Federation of European Accountants
Fédération des Experts comptables Européens

FEE Position on
The High-Level Group on Financial Supervision in the EU " de Larosiere " Report and related EC Consultation

Key messages

- ***Financial crisis is a global phenomenon that calls for a global reaction;***
- ***Reporting standards and interpretations should be set at the global level;***
- ***Providing transparency on the financial performance and position of an entity is the key objective of financial reporting;***
- ***Regulatory reporting and general purpose financial reporting have different objectives;***
- ***The financial reporting role in financial stability is to provide and in current circumstances restore market confidence by providing transparency and a true and fair view on the financial performance and position in individual reporting periods;***
- ***A level playing field between IFRS and US GAAP is important but risks to drive the global financial reporting towards the lowest common denominator;***
- ***The principle of convergence should be supported, provided that it leads to the highest quality accounting solutions;***
- ***Financial reporting based on IFRS and notably fair value accounting for financial instruments, has revealed the economic reality of market participants' positions at an earlier stage than otherwise would have been the case under a more cost basis driven model;***
- ***The IASB needs to provide further guidance about the question when to apply fair value;***
- ***Having a mixed attributes model for financial instruments should be supported;***
- ***Strengthening the IASCF for the future is important:***
  - ***The organisation should be accountable but independent;***
  - ***The organisation should work closely with the FSF and IOSCO and other stakeholders;***
  - ***Establishment of the Monitoring board is welcomed by FEE;***
  - ***Reducing complexity aiming and clear and comprehensible standards;***
  - ***Public consultation on the IASB work plan is needed.***
- ***Dynamic provisioning needs careful consideration and consultation;***
- ***The Role of IASCF and IASB in the overall framework for financial stability needs to be considered.***

<u>General</u>

1. FEE (Federation of European Accountants) shares the concerns expressed in the de Larosiere report on the serious and disruptive implications of the financial crisis whereby many parts of the financial system have come under severe strain and still remain so to date. We appreciate the possibility to contribute within our area of expertise and competence to reflections how to prevent the systemic and inter-connected vulnerabilities, including in particular the assessment of risk and the complexity of structured financial products, of the current crisis in future situations.

2. The financial crisis is a global phenomenon that calls for a global reaction. Global financial markets require financial information prepared in accordance with global standards for reasons of competitiveness and comparability, as well as for capital raising purposes. FEE is strongly committed to high quality, principle-based financial reporting standards that are generally accepted around the globe, and therefore fully supports the objective of creating a single set of global standards.

3. FEE is of the opinion that providing transparency on the financial performance and position of an entity is the key objective of financial reporting. The role of financial reporting in financial stability is to provide the basis for, and in the current circumstances restore, market confidence. In this context, the accountancy profession has a contribution to make in helping to restore this confidence.

4. FEE has now issued four Policy Statements on the Accountancy Profession's Contribution to the Debate on the Crisis: the first statement presented the background information and analysis on the crisis, the second statement addressed matters of specific relevance for the statutory auditors during the financial crisis, the third paper contained views of specific relevance to SME and the fourth paper, recently issued, gave FEE's views on dynamic provisioning for financial instruments. These policy statements on the crisis can be downloaded from the FEE website www.fee.be.

5. FEE supports the efforts to achieve effective, and preferably, transnational regulations for all financial sectors to assure sustainable stability and integrity of financial markets. Compliance with such regulations would need to be monitored on a continuous basis. Financial regulatory reform efforts must include the development of effective mechanisms to manage the systemic risk of all significant entities that have a role in international capital markets.

6. In the remaining part of this paper we provide some observations on the recommendations or part of recommendations where we believe we have a contribution to make given the experience, competence and expertise of our profession.

Recommendations

Recommendation 4: With respect to accounting rules the Group considers that a wider reflection on the mark-to-market principle is needed and in particular recommends that:

- **Expeditious solutions should be found to the remaining accounting issues concerning complex products;**
- **Accounting standards should not bias business models, promote pro-cyclical behaviour or discourage long-term investment;**
- **The IASB and other accounting standard setters should clarify and agree on a common transparent methodology for the valuation of assets in illiquid markets where mark to market cannot be applied;**
- **The IASB further opens its standard-setting process to the regulatory, supervisory and business communities;**
- **The oversight and governance structure of the IASB be strengthened**

Expeditious solutions should be found to the remaining accounting issues concerning complex products

7. FEE contributed to the EC Stakeholders Meeting of 21 October 2008 in which the following areas were identified by the stakeholders present and of which accounting standards need to be improved:

   a. Guidance on the application of fair value in illiquid markets
   b. Out of the fair value option classification
   c. Embedded derivatives in synthetic CDOs
   d. Impairment of available for sale assets

   FEE also contributed to the IASB/FASB Roundtable on the financial crisis of 14 November 2008. The IASB/FASB Financial Crisis Advisory Group is addressing these and other aspects of the financial crisis in relation to financial instruments

8. The FASB has published in January 2009 draft guidance on synthetic CDOs including derivatives. The FASB was expected to clarify whether synthetic CDOs include derivatives that would need to be separated if the host instrument is not classified in the fair value through profit or loss category with the objective to create a level playing field between US GAAP and IFRS in this respect. We understand that the proposed FASB guidance has not (yet) solved the issues since the FASB's objective was to clarify their own literature rather than to ensure consistency with IFRS. The current discrepancy between the application of US GAAP and IFRS in the above mentioned particular situations may have the unintended consequence that some preparers nonetheless now expect the US GAAP guidance to be equally applicable to IFRS and consequently may lead to diverging interpretations. We believe the IASB should as a matter of urgency clarify that a GAAP difference remains and consider, with FASB how best to address the difference with an appropriate due process in view of the discrepancy between IASB's earlier communications and the draft FASB DIG C22.

9. We agree with the IASB that the other two issues – out of the fair value option classification and impairment of available for sale assets – need to be addressed as part of the larger project on financial instruments and that a piece-meal change of IAS 39 would not be helpful. We appreciate that IASB and FASB have recently announced the acceleration of the financial instruments project.

Accounting standards should not bias business models, promote pro-cyclical behaviour or discourage long-term investment

10. Regulatory reporting and general purpose financial reporting have different objectives and these objectives might require the retention of the existing and establishment of new differences between both types of financial reporting. Financial stability is primarily the area of 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 the 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 may not necessarily reflect the inherent underlying economical cyclicality faced by the reporting entities.

11. 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. What is appropriate from a regulatory point of view is not necessarily the best presentation from a general purpose financial reporting point of view.

12. 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. 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.

13. Fluctuations in fair value may impact long-term investment decisions for those financial instruments that are not in the held till maturity category. The impact of fair value measurement on long-term investment decisions may need to be further examined. In addition, fair value measurement tends to concentrate on the "how much" question, but is not always helpful to answer the "why" question of fair value measurement and fluctuations therein. Further developments on disclosures may enhance users' understanding of the background of fair value fluctuations and therefore reduce their nervousness to short term fluctuations that have limited meaning for the long-term.

14. FEE welcomes the investigation of the Financial Crisis Advisory Group of the accounting and reporting matters related to the crisis based on the experience and developments so far. Only genuine improvements to financial reporting should be considered. Although a level playing field between IFRS and US GAAP is important, this also risks to drive the global financial reporting towards the lowest common denominator. FEE supports the principle of seeking convergence, provided that this leads to the highest quality accounting solutions. Convergence may start with a careful analysis and selection of the best and most recent thinking under IFRS, US or any other national GAAPs where relevant. The development of the best accounting standards should however not be limited to the existing standards. Where necessary and relevant, the process should include new solutions and new thinking and the willingness of all involved to enter into new domains resulting in improved high quality accounting standards. We suggest therefore that convergence, in order to be successful, needs to go beyond existing accounting standards. New high quality standards on major issues such as financial instruments or pensions, developed jointly by the best resources from national/regional standard setters and the IASB, that are generally acceptable to all stakeholders will in themselves ensure a level playing field for all countries that have adopted IFRS. Convergence of IFRS towards an existing particular national standard is then no longer needed to achieve that aim.

15. Another issue we would like to raise is auditability of the financial information and the accounting treatments to be applied. The reliability and verifiability of measurement is of concern when concepts such as "real economic value" came into the picture. Also Level 3 Measurement brings a high degree of subjectivity and requires substantial judgement of both the preparer and the auditor. Relevance is a significant qualitative characteristic of financial information but requires a balance with the reliability and verifiability characteristics.

The IASB and other accounting standard setters should clarify and agree on a common transparent methodology for the valuation of assets in illiquid markets where mark to market cannot be applied

16. 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. Financial reporting has been blamed by some commentators for its pro-cyclical influence, thus aggravating the situation in markets that have become distressed or illiquid.

17. In our view the current market volatility is captured, but not caused by fair value accounting. Fair value provides a timely and relatively objective measure of existing value. Failure to report such values would leave investors and policy decision makers less aware or even unaware of credit and liquidity challenges. The accounting policies need to indicate carefully, on which basis the fair values concerned have been determined.

18. FEE believes strongly that financial reporting based on IFRS, and notably fair value accounting for financial instruments, has revealed the economic reality of market participants' positions at an earlier stage than otherwise would have been the case under a more cost basis driven model. In our view, the requirement to account for certain financial instruments at fair value has not caused the financial crisis nor has it been a significant contributing factor. Nevertheless, practice has shown that fair value accounting is more difficult to apply in illiquid markets and preparers and auditors have had to use significant judgments to arrive at consistent valuations in difficult market circumstances. Preparers would benefit from additional guidance on fair value measurements when observable market prices are not available. In particular, additional guidance on the effect of illiquidity and risk premia could result in greater comparability of information across industry sectors and geographic boundaries.

19. The IASB has published in October 2008 the educational guidance on the application of fair value measurement when markets become inactive. We note the publication of the proposed FASB guidance FSP 157e on fair value measurement.

    Standard setters should work on measurement solutions for situations where markets (partly) lose their efficiency. Effectively, the consequence of such a financial crisis situation is that the going concern value of a complex of assets and liabilities (e.g. bonds in conjunction with insurance liability) is different from the market-based fair value of the individual assets and liability. Factually, the question is, whether a market inconsistency adjustment in financial statements should be made in crisis situations or in situations of stressed liquidity or illiquidity in financial markets.

20. Although FEE supports the aim of broad convergence between IFRS and US GAAP, and thereby providing a level playing field to the preparers, convergence should aim at the best possible accounting treatment which can be different from the existing requirements under IFRS and US GAAP. Too much focus on the level playing field may constitute a risk of going for the lowest common denominator and undermine the quality of financial reporting and investor confidence in financial markets. We note that the IASB did not participate in the development of the FASB's proposed FSPs.

21. The IASB need however to provide further guidance about the question when to apply fair value. A debate is needed to define "when and what" to fair value in the form of criteria and definition of candidate measurement bases. The IASB should not expand the use of fair value in financial reporting. A mixed attribute measurement model would be more satisfactory at present and we therefore suggest that such a model should be subject to further research. Having a mixed-model for financial instruments should be

favoured, as the accounting treatment should be driven to the extent possible by the consistently applied business model under which financial instruments are held by the entity. Since both banks and other preparers usually manage their financial instruments under different business models, the importance of the business model should be a key consideration for determining what measurement basis to apply for all different types of financial instruments (amortised cost or fair value). These business models describe how financial instruments are held and the underlying facts thereof (for example keeping financial assets for a continuing use in order to benefit from the cash flows associated over time or managing financial assets and liabilities based on their fair value),

22. There is significant complexity in the current reporting of financial instruments and there is a need to reduce this complexity recognising that by nature the subject of financial instruments is complicated, given the diversity of financial instruments and the related management methods ("business models").

23. The IASB/FASB Financial Crisis Advisory Group is at present seeking input on several major issues including fair valuing and a refined mixed attributes model.

The IASB further opens its standard-setting process to the regulatory, supervisory and business communities

24. We are strongly of the view that technical accounting standard setting should remain independent and not be politically influenced. Standard setting has become of greater interest to public policy makers and regulators as a result of wider international adoption of IFRS and the financial and economic crises. The creation of the Monitoring Board provides a mechanism to achieve appropriate accountability.

25. FEE underlines the importance of robust oversight and accountability arrangements to ensure global acceptance of IFRS, including Europe. The fact that, in Europe, IFRS has become part of the legal framework through the endorsement mechanism, adds a political dimension to the process of oversight and accountability. Consequently, the accountability of the IASB is of key importance, with a focus on appropriate democratic oversight and improved transparency. We agree that the recent creation of a link between the Trustees and the Monitoring Board is a necessary, as well as appropriate, measure to establish such democratic oversight and to enhance the credibility of both the IASCF and the IASB.

26. FEE is of the opinion that it is the IASB's role to develop IFRS so as to help ensure that general purpose financial reports are as effective as possible in meeting their objectives in a way that minimises costs for preparers and users. It should not involve itself in other issues. As far as we are aware, the IASB is not addressing any issues that fall outside the scope that we have just described. We would furthermore be strongly against encouraging the IASB to address issues that fall outside this scope, such as issues on financial stability or prudential regulation that go beyond what is necessary to meet the objectives of general purpose financial reporting.

27. FEE believes that accounting standards should continue to focus on the primary objective of meeting the needs of capital market users. Macro-economic objectives other than transparency of financial position and performance of reporting entities, including financial stability should be achieved by other means such as macro-economic policy and regulatory actions as described above. Nevertheless, the IASB needs to consider the impact its standards may have on the stability of financial markets. Therefore, continued cooperation between the IASB and global regulatory networks such as IOSCO and FSF are important. We support the IASB and FASB in the efforts to maintain and enhance there relationships by participating actively in the FSF and IOSCO accounting related activities.

The oversight and governance structure of the IASB be strengthened

28. High quality standards that deliver transparent and comparable information and thereby support confidence in capital markets, require a robust standard setting process that permits all stakeholders to be involved, even if only in reduced time frames.

29. We are of the opinion that strengthening the IASCF for the future is important:

    a. The organisation should be accountable but independent;
    b. The organisation should work closely with the FSF and IOSCO and other stakeholders;
    c. Establishment of the Monitoring Board is welcomed by FEE;
    d. Reducing complexity aiming and clear and comprehensible standards.

30. We are broadly satisfied with the Trustees' role and oversight responsibilities as set out in the Constitution. However the way the Trustees carry out these responsibilities should reflect changing times: the role and responsibilities have changed from the setting up of IASB and getting the standards internationally recognised towards monitoring and oversight. The Trustees' activities should evolve accordingly. One example is the role of the Trustees in relation to agenda setting.

31. We believe that the IASCF should submit the IASB workplan to an annual public consultation process. Better defined procedures need to be in place - with appropriate oversight - for adding issues to, but also deleting issues from, the work programme. Completion of such a public consultation would also assist in getting the priorities right and may help to address the problem of current heavy agenda (we note the serious delay to some of the most important projects). We consider that this may now be at the right point in time to launch such a public consultation given the clear need for the IASB to reconsider its priorities.

32. Before issues are added to the agenda, a needs analysis, including an initial costs/benefits analysis, should be carried out to demonstrate that there is a genuine need for a new or revised standard in areas not already covered by an existing standard or interpretation.

Recommendation 1: The Group sees the need for a fundamental review of the Basel 2 rules. The Basel Committee of Banking Supervision should therefore be invited to urgently amend the rules with a view to:

- **…….**
- **Reduce pro-cyclicality, by e.g. encouraging dynamic provisioning or capital buffers;**
- **Introduce stricter rules for off-balance sheet items;**

- ……….

Reduce pro-cyclicality, by e.g. encouraging dynamic provisioning or capital buffers

<u>Dynamic Provisioning</u>

33. 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. 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.

34. FEE has issued on 23 March 2009 a policy statement on Dynamic Provisioning for Financial Instruments (please find a copy attached).

35. There is no clear and common understanding or shared general definition of what dynamic provisioning is. 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. Losses incurred in a particular period are generally deducted from the provision rather than being recognised immediately in profit or loss. 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. 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.

36. The main FEE views developed in this statement differentiate between the short term and the long term view and are the following:

<u>Short term view</u>

37. If regulators allow entities to set up a dynamic provision for regulatory purposes ("economic cycle buffer") as part of their short-term agenda 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.

38. FEE also encourages the IASB to provide further educative guidance and explanation as to how to 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

39. 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.

Introduce Stricter Rules for Off-Balance Sheet Items

40. IASB has published in December 2008, ED 10 on Consolidated Financial Statements with the objective of publishing a single IFRS on consolidation to replace the consolidation requirements in IAS 27 "Consolidated and Separate Financial Statements" and SIC 12 "Consolidation – Special Purpose Entities". The objective of ED 10 is to improve the definition of control and related application guidance so that a control model can be applied to all entities and to improve the disclosure requirements about consolidated and unconsolidated entities. Following the recommendations of the Financial Stability Forum, this consolidation project was accelerated.

41. However, we are unaware that investments in subsidiaries and/or other structured entities are left off-balance sheet under the existing requirements of IAS 27 and SIC 12. On the contrary, we are unsure at present whether the new model proposed in ED 10 is an improvement compared to existing IFRS and meets the concerns expressed by the Financial Stability Forum that certain structured entities are inappropriately non-consolidated and left off-balance sheet. Field testing and further analysis of user needs may be needed to ensure that the future standard will not result in unintended recognition and derecognition of assets and liabilities.

42. We appreciate the general direction of the new disclosures under ED 10 addressing two objectives: (i) providing better disclosure where significant judgment was used in determining whether to consolidate (or not consolidate) certain entities and (ii) providing more general disclosures related to the reporting entity's business risks taken through its involvement in non-consolidated entities.

Recommendation 5: The Group considers that the Solvency 2 directive must be adopted and include a balanced group support regime, coupled with sufficient safeguards for host Member States, a binding mediation process between supervisors and the setting-up of harmonised insurance guarantee schemes.

43. FEE agrees that the Solvency 2 Framework Directive is an important step forward the effort to improve insurance regulation and welcomes the acceleration suggested by the Group of the adoption of the Directive. We also welcome the development of the necessary implementing measures and are contributing to some auditing aspects of the related CEIOPS advice.

44. We also wish to underline that the banking/financial institution industry should not automatically be taken as model for the insurance industry: differences between business models need to be taken into account in further regulatory measures using the experience gained from the crisis.

45. Recommendations of the Group to enhance a supervision on the groupwide basis should be implemented in the further development of Solvency II.

46. Lessons may be learned from the expertise with Basel II and its procyclical impact for the future Solvency II regime.

Recommendation 25: The Group recommends that, based on clear objectives and timetables, the Financial Stability Forum (FSF), in conjunction with international standard setters like the Basel Committee of Banking Supervisors, is put in charge of promoting the convergence of international financial regulation to the highest level benchmarks.

In view of the heightened role proposed in this report for the FSF, it is important that the FSF is enlarged to include all systematically important countries and the European Commission. It should receive more resources and its accountability and governance should be reformed by more closely linking it to the IMF.

The FSF should regularly report to the IMF's International Monetary and Financial Committee (IMFC) about the progress made in regulatory reform implementing the lessons from the current financial crisis.

The IMFC should be transformed into a decision-making Council, in line with the Articles of the IMF agreement.

47. The report provides a new European Framework for Safeguarding Financial Stability and wishes to establish a similar integration and cooperation at international level. One needs to reflect about the position and the role of the IASB in relation to this process. Financial reporting has a role to play in relation to financial stability as set out before. The Role of IASCF and IASB in the overall framework for financial stability needs to be considered. We agree that regulatory consistency and international regulatory convergence including a clear mandate with precise objectives and timetables for international standard setters as discussed in the G20 context.

Other

48. Annex V addresses the indicative allocation of competences between national supervisors and the Authorities in the ESFS (European Framework of Financial Supervision). We note that it is mentioned that it is envisaged to have mandatory accounting recommendations under securities supervision in stage 1 at national level and in stage 2 at European level. We are not sure what is meant by mandatory recommendations but we strongly believe as set out earlier that financial reporting standards and interpretations should be set at the global level. We assume that reference is made to the publication of "generalised" enforcement decisions instead of to accounting requirements in whatever form.