ACCOUNTING FOR FINANCIAL INSTRUMENTS FOR BANKS

Joint Working Group of Banking Associations on Financial Instruments
October 1999
Executive Summary

“Accounting for Financial Instruments for Banks” sets out the position of the Joint Working Group of Banking Associations on Financial Instruments (JWGBA) (the banking associations of the United States, Australia, Canada, Japan and the European Union) on the measurement of financial instruments by banks in the primary financial statements. The paper concludes that the mixed measurement system provides the optimal means of reporting financial performance. A separate paper has been prepared in response to the Joint Working Group of Standard Setters’ paper “Financial Instruments – Issues Relating to Banks” dated 31 August 1999.

Both the mixed measurement and fair value accounting models are considered in relation to the qualitative characteristics that make information “useful”. It is concluded that:

- users of bank financial statements do not support the proposed change to full fair value accounting. This is because a full fair value system does not provide a sound basis for predicting banking book net cash flows and lacks relevance.

- banking book income is earned on an ongoing basis over time and not from taking advantage of short term fluctuations in prices; the accruals accounting method provides a dynamic and faithful representation of both this earning process and the manner in which a bank’s management operates. It, therefore, provides a more relevant and reliable representation of this earning process. A notional fair value snapshot taken at a historic balance sheet date fails to achieve this.

- fair value accounting is perceived by the standard setters as solving problems with issues relating to hedging and management intent. The reality is that fair values for a banking operation are significantly more subjective than values derived under the mixed measurement accounting model and this would reduce both the reliability and comparability of financial statements.

- financial statements prepared using the mixed measurement method of accounting are well understood by users who have developed sound and extensive financial management processes that rely on this information as a basis for economic decision-making. A move to a full fair value measurement basis would represent a radical change to those analytical processes. This should not be undertaken as the case for such a radical change has not been made with sufficient conceptual justification.

Within any given accounting measurement model, it is not possible to encapsulate in a single measure everything that an investor needs to know. Both fair value and historical cost accounting need to be supplemented by appropriate risk-based and other disclosures in order to provide investors with a complete picture.

The JWGBA believes that the needs of the users of bank financial statements are already being met by the existing accounting measurement and disclosure practices of the banking industry. If there are areas where users’ needs are not being met, the JWGBA would welcome the opportunity to discuss how current practices could be improved.

It is important that a full and open debate on this important subject now takes place with contributions from all interested parties.
1 The objectives of financial reporting

1.1 The objectives of financial reporting for all entities, including banks, are to provide information:

- that is useful to present and potential investors, creditors and other users in making rational investment, credit and similar decisions;

- to help current and potential investors, creditors and other users in assessing amounts, timing and uncertainty of prospective cash receipts from dividends or interest, the proceeds from the sale, redemption or maturity of securities or loans, the entity’s capital transactions and other factors that affect liquidity;

- about the economic resources of an entity, the claims to those resources and the effects of transactions, events and circumstances that change resources and claims to those resources;

- about an entity’s financial performance given by measures of earnings and its components in order to help in assessing the prospects of an entity;

- about how management has discharged its responsibility to shareholders for the stewardship of the entity’s resources; and

- that is useful to management in making decisions in the interest of shareholders.

1.2 Of the above, usefulness for investor decision making is perceived as the key objective. In common with the frameworks of accounting standard setting bodies, it is envisaged that the objectives above can only be satisfied if the information included in financial statements possesses the following qualities:

- relevance (section 2);
- reliability (section 3);
- understandability (section 4); and
- comparability (section 5).

1.3 This paper concludes that, against each of the criteria in 1.2, the objectives outlined in 1.1 are best met for a commercial bank by use of the mixed measurement approach with additional disclosure, where appropriate, of fair values.

1.4 The consideration of all proposed accounting policies must include a review of the likely costs and benefits of changing the current policy. Introduction of a fair value accounting measurement system would almost certainly result in banks having to maintain two separate accounting systems. Accounting records would still have to be maintained on a historical cost basis to meet the needs of management information and of customers as it is inconceivable they would wish to receive fair value bank statements. A second system would be required to produce fair values for the financial statements. Such a requirement would represent a significant and unjustifiable cost for the banking industry in the light of any perceived benefit to be gained from reporting fair values for all financial instruments.
2. **Relevance**

2.1 **Fundamental question**

The fundamental question that requires consideration is:

“For a commercial bank, are the external primary financial statements more relevant if prepared using a full fair value measurement basis than if prepared under the existing mixed measurement framework?”

2.2 **Capable of influencing decisions**

2.2.1 For information to be relevant, it must be capable of influencing economic decisions made by users by helping them to evaluate past, present or future events or confirming, or correcting, their past evaluations. Such decisions include whether to purchase, sell or continue to hold equity and/or debt positions in a bank. These decisions are made by reference to the bank’s financial performance together with specific performance ratios such as earnings per share and return on capital. Fair values alone are not sufficient to influence decision making.

2.2.2 Information about a bank’s risk profile is also important in the assessment of its financial position and prospects. Supporters of fair valuing all financial instruments have, to date, seemingly been influenced by an interest in market risk and the desire to use fair values as a proxy for providing information on that risk albeit that the fair value will be historic and, therefore, not useful for prediction given the time that elapses between the balance sheet date and that when the financial statements are approved and subsequently distributed to shareholders.

2.2.3 Market risk, however, is only the prime risk with regard to a bank’s trading activities where the bank stands to gain or lose through short-term movements in rates or prices and engages in transactions with that short-term objective. Such business is, generally, conducted against a backdrop of openly quoted changing market values and it is widely recognised that fair value is the most appropriate measurement basis for recognition.

2.2.4 However, fair values tell the reader little about a bank’s risk profile and that adoption of a fair value measurement basis for trading activities has not obviated the necessity for extensive supplementary disclosures on banks’ market risk profiles.

2.2.5 In the non-trading or banking book, the principal risk is not general market risk but credit risk. Credit risk is managed over time; for the majority of loans, credit risk does not result in any loss despite fluctuations in the perceived credit rating of the borrower over the period of the loan. Financial information based on the historical cost of the loan is more relevant to users as it is the amount which the bank stands to lose if the borrower defaults.

2.2.6 Income earned from banking book transactions and other income, such as commissions, reward banks for assuming risks that are mitigated through active management on a portfolio basis – a process known as asset and liability management. Asset and liability management utilises transactions with customers
wherever possible but will also involve loans and deposits in the wholesale markets, the issue and purchase of debt securities and the use of derivatives where appropriate. Its purpose is to ensure that any potential adverse effect on liquidity and structural interest rate risk is reduced and a margin is earned over the life of the portfolio in line with the risks being borne. Historical cost measurement provides the most appropriate accounting information required to manage inherent portfolio risks and is, for that reason, the most relevant basis to report information on which to assess management’s performance. Banks’ management of structural interest rate risk is best explained in supplementary information to the financial statements by way of, for example, a table illustrating repricing intervals for non-trading financial instruments or by sensitivity analysis.

2.2.7 Users do not favour replacing the current mixed measurement system because it provides them with information that is useful in understanding the business and identifying trends and in valuing a business by projecting earnings and cash flows. It, therefore, gives access to the core financial information that shapes users’ decisions.

2.3 Predictive value of information

Future prospects

2.3.1 To be relevant, the information presented should have a predictive value and be considered to make a useful contribution to the predictive process, even though it is not the information itself that is judged to be a prediction of future outcomes. Relevant information will reduce uncertainty, thereby enhancing its predictive value.

2.3.2 In assessing the financial performance and future prospects of a commercial bank, there is no evidence that users such as investors and practising analysts would prefer fair value accounting to be used to measure banks’ non-trading or traditional banking activities in the primary financial statements, as opposed to disclosure of this information. Many banks already make additional fair value disclosures in the notes to their financial statements; few questions are ever asked about this data. Fair value data is perceived to be of limited usefulness as future net cash flows in a banking book cannot be predicted from fair values. The investor community bases its decision making on transaction-based measurements. This data is reliable and represents the ‘hard’ values that analysts and investors can depend on to pay dividends, repay loans and invest in growth. By contrast, fair values are ‘soft’ and detached from the underlying transactions and there is no demand from users for its use as the measurement basis for the primary financial statements of banks.

2.3.3 Reporting market values at a historic point in time has little predictive value since markets are, by their nature, volatile. For this reason, the balance sheet value of non-trading assets should not be based on short-term price movements. Where banks report fair values of non-trading items, use of these for comparative analysis is discouraged by those banks because they do not represent the value of certain financial instruments to the bank as a going concern. Rather they are an opportunity cost valuation at a point in time based on the key assumption that liquid markets are available. Furthermore, these fair values are likely to be out of date not only when they become available to users, but also shortly after they are prepared.
2.3.4 Application of a fair value measurement basis to a bank’s non-trading book would result in reporting information that is unrelated to the economic substance of the transactions which gave rise to the amount being “fair valued” and which, therefore, has limited predictive value. One of the principal factors affecting profits and losses, therefore, would not be whether the bank achieved a margin on the principal advanced but whether there had been incremental changes in the unrecognised gains or losses arising from unhedged changes in market rates. This is not useful for measuring banks’ performance as it is an inappropriate basis for judging the performance of lending and other non-trading activities, whether externally or internally by bank management.

*Risk profile*

2.3.5 Additional qualitative and quantitative information about banking risks can significantly assist users in understanding the risk profile of a bank and in making predictions on future performance. This profile cannot be properly represented in a balance sheet measured at fair value. Many of the assumptions concerning the various risks and their effect are necessarily based on highly subjective assessments of the consequences of future events or events that have not yet fully unfolded.

2.4 *Effect of management intent on performance*

*Transfers between portfolios*

2.4.1 One common criticism of the currently used mixed measurement system for bank accounting is that it relies on management intent resulting in information that is subjective and difficult to verify. However, no evidence has been produced to demonstrate that this concern is valid.

2.4.2 This argument assumes that management categorisation between trading and non-trading books is entirely subjective, whereas in reality the different books result from essentially different business activities – trading books from banks’ dealing operations in the financial markets and their non-trading books from their retail and commercial banking business. For both internal management and external reporting purposes, a clear division is required to be made between trading and banking book activities. These rules govern both the initial allocation of the trade to a book and transfers between the banking and trading books, with disclosure required of gains and losses arising on the disposal of banking book assets. These transfers are required to be made at market value. In addition, the banking/trading split is clearly disclosed in the financial statements to enable the user to evaluate the impact of management’s actions in this area.

2.4.3 Management intent is already a feature of other accounting measurement principles. For example, the classification between fixed assets and current assets is effectively determined by intention relating to use within the business and different accounting policies apply to the two categories. It is, therefore, an accepted accounting convention that different values can appear in the balance sheet for similar items depending on the nature of their use.
2.4.4 It has also been alleged that the existence of investment portfolios permits management to cherry-pick assets for disposal to enhance earnings. Banks generally disclose investment gains or losses recognised in their financial statements and the level of these gains reported as a proportion of their profits is comparatively low reflecting the strict rules that govern disposals out of non-trading books. The difference between the carrying value and the market value of accruals accounted investments is also disclosed. Accordingly users of the financial statements have relevant supplementary information to assess the possible impact on the bank’s financial position should it liquidate its portfolios in an economic and market environment identical to that existing at the historic balance sheet date.

Hedge accounting

2.4.5 Supporters of a comprehensive fair value approach cite the difficulties of accounting for hedges as a key problem caused by using a mixed measurement approach. However, hedging is an economically sound activity in that it allows an entity to manage the variability of cash flows. Accounting treatments that recognise the fair values of hedging items do not report an entity’s result faithfully. A framework for the proper reporting of hedging activities has already been developed using a mixed measurement model.

2.5 Application of the ‘relevance’ criteria

Loans and advances to customers

2.5.1 In order to be useful to investors, the financial statements of a bank should include information that enables a user to make decisions regarding the future profit-generating capacity and cash flows of that bank. For this purpose, information required for loans includes the principal amount lent, the interest being generated from those loans and the amount of the loan principal expected to be recovered. Extensive disclosures are, therefore, provided in a bank’s Operating and Financial Review about the nature and concentration of credit risk. Users also require an assessment of the potential for future loan growth and an understanding of management’s strategy for developing that business.

2.5.2 It has been argued that the development of securitisation and credit derivatives means that management can realise loan fair values readily. However, outside the USA these markets are miniscule compared with the overall stock of bank loan assets. Furthermore, securitisation is rarely identical to the sale of an asset and the value realised by a securitisation is not the equivalent of a fair value. The securitising bank normally retains a residual interest in the assets or supplies credit enhancement. Credit derivatives markets are in their infancy and are currently little used by banks to adjust credit risk profiles within their banking books.

2.5.3 Notwithstanding the development of securitisation techniques and credit derivatives, it remains the case that customer loans are generally held to maturity by banks without variation of the original contractual terms of the loan. Accounting for these loans on an historical cost basis, therefore, most closely reflects the economic substance and cash flows, namely, that income is earned over the period of the loan. The bank is exposed to risk on the non-repayment of the principal advanced.
2.5.4 It has been argued that the fair value of a customer loan provides relevant information about the current credit quality of that loan; as a borrower’s credit standing deteriorates, the credit spread demanded rises and therefore the fair value falls and a loss occurs. However, this loss is theoretical because the widening of the spread neither has an impact on the existing loan contract nor on the ultimate repayment of the loan in the majority of cases.

2.5.5 The converse arises in the case of an entity’s own debt where a gain results. Higher credit spreads are usually charged to less creditworthy borrowers, but changes in credit spreads can be driven by factors that are totally unrelated to a change in a particular borrower’s credit standing such as supply and demand or market illiquidity. Therefore, the credit quality of a bank’s loan book and user information demands about risk concentrations are best met through risk-based disclosures and not through the single measure of fair value.

2.5.6 Furthermore, it must be understood that it is neither practicable nor realistic to assume that a large commercial bank could realise the difference between carrying value and fair value of its loan book as deep and liquid markets for such assets do not exist globally. Even if this could be achieved by selling these loan assets, this is not the purpose for which these assets are held and runs contrary to these banks’ business role. There is limited scope for hedging or modifying credit risk by using credit derivatives as markets are thin and restricted to the larger corporates in a very small number of markets.

2.5.7 The historical cost of the loan book represents useful information as it is the maximum amount that the bank could lose if the borrower defaults as well as the principal amount on which interest is charged. By contrast, the fair value of the loan book provides less relevant information as it is a function of the current credit spread and prevailing interest rates.

Retail deposits

2.5.8 Determination of a fair value for retail deposits illustrates the irrelevance of fair value measurement for banking book items. Retail deposits provide banks with a cheaper and more stable source of funds than the wholesale markets. Interest paid is not the only cost of the deposits. In order to attract deposits, a bank must advertise and provide branches and support services. Nonetheless, the total cost of retail deposits is generally less than the cost of borrowing in the wholesale markets at often volatile market rates.

2.5.9 If a bank were required to fair value its retail deposits, the difference between the ‘real’ costs and the cost of alternative funding would result in the recognition of an asset because the difference represents a saving to the bank. This asset is sometimes referred to as the “core deposit intangible”. Inclusion of such an asset in the balance sheet results in the recognition of internally generated goodwill on the balance sheet which is not generally permitted in financial statements.

2.5.10 Such an asset represents an ‘opportunity benefit’ for the bank. It will never be realised other than through the sale of the business as a going concern. Internal
management systems are not concerned with such opportunity benefits but rather the funding potential of these deposits. Therefore, of more value to a user when making decisions is the historical cost of the deposit base and the interest paid on it. Extensive average balance sheet and interest margin and spread information is already provided in the Operating and Financial Review section of banks’ Annual Reports and Financial Statements.

2.5.11 In a similar manner to the interest rate charged to its customers for borrowing (see paragraph 2.5.5), the interest rate paid by a bank to its depositors is also affected by the credit standing of that bank. On a fair value measurement basis, as the creditworthiness of that bank deteriorates, the credit spread demanded by depositors increases and the bank records a gain as the current value of its liabilities falls. This would be misleading.

2.6 Conclusion

A full fair value system for the measurement of financial instruments in the primary financial statements of the banking industry would not be an improvement on current practice with reference to the relevance criteria outlined in paragraphs 2.2.1 and 2.3.1 above. Fair valuing a bank’s non-trading items in the primary financial statements at an historic date does not improve the quality of information available to users of financial statements and may be misleading to those making economic decisions. Furthermore, where such information is provided in the notes to the financial statements it is not perceived by users as possessing attributes that contribute greatly to the predictive process. This is borne out by the emphasis placed on the use of the contractual future cash flows for traditional banking activities in preference to fair values in this area, even when the latter are provided, because measurement at fair value will not change the cash flows the bank will actually generate.
3 Reliability

3.1 Fundamental question

The fundamental question that requires consideration is:

“Does a full fair value accounting model faithfully represent the commercial effect of a bank’s non-trading transactions and would the results be free from material error and bias?”

3.2 Faithful representation

Revenue recognition

3.2.1 It is important that the framework used by management for decision making is reflected in the financial statements so that the user can assess the performance of an entity in the context of the objectives of management. Furthermore, this framework should recognise revenues and profits on a basis that is consistent with the fundamental profit-earnings process that is occurring in the business. For a bank, that profit-earnings process is different for banking and trading activities.

Banking activities

3.2.2 At its simplest level, banking consists of raising funds and investing these funds in assets. Banks aim to make a profit by earning a margin between the amount received on interest-earning assets and the amount paid on interest-bearing liabilities. In undertaking these activities banks act as intermediaries between their customers, on the one hand taking deposits and on the other making loans on terms that meet customers’ needs. These activities are best measured on a historical cost basis because revenue is earned by the accrual of interest on a daily basis and not by taking advantage of short term fluctuations in fair value.

3.2.3 Central to this function is the customer relationship that the bank enters into on a long-term basis. The focus of management when entering into both lending and deposit taking activities is the margin that the transaction is expected to generate together with any related fee income arising from cross-selling other products or services. For example, the provision of a current account would be expected to provide both incremental net interest income (from the low interest or interest-free nature of the account) and fee income, either from service charges levied on the running of the account itself or from other facilities, such as the provision of foreign currency or from the sale of other products such as residential mortgages, credit cards or household insurance. The same relationships also hold for corporate business as banks increasingly focus on the totality of income earned from a customer relationship when determining pricing for any one product.

3.2.4 It follows that a bank’s management is not interested in either the current value of the banking assets or liabilities at a point in time, because it does not reflect the nature of the transactions that have been entered into, or the completed set of income streams likely to result. There is no intention to dispose of the assets or liabilities in question; indeed in many cases the bank would not be able to do this. The transactions are part
of a long-term customer relationship under which income accrues over time and fair value measurement would fail to reflect this.

3.2.5 Applying fair values to the banking book would result in transactions being depicted in a manner that is entirely unrelated to their commercial substance. Gains and losses would be recognised following changes in theoretical market rates and not when income has been earned or a loss incurred. This is not a faithful representation of the earnings streams that are generated from banking book transactions.

Non-banking (or trading) activities

3.2.6 A bank’s trading activities are fundamentally different in substance from banking activities. The objective of management when trading is to profit from short-term fluctuations in market prices. In a trading environment, where active decisions are taken to hold financial instruments as well as dispose of them, a fair value basis of measurement better represents the transactions entered into and management performance.

3.3 Freedom from material error and bias

3.3.1 Advocates of the fair value basis of measurement argue that robust fair values suitable for inclusion in a set of financial statements are available for many financial instruments. Examples in support of this are cited as:

- the existence of active and liquid markets for many financial instruments;
- the use of current values for internal risk management purposes;
- for many financial instruments, cost is likely to be a reasonable approximation of fair value;
- companies reporting in accordance with US GAAP are already reporting fair value information for all financial instruments; and
- models have been developed by financial institutions and others to value financial instruments for which there is no active market.

3.3.2 Although it is acknowledged that, in some cases, fair values will not be readily available and estimates and assumptions will need to be made, this is not regarded by standard setters as undermining the integrity of the approach. It is acknowledged that assumptions and estimates play an important role in the mixed measurement system and that fair value estimates should be evaluated in relation to the range of estimates accepted in other areas.

3.3.3 This grossly underestimates the fundamental difficulties associated with arriving at fair values for many of the most common financial instruments. Given the high level of gearing in a bank’s balance sheet, the effect of errors or inaccuracies in the calculation of fair values will be greatly magnified. In these circumstances it is hard to envisage how the directors will satisfy themselves that they have fulfilled their legal obligation to prepare financial statements showing a true and fair view. In addition, discussions about auditability have concentrated on the difficulty of auditing the range of possible model outcomes and serious concerns were expressed about how models subject to a wide range of management discretion could be audited. Given that for many financial instruments there is no readily available market value, and
that, therefore, widespread use of internal models developed by management would be required for external financial reporting, it is questionable whether the resulting fair values will be capable of being audited and a “true and fair” view audit opinion expressed.

3.3.4 The “fair values” calculated using discounted cash flow techniques and credit spreads determined by management will not be a “fair value” within the definition used for financial reporting, that is, the amount at which those loans could be sold in an arm’s length transaction between informed and willing parties.

3.3.5 The introduction of an accounting measurement framework based on fair values would lead to an unacceptable level of subjectivity. Opponents of the existing mixed measurement system contend that it allows management to manipulate disclosed earnings, either by the selective realisation of gains or the establishment of excessive provisions. Given the probable dependence of the models required to arrive at fair values for many non-traded instruments upon the underlying assumptions made by management, in our view a full fair value system is likely to offer more opportunity for “creative accounting” than is currently the case. There will not be any reduction in the degree of subjectivity necessary for determination of loan loss provisions but the assessment of credit spreads by management will only serve to increase subjectivity in measurement.

Active and liquid markets

3.3.6 Whilst active and liquid markets exist for a number of financial instruments, principally debt securities of various kinds, equity shares and certain derivative products, there is no market of any substance for loans and deposits. In 1998 the volume of loans traded on the secondary market in Europe totalled approximately US$30 billion. This represents 0.66 per cent of the estimated US$4,500 billion of total outstanding lending.

3.3.7 As stated in 2.5.2, securitisation remains in its infancy outside the US market and is unknown for many classes of asset. Furthermore, in some jurisdictions, legal constraints limit the possibility of effective sales of loans.

Internal risk management

3.3.8 Knowledgeable users of financial instruments have well developed internal risk management functions. These functions use a number of different risk management techniques reflecting both the underlying nature of the transactions and all the inherent risks. In this process, fair value information is not used for traditional banking operations (other than for assets held as part of the asset and liability management process).

US reporting

3.3.9 A number of banks reporting under US requirements already provide fair value information for financial instruments. However, the provision of this information by way of a note to the financial statements is generally accompanied by “health warnings” as to its reliability. This is because the level of assumptions and estimates
that have been made would not be considered acceptable for financial reporting in the primary statements.

Models

3.3.10 Whilst some models exist for valuing financial instruments, these are generally only available to support trading activities. New models would need to be developed to deal with the lending and deposit portfolios and much work has recently been done on credit risk models. However, the paper published by the Basel Committee in April 1999 “Credit risk modelling, current practices and applications” noted the significant problems that still need to be overcome before these models are conceptually sound, empirically validated and comparable across banks. Because models vary owing to the assumptions used in creating the model and the sensitivity of the variables input, they cannot be considered reliable. This weakness could be addressed by requiring the use of a standard model with a pre-determined range of variation allowed in the inputs. However, banks operate in evolving markets, sensitive to external change, for example, in the economy, and, therefore, any such restrictions would quickly become out of date rendering the model irrelevant.

3.4 Loans and deposits

3.4.1 The balance sheets of most commercial banks are dominated by lending to, and deposits from, customers. To measure these balances reliably on a fair value basis would cause particular problems as set out below.

Loans

3.4.2 Loans can be classified into two broad groups comprising non-homogeneous (for example, commercial and larger personal loans), and homogeneous loans. For the former, credit quality may be monitored individually for each loan whilst for the latter, credit quality may be measured on a pooled basis for a collection of similar loans (for example, credit card and personal loans). Homogeneous loans are typically classified into pools of loans with similar characteristics that will be affected by similar factors and to a similar extent when those factors change. The credit quality of such loans can accordingly be assessed on a collective rather than an individual basis.

Non-homogeneous loans

3.4.3 There is virtually no market for non-homogeneous loans. Therefore, fair value can only be estimated using discounted cash flow techniques that employ, for example, forward rates from the zero coupon yield curve for loans with the borrower’s existing credit rating. However, there is no published or reliable data available on the current credit spread for most borrowers and only very limited alternative sources in the form of prices of traded debt securities. Any estimate of credit spread would need to be made using internal pricing guides and/or the prices offered by other finance providers. Internal pricing guides provide only a general indication of the rate to be charged and this rate will be determined having regard to the bank’s relationship with the individual customer and the range of products and services provided. In addition,
the range of products in the market renders any precise comparison with other lenders impossible.

3.4.4 The credit spreads applicable to many of these loans will reflect different levels and types of security held as collateral. A high degree of subjectivity would also be inherent in such valuations owing to the range of estimates available for the discount rates and other parameters applied in the discounted cash flow calculations used in such models. This would become increasingly significant as the term of the loan increases.

3.4.5 An upgrade or downgrade in the borrower’s creditworthiness will result in a change in the fair value of the loan (see paragraph 2.5.5). Fair value will also change if there is a shift in the credit spread caused by, for example, competition or volatility in the lending market, as the current rate for the loan will differ from the rate charged under contracts with existing borrowers.

3.4.6 Stock and bond prices exhibit considerable randomness or ‘noise’ unrelated to identifiable economic fundamentals. This includes exaggerated price swings caused by disproportionate changes in market sentiment and speculative activity. Recent examples of market movements provide ample evidence of the extent to which market prices can move, particularly in thin markets, without economic justification. Any attempt to adjust for perceived abnormality in the markets will add more subjectivity to the reporting process. Full fair value measurement may exhibit volatility that does not reflect an institution’s underlying economic value.

3.4.7 Impairment could be factored into the discounted cash flow calculations on an individual basis. However, this will introduce further subjectivity into the valuation process because estimates of the recoverability of future cash flows will need to be made and will often be complicated by the requirement to take account of the value of the collateral held.

Homogeneous loans

3.4.8 The fair value of homogeneous loans would also be determined using discounted cash flow techniques that suffer from many of the problems experienced with non-homogeneous loans. Under this method, the cash flows from the loans in a pool are aggregated into different time buckets based on their due date, and discounted at the forward rates derived from the zero coupon curve applicable to the loans in the pool. As for non-homogeneous loans, the discounted cash flows will become increasingly subjective as the terms of the loans increase.

3.4.9 For certain loan products such as fixed rate loans, using the contractual due dates in the valuation model will be inappropriate since this ignores the existence of the embedded option for the borrower to prepay, with or without penalty. Therefore, any estimate of future cash flows will be based on a model that captures both future interest rates and consequent borrower behaviour. As borrowers often do not exercise their embedded option on a rational basis, any resulting valuation will be highly subjective and not comparable between banks other than in established securitisation markets, most notably the US mortgage market. Similar problems will also be encountered for pools of loans such as credit card receivables with no fixed maturity.
Retail deposits

3.4.10 The retail deposit base represents a core source of funds for many banks. There is no market for retail deposits and it is not possible to determine a sufficiently reliable fair value for such instruments for financial reporting. Valuation of retail deposits also presents other difficulties as it will require an understanding of the behavioural patterns of a bank’s customers. For example, current accounts and some deposit accounts can be withdrawn without notice. However, in practice a large element of these deposits may remain in place for the long term and often form the basis of a bank’s relationship with its customers. Any estimates of fair value will, therefore, need to incorporate an estimate of the average maturity of such deposits which will be subjective and will also include an element of goodwill reflecting the future value of the customer relationships.

3.4.11 The valuation of fixed term savings accounts presents similar problems. Many accounts of this kind will earn interest at a sub-market rate, reflecting the nature of the product and size of the deposit. Consequently, a fair value measurement basis would result in a gain being recognised at the inception of the transaction. This is inappropriate because the gain crystallises over a period of time as the bank invests the funds received at a higher rate of interest, thereby securing its return.

3.5 Conclusion

3.5.1 The mixed measurement basis faithfully represents the earnings process in banks for both the banking and trading books. For the banking book, income is earned on an ongoing basis through the intermediation period, not from gains or losses arising from short term holdings of positions in the expectation of market changes which is undertaken in the trading book. The reporting is also free from bias as banking book transactions are recorded at their cost at acquisition which is unbiased by subsequent judgement and market changes except in instances of impairment.

3.5.2 Fair valuing items in the banking book does not link to the earnings process. In addition, such a measurement basis would be highly subjective in its determination of amounts to be recognised in the balance sheet. This arises from the lack of tradability and trading of the underlying instruments. Establishing value will require significant assumptions concerning liquidity, credit worthiness, collateral realisability, optionality and expected customer behaviour. Extensive subjective judgement seriously undermines the reliability of fair value accounting as a basis of measurement.
4 Understandability

4.1 Introduction

The fundamental question to be addressed is:

4.1.1 “For a commercial bank, does measuring all financial instruments at fair value result in a presentation of information in the financial statements which is more understandable and thus enables users to make economic decisions better than under the existing framework?”

4.1.2 First, changing the way in which financial instruments are measured also changes the way the resulting values need to be presented in a bank’s financial statements. This issue does not arise in the same way for non-financial entities whose use of financial instruments is more incidental to their core activities. Secondly, it is also the case that behind any decision to choose between different models for measuring financial instruments will lie value judgements about what is significant.

4.1.3 Imposing fair value accounting for financial instruments held in the banking book creates inherent presentational problems and difficulties in understanding for even relatively sophisticated users. Additionally, and more seriously, it reflects an unbalanced view of what is significant not only for this area in a bank’s financial statements but also for a bank’s financial statements as a whole. Understandability would thereby be reduced.

4.2 Presentation

4.2.1 The existing mixed measurement system is well understood by users. Any change to a full fair value measurement basis represents a radical recasting of financial reporting. Attendant problems are more fundamental than those associated with educating users in a new accounting policy. The manner in which financial performance is to be presented must be articulated fully. The impact on users and their related financial processes also requires consideration. Proposals for measuring banking book financial instruments at fair value have not addressed presentation issues in the primary financial statements.

4.2.2 Users of bank financial statements have well developed processes that utilise the existing historical cost information for the banking book. These processes include assessing the future cash flows that can be generated by the bank’s business. A fundamental change to the underlying accounting model will impact significantly on decision making processes of investors and should not be undertaken without full consideration of the implications for the investor community.

4.2.2 Lack of a specific framework in which the fair value movements of banking book financial instruments could be presented contrasts with the current reporting model which is well understood by users and is consistent with mixed measurement systems used by other businesses. Additionally it reflects the way in which the entity reports internally and assists management to communicate performance and financial position in a manner that most users understand.
4.3 **Significance**

4.3.1 The confusing recasting of banks’ reporting framework that a move to full fair value accounting would entail is said to be justified by standard setters on the grounds that it will provide users with better quality information about banks’ performance and financial position. This view is completely at odds with the view which exists amongst banks in this area and the lack of demand for change from users. Furthermore, to make such a change will obscure what is significant while highlighting that which is incidental.

4.3.2 Using fair values as a measurement basis implies that it is the management of the various risks (for example, credit risk and interest rate risk) assumed by a bank when it sells a financial product to a customer that is of prime significance in considering its performance and financial position. This is because performance in a period will be based on changes in the fair value. The banking industry would agree that this is the correct approach for trading books.

4.3.3 Commercial banking transactions such as loans and deposits are not entered into with a view to profiting from movements in market rates or changes in a customers’ credit risk; rather banks are seeking to earn a margin over the life of the transaction. Banking book risks are managed to secure this margin. Accordingly, measuring banking book transactions at fair value obscures more relevant and reliable information on performance which is provided by a historical cost measurement basis.

4.3.4 This is illustrated by examining the reporting of a bank’s interest-earning activities under the current framework. Net interest income that a bank earns is determined by the rate of interest it earns on its interest-earning assets, the volume of these assets, the interest rate it pays on its interest-bearing liabilities and the volume of its net free funds. It is one of the key sources of a bank’s income. Management uses certain key ratios to monitor trends in net interest income and provides users of the bank’s financial statements with extensive discussion on how net interest income has changed. These ratios are:

- interest spread – defined as the difference between the interest earned on average interest-earning assets and the interest paid on average interest-bearing funds; and

- net interest margin – being net interest income expressed as a percentage of average interest-earning assets.

Future cash flows that a bank can generate from interest income will, therefore, be determined by each of these factors. Analysts review closely how a bank’s margin changes over time, the volume of growth in interest-earning assets and how these may change going forward as these are key drivers of revenue growth prospects. These key ratios are calculated using historical cost data because this best reflects how a bank actually charges and pays interest.

4.3.5 By contrast, a fair value model would show net income including interest received and fair value changes and report interest-earning assets and interest-bearing liabilities at fair value. The relationship, therefore, between net income and interest-earning assets would bear little relation to the way in which income is earned. The net interest
margin derived under the fair value model by dividing net income by average interest-earning assets would have no meaning and would display trends that would be complex to explain and would have no predictive value. Hence, analysts in the absence of additional disclosures on an alternative basis, would be unable to assess key business drivers from the financial statements, such as the capacity of a bank to generate future cash flows from one of its major income streams. This is a serious weakness arising from the use of fair values as the primary basis for measuring banking book items in the financial statements.

4.4 Conclusion

The mixed measurement basis is well understood by the users of financial statements who have developed extensive financial management processes which rely on the information as a basis for decision making. Any change to fair value accounting for banking book will lead to financial statements being significantly more difficult to understand and will impair the understandability of financial statements.
5 Comparability

5.1 Fundamental question

The key issue to be considered is:

“Are financial statements prepared under a fair value basis more or less comparable from period to period, or between entities, than those prepared using a mixed measurement approach?”

5.2.1 Information provided by financial statements needs to be comparable. Comparability is desirable as it allows users to compare:

- an entity’s financial information over time in order to identify trends in its financial performance and financial position; and

- the financial information of different entities in order to evaluate their relative financial performance and financial position.

Comparability requires the consistent application of a reporting entity’s accounting policies both within each accounting period and from one period to the next. In order to compare the results of different entities, disclosure is required of the accounting policies used together with changes, detailing particulars, effects and reasons for the changes.

5.2.2 The mixed measurement system is a known and tried basis of accounting which aids comparability. It faithfully represents both the profit-earning process and management’s approach to the business. The level of subjectivity involved in the determination of profits under this system is limited to a small number of critical areas, for example, loan loss provisions. Resulting figures, and their limitations, are well understood by users of accounts.

5.2.3 Proponents of a fair value measurement basis claim that the mixed measurement approach is flawed because identical items have different carrying values if recognised at different times (in the banking book) or if acquired for different purposes (i.e. trading or banking). However, the different values are integral to an important element of comparability in banks’ financial statements. The mixed measurement approach distinguishes trading from banking activities and measures performance in both areas using different, but more relevant, measures.

5.2.4 Supporters of a full fair value model maintain that it provides greater comparability from the use of a common accounting policy – “fair value”. In practice, however, greater subjectivity will be involved because the underlying assumptions necessary to value the banking book are capable of wide variation. Adoption by entities of assumptions that differ, albeit only slightly, would significantly reduce comparability.

5.3 Conclusion

5.3.1 The existing mixed measurement system is well understood by users of accounts and provides a satisfactory degree of comparability. A move to full fair value accounting
would reduce, rather than increase, comparability. This would represent a radical change, the need for which has not been proven.
6 Overall conclusion

6.1 The mixed measurement system which reports the banking book at cost and the trading book at market values continues to provide the most appropriate basis for communicating financial information to investors, lenders, creditors and other users for use in making economic decisions and assessing management stewardship. It continues to be both relevant to users and reliable. It is well understood and allows for comparison between entities.

6.2 This system has been integrated into the financial markets and their related processes encompassing analysis, decision making and ascribing overall value to equity as well as reporting forming the basis of financial management. A change is, therefore, a change in the essential financial management model and should not be viewed merely in the context of financial reporting.

6.3 Fair value does not provide a conceptually sound basis for the measurement of a bank’s financial position and performance as it will not provide useful information to the users of financial statements in accordance with the qualitative characteristics of relevance, reliability, comparability and understandability.