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BUNDESVERBAND DEUTSCHER BANKEN

Financial Crisis Advisory Group
c/o Adam Van Eperen

ajvaneperen@fasb.org

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Views of users on the financial crisis

Dear Sir,

We are grateful for the opportunity to comment on accounting and reporting matters related to the financial crisis and wish to reply to your questions as follows:

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.

The financial crisis has brought to light some problem areas within existing accounting rules. We should like to specifically mention here fair value measurement, the definition of illiquid markets, convergence between IFRS and US GAAP and the tainting rule in connection with Held to Maturity (HtM) financial instruments.

The Association of German Banks has long been against full fair value accounting of financial instruments and has drawn attention to potential weaknesses. The large number of heterogeneous financial instruments for which little or no market information is available raises the question of the extent to which "market prices" determined are also actually realisable. It has been shown that this is not always possible with illiquid markets and that measurement solely at fair value therefore does not deliver any meaningful or relevant information. Moreover, fair value measurement may accelerate the current economic downward spiral as more and more write-downs ultimately cause balance-sheet capital – and as a consequence – regulatory capital to shrink. In this context, the amended rules on the reclassification of financial instruments issued by the IASB in October 2008, which also place a stronger focus on management intent, are to be welcomed.

Bundesverband deutscher Banken e.V. · Postfach 040307 · 10062 Berlin · Burgstr. 28 · 10178 Berlin · Tel. (030) 1663-0 · Fax (030) 1663-1399 · www.bankenverband.de

A central problem in the present environment is the valuation of assets on illiquid/inactive markets. As the IFRS do not give any exact definition of when a market is considered to be inactive, providing proof thereof – also to the relevant auditor – is extremely onerous for banks and effectively impossible to some extent. Entities should therefore be enabled to obtain effective proof of market illiquidity without being unduly burdened in the process. This also appears to be the aim of the FASB's latest proposals. In this context, we believe, however, that the IASB and the FASB should act jointly in order to avoid any divergence of accounting standards.

Efforts aimed at establishing uniform worldwide accounting standards should, in our view, continue to be driven forward. While some differences in the application of IFRS and US GAAP have fortunately already been removed, others still remain, e.g. with regard to the treatment of embedded derivatives.

The restrictive rules associated with the classification of financial instruments in the HtM category have led entities to hold a large number of their assets, irrespective of management intent, in the Available for Sale (AfS) category and thus to report these at fair value. For the above-mentioned reasons, this may be problematic. To allow classification geared more strongly to management intent, the current restrictive arrangements (tainting rule) should be reconsidered.

Further clarification and revision of the impairment rules for AfS instruments (equal treatment of debt and equity instruments, harmonisation of impairment for financial instruments in the Loans and Receivables (LaR) and AfS categories) are required in our view.

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.

Various "dynamic provisioning" models are currently being discussed, so that a consensus on a uniform definition is needed before introducing any such model.

In our view, dynamic provisioning is basically suited to reducing the fluctuations in core capital/equity and the solvency ratio that occur during the economic cycle. We advocate recognising dynamic provisioning in the determination of income. The advantage of loan provisions recognised in income compared with allocations to retained earnings recognised directly in equity is that the profit and loss account would also fluctuate less sharply during the economic cycle.

Question 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?

The scale and duration of the financial crisis are determined by the complex interplay of a large number of factors. Weighting individual factors to identify which of these have been more contributory to the financial crisis than others is extremely difficult in our view. Such weighting is, moreover, a highly individual process and depends mainly on the specific business model of each bank. However, it can be said that the non-inclusion of special-purpose entities in the scope of consolidation appears to be a problem that has more to do with the arrangements under US GAAP. We are thinking here of Qualifying Special Purpose Entities (QSPEs).

We believe that principles-based, flexible rules for reporting special-purpose entities are needed. The control concept established in the IFRS meets these criteria and can, in our view, be used to ensure appropriate consolidation of special-purpose entities. As far as we are concerned, alignment of US GAAP towards IFRS would thus be a step in the right direction.

In our opinion, changes may be needed more when it comes to ensuring careful and responsible application of the rules and enhancing the transparency of off-balance-sheet transactions. However, any improvement in transparency should be achieved prudently, keeping decision-usefulness in mind.

Question 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?

As explained in detail in our comments to the IASB on the discussion paper entitled Reducing Complexity in Reporting Financial Instruments, we are in favour of retaining the mixed attributes model. In our view, it gives a more accurate picture of economic reality, consisting of the various types of financial instrument and different business models used by entities, than uniform fair value measurement. Hence, a mixed attributes model delivers more decision-useful and more plausible information and creates sufficient transparency.

The classification and measurement of financial instruments should basically depend on which business models and holding strategies are associated individually with each financial instrument. A differentiated approach to the measurement of financial instruments is therefore required, allowing entities to report financial instruments managed both at fair value and at cost appropriately and deliver relevant, reliable and decision-useful information. The short-term fluctuations in cash value that occur in fair value measurement of transactions with a long-term perspective concluded outside the trading segment are not a sustainable indicator. Reporting non-tradable financial instruments on the basis of short-term price changes is particularly unsuitable if the 'assumption of disposal' in marking to market is at odds with an entity's individual business strategy. In the cases where the entity manages financial instruments at (amortised) cost in order to obtain sustainable cash flows, fair value is consequently not a suitable measurement benchmark. A mixed attributes model thus means that the profit and loss account also shows the changes that are consistent with the way the actual earnings power of the business model adopted in each case is reported. The importance of management intent is already enshrined in the current IAS 39 by means of the classification of financial instruments. In addition, recent developments in connection with other standards, such as segment reporting under IFRS 8, show that the special management perspective gives users decision-useful information. This is because the intent pursued by the management with a financial instrument may also provide users with information that is of importance for their investment decisions.

A mixed attributes model therefore constitutes the principles-based approach called for by the IASB, allowing entities to measure financial instruments in line with their individual business model and holding strategy.

However, we also see the need to amend the existing mixed attributes model, particularly with regard to the rules on hedge accounting (easier hedge effectiveness testing and documentation) and the fair value option (easier opt-out and improved designation arrangements also after first-time reporting).

Question 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?

The past months have shown that in emergency situations accounting standards may have to be amended at very short notice. For this reason, the conditions for and concrete form of any shortened (fast-track) due process system should be set out in the Articles or Due Process Handbook. In contrast, completely dispensing with due process is no alternative in our eyes, even in cases of extreme urgency.

A key condition for the success of any fast-track process is that it is defined in concrete terms so that it is understood uniformly. Scope for shortening due process lies in dispensing with individual elements and cutting consultation periods, as well as in a combination of both. To avoid jeopardising the quality of standards, definition of graduated ways of shortening due process, which could then be adopted depending on the time available, is conceivable.

Question 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?

We consider it extremely important that accounting/reporting issues are addressed jointly by the IASB and the FASB with convergence in mind. In the process, we believe that the IASB's technical work should continue to be performed free of any political influence. We welcome it that the Expert Advisory Panel and the FCAG have been asked to advise both boards on issues related specifically to accounting. Where issues that also concern prudential issues are concerned, the relevant organisations should be involved more closely than hitherto.

Question 7: Is there any other input that you'd like to convey to the FCAG?
As already explained above, the valuation of assets on illiquid markets is a central problem. Entities should therefore be enabled to obtain effective proof of market illiquidity without being unduly burdened in the process.

Yours sincerely,

Dirk Jäger

Ingmar Wulfert