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Dear Sirs,

Re: Commission Services Staff Working Document: Possible Further Changes to the Capital Requirements Directive

(1) FEE (the Federation of European Accountants) as the representative organisation of the European accountancy bodies welcomes the opportunity to provide our view on further possible changes to Directives 2006/48/EC and 2006/49/EC ('the Capital Requirements Directive' ('CRD').

(2) Our responses to selected questions in the Commission's working document are attached in the Appendix to this letter. In our response we focus particularly on the issues included in Section 1, since this is clearly an area of our professional expertise and we feel it would be more appropriate that reaction to Sections 2-4 is provided by the banking industry and national regulators. In our covering letter we highlight what we consider to be some of the more significant issues related to the through-the-cycle provisioning proposals in Section 1.

(3) We are strongly of the view that the proposals set out in Section 1 should remain in the prudential reporting domain and should not be reflected in the income statements or statements of other comprehensive income prepared on the basis of IFRS or local GAAP as applicable, as they do not allow to present the underlying performance of financial institutions to investors. In that respect we refer to the FEE Policy Statement of March 2009 "Dynamic Provisioning for Financial Instruments" and we provide the key reasons and further arguments to support our position in this debate below and in the Appendix.

(4) We support the focus of the document on providing counter-cyclical buffers that should be added on top of the regulatory capital in good times to strengthen the institutions stability and capital base for the bad times. However, we note that there are many practical issues that need to be addressed before the proposals could be implemented, the most critical one being the conditions for release and utilisation of these buffers.

(5) We would also strongly recommend to establish such system on a truly global basis through the Financial Stability Board or the Basel Committee of Banking Supervisors, since the proposals once implemented may disadvantage banks incorporated in the EU as compared to their competitors outside the EU. This is even more significant in periods where the governments will try to re-privatise their stakes acquired during the government assisted rescue operations in the current financial crisis.

(6) We would like to stress the existing confusion among all stakeholders in this debate regarding the differing terminology used to describe the mechanics of the various proposals currently made for provisioning and counter-cyclical buffering, particularly caused by the different objectives of financial reporting and prudential regulatory reporting. To address this issue, FEE and EFRAG are currently developing a joint paper "Impairment of Financial Assets: The Expected Loss Model" where we are jointly trying to provide some insight into the most commonly used concepts and their definition and we will provide you with this paper as soon as it becomes available.

(7) We set out below our arguments for the views presented above.

1. Through-the-cycle provisioning should not affect general purpose performance reporting

(8) We understand that smoothing out fluctuations over a whole economic cycle is relevant from the perspective of financial stability and establishment of sufficient level of regulatory capital. However, it is undesirable from the perspective of financial reporting to investors. The key issues we wish to raise in consideration of the proposed model and its potential reflection in general purpose financial reporting are as follows:

(i) The Commission's model would create day-one losses on inception of any new loan. Initial recognition of loans and receivables under IFRS is at fair value, so any model which requires recognition of a day-one loss would conflict with the measurement standard. It would also be very difficult to define in the accounting policies, disclosed in the notes, what the actual measurement basis of a loan at inception is.

(ii) General purpose financial reporting should faithfully reflect the effects of transactions when they occur. The average duration of loan and receivables portfolios could be significantly shorter than the economic cycle. Accordingly, the through-the-cycle expected loss provisioning model would establish buffers for loans which have not yet been granted and ignores the duration of loan portfolios. It is our strong opinion that it is inappropriate to make provisions for loans which have not yet been granted.

(iii) The Commission's model uses industry average losses for each country which do not reflect the quality of the lending process and differences in the risk appetite of individual institutions as demonstrated by the quality of their loan portfolios. Users of general purpose financial statements rightly expect that the quality of a particular loan portfolio is reflected in the balance sheet and income statement of the reporting entity. Furthermore, it remains unclear how the proposals should be applied in the case of international operating banks in various countries and market segments.

(iv) The model is unclear regarding the critical question of when the through-the cycle provision is to be released/utilised. Although this is a key consideration also for prudential reporting, it is a condition-sine-qua-non for financial reporting. If the model would allow hiding worsening of a loan portfolio of the reporting entity, which would be the case of most automatic release triggers, it would be unacceptable for financial reporting. If the release/utilisation would be based on a regulatory decision, it is unclear on what factors such decision would be based and we can hardly imagine that such decision would reflect the actual situation of each individual reporting entity.

(v) The proposal would put the regulated banks into unfavourable position vis-à-vis both the unregulated reporting entities in the EU and regulated banks outside EU. Although this is also true in the case of regulatory reporting, this argument is significantly more relevant in the area of general purpose financial reporting, as clearly demonstrated in the recent discussions about level-playing-field among EU and US financial institutions on the basis of IFRS respectively US GAAP.

(9) On the basis of the arguments mentioned above we consider that the proposals set out in Section 1 should not be reflected in the income statement or statement of other comprehensive income as they would prevent the faithful representation of the underlying performance of financial institutions and put them into competitive disadvantage vis-à-vis their competitors.

2. Practical issues related to the prudential regulatory reporting

(10) We support in principle the application of the counter-cyclical provisions as an add-on to the regulatory capital. The argument for taking this approach – that the low point in the economic cycle is the hardest time to make provisions or raise additional capital and therefore provisions should be made in the good times to avoid superficial distributions of earnings – is persuasive.

(11) However we identified many issues that would need to be addressed before the proposals in the working document could be implemented in practice, such as:

(i) *Duration of the economic cycle*
The proposed model ignores the duration of loan portfolios which is generally different and usually significantly shorter than the economic cycle. Unless the regulators are ready to assume that the current loan exposures are going to be replaced by similar exposures in the future, which needs to be provided for now (and is a statement that will need to be substantiated), the through-the-cycle provisioning would only be suitable for those loans that are by chance provided for the estimated length of the economic cycle.

(ii) *Data availability and cycle comparability*
It is difficult to assume that individual economic cycles are broadly comparable (as evidenced by the latest one) and it is also unlikely that all EU Member States will have data available that cover a full economic cycle.

(iii) *Counter-cyclical factors for loans originated outside the EU*
To enable CEBS to calculate the countercyclical factors for loans originated outside the EU will require a significant amount of regulatory cooperation around the world. This problem would be substantially solved, provided the regulatory regime is defined and applied at the global level by FSB or BCBS as proposed in paragraph 12 below.

(iv) *Release/utilisation of the through-the-cycle provisions/buffers*
As already briefly discussed in paragraph 8 (iv*)*, the released/utilisation of the provision can either be automatically triggered, e.g. in the case that the provision for expected losses of the reporting entity exceeds the national industry average for the through-the-cycle provision. However, in such case it is arbitrary if such release could be justified by the move to the down part in the economic cycle or by the crystallisation of wrong lending decisions of the institution in the past. In the later case, the model would hide problems rather than contribute to their solution. Provided such triggers are defined by the regulator, it would be extremely difficult and also politically sensitive for the regulator to rightly define the point for release and if this is done for the whole sector, it could be arguable if such decision would reflect the situation of individual reporting entities.

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(v) *Features of banks' individual circumstances are ignored*
The proposed model is less sophisticated than those used internally by the largest financial institutions and the arguments stressing the differences between the country industrial averages and the idiosyncratic situation of individual institutions raised against the application in financial reporting above should also be considered for regulatory reporting, since financial institutions that manage their portfolios well may be penalised is comparison to poorer performing institutions.

3. Global coordination and competitive issues

(12) Isolated implementation of the system for through-the-cycle provisioning in the EU risks to put European banks into a less competitive position compared to their peers outside the EU. From a practical regulatory point of view, the regulatory coordination around the world under the auspices of the Basel Committee, following the recent proposals of the G20 Finance Ministers and Central Bank Governors would be preferred and could mitigate these competitiveness issues There is also the risk of regulatory arbitrage and establishment of divergent regulatory models throughout the world with additional implementation and compliance costs.

4. Different objectives of regulatory reporting and general purpose financial reporting

(13) Section 1, point 3.2 refers to the current drafting efforts by the IASB to examine an 'expected loss' model for provisioning. We are convinced that there is confusion around the terminology used to describe the mechanics of the through-the-cycle provisioning model as described in the document and the expected loss model as anticipated by the IASB in its document "Request for information ("Expected Loss Model") Impairment of Financial Assets: Expected Cash Flow Approach published in June 2009. Under the IASB's proposed model, interest income is recognised on the basis of expected cash flows (including immediate reduction for expected credit losses) upon the initial recognition of an instrument. Impairment results from an adverse change in credit loss expectations (i.e. expectations of credit losses are higher than those previously expected). An impairment loss is recognised and measured as the difference between the carrying amount of the financial asset and the present value of the revised expected cash flows of that asset discounted at the effective interest rate set at the acquisition. It should furthermore be noted that the IASB definition of expected loss is not identical to the definition used by the Basel Committee in the application of Basel 2 norms.

(14) The IASB model is not designed to smooth out fluctuations over a whole economic cycle since it takes into account the period from reporting date to (at maximum) maturity of the measured assets. Therefore it will continue to reflect the economic cycle, but revenue from interest income will not include the premium built in to reflect expected losses and impairment losses will be recognised earlier than under an incurred loss model, since the reporting entity will not be deferring impairment recognition till the identification of the loss event.

(15) The through-the-cycle expected loss provision model proposed in the Commission's working document is by contrast designed to smooth out fluctuations over a whole economic cycle – which is likely to be significantly longer than the maturity periods of individual financial instruments.

(16) The different models reflect the different objectives and perspectives of prudential reporting and general purpose financial reporting. We are convinced that this distinction is fully justified and continue to support the application of different models to achieve different objectives.

We would appreciate to discuss the above issue in a meeting with the Commission experts to explain in detail the arguments raised in this letter. For further information on this letter, please contact either myself, Mr. Petr Kriz, Vice-President Financial Reporting and Chair of our Banks Working Party, or Saskia Slomp, Technical Director.

Yours sincerely,

Hans van Damme
President

APPENDIX

Response to specific questions – Commission Services Staff Working Document: Possible Further Changes to the Capital Requirements Directive

Section 1: Through-the-Cycle Expected Loss Provisioning ('Dynamic Provisioning') – Questions 1 through 3

(17) Considering the nature of our organisation, we are not able to answer Questions 1-3.

Question 4: The Commission services suggest that the through-the-cycle value adjustment should not count as regulatory capital. Do you agree?

(18) Under Basel 2, regulatory capital in banks is intended to cover both unexpected losses and losses expected to crystallise after more than 12 months. Hence we do not agree with the statement in the working document that capital is intended to cover only unexpected losses. Any through-the-cycle adjustment should be reflected in regulatory capital or as additional capital buffer incremental to the regulatory capital as defined by the current Basel 2 rules, and not in the financial reporting of financial institutions. We would prefer to keep this additional capital buffer next to the regulatory capital as currently defined to avoid fluctuations of the reported capital adequacy.

Question 5: Should off-balance sheet items be captured under the formula for through-the-cycle expected loss provisioning, given that 'provisions' for off-balance sheet items are not recognised in all relevant accounting standards? Should only assets subject to an impairment test be subject to through-the-cycle expected loss provisioning?

(19) Unrecognised loan commitments and guarantees are currently covered by IAS 37, which uses already an expected loss model, whereas loan commitments and guarantees are provided for in the case that loss is more probable than not. In the case of similar items, such consideration needs to be based on a portfolio basis. Furthermore, provisions for items not recognised as assets cannot be deducted from any asset line in the balance sheet and need to be presented as liabilities of the reporting entity. The model should cover, probably in the form of an additional prudential filter, existing exposures not covered by the accounting standards (if at all existing), however, it needs to avoid double counting.

Question 6: At this point, the suggestion is not to include the option for competent authorities to allow internal methods to determine expected losses across an economic cycle. As an alternative to the regulatory approach to calculate counter-cyclical factors, would it be desirable to allow the firms' internal methodologies (to be validated by supervisors)?

(20) We are of the view that it would be desirable to allow banks to use validated internal methodologies for the following reasons:

The model proposed is likely to be less sophisticated than that deployed by some of the largest banks in the EU. Therefore it may be less accurate than those banks' existing internal models, as well as necessitating those institutions to maintain records on multiple bases.

Moreover, well-controlled banks with high-quality lending processes have lower expected losses at any time in the business cycle compared to underperforming banks which have higher expected losses than the industry average throughout the cycle. Unless internal models are permitted, above average institutions will be permanently overprovided and below average institutions permanently underprovided. Therefore, rather then distinguishing good and bad banks, the model is averaging their results.

There have been good reasons in the past to allow internal models for the determination of the regulatory capital under Basel 2, in order to better reflect the different business models and different banking activities and hence we believe further consideration should be given to allowing internal models to be used, subject to regulatory approval. A bank using an internal model would be expected to demonstrate to the appropriate national regulator why its approach was superior.

We understand that proper balance needs to be taken to reflect the systemic issues at the global and national level with the national and institutional specifics in order to ensure both the financial stability and fairness of the selected model.

Question 7: Should the exposure class of Article 86 (i.e. for credit institutions subject to the IRB approach) be used irrespective of the fact that the credit institution may be under the Standardised approach? It may be noted that a mapping between exposures class under the Standardised approach and under the IRB is already used in the prudential reporting of system of some Member States. As an alternative, should countercyclical parameters be defined for the 16 exposure classes under the Standardised approach?

(21) No particular comments to make; we leave this to the sector to respond to.

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Question 8: Please give your views on the following approaches:
(1) the Spanish model of through-the-cycle expected loss provisioning
(2) a 'simplified' Spanish model.

In particular, we would welcome views on the relative merits of both options in terms of the building up of provisions in a graduated manner over time.

(22) Provided that the through-the-cycle provisions are applied only to regulatory capital, our view is that Option (2) – the simplified model – is the only logical approach in the case that financial reporting moves to the expected cash-flow loss provisioning model.

(23) For the reasons set out in our covering letter, we do not believe that Option (1) is compatible with the currently existing IASB incurred loss model nor with the 'expected loss' model currently being developed by the IASB. Further, and also as explained in our covering letter, we do not consider that either of these options should be reflected in the external financial reporting of banks and credit institutions.

(24) Consideration will also need to be given to the interaction between the accounting provisions and impairment and the through-the-cycle provisioning reflected in regulatory capital. How should a position be treated where the financial accounting provisions exceed the through-the-cycle provisioning level? The model may not be able to recognise whether this excess reflects bad lending decisions and/or insufficient provisioning in the past (in which case the release of the buffer will hide this problem and make it non-transparent) or whether the excess is a simple result of the downward move in the economic cycle due to the bad times (in which case the release of the buffer will be justified).

Question 9: Should new risk categories (as suggested above) be introduced along the lines of the Spanish system or, alternatively, should the current risk categories of the CRD (e.g. credit quality steps in Annex VI) be used?

(25) No particular comments.

Question 10: Is the 'location of the borrower' (as opposed to the booking of the exposure) the right approach, with a view to avoiding regulatory arbitrage?

(26) While 'location of the borrower' may be the correct approach, it will depend on credit data being available and counter-cyclical factors being calculated for those locations, since the economic cycle may differ significantly between regions. As noted below in our responses to Questions 11 and 12, we believe there are potential practical difficulties still to be overcome in generating that information.

Question 11: Will the data to determine counter-cyclical factors be easily available?

(27) We understand that in those countries such as Spain that have experience in the application of dynamic through-the-cycle provisioning, data for periods of up to 40 years are used. We are doubtful whether many EU Member States will have data available of equivalent length. Indeed, some of the newer Member States may only have data for very short periods available, or may need to institute new procedures for data capturing. However, it is doubtful what relevance historical data older than 20 years would have. This is a particular problem for the countries which started to develop their market economies in the ninetieths.

(28) To the extent that CEBS is expected to provide countercyclical factors for non-EU countries, the same or even more severe difficulties of data capture and history may apply.

Question 12: Please give your views on the methodologies for calculating the through-the-cycle expected loss provisions at consolidated level.

(29) We believe there will be potential difficulties in calculating the appropriate provisions at consolidated level, in particular for those institutions that have significant foreign (non-EU) operations. Groups will have to determine whether provisions in subsidiaries should be calculated in accordance with head-office rules or in accordance with local regulatory requirements, or (in case of other EU countries) both.

(30) As noted in paragraph 5 of our covering letter, the through-the-cycle provisioning model should be set at an international level through the Basel Committee of Banking Supervision (as anticipated by the recent Declaration of the Finance Ministers and Central Bank Governors on further steps to strengthen the financial system) or the newly established Financial Stability Board. Such approach could avoid different data having to be captured and different factors having to be calculated depending on the holding company and subsidiary jurisdiction.

Question 13: Please give your views on the scope of disclosure requirements for through-the-cycle expected loss provisioning.

(31) We assume that the requirements proposed in Annex XII are intended to be disclosed only in the regulatory capital filings, which we support. In such case the extent of disclosure seems appropriate. However, if it were to be the case that provisions are to be formed for financial reporting as well on this basis we would assume that IASB will develop disclosure requirements to be included into IFRS 7.

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