



EUROPEAN CENTRAL BANK

EUROSYSTEM

# ASSESSMENT OF ACCOUNTING STANDARDS FROM A FINANCIAL STABILITY PERSPECTIVE

DECEMBER 2006

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## I EXECUTIVE SUMMARY

This report, which was prepared by the ESCB's Banking Supervision Committee (BSC), focuses on the recent introduction of the new accounting framework – based on the International Financial Reporting Standards (IFRSs) – in Europe and analyses the possible consequences thereof for, in essence, the banking sector and other financial firms from the perspective of system-wide financial stability. In this respect, it needs to be recalled that, since 1 January 2005, all listed companies in Europe, including banks, have been required to publish their consolidated financial statements in accordance with the accounting standards issued by the International Accounting Standards Board (IASB) – the IFRSs. Other non-listed companies may also apply the IFRSs, depending on the implementation of the Regulation (EC) No 1606/2002 of the European Parliament and of the Council of 19 July 2002 on the application of international accounting standards<sup>1</sup> by each Member State. Further implementation of the IFRSs is scheduled to take place in 2007, in particular for companies that issue public bonds on a regulated European market.

Accounting standards can have a significant impact on the financial system, in particular via their potential influence on the behaviour of economic agents. First, published financial statements provide signals on which financial and economic decisions are based. Second, financial analysts and shareholders assess the quality of management largely on the basis of accounting figures; management decisions, in turn, are influenced by accounting. Hence, accounting standards can cause financial institutions to behave in a certain way that may, in turn, have an impact on financial stability. Financial stability can be defined as a “condition in which the financial system – comprising financial intermediaries, markets and market infrastructures – is capable of withstanding shocks and the unravelling of financial imbalances, thereby mitigating the likelihood of disruptions in the financial intermediation

process which are severe enough to significantly impair the allocation of savings to profitable investment opportunities”.<sup>2</sup>

The report provides a framework for assessing how and to what extent the accounting standards meet financial stability objectives. To this end, the report first presents benchmark criteria and then evaluates the IFRSs in terms of those criteria that are considered relevant from the perspective of financial stability.

It should be stressed from the outset that the report does not aim at assessing the new accounting standards as such. Furthermore, the report does not intend to set forth additional or alternative accounting standards. Instead, it aims at identifying issues and areas where the IFRSs may, or may not, be beneficial to financial stability and, wherever necessary, at proposing possible directions for improvements from a macro-financial and macroeconomic point of view.

Given the complexity of the subject and the existence of multiple viewpoints, the report benefited from consultations and informal exchanges of views with various constituents (24 in all), ranging from banking associations and individual banks (from Denmark, Finland, France, Germany, Spain and the United Kingdom) to accounting standard-setters, academics, auditors, supervisors and central bankers. However, the views set out in this report are those of the BSC.

The core report is structured as follows: first, the report puts forward ten criteria deemed important from the perspective of financial stability with which accounting standards should be consistent. The selected criteria are: (i) reliance on principles-based accounting standards; (ii) use of reliable and relevant values; (iii) recognition of the allocation and magnitude of risks; (iv) provision of comparable financial statements; (v) provision of clear

1 Official Journal of the European Union (OJ) L 243 of 11 September 2002, pp. 1-4.

2 See *Financial Stability Review*, ECB, December 2006, p. 7.

and understandable financial statements; (vi) portrayal of the financial situation of banks (solvency, profitability, liquidity); (vii) alignment of accounting rules and sound risk management practices; (viii) promotion of a forward-looking recognition of risks; (ix) avoidance of negative and promotion of positive externalities, in particular regarding the behaviour of banks; and (x) enhancement of market confidence and corporate governance. Although the importance of some of these principles is self-evident, the report provides the underlying rationale as to why accounting standards should be consistent with each and every one of them, thus fostering financial stability.

Second, the report analyses to what extent accounting standards are consistent with these criteria, notably when applied to the banking sector. Given their prominence in banks' balance sheets, the report focuses on financial instruments – making a distinction between those exposed more to market risk and those exposed more to credit risk – and selected liabilities, in particular on demand deposits and issued bonds. For each of these categories, consistency with each principle was assessed, and potential issues that could raise financial stability concerns were identified.

Third, the main findings and proposals to enhance financial stability are presented. These findings and proposals benefited very much from, and built upon, work undertaken in other fora, namely in the Basel Committee on Banking Supervision (BCBS)<sup>3</sup> and the Committee of European Banking Supervisors (CEBS).

The main findings can be summarised as follows. First, as far as can be assessed, many aspects of the new accounting framework in the European Union (EU) may contribute to more financial stability. However, the report focuses on those areas in which further improvements would be welcomed from a financial stability perspective. In principle, the introduction of the IFRSs should lead to a substantial increase

in comparability and transparency, thus enhancing the level playing field between banking institutions and strengthening market discipline. The analysis of the current situation in Europe, however, leads to the observation that this benefit has not been reaped in full, as implementation of the IFRSs appears, for the time being, to be rather diverse. For the banking sector, this is particularly noticeable in respect of issues such as fair value versus hedge accounting, or provisioning (see Box 4). For insurance firms, it is noticeable in the currently diverse accounting treatment of insurance liabilities (see Box 5). A consistent implementation of a principles-based framework requires strong accounting governance in Europe, also because divergent implementation could have an impact on competition.

The IFRSs, if implemented consistently and reliably, can provide various stakeholders with some early warning signals on exposures or risks. This holds particularly true of investment banking activities, the use of risk transfer instruments, or liability recognition, as in the case of defined benefit pension schemes. Accounting standards that correctly reflect the underlying economic substance of operations and the risks incurred create incentives for management to adequately control open positions, as their consequences rapidly become visible in the published accounts.

The principles-based framework of the IFRSs (as compared with a rules-based framework) appears to be generally appropriate, at least in the medium and long term – which implies accepting adaptability and some complexity in the implementation process. That said, the approach taken by the IFRSs in certain situations makes it difficult to sufficiently capture some specific features of the financial

<sup>3</sup> The publication by the BCBS, in June 2006, of the “*Supervisory guidance on the use of the fair value option for financial instruments by banks*”, which requires that the fair value option be used in a context of sound risk management by banks, and the guidance on “*Sound credit risk assessment and valuation for loans*”, which stresses the need banks have for appropriate credit risk management and provisioning policies, deserve particular attention in this context.

system and the underlying economic rationale of certain operations. This point remains valid even when acknowledging that the IFRSs were developed to account for transactions and events, rather than for particular sectors such as the banking sector. Liquidity or model valuation issues, for example, do not appear to have been fully addressed, although they are emerging as one of the most important issues to be dealt with in coming years. Another example is the non-recognition in the accounting framework of the economic maturity of certain items, such as demand deposits, even though the economic maturity is regularly used by banks in their risk management practices. More generally, the underlying economics of the operations may not always be taken into account by an instrument-based and sometimes legalistic approach. Such situations can lead to a gap between economic reality and accounting figures. In such cases, banking behaviour could be biased, with possible adverse consequences for financial stability.

The report identifies three areas that deserve particular attention:

- (i) the *reliability of the "fair" values*: fair values should be measured accurately and conservatively,<sup>4</sup> and should be appropriately documented. This should avoid any inappropriate upfront recognition of gains that are unrealisable and prevent herd behaviour that is based on accounting factors, rather than on the underlying economics. Moreover, the use of fair value should not be encouraged for the main part of the loan books, or for core deposits, as long as there is no large and liquid market for these products, nor intent to trade in them;
- (ii) the *economic basis for hedge accounting*: the accounting framework should reflect the underlying economic situation and take adequate account of strictly documented risk management practices as that would encourage sound risk management; and

- (iii) the *provisioning regime*: the implementation of standards on provisioning should not be conducive to increased pro-cyclicality, but should rather encourage the use of methods that aim at identifying credit losses already inherent in a particular credit portfolio at the present time.

It is frequently mentioned that financial reporting in accordance with the IFRSs has not resulted in significant changes and that no financial instability has been observed in EU financial markets. This fact is acknowledged, but the potential long-term impact of the IFRSs should not be disregarded. Indeed, first-time application figures, while very interesting to observe, reflect more the nature and magnitude of the accounting adjustments that result from the transition to the new framework than what could be considered a medium or long-term impact. Moreover, the fact that banks tend to adopt a rather conservative approach in the period of first-time implementation<sup>5</sup> should also be taken into account when assessing the impact of the transition to the IFRSs.

In addition, it should be stressed that the analysis set forth in this report by necessity reflects the current state of play in which the number of years that have elapsed is insufficient to allow more concrete experience of the effective impact of the use of the IFRSs to be gained, in particular because experience thereof in an economic downturn is lacking. This is all the more relevant for EU countries in which the national accounting framework was not similar to the IFRSs. From this point of view, the analysis conducted in the report should partly be viewed as a tentative discussion of possible future systemic issues. Indeed, it is useful to envisage possible effects of the IFRSs on financial stability and, in doing so, to contribute

4 Given a possible range of estimates, expert judgement and experience in choosing the appropriate value should be considered.

5 It was found that the explanation of the accounting adjustments stemming from the introduction of IFRS to analysts and investors was already a large endeavour that did not need to be made more complicated by introducing further significant changes that would need additional explanations.

both to the accounting debate from this important angle and to reflections on the evolution of accounting standards, in particular at a time when work has already started on the “conceptual framework” of the IFRSs. As the number of both the years and the companies applying the IFRSs in different parts of the world increases, the wealth of experience will grow dramatically and may warrant a review of the conclusions presented in this report. In this context, one important issue to be closely monitored and analysed relates to the potential for increased pro-cyclicality<sup>6</sup> that the application of the new standards is expected to entail.

Henceforth, the importance of promoting a dialogue on financial stability issues with the IASB should be acknowledged. The recent initiatives undertaken by the IASB at the political level, e.g. the introduction of regular reporting before the Financial Stability Forum and the European Parliament, are welcomed and encouraged. In this context, the dialogue between the IASB and the central banks and the supervisory authorities in Europe could be intensified. More generally, it seems important that the financial stability dimension be given greater weight in the dialogue between specialists on accounting standards. Three objectives feature prominently in this context, namely: (i) enhancing consistency in IFRS implementation, hence fostering a more level playing field, in particular through reinforced accounting governance in Europe; (ii) promoting an implementation of the IFRSs that is risk-based and not conducive to increasing pro-cyclicality; and (iii) safeguarding the positive features of the IFRSs from a financial stability perspective when discussing “convergence” with US accounting rules.

6 Pro-cyclicality in this context refers to the amplification of the economic cycle by reinforcing its current direction as a result of changes in the accounting rules.



## 2 INTRODUCTION

Financial information is crucial for the economy. It forms the basis on which economic and financial agents, as well as authorities, take their decisions. When meeting sound principles, financial information can underpin market confidence and market discipline. Hence it can contribute to efficient financial intermediation through markets, banks and other financial institutions, as well as support the stability of the financial system by helping to create “conditions in which the financial system – comprising financial intermediaries, markets and market infrastructures – is capable of withstanding shocks and the unravelling of financial imbalances, thereby mitigating the likelihood of disruptions in the financial intermediation process that are severe enough to significantly impair the allocation of savings to profitable investment opportunities.”<sup>7</sup>

The quality of financial statements depends on the accounting standards on which they are based. Therefore, the introduction of the new accounting framework in the EU – based on the International Financial Reporting Standards (IFRSs) – deserves the attention of European banking supervisors and central banks, not only for its immediate impact on the financial statements of the European financial sector, but also for its effect on the global and increasingly interwoven financial system. Accounting standards have a direct impact on supervisory work, and on central banks’ oversight, given that banks’ accounting figures form the basis for calculating financial and regulatory ratios. Hence, changes in the accounting rules will affect market perception, the financial ratios and reports that supervisors use for assessing both the condition of individual banks and, along with central banks, the global condition of the financial system. In practice, this effect can be mitigated to a certain extent<sup>8</sup> by supervisors and central banks adjusting the accounting figures to suit their purposes, e.g. use of “prudential filters” in the calculation of own funds.

It is important that accounting standards effectively contribute to a further strengthening of financial stability. Recently, the financial stability perspective has been at the centre of accounting discussions. The ECB, together with the Basel Committee on Banking Supervision (BCBS), played a decisive role in the amendments introduced in IAS 39 regarding the fair value option, bringing into the debate the importance of capturing and adequately addressing financial stability concerns. The publication, in May 2006, by the BCBS of the “Supervisory guidance on the use of the fair value option for financial instruments by banks”, which requires that the fair value option be used in a context of sound risk management by banks, deserves particular attention in this context.

Against this background, the Banking Supervision Committee (BSC) of the European System of Central Banks (ESCB) set out to analyse the new accounting standards for banks in Europe with the aim of assessing whether the new accounting framework effectively contributes to further enhancing financial stability. This report is the outcome of this analysis.

## 3 CRITERIA FOR ASSESSING ACCOUNTING STANDARDS FROM A FINANCIAL STABILITY PERSPECTIVE

As a basis for the analysis, the report identifies criteria for accounting standards, which are fundamental from a financial stability perspective. These benchmark criteria provide a framework for assessing whether the accounting standards make a positive

<sup>7</sup> See *Financial Stability Review*, ECB, December 2006, p. 7.

<sup>8</sup> Accounting adjustments introduced by supervisors, such as “prudential filters”, do not apply to non-financial institutions that are counterparties to banks.

contribution to further strengthening financial stability.<sup>9</sup>

Given the pivotal role of banks in the financial system, the criteria were drawn up with mainly this type of financial institutions in mind. That said and given the interdependencies between the stability of banks, other financial firms and non-financial corporates, it is important from a financial stability point of view that all entities provide sound and economically meaningful financial statements. Given the general nature of the criteria proposed, they may also be relevant for these other entities.

The criteria aim at outlining the main objectives that accounting standards should pursue from a financial stability perspective. They also aim at addressing the objectives and needs of different economic agents, the main users of financial statements. Indeed, the diversity of economic agents should be acknowledged, in particular regarding their respective time horizons. For example, traders are more interested in the short term, while other investors such as pension funds tend more often to pursue longer-term goals. Yet, both types of investors contribute to economic welfare and growth, and the diversity of their financial objectives should be taken into account from an economic perspective and in a principles-based framework.

### **3.1 CRITERION I – RELIANCE ON PRINCIPLES-BASED ACCOUNTING STANDARDS**

Accounting standards should be such that they result in financial statements that reflect the economic substance of the operations. It is difficult for accounting standards to achieve this objective given the fast pace of development in financial markets, in particular the emergence of complex and sophisticated new financial instruments. Rules-based standards may provide clear and assertive guidance on how to account for operations, which makes it easier to enforce compliance. However, rules quickly become obsolete in rapidly evolving markets. Furthermore, given the current pace of financial

innovation and financial engineering, detailed rules may be more easily circumvented. Indeed, their rigidity may create incentives for changing the form of operations with the view to making the accounting figures more “flattering”. Reality has revealed that even the most advanced financial systems are not immune to deficiencies in financial reporting and that a rules-based environment may become prone to accounting creativity, which can seriously undermine investors’ confidence, with negative effects on the financial system as a whole.

A principles-based approach is more robust to change and thus more likely in the long term to yield accounts that reflect economic reality. However, principles are, by design, general in character and call for strict discipline in implementation. To ensure the effectiveness of principles, internal and external vigilance is important, in particular with respect to the level of accounting governance (e.g. effective audit committees and high-quality external audits).

Hence, it is important from a financial stability point of view that the financial accounts effectively capture the underlying economics, and – in a dynamic and innovative field such as the banking sector – principles seem better placed to do so. Corporate governance, compliance and vigilant external audits should, however, be regarded as crucial complementary elements to a principles-based approach.

### **3.2 CRITERION II – USE OF RELIABLE AND RELEVANT VALUES**

Accounting figures constitute the basis on which economic decisions are taken; hence, they should provide correct signals to economic agents and authorities. Accounting figures

<sup>9</sup> The identification of criteria to form the benchmark which serves as the basis for making the evaluation is necessary. In the *Report to G7 Finance Ministers and Central Bank Governors on International Accounting Standards*, Bank for International Settlements, Basel, April 2000, pp. 11-12, the BCBS identified three general criteria and ten specific criteria that are important from a banking supervisory perspective and that were used as a basis for its evaluation of the accounting standards.

should thus be reliable, i.e. reflect the effective value at which an arm's-length transaction could be settled. They should also be relevant, i.e. provide the information that is valuable and useful to all internal and external users of the financial statements in question.

It should be noted that officially quoted market prices do not always provide reliable information. In particular in cases where markets are not developed or are insufficiently liquid, quoted prices may deviate from the underlying fundamentals. Indeed, certain markets may not have reached a level of maturity that suffices for their long-term liquidity to be assessed with an adequate degree of certainty.

When market prices are unavailable or clearly unreliable, marked-to-model measurements may also be used. These should correctly reflect the underlying economic and financial values of the different basic elements of the transaction and their degree of correlation. Although useful and – in a way – “unavoidable”, model-based measurements include assumptions and parameters whose reliability may be questionable in certain circumstances.

Measurements should also reflect the capacity to trade positions rapidly and effectively. If an entity holds a significant portion of an issued instrument, this should be taken into account. This means recognising that the market could find it difficult to absorb such “block” holdings and that the values could be depressed substantially if the holdings were to be sold at the same time.

Overall, the reliability of marking-to-market or model measurements may be variable and uncertain. It is thus important, from a financial stability perspective, to assess whether price adjustments could be useful and better reflect the underlying uncertainty and value of the financial instrument in the framework of the accounting standards.

From a macroeconomic point of view, it is also important that measurements are not disconnected from the underlying fundamentals, given that this may trigger significant risks not only of a misallocation of resources, but also of mispricing and, possibly, of fuelling financial bubbles.

### **3.3 CRITERION III – RECOGNITION OF THE ALLOCATION AND MAGNITUDE OF RISKS**

The allocation of risks between different economic agents is a central part of financial intermediation, and the quality of this process directly affects the shock resilience and efficiency of the financial system. To support this process, financial statements should adequately reflect the allocation and magnitude of the exposure to risks. Financial statements should provide clear information both on the allocation of risks and on their potential impact on the financial condition of the institution involved. They should take into account certain types of risk that markets cannot easily assess themselves, e.g. instruments acquired with a long-term perspective. In the same vein and in the light of the surging growth of sophisticated risk transfer instruments, accounting figures should reflect the economic effectiveness of the risk transfers.

### **3.4 CRITERION IV – PROVISION OF COMPARABLE FINANCIAL STATEMENTS**

It is widely accepted that a harmonised accounting framework helps to create a level playing field. It enhances the efficiency of capital allocation via the increased cross-border comparability of firms' financial statements and fosters the rational utilisation of resources, thus contributing to economic development. Moreover, financial markets often rely on relative rather than on absolute pricing. Comparability is therefore essential for financial market efficiency. Conversely, a lack of comparability may erode the credibility of financial information, and ultimately undermine market confidence. Comparability is enhanced by applying the same accounting treatment to

the same or highly similar operations from a financial or economic perspective. It also entails recognising that apparently identical financial instruments may be subject to varying degrees or types of risk and should therefore be recorded differently.

Comparability is particularly important for the European banking sector. It facilitates consistent supervision and also helps to alleviate risks that might otherwise arise from misinformed domestic or cross-border banking acquisitions and that could, given the significance of some of the transactions involved, become systemic in nature.

### **3.5 CRITERION V – PROVISION OF CLEAR AND UNDERSTANDABLE FINANCIAL STATEMENTS**

A sound accounting framework should foster market discipline by enhancing transparency via the presentation of self-evident and understandable financial statements.

For market discipline to be exercised effectively, financial statements need to be clear and comprehensible, not only to specialised accountants, but also to financial analysts and market participants in general. This is particularly challenging on account of the proliferation of complex financial instruments. At the same time, a balance has to be struck between understandability, on the one hand, and relevance and reliability, on the other. After all, if disclosures are too simple, they may lack relevance and inadequately reflect the underlying risks incurred. A reasonable balance between these two objectives must therefore be reached by the accounting standard-setters.

While disclosures are indeed useful tools to complement primary financial statements, they should not be viewed as a means to correct financial statements that provide information which is not entirely clear or even misleading. Indeed, disclosures cannot replace ambiguous primary financial statements. As experience gained from recent high-profile cases of accounting malfeasance has shown, even when

disclosures include relevant information that may raise questions regarding the relevance of certain figures in the consolidated accounts of the primary financial statements, that information can be “buried” or “hidden” in such a way that makes it increasingly difficult for even professional analysts to grasp. In addition, many users may not have the resources to adjust published “bottom line” figures.

Another aspect to be considered relates to the length of the disclosures. If they are too extensive and time-consuming, disclosures may become “counter-productive” in some situations, thus actually reducing clarity. This supports the need for enhanced clarity and focus, whilst ensuring that key information that could materially affect the bottom-line figures or information regarding risk management should not be excluded.

### **3.6 CRITERION VI – PORTRAYAL OF THE FINANCIAL SITUATION OF BANKS (SOLVENCY, PROFITABILITY, LIQUIDITY)**

Financial statements should provide an accurate representation of the financial condition of the institution. From a financial stability perspective, the solvency, profitability and liquidity are particularly relevant both in the short and in the long run. In this context, it would be misleading to provide the market with implicit assurance of the present and future tradability of financial instruments at a certain price when this may not necessarily be the case. This may result in a biased assessment by investors and market users more generally. This is particularly relevant in an environment where market decisions focus on accounting ratios (e.g. return on equity), which are sensitive to bottom line accounting figures.

### 3.7 CRITERION VII – ALIGNMENT OF ACCOUNTING RULES AND SOUND RISK MANAGEMENT PRACTICES

Financial statements should reflect sound risk management practices<sup>10</sup>, thus producing financial information that is economically meaningful and recognises the risks incurred by the institution.

Financial statements (including disclosures) that are inconsistent with sound risk management practices could provide a false image of the effective financial and economic features of individual businesses. Moreover, if accounting is not aligned to risk management, this may prompt management to align risk management to accounting, which may, in turn, lead to less prudent risk management and may thus weaken the stability of the banking system. It should be noted in this context that in the guidance on the use of the fair value option published by the BCBS, risk management is seen as the key common basis for financial reporting, prudential supervision and their potential interaction with financial stability.

### 3.8 CRITERION VIII – PROMOTION OF A FORWARD-LOOKING RECOGNITION OF RISKS

An adequate assessment of risks must not only incorporate information from the past, but also projections for the future. For accounting figures to reflect the degree of risk, they must incorporate forward-looking elements. Market values are intrinsically forward-looking. Indeed, it is commonly accepted that capital markets tend to be efficient in the long run, and that market values will, at least eventually, incorporate all publicly available information, including forward-looking elements. However, important challenges remain. For example, some market participants tend, on a day-to-day basis, to focus on a very short-term horizon. This leads to short-term price fluctuations, which partly result from market imperfections or other short-lived factors (such as rumours, self-inflated market tendencies, anecdotal

evidence, etc.). Moreover, markets experience price movements at times that are triggered by “herding” or a “speculative hunt for yield”. Similar challenges arise in marked-to-model accounting, in particular concerning market-based elements in the models. These price movements may depart from the economic fundamentals and could fuel financial bubbles.

In certain situations, a short-term perspective or a “point-in-time” approach may be more appropriate given that it reflects the conditions at that specific moment. However, a more forward-looking approach may avoid or mitigate artificial pro-cyclical swings in valuations by taking a longer term perspective into account.<sup>11</sup> This aspect is of a particular importance for financial stability in Europe, where the application of the same accounting standards by cross-border banking groups might facilitate the building-up of financial bubbles if these standards are not sufficiently forward-looking.

### 3.9 CRITERION IX – AVOIDANCE OF NEGATIVE AND PROMOTION OF POSITIVE EXTERNALITIES, IN PARTICULAR REGARDING THE BEHAVIOUR OF BANKS

Accounting standards directly or indirectly create incentives for economic agents to invest in, or divest from, specific types of instruments (or to change the financial features of those instruments), which may have a long-term macroeconomic impact. In this context, it can be regarded as preferable from an economic point of view to strive for accounting neutrality (i.e. economic decisions are taken irrespective

10 Fundamental elements of sound risk management include the following: (i) senior management and the governing board must set the institution’s risk profile by establishing appropriate policies, limits and standards, and by ensuring that they are followed and enforced; (ii) risks must be measured, monitored and controlled throughout the institution; (iii) clear procedures for assessing risk and evaluating performance must be established; (iv) adequate accountability, clear lines of authority and separation of duties between business functions, risk management and internal controls must be ensured.

11 This treatment should be adequately documented, disclosed and audited so as to prevent the creation of “hidden” reserves at the management’s discretion.



of the accounting treatment), so as to avoid any distortion in the allocation of resources.

However, accounting rules can also create positive externalities that may improve the allocation of resources and the resilience of the financial system to shocks. Such effects should be acknowledged and fostered.

### **3.10 CRITERION X – ENHANCEMENT OF MARKET CONFIDENCE AND CORPORATE GOVERNANCE**

Accounting standards should discourage and, to the extent possible, prevent the manipulation of accounts or so-called “creative” accounting. This would enhance market confidence, which is of key importance for financial stability. Indeed, creative accounting can damage market trust and have disturbing effects on both financial stability and economic development. It should be acknowledged, however, that market confidence and corporate governance cannot be satisfied by adequate accounting standards alone; the implementation of adequate internal controls and internal corporate governance also play a crucial role.

## **4 CONSISTENCY OF THE ACCOUNTING STANDARDS WITH THE CRITERIA DEEMED RELEVANT FROM A FINANCIAL STABILITY PERSPECTIVE**

In this section, the report assesses whether and, if so, the degree to which the IFRSs are consistent with the principles identified in the previous section, which are important from a financial stability perspective. The focus of the analysis is placed on the banking sector. Hence, under each principle, the analysis focuses on those categories in banks’ balance sheets that would be significantly affected or changed as a result of the introduction of the accounting rules. The three main categories of asset and liability classes selected were based on the main risks incurred, but it is also acknowledged that in reality different categories of risks are often present in a single banking operation. With this in mind, the following categories

were identified to facilitate and structure the analysis: (i) financial instruments exposed more to market risk (i.e. normally part of a bank’s trading book); (ii) financial instruments exposed more to credit risk (i.e. normally part of a bank’s banking book); and (iii) selected liabilities, where the focus was placed on demand deposits and issued bonds.

### **4.1 CRITERION I – RELIANCE ON PRINCIPLES-BASED ACCOUNTING STANDARDS**

In general, the principles-based IFRS framework seems particularly well-tailored, as targeted, to international implementation. Legal, tax and regulatory environments differ from one country or economic area to another, so that the flexibility provided by a principles-based approach seems highly suitable. Although the trend towards increasing financial integration reduces those peculiarities, principles-based standards fit better to this type of situation. The IFRSs set out general principles, which include examples or application guidance, but without presuming to capture every kind of operation in a specific rule. Hence, accountants and auditors are left room for judgement and adaptation under the IFRSs.

However, the IFRS framework appears to be relatively prescriptive, i.e. much closer to a rules-based approach, in the specific area of financial instruments (i.e. IAS 39). Indeed, if hedge accounting is taken as an example, institutions need to comply with a strict set of requirements. Given the possibility of deferring or bringing profits or losses forward, it is understandable that the IASB has come to the conclusion that this discretion be governed by stricter and detailed rules. Nevertheless, there is some inconsistency with the global principles-based approach, which could also create complex implementation issues (see Criterion VII).<sup>12</sup>

<sup>12</sup> The main user groups of financial statements are rather heterogeneous, which may imply different assessments of, or weightings given to, concepts such as reliability or relevance of financial information.

## 4.2 CRITERION II – USE OF RELIABLE AND RELEVANT VALUES

For instruments or operations that have a short time horizon and that are traded in active, deep and liquid markets, historical cost is close to meaningless and the reliability and relevance of market or model values is not questioned. These market values are easily determined from observable market prices, which should incorporate all relevant information, or from widely accepted models that mainly use observable market inputs. Hence, in this context, market or model values do, indeed, provide appropriate signals for economic decisions.

However, concerns arise upon departure from that stylised set of assumptions. Indeed, quoted prices may not always provide reliable and relevant information, e.g. in cases where the market is insufficiently liquid or where an institution has a large “block” holding. Moreover, liquidity may also vary over time, depending on current economic conditions. Unexpected or sudden developments could also rapidly affect the liquidity of operations within an economic sector, a category of counterparties (e.g. hedge funds) or when there are a limited number of participants in a market sector, as in the case of complex structured financial products that are developed by large international banking organisations. In a nutshell, “marking-to-market” values are not always a synonym for “fair” values.<sup>13</sup>

Furthermore, the calculation of market values for non-traded financial instruments with a predominant market risk component that cannot be readily valued on the basis of “observable” market prices or standard models may also raise concerns about reliability and thus relevance. The marking-to-model of these instruments, although unavoidable, may prove to be very complex, and the robustness of these calculations does not always result in estimated current values with the same degree of reliability. Limitations or difficulties can arise when valuing, for example, (i) “tailored” or

complex products that cannot be priced through generally accepted models or that require unobservable inputs for pricing, or (ii) long-term financial instruments that are extremely sensitive to the underlying parameters, i.e. cases where a marginal change in one of the model’s parameters results in a material change in the value. IFRS 7 (*Financial Instruments: Disclosures*) may partially address this issue as firms have to disclose the consequences of probable changes in the parameters, but the bottom-line figures will remain subject to this pricing fragility.

In certain situations, some of these limitations could be addressed. For example, the market or model-based value could be adjusted, in order to take liquidity constraints, “block” holdings or model risks into account. These valuation adjustments or haircuts, however, would need to be accurately measured, coupled with strict internal controls on their use, in particular regarding possible changes in the parameters, to avoid any type of cherry-picking. They should also be supported by robust economic analysis and be thoroughly cross-checked by external auditors. In addition, enhanced disclosures for material valuations derived from marking to model should be provided in the financial statements, in particular the key assumptions of the model and the degree of uncertainty associated with the values. It should be noted that the purpose of this proposal is not to decrease the degree of transparency or to allow the creation of “hidden reserves”. These disclosure requirements, which are partly implemented by IFRS 7, could address the fact that accounting figures are mere point-in-time estimates that do not necessarily convey adequate information on the risk exposure or on the distribution of the values.

These concerns also arise for non-traded financial instruments that are predominantly exposed to credit risk. Bank loans represent a

<sup>13</sup> This concern is also voiced by market professionals (see, for example, Ernst & Young, *How fair is fair value?*, London, May 2005, p. 4).

large proportion of banks' balance sheets in Europe. Although most of these assets are accounted for at amortised cost, the IFRSs have increased the possibility of using a fair valuation of loans, through their classification as held-for-trading, available-for-sale assets, or via the use of the fair value option when they are either hedged by a derivative or when the loan has an embedded derivative that cannot be measured separately. Calculating fair values for these instruments, even for traded loans, may not be very reliable as market liquidity is currently not very deep, given the currently small scale of secondary markets for loans in Europe and the relative lack of standardisation. However, the advent and strong growth of securitisation operations could be advocated as a potential source of liquidity provision to the credit market in Europe.<sup>14</sup> These changes, together with the improvements in modelling techniques, could contribute to improving the reliability of market or model values for loans.

Nevertheless, even if valued reliably, the question as to whether fair values would adequately reflect the economic reality of the way loans are managed also arises. Indeed, most loans are not, in effect, held for trading, but are held with the aim of earning recurrent income from the margin over the lifetime of the lending relationship.

To sum up, the marking-to-market or marking-to-model of credit instruments does not at present seem to be sufficiently reliable in Europe. However, this may change with the development of secondary markets over time, as is already under way in certain European countries.

Thus far, the analysis has focused on the asset side of the balance sheet. In the following paragraphs, the liability side will be analysed, namely the specific features of demand or core deposits and the treatment of own credit risk from issued liabilities.

Demand deposits are always recognised at par value for accounting purposes. However,

literature on financial economics typically finds that the economic value of demand deposits may differ significantly from its par value, in particular when deposit rates are substantially below market rates and when deposits are not withdrawn instantaneously but remain in the account for a longer period. The difference between the par value and the economic value is often referred to as the "deposit premium". The calculation of the economic value of demand deposits could be of particular interest when analysing the interest rate sensitivity of the economic value of demand deposits and profitability across deposit-taking institutions. However, the calculation of the economic value of demand deposits (and hence the deposit premium), while certainly conveying relevant information, is subject to significant model risk.<sup>15</sup>

A possible way forward would thus be to continue to record demand deposits in the balance sheet at par value and to require the disclosure of the interest rate sensitivity, i.e. the decomposition of the par value into the sum of the economic value and the deposit premium, in the notes to the financial statements. Hence, the information content would not be lost and may also provide incentives for institutions to continue to develop their measurement models further.

For issued liabilities, the question is whether the effect of changes in own creditworthiness on the market price of a liability should be

<sup>14</sup> However, it is not clear whether operations will continue to increase significantly in the future. The new solvency rules (Basel II) contain stricter requirements for the treatment of securitisations that may result in significantly higher capital charges when compared with the current situation, thus potentially stifling banks' appetite for such funding. By providing a means for banks to unload risks to other economic players, however, recourse to securitisations could still continue to develop further. In such a case, prices inferred from securitisation operations may appear heavily dependant on the level of the first-loss credit protection provided to investors by the sponsors of such operations and by the accounting regime for risk transfers.

<sup>15</sup> See H. Dewachter, M. Lyrion and K. Maes, *A Multi-Factor Model for the Valuation and Risk Management of Demand Deposits*, Working Paper No 83, National Bank of Belgium, Brussels 2006, and the references therein.

included in the balance sheet value. Generally, the lower the credit standing of an institution, the lower the market value of its liabilities will be.<sup>16</sup> In a situation where an institution's credit rating deteriorates, the value of its liabilities would decrease, which would result (*ceteris paribus*) in the recognition of an accounting gain. The underlying assumption is that the institution may repay its liabilities at a lower cost and thereby realise a gain. Several arguments can be brought forward in favour of including the discount for default risk – or so-called “own credit risk”. From the perspective of solely reliability and relevance (which is addressed here), however, the ability of a firm to carry out early repayments of all its issued liability is questionable, especially when the institution faces a higher degree of financial distress. In such situations, raising its capital or increasing its borrowing are not viable options. The firm would need to sell assets, which would have an unfavourable effect on the respective price, and that, in turn, would offset the theoretical gain on the liabilities side. Furthermore, as from a certain degree of financial distress, the reduction in the credit standing will eventually be reflected either in a deterioration of the quality of assets or via a reduction in the flow of income, both of which would ultimately offset the gain recognised from the lower value of the liabilities. Therefore, it seems undesirable for fair valuation to take this default risk premium in the discount rate into account, given that this would reduce the relevance of the accounts and the quality of the signals from a financial stability perspective.<sup>17</sup>

#### 4.3 CRITERION III – RECOGNITION OF THE ALLOCATION AND MAGNITUDE OF RISKS

The IFRSs should improve the information pertaining to the financial position of the bank, as the accounting standards require a more comprehensive recognition of risks in the balance sheet. Indeed, all derivatives will have to be reported in the balance sheet at their fair value. This is a significant and highly welcomed improvement over the rules previously existing in most European countries, where derivatives

not held for trading were kept off-balance-sheet at cost, thus concealing the effective risks incurred.

The IFRS rules for de-recognition and consolidation could also have a favourable impact as they seem adequately to reflect effective risk exposures in most situations. Indeed, the IFRS approach for de-recognition mixes a risk-and-reward approach, which tends to precisely track the economic allocation of risks, with a control-oriented approach, while giving precedence to economic substance over the legal form. Such rules could be regarded as particularly helpful both in a context where risk transfers are developing between banks, on the one hand, and insurance companies, mutual funds, hedge funds and pension funds, on the other, and with a view to the potential financial stability implications if unidentified risks were to emerge.

Regarding demand deposits, IFRS provisions do not recognise the fact that, on a collective basis, their economic value is sensitive to changes in interest rates and could, in this context, be eligible as a hedged item. By valuing more assets at fair value without allowing demand deposits to be recognised as an economic hedge, the IFRSs introduce volatility in earnings and equity that may not relate to, or result from, a change in the underlying economic risks.

In addition, it is indisputable that different holding periods imply exposure to different

16 This can take two basic forms. The institution may receive less than the face value of the liability it takes on (as in the case of a zero-coupon bond). Alternatively, it may pay interest above the risk-free rate (as in the case of a bank loan or a coupon-bearing bond). The discount in the case of the former, and the mark-up in that of the latter, will be a function of its credit standing. In fact, the two forms are financially equivalent for two bonds with the same face value in that the net present value of the additional interest paid should equal the discount.

17 From a financial stability perspective, the impact of “own credit risk” becomes a concern when it is material, so that the exclusion of the default risk premium could be made conditional on a materiality check, i.e. to provide for default discounts to be extricated from market prices only when the own credit risk is material.

kinds of risk. A financial instrument that is held for a short period of time is mainly exposed to market risk, i.e. expected future cash flows depend largely on the financial market conditions that affect the instrument's market price. When the same financial instrument<sup>18</sup> is held for a longer period of time, it will become more sensitive to credit risk, as the importance of the probability of default rises with the length of the period of time that the instrument is held for. In short, when holding periods are different, it seems appropriate that accounting should also reflect this fact. Finally, the capacity of markets to appropriately capture and estimate all types of risk that financial instruments are exposed to can be questioned, especially with respect to liquidity risk, volatility risk and credit risk.

Regarding credit risk, measurements by financial markets, e.g. through spreads, are still imprecise and can be influenced by factors other than those directly linked to the counterparty's credit risk. First, competition between banks plays a key role in the pricing of credit risk (e.g. real estate loans in some European countries), an area where mispricing could be significant. Second, the problem of the asymmetrical character of the information available to well-informed creditors (e.g. banks) and that at the disposal of market participants may be particularly noteworthy in this context. Credit spreads assess the credit risk profile of certain well-known issuers. But not all financial instruments are issued by rated or well-known issuers, and – even in this case – changes in credit spreads may be linked to changes in the general sentiment of market participants and to their relative reluctance to accept, or appetite for accepting, credit risk in general, rather than to changes in the counterparty risk profile of the issuer. In the same vein, the evolution of spreads may simply be related to the overall macro-environment: spreads, for instance, tend to become larger when risk-free interest rates increase and smaller when risk-free interest rates decrease. Competition and liquidity effects or, more generally, the interaction of bid and ask prices

may also influence the level of spreads, as has been observed in many EU countries in recent years. In sum, spreads can be regarded as only partially correlated to the expected evolution of probabilities of default that emanate from increases in the cost of debt. However, the implementation of Basel II could tighten the link between spreads and borrowers' individual situations. As stated previously, counterparty risk arises especially when the instruments are not managed with a view to being sold in the short term (i.e. when the holding period is longer). Thus, this risk may be particularly significant for available-for-sale assets or assets designated as at fair value through profit or loss that could be kept in the balance sheet for a very long period of time (as in the case of strategic investments in equity instruments). The “snapshot” given by a market value would not capture this exposure, whereas valuation models might include such risk.

#### **4.4 CRITERION IV – PROVISION OF COMPARABLE FINANCIAL STATEMENTS**

The adoption of common accounting standards in Europe as such means a major improvement in the comparability of financial statements. In principle, the introduction of the IFRSs provides a substantial increase in comparability and transparency. An analysis of the current situation in Europe, however, leads to the observation that this benefit has not been fully reaped, as implementation of the IFRSs appears, for the time being, to be rather diverse. The discussions with market participants showed differences in the implementation of the IFRSs, in particular on account of strong domestic accounting cultures and divergent positions among external auditors across jurisdictions. In this context, the IFRSs should not cover provisions, nor should their implementation create ambiguities that could jeopardise the objective of enhanced comparability. However, certain provisions of the IFRSs, notably IAS 39

<sup>18</sup> The example considers financial instruments that are effectively exposed to credit risk, thus excluding other financial instruments such as government bonds from the argument.



(*Financial Instruments: Recognition and Measurement*) and IFRS 4 (*Insurance contracts*), raise some questions.

For the purpose of measurement, IAS 39 groups financial instruments into four categories that are based on management intent. The intent behind management's holding an instrument is also used as the determining factor in existing local European rules. It is thus an accepted accounting convention that different values can appear in the balance sheet for similar financial instruments, depending on the nature of, or intent behind, their use. It is also consistent with the objective that accounting should be aligned to sound risk management practices. However, some aspects of IAS 39 may raise concerns about comparability insofar as it permits identical or similar positions that are managed in the same way to be accounted for differently.

This concern is particularly great regarding the application of the fair value option, although the version of IAS 39 amended by the IASB in June 2005, as a consequence, in particular, of the work undertaken together with the ECB and the BCBS, limits its use and potential abuse. This option, which was introduced mainly to simplify the application of the provisions on hedging arrangements, enables management to record many assets and liabilities at fair value. It could thus be problematic in terms of comparability, notably for banking organisations. Although banking supervisors may be vigilant with regard to the use of the fair value option and have issued guidance relating to its application,<sup>19</sup> it is essential that use of the fair value option be carefully assessed, in the first place, by the banks and then be reviewed by the external auditors.

Another issue arises from the discretion to apply hedge accounting, which may have a significant impact on the profit and loss account. The distinction made between a fair value hedge and a cash flow hedge is a good example. Despite different definitions, the distinction is not always clear and allows a

discretionary use of either one method or another in similar economic situations. For example, when hedging the gap between a fixed interest rate asset and a variable interest rate liability with an interest rate swap, the same transaction can be declared as a fair value hedge if the asset is designated as the hedged item or as a cash flow hedge if the selected hedged instrument is the liability. Fair value changes relating to the former are recognised in the profit and loss account, while they are attributed directly to equity in the case of the latter; this runs counter to the objective of financial statement comparability (see Box 1 for an example).

<sup>19</sup> See Basel Committee on Banking Supervision, *Supervisory guidance on the use of the fair value option by banks under IFRS*, Bank for International Settlements, Basel 2006. The document communicates supervisory expectations about the use of the fair value option and emphasises the importance of risk management and controls when utilising the fair value option. It should be noted that risk management is seen as the common basis for financial reporting and for prudential supervision.

Box I

**EXAMPLE OF THE DIFFERENCE BETWEEN THE ACCOUNTING TREATMENT OF A CASH FLOW HEDGE AND THAT OF A FAIR VALUE HEDGE UNDER IAS 39**

**Assumptions:** A ten-year fixed-rate financial asset is financed by a ten-year variable-rate liability. A ten-year swap is contracted whereby a fixed rate is paid and a variable rate received. The purpose of the swap is to eliminate the sensitivity of the future interest spread to changes in interest rates.

**Table A Interest spread arising from the combination of cash flows generated by these instruments**

	t <sub>0</sub>		Changes in market interest rate <sup>1)</sup>		
			t <sub>1</sub>	t <sub>2</sub>	t <sub>3</sub>
Fixed interest rate received (financial asset)	3,67%				
Fixed interest rate paid (swap)	3,44%	Financial asset	4,30%	4,27%	5,05%
Variable interest rate received (swap)	+ EURIBOR	Swap	4,07%	4,04%	4,82%
Variable interest rate paid (financial liability)	- EURIBOR				
<b>Interest spread generated</b>	<b>0,23%</b>				

1) Corresponds to the interest spread between risk-free government bonds and swaps. No credit spread is considered.

**Table B Changes in fair values for these instruments**

	Fair value			
	t <sub>0</sub>	t <sub>1</sub>	t <sub>2</sub>	t <sub>3</sub>
Financial asset	1000	953	960	920
Financial liability	1000	1000	1000	1000
Interest rate swap	0	47	40	80

**IAS 39 accounting principles applying to these transactions:** The sensitivity of the interest spread to movements in the EURIBOR is eliminated. From an economic point of view, the swap is a hedging instrument that reduces the interest rate exposure. However, IAS 39 does not allow the hedging of net risk positions, which means that the swap must be designated as a hedge of either the asset or the liability. If the bank decides to designate the asset as the hedged instrument, the hedge is a fair value hedge, as the interest rate risk relates to the value in the balance sheet. If the bank decides to designate the liability as the hedged instrument, the hedge is a cash flow hedge, as the interest rate risk relates to the future interest flows.

**Accounting treatment based on a fair value hedge of the asset for year t<sub>1</sub>:** The change in the fair value of the asset (-47) is recognised as a loss, and the carrying value of the asset is decreased by the same amount. The change in the fair value of the swap (+47) is recognised as a gain, and as an asset in the balance sheet. The net result is zero.

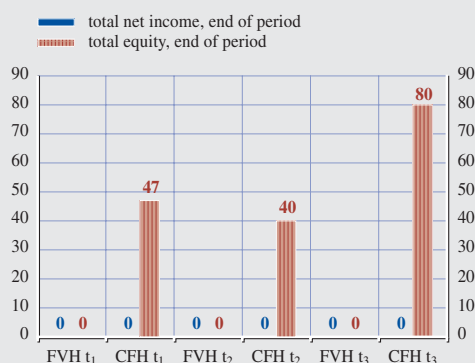
**Accounting treatment based on a cash flow hedge of the liability for year t<sub>1</sub>:** The change in the fair value of the swap (+47) is taken directly to equity, and recognised as an asset. There is no change in the income statement, and total equity and assets increase (+47).

**Table C Comparison of the results based on a fair value hedge and a cash flow hedge**

	Fair value hedge (FVH)			Cash flow hedge (CFH)		
	t <sub>1</sub>	t <sub>2</sub>	t <sub>3</sub>	t <sub>1</sub>	t <sub>2</sub>	t <sub>3</sub>
Total assets, end of period	1000	1000	1000	1047	1040	1080
Total equity, end of period	n.a. <sup>2)</sup>	n.a. <sup>2)</sup>	n.a. <sup>2)</sup>	47	40	80
Total net income, end of period <sup>1)</sup>	0	0	0	0	0	0

1) Excluding interest income and expenses.

2) Tax treatment and dividend distribution pending.



**Conclusion:** Depending on whether the asset or the liability is designated as the hedged item, the impact of the accounting treatment on net income and equity is very different. This could provide scope for choosing a particular treatment solely to achieve a particular accounting effect.

As regards accounting for insurance liabilities, the flexibility currently granted to those drawing up financial statements may also raise some questions regarding the capacity of the market to compare the financial statements of insurance companies. From the perspective of both financial stability and banking supervision, the fact that the insurance sector is increasingly involved in risk transfer operations with the banking sector and that financial conglomerates or bancassurance groups are amongst the most important financial intermediaries in some European countries make the comparability of the financial statements of insurance companies a matter of crucial importance.

The argument has been put forward that applying full fair valuation will cause comparability to increase automatically. For this to occur, however, the fair valuations need – as stated previously – to be measured reliably and to incorporate all meaningful parameters, such as the liquidity of the market and other relevant factors. When this is the case, “fair” values can, in principle, allow more meaningful comparisons of the financial status of different entities.

The ability of the International Financial Reporting Interpretations Committee (IFRIC)<sup>20</sup> to respond in a timely manner to an increasing number of requests from a growing constituency of users of the IFRSs is also a source of concern. In this context, the recent initiative of the European Commission to set up a roundtable for a “consistent application of the IFRSs”, which would function as a forum for European accounting experts to identify, at an early stage, emerging and potentially problematic accounting issues in relation to consistent application should be commended. By ensuring consistent application, the objective of maintaining comparability is also promoted.

#### 4.5 CRITERION V – PROVISION OF CLEAR AND UNDERSTANDABLE FINANCIAL STATEMENTS

The situation with respect to the accounting framework is one of transition, which needs to be monitored and requires companies to take

20 The interpretative body of the IASB, the IFRIC, provides guidance on the application and interpretation of the accounting standards, following an open due process, and reviews accounting issues that are likely to receive divergent or unacceptable treatment in the absence of authoritative guidance, with a view to reaching consensus as to the appropriate accounting treatment.

additional care in communicating their financial statements to the markets. They should provide comprehensive disclosures that are coupled with detailed explanations, in particular regarding the material impacts from the change in the accounting rules that would give the markets the necessary information to adequately judge the performance of the entity and make informed investment decisions. The provision of an adequate communication policy to the market is particularly important for banks, which are much more sensitive to changes in the confidence and trust of the public than many other firms. However, the sheer volume of the disclosures should not, in itself, provide a disincentive to effectively analyse these disclosures and extract the relevant information. Recent surveys<sup>21</sup> have shown that analysts are still coming to grips with the IFRSs. The additional volatility resulting from the increased use of market values will impact on the earnings-based valuation metrics commonly used by analysts at present. This may make it more difficult to discern underlying trends from fluctuations that will not have an economic impact on the bank, or to extricate gains and losses that are more related to the accounting method used (e.g. the reclassification of gains and losses from cash flow hedges into the profit and loss accounts). The banking sector has traditionally been considered by investors to be a “high-risk” sector, in particular on account of the high leverage and relative opaqueness of the sources of earnings. Although the increased comparability may lead to a lower cost of capital, this potential benefit could be partially or fully lost if the perceived complexity of the IFRSs were to add to the aforementioned sources of risk. However, this issue will diminish over time as analysts and investors, as well as other relevant users of financial statements, become more accustomed to the IFRSs and better understand their implications.

While disclosures may be a necessary complementary tool, they are not sufficient in that they cannot replace adequate accounting figures in the primary financial statements. Indeed, they should not be seen as a means to correct financial statements that would convey misleading

information to the market. For example, significant impacts to equity are disclosed, but the statement reflecting the changes and adjustments to equity is not always clear and easy to understand. In this respect, it might be appropriate to add to the clarity by separating changes in equity arising from profit or loss of the period from other components of recognised income and expense (i.e. other comprehensive income), such as gains and losses from revaluations, re-measurements at fair value, foreign exchange translations and cash flow hedges.

#### 4.6 CRITERION VI – PORTRAYAL OF THE FINANCIAL SITUATION OF BANKS (LIQUIDITY, PROFITABILITY, SOLVENCY)

The current level of financial sophistication makes it increasingly harder to measure the liquidity situation of a bank, partly because of the growing role played in financial transactions by non-regulated financial entities such as hedge funds. IFRS 7 (*Financial Instruments: Disclosures*) does not seem to provide an answer to this need for enhanced disclosures, given that the information provided (in particular with regard to the legal maturity) would not suffice to capture current developments in banking liquidity. Hence, the provision of information on the liquidity position of a bank could be enhanced further.

From a financial stability perspective, the increased use of model or market values in accounting raises concerns about the recognition and treatment of unrealised gains and losses. Indeed, the current accounting framework fails to distinguish between realised and unrealised gains, thus allowing the latter to be distributed, provided that there is no provision against such distribution. This is particularly imprudent for instruments for which there is frequently no active secondary market, so that the information on changes in their fair value may not always provide insightful economic information. For

21 KPMG, *Introduction of IFRS – Analyst Research Survey*, Dublin, October 2004, p. 4, where 40% of analysts rated their own knowledge of the IFRSs as poor, and Citigate Dewe Rogerson, *The adoption of International Financial Reporting Standards – Who should lead the way?*, London, March 2005.

these instruments, it would often not be possible to realise any measured gain immediately. The concern is even more acute in the case of the use of fair values for issued bonds. This may provide misleading information concerning solvency, given that profits arising from reduced liabilities due to increased own credit risk are often unrealised. The resulting artificial profits, and the improvement in solvency, would give a completely contradictory signal concerning the financial situation and performance of the firm. This risk does not arise in other accounting treatments where own credit risk is not present. Thus, the impact on the profitability of the institution and the resulting excessive volatility in income and equity, and consequently on solvency, may not provide economically relevant information.

The use of cash flow hedging also has the potential to provide an unclear picture regarding the bank's capital position and may warrant additional care and attention in the interpretation thereof. This accounting approach requires that the portion of changes in the fair value of the derivative used to hedge future cash flows that is determined to be an effective hedge be recognised directly under equity. However, these fluctuations in equity do not actually represent increases or decreases in capital, they merely represent fluctuations in the fair value of the derivative that will subsequently be offset by the actual changes in the cash flows that the derivative is hedging. Of course, the extent to which the fluctuation of the hedging instrument is compensated for by changes in the actual future cash flows depends on the degree of effectiveness of the hedge. A perfect hedge will completely offset. Hence, these fluctuations in equity may be considered mere "noise" in equity, and to be providing investors with a misleading picture of the entity's overall solvency.

It should be noted, however, that banking regulators have developed mitigating measures in their prudential reporting to deal with the aforementioned issues. More specifically, banking supervisors – and, to some extent,

insurance supervisors – have responded to these concerns by introducing "prudential filters" in the calculation of regulatory capital that would prevent banks' own funds from including, for example, unrealised gains that do not meet certain criteria, relating to their permanence and loss-absorbing capacity, for consideration as regulatory capital.<sup>22</sup> The efficiency of these filters will depend, in part, on the degree of harmonisation and consistency reached upon implementation, both in the EU and throughout the world. Given that markets assume that solvency ratios, which constitute an important indicator, are calculated in a harmonised way, prudential filters should be implemented in a similar and transparent manner.

#### **4.7 CRITERION VII – ALIGNMENT OF ACCOUNTING RULES WITH SOUND RISK MANAGEMENT PRACTICES**

When comparing international accounting rules with sound risk management practices, three main issues arise regarding trading, provisioning and hedging.

With regard to trading, marking-to-market or marking-to-model measurements, when appropriately calculated, provide senior managers and, eventually, stakeholders with very useful early warning signals on exposures. The immediate impact on profitability is generally a strong incentive to adequately manage exposures. This anticipatory effect can be considered a sound risk management tool on an individual basis.

Where provisioning is concerned, accounting should ideally incorporate a pro-active approach that is comparable to sound credit risk management, which tries to identify expected collective losses as soon as possible, in particular those that may be embedded in loans and relate to sectoral, geographical or even

<sup>22</sup> See [www.bcbs.org](http://www.bcbs.org) and [www.c-eps.org](http://www.c-eps.org) for a full description of the capital treatment of certain items under the IFRSs and of the "prudential filters" that have been developed.



global monetary and other economic developments, be they existing or anticipated. Otherwise, banks may persist in pursuing very dynamic lending strategies or practices, and thus potentially continue to accumulate significant future loan losses. If, during economic upturns, the accounting framework is not sufficiently flexible to allow the recognition in the accounting of the increasing credit risk that banks incorporate in their loan portfolios, the impact would be much greater in phases of downturn, since large amounts of losses would suddenly have to be recognised. Therefore, an accounting regime that does not allow forward-looking provisioning may deepen crises and have a pro-cyclical effect. The IFRSs can be questioned in this regard, as they do not explicitly provide for such an approach in the incurred-loss model proposed.

The IFRSs do not always reflect the underlying economics. For example, with regard to hedge accounting, the IFRSs should reflect the economic substance of the transactions. Despite improvements introduced to IAS 39 (*Financial Instruments: Recognition and Measurement*) that bring hedge accounting closer to the risk management methods used by credit institutions, some important problems remain to be solved.

First, the effectiveness test focuses on an accounting correlation between the changes in the fair value of the hedged items and that of the hedging items, and not on the reduction of the risk exposure, thus recognising, among other things, material ineffectiveness from under-hedging for a portfolio of interest rate risk, which is contrary to current risk management practices. Moreover, in such cases, the effectiveness test imposed by the IFRSs is not consistent with those performed by risk management and could lead to conflicting conclusions.

Second, demand deposits cannot be designated as hedged items according to IAS 39 (*Financial Instruments: Recognition and Measurement*), as deposits may contractually be withdrawn at any given moment. In practice, however,

deposits may remain rather stable on an aggregate basis. It has been argued that a proper valuation of deposits should only concern existing ones, and that new deposits attracted in future should be excluded.<sup>23</sup> However, even if such a restrictive stance is assumed and new deposits are excluded from the analysis, the belief that current deposits flow out of the accounts after only a few weeks may not hold true of all kinds of deposit accounts across European countries.

Third, loans that are hedged by credit derivatives are not appropriately recognised: either the loans are booked at their amortised cost, and the symmetrical credit derivatives at their market value (as the hedge rarely meets the criteria for hedge effectiveness), which could be regarded as inappropriate or even misleading as the bank will suffer losses when the quality of the loans improves after the purchase of the derivative,<sup>24</sup> or the loans must be marked to market if the fair value option is used, which may de facto be unreliable in many cases.

Fourth, under the IFRSs, held-to-maturity investments cannot be designated as hedged items with respect to interest rate risk (IAS 39.79) on the basis that their measurement at amortised cost would make them completely insensitive to interest rates. However, these instruments can be economically exposed to such a risk on a pro rata basis when funded through variable rate resources.

Finally, undesirable arbitrage opportunities could arise between fair value hedges and cash flow hedges in economically equivalent situations, with very different impacts on net income or equity.<sup>25</sup>

Hence, in certain situations, the IFRS accounting framework does not allow the economic and

23 M. Barth, *Including estimates of the future in today's financial statements*, Working Paper, Stanford University, Palo Alto, 2005, pp. 11-13.

24 The market value, or cost, of a guarantee received decreases when the risk also decreases.

25 See Box 1 for an example.

financial reality of interest rate risk management to be adequately reflected in the financial statements. This could induce banks to abandon certain hedging practices, even though they are viewed as prudent and effective from a business point of view, or it could reduce the overall incentive to hedge risks properly. Indeed, taking this argument further, this could have adverse consequences if credit institutions were tempted to abandon part of their hedging that is grounded on sound risk management practices for any of the accounting reasons listed above.

However, it should be recalled that some of these concerns may be partly addressed by the use of the fair value option. The positive work of the ECB and the BCBS, in conjunction with the IASB, on the amended fair value option standard should be acknowledged. The fair value option allows economic hedging without meeting the hedge effectiveness test. However, the fair value option presents a practical alternative that calls for vigilant implementation. In this regard, banks are expected to use the fair value option in a manner that is consistent and that addresses the prudential concerns which have been raised by the BCBS.

The current carve-out in the EU of certain hedge accounting provisions eliminates some inconsistencies between the treatment of macro-hedging and general risk management practices. For example, by eliminating certain hedging provisions of IAS 39, the European carve-out allows demand deposits to be designated as hedged items. However, the carve-out, which – as explicitly stated by the European Commission – is temporary in character, does not directly address the underlying fundamental issue, but merely provides a practical answer to the problem, which does not represent an optimal long-term solution.

#### **4.8 CRITERION VIII – PROMOTION OF A FORWARD-LOOKING RECOGNITION OF RISKS**

Two issues could be considered in this context: (i) the forward-looking nature of “fair” value accounting and (ii) the incorporation of forward-looking elements in the provisioning of instruments measured at amortised cost.

Fair value accounting could be regarded as forward-looking by nature, given that expectations regarding the future performance of assets and liabilities should, in theory, be reflected in market valuations. Indeed, fair value leads to the revaluation of an asset when there is a change in its market price or (in the absence of a market for the asset) in the present value of the future stream of cash-flows to be generated by the asset.

However, the view that the use of the fair value should generally lead to a more timely recognition of losses (for example, on bank loans) – i.e. the assumption that a change in risk at any given point in time in the holding period will immediately be reflected in the current fair value of the asset – may not always be true. The capacity of markets to appropriately capture and estimate all types of risks that financial instruments are exposed to may be questioned, especially with respect to credit risk and liquidity risk. When market prices do not exist, the use of models would make it possible to reflect such risk in the fair values, but the development of robust credit risk models is still in an early stage. In addition, fair value accounting makes no distinction between credit risk and other types of risk (interest rate risk, foreign exchange risk, etc.) that have no bearing on counterparty quality, but are encompassed in the fair value calculation. Furthermore, a loan valuation method based on market prices would inevitably introduce extra volatility in banks’ profits and equity, which would not only reflect changes arising from fluctuations in credit risk, but also temporary changes caused by market fluctuations. Hence, in certain situations, it

could provide a distorted image of banks' underlying performance. Finally, at the macro-economic level, it could be argued that the greater use of fair values might have a pro-cyclical impact.

An approach to promoting forward-looking provisioning by adjusting the value of the banking book in the form of dynamic provisioning has been discussed, in particular by supervisors.<sup>26</sup> Dynamic provisioning recognises that (i) a certain fraction of a currently unimpaired portfolio can be expected to deteriorate in the future and that (ii) the magnitude of these "expected-but-not-materialised" losses over the lifetime of the portfolio can be predicted on the basis of statistical analysis of similar portfolios. As a result, dynamic provisioning prevents latent credit losses from remaining hidden, since the losses are recognised before the signs of deterioration become evident.

With regard to financial instruments measured at amortised cost, i.e. bank loans, incorporating forward-looking elements in loan provisioning would have a stabilising influence on the economic cycle and would, notably, reduce the cyclical nature (and hence the volatility) of the recognition of credit risk. The recognition of an instrument's true inherent risk over its lifetime – so-called "through-the-cycle" recognition – would enhance banks' safety and soundness, thereby strengthening the stability of the financial system as a whole and ensuring that it can better serve as a lasting source of credit and growth for the economy.

By contrast, a rule that would recognise the risk only when it is crystallised by a specific event would tend to create a cyclical pattern in banks' earnings from lending activities, with impairment provisions appearing only at low points in the economic cycle when defaults cause the risk to surface. The knock-on effects on the financing of the economy can be substantial in times of sharply fluctuating economic conditions.

In the case of a broad interpretation of the respective provisions of IAS 39 (*Financial Instruments: Recognition and Measurement*), the IFRS approach can be implemented in very different ways, but the most immediate one would be to refer to the "incurred loss" pattern and therefore not to recognise credit risks through provisions until a fairly late stage. More clarity in favour of a forward-looking approach seems beneficial from a financial stability perspective, as it would take into account highly probable risks, either estimated on a statistical basis or based on rational forecasts regarding a sector or geographical area. This issue is particularly critical when the credit risk cycle is on the upside. The current period may not be the most appropriate to quantitatively assess the situation: although many banks have succeeded in largely retaining their collective provisioning in the course of the first-time implementation of the IFRSs, their ability to continue to create provisions in the same manner has to be monitored.

#### **4.9 CRITERION IX – AVOIDANCE OF NEGATIVE AND PROMOTION OF POSITIVE EXTERNALITIES, IN PARTICULAR REGARDING THE BEHAVIOUR OF BANKS**

Conceptually, it seems uncontroversial that accounting should provide an unprejudiced set of information to stakeholders, on which they can base their decisions. In this context, the introduction and application of new accounting standards should not pre-empt market participants' decisions. In reality, however, it is more than likely that accounting has a strong impact on behaviour (e.g. the closing-down of pension schemes by some companies as a result of the introduction of the new accounting rules).<sup>27</sup> Accounting neutrality can be an

<sup>26</sup> See G. Jiménez and J. Saurina, "Credit cycles, credit risk and prudential regulation", *International Journal of Central Banking*, Washington, June 2006, pp. 65-98, for a discussion of the relationship between credit risk along the cycle and loan-loss provisions, in which they argue in favour of dynamic provisioning.

<sup>27</sup> It must be noted that, in this situation, the on-balance-sheet recognition of existing liabilities which were "hidden" off the balance sheet was a positive development, thus better reflecting the underlying exposures the entity was incurring.

attractive and accepted concept until the practical interaction between operations and their recognition in the accounting figures is taken into account.

In particular, considering the pivotal role of banks in the economy, it can be argued that, if the IFRSs better reflect their financial situation and their exposure to risk, then the accounting standards could foster positive externalities. The better recognition of risk exposures would make management more accountable and investors more aware, and this could create incentives for institutions both to reduce their risks and to better allocate their resources. It may also encourage banks to improve their risk measurement and management practices, by providing due justification for investment in better IT systems and for putting improved internal control systems in place. These potential positive externalities, which would benefit the economy in the long run, should be promoted and seen as a positive effect of the accounting standards.

However, the application of accounting standards may also give rise to negative externalities. A key requirement to avoid the emergence of negative externalities is to have accounting rules that are aligned with the underlying economic substance. When there is a discrepancy between the two, there may be scope for the surfacing of adverse incentives.

Another aspect linked to the difficulty of applying the strict hedging rules defined in the IFRSs, which may have resulted in a negative externality, is the potential increase in the use of short-term variable rate financing. This behavioural impact could affect the traditional role of financial institutions regarding maturity and liquidity transformation, making them more focused on short-term results at the expense of long-term customer relationships and investment needs. In this context, interest rate risk, which is currently managed by banks via the transformation of short-term sources of funds into medium-term loans, would then be passed on to non-financial economic agents,

namely households, who are not the best placed to manage this risk. In the long run, this may also “backfire” on banks through an increase in customer insolvencies in the event of a significant upward change in the interest rate environment.

In addition, it should be noted that an increased use of marking-to-market, in particular for loans, could result more globally in “artificial” volatility. Market prices reflect actions of market participants – when these agents have a short-term horizon, short-term price fluctuations affect their behaviour – which lead to a “feedback loop”, where the anticipation of short-term price movements induces agents to react in a way that amplifies the price movements (banks, for example, would sell more assets than they would normally wish to in order to pre-empt the consequences of an anticipated fall in prices on their accounts, and this would, in turn, exacerbate the price evolution).<sup>28</sup> When such a feedback process is strong, entities’ decisions are based on attempts to anticipate decisions of others, rather than on fundamentals. Hence, marking-to-market, coupled with the potential anticipation effect of price movements, creates herd behaviour and actually amplifies the movements, thus creating “artificial” endogenous volatility in prices and in banks’ portfolios that does not stem from changes in the fundamental economic value of the financial instrument. It has been found that these behavioural effects would be strongest, and would possibly override the positive aspects of fair valuation, in the case of long-term, illiquid and senior claims.<sup>29</sup> Given that these are currently some of the main characteristics of the financial instruments in the banking book, this argument is especially relevant for the banking industry.

<sup>28</sup> See G. Plantin, H. Sapra and H.-S. Shin, *Fair value reporting standards and market volatility*, London, October 2004, pp. 5-8.

<sup>29</sup> See G. Plantin, H. Sapra, and H.-S. Shin, *Marking-to-Market: Panacea or Pandora's box?*, GSIA Working Paper No 2005 – E4, Carnegie Mellon University, Tepper School of Business, Pittsburgh, December 2004, pp. 6-9.

Adverse incentives could also arise from the recognition of issued liabilities at fair value. Indeed, as the institution suffers a deterioration in its own creditworthiness, this would translate into a reduction of the fair value of its liabilities (via the increase in the cost of capital), which would (*ceteris paribus*) result in an accounting gain.<sup>30</sup> This treatment can trigger a “gambling for resurrection”-type of behaviour in the sense that, if an institution finds itself in a situation of financial distress,<sup>31</sup> the recognition of a profit from the decrease in the rating could create incentives for using these gains to fuel additional risk-taking. Furthermore, the recognition of own credit risk in the face of a deterioration in credit quality, and the resulting recognition of an accounting gain, simply redistributes value from the holders of debt to the shareholders; in itself, this redistribution would not generate any value in the economy.

#### **4.10 CRITERION X – ENHANCEMENT OF MARKET CONFIDENCE AND CORPORATE GOVERNANCE**

The increased awareness of the importance of strengthening, and of the need to strengthen, corporate governance arrangements was the result of the outcry on markets in response to various corporate scandals that have surfaced in recent years, such as Enron, Worldcom, Parmalat and, more recently, Refco. Indeed, as these experiences have demonstrated, shortcomings in accounting, as well as weak corporate governance, could undermine overall market confidence and thereby potentially threaten financial stability.

While strong corporate governance is not fully proof against outright fraud, it is an important tool to prevent fraud from happening in the first place by providing a framework for setting in place appropriate checks and balances on corporate behaviour that should ensure proper oversight by boards and sufficient control over management by shareholders as well as adequate internal audit and risk management processes.

Similarly, high-quality accounting standards are necessary, but not sufficient to ensure appropriate corporate governance and to enhance market confidence in disclosure. Proper implementation is needed; hence the role of the external auditors in the verification of financial statements is key.

The strength of corporate governance is intimately linked to the provision of financial statements that give an accurate representation of the financial situation of an entity, in particular of the risks incurred, and that, in this context, channel adequate information both for the exercise of internal corporate governance via the Board, and external corporate governance via the market.<sup>32</sup> This is even more important for areas, such as banking, where globalisation and financial innovation may contribute to “hiding” the true risk profile of an entity. In view of the importance of the proper implementation of accounting standards, i.e. ensuring a faithful representation of economic reality to the largest extent possible, governance issues must be considered inherent to discussions on accounting standards. In that context, strict rules governing external auditors, or sound guidance on the role of audit committees, seem appropriate to strengthen the enforcement of the accounting rules.

In most cases of accounting malfeasance, management had used the accounting rules in a way that misrepresented the true economic and financial situation of their companies, which was only revealed when the entity was on the verge of insolvency. Appropriate accounting

<sup>30</sup> It can also be argued that a deterioration in the creditworthiness that is promptly recognised via the marking-to-market of debt may be based on a deterioration of the asset quality, but – given that these assets could be accounted for at amortised cost – the actual recognition of a loss or an impairment of the assets may take longer to materialise.

<sup>31</sup> In a situation of financial distress, the argument that an institution can go to the market to take advantage of its lower rating by buying back its debt at a lower value than par and actually cash in the gain is largely unrealistic as its funding capacities are generally limited in such a situation.

<sup>32</sup> Internal corporate governance refers to the mechanisms that enable shareholders to exercise management control. External corporate governance relates to the controlling function performed by financial markets.



standards should discourage and prevent the manipulation of accounts or so-called “creative accounting”, by adequately reflecting underlying economic reality. If accounting adequately captures the underlying economics, then scope for “creative accounting”, or the possibility of inappropriately using or circumventing the accounting rules to hide incurred risks, is significantly reduced.

Although many of the recent cases of corporate accounting malfeasance occurred in a rules-based accounting environment, a principles-based framework is not shielded against possibilities of creative accounting and the managing of results, in particular with regard to certain areas where complexity is high (e.g. hedge accounting provisions under IAS 39), or where (i) standards are not sufficiently precise, (ii) various options exist for accounting for the same operation with very different impacts on the primary financial statements or (iii) more subjective data is used (i.e. data ranging from objectively observed market data to subjective model inputs).

Furthermore, if the market regards an entity’s corporate governance as poor, this would also be captured by the rating agencies and may result in a rating downgrade. For an entity that recognises its own liabilities at fair value, this deterioration would result in an accounting gain that would actually remunerate the entity for its lack of strong corporate governance. Such windfall profits stemming from bad governance should be avoided, and the provision of such adverse incentives should be corrected and adequately reflected in the markets.

In conclusion, it seems clear that the role of external auditors will be key for promoting a sound implementation of the IFRSs. Increased focus will be put on their professionalism, the appropriateness of the resources at their disposal for their auditing task and their independence vis-à-vis their clients. Progress in corporate governance is also very much needed to foster “true and fair” accounting. In particular, audit committees should be suited to

assess the significance of the accounting figures produced within the IFRS framework.

## 5 MAIN FINDINGS AND PROPOSALS

*Thus far, the report has analysed what appeared to be the most relevant features of the application of the IFRS framework for the banking sector. To this end, a number of representatives from the banking industry, as well as academics, accounting standard-setters, supervisors and central bankers, were interviewed. In conclusion of this analysis and in consideration of the proposed criteria, several main findings (MFs) have emerged and are presented below. These findings have naturally led to a number of proposals (FSPs) that are presented thereafter.*

**MF 1:** By offering greater transparency and risk-oriented reporting, the IFRSs may provide early warning signals on exposures or risks. Moreover, the introduction of the IFRSs has the potential for enhancing comparability, thus improving the level playing field between banking institutions and strengthening market discipline. However, current implementation of the IFRSs in Europe seems to be rather diverse, thereby undermining these enhanced benefits.

**MF 2:** In order to accommodate the increased complexity and the fast pace of innovation that dominate the financial sector, accounting standards should preferably be principles-based, which is generally the case for the IFRSs. They should also reflect operations, and not only the different types of financial instruments used. For example, accounting for hedging operations should be based on the hedging intent of the institution, provided that it can be demonstrated, measurably and effectively, rather than on the nature of the financial instruments involved.

**MF 3:** High-quality accounting standards are important for financial stability and should not merely represent a starting point for regulators and supervisors, which would require further

adjustments. Appropriate accounting standards remain necessary, and – wherever possible – consistency should be achieved for several reasons.<sup>33</sup> First, although banking and insurance supervisors have developed “prudential filters” to adjust the IFRSs for the calculation of regulatory capital and to address specific regulatory concerns, complex accounting problems cannot all be easily adjusted or resolved by a “filter”. Moreover, the persistent existence of two sets of figures would not only increase operational risk, but also raise costs. It could also lead to misunderstandings and complexity for top managers and users of financial statements, thus reducing overall internal and external transparency. In addition, as “filters” do not apply to non-bank counterparties, any significant undesirable feature in the accounting standards would not be sanitised and could hinder credit risk analysis within banks.

**MF 4:** Financial information in line with the IFRSs that has thus far been published by financial institutions has not resulted in any significant changes. The long-term impact of the IFRSs, however, should not be underestimated. Indeed, first-time application figures, while very interesting to observe, reflect more the nature and the magnitude of the accounting adjustments that result from the transition to the new framework and the first-time implementation than what could be considered a medium or long-term impact thereof. Furthermore, as with any transition period, one-off effects, and temporary local transitional measures may “blur” the analysis. In addition, the recent overall rather non-volatile monetary and economic environment makes it particularly difficult to assess what the impact of the new accounting regime might be in more stressed situations.

**MF 5:** The existence or absence of volatility in banks’ accounts does not, per se, constitute an adequate criterion for assessing the appropriateness of accounting standards from a financial stability perspective. Indeed, volatility stemming from marking-to-market or marking-

to-model trading operations that adequately reflect risk exposures provides relevant information and may play a pre-emptive role against too risky attitudes. Conversely, volatility that would be created by systematically marking-to-market financial instruments traded on illiquid markets or currently non-traded instruments, such as traditional bank loans,<sup>34</sup> which are not measurable in a reliable way in most European countries and which are often not held on a short-term basis, can generally be regarded, at least for the time being, as “spurious” and may adversely impact on highly relevant information on banks’ solvency.

**MF 6:** The current practice of prudent<sup>35</sup> adjustments to “screen” or model prices for certain trading operations to take account of liquidity discounts or model uncertainties seems to reflect market needs, which are increasingly incorporating liquidity and systemic concerns. These adjustments are intended to reflect the value of these operations if they were to be carried out effectively. They do not seem to present a higher level of risk regarding potential accounting manipulation than that arising when an internal model is used for the valuation of an instrument, provided they are closely monitored, fully documented and justified by expert reasoning.

**MF 7:** As a result of an instrument-based approach, IFRS hedging techniques can be regarded as very complex, to the extent that they are confusing even for banks and stakeholders, including financial analysts. Furthermore, the accounting standards do not seem to always address all the needs of sound risk management. For example, it was found in

33 In this context, particular attention should be paid to the *Report to G7 Finance Ministers and Central Bank Governors on international accounting standards*, published by the Bank for International Settlements (BIS) in April 2000.

34 For example, loans in an investment banking environment, i.e. loans extended to large counterparties with access to capital markets (which usually also have public bond issues outstanding that support pricing), are more easily marked-to-market than retail loans. For the latter, there may often be no liquid market and no possibility of observing market prices.

35 Meaning marking down “screen” prices.

certain situations that they could even induce certain banks to reduce, or even abandon, their hedging transactions, which cannot be considered a positive development from a financial stability perspective. However, in this context, it should be noted that the amended version of the “fair value option” of IAS 39, which resulted from the positive and constructive dialogue between the ECB, the BCBS and the IASB, marks significant progress in this field, especially when supplemented by the supervisory guidance on the use of the fair value option recently published by the BCBS,<sup>36</sup> which requires the fair value option to be used in the context of sound risk management.

**MF 8:** The provisioning regime incorporated in the IFRSs<sup>37</sup> can be implemented in a sufficiently forward-looking manner so as to avoid increased credit cyclicity. This is also the case for the banking sector in the United States, where the respective Statements of Financial Accounting Standards (SFAS)<sup>38</sup> are rather similar to the IFRSs in this field. This path appears to be consistent with financial stability objectives.

**MF 9:** The economic maturity of demand deposits is not acknowledged within the current IFRS framework, thus making hedging of these resources difficult. Financial statements in a principles-based framework should preferably reflect the underlying economic substance. However, a marking-to-market or marking-to-model of deposits on the balance sheet may have detrimental effects on financial stability, given their potential impact on the behaviour of depositors and the difficulty in calculating reliable values in the absence of a liquid market in which deposits are traded.

**MF 10:** The inclusion of default discounts from own credit risk in balance sheet valuations appears to be less relevant, or even counter-intuitive, for most stakeholders. This might give misleading accounting signals in times of crisis and may also lead to undesirable risk-taking in such situations.

**MF 11:** Consolidation and de-recognition rules under the IFRSs, while complex, go in the right direction as they tend to correctly identify where the actual risks are, which should promote proper risk management and effective market discipline. It might be considered, however, to attain consistency in this area with the criteria used for regulatory purposes to assess the significance of transfers of securitised credit risk exposures and, notably, to calculate capital requirements.

**MF 12:** The publication of enhanced financial disclosures<sup>39</sup> strengthens market discipline. Indeed, enhanced disclosures are useful for understanding the core figures in financial statements and should be seen, in this context, as complementary, but without being regarded as compensating fully for accounting figures that do not reflect the underlying economic situation, in particular because the figures that make up the bottom line in primary financial statements are those that generally drive external assessments of a given financial situation.

**MF 13:** At the current juncture, insurance accounting seems to allow too much flexibility. The current framework essentially permits an insurer to follow the accounting policies that it has used previously, which gives rise to potential understandability and comparability issues regarding the figures reported in the

36 See Basel Committee on Banking Supervision, *Supervisory guidance on the use of the fair value option by banks under IFRS*, Bank for International Settlements, Basel, June 2006, pp. 7-9.

37 In particular, IAS 39 (*Financial Instruments: Recognition and Measurement*).

38 Standards issued by the Financial Accounting Standards Board (FASB) in the United States. The FASB is the designated organisation in the private sector for establishing standards on financial accounting and reporting. Those standards, among others, govern the preparation of financial reports. They are officially recognised as authoritative by both the Securities and Exchange Commission (SEC) and the American Institute of Certified Public Accountants (AICPA).

39 Such as those contained in IFRS 7 (*Financial Instruments: Disclosures*).

EU.<sup>40</sup> The need to address this matter is enhanced by the increasingly closer relationships between banks and insurance companies, which are reflected, in particular, by the number of financial conglomerates.

*In many ways, the IFRSs should, in principle, improve the transparency, rigour and comparability of the financial statements of European banks, thus supporting a level playing field for banking institutions and strengthening market discipline. However, reality is currently different and much diversity seems to remain in place. Furthermore, the convergence process with the US accounting framework – the US GAAP<sup>41</sup> – is of great importance and deserves due attention, in particular with regard to the timing of the project, as well as its direction and technical content. It is therefore important to consider in depth the main proposals that should reflect the concerns of stakeholders, most of whom are interested in the long-term consequences of the accounting standards on management practices, economic development and financial stability. The issues labelled “financial stability proposals” (FSPs) below present possible enhancements to the IFRS accounting framework from a financial stability perspective. Eight FSPs have been drawn up.*

**FSP 1:** The reliability of “fair” values is a very important issue from a financial stability perspective. Marking-to-market or model values for, in particular, financial instruments in the trading portfolio, as well as in the “available for sale” category, should be measured accurately and conservatively. For

certain financial instruments, in particular instruments which are not actively traded and for which no deep and liquid market exists or of which the institution has a large “block” holding, the amount calculated by multiplying the market price by the quantity held need not represent the “fair” value of the financial instrument, in the sense of what could reasonably be expected to be realised in cash in the normal course of business. In this context, an inappropriate upfront recognition of gains that are unrealisable is avoided by measuring the value of financial instrument accurately and conservatively.<sup>42</sup> The fair values that are calculated in this manner should be explicitly audited, adequately disclosed and, for supervised entities such as banks, could be subject to general monitoring by supervisors. These adjustments may also play a counter-systemic role, as herd behaviour based on accounting figures, and not on the underlying economic rationale, could be mitigated. A presentation of this macro-financial benefit is presented in Box 2 below.

40 At present, local standards are still largely accepted and IFRS 4 (*Insurance Contracts*) provides for much latitude. However, it should be acknowledged that the IASB is aware of the importance of making headway in this area, and is currently engaged in a medium-term project that is intended to address the issues of insurance accounting (so-called Phase II). The IASB expects to issue a Discussion Paper with the fundamental principles on which a standard would be based in the first quarter of 2007. Insurance supervisors are contributing to the relevant IASB work.

41 GAAP = Generally Accepted Accounting Principles.

42 Given a possible range of estimates, anyone preparing accounts should make use of expert judgement and experience in choosing the appropriate value.

## Box 2

### HOW VALUATION ADJUSTMENTS CAN CONTRIBUTE TO AVERTING SYSTEMIC DISTURBANCES

It is acknowledged that price fluctuations may affect the interests of market participants and would therefore influence their actions. Price movements may actually induce market participants to act in such a way that these price movements would be amplified. In an environment of full marking-to-market accounting, for example, a sudden decrease in prices could lead market participants to “overshoot” in their reactions to such movements by triggering

“panic sales” (i.e. the disposal of assets as quickly as possible in order to avoid a major negative impact on the profit and loss account, or the own funds, as a result of further decreases in value), thereby leading to higher corrections in valuations on a macro basis.

This kind of risk can be all the more important when a relatively small number of market players hold specific categories of assets, as is the case for some types of banking operations (e.g. structured finance). Systemic risk could thus increase as a result of these amplified valuation effects.

In such cases, conservative valuation adjustments could be regarded as a useful tool that could contribute to reducing this potential systemic risk since the value of the assets held would already partially embed the probable potential reduction in value and would therefore alleviate the pressure on market participants to dispose of their assets. This would mitigate the risk of “panic selling”, without preventing banks from selling if they so decide. But this decision would be based mainly on the underlying economics and not on accounting figures.

**FSP 2:** Fair value should not be encouraged for the main part of loan books, or for core deposits of European banks, as long as no reliable, large and active market or trading intent exists for these products.<sup>43</sup> Otherwise “fair” values could create artificial volatility in the accounts and may potentially lead to a change in banks’ behaviour, as they would focus mainly on the short term, with potentially significant

financial stability implications in the long run (see Box 3).

<sup>43</sup> Even if reliable measures do exist, there is still the issue of the potential lack of relevance of fair values for a banking book where the intention is to earn an interest margin by holding items to maturity (see A. Enria, L. Cappiello, F. Dierick, G. Sergio, A. Haralambous, A. Maddaloni, P. Molitor, F. Pires and P. Poloni, “Fair value accounting and financial stability”, Occasional Paper No 13, ECB, April 2004, pp. 7-8. Exceptions may be investment bank loans managed on a fair value basis and the special case of Danish mortgage loans, for which reliable prices are available.

### Box 3

#### HOW FAIR VALUE ACCOUNTING OF LOANS CAN LEAD TO AN INCREASED PRO-CYCLICALITY OF LENDING BEHAVIOUR AND RESULT IN MORE PRONOUNCED ECONOMIC CYCLES

Lending activities are by nature pro-cyclical. But the use of fair value could increase this trait. Indeed, under fair value accounting, the valuation of loans would fluctuate in response to short-term changes in market interest rates and to assumptions regarding prepayment rates, yield curves or the estimation of risks.

During economic booms, banks are likely to overestimate the creditworthiness of borrowers, and this wave of overly optimistic assessments of risk is often translated into further credit growth. The realised or unrealised gains due to asset price increases, or improved credit quality, could fuel the banks’ profit and loss accounts or their own funds, thereby providing the basis for a further expansion of lending. Conversely, in an economic downturn, the tendency of markets to overestimate risk would artificially lead to a decrease in the fair value of loans. These downward adjustments in asset valuations would have an effect on banks’ accounts that could encourage banks to react by rapidly selling assets or by tightening lending standards even further, thereby contributing to a further deterioration of fair valuations and fuelling the systemic effects.



In sum, such an accounting regime may have pro-cyclical effects which would need to be carefully taken into account. A simulation exercise published by the ECB in 2004 included an interesting example in this regard.<sup>1</sup> The simulation was aimed at gauging how various shocks would affect the balance sheet of a bank. It showed clearly that, in a real estate crisis characterised by a reduction of collateral values and an increased fragility of borrowers, coupled with an increase in interest rates, a full fair value accounting framework would actually aggravate the effects of the shock and have a pro-cyclical impact.

<sup>1</sup> See A. Enria, L. Capiello, F. Dierick, S. Grittini, A. Haralambous, A. Maddaloni, P. Molitor, F. Pires and P. Poloni, "Fair value accounting and financial stability", Occasional Paper No 13, ECB, Frankfurt am Main, April 2004, pp. 14-26.

**FSP 3:** The hedge accounting regime should adequately take into account sound and strictly documented risk management practices, which would help to mitigate risks. In particular, the non-zero economic maturity of demand deposits could be considered for hedge accounting.<sup>44</sup> For that purpose, financial institutions should compile statistical documentation that demonstrates the relevance of hedging operations, in particular with a view to meeting tests of their effectiveness. If that were the case, it would seem possible to record deposits at par value and require the disclosure of interest rate sensitivity in the notes to the financial statements. Counterparty risk protection through guarantees, including the use of credit derivatives, could also be recognised in a more comprehensive and consistent manner.<sup>45</sup>

**FSP 4:** The inclusion of material default discounts arising from own credit risk in the balance sheet valuations obscures the relative riskiness of institutions, especially in times of crisis, unless the resulting profit or loss is realised with external parties. To prevent misleading accounting signals and to facilitate comparability, own credit risk should, at least, not increase the own funds of firms, as set out by the BCBS and CEBS for banking institutions, and should be adequately disclosed.

**FSP 5:** From a financial stability point of view, the provisioning regime for loans needs to be sufficiently forward-looking to reduce the risk of banks developing policies conducive to an increased pro-cyclicality of loans (see Box 4). Taking into account the entity's best estimate of losses over the life of the loan could be regarded as one possibility that would have the added benefit of making the accounting figures more consistent with the Basel II concept of expected losses and more adapted to the specificities of the banking sector. The practices observed in large banking groups regarding provisioning policies for loans often seem to incorporate a pro-active approach, which tries to identify expected collective losses as soon as possible.

<sup>44</sup> Although controversial, the inclusion of core deposits in macro-hedging operations can be coupled with their continued recognition at nominal value in the balance sheet. Indeed, the "fair" valuation of balance sheet items requires, in particular, specific management intent and market liquidity. Items that did not meet those conditions might nevertheless be eligible for hedging.

<sup>45</sup> The currently limited recognition of credit derivatives as hedging instruments can lead banks to forfeit the hedging of counterparty risks. The marking-to-market of loans that are guaranteed could prove very difficult to achieve in view of the currently non-existing market for loans and would therefore generally be artificial at present. In order to promote sound risk management, the use of cash flow hedge accounting, or pro-rata accounting, or a broader use of the concept of financial guarantees, could be studied further.

### LOAN IMPAIRMENT AND CYCLICALITY

The BCBS report entitled “Sound Credit Risk Assessment and Valuation for Loans”<sup>1</sup> correctly promotes the use by banks of sound and prudent credit risk assessment and valuation policies and practices. Moreover, it considers that the processes for estimating probability of default and expected losses under Basel II can be used in measuring impairment losses for accounting purposes. This point of view is in line with the aim of strengthening financial stability. Indeed, it seems advisable that the credit risk assessment system used for accounting purposes and the prudential expected-loss approach under Basel II be better aligned, while at the same time expanding the loan-loss provisioning method beyond the one-year time horizon, in order to wholly capture the maturity of loans and related risks.

In that respect, the US experience regarding loan impairment is interesting. According to the US GAAP rules on loan-loss allowances (i.e. SFAS 5 and SFAS 114)<sup>2</sup>, no impairment loss should be accrued unless the impairment (i.e. the probability, on the date of the financial statements, that the creditor will be unable to collect all amounts due according to the contractual terms) can be attributed to events or activities of the current or prior periods (SFAS 5, Article 59), and no anticipated losses that do not relate to the current period should be accrued (SFAS 5, Article 64). These provisions, which are very similar to those of the IFRSs, can be, and have been, interpreted in various ways.

While requiring that the financial institutions’ methodologies be consistent with the US GAAP, the US banking supervisory agencies, in collaboration with the SEC, have developed joint guidance in which they recommend that the institutions estimate collective impairment for groups of loans by applying to loan balances loss rates that reflect their historical charge-off experience adjusted for the effects of current conditions. This guidance also allows the overall allowances to include “unallocated” components, as long as these components reflect an adequately documented estimate of probable losses, and recognises that determining an appropriate allowance involves a high degree of managerial judgment. A similar approach could be conceivable under the IFRSs.

In Europe, alternative approaches have been considered for the collective assessment of impairment. For example, some banks are considering the use of a loan-loss methodology for determining amounts of loan provisions that is based on internal credit risk grading processes and changes in national and international economic and business conditions on each reporting date. In this respect, the methodology takes into account business cycles, i.e. simulates the changes in the credit risk profile of the borrowers and their subsequent rating changes for determining collective provisions on each reporting date. In addition, this methodology incorporates management’s experience-based judgements about the estimated evolution of the credit quality of the loan portfolio.

In this context, the specific case of Spain also proves interesting. Banco de España (Circular 4/2004) has adopted the IASB’s accounting standards on provisions for bad debts.

<sup>1</sup> See Basel Committee on Banking Supervision, *Sound credit risk assessment and valuation for loans*, Bank for International Settlements, Basel 2006.

<sup>2</sup> SFAS = Statements of Financial Accounting Standards.

Data in the Central Credit Register (CCR), which cover virtually the last twenty years, have been used to construct a set of matrices of specific provisions to cover losses incurred and individually identified, distinguishing between companies and sole proprietors, on the one hand, and other individuals, on the other. This distinction is based on the difference in the amount of losses of these two groups of borrowers. In addition, the role of the various types of real guarantees in mitigating risk is acknowledged. As regards general provisions, the losses inherent in loan portfolios classified as normal risk must be covered in accordance with the historical experience of impairment and other circumstances known at the time of assessment. Again, the use of the CCR has enabled a parametric method to be developed, based on statistical procedures, for the calculation of the coverage of losses that have been incurred but not individually identified. The accounting standard establishes the possibility that institutions may use internal models to calculate their bad debt provisions.

**FSP 6:** A number of IFRS guidelines present positive features from a financial stability perspective (e.g. principles-based rules, recognition of risks versus formal accounting based on legal aspects, the conditions under which to use the fair value option, the day-one profit measurement issue). These features are of paramount importance and should not be forsaken in the future, for instance, within the context of the international convergence project.

**FSP 7:** It is essential that clear and coherent insurance accounting standards are established in a timely manner (see Box 5). Indeed, it is important to ensure transparency and an appropriate recognition of risks, both for the market and for supervisors, in particular for the monitoring of financial conglomerates. In that regard and from a financial stability perspective, the respective merits of “fair” valuation, on the one hand, and the stability of the insurers’ investments, on the other, will have to be addressed.

#### Box 5

#### INSURANCE ACCOUNTING

Insurance accounting in the EU is currently harmonised under the Fourth Council Directive 78/660/EEC of 25 July 1978 based on Article 54 (3) (g) of the Treaty on the annual accounts of certain types of companies,<sup>1</sup> the Seventh Council Directive 83/349/EEC of 13 June 1983 based on the Article 54 (3) (g) of the Treaty on consolidated accounts<sup>2</sup> and the Insurance Accounts Directives<sup>3</sup>. The Directives contain a significant number of options that have been exercised differently in Member States. The introduction of the IFRS should create a harmonised set of rules for insurance accounting and hence increase the comparability and transparency of financial statements.

1 OJ L 222 of 14 August 1978, p. 11.

2 OJ L 193 of 18 July 1983, p. 1.

3 Council Directive 91/674/EEC of 19 December 1991 on the annual accounts and consolidated accounts of insurance undertakings (OJ L 374 of 31 December 1991, p. 7) and Directive 2006/46/EC of the European Parliament and of the Council of 14 June 2006 amending Council Directives 78/660/EEC on the annual accounts of certain types of companies, 83/349/EEC on consolidated accounts, 86/635/EEC on the annual accounts and consolidated accounts of banks and other financial institutions and 91/674/EEC on the annual accounts and consolidated accounts of insurance undertakings (OJ L 224 of 16 August 2006, p. 1).

The framework for insurance accounting is being developed in two stages: Phase I, which was considered a transitory system and provided for limited modifications to the current accounting practices, was completed with the issuance of IFRS 4 (*Insurance Contracts*) on 31 March 2004; Phase II, which will address broader conceptual and practical issues related to insurance accounting and will replace Phase I, should be implemented before 2010.

IFRS 4 applies to all contracts that meet the definition of an insurance contract<sup>4</sup>, including reinsurance contracts, and to certain financial instruments<sup>5</sup>. This accounting standard does not prescribe any particular accounting policy, so that existing practices continue to be applied provided that they meet the minimum requirements of a liability adequacy test<sup>6</sup>, along with some other conditions (recognition and measurement rules, impairment of assets, changes in accounting policies, offsetting).

Given the new definition of insurance contracts, it is likely that certain life insurance contracts will no longer be accounted for as insurance contracts and will be subject to IAS 39 (*Financial Instruments: Recognition and Measurement*). Moreover, the financial assets purchased to back insurance risks would also fall within the scope of IAS 39. The majority of these assets would be classified as “available for sale” and measured at fair value – as they would not meet the criteria of the portfolios measured at amortised cost (“held to maturity” or “loans and receivables”) while insurance liabilities will continue to be valued at amortised cost.

In order to mitigate the consequences of a potential mismatch between financial assets and assets backing insurance liabilities, IFRS 4 provides for exceptional measurement methods in the case of insurance contracts. It permits an insurer to measure designated insurance liabilities so as to reflect “current market interest rates” and to recognise changes in those liabilities as a profit or loss (IFRS 4.24). The designation is irreversible. However, it seems that insurance companies have some leeway in determining what the current market interest rate is. Choices made in that respect could then have a material impact on the amount of insurance liabilities and could reduce the comparability of financial statements. In addition, IFRS 4 allows unrealised gains or losses on assets which are recognised in equity to be reflected in the measurement of insurance liabilities. The related adjustments to insurance liability will be recognised in equity, if the unrealised gains and losses on the assets are recognised in equity – so-called “shadow accounting” (IFRS 4.30). Insurers can also continue most of their existing (pre-IFRS) practices for the measurement of their liabilities which could also have an effect on comparability.

The introduction of the IFRSs, should create a harmonised set of rules for insurance accounting and hence increase the comparability and transparency of financial statements. However, this will only be possible with the introduction of so-called Phase II, which should be implemented by 2010. Insurance supervisors are contributing to the relevant IASB work in order to define an accounting standard that would also take supervisory concerns into consideration. In the meantime, even though “shadow accounting” helps to mitigate the distortion created by the accounting mismatch, it raises particular concerns with regard to comparability, at least in the EU. Indeed, the measurement practices used to determine the related adjustments seem to differ

4 A contract under which one party (the insurer) accepts significant risk by agreeing to compensate another party (the policyholder) or any other beneficiary if a specified uncertain future event (the insured event) adversely affects the policyholder or other beneficiary.

5 Financial instruments that the insurer issues with a discretionary participation feature.

6 Insurance liabilities should be adequate and should cover the current estimates of future cash flows under insurance contracts. Any deficiency must be recognised as a profit or loss.

depending on the country or the insurer. Some insurers temporarily assign 100% of revaluation gains or losses on related assets to a specific account (e.g., “Funds for Future Appropriations”), without estimating the proportion of unrealised gains or losses which will ultimately be allocated to shareholders or policyholders. Other insurers prefer to retain an estimated allocation rate and immediately allocate a share of unrealised gains or losses to shareholders.

**FSP 8:** Accounting governance should be strengthened. In this context, ensuring the reliability and quality of external audits is of paramount importance in the implementation of principles-based standards. Furthermore, given the important and challenging role of an interpretative body<sup>46</sup> in a principles-based accounting framework, especially in the first years of implementation, it must have adequate resources to tackle this demanding task.

<sup>46</sup> The International Financial Reporting Interpretations Committee (IFRIC) is the interpretative body of the IASB.



## ANNEX I: GLOSSARY OF MAIN TERMS

**Amortised cost:** the amount at which the instrument is measured on initial recognition minus repayments of principal, plus or minus cumulative amortisation, using the effective interest method, of any difference between that initial amount and the maturity amount, and minus any reduction for impairment or uncollectibility.

**Cash flow hedge:** a hedge of the exposure to variability in cash flows related to an existing or forecast transaction.

**Consolidated financial statements:** the financial statements of a business group presented as those of a single economic entity, drawn up by combining the individual financial statements of the parent company and its subsidiaries line by line and adjusting them by eliminating in full all intra-group transactions, balances, income and expenses and by harmonising the accounting methods used.

**Creative accounting:** engineering the recognition of operations with the aim of achieving a specific accounting result at the expense of reflecting the underlying economic substance.

**Credit risk:** the risk that a counterparty will not settle an obligation in full, either when due or at any time thereafter.

**Credit risk instruments:** financial instruments that are considered, for the purposes of this report, to be exposed more to credit risk than to other risks.

**Demand deposits:** deposits with a demand feature. Notwithstanding the fact that the contractual time to maturity of these deposit accounts is basically instantaneous, the effective time to maturity may not be zero and relatively long. Savings deposits in a large number of European countries can be interpreted as demand deposits.

**Embedded derivative:** a component of a hybrid (combined) instrument that also includes a non-derivative host contract with the effect that some of the cash flows of the combined instrument vary in a way similar to those of a stand-alone derivative.

**Fair value:** the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's-length transaction. In practice, the fair value is often equal to the quoted market price, or is estimated using a valuation technique to discount future cash flows.

**Fair value hedge:** a hedge of the exposure to changes in the fair value of a recognised asset, liability or an unrecognised firm commitment, or an identified portion of any such asset, liability or firm commitment, that is attributable to a particular risk and could affect the profit or loss.

**Fair value hierarchy:** the reliability of calculated fair values decreases in the following sequence (top to bottom):

1. the existence of published price quotations in an active market is the best evidence of fair value, and these price quotations are thus used wherever available to measure the value of a financial asset or liability;

2. when quoted market prices are not available, the price of the most recent transaction provides evidence of the current fair value;
3. if conditions have changed since the time of the transaction, the fair value is estimated by reference to current prices or rates for similar financial instruments;
4. if the market for a financial instrument is not active, the fair value is estimated by using a valuation technique that makes maximum use of market inputs; and
5. if the market for a financial instrument is not active and the fair value cannot be reliably measured, the instrument is valued at cost (or at current replacement cost in the case of a debt instrument).

**Financial instrument:** any contract that gives rise, in an accounting context, to a financial asset of one entity and a financial liability or equity instrument of another entity.

**Financial stability:** a condition in which financial intermediaries, markets and market infrastructures are readily able to withstand shocks without giving way to cumulative processes that impair the allocation of savings to investment opportunities.

**Financial statements:** a set of statements comprising the *balance sheet*, which provides information on the entity's financial position at the end of the period specified, the *income statement* (or *profit and loss account*), which provides information on the entity's performance in the period, the *cash flow statement*, which indicates the cash inflows and outflows for the period, the *statement of changes in equity*, which reports the changes in shareholders' equity for the period, and the supporting *notes*, which consist of a summary of significant accounting policies and other explanatory notes.

**Hedge accounting:** an accounting technique that consists of designating one or more hedging instruments (mostly derivatives, such as forwards, futures or swaps) the fair value or cash flow of which is expected to offset, in whole or in part, changes in the fair value or cash flows of a specified instrument (the hedged instrument) that exposes the entity to the risk of changes in the fair value or changes in future cash flows.

**Historical cost:** a measurement basis used for accounting purposes, in which the value of a financial instrument is recognised as the amount of cash paid or as the fair value of the consideration given to acquire it at the time of the initial purchase of the instrument.

**Impairment loss:** the amount by which the carrying amount of an asset exceeds its recoverable amount. The recoverable amount of an asset is the sum of estimated future cash flows discounted at the asset's original effective interest rate.

**International Financial Reporting Standards (IFRSs):** a numbered series of pronouncements – standards and interpretations – adopted by the International Accounting Standards Board (IASB). They comprise International Financial Reporting Standards, International Accounting Standards (IASs) and Interpretations originated by the International Financial Reporting Interpretations Committee (IFRIC) or the former Standing Interpretations Committee (SIC).

**Liquidity risk:** the risk that a counterparty or a participant in a payment or settlement system will not settle an obligation at its full value when due. Liquidity risk does not imply that the counterparty is insolvent, since it may be able to settle the required debt obligations at some unspecified time thereafter. In practice, lack of liquidity when accessing financial markets results in the risk that

the costs of adjusting financial positions may increase significantly and thus the value of the instrument may fall.

**Market risk:** the risk of unexpected changes in market prices or rates, which may result in a potential for either gains or losses. Market risk includes, for example, currency risk, interest rate risk and price risk.

**Market risk instruments:** financial instruments that are considered, for the purposes of this report, to be exposed more to market risk than to other risks.

**Point-in-time rating:** an internal rating that reflects the assessment, at that precise point in time, of a borrower's most likely future condition over the chosen time horizon. This rating changes as the borrower's condition changes in the course of the business cycle.

**Pro-cyclicality:** the amplification of the economic cycle by reinforcing its current direction as a result of changes in regulatory capital requirements or other regulations (e.g. the provisioning regime).

**Securitisation:** a financial technique involving the issuance of new negotiable securities backed by existing assets such as loans, mortgages, credit card debt, or other assets (including accounts receivable).

**Structured finance:** the creation of debt instruments by securitisation or the addition of derivatives to existing instruments.

**Through-the-cycle rating:** a rating based on an assessment that focuses on the permanent, long-term and structural components of default risk after filtering out the temporary and short-term components.

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