Federation of European Accountants
Fédération des Experts comptables Européens

Policy Statement

Standing for trust and integrity

March 2009

The Accountancy Profession's Contribution to the Debate on the Crisis (IV)

Dynamic Provisioning for Financial Instruments

FEE, the Federation of European Accountants – Fédération des Experts comptables Européens, wishes to contribute its views and experience to the debate on the current crisis, the ways to mitigate its effects and to speedup recovery. This paper presents the views of FEE on dynamic provisioning. Three other papers have been issued in December 2008, one presenting background information and analysis on the crisis (I), a second paper on the matters of specific relevance for statutory auditors during the financial crisis (II), and a third paper containing views of specific relevance to SMEs (III).

About FEE

FEE represents 43 professional institutes of accountants and auditors from 32 European countries, including all 27 EU Member States. It has a combined membership of more than 500.000 professional accountants. In representing the profession, FEE recognises the public interest. Professional accountants work in different capacities in public practice, business, and public sector; based on the practical experience gained in this daily involvement in all aspects of the economy and the set of values underpinning the profession's practice, FEE believes it has a contribution to make in the current discussions.

Background

The financial crisis has accelerated the discussion on the need to introduce anti-cyclical measures to the global system of financial regulation and to a certain extent also to financial reporting. Such discussion inevitably opened the issue whether and to what extent to converge regulatory/prudential financial returns and general purpose financial statements. One of the related issues discussed is the level at which both types of reporting have contributed to pro-cyclicality. Also the de Larosière report as issued at the end of February 2009, refers to pro-cyclicality in recommendation 4: *"accounting standards should not bias business models, promote pro-cyclical behaviour or discourage long-term investment"*.

In the current discussions on reporting implications of the financial crisis dynamic provisioning is often mentioned as one of the possible "solutions" to avoid pro-cyclicality not only in the prudential returns but also in the general purpose financial statements. G20 has a work stream on dynamic provisioning in preparation for its April 2009 meeting.

Dynamic provisioning

There is no clear and common understanding or shared general definition of what dynamic provisioning is. Various approaches are using loan specific, entity specific, country specific loss expectations, in most cases covering the whole period to maturity of the loan. Depending on the country, history and culture different views are held about what is a dynamic provision and whether such a provision is compatible with IAS 39. There are also differing views on when an "incurred loss" is incurred, opening the issue whether the current model is consistently understood and applied.

The underlying question is whether general purpose financial reporting should embrace provisions for future losses on existing loans/receivables which arise from events or circumstances which have not yet arisen but which are expected to arise over the term of the loan, i.e. an expected loss model. Should such an expected loss model be considered rather than continue with a conservatively applied incurred loss model as currently applied?

The mainstream understanding of expected loss provisioning is a provision for expected losses that have not yet been incurred, but have been priced into loan portfolios at inception. This expected loss provision is formed in periods where incurred losses are below the expected loss figures and is released in periods in which the incurred losses exceed the expected loss figures. Beyond that our understanding is that some commentators would welcome general "reserves" which might be established in "good times" and released when it is perceived that "bad times" are creating incurred losses. Both the expected losses and general reserves referred to above are contemplated within our understanding of the various definitions of dynamic provisions. The key input into this dynamic provisioning model is the expected loss and its allocation between reporting periods.

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FEE position

Regulatory reporting and general purpose financial reporting have different objectives. Financial stability is primarily the responsibility of the regulators. The financial reporting role in financial stability is to provide and in the current circumstances restore market confidence by providing transparency and a true and fair view on financial performance and position in individual reporting periods. This role is so important that it should not be biased by attempts to counter potential pro-cyclical effects, which do not reflect the inherent underlying economical cyclicality faced by the reporting entity. Dynamic provisioning itself could also contribute to the pro-cyclical effect, when the provision is increased in "bad times" since even higher losses in "worse times" may be expected.

Regulators are only one of the stakeholders of financial statements and their main objective is to ensure the long-term stability of the system on behalf of depositors, which results in the incentives to keep the necessary capital within the financial institutions whereas shareholders and investors require a more performance oriented view. Including dynamic provisions – whereby the provisions are recognised as liabilities through a profit and loss charge – and which have a prudential objective, in general purpose financial reporting standards will not be helpful to investors and other stakeholders to understand the results of the period concerned or assess the quality of the earnings. Therefore, what is appropriate from a regulatory point of view is not necessarily the best presentation from a general purpose financial reporting point of view.

Good cooperation between the regulators and accounting standard setters is important and we welcome their increased cooperation in this respect.

FEE is of the opinion that transparency of the financial performance is the key objective of financial reporting and therefore regulatory adjustments should not automatically have financial reporting implications, since this approach does not distinguish periods of good and bad financial performance. Financial reporting should make the underlying economic reality including the economic cyclicality transparent. We support the IASB Conceptual Framework Approach that the objective of financial statements is to provide information that is useful to a wide range of users in making economic decisions, with priority given to the needs of providers of debt and equity capital. Primacy should not be given to the needs of governments and regulators since they typically have the power to obtain additional information directly from the company's management.

What preferable action should the international accounting standard setters take?

Short term view

If regulators allow entities to set up a dynamic provision for regulatory purposes ("economic cycle buffer") as part of their short-term agenda based on the de Larosière report then part of non-distributable reserves in equity in the general purpose financial statements could be allocated as a buffer with proper note disclosures whereby the amount is determined in the prudential returns (by the regulatory rules). FEE is not supportive of any form of dynamic provisioning in general purpose financial statements affecting net assets or performance measures of the reporting entity.

FEE also encourages the IASB to provide further educative guidance and explanation as to how to conservatively apply IAS 39 for incurred losses since the incurred loss model is not equally applied by users in various territories. Such guidance would notably need to address the link to past events and losses inherently existing based on historical evidence adjusted for current circumstances.

Long term view

Any more fundamental change of general purpose financial reporting that would be considered by the IASB including potential move away from the current incurred loss model perhaps towards an expected loss model represented either by dynamic provisioning or a fair value model should be subject to in depth discussions and consultation and the full due process would need to be followed. The consistency with the currently discussed Conceptual Framework and other ongoing IASB projects, notably on financial instruments and fair value measurement (of which dynamic provisioning could be considered a sub-set, needs to be taken into account. In addition it is important that any changes to financial reporting should be made at a global level to IFRS to support comparability and maintain a level playing field. ■