european contact group

Square de Meeus, 37
1040 Brussels

Commissioner Charlie McCreevy
European Commission
Rue de la Loi, 200
B-1049 Brussels

Date: 31 March 2009

Dear Charlie,

Dynamic Provisioning of loan portfolios

At a recent meeting between representatives of the large firms and Pierre Delsaux, Juergen Tiedje and Jan Robberechts of your Directorate General, Pierre asked us to provide some thoughts on the issue of dynamic provisioning and, in particular, to suggest ways in which the objectives of those charged with oversight of the banking system could be accommodated without undermining the primary purpose of financial reporting.

Dynamic provisioning has often been mentioned in the context of the current crisis with a view to introduce anti-cyclical measures to the financial system. However, there is some confusion as to what the term “dynamic provisioning” really means. The European Accounting Federation, FEE, has recently provided a useful analysis of the different understandings of dynamic provisioning, with which we concur. A copy is attached to this letter.

Whilst we support the European Commission’s efforts to introduce some anti-cyclical measures in order to enhance stability of the financial system, it is essential to acknowledge differences between the objectives of prudential supervision and the primary purpose of financial reporting.

Accordingly, we believe that any element of prudential accounting should be considered in the context of the EU Capital Requirements Directive for Banks and not financial reporting.

For the purposes of this letter we have categorised the various dynamic provisioning proposals made by different commentators into two general categories:

1. Improvements to or changes from the “incurred loss” model employed by current IFRS, and
2. Introduction of a “Buffer Fund” to address cyclicality

Improvements to or changes from the "incurred loss" model employed by current IFRS

We support the European Commission's encouragement of the work being undertaken by the IASB and FASB on loan loss provisioning, which includes consideration of the expected loss model as a possible alternative to the currently used incurred loss model. We believe that a comprehensive project on impairment designed to meet the needs of debt and equity providers is the right way to proceed and should lead to alignment of impairment measurement for both standard setters.

However, we do not support proposals to introduce into financial reporting an excessively conservative model for loan loss provisioning that could undermine the primary purpose of financial reporting to provide a true and fair view of financial performance and financial position for the reporting period.

Introduction of a "Buffer Fund" to address cyclicality

Many commentators have proposed the establishment of a counter-cyclical "Buffer Fund" for regulatory purposes. If these proposals are implemented, the issue for financial reporting is whether and, if so, how the "Buffer Fund" should be recognised in financial statements.

One suggestion is that the "Buffer Fund" could be created by establishing additional loan loss provisions (or otherwise adjusting the carrying value of loans to reflect future losses) through the income statement or the statement of other comprehensive income.

We strongly object to this proposal because this accounting treatment would compromise the role of financial reporting. We believe that incorporating provisioning which has a prudential objective in accounting standards used for financial reporting purposes will make it more difficult for investors understand the results for the period in question or assess the quality of earnings. Applying a mixture of financial and prudential accounting in the financial statements will damage the transparency, consistency and comparability of financial statements to the detriment of capital market users.

An acceptable alternative

Whilst we do not support proposals to create a "Buffer Fund" by way of dynamic provisioning and impairment measurement, we acknowledge the need to reflect the impact of such a fund in the financial statements. This could be achieved by a transfer out of retained earnings into a separate reserve. Any increase or decrease of this Buffer Fund must not be included in comprehensive income.

For users of financial statements to fully understand the implications of this reserve, adequate disclosures will be necessary in the notes to financial statements.

In addition, bank regulators should provide adequate rules with respect to the calculation of these reserves. If these reserves are not to be available for distribution, this will need to be specified by the banking regulators.

If you would like to discuss these views further with representatives of the large firms, please let me know.

With kind regards,

Yours sincerely,

Jeremy Jennings

cc Commissioner Joaquin Almunia
Marco Buti, Director General, DG Economic & Monetary Affairs
Joao Vale de Almeida, Cabinet of President Barroso
Joergen Holmquist, Director General, DG Internal Market
David Wright, Deputy Director General, DG Internal Market
Pierre Delsaux, Director, DG Internal Market
Juergen Tiedje, Head of Unit, DG Internal Market
Patrick Pearson, Head of Banking Unit, DG Internal Market