groups of users are incompatible" (page 115).

"Fair Value of Financial Instruments – Disclosure & Reaction: A Study of Bank Holding Company Annual Reports for 1992", KPMG, published 1993

- The case for fair value disclosures has not been made. KPMG found:

  "… a significant drop-off in views towards the usefulness of actual 1992 fair value disclosures when compared to the anticipated usefulness, with the largest drop-off in loans, deposits, letters of credit, swaps, options, and futures" (page 16).

> "Now that the preparers and users have gone through their first experience with fair value disclosures, it appears that the concerns over fair value estimates remains consistent with the initial expectations of both users and preparers" (page 17).

- Little, if anything, was learned from fair value disclosures. Users were asked if anything new was learned from the disclosure of fair values. Approximately 82% of users said that nothing new had been learned. Those answering in the affirmative believed that fair value disclosures provided this new information: loan portfolios were undervalued, the fair values of liabilities were highlighted and what might occur in the case of failure.

- Fair value disclosures are not indicative of an institution's financial strength. "The majority of users believed that the fair values disclosed were not indicative of an institution's financial strength" (page 18).

- The current accounting model should not be replaced with a fair value model. Approximately 88% of users believe that the historical cost based accounting should not be replaced with fair value based accounting (page A-11). Approximately 92% believe that financial statements adjusted to reflect fair value would not provide a more accurate presentation of an institution's financial position and results of operations than would financial statements prepared on a historical cost accounting basis supplemented with fair value disclosures (page B-28).

- Management's intent is important to users for measuring assets. A majority of the users surveyed believe that fair value accounting is not appropriate if an institution has the intent and ability to hold assets for the foreseeable future (page A-13).

- Fair value accounting will not provide a more accurate measure of a financial institution's capital. A majority of the users surveyed believe that fair value accounting will not provide a more accurate measure of a financial institution's capital (A-14).

Association of Reserve City Bankers - KPMG Peat Marwick Study, 1992

The ARCB questionnaire tested the opinions of institutions towards the prospect of FASB requiring the use of fair market value for financial statements instead of historical cost accounting.

Section III – Fair Value Accounting

Question 1 dealt with the usefulness of different presentations of the financial statements.

- 70% felt that historical cost with fair value disclosures was "very useful".
- 68% felt that historical cost without fair value disclosures was "useful".
- 70% felt that financial statements adjusted to reflect fair value was not "useful".

Question 2 asked whether fair value accounting should be the measurement basis for an institution's financial statements.

- 90% replied that fair value accounting should <u>not</u> be the measurement basis for an institution's financial statements.
- Many of the comments stressed that fair value is too volatile and judgmental and that it lacked usefulness and accuracy.

Question 3 dealt with how institutions preferred fair values to be presented in the financial statements in respect of different asset categories.

- A solid majority expressed a preference for historical cost accounting basis supplemented with fair value disclosures.
- On loans, 77% preferred either historical cost or historical cost with fair value disclosure.

Question 4 asked whether historical cost should be replaced by fair value accounting if the information on disclosure of fair values, realized and unrealized gains and losses, cash flow information and maturities and yields of investment securities is available.

- 88% were against this, with many of the comments focusing on the unreliability and inconsistency of fair value accounting.

Question 5 asked if fair value is required by FASB for certain investments, would it also be useful for liabilities to be recorded in the same way and then asks which liabilities.

- 85% responded yes.
- Demand deposits (50%), time deposits (60%), long term debt (70%) and other borrowings (65%) were all thought to be useful.
- Insurance liabilities (2%) and all liabilities (13%) were seen as not useful.

Question 6 asked whether assets that will be held for the foreseeable future,12 to 18 months, should be recorded at fair value.

- 60% responded no.
- Comments centred around the idea that 12 to 18 months was too short.

Question 7 asked whether a financial institution's capital would be more accurately measured with fair value accounting.

- 60% responded no.

Question 8 asked how many weeks users would be willing to wait to receive their financial statements in fair value in addition to the two weeks it takes for historical cost, given that fair value accounts will take longer to prepare.

- 58% responded with two weeks or less.
- 18% said 3 to 4 weeks.
- 0% responded between 5-8 weeks.
- 24% said other or did not respond.
- Comments centred on the idea that reports should be delivered on time.

Section V – Fair Value Accounting

Question 1 asked if the institution's fair value adjustments should be reflected in the financial statements.

- 65% responded no.
- Of the 28% responding yes, 23% believed only permanent movements in fair value should be reflected.

Question 2 stated "whether you believe financial statements adjusted to reflect fair value would provide a more accurate presentation of an institution's financial position and results of operations than would financial statements prepared on a historical cost basis supplemented with fair value disclosures."

- 92% responded no; comments focused on subjectivity.

"Accounting Treatment of Financial Instruments – A European Perspective", Fϑdϑration des Experts Comptables Europϑens

The European Parliament requested the European Commission to develop a proposal on amendments to the Bank Accounts Directive. The Parliament sought the adjustment of "the accounting and disclosure standards to the special characteristics of contingent liabilities and assets, and in particular of financial derivative instruments, in the certified accounts of companies,…with a view toward prompting Member States to urgently clarify their legislation and bring it up to date". (1.1) FEE, the European representative body of the accounting profession, was asked by the Commission to help develop these rules and standards and formed a task force to help accomplish this.

The task force recommendations emphasised the distinction between the the trading and non-trading books:

- *"No specific criteria for the recognition and derecognition of financial instruments are proposed, other than those that are implied by the recommended valuation rules." (2.1)*

- *"The difference between trading and non-trading portfolios should be recognized. The financial instruments that are in the trading portfolio should be recorded at fair value on the balance sheet, with the resulting gains and losses taken to the profit and loss account immediately. Financial instruments in the non-trading portfolio should be recorded the way the rules of the Bank Accounts Directive state." (2.2)*

- *"Reclassification between portfolios should be permissible, under specified circumstances. Transfers between portfolios should be made at their fair value at the date of transfer; in the case of a reclassification from non-trading to trading, any resulting gain or loss should be taken to the profit and loss account in conformity with the treatment of gains and losses on realised transactions in the non-trading portfolio." (2.3)*

- *"Banks should develop systems for identifying instruments held for hedging purposes and should include the contemporary documentation of their effectiveness and purpose." (2.4)*

- *"Instruments held for hedging purposes should be classified as trading or non-trading on the same basis as the instruments being hedged." (2.5)*

"**Rethinking the Quality of Risk Management Disclosure Practices", Rajna Gibson, February 1999**

The author begins by saying that recent events in the financial markets, such as the Asian crisis, the Russian debt crisis, and the collapse of the hedge fund Long Term Capital, bear in common delayed and incomplete information channelling to market participants. This has led to lack of confidence globally. As a result the financial service industry, auditing firms and supervisory authorities perceive a common framework for the disclosure of risk management practices to be a valuable goal.

She comments that at first glance marking-to-market valuation is more appealing than book valuation under normal market conditions, but adds (on page 3) that *"its extension to on and off-balance sheet assets poses a multitude of problems:*

- *lack of liquidity of the asset or the underlying instrument;*
- *informational asymmetries; and*
- *poorly quantifiable risk factors – legal, political, credit and operational."*

The study proposes framework for risk management disclosure *"along the main economic functions [of a bank], in other words along their trading and non-trading activities. Several reasons motivated this partitioning. First, the assets in the trading book are generally more actively traded and their marking-to-market is, under normal market conditions, less problematic than for assets in the non-trading book. The time horizon pertaining to both activities is also fairly different and thus influence the economic value assessment. For trading book assets, the market value concept is more accessible due to their rapid turnover. On the other hand, for many assets in the non-trading book, strategic or liquidity considerations may often lead [banks] to place more weight on concepts such as the synergy value, the liquidating value or the ongoing concern value."*

She adds that *"a financial firm that has mostly non-trading activities should not be directly compared or penalised relative to another firm that relies heavily on the trading book to generate income (and thus has an easier task of disclosure)*" (page 6).

The author proposes to analyse the quality of the risk management disclosure practices following the functional approach. This approach recognises the difference between trading and non-trading activities, such as:

- *"fair economic valuation;*
- *the level of quantitative modelling; and*
- *the depth of the analysis of credit risks"* (page 10).

The author concludes by emphasising the need for a separation between trading and non-trading books and stresses the use of the functional approach. *"This preliminary attempt to define a conceptual framework for assessing the quality of the risk management practices is based on a functional approach…It can be implemented to capture the differences in the valuation constraints, holding periods and the mandatory information disclosures at the level of trading and non-trading activities of financial firms"* (page 38).

"Credit Risk Rating at Large U.S. Banks", Federal Reserve Board Bulletin, November 1998

The paper concludes that there cannot be a single method for an internal rating system. Banks can vary in many ways, ranging from size, business mix and in the uses to which ratings are put. This makes a single form of internal rating system quite difficult to develop. Among the variations in this business mix, the amount and size of large corporate loans have the greatest effect in which rating system it chooses. Depending on the size of a bank's corporate market presence, there will be a different degree of stress placed on the distinction of low-risk credit.

In concluding the article, the author stresses the difficulty of an external entity use of internal ratings. *"The use of internal ratings by external entities such as regulators and investors has the potential to introduce new stresses in which incentives conflicts that pit banks' interests against those of the external entities compound existing internal tensions. Use of internal ratings by entities outside the bank would probably require some external validation of the ratings and the systems that generate them."*

The author comments that a validation of the ratings and the system that generates them is possible, but adds that *"careful development of a new body of practice will be required."*

Euromoney US: "Risk Scientists Look Beyond Their Silos" (1999)

The following extracts are taken from a Euromoney US article reporting a high level meeting of regulators and bankers in Geneva earlier this year.

- *"Russia's default on August 17, 1998 and the near-collapse of Long-Term Capital Management (LTCM) a month later jolted banks and their supervisors out of the comfortable notion that the prevailing market price is the best guide to valuing assets. Even add-ons for liquidity risk and credit factors didn't get close to anticipating the correlated market chaos of last year. Value-at-risk (VAR) matrices nicely compartmentalized credit and market risk buckets with some offsetting correlation factors – are handy fair-weather trading tools, but they don't work in a storm"* (page 26).

- *"Regulators now worry that they were too hasty in agreeing back in 1996 that banks could use their internal (approved) VAR models as a basis for setting regulatory capital for their trading book. Last month they held back proposals for parallel recognition of internal models designed to calculate credit exposure. That was hardly surprising considering regulators' sceptical reactions as recently as last September to a roadshow of credit models - "half-baked" was the adjective used by one German regulator. And that was before the LTCM debacle"* (page 26).

- *"Mark-to-market, lionized since around 1993 as the ultimate discipline, has proved inadequate at times of poor liquidity. Either it leads to a sharp decline in close-out value or it severely undervalues the assets of a going concern. "When liquidity dries up," said another investment banker, "we suddenly see asset classes that aren't fungible. There are big changes in the bid-offer spreads and that makes our [liquidity] reserves go up substantially." But that doesn't accurately reflect the economics of the business, he argued: "We aren't going to close out at those distress levels" "* (page 27).

"The Geneva meeting identified huge problems with applying standardized valuation methods to loan books and other less-liquid assets. Marking loans to market suggests they are tradable, and very few are. 'In my experience loans either trade at 99 ¾ or they don't trade at all,' said one delegate. Marking to market is only relevant when you are trying to get out of the position and then the state of the market, the size of the position and the credit rating must be factored in" (page 27).

ON FINANCIAL INSTRUMENTS

Chairman: Mr Gérard GIL

Christopher B. BEGY, C.A.
Vice-President and Chief Accountant
Bank of Montreal
First Canadian Place, 27th Floor
100, King Street West
CANADA - TORONTO, Ontario M5X 1A1
Tel. 1.416 643 19 00
Fax. 1.416 360 40 54 E-mail: chris.begy@bmo.com

Andreas BEZOLD
Direktor
Dresdner Bank AG
D - 60301 FRANKFURT
Tel. 49.69 263 589 66
Fax. 49.69 263 507 00 E-mail: andreas.bezold@dresdner-bank.com

Paul CHISNALL
Director
British Bankers' Association
Pinners Hall
105 - 108 Old Broad Street
GB - LONDON EC2N 1EX
Tel: 44. 171 216 8865
Fax: 44. 171 216 8958 E-mail: paulchisnall@bba.org.uk

Judith DOWNES
Australia and New Zealand Banking Group Limited
Level 8, 100 Queen Street
AUSTRALIA - Melbourne VIC 3000
Tel. 61.3 92 73 52 66
Fax. 61.3 92 73 61 50 E-mail: downesj2@anz.com

Donna J. FISHER
Director
Tax and Accounting
American Bankers Association
1120, Connecticut Ave, NW
U.S.A. - WASHINGTON DC 20036
Tel. 1.202 663 53 18
Fax. 1.202 828 45 48 E-mail: dfisher@aba.com

Gérard GIL
Directeur

Comptabilité Générale
Banque Nationale de Paris
Boulevard des Italiens, 16
F - 75009 PARIS
Tel. 33.1 40 14 24 63
Fax. 33.1 40 14 69 55 E-mail: gerard.gil@bnpgroup.com

Reinout L. HOOGENDOORN
Advisor Banking Supervision
Nederlandse Vereniging van Banken
Postbus 3543 Adresse: Singel 236
NL - 1001 AH AMSTERDAM NL - 1016 AB AMSTERDAM
Tel. 31.20 550 28 88
Fax. 31.20 623 97 48 E-mail: algemeen@nvb.nl

Akira KANNO
Vice Chairman & Senior Executive Director
Federation of Bankers'Association of Japan (ZENGINKYO)
3-1, Marunouchi 1-Chome
JAPAN – Chiyoda-Ku, TOKYO 100
Tel. 81.3 52 52 37 52
Fax. 81.3 32 14 02 30 E-mail: ba-japan@hello.email.ne.jp

Russell PICOT
Group Chief Accountant
HSBC Holdings plc
10, Lower Thames Street
GB - LONDON EC3R 6AE
Tel. 44.171 260 82 82
Fax. 44.171 260 99 17 E-mail: russellpicot@hsbc.com

Rex S. SCHUETTE
Senior Vice President and Chief Accounting Officer
State Street Corporation
225, Franklin Street, 7th Floor
U.S.A. – BOSTON, MA 02110
Tel. 1.617 664 45 01
Fax. 1.617 664 48 86 E-mail: rsschuette@statestreet.com

Mark WESELUCK
Vice President
Banking Operations
Canadian Bankers' Association
199, Bay Street., Suite 3000
Commerce Court West
CANADA - TORONTO, Ontario M5L 1G2
Tel. 1.416 362 60 93 - Ext. 289
Fax. 1.416 362 05 63 E-mail: mweseluck@cba.ca

Wilfried WILMS
Fédération Bancaire de l'Union Européenne
rue Montoyer 10
1000 BRUXELLES
Belgium
Tel. 00 32 2 508 37 31
Fax: 00 32 2 502 79 66 E-mail: w.wilms@fbe.be