Centre for Financial Market Integrity

11 November 2008

Mr. Christopher Cox
Chairman
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549

Re: SEC Study of Mark to Market Accounting (File No. 4-573)

Dear Chairman Cox:

The CFA Institute Centre for Financial Market Integrity (CFA Institute Centre),[1] in consultation with its Corporate Disclosure Policy Council (CDPC)[2], appreciates the opportunity to comment on the SEC Study of Mark to Market Accounting (File No. 4-573).

CFA Institute represents the views of its investment professional members, including portfolio managers, investment analysts, and advisors, worldwide. Central tenets of the CFA Institute Centre mission are to promote fair and transparent global capital markets, and to advocate for investor protections. An integral part of our efforts toward meeting those goals is ensuring that the quality of corporate financial reporting and disclosures provided to investors and other end users is of high quality. The CFA Institute Centre also develops, promulgates, and maintains guidelines encouraging the highest ethical standards for the global investment community through standards such as the *CFA Institute Code of Ethics* and *Standards of Professional Conduct.*

INTRODUCTION

We are experiencing exceptional economic times and we generally support measures to contain the systemic risk that could arise from a financial meltdown. To that end we support the Commission's efforts to conduct a study of "mark-to-market" accounting applicable to

[1] The CFA Institute Centre for Financial Market Integrity is part of CFA Institute. With offices in Charlottesville, VA, New York, Hong Kong, and London, CFA Institute is a global, not-for-profit professional association of more than 96,000 investment analysts, portfolio managers, investment advisors, and other investment professionals in 133 countries, of whom nearly 83,000 hold the Chartered Financial Analyst® (CFA®) designation. The CFA Institute membership also includes 136 member societies in 57 countries and territories.

[2] The objective of the CDPC is to foster the integrity of financial markets through its efforts to address issues affecting the quality of financial reporting and disclosure worldwide. The CDPC is comprised of investment professionals with extensive expertise and experience in the global capital markets, some of whom are also CFA Institute member volunteers. In this capacity, the CDPC provides the practitioners' perspective in the promotion of high-quality financial reporting and disclosures that meet the needs of investors.

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financial institutions, including depository institutions, under the Emergency Economic Stabilization Act of 2008.

Our key message is that we do not consider current accounting standards and the application of fair value accounting by financial institutions, in particular, to be one of the causes of credit crisis. We therefore encourage the authorities to focus on the real causes of the crisis.

Therefore, it is troubling that some of the initial responses have focused on and overstated the role of accounting during the credit crisis.

On November 3, 2008, CFA Institute Centre for Financial Market Integrity submitted written testimony to The Treasury Select Committee of the United Kingdom Parliament in advance of the Committee's session dealing with accountancy and the banking crisis to be held on November 11, 2008. This written testimony is our comprehensive position and view of the matters surrounding the credit crisis and is attached for your review. In our written evidence we recommended the following:

KEY RECOMMENDATIONS

- Fair value standards which are critical to the integrity of the financial markets should be maintained.
- Any systemic circuit-breaker should be introduced through the regulatory capital regime.
- The emphasis should be on helping investors to interpret reported values. Rather than suspension, we recommend the improvement of fair value reporting presentation and enhancement of associated disclosures.
- Political leaders support and safeguard measures to ensure the independence of the standards setters and its accountability to its key stakeholders including investors.
- Political leaders should resist the temptation to impose regional carve-outs of financial reports as this will reduce the comparability of financial reports for investors.

FAIR VALUE MEASUREMENT

During the crisis, a debate has arisen on whether fair value reporting, by marking assets to their external market prices:

- provides a more reliable indicator of economic worth compared to alternative reporting methods during inactive markets, and

- is pro-cyclical and detrimental to the solvency of financial institutions.

A recently published, October 2008, IMF report has carefully studied these two questions and finds that on balance fair value is the best available approach for accounting for financial instruments. The pro-cyclical effects are overstated. The pro-cyclical effects can be managed by separating regulatory capital decisions from information required for transparency.

- CFA Institute's support for fair value accounting is backed by a poll conducted of our 12,000 person EU membership, which shows that ***79% were opposed to suspension of fair value and 85% believe that suspending fair value would decrease investor confidence in the banking system***. We acknowledge that there are some limitations and implementation difficulties associated with the fair value measurement approach including measurement error. But these limitations are not unique to the fair value approach. In fact, fair value has a well established history of application under US Generally Accepted Accounting Principles (US GAAP) for financial assets for 15 years. Considering its overall benefits, fair value is the best available alternative of measuring financial instruments and on balance, it significantly contributes to the overall transparency of financial institutions.

- Financial reporting information is used by investors for capital allocation and concurrently by regulators for the assessment of safety and soundness of financial institutions. Nevertheless, there is a need to disentangle these two objectives as there is a tension between the need to provide relevant information for investors versus information that is geared at stability and soundness. Pro-cyclical effects of fair value accounting often arise due to the failure to delink information required for overall transparency from that applied in the determination of capital adequacy. We note that bank write-downs would arise due to impairments under a historical cost approach.

- The anticipation that concealing mark-to-market losses will re-instil investor confidence and is an antidote to pro-cyclicality seems to be based on the misconception that observed net income volatility is the sole stimulus to investor perception of the risk of financial institutions. We argue that a more effective way of restoring confidence and ensuring investors do not misinterpret firm performance is to enhance financial statement presentation to enable investors to distinguish between core operating earnings from gains or losses of holding assets. This should be coupled with meaningful disclosures that can convey the inherent uncertainty and margin of error on the valuation of complex financial instruments.

ACCOUNTING STANDARD SETTING PROCESS

- Admittedly fair value measurement basis is not without limitations and there is clearly more work to be done to ensure the consistent application of current accounting literature on fair value for illiquid financial instruments. However, consideration of the application rules needs a deliberative process that necessarily draws upon the expertise and mandate of independent standard setters.

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- A rigorous and inclusive due process is important because of the complexity of the amendments required

- Any rushed or partisan influence of minority interests that forces the standards setters to adjust accounting standards will be detrimental to the overall quality of financial reporting. In addition, it can derail the ongoing convergence and improvement of global financial reporting.

CLOSING REMARKS

If you, other board members or your staff have questions or seek further elaboration of our views, please contact Patrick M. Finnegan, CFA, by phone at 212-754-8350, or by e-mail at patrick.finnegan@cfainstitute.org.

Sincerely,

/s/ Kurt N. Schacht

Kurt N. Schacht, CFA
Managing Director

/s/ Patrick M. Finnegan

Patrick M. Finnegan, CFA
Director, Financial Reporting Policy Group

Centre for Financial Market Integrity

CFA INSTITUTE MEMORANDUM TO THE TREASURY SELECT COMMITTEE

‘ACCOUNTING AND THE BANKING CRISIS’

3rd November 2008

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1. INTRODUCTION

The CFA Institute Centre[1] represents the views of its members, including portfolio managers, investment analysts, and advisors, worldwide. Central tenets of the CFA Institute Centre mission are to promote fair and transparent global capital markets, and to advocate for investor protection. An integral part of our efforts toward meeting those goals is ensuring that the quality of corporate financial reporting and disclosures provided to investors and other end users is of high quality. The CFA Institute Centre also develops, promulgates, and maintains guidelines encouraging the highest ethical standards for the global investment community through standards such as the *CFA Institute Code of Ethics and Standards of Professional Conduct.*

The Centre is involved in policy formulation, advocacy and thought leadership on financial reporting matters. To fulfil its mandate the centre actively engages with accounting standard setters and with its membership.There are several strands to the centre's work on financial reporting. These include ensuring investor considerations are factored into accounting standard setting process, communicating to members and pooling their views on key financial reporting issues and public awareness on financial reporting transparency.

[1] The CFA Institute Centre for Financial Market Integrity is part of CFA Institute. With headquarters in Charlottesville, VA, and offices in New York, Hong Kong, and London, CFA Institute is a global, not-for-profit professional association of more than 98,000 members. The membership comprises of investment analysts, portfolio managers, investment advisors, and other investment professionals in 134 countries, of whom nearly 83,000 hold the Chartered Financial Analyst® (CFA®) designation. In addition we have a network of 136 member societies organised across 57 countries and territories.

2. EXECUTIVE SUMMARY

2.1. The causes of the current financial crisis are poor lending practices, inappropriate risk management, model failure, asymmetrical compensation schemes and poor governance, not fair value or mark-to-market reporting. In fact, fair value reporting has helped to reflect the true severity of these problems.

2.2. **At the crux of the debate on fair value reporting by banking institutions is whether it provides a more reliable proxy of economic worth compared to alternative reporting methods during inactive markets.** We believe that where available, market prices provide the best proxy of underlying economic worth. Including a discount for both liquidity and non performance risk in observable market prices enables the reflection the economic reality and conveys information to investors about the effects of these risk factors.

2.3. Considering the bespoke structured products that significantly contributed to the credit crisis, there are lessons to be learnt about the high likelihood of model error due to over-optimistic assumptions when relying largely on internal models. See 7.2.5

2.4. A summary of our key messages follows:

A. Fair value provides the best representation of economic reality. It provides an early warning system and is the only accounting regime that can facilitate the timely correction from previous bad decisions.
B. Investors are opposed to the suspension of fair value and believe fair value contributes to transparency in financial institutions.
C. The pro-cyclical effects of fair value accounting arise because of the failure to delink information required for overall transparency from that applied in the determination of capital adequacy. Please see paragraph 7.8 for elaboration.
D. Rather than reducing the application of fair value, the focus should be on improving and expanding its current application across all financial instruments.

3. RECOMMENDATIONS

We recommend the following for the Committee's consideration:

3.1. Attention should be focused on the causes of the financial crisis as highlighted in paragraph 1.1 and 6.1, not financial reporting.

3.2. Support the expansion and development of fair value across all financial instruments. See sections 6

3.3. That any systemic circuit-breaker should be introduced through the regulatory capital reserve. See section 7.8.

3.4. That political leadership should be directed at safeguarding the integrity and independence of the international financial reporting standard setting framework, and supporting the ongoing convergence and improvement of financial reporting quality under the auspices of the International Accounting Standards Board (IASB). See sections 8 and 9.

4. PREAMBLE

4.1. CFA Institute's support for fair value accounting is backed by a poll conducted of our 12,000 person EU membership, which shows that **79% were opposed to suspension of fair value and 85% believe that suspending fair value would decrease investor confidence in the banking system**. We acknowledge that there are some limitations and implementation difficulties associated with the fair value measurement approach (see paragraph 6.5). Nevertheless, fair value has a well established history of application under International Financial Reporting Standards (IFRS). Fair value is the best available alternative of measuring financial instruments and on balance, it significantly contributes to the overall transparency of financial institutions. **Hence, fair value standards are critical to the integrity of the financial markets and should be maintained.**

4.2. Financial reporting information is used by investors for capital allocation and concurrently by regulators for the assessment of safety and soundness of financial institutions. Nevertheless, there is a need to disentangle these two objectives as there is a tension between the need to provide relevant information for investors versus information that is geared at stability and soundness. Pro-cyclical effects of fair value accounting often arise due to the failure to delink information required for overall transparency from that applied in the determination of capital adequacy (see paragraph 7.8). **Any systemic circuit-breaker should be introduced through the regulatory capital regime.**

4.3. The anticipation that concealing mark to market losses will re-instil investor confidence and is an antidote to pro-cyclicality seems to be based on the misconception that observed net income volatility is the sole stimulus to investor perception of the risk of financial institutions. We argue that a more effective way of restoring confidence and ensuring investors do not misinterpret firm performance is to enhance the financial statement presentation so as to enable investors to distinguish between core operating earnings from gains or losses of holding assets. This should be coupled with meaningful disclosures that can convey the inherent uncertainty and margin of error on the valuation of complex financial instruments. **The emphasis should be on helping investors to interpret the reported values. Rather than suspension, we recommend the improvement of fair value reporting and associated disclosures.**

4.4. As stated the fair value measurement basis is not without limitations and there are clearly challenges on how to consistently apply fair value for illiquid financial instruments. However, consideration of the application rules needs a deliberative process that necessarily draws upon the expertise and mandate of an independent standard setter, namely the IASB. Any rushed or partisan influence of minority interests that forces the IASB to adjust accounting standards will be detrimental to the overall quality of financial reporting. It can derail the ongoing convergence and improvement of global financial reporting. **There is a pressing need for our political leaders to support the work of the IASB and to separately address the causes of the credit crisis.**

4.5. EU has provided global leadership in the path to the realisation of converged, high quality accounting standards. Given the considerable progress that has been made and resources invested in the convergence process, it will be hubristic, wasteful and contrary to the welfare of investors, auditors and financial statement preparers if European authorities take any measures to undermine the IASB

5. PURPOSE AND INTENDED AUDIENCE OF FINANCIAL ACCOUNTS

5.1. We consider financial accounting information to be the '*lifeblood of capital markets* and a key part of the mosaic of information applied by investment analysts and portfolio managers when they are assessing the performance prospects and risks of reporting entities. Financial accounting information is an important conduit for corporate managers to convey and communicate the past, current and prospective economic reality of their reporting firms.

5.2. We concur with the objective of financial reporting articulated by the IASB conceptual framework[2] identifying the primacy of investors as users of financial statements. The framework states

> *"The objective of financial statements is to provide information about the financial position, performance and changes in financial position of an entity that is useful to a wide range of users in making economic decisions"* and that "*Financial reporting should provide information to help present and potential investors and creditors and others to assess the amounts, timing and uncertainty of the entity's future cash inflows and outflows."*

5.3. An updated pronouncement, contained in the exposure draft 'Preliminary views on improved financial reporting: The Objective of Financial Reporting and Qualitative Characteristics of Decision Useful Financial Reporting Information', states

> *"The objective of general purpose external financial reporting is to provide information that is useful to present and potential investors and creditors and others in making investment, credit and similar resource allocation decisions".*

5.4. The framework further delineates the primary qualitative characteristics of useful financial information namely relevance (i.e. decision useful), reliable (faithful

[2] International Accounting Standards Board: Framework for the Preparation and Presentation of Financial Statements; London 1989.

representation of economic reality), comparability, understandability and timeliness.

5.5. CFA Institute Comprehensive Business Reporting Model[3] (CBRM) similarly asserts that to be useful in making investment and other financial decisions, reported information must be timely, accurate, understandable and comprehensive.

6. BENEFITS OF FAIR VALUE FOR FINANCIAL INSTITUTIONS

6.1. **Fair value is not one of the causes of the credit crisis**. The causes of the crisis have been well chronicled by different bodies such as the Financial Stability Forum. The focus on fair value detracts from the real factors that created and exacerbated the credit crisis. Several factors within financial institutions including excessive leverage, reckless lending practices, weak risk management practices, risk distribution mechanisms that encouraged morally hazardous behaviour and the systemic uncertainty on the location of transferred risk, all contributed to the crisis.

6.2. We consider fair value accounting to be an integral part of high quality financial reporting. Fair value as a measurement approach has a long history of implementation under both International Financial Reporting Standards (IFRS) and the preceding UK Financial Reporting Standards (FRS). It is **neither a novel nor a recently enacted approach**. The application of fair value across different asset and liability categories has history dating back to almost 25 years. In addition to financial instruments under IASB standards, fair value can, for example, also be used in the measurement of property, plant and equipment, investment properties and biological assets. The adoption and implementation of fair value has always been the by-product of a deliberative process by the IASB. Besides the long established use of fair value under IFRS, the merits of fair value have been under consideration and debated by investors, preparers, auditors, regulators, and academics for decades**.**

6.3. In our advocacy to the accounting standard setters, **CFA Institute has consistently supported the use fair value as the appropriate measurement basis for all financial instruments**. This view is further supported by the results of recent surveys of investment professionals. In particular, of the 2,006 respondents to a March 2008 survey of CFA Institute members on the topic, 79 percent believe that fair value improves financial institution transparency and understanding of risk profile and 74 percent believe that it improves market integrity. Two follow up surveys were conducted during the months of September and October 2008 and the results confirmed earlier findings. Our survey of membership in the EU showed that 79% were opposed to suspension of fair value and 85% believe that suspending fair value would decrease investor confidence in the banking system, see Appendix (section 12) for detailed results. These findings reaffirm our position that **continuing the use of fair value in accounting for financial instruments is vital to the integrity and transparency of markets**.

[3] CFA Institute Centre for Financial Market Integrity ' A Comprehensive Business Reporting Model'- Financial Reporting for Investors- July 2007

6.4. Full fair value accounting of all financial instruments is superior to the alternative of amortised historical cost. This is so for various reasons including the:

- provision of timely, relevant and decision useful information. It is the only accounting regime that can provide an early warning system and facilitate correction.
- fair value ensures the consistent application of accounting for financial instruments and therefore yields more comparable information.
- the timely information content of fair value and associated disclosures can contribute to a firm's risk management processes.

We elaborate further on these benefits in the appendix under section 10

6.5. The two often cited limitations of fair value are a) measurement error and b) artificial income volatility. In response we note that

A. Measurement error is not peculiar to the fair value approach. Accounting as a practice has always allowed a significant level of estimation when managers are exercising judgement. For example, the provisioning for bad loans and the determination of amounts by which to depreciate properties, are all a matter of judgement and inherent in these judgements is a susceptibility to measurement error. On the other hand the fair value approach is designed to minimise measurement error as it necessitates reference to market prices where available, and thus allows the reflection of consensus views on the worth of financial assets. This minimises the measurement error that could arise from a single firm's management team.

B. Artificial income volatility: Artificial income volatility in part arises due to the hybrid, mixed measurement attribute approach where both fair value and amortised historical cost are applied and the mismatches in approach for corresponding assets and liabilities leads to income volatility. In this instance fair value is not the cause of artificial volatility and in fact the adoption of full fair value will be a remedy.

C. Unrealised holding gains and losses can also result in income volatility. Two questions that arise are a) whether income volatility associated with unrealised holding gains and losses has information content for investors, and b) whether it reflects economic volatility. For a financial institution, the decision to hold, sell or buy financial instruments is in part driven by their market value. Hence unrealised holding gains and losses have information content for investors on the effective asset and liability management. At the same time it allows accounting volatility to match economic volatility. Enhanced disclosure of the nature of income and a presentation that differentiates between realised and unrealised gains or losses, can help investors to comprehend the information content.

6.6. **We believe that the fair value accounting treatment encapsulates the essential attributes of relevance and faithful representation of economic reality.** Reducing the quality of financial reporting disclosure by suspending or restricting the application of fair value accounting for financial institutions can have multiple undesirable consequences. These will include reducing the information quality and imposing capital allocation inefficiencies.

- **Reducing financial information quality**: Suspending or curtailing the application of fair value for a financial institutions breaks the link between market changes in financial instruments and their valuation in financial reports. **One of the problems highlighted by the ongoing crisis is the delayed reflection of underlying fundamental data (e.g. declining home prices) in the valuation of financial instruments that were not reported at fair value, such as mortgage loans.**

- **Capital allocation inefficiency**: Reducing the disclosure quality will escalate the difficulties that investors and financial institution counterparties have in differentiating between high risk and low risk firms. This in turn will lead to adverse selection and capital misallocation and likely translate to a higher uncertainty premium and a corresponding increase in the cost of capital. The lost decade in Japan, where financial institutions concealed losses, is an appropriate reference point of the counter-productiveness of deferral of recognition of real economic losses. **Reducing transparency can only limit the self-correcting capacity of capital markets.**

7. FAIR VALUE AND THE CREDIT CRISIS

7.1. In the context of the credit crisis, two main aspects that are frequently debated is whether it is a) appropriate to apply fair value treatment for financial instruments during inactive or distressed markets and b) whether fair value has pro-cyclical effects.

7.2. Fair value and illiquid instruments

7.2.1. It is true that markets do go through phases of exuberance and depression and in these situations market prices may have noisy and anomalous characteristics. Nevertheless, market prices remain the best measure for economic worth as they are unbiased and reflect the consensus of capital market participants on the economic worth at any point in time. As stated earlier, we believe that fair value is the most relevant (i.e. decision useful) and reliable (faithful representation of the economic reality) of financial instruments.

7.2.2. The question often debated is whether market prices are appropriate proxies of economic worth for illiquid financial instruments. At the heart of the debate is whether observable market prices during an inactive market:

A. Are superior to the application of entity specific models? A consensus view of economic worth has the merit of being unbiased. Besides the accounting standard allows for adjustments of market inputs. We develop this notion further in 7.2.3.

B. Are superior to historical cost as a proxy of economic worth? As argued fair value provides an updated assessment of economic fundamentals and conveys information on other risk factors such as liquidity and non performance risk. In this respect it is much more relevant than historical cost for financial instruments. Historical cost for financial instruments can totally hide risk such as is the case with derivative instruments that do not require investment at inception. They could reflect outdated, overstated values for example for mortgage instruments that were originated during the phase of market exuberance. Hence historical cost both underestimates values (i.e. derivatives) and overestimates values (i.e. assets incepted during asset bubbles).

7.2.3. The contention often made by financial institutions is that they are holding assets to maturity, therefore that they do not have to monetise such assets at the reporting date. On this basis they anticipate that the future cash flow realisation is likely to be higher than that reflected by the observable market price. This thinking is premised on the anticipation that risk factors such as illiquidity discount will not be a factor at the point of realisation. However, such an optimistic anticipation of change of market conditions at realisation is not necessarily founded on any verifiable evidence. On the other hand, market prices when available reflect the consensus prediction of risk factors that currently exist and are likely to arise in the foreseeable future.

7.2.4. The merit of fair value is that it allows an updated assessment of all risk factors including liquidity and non performance risk. Should the instrument specific liquidity conditions improve, then the financial institutions shall be able to report gains. The reflection of the impact of changing market conditions on risk factors has information content for investors. As we have stated in paragraph 6.5 tracking the impact of these risk factors on financial instrument values has information content on asset and liability management practices.

7.2.5. The credit crisis in part stemmed from the volume of structured, bespoke products where a significant number of capital market participants unwisely placed excessive reliance on the rating of Credit Rating Agenices (CRAs), when pricing the risk associated with these products at their origination. CFA Institute has been involved in the review of the role of CRAs and our findings show that one has to be cautious about unduly relying on internal models for valuation purposes. This is because they have a bias towards being too optimistic in their assumptions. **There are lessons to be learned on the risks that could arise due to internal model error.**

7.2.6. The concerns raised on the question of illiquid financial instruments by various financial institution preparers and other stakeholders, makes it evident that there have been legitimate difficulties in ensuring the consistent application of the existing accounting literature on this matter. There is difficulty in identifying situations of where a disorderly transaction has occurred and therefore market inputs can be ignored according to current accounting standards.

7.2.7. In this regard we welcome the deliberations undertaken by the International Accounting Standards Board's (IASB) valuation expert advisory panel. We concur with the findings in their report issued on October 31st 2008.

7.2.8. This report upholds the application of fair value in the valuation of financial instruments while illuminating on how to handle difficulties that can arise when measuring financial instruments during inactive markets. The report also dispels the misconception that there are scenarios in which accounting standards compel reporting entities to provide misleading values because of prevailing distressed markets.

7.2.9. The objective of the international accounting standards on financial instruments (IAS 39 and IFRS 7 under IASB) was to reflect the economic reality of reporting entities in all instances. In particular, it is helpful that the paper clarifies that current accounting literature **does not prohibit the use of management's internal assumptions when observable market inputs are unavailable**. However, the assumptions used must include appropriate risk adjustments that market participants would make for non-performance and liquidity risks. Factoring in illiquidity discounts and non-performance enables a depiction of economic reality of financial instruments.

7.2.10. Regardless of whether financial institutions either apply market based inputs or their internal models, we believe that disclosures of how managers determine values and the inherent uncertainty around these values is what is most helpful for investors. **Comprehensive disclosures can help avoid misinterpretation of numbers and therefore ensure that investors are informed about the financial condition of a reporting financial institution.**

7.2.11. Clearly there is need for continued education from the accounting standard setters to help ensure consistency in application in the accounting principles of illiquid financial instruments. We support the initiative undertaken by the two significant accounting standard setters IASB and the US Financial Accounting Standards Board (FASB) to clarify the application of literature.

Fair value and Pro-cyclicality

7.3. The main point we would like to state is that the pro-cyclical effects of fair value are overstated. (Please see attached articles[4])

7.4. A useful backdrop to the debate around the pro-cyclical effects of fair value treatment is to consider the extent to which the recognition of fair value gains and losses through the profit and loss account occurs within European financial institutions. The recognition of fair value gains and losses through profit and loss is required for financial instruments held in the trading book. IMF report published in October 2008 (attached as supplementary material) provides illustrative aggregate data of European financial institution as of the end of December 2006. The

[4] 1) Nicolas Veron, May 2008-' Fair value accounting is the wrong scapegoat for the crisis' and 2) IMF Chapter 3 'Fair Value Accounting and Procyclicality'- October 2008

published data shows that the **fair value adjustments that require recognition through the profit and loss account are not applied across the entire financial institution balance sheet**. Financial institution losses also arise from amortised cost impairments and from realised losses of available for sale and held to maturity items. Fair value write-downs that are not made through the profit and loss (e.g. those relating to available for sale) do not impact on regulatory capital and besides the regulators have the option of writing back losses that they believe do not pertain to the solvency of the reporting institution.

Trading Book- European Financial Institutions as of December 2006	
Assets	Percentage
Debt Securities	14.98
Equity Securities	6.32
Derivatives	14.71
Percentage of book assets	**36.01**
Liabilities	
Debt and Equity Securities	12.77
Derivatives	15.34
Percentage of book liabilities	**28.11**

IMF report Fair value accounting and pro-cyclicality

7.5. Understated in the debate on the pro-cyclical effects of fair value are the equivalent impacts of the alternative amortised cost approach. Impairment of assets, though less frequent would still be necessary under an amortised cost regime. This is because the amortised cost treatment requires the recognition of gains and losses using the lower of cost or market value principle. **Hence it is important to consider that write-downs will not arise exclusively due to fair value accounting.**

7.6. Fair value accounting facilitates self correction. However, not often mentioned in the debate is the economic pro-cyclical effects of delayed or less frequent write-downs under a amortised historical cost approach. The delayed recognition of losses reduces the incentives of managers to engage in economic risk management and restructuring during economic climate downturns. Relative to fair value accounting, an amortised cost approach can result in morally hazardous risk origination during a buoyant and booming economic period because financial institutions are aware that they may have relatively more flexibility to defer their losses if a downturn occurs. The combination of morally hazardous risk origination during booming economic environments and relative inertia during market downturns has pro-cyclical economic consequences. We refer to the lost decade in Japan as a suitable reference point.

7.7. It is also important to realise that because fair value accounting requires the updated valuation of financial assets and financial liabilities, the write downs of assets are offset by gains of liabilities. The relatively symmetrical treatment of assets and liabilities under fair value effectively dampens any pro-cyclical effects of fair value accounting in contrast to the write downs incurred through the amortised cost approach confined to assets.

7.8. Managing Pro-cyclicality

7.8.1. As pointed out in the IMF report, pro-cyclicality of fair value could possibly arise due to a) the linkage between financial reporting and regulatory capital and b) investor over-reaction to artificial net income volatility. **Hence given the overall benefit of transparency derived from fair value accounting, we would propose measures should be taken that mitigate any pro-cyclical effects rather than suspending fair value accounting.**

7.8.2. **The October 2008 IMF report suggests that a way of mitigating fair value volatility from affecting the solvency of financial institutions is to delink financial reporting information from capital adequacy determination**. Regulators should have flexibility to determine the parameters that provide the most appropriate yardstick of the solvency of financial institutions and thereafter to determine the required capital buffers. We would support measures that focus on regulatory capital changes if the objective is to provide a systemic circuit breaker during the credit crisis

7.9. Managing possible over-reaction to net income volatility

7.9.1. The push to suspend mark to market accounting is in part triggered by concerns about the consequences of observable net income volatility on investors' perception of risk. Net income is unquestionably an input used by investors when assessing firm performance, but it is a single input. Simply managing the net income number underestimates the sophistication and reflects a misunderstanding of the decision heuristic of investors. This is because financial reporting is part of the mosaic of information that helps to inform investors to assess the risks and prospects of reporting entities. There remain alternative indicators showing that financial institutions are under strain.

7.9.2. The current crisis reflects a loss of confidence by investors and between counterparties on the true financial condition of financial institutions. In the absence of information on updated economic values of financial instruments, investors will likely impute market value of these instruments. **Hence, suspending fair value accounting will only encourage investors to engage in a guessing game on the true financial condition of and fuel the sense of uncertainty about financial institutions.** The choice is whether to rely on fully informed investors to make corresponding capital allocation decisions.

7.9.3. To enable investors to identify the nature and sources of earnings volatility, we encourage the provision of a better and more disaggregated financial statement presentation format that is more comprehensible for investors. Under such a format investors should be able to differentiate between core operating earnings from the gains and losses of held assets (as also recommended in paragraph 6.5) In addition we recommend enhanced disclosures that help investors understand the uncertainty associated with reported valuations. The focus should be on refining the current accounting framework so as to minimise the risk of investors and other users misunderstanding reported net income numbers.

8. ROLE AND ACCOUNTABILITY OF IASB

8.1. The raison d'être of the IASB is to create a single, high quality set of financial reporting standards. The genesis and evolution of standard setting by the IASB and its predecessor, the IASC from 1973 to the present is indicative of the demand for a single set of accounting standards. We strongly support the creation of a single set of high quality, global accounting standards as this will enable the comparability of investee firms across the globe and facilitate cross border asset allocation.

8.2. It is worthwhile for the member states of the EU, including the UK, to reflect on the history of the IASB. In particular on the impact of the decision by the EU, made in 2000, in wake of the Financial Services Action Plan, followed on by the 2002 legislative endorsement that saw the adoption of IFRS by listed EU companies with effect from 2005. These set of decisions marked a watershed moment in the overall convergence process. It provided impetus to the whole process and presents an example where the EU provided global leadership in the path to the realisation of a desirable, global product for investors, auditors and multinational financial statement preparers. During the last 12 months, there has been serious deliberation undertaken by the US Securities and Exchange Commission (SEC) to adopt IFRS, the lifting of reconciliation requirements for foreign filers on US exchanges and the ongoing convergence between IFRS and US GAAP under the memorandum of understanding between the IASB and FASB. The observed willingness to adopt IFRS by the world's largest capital market is arguably in part a by-product of the earlier EU decision to adopt IFRS.

8.3. The independence and accountability of the IASB is a necessary prerequisite to enable the ongoing convergence of accounting standards between US GAAP and IFRS. We believe that independence and accountability of the IASB to its key stakeholders will result in efficiency, rigour, and inclusiveness in both the due process and substance of the board's deliberations.

8.4. Our proposals to ensure the independence and accountability of the IASB were addressed in our consultative response to the review of the IASCF constitution. A summary of the key proposals is contained in the appendix, paragraphs 11 (IASCF Constitution recommendations).

8.5. At this juncture, regional intervention could derail the convergence of international financial reporting as it will set a precedent for similar responses by other current and prospective adopters of IFRS. For this reason, we would be concerned about any political override to current accounting rules.

8.6. **Given the considerable progress that has been made and resources invested in the convergence process, it would be hubristic, wasteful and contrary to the welfare of investors, auditors and financial statement preparers if European authorities take any measures to undermine the IASB**. The European political authorities should instead safeguard the ongoing process of financial reporting convergence.

8.7. We strongly encourage the UK and other European legislative and regulatory authorities to facilitate and enable the functioning of an independent, accountable, efficient and effective IASB that can thoughtfully address all financial reporting matters including the concerns related to accounting for financial instruments under IAS 39.

8.8. The authorities should not overlook the benefits of UK and other European markets aligning their financial reporting with that of other leading capital markets such as the US and Japan. The credit crisis has shown that global oversight capabilities are desirable to match the reality of the global economy that includes an interconnected global financial architecture. The establishment for a single, high quality set of standards is consistent with the objective of attaining global oversight.

9. STANDARD SETTING PROCESS

9.1. We understand that these are exceptional times and governments are expected to resolve the economic and banking crisis. While this situation may warrant the expeditious implementation of several identified measures, there is the risk that circumventing the due process of the current accounting standard setting process, based on the concerns of a single industry, could be detrimental to the broader welfare of other stakeholders and especially investors. Recognition should be made that financial reporting rules made with financial institutions in mind during the crisis will also affect the preparers and investors of non financial institutions.

9.2. The last few weeks have raised several and significant concerns with regard to consideration of financial reporting rules. On 13th October 2008, the IASB enacted new reclassification rules under what seemed to be at the behest of EC political pressure and thereafter there have been proposals for further amendments to IAS 39. We are very concerned by the events of the last few weeks because

9.2.1. There is no coherence in the objective of the amendments. The only common goal seems to be to change accounting rules to allow financial institutions to present favourable results in the next few quarters. The changes in some instances claim to be aimed at lowering the competitive disadvantages of European Financial Institutions relative to US peers. **From an investor perspective, global convergence is desirable as it captures two important dimensions a) harmonisation that enables comparability and b) an improved set of standards.** However the proposed amendments related to financial instruments, seem to only apply the principle of harmonisation to US

GAAP on an opportunistic and selective basis and in ways that lower the quality of financial reporting for investors (e.g. allowing flexible reclassification that reduces comparability). There is a real risk of cross jurisdictional, mutually reinforcing deterioration in the quality of standards.

9.2.2. The changes have a short term orientation and mainly cater to financial institutions. They mainly aim to improve quarterly numbers of the financial institutions. As stated earlier this will likely compromise the comparability of financial institution performance.

9.2.3. There is no explicit reference or articulation of intent to ensure the quality and comparability of standards in the amendments that are being considered.

9.2.4. The due process is not inclusive and investors are under-represented in the considerations. For example the EC stakeholder consultation on the 21st October was to a selected number of participants. **Such a process cannot ensure an unbiased and representative contribution from all financial reporting constituencies.**

9.2.5. The changes to accounting rules do not seem to be congruent with the other interventions by the governments in this crisis. For example with the taxpayer investment in financial institutions, it is important to consider which accounting regime will provide transparency, enable ongoing performance monitoring and likely ensure the realisation of gains on the massive fiscal investment made.

9.2.6. Finally there is an inherent contradiction between measures that threaten to fragment current international financial reporting and the espoused intention of establishing global oversight capacity.

9.3. The trigger for the intended amendments to accounting standards are the concerns related to fair value accounting. As illustrated in paragraphs 7.3 to 7.9, this is a false premise for change as the pro-cyclical effects are overstated. We reiterate that fair value is not a novel approach to accounting. Although limited to particular assets and liabilities, fair value accounting is a well established component of the financial reporting landscape. As asserted, it does provide investors with timely and decision useful information and is the only accounting regime that has early warning system characteristics.

9.4. The overall accounting standard setting process should not be compromised due to general concerns related to a specific accounting standard (i.e. IAS 39). Accounting information has multiple dimensions including defining the measurement approaches and disclosures of different assets and liabilities. Beyond financial instrument and financial institution related accounting, there exists a vast body of accounting literature that depends on the current standard setting architecture. These include literature relating to operating assets, intangible assets, pension accounting to mention a few examples. Hence, an ad-hoc or politicised process targeted at a single standard can have disruptive effects and impose negative externalities to the entire accounting framework.

9.5. As is evident from the current debate, the application of fair value is an area with multiple dimensions and encompassing an array of complex issues. These issues can only be meaningfully resolved based on deliberative consideration. An unduly rushed up amendment to current accounting standards, catering only for the concerns of the financial institution fraternity can be detrimental to the overall quality of financial reporting. This is particularly true for IAS 39, which is one of the most complex standards issued by the IASB.

9.6. The history of standard setting can provide examples showing that the absence of rigorous deliberation at inception of accounting standards will only necessitate significant interpretative guidance and their revision at future dates. On this basis we strongly support the existence of an independent and accountable standard setting board (i.e. IASB).

10. APPENDIX I (ELABORATION OF BENEFITS OF FAIR VALUE)

10.1. INFORMATION CONTENT AND REPRESENTATION OF ECONOMIC REALITY

10.1.1. Fair value by definition, considers the most current and complete assessments about the value of economic items. Fair value accounting is preferable to historical cost accounting because it provides an early warning system about an entity's financial condition by emitting signals about the risk exposures of the assets held. Fair value accounting also provides information on the opportunity cost of continuing to hold financial instruments.

10.1.2. Unlike fair value accounting, under an amortised cost approach, gains and losses can be deferred. An amortised cost treatment leads to less frequent recognition of the gains and losses of financial instruments held.

10.1.3. Due to the untimely recognition of impairment gains and losses, the amortised cost approach can mask economic reality and is not as transparent as the fair value approach. Due to these features, amortised cost accounting can dis-incentivise managers from acting in the best interests of its shareholders. For example, an institution holding a loan recorded at cost that was issued during a phase of market exuberance may be slow to recognize impairment of the loan caused by deteriorating economic conditions. In that case, the cost approach is a lagging indicator of a firm's true economic position.

10.1.4. In contrast to amortised cost impairment related adjustments, mark to market adjustments convey more meaningful economic information and have higher predictive values. For example, the effective interest rate under fair value accounting is indicative of the likely cost of refinancing at the time of reporting. The same can be said of other risk factors (e.g. prepayment and default rates) applied to valuation of reported assets and liabilities.

10.2. *FAIR VALUE ENABLES THE CONSISTENT ACCOUNTING TREATMENT OF SIMILAR ECONOMIC ITEMS*

10.2.1. Fair value accounting for financial instruments eliminates accounting that is determined by managerial intent. For example, two instruments with exactly the same economic characteristics should not be accounted for differently simply based on whether management intends to hold one to maturity and the other for sale. The application of multiple accounting treatments for similar financial instruments can make it very difficult for users to translate the economic meaning of reported numbers in the balance sheet and income statement. This view is backed by survey evidence. 72% of respondents to the 2007 CFA Institute Financial Reporting and Measurement Survey indicated that companies should not have recognition and measurement options for similar instruments. **Comparability is at the heart of investor financial analysis**.

10.2.2. We also believe that accounting that is based on managerial intent can introduce management bias. Firms can for example manage earnings through the selective realisation of unrealised gains and losses.

11. APPENDIX 2 (IASCF RECOMMENDATIONS)

The Trustees of the International Accounting Standards Committee (IASC) Foundation initiated their second five year review of the organization's constitutional arrangements. A summary of our positions on key proposals are

11.1. *Monitoring Group:* We support the Trustee's proposal to create a Monitoring Group with accountability to public authorities. This group will strengthen the overall process for standard setting by conducting liaison activities with governmental and other organizations. Furthermore, it will provide an effective means for overseeing the functioning of the IASB and its Trustees to ensure their objectives are met. However we feel that the proposed membership of the Monitoring Group could be strengthened by including investors. Investor representation would provide direct experience with standard setting issues and enhance public confidence in the quality of standards.

11.2. *Investor Representation on the Trustees:* Investor representation on the Trustees should be expanded to include more investors. Currently, the Trustees are dominated by preparers, auditors, and regulators. Increased investor representation greatly enhances the confidence of users in the oversight of the standard setting process.

11.3. *Functions of the Monitoring Group:* The proposed functions of the monitoring group are reasonable and appropriate. This includes approval of the appointments of Trustees; overseeing the functioning of the Trustees; and serving as the interface between the IASB and public authorities and other organizations.

11.4. *Self Interest Threat and Governance:* The development of the plans for the institution of the Monitoring Group are at an early stage. The plans call for the revision and reform of the Foundation's governance and procedures to ensure the IASB's long-term sustainability and independence. We encourage the Trustees to expose the Memorandum of Understanding, which will define the terms of reference of the relationship between the Monitoring Group and the Trustees to the public for comment. Furthermore, we stress that the Monitoring Group be designed to act solely in the public interest.

11.5. *Role of Trustees' Appointments Advisory Group:* We do not feel that there is a role for the Trustees' Appointments Advisory Group since these selections and appointments will be the responsibility of the Monitoring Group.

11.6. *IASB Funding:* We believe that the Monitoring Group must seek and obtain an entirely independent and sustainable source of funding for the IASB. This will ensure independence of the IASB and its standard-setting function from the influence of special interests.

11.7. *Expanding Membership:* We believe the proposal to expand the IASB to 16 members is unnecessary to ensure that it efficiently and effectively meets its objectives. Of much greater importance to us is that the IASB comprise full time members with no remaining responsibilities or obligations to any other bodies or organizations and that it have adequate investor representation. Furthermore, we believe that increased investor representation on the IASB is critical to firmly establishing public confidence in the standard setting process. To that end, we strongly urge the Trustees to require that if new positions are created, such positions are filled with investor representatives

11.8. *Geographical Dispersion:* The proposed regional representation is appropriate to ensure the representation of global views in the standard setting process, however, we believe the targets for geographical diversity should be re-assessed no less than every 5 years to ensure the targets adequately and fairly represent a broad base of international interests.

12. APPENDIX 3 (CFA Institute Member Polls)

12.1 **CFA Institute overnight poll of EU based members on the suspension of Fair Value Accounting. Results as of 2nd October 2008.**

Do you support a suspension of fair value standards under the International Financial Reporting Standards (IFRS)?

Yes	127	**21%**
No	470	**79%**

Total=597

Do you think such a suspension would increase or decrease confidence in the European banking system?

Increase	86	**15%**
Decrease	473	**85%**

Total=559

These percentages exclude anyone who selected “not sure” for the particular question asked.

We have just over 11,600 members in the European Union—meaning each of these questions has a margin of error of +/-4% at the 95% confidence level.

12.2 CFA Institute Member Poll Results on bank bailouts as of Oct. 14, 2008

(5,148 respondents; poll was distributed on Oct. 9, 2008)

Q1. Last week, the U.K. government announced plans to strengthen the capital base of domestic banks by direct investing in the equity of those banks. Is this approach a model that governments worldwide should follow?

	Number of responses	**Response percentage**
Yes	3174	75%
No	1082	25%

Q2. If governments were to guarantee all short-term debts of solvent financial institutions, would this restore the confidence institutions need to begin trading with each other again?

	Number of responses	**Response percentage**
Yes	3142	83%
No	660	17%

Q3. To what extent would the following government measures, other than direct investment in banks and guaranteeing of bank debts, help to unfreeze the credit markets? (1 = not at all; 5 = completely agree)

	1	**2**	**3**	**4**	**5**
Central banks taking steps to eliminate insolvent institutions and to foster recapitalization of institutions deemed solvent. (N=5091)	5%	11%	22%	46%	16%
Full disclosure of bank assets, asset valuations, and valuation assumptions to the market.(N=5094)	5%	15%	23%	33%	25%
Government doing nothing: the markets will sort this out without additional government intervention.(N=5076)	51%	25%	11%	7%	6%

Q4. The markets remain volatile even after the measures taken by governments in recent weeks. To what extent have the following contributed to the continuing volatility? (1 = not at all; 5 = completely agree)

	1	2	3	4	5
Concern about the likelihood of a global recession (N=5109)	1%	6%	16%	49%	29%
Concern that financial institutions continue to hold assets at values that do not accurately reflect current market value.(N= 5111)	1%	8%	16%	44%	31%
Lack of coordinated actions by regulators across regions. (N=5113)	7%	22%	30%	28%	12%
Mark-to-market accounting (N=5097)	15%	24%	25%	24%	12%
Slow pace of implementation of the original US$700 billion bailout package in the United States. (N=5107)	12%	28%	29%	23%	9%
The end of the ban on short selling in the United States (N=5105)	28%	30%	21%	15%	5%
The unwillingness of commercial banks to lend to each other.(N=5109)	1%	3%	8%	36%	52%