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Dear Mr Angeloni,

Re: FEE¹ recommends the European Central Bank (ECB) to address certain issues before executing the ECB Comprehensive Assessment

We are writing to you in connection with the ECB's plan to carry out a comprehensive assessment of the most significant banks in the Eurozone in line with the provisions of Regulation (EU) No 1024/2013 on the role of the ECB within the single supervisory mechanism. FEE understands that the comprehensive assessment will have three pillars: a supervisory risk assessment; an asset quality review (based on positions at 31 December 2013); and a forward-looking stress test. The comprehensive assessment will require a great effort on the part of the ECB, national competent authorities and banks. It also will present major commercial issues for banks that may be required to increase their capital or reduce risk positions.

¹ FEE (Fédération des Experts-comptables Européens - Federation of European Accountants) represents 48 professional institutes of accountants and auditors from 36 European countries, including all of the 28 EU Member States. It has a combined membership of more than 800.000 professional accountants, working in different capacities in public practice, small and big firms, government and education, who all contribute to a more efficient, transparent and sustainable European economy. FEE's ID number in the European Commission's Register of Interest Representatives is 4713568401-18.

Below we will first introduce FEE's perspective on the ECB Comprehensive Assessment in section 1, followed by the questions raised by the accounting profession in this regard in section 2. Finally, section 3 lists what issues FEE would recommend the ECB to address before executing the review.

Introduction

1.1. FEE is highly supportive of the main objectives of the ECB Comprehensive Assessment

The single supervisory mechanism will represent a major change in the role of the ECB and in the regulatory framework for banks in the Eurozone. The comprehensive assessment represents a critical step towards the ECB's assumption of this new role as a prudential supervisor. FEE fully supports the main objectives of the ECB's comprehensive assessment, as stated in the ECB's announcement of 23 October 2013², i.e. transparency (enhancing the quality of information available concerning the condition of banks); repair (identifying and implementing necessary corrective actions, if and where needed); and confidence building (namely assuring all stakeholders that banks are fundamentally sound and trustworthy). Attaining these objectives would improve financial stability within the European Union (EU) and strengthen the ability of the banking sector to provide credit and liquidity to European businesses and households and support growth in the European economy.

1.2. Transparency is a shared objective of both financial reporting and prudential regulation

Transparency in the reporting of financial information to investors is a fundamental objective of the accounting profession within the EU. This is also reflected in the law and institutions of the EU. As required by the 2002 Regulation (EC) No 1606/2002 (the IAS Regulation), listed companies, including banks, in the EU are required to publish consolidated financial statements in accordance with the requirements of International Financial Reporting Standards (IFRS) as endorsed by the EU. The European Securities and Markets Authority (ESMA) is responsible for overseeing the enforcement of these and other requirements for accurate and timely disclosure of information to investors, including the appropriate and consistent application of IFRS. ESMA has intensified its scrutiny of the financial reporting of banks and in November 2013 published a *Review of Accounting Practices - Comparability of IFRS Financial Statements of Financial Institutions in Europe*³ (2013 Review). As noted by ESMA, transparent financial information plays a key role in maintaining market confidence, improving markets' efficiency by allowing investors to identify risks in a timely manner and contributing to financial stability. Furthermore, transparent financial information is a pre-requisite in creating the premise for sound economic growth.

² European Central Bank Note Comprehensive Assessment October 2013
(<http://www.ecb.europa.eu/pub/pdf/other/notecomprehensiveassessment201310en.pdf>)

³ http://www.esma.europa.eu/system/files/2013-1664_report_on_comparability_of_ifrs_financial_statements_of_financial_institutions_in_europe.pdf

Prudential and securities market regulators and the accounting profession therefore have shared interests in promoting transparency that contributes towards financial stability. It is important that effective channels of communication between these stakeholders are strengthened.

1.3. Financial reporting and prudential regulation are different, but complementary in achieving transparency

Even though both financial reporting and prudential regulation aim for transparency, it is essential to recognise that they are different but complementary in this regard. Not only are they subject to different legislative requirements and standards, the roles and objectives of financial reporting differ from those of prudential regulation. The mission of prudential regulators is to ensure the safety, soundness and stability of financial institutions, including whether they will have sufficient resources to withstand future adverse economic developments. The objective of financial statements is to provide fair, unbiased and useful information to investors about an entity's financial position and performance.

2. Questions related to the ECB Comprehensive Review as raised within the accounting profession

With these respective requirements in mind, we would like to draw your attention to certain matters related to the comprehensive assessment which have given rise to questions within the accounting profession in general and auditors specifically, and which would be helpful for the ECB to address in order to avoid potential misperceptions or unintended consequences that may reduce transparency or market confidence in banks.

2.1. Revision according to a conservative interpretation of IFRS

The ECB's 23 October 2013 announcement stated: *"all types of financial instruments will be subject to revision according to a conservative interpretation of current International Financial Reporting Standards ..., where necessary taking national generally accepted accounting principles into account. Special consideration will be given to illiquid assets, valued through models (fair value level 3 assets)."*

The meaning of this statement is unclear and may therefore lead to confusion. The only IFRS that applies in the EU is namely IFRS as endorsed by the EU under the IAS Regulation. Hereby, IFRSs become part of EU law, including all applicable principles, requirements and options if so appropriate. Whereas the ECB can of course use a conservative interpretation of the financial information provided by a bank under IFRS for its prudential purposes, the ECB cannot mandate a conservative interpretation of the standards themselves. The ECB interpreting IFRSs also carries wider risks, particularly regarding the part of the European banking sector that is not included in the ECB Comprehensive Assessment.

We are aware that there have been instances in the past where accounting applications for banks with regard to loan loss provisioning were influenced by national supervisors' views from a prudential perspective. Without a clarification by the ECB that the reference to "a conservative application of IFRS" is not intended to mandate specific accounting estimates for financial reporting purposes, there is a risk that national banking regulators may develop divergent views on the application of the ECB's statement quoted above, which may compromise the transparency and comparability of the information in banks' financial statements.

2.2. "Conservative interpretation" of IAS 39 or sound application judgements?

To illustrate our point above, please note that IFRSs do not include a notion of "conservative interpretation". Instead, the International Accounting Standards Board (IASB)'s *Conceptual Framework* refers to "neutrality" as a key qualitative characteristic of useful financial information.

More specifically, IAS 39, *Financial Instruments: Recognition and Measurement*, includes an incurred loss model that requires an entity to recognise an impairment loss for a financial asset (or group of financial assets) carried at amortised cost, if the following two conditions are fulfilled. Firstly, there should be objective evidence of impairment as a result of one or more events that occurred after the initial recognition of the asset, but before or at the reporting date (a 'loss event'). Secondly, that loss event should have an impact on the estimated future cash flows of the financial asset or group of financial assets that can be reliably estimated. For assets measured at amortised cost, the impairment loss is measured by reference to the present value of estimated future cash flows (excluding future loss events that have not been incurred at the reporting date) discounted at the financial asset's original effective interest rate. The calculation of this present value for a collateralised financial asset reflects the cash flows that may result from foreclosure, less costs for obtaining and selling the collateral.

When assets have to be accounted for at fair value, IFRS 13 *Fair Value Measurement* requires fair value to be determined based on the amount that is most representative of the price that a market participant would pay to purchase an asset, or require to assume a liability, at the measurement date.

The IASB has acknowledged that there is diversity in practice in the application of IAS 39 because of different judgements about when a loss has been incurred. Also, estimates of future cash flows used in impairment calculations are highly dependent on the specific facts and circumstances and may involve judgement when determining the most probable future cash flows. As a principles-based standard, IAS 39 does not mandate a single detailed methodology for identifying individual impairment or measuring collective impairment. Similarly, for collateralised financial assets, IAS 39 focuses on estimating the amount and timing of cash flows that may result from foreclosure without prescribing a specific method. Measurements of fair valued assets also may involve considerable judgement, especially where significant inputs are not observable or there are differing views in the marketplace on the valuation techniques to apply.

It is essential for banks to ensure that they have the processes and controls in place to apply IAS 39's incurred loss model, including reflecting the impacts of forbearance activities⁴ and valuing collateral, and to measure fair values under IFRS 13 with appropriate rigour; they have to make objective unbiased judgements based on the information reasonably available and update estimates as circumstances change. Also, IFRS requires disclosure of significant policies, estimates and judgements. These are key themes of ESMA's 2013 Review. However, it would be wrong to supplant or even substitute reasonable application judgements made by management and directors of banks with more "conservative" or "prudent" alternatives thereby implying that those judgements were errors.

Such an approach would tend to undermine the credibility of IFRS as a mechanism for supplying the capital markets with transparent and useful information that fairly reflects the effects of changes in economic conditions. This could have a destabilising effect on financial markets. It also would upset long-standing corporate governance norms under which the directors of an institution are responsible for preparing financial statements in accordance with applicable financial reporting standards. As indicated in Regulation (EU) No 1024/2013, the single supervisory mechanism does not change the accounting framework applicable under EU or national law.

FEE agrees that the financial crisis has demonstrated that banks required bigger buffers against future downside losses and shocks. It is important that prudential supervisors continue to work toward this through consistent regulatory metrics, increased capital requirements and robust stress testing. This may include supervisors focusing on expected and unexpected losses and differing prudential valuations of assets and liabilities as inputs to this process. However, these should not be confused with measurements required under current accounting standards⁵.

⁴ See ESMA [Press release with a summary of the Public Statement](#) on the Treatment of Forbearance Practices in IFRS Financial Statements of Financial Institutions: *Forbearance occurs when the borrower is considered to be unable to meet the terms and conditions of the contract due to financial difficulties and, based on these difficulties, it decides to modify the terms and conditions of the contract to allow the borrower sufficient ability to service the debt or refinance. Therefore, forbearance measures constitute objective evidence of impairment under IFRS.* As noted in the 2013 Review, during 2013 the European Banking Authority (EBA) issued draft Implementing Technical Standards, which set out a single definition of forbearance for use in the EU. ESMA worked closely with EBA to ensure that the definition in supervisory reporting is consistent with the financial reporting requirements as included in the ESMA Statement and expects that the common definition would be used for financial reporting as well.

⁵ We note that many stakeholders want to see banks move to a more forward-looking expected loss accounting model for loan impairment and the IASB is working urgently towards a new standard. However, in the meantime banks have to continue applying IAS 39 and they cannot adopt an expected loss standard that has not been finalised or endorsed by the EU. Although a new accounting standard would include different principles, its goal still would be fairness and neutrality, not unwarranted pessimism or "through the cycle" concepts that do not reflect current conditions and actual reasonable forecasts at the reporting date. Applying a new standard in the future would still involve difficult judgements under conditions of uncertainty – with a continuing possibility for divergent views and the risk of additional unexpected losses materialising in the future as actual experience turns out different from what was expected.

2.3. Assessment of uncertainties relevant to going concern and disclosures of uncertainties

IAS 1, *Presentation of Financial Statements*, requires management of an entity to make an assessment of an entity's ability to continue as a going concern. When management is aware of material uncertainties related to events or conditions that may cast significant doubt upon the entity's ability to continue as a going concern, the entity shall disclose those uncertainties. This is an especially sensitive area for banks as they have large short-term and demand liabilities and disclosure of significant doubt may cause a run on the bank.

The expected outcome of the comprehensive assessment, in particular the stress test element, will be an important consideration in management's assessment of an entity's ability to continue as a going concern. The ECB has not yet announced details of the methodology that will be applied in stress tests. The treatment of sovereign debt exposures will be significant for many banks. Also, although the ECB initially announced a Common Equity Tier 1 benchmark of 8% for the stress test, this has not been finally confirmed.

This lack of clarity may pose severe challenges for banks and auditors in concluding that there are no material uncertainties related to the outcome of the stress test.

3. Recommendations

As the ECB works towards finalising and publishing the methodologies underlying the comprehensive assessment, we recommend that it expeditiously and publicly clarifies the following three issues:

- That it does not intend to require banks to revise financial information that is fairly presented in accordance with IFRS, as adopted in the EU, or amend reasonable judgements made in the application of IFRS;
- Limited cases, where the accounting policies are not able to serve the prudential principles, if any, and defines objective prudential filters to be applied to reconcile the general financial reporting and prudential reporting mission; and
- The methodology and benchmarks that will be incorporated in its stress tests.

The analysis performed by asset quality reviewers working on behalf of the ECB may however provide valuable alternative insights and perspectives on the data, estimates and judgements used by management in preparing IFRS information. Also, although the findings of asset quality reviewers may not be relevant to IFRS measurements, these will provide an input into the stress tests that may affect management's going concern assessments and disclosures. As the asset quality review is unlikely to be complete before most banks publish their December 2013 financial statements, we recommend that the ECB encourages early and ongoing communication between asset quality reviewers, bank managements and auditors so that management and auditors can assess issues and findings that may be relevant to the financial statements as soon as possible.

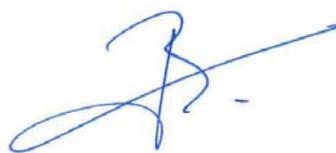
More generally, we believe that regular dialogue, also at a European level, between banking associations, prudential supervisors, securities market regulators and auditors about reporting and risk issues can be valuable in improving the quality of financial reporting and auditing and effective prudential supervision. We, of course, stand ready to assist in facilitating such dialogue.

FEE is at your disposal to further inform this important issue and provide more technical details if needed. Should you wish to discuss any of these points, please contact Olivier Boutellis-Taft, FEE Chief Executive at +32 (0)2 285 40 85 or via e-mail at obt@fee.be.

Yours sincerely,

A handwritten signature in blue ink, appearing to be 'AK', with a horizontal line underneath.

André Killesse
President

A handwritten signature in blue ink, appearing to be 'OBT', with a horizontal line underneath.

Olivier Boutellis-Taft
Chief Executive