Centre for Financial Market Integrity

CFA INSTITUTE

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Pierre Delsaux
Director
Directorate F – Free Movement of Capital, Company Law and Corporate Governance
DG Internal Market
European Commission
Rue de la Loi 200
1040 Brussels

Cc: Charles McCreevy
Johannes Joeroen Hooijer
Ulf Linder
Stig Enevoldsen EFRAG

Dear Mr Delsaux,

Re: EC Declaration on amendments to International Accounting Standards statement no 39 (IAS 39)

As a global body representing 98,000 investment professionals – with approaching 12,000 practicing members across the European Union – CFA Institute is pleased to provide comment on any further amendments to International Accounting Standards no 39 (IAS 39); *Recognition and Measurement of Financial Instrument.* We understand that the EC Declaration, dated 15th October 2008, mandates the identification and review of aspects of IAS 39 that need to be immediately addressed. This declaration was made after the endorsement by the Accounting Regulatory Committee (ARC) of the International Accounting Standards Board (IASB) 13th October 2008 decision, to allow the reclassification of financial instruments accounted for under the 'trading' and 'available for sale' categories.

In our letter to the Accounting Regulatory Committee, dated 14th October 2008 we expressed our concern that this proposed step would be **going further than the originally articulated objective of simply levelling the playing field** across key capital markets i.e. the EU and US. We strongly urged there to be no further amendments or carve-outs to IAS 39. Any such carve-outs could significantly undermine investor interests by yielding even more incomparable financial statements across countries that comply with International Financial Reporting Standards (IFRS). Such measures will also precipitate investor loss of confidence as shown by CFA Institute EU membership surveys[1].

We would also like to specifically comment on a) the flawed premise of changes being made, b) importance of a rigorous due process and c) the time frame of changes. An important message through our comments is that even at the heart of the current crisis, legislators and regulators need to enact policy that can be robust through different economic cycle.

[1] 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

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FLAWED PREMISE OF CHANGE

We generally support the intervention by the governments of European member state in the effort to rescue financial institutions. A membership poll showed that 75% believed that governments around the world should strengthen the capital base of their financial institutions. We also believe as respective governments act to safeguard the overall economic prospects of their respective countries, they should actively recognise that the **taxpayer will effectively be an investor in the financial institution sector**. On behalf of the investor and tax payer across EU states, we urge the EC to carefully consider and evaluate the question of which accounting regime will likely ensure the realisation of gains on the massive fiscal investment made and provide ongoing transparency of the financial condition of the respective financial institutions. It is important for the EC to make decisions that alleviate and extend beyond the ongoing crisis period. A suitable reference point to identify the information requirements of the public as a shareholder is to also understand the information requirements of private shareholders.

Our understanding is that the proposed changes to IAS 39 are premised on the concern that the fair value accounting regime bears pro-cyclical characteristics that exacerbated the credit crisis. A detailed study conducted by the IMF published in October 2008, evaluated the pro-cyclical impacts on aggregate and company specific banking data across the EU and US. Through chapter 3 '**Fair Value Accounting and Pro-cyclicality**', the IMF report concludes that

'*While weaknesses in the fair value accounting methodology may introduce unintended volatility and pro-cyclicality, thus requiring some enhancements, it is still the preferred accounting framework for financial institutions. It concludes that capital buffers, forward looking provisioning and more refined disclosures can help mitigate the pro-cyclicality of fair value accounting*.'

We urge the EC to consider the findings of the IMF report and to anchor its thinking on similar studies that have looked at or will look at the aggregate impact of applying fair value in financial institutions. Presumably, the newly formed EFC group shall be able to conduct such a study.

IMPORTANCE OF RIGOROUS DUE PROCESS

We understand that these are exceptional times and governments are expected to resolve the crisis. While this situation may warrant the expeditious implementation of identified measures, there is the risk that the unilateral override of the current accounting regime in a hurried fashion and circumventing the due process, based on the concerns of a single industry, could be detrimental to the broader welfare of other stakeholders and especially investors.

Across different financial reporting stakeholders, there seems to be unanimity that IAS 39 needs to be improved. This was evident during the six month comment period of the recently published discussion paper on '*Reducing Complexity for Financial Instruments*' that ended on September 19th 2008. **The comments to this discussion paper from all the key stakeholders including financial and non financial institution preparers, auditors and investors, are a necessary reference point, if the EC objective is to exhaustively identify the problematic areas of IAS 39.** 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.

It is inevitable that there will be different perspectives across the stakeholders on which aspects of IAS 39 needs to be improved upon. Despite these differences there remains the overarching need for a comprehensive, unbiased evaluation and inclusion of all key stakeholder considerations so as to construct an accurate cost-benefit analysis of any changes adopted. The issues selected by the EC for consideration through its stakeholder consultation are highly complex. The issues mentioned in the declaration include the fair value option, embedded derivatives and insurance contracts. It seems implausible that a rigorous basis of resolution and revision of these, plus the 'laundry list' of any other issues that could be provided by the participating stakeholders, can be achieved in such a short time frame. IAS 39 is one of the most complex standards and despite its imperfections it reflects a significant period of considered deliberation. Hence, **any revision to this standard should draw on the expertise of and be necessarily determined by the IASB as the standard setter**.

We therefore implore the commission not to compromise the principles of rigour and inclusiveness in drawing its conclusions. The EC should recognise the significant and inherent shortcoming of using anecdotal evidence from a limited number of stakeholders, during a very compressed comment period, as a basis of conclusion. The conclusions arrived at are likely to lack legitimacy and could simply end up reflecting partisan interests. This in turn could have undesirable long term consequences of encouraging accounting that is a reflection of special interest groups rather than that of broader users of financial reports such as investors.

TIME FRAME OF CHANGES

Financial reporting is part of the mosaic of information to assess the overall risk and prospects of reporting entities. At this juncture of the crisis, changing accounting rules will not re-instil the confidence of investors and capital market participants in financial institutions. The market panic and unwillingness to lend in part is a crisis in confidence about financial condition of counterparties. Hence we believe that the urgency of curtailing the application of fair value in financial institutions is being overstated, instead the focus should be on measures that help investors and counterparties understand the level of risk held by financial institutions (e.g. enhanced disclosures).

Another difficulty related to the mentioned EC declaration is that it has resulted in the intermingling of the pro-cyclicality question with routine matters pertaining to how fair value is implemented (e.g. the application of the fair value option). A false urgency is being juxtaposed onto implementation issues that **should really require consideration through the IASB due process**.

CLOSING REMARKS

If you, other board members or your staff have questions or seek further elaboration of our views, please contact either Vincent T. Papa, CFA, by phone at +44.207.531.0763, or by e-mail at vincent.papa@cfainstitute.org.

Sincerely,

/s/ Nitin Mehta
Nitin Mehta,
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/s/ Charles Cronin
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/s/ Vincent Papa
Vincent Papa
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About CFA Institute

The CFA Institute Centre[2] 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.*

[2] The CFA Institute Centre for Financial Market Integrity is part of CFA Institute. With headquarters in Charlottesville, VA, and regional offices in New York, Hong Kong, and London, CFA Institute is a global, not-for-profit professional association of more than 97,000 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. The CFA Institute membership also includes 136 member societies in 57 countries and territories.