CEBS Committee of European Banking Supervisors

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FCAG
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Dear Mr. Van Eperen

Financial Crisis Advisory Group Seeking Input from Constituents

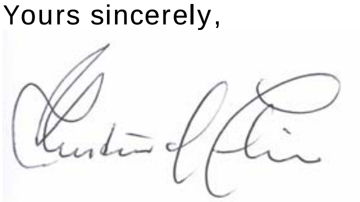
The Committee of European Banking Supervisors (CEBS), comprised of high level representatives from banking supervisory authorities and central banks of the European Union, welcomes the opportunity to comment on the questions put forward by the Financial Crisis Advisory Group (FCAG).

Banking supervisory authorities and central banks have a strong interest in promoting sound and high quality accounting and disclosure standards for the banking and financial industry, as well as transparent and comparable financial statements that would strengthen market discipline.

CEBS is in particular closely monitoring all the developments with respect to the financial crisis, a fact which is clearly shown in the work that it has carried out in the last few months in this area. Many of our conclusions are of relevance to the questions raised by the FCAG and have been either reiterated or referenced as appropriate.

The comments put forward in the annex have been coordinated by CEBS's Expert Group on Financial Information (EGFI) chaired by Mr. Didier Elbaum (Deputy Secretary General, Commission Bancaire)- in charge of monitoring any developments in the accounting area and of preparing related CEBS positions. If you have any questions regarding our comments, please feel free to contact Mr. Elbaum (+33.1.4292.5801).

Yours sincerely,



Kerstin af Jochnick
Chair, Committee of European Banking Supervisors

Annex - Responses to the questions put forward by the FCAG

Question 1. From your perspective, where has general purpose financial reporting helped identify issues of concern during the financial crisis? Where has it not helped, or even possibly created unnecessary concerns? Please be as specific as possible in your answers.

It was noted that general purpose financial reporting helped identify issues of concern, even though it was felt that the crisis also identified a number of problems related to financial reporting. It would however be unjust to single out financial reporting as a main contributor to the crisis

In fact it is felt that financial reporting helped providing a timely – albeit potentially incomplete - picture of problems, i.e. the impact of the crisis, for the institutions concerned. There is the view that this was notably the case in areas where fair valuation was applied as this enabled participants and analysts to identify which entities have problems in a relatively timely manner. However, the application of fair value accounting also raised significant issues that are highlighted below.

One general concern relates to the fact that the financial information reported by institutions was not sufficiently focused on assessing potential risks institutions were exposed to in relation to their activities and their investments, either directly or indirectly (e.g. pension funds, structured entities, etc). Early in the financial crisis, regulators (such as the FSF and the SSG or CEBS) recommended institutions to provide detailed information on exposures to structured instruments and structured entities, and the assessment of the liquidity risk in a more prospective way and at more regular intervals.[1]

At the same time the crisis also identified a number of problems with regard to the IFRS framework. Some of these problems are A) directly related to the standards as such, B) linked to their interpretation, implementation or the way they are being audited and C) linked to other issues.

A) Identified problems directly related to the financial reporting framework (including differences with other accounting frameworks)

This section discusses the following issues in more detail:

1) Issues related to valuation in inactive markets and for illiquid instruments / and related disclosures;

2) Issues that relate to valuation in the wider sense;

3) Consolidation of off-balance sheet items and structured entities;

4) Complexity of IAS 39;

5) Financial statements presentation;

6) Other concerns.

In particular CEBS would like to share the following thoughts and views:

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[1] The CEBS good practice disclosures issued in June 2008 can be accessed here: http://www.c-ebs.org/getdoc/2b6375de-8fc0-444c-9655-f8af1a4d474c/CEBS-publishes-report-on-banks'-transparency-on-ac.aspx

1) Issues related to valuation in inactive markets and for illiquid instruments / and related disclosures

In June 2008 CEBS already raised a comprehensive range of issues related to the **valuation** of complex and illiquid financial instruments. These issues, which were addressed to financial institutions and standard setters,) have recently been re-assessed against measures taken in that respect. The outcome of this assessment has been published in March 2009 in a separate report.

The March 2009 report highlights the most pressing issues - which are considered to be related to valuation issues in the wider sense - that the IASB should address.

Those issues will be discussed in more detail under point 2 below.

Furthermore, whereas the report also recognises that progress has been made with respect to guidance on the measurement of fair values and modelling techniques, there are still a number of particular aspects of valuations that require further clarification: In particular, the guidance of the IASB Expert Advisory Panel should elaborate on the use of primary market transactions for similar instruments. Furthermore, the Panel should also offer explicit guidance on the list of factors to be considered for valuation adjustments (including those factors listed by CEBS in its June 2008 report). Specifically, it should be clarified whether valuation adjustments should be assessed on an item-by-item approach or on the basis of a portfolio.

In order to ensure that the guidance of the Expert Advisory Panel is consistently applied, consideration should given to elevating the standing of the educational guidance as well as to issue clear statements such as those published by the FASB staff. The fair value measurement project offers a suitable opportunity for addressing these issues.

The report also suggests further clarifications on the consistency of IFRS and US GAAP with respect to the reclassification of structured instruments containing embedded derivatives (especially synthetic CDOs).

One other point that has already been raised in the CEBS valuation report relates to disclosures on fair values and on valuation techniques, notably on the type (or level) of fair value used.

In the light of the developments of the crisis, CEBS suggested that IFRS 7 is revised and that the IASB considers the i) incorporation of quantitative disclosures on fair values determined for each of the different fair value hierarchy levels, and ii) quantitative disclosures on stress scenarios reflecting the sensitivity and uncertainty of valuations.

CEBS already commented on the ED Proposed amendments to financial instruments disclosures issued in October 2008 and had also previously suggested further consideration of that point in its June 2008 report.

In addition CEBS suggested that the IASB considers how the educational guidance published by the Expert Advisory Panel on 31 October 2008 could be incorporated into IFRS 7. The Expert Advisory Panel's report provides ample guidance for enhanced disclosures about financial instruments when markets are no longer active and for fair value measurement. In this context it should also be noted that the latter guidance does not seem to address the issue of quantitative disclosures on stress scenarios reflecting the sensitivity and uncertainty of valuations.

A first preliminary analysis of the recently published Amendments to IFRS 7 Improving Disclosures about Financial Instruments suggests that not all of the points have been taken into account. While the final amendments incorporate some of the guidance, other issues have not been addressed.[2]

2) Issues that relate to valuation in the wider sense

As set out above there are issues of concern that are related to valuation in the wider sense. These are:

i) impairment measurement issues for available-for-sale assets (although CEBS acknowledges that a comprehensive review of accounting for impairment is taking place);

ii) consistency with regard to the treatment of Day 1 profits and losses; and

iii) convergence regarding the determination of the effect of own credit risk and related disclosures.

i) Impairment measurement issues for available-for-sale assets

Impairment is an important area of concern. The actual framework comprises different impairment models and the model used for available-for-sale (AFS) financial assets has been a specific area of concern. Of particular concern for AFS debt instruments is the fact that when there is objective evidence that the asset is impaired, the cumulative loss that has been recognised in other comprehensive income has to be reclassified from equity to profit or loss (IAS 39.67). We would prefer a reclassification limited to the impairment arising from credit risk as the current approach could be a disincentive to timely recognition of impairment.

Of similar importance is a concern that for equity instruments, once an impairment loss has been recognised, it is not permitted to recognise a reversal through profit or loss.

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[2] In addition to these common conclusions, there are CEBS members that consider the recognition and measurement of a financial instrument "at fair value through profit or loss" (other than for derivative instruments and financial instruments that are subject to the fair value option) should only to be allowed for instruments that are actively traded, meaning only when a quoted price is available. These members welcomed the amendments to IAS 39 issued in October 2008 introducing the possibility to reclassify financial instruments in certain circumstances. Although - according to some - the amendment should have comprised financial instruments categorised as "designated at fair value through profit or loss" (fair value option) as well. Some mentioned that in their view most problems could be solved with a proper initial allocation of financial instruments (avoiding that some particular instruments like, for instance, hedge funds, are classified in the trading portfolio), while reclassification should be seen as an exceptional remedy.

Some members also feel that the immediate recognition of unrealised losses emanating from the mark-to-market valuation of securities may have exacerbated the situation as. valuation differences (especially based on fair values using observable market data) could not be separated into impairment losses in connection to credit risk andpotential losses related from liquidity/demand shortages in the market. This issue is also related to concerns about the impairment of AFS instruments.

In addition to these common views there are concerns that the interpretation of the impairment ‘rules’ leads to inconsistencies in their application between institutions. This is particularly evident in the case of equity instruments where objective evidence of impairment consists in a “significant or prolonged decline in the fair value” of those instruments (IAS 39, par. 61). In this case it is also difficult to qualify the impairment as deriving from “credit risk” (because there is not a credit); perhaps it would be more appropriate to say that impairment is linked to “specific risk” within the more general category of market risks.

ii) Consistency with regard to the treatment of Day 1 profits and losses

CEBS suggested in its June 2008 report that the IASB clarifies the accounting provisions with regard to the treatment of **Day 1 profits and losses** to ensure consistency of application. Several approaches have been observed: these include i) amortising the Day 1 profit either over the contractual life of the transaction or over the period during which the valuation parameters are expected to remain non-observable; ii) deferring the recognition of that component until maturity or until settlement; and iii) deferring it until the profit or loss is offset by other opposite transactions or until it is realised.

The topic is currently under consideration by the Board as part of the Fair Value Measurement project. However it is felt necessary that the IASB - against the tentative decisions set out in the December 2008 IASB Update[3] - has a full debate and follows full due process before modifying the IAS 39 treatment.

iii) Convergence regarding the determination of the effect of own credit risk and related disclosures

A further area of concern deals with **own credit risk** where CEBS suggested in its June report that standard setters clarify the accounting provisions to ensure consistency with regard to the determination of the effect of own credit risk and to enhance disclosures on own credit risk for liabilities held for trading.

CEBS recognises that this issue has been discussed in the educational guidance on the application of fair value measurement when markets become inactive prepared by the IASB Expert Advisory Panel even though it is not felt that this is enough to ensure consistent calculation.

CEBS also notes that the issue is currently under consideration by the Board. It appears from the recent Board meetings that an invitation to comment will be issued by the IASB in early 2009. It is however not clear whether these efforts will result in clarifications on how the effect should be determined.

More generally the issue is that the fair valuation of liabilities can be misread with respect to an entity’s capacity to sustain losses arising from assets. A matching measurement of assets and liability measurement at fair value – which results in an offsetting in the income statement of the losses on assets by gains on liabilities – can be misinterpreted as regards the real financial situation of banks. More specifically, from a legal perspective a bank should be able to fulfil a customer deposit at the nominal amount (face value) of the

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[3] See IASB UPDATE December 2008 “Day 1 gains or losses … The Board tentatively decided that: .. if there is evidence that the transaction price does not represent fair value at initial recognition, an entity recognises a day 1 gain or loss, even when the initial fair value measurement is derived using unobservable inputs.”

liability (not the fair value). The economic gain deriving from the write-down of a liability often cannot be realised (although we accept it is realised where banks are able to buy back their own debt in the market at a discount to face value).

This issue has also been picked up by the SEC which recommends in its Study on Mark-to-Market Accounting that the FASB assesses whether the incorporation of a company's own credit risk in the measurement of liabilities provides decision-useful information to stakeholders, including whether sufficient transparency is currently provided.

3) Consolidation of off-balance sheet items and structured entities

Another area that gave rise to concerns is the accounting for **off-balance sheet structures and structured entities**. It is felt that, although the consolidation models (IAS 27 and SIC 12) are robust, the lack of guidance has led to questions whether all entities/structures that had to be consolidated were indeed recognised in the statement of financial position.

These uncertainties with respect to the scope of consolidation, particularly with reference to SPEs, resulted in uncertainties about the correct quantification of exposures.

This issue will be further discussed in our response to question 3.

4) Complexity of IAS 39

A further area of concern is the **complexity of IAS 39**. It has been mentioned by many constituents that there are too many measurements attributes and too many categories. In particular the AFS category may contain financial instruments with a variety of characteristics.

CEBS agrees that some complexity could be removed from the standard. In its comment letter to the DP issued by the IASB on this issue CEBS has expressed some concerns about the avenues proposed in the paper to achieve this objective.

This discussion is related to question 4 that sets out our views in more detail.

5) Financial statements presentation

Some members also consider that the lack of a detailed common format for the presentation of the financial statements of financial institutions, as foreseen for banks by the former IAS 30, has raised comparability issues for market participants and analysts.

CEBS acknowledges the IASB's continued efforts to improve financial statement presentation. In particular, we welcome the DP Preliminary Views on Financial Statement Presentation, which addresses important issues and find value in some of the broad objectives identified such as cohesiveness and disaggregation. Nevertheless, CEBS questions the usefulness of the proposed presentation for financial institutions and queries whether the benefits obtained regarding the provision of additional decision-useful information to users will be worth the incremental costs incurred. We believe 'full scale' cost-benefit analysis, based on broader field testing than carried out so far, would be required.

Still in the presentation context, some members argued that financial statements should always allow for a distinction of realised and unrealised gains and losses in the primary financial statements.

Such a distinction could also help with respect to company law in order to avoid the distribution of unrealised income.

6) Other concerns

Other concerns that members raised related to the accounting of what was sometimes referred to as 'non-assets', notably, goodwill and deferred tax assets.

Whereas the current IFRS treatment of goodwill (recognition as an asset without systematic amortisation) has highlighted the business implications of various prominent acquisitions made during the years of buoyant economic conditions, this treatment seems to have encouraged some banks to make acquisitions (that have recently led to major difficulties) that they otherwise might not have made had the accounting required systematic amortisation of goodwill through profit or loss.

Regarding deferred tax assets, members noted that some of these assets that have been booked by some banks seem to be imprudent as it is rather uncertain whether that they can be realized in the future.

B) Problems linked to the interpretation, the implementation or the way Financial Reporting is being audited

It has already been mentioned in the discussion on impairment that there are concerns about the interpretation of 'rules' and related inconsistencies in their application between institutions, especially given the apparent existence of parties that forego judgement.

It is paramount for the reporting framework to offer unambiguous clarity, such that all parties involved apply the same rules in the same way. If necessary, additional guidance should be offered to ensure that this also applies where the standards implicitly or explicitly rely or require the use of judgement.

An additional concern that has been raised relates to the 'auditability' of the standards, in particular of IAS 39.It could be envisaged involving the IAASB at an early stage in the IASB standard setting process to mitigate concerns and problems in a timely fashion. Likewise, the IASB could become involved in the work of the IAASB.

C) Problems linked to other issues

As regards other possible sources for concern, members noted bank management and investor's behaviour. The financial crisis has demonstrated that a number of banks retained insufficient reserves to withstand a economic shock, as a result of management and investor behaviour in previous periods. Indeed, many banks adopted significant share buy-back strategies and generous dividend policies to cater to the interests of investors. The financial crisis should lead to a repositioning of bank management and investors. General purpose financial reporting could contribute to the repositioning process by focusing on a wider set of stakeholders than it currently does. The focus could therefore shift from predominantly investors to creditors, analysts, supervisors and regulators. Furthermore, general purpose financial reporting could consider adopting financial stability as an important objective.

Question 2. If prudential regulators were to require 'through-the-cycle' or 'dynamic' loan provisions that differ from the current IFRS or US GAAP requirements, how should general purpose financial statements best reflect the difference: (1) recognition in profit or loss (earnings); (2) recognition in other comprehensive income; (3) appropriation of equity outside of comprehensive income; (4) footnote disclosure only; (5) some other means; or (6) not at all? Please explain how your answer would promote transparency for investors and other resource providers.

Before discussing the questions put forward by the FCAG, and, as pointed out in our response to question 1, we would like to highlight that impairment rules under IFRS are an important area of concern. In addition to the points regarding the AFS instruments, we note that there are concerns that the interpretation of the impairment ‘rules’ leads to inconsistencies in their application between institutions.

Therefore, it seems to us that this issue goes beyond a mere discussion of prudential regulators requiring 'through-the-cycle' or 'dynamic' loan provisions that differ from the current IFRS or US GAAP requirements.

The question should therefore also include possible ways to address shortcomings in IAS 39 that make it difficult to achieve levels of provisions that are appropriate for entities to cover losses.

With this in mind CEBS would nevertheless like to highlight the importance of “through the cycle provisioning or reserving” for credit institutions. Many of the aspects that are being discussed below reflect a collection of input provided by CEBS members. We would encourage the FCAG to ensure that the IASB engages in exchanges with supervisors to ensure that a commonly acceptable solution can be reached.

In the banking industry, loans are provided in mass, and, therefore, there is a need to estimate losses by portfolio analysis and with the application of judgment. Historical experience that looks back through a complete cycle gives very good information of impairment, given the fact that under expansionary parts of the cycle risk is underestimated, as well as it is overestimated in the downturn. Also there are views that some of the problems related with loan loss impairment derive from the application of the “incurred loss” model with insufficient rigor and from a very narrow view of the concept of “loss event”.

CEBS believes it is important that investors are aware of the potential effects of economic cycles on the profitability of banks. It also believes that it is of the utmost importance that a bank’s equity be sufficient to cover credit losses that are deemed likely to arise.

This being said, CEBS is aware that issues remain that should be solved before “through the cycle provisioning or reserving” can be implemented in a transparent way, specifically with respect to the evaluation (or audit) of provisions. Transparency is essential to investors and depositors and should not be impaired by the implementation of “through the cycle provisioning or reserving”. Various studies have been conducted on how to calculate those provisions, and we believe it is feasible to come up with a method of calculation that will take away the “smoothing” opportunity that some have associated with “through the cycle provisioning or reserving”. We encourage the IASB to take a close look at those studies, in order to come up with its own conclusions on how the provision should be calculated.

In any case, to be as transparent as possible, information in the notes on the methods and assumptions used for the calculation of the provisions, as well as the amounts booked, is of the utmost importance.

Another issue that remains to be solved is where the provision or reserve should be booked in the financial statements. The location depends on the economic content of provisions. In any case, the adopted accounting approach will clearly distinguish between what is an economic cost (probable losses) – to be recognised in the income statement – and what is an appropriation of earnings (unpredictable losses, even on the basis a stress scenario). In this perspective it is important to note that, while over the past years accounting rules have significantly evolved following financial innovation, rules on distributable profits remain unchanged.

Against this background, cases have been made for inclusion either in the statement of profit and loss (P&L), or in the statement of comprehensive income, or as a specific reserve within equity.

Among the arguments that could be put forward for P&L is the information of investors: if losses are deemed likely to occur and if it will affect the long term profitability of a credit institution, it is of the utmost importance that investors be aware of those losses. Therefore P&L would appear to be the right place for the display of through the cycle provisions.

On the other hand, because of the degree of uncertainty surrounding the expected losses in an economic downturn, an accounting treatment through “other comprehensive income” could be appropriate.

Finally, it could be argued that “through the cycle provisions” is a general business risk and therefore, should be covered by non distributable reserves within equity, on a specific line item clearly visible to investors. Also, there seems to be a consensus that no dividend should be paid without taking into account “through the cycle provisioning or reserving”.

In any case, considering the above, CEBS is not convinced, as yet, by the arguments that have been put forward advocating that through the “cycle provisioning” is not consistent with the current IASB literature. It may be true that the first two options are not consistent with current IAS 39 requirements. However, as the whole point is to come up with a change of IAS 39, we consider that the consistency of “through the cycle provisioning” should not be evaluated against IAS 39, but against the entirety of IASB standards, notably the framework, and in particular user needs, IAS 37, both in its current form and taking into account the work that has been pursued for its revision. Once again, considering the importance of “through the cycle provisioning or reserving” in the current financial crisis, we would encourage the IASB to conduct this work on a timely basis.

3. Some FCAG members have indicated that they believe issues surrounding accounting for off-balance items such as securitisations and other structured entities have been far more contributory to the financial crisis than issues surrounding fair value (including mark-to-

market) accounting. Do you agree, and how can we best improve IFRS and US GAAP in that area?

In the absence of empirical evidence it is difficult to assess whether issues surrounding accounting for off-balance items such as securitisations and other structured entities have been far more contributory to the financial crisis than issues surrounding fair value (including mark-to-market accounting).

With that in mind it nevertheless seems fair to say that CEBS members consider – in line with our response on question 1 - the issue of accounting for off-balance items and related disclosures to be of utmost importance.

In the comment letter on ED 10 CEBS notes that it considers the project on consolidated financial statements to be crucial in ensuring that users of financial statements are provided with decision-useful information about consolidated and unconsolidated entities. The availability of this information should enhance transparency and strengthen market discipline mechanisms, which supervisors regard as an important tool to promote international financial stability and to enhance the soundness of the financial system. It is of particular importance to capture all information that is necessary for the assessment of an entity's involvement in structured entities and on the risks and exposures this implies, not least given the leverage effect of some structures.

CEBS members share a perception that this issue is of greater concern in the US environment. It is felt that current IFRS-requirements are tighter than those applicable under US GAAP. More particularly it is felt that the general principles laid down by IAS 27 and SIC 12 are sufficiently clear on the treatment of structured entities, whereas US GAAP – which are rules-based - may offer more room for arbitrage.

At the same time there is a view that the application of SIC 12 lacked consistency and that this issue could be addressed with further guidance and, possibly, enhanced enforcement. The IASB however, has chosen to review the consolidation rules for all entities (regular and structured) and issued ED 10 very quickly.

CEBS is not convinced that the proposed ED will address all the issues in a better way than SIC 12 (which includes a risks and rewards approach) for ad hoc entities. In its comment letter on ED10 CEBS expressed a concern that fewer structured entities could be consolidated under the proposed approach than under current guidance because of ambiguity in the control model which could lead to structured entities not being consolidated, even though there is exposure to economic risks and rewards.

CEBS considers that conceptually the objective of trying to develop a control definition that encompasses all entities within the scope of IAS 27 Consolidated and Separate Financial Statements as well as those within the scope of SIC 12 Consolidation-Special Purposes Entities is appropriate. However, we have concerns regarding the application of this new definition to structured entities as there seems to be too much focus on control instead of returns.

With respect to possible improvements of the current framework for off-balance items CEBS recommends that more prominence is given to the role of risks and rewards in identifying control. In addition the IASB should consider ways to show the linkage between assets and liabilities included in the balance sheet as a result of the consolidation of a specific entity as there might be restrictions in their usage that may be significant to users of financial statements.

More generally, members feel that there is a strong need for enhanced disclosures on structured entities and securitisations whether consolidated or not in order to allow users to get a clear picture of a reporting entity's involvement as well as to assess the risks to which it might be exposed. CEBS generally welcomes the disclosure requirements proposed in ED10.

It will also be important to assess how the approach put forward in ED10 interacts with the related approach which is expected to be adopted in the work on Derecognition.

Considering the short time frame adopted for this project, it is felt that the focus of the IASB should be on the most pressing issue, i.e. the consolidation of special purpose entities and related disclosures. The broader issue - that is a conceptual review of IAS 27 and the aim to unify the consolidation models in one standard - should be considered following the usual due process.

Also we urge the IASB to conduct substantial field tests in this area in order to understand which entities not consolidated under the current standard could be consolidated with the new Standard and vice versa.

The outcome of these efforts should be both principles-based and supported by comprehensive and clear guidance. In particular, the new standard should state general principles, but also give preparers of financial statements clear guidance (e.g. through examples and presumptions), in order to assess the control in challenging situations and so to promote a consistent application among entities and in time.

Members also stressed the importance of convergence between IAS/IFRS and US GAAP. It follows from the IASB's work programme that this is a joint project of the two boards, but CEBS notes that no corresponding ED has been presented by the FASB. CEBS therefore urges both boards to ensure that global consistency is achieved on this aspect and notably that a similar treatment is applied to special purpose entities under both GAAPs.

Even if some measures have been taken by the FASB (as regards QSPE for example) it is still not easy at this stage to compare the two frameworks and their practical implications.

4. Most constituents agree that the current mixed attributes model for accounting and reporting of financial instruments under IFRS and US GAAP is overly complex and otherwise suboptimal. Some constituents (mainly investors) support reporting all financial instruments at fair value. Others support a refined mixed attributes model. Which approach do you support and why? If you support a refined mixed attributes model, what should that look like, and why, and do you view that as an interim step toward full fair value or as an end goal? Whichever approach you support, what improvements, if any, to fair value accounting do you believe are essential prerequisites to your end goal?

CEBS agrees that the current IAS 39 is unnecessarily complex in some instances.

However, as stated in CEBS's response to the [Discussion Paper on reducing complexity in reporting financial instruments], we do not consider that reporting all financial instruments at fair value would reduce complexity, as issues related to the implementation of a mixed model would be replaced by issues related to the valuation of financial instruments. These valuation issues would in addition increase the complexity of disclosures on the different valuation methods and thus reduce the understandability of the financial statements.

Many financial instruments are not traded in active markets and their valuation requires the use of models that may or may not rely on observable data, depending on their availability. These valuation exercises have proven difficult, notably for illiquid instruments. Valuing all financial instruments at fair value would require ample guidance on how to measure, and it is foreseeable that complexity would move away from the rules related to a mixed model, to setting valuation rules and harmonising valuation practices. This has proven especially true in the wake of the current financial crisis.

In addition, a full fair value model for financial instruments would not adequately represent the diversity of financial instruments, nor the business models underlying the way the instruments are managed. In many European financial institutions business models are built on long term funding of assets that are held to maturity. An accounting model should reflect, in principle, the way cash is generated. Therefore, it would be a sound practice that to account for non-traded financial instruments at amortised cost rather than at fair value. Fair valuing all financial instruments would induce high volatility in the P&L and equity financial institutions, which would not be consistent with the reality of their business models.

Moreover, fair valuing all financial instruments would also be problematic when assessing financial liabilities at fair value, notably with regards to own credit risk.

To summarise, as stated in CEBS's comment letter on reducing complexity in reporting financial instruments, we consider that a wider use of fair value could not be envisaged before the following criteria are met:

- the conceptual and practical issues associated with fair value are resolved ;
- active markets develop for major aspects of banking book positions;
- bank risk management evolves to rely on fair value measurements and
- a broad range of users of financial statements, including creditors of banks consider fair value to be the best measurement basis in primary financial statements.

Although some developments have been observed, our view is that few of these criteria have yet been met.

That being said, we consider that any simplification of accounting rules for financial instruments should focus on areas where actual problems have been identified. The accounting for hedging is the obvious candidate, as current accounting rules are unduly complex and do not reflect business practices. This simplification however should not be done to the detriment of the quality of the documentation and justification to be provided by institutions.

Regarding the simplification of the categories applicable to financial instruments, some members think that reducing the number of categories could be a possible way forward while others do not see a need for such a reduction. However, due to the complexity and the importance of the matter, we also consider that before adopting such a new approach, it is important to undergo a thorough due process analysis, as well as an impact assessment (including field testing and cost benefit analysis). This should include a Discussion Paper (not an Exposure Draft) on the suggested approach..

Lastly, we are concerned by some classification criteria that have been recently discussed, notably the foreseeable nature of the cash flow. We tend to consider that such a criterion would lead to a lot of practical implementation issues, and therefore would not reduce complexity. We also question its ability to adequately reflect the way businesses are managed.

5. What criteria should accounting standard-setters consider in balancing the need for resolving an 'emergency issue' on a timely basis and the need for active engagement from constituents through due process to help ensure high quality standards that are broadly accepted?

CEBS acknowledges that the normal due process does not provide the appropriate basis to address emergency accounting issues on a <u>timely</u> basis. Accordingly, we recommend that the usual due process is modified to include “fast-track” mechanisms, although good care should be taken to ensure that the use of such accelerated due process is strictly restricted to avoid stakeholder’s confidence in accounting standard setting being undermined. Defining a set of criteria is one way of ensuring consistency in that respect. At the same time it is critical to clearly establish the fast-track due process itself.

In this context, it could be useful to mention that the IAASB faces a similar issue, known as 'Responding to Emerging and Urgent Issues'. The IAASB Staff has identified five general components of a framework for responding to emerging or urgent issues that, in the context of the IASB, could be adapted as follows:

- the Board should establish a team of members charged with evaluating urgent issues and developing recommendations for consideration by the Board;
- criteria should be established against which a decision on the need for a rapid response is made and evaluated. Such criteria could be:
    - o the issue to be addressed is clearly defined and specific to a new and unique and rare circumstance not previously deliberated by the Board and has broad public interest relevance;
    - o a pronouncement is necessary to the effectiveness and proper and consistent application of the existing pronouncements;
    - o the issue requires a change to an existing pronouncement within a period shorter than that which can be accommodated by following full due process;

        - o the anticipated response is limited to the identified issue and there is no indication that the response will have potential unintended consequence;
- the Board should get an approval of the Trustees/Monitoring Board, that such criteria have been met in principle in advance;
- the due process should require at least:
    - o notification at least 30 days in advance on the IASB website;
    - o circularisation of comments received directly to the Board members, to allow them to familiarise themselves with the issues;
    - o deliberation by the Board in a physical meeting open to the public;
    - o unanimous approval by the Board that the criteria for rapid response have been met (some CAG members were not convinced of the unanimous approval - it may not be workable);
    - o approval of the pronouncement according to the normal voting procedures;
    - o voting by the Board on whether there have been any significant concerns raised such that exposure is considered necessary;
    - o communication of the decision;
- confirmation by the Trustees/Monitoring Board that modified due process has been met;
- describe the circumstances in which the "emergency procedure" could be applied, in way that ensures that this should be exceptional and rare.

6. Are there financial crisis-related issues that the IASB or the FASB have indicated they will be addressing that you believe are better addressed in combination with, or alternatively by, other organisations? If so, which issues and why, and which organisations?

As pointed out earlier it is felt that in order to achieve a commonly acceptable solution in the context of impairment the IASB should engage early in exchanges with supervisors.

Although not directly related to the crisis, there is occasionally a discussion on interpreting standards. Auditors are a key party in the process of interpreting accounting standards and it should be considered that discussions with the IAASB on standards would contribute to high-quality financial reporting.

7. Is there any other input that you'd like to convey to the FCAG?

One concern that has been raised in that context relates to a perception that the current crisis was aggravated by the fact that users of financial statements, in particular investors were not sufficiently educated about fair values and their information content. Obviously, this phenomenon also worked prior to the crisis in the opposite way. In taking forward the projects on accounting for financial instruments and on fair value measurements the IASB should devote further work on this important topic.