CFA INSTITUTE | Centre for Financial Market Integrity

CFA Institute Centre Brief for MEPs: November 2008

Credit Crisis - "Maintaining independent, international and accountable standard setting is in the interest of European investors"

ABOUT US

CFA Institute is a global body representing 98,000 investment professionals – with approaching 12,000 practicing members across the European Union. We have member societies, representing practicing investment professionals, located in 20 EU member states including Austria, Belgium, Bulgaria, Cyprus, Czech Republic, Denmark, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Luxembourg, Netherlands, Poland, Romania, Spain, Sweden and United Kingdom.

CFA Institute is involved in policy formulation, advocacy and thought leadership on financial reporting matters. We have recently provided written evidence to the UK Treasury Select Committee on 'Accounting and the Banking Crisis' and will be providing oral evidence on 11th November 2008**.**

INTRODUCTION

We are experiencing exceptional economic times and we generally support measures to contain the systemic risk that could arise from a financial meltdown. For example, a poll showed that 75% of our members believed that governments around the world should strengthen the capital base of their financial institutions.

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, and to concurrently support an independent and accountable International Accounting Standards Board (IASB).** The EU in its decision to adopt IFRS with effect from 2005 provided global leadership and considerable momentum towards the goal of attaining a single, global, high quality set of financial reporting. Converging financial accounting has the benefit of providing more comparable and higher quality standards that are desirable for investors and multinational preparers.

PROPOSED EC AMENDMENTS

It is troubling that some of the initial responses have focused on and overstated the role of accounting during the credit crisis. The European Commission (EC) sent a letter to the International Accounting Standards Board (IASB) on 27th October 2008 requiring further amendments to be in place for the benefits of banks reporting during the 4th quarter. The proposed amendments aim to curtail the application of fair value. In our written evidence to the Treasury Select Committee we raised several concerns, including:

- 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

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reclassification that reduces comparability). There is a real risk of cross jurisdictional, mutually reinforcing deterioration, in the quality of standards.

- The trigger for the intended amendments to accounting standards are the concerns related to fair value accounting. However, this is a false premise for change because the pro-cyclical effects of fair value accounting are overstated.

- The changes have a short term orientation and mainly cater to financial institutions. They mainly aim to improve quarterly financial results of the financial institutions. This will likely compromise the comparability of financial institution performance.

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

- The due process was 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.

- Amendments to accounting rules that curtail fair value accounting do not seem to be congruent with the other interventions by the governments during 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.

- The EC proposed amendments place the IASB under undue pressure and the imposition of regional pressures could undermine the IASB and the convergence of financial reporting.

- There would be an inherent contradiction between measures that threaten to fragment current international financial reporting and the espoused intention of establishing global oversight capacity.

As the matters of accounting standards are under deliberation we encourage the legislative and regulatory policy makers to factor in:

- interests of the full range of stakeholders including investors;

- benefits of fair value measurement approach for financial instruments for investors and that is an inappropriate focus target when resolving the credit crisis;

- dependence by non financial institutions on the current accounting standard setting process and that a single sector cannot define the aggregate, desirable financial reporting framework;

- aggregate progress and benefits of international financial reporting convergence.

- consequences of any regional carve-outs on financial reporting standards. It will be a wasted opportunity if the EU was to forfeit its leadership role and reverse the progress made on the accounting convergence process. Carve-outs do not cater for the greater good of all preparers and users of financial accounting information.

KEY RECOMMENDATIONS

CFA Institute recommends that:

- 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 the 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 IASB and its accountability to its key stakeholders including investors.
- Political leaders resist the temptation to impose regional carve-outs of financial reports as this will reduce the comparability of financial reports for investors.

CFA INSTITUTE VIEWPOINT

FAIR VALUE MEASUREMENT

During the crisis, the question has arisen 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 conducted a substantial empirical study on these 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. However, these limitations are not unique to the fair value approach. In fact, fair value has a well established history of application under International Financial Reporting Standards (IFRS) running over 25 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 an amortised historical 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 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.

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 an independent standard setter, namely the IASB.

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

- 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. In addition, it can derail the ongoing convergence and improvement of global financial reporting.

CLOSING REMARKS

If you 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,

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CFA INSTITUTE

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.