

# COUNCIL OF INSTITUTIONAL INVESTORS

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## Via Email

April 30, 2009

Adam Van Eperen  
Financial Accounting Standards Board  
401 Merritt 7  
PO Box 5116  
Norwalk, CT 06856-5116

*Re: FCAG Written Submissions from Constituents*

Dear Mr. Van Eperen:

I am writing on behalf of the Council of Institutional Investors, a nonprofit association of more than 130 public, corporate and union pension funds with combined assets of over \$3 trillion. As the leading voice for shareowner rights and strong corporate governance, the Council appreciates the opportunity to assist the Financial Crisis Advisory Group (FCAG) in discussing accounting and reporting matters related to the financial crisis.

The Council recognizes that the global financial system is experiencing levels of stress unprecedented since the Great Depression. With the credit crunch and dramatic market decline has come an increased focus on how troubled financial instruments are valued. As financial institutions have seen their capital eroded due to write downs, some have called for the suspension or even the elimination of certain accounting standards issued by the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB). Such proposals are extremely troubling.

Accounting standards should be promulgated to serve the interests of investors, the key consumers of financial reports. Now more than ever, investors require accounting standards that report relevant and useful information—regardless of the direction of markets. Abandoning rigorous accounting standards amid market turmoil is no path to recovery. In order to restore investor confidence and help markets work through the ongoing crisis, the FASB and IASB should remain unquestionably committed to providing investors with the best and most timely information available.

We offer the following additional comments in response to the specific questions raised by the FCAG.

**Q1 From your perspective, where has general purpose financial reporting helped identify issues of concern during the financial crisis? Where has it not helped, or even possibly created unnecessary concerns? Please be as specific as possible in your answers.**

Despite the criticisms of some, fair value accounting when used and properly implemented has assisted markets in identifying areas of concern during the financial crisis. The self-correcting mechanism inherent in fair value has proven useful in the wake of now obvious “irrational exuberance” in credit and housing markets. As investors attempt to sort out the relative impact of the crisis on individual financial institutions, fair value measurements provide the relevant, timely, and comparable information markets need. By recognizing rather than obscuring expected future losses, fair value accounting helps investors and policymakers identify financial institutions most severely affected by the financial crisis.

More, rather than less, fair value accounting would further speed the road to recovery by providing this much needed transparency. As Professor Stephen G. Ryan of NYU notes in a recent Council commissioned white paper entitled “Fair Value Accounting: Understanding the Issues Raised by the Credit Crunch:”

Because of its timeliness and informational richness, fair value accounting and associated mandatory and voluntary disclosures should reduce uncertainty and information asymmetry faster over time than amortized cost accounting would, thereby mitigating the duration of the credit crunch.

**Q2 If prudential regulators were to require 'through-the-cycle' or 'dynamic' loan provisions that differ from the current IFRS or US GAAP requirements, how should general purpose financial statements best reflect the difference: (1) recognition in profit or loss (earnings); (2) recognition in other comprehensive income; (3) appropriation of equity outside of comprehensive income; (4) footnote disclosure only; (5) some other means; or (6) not at all? Please explain how your answer would promote transparency for investors and other resource providers.**

If prudential regulators were to require ‘through-the-cycle’ or ‘dynamic’ loan provisions that differ from the current IFRS or US GAAP requirements, the Council would not be opposed to disclosing those provisions through footnote disclosure. The Council, however, would strongly object to the recognition of those provisions in the face of the financial statements because doing so would reduce the usefulness of those statements to investors.

The Council appreciates the challenges of dealing with the financial instability resulting from the toxic assets held by banks and other financial institutions. However, changing financial accounting standards is not the solution to addressing regulatory capital problems. Investors and regulators need to know the fair values of loans and securities in order to make rational investment and policy decisions. Fair value accounting with robust disclosures provides more reliable, timely, and comparable information than amounts that would be reported under other alternative accounting approaches.

Whether or how fair values affect the capital requirements, and whether they should result in institutions' running afoul of such requirements, is a decision to be made by prudential regulators. The FCAG and others should not confuse the independent private sector accounting standard setter's role and responsibilities to provide useful information to investors with the role and responsibilities of the regulatory bodies charged with the oversight of the safety and soundness of financial institutions.

**Q4 Most constituents agree that the current mixed attributes model for accounting and reporting of financial instruments under IFRS and US GAAP is overly complex and otherwise suboptimal. Some constituents (mainly investors) support reporting all financial instruments at fair value. Others support a refined mixed attributes model. Which approach do you support and why? If you support a refined mixed attributes model, what should that look like, and why, and do you view that as an interim step toward full fair value or as an end goal? Whichever approach you support, what improvements, if any, to fair value accounting do you believe are essential prerequisites to your end goal?**

The Council in general agrees that the current mixed attributes model for accounting and reporting of financial instruments is fundamentally unsatisfying. We thus support fair value accounting for all financial instruments accompanied by robust disclosures. As Professor Ryan notes in the Council's white paper:

The mixed attribute model often allows firms to choose the measurement attribute they desire for a position through how they classify the position. For example, under FAS 115 a firm may choose to classify a security as any one of trading, available for sale, or held to maturity, and thereby obtain one of three different accounting treatments...

Similar to (and in some respects worse than) amortized cost accounting, the mixed attribute model poorly describes the net value and risks of financial institutions' portfolios of financial instruments. In particular, this model can make effective risk management by these institutions appear to be speculation, and vice-versa. For example, consider a bank that acquires fixed-rate securities that it classifies as trading and that finances those securities with fixed-rate debt with the same duration and other risk characteristics, so that the bank has no interest rate risk. If interest rates rise, then the bank's trading assets will experience an unrealized loss that is recorded in net income, while its debt will experience an unrealized gain that is not immediately recognized for any accounting purpose. Hence, this bank will appear to have been speculating on interest rate movements. Conversely, consider a bank that acquires floating-rate securities and finances those securities with the same fixed-rate debt as before, so that the bank is speculating that interest rates will rise. If interest rates do rise, then the unrealized gain on the bank's debt will not be immediately recognized for any accounting purpose and so the bank will appear to be immune to interest rate risk.

Because of these severe limitations...consistent fair value accounting for all of financial institutions' financial instruments is clearly preferable to either the current mixed-attribute accounting model or to a pure amortized cost model. Because amortized costs are useful as a check on fair values and for specific types of investment and other decisions, however, the FASB should require firms to disclose the amortized costs of financial instruments.

**Q5 What criteria should accounting standard-setters consider in balancing the need for resolving an 'emergency issue' on a timely basis and the need for active engagement from constituents through due process to help ensure high quality standards that are broadly accepted?**

The Council's policies support the need for a thorough public due process that includes solicitation of investor input on proposals and careful consideration of investor views before issuing proposals or final standards. We, however, would not object to accounting standard-setters' accelerating their due process in truly extreme and unusual circumstances in which a standard or other form of guidance is deemed necessary to resolve an "emergency issue" if, and only if, the following two criteria have first been satisfied: (1) the expedited due process includes solicitation and consideration of investor input; and (2) most of the investors solicited for input believe the proposed standard results in an improvement to financial accounting and reporting.

**Q6 Are there financial crisis-related issues that the IASB or the FASB have indicated they will be addressing that you believe are better addressed in combination with, or alternatively by, other organizations? If so, which issues and why, and which organizations?**

Much of the recent fervor surrounding fair value accounting seems to involve concerns regarding the impact of fair value accounting on financial institutions' regulatory capital. As discussed in our response to Q2, such concerns should be appropriately addressed by prudential regulators by exercising their statutory authority to make appropriate adjustments to US GAAP for regulatory capital purposes that they believe are necessary to foster safety and soundness and financial stability. We should not confuse the role of the independent private sector bodies responsible for developing and improving financial accounting and reporting standards to meet the information needs of investors with the role and responsibilities of the regulatory bodies charged with the oversight of banks and other financial institutions.

In conclusion, we wish to emphasize that the Council continues to support the ongoing efforts of the FCAG to work cooperatively with investors and other interested parties to develop recommendations to address accounting and reporting matters related to the financial crisis. We appreciate the opportunity to respond to the proposed questions. Please feel free to contact me with any questions at (202) 261-7096 or [jonathan@cii.org](mailto:jonathan@cii.org).

Sincerely,



Jonathan D. Urick  
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Council of Institutional Investors