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Our ref: ICAEW Rep 92/09

markt-hl@ec.europa.eu

Dear Sir or Madam

Possible further changes to the Capital Requirements Directive

The Institute of Chartered Accountants in England and Wales is pleased to respond to your request for comments on *Possible further changes to the Capital Requirements Directive*.

Please contact me should you wish to discuss any of the points raised in the attached response.

Yours sincerely

Dr Claire Stone ACA
Manager, Audit & Reporting
Financial Services Faculty

T +44 (0)20 7920 8446
F +44 (0)20 7920 6009
E claire.stone@icaew.com

THE INSTITUTE OF CHARTERED ACCOUNTANTS IN ENGLAND AND WALES

ICAEW REPRESENTATION

ICAEW REP 92/09

POSSIBLE FURTHER CHANGES TO THE CAPITAL REQUIREMENTS DIRECTIVE

Memorandum of comment submitted in September 2009 by The Institute of Chartered Accountants in England and Wales, in response to the Commission services staff working document, 'Possible further changes to the Capital Requirements Directive' published in July 2009.

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Chartered Accountants' Hall
PO Box 433 Moorgate Place London EC2P 2BJ UK
www.icaew.com

T +44 (0)20 7920 8100
F +44 (0)20 7920 0547
DX 877 London/City

INTRODUCTION

1. The Institute of Chartered Accountants in England and Wales (the Institute) welcomes the opportunity to comment on the working document *Possible further changes to the Capital Requirements Directive* published by the Commission services staff.

WHO WE ARE

2. The Institute operates under a Royal Charter, working in the public interest. Its regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the Financial Reporting Council. As a world leading professional accountancy body, the Institute provides leadership and practical support to over 132,000 members in more than 160 countries, working with governments, regulators and industry in order to ensure the highest standards are maintained. The Institute and its Financial Reporting Faculty plays an active role in the development of financial reporting nationally and internationally. The Institute is a founding member of the Global Accounting Alliance with over 775,000 members worldwide. The Institute is listed in the European Commission's Register of Interest Representatives (reference 7719382720-34).

3. Our members provide financial knowledge and guidance based on the highest technical and ethical standards. They are trained to challenge people and organisations to think and act differently, to provide clarity and rigour, and so help create and sustain prosperity. The Institute ensures these skills are constantly developed, recognised and valued.

4. The Institute's Financial Services Faculty was established in 2007 to become a world class centre for thought leadership on issues and challenges facing the financial services industry, acting in the public interest. It draws together professionals from across the financial services industry and from the 25,000 members specialising in the sector. This includes those working for regulated firms, in professional service firms, intermediaries and regulators.

MAJOR POINTS

5. We are principally interested in your proposals on through-the-cycle expected loss provisioning in Section 1 and Annex 1, and our major points relate to this rather than to the other proposals in your paper.

Financial reporting and prudential requirements are different

6. We understand that there is concern that losses reasonably anticipated to arise in banks are not being sufficiently factored into the capital buffers they hold, and recognise that a response to this concern is needed. However, your paper gives a confused picture of current and proposed financial reporting and regulatory requirements, and the proposals - depending on how they finally emerge - may not meet the desired prudential objectives and run the risk of obscuring meaningful information in the financial statements.

7. In our view, the objectives set out in the first part of Section 1 are inappropriate in a number of respects. First, the paper states that the provisions are being proposed 'in order to stabilize bank capital and earnings over time' (paragraph 3.2). Bank capital required for prudential purposes and reported profits are two separate matters which should be dealt with independently, by regulations for capital and financial reporting standards respectively, because they have different objectives. We are opposed to profit smoothing as a matter of principle, as we consider that obscuring real volatility in reported earnings is unhelpful and misleading to users of financial statements. In the event that banks' reported earnings over time were to be changed (and the case for this would need to be made), such changes should be introduced by way of financial reporting standards and not as part of a review of capital requirements. The focus instead should be on institutional stability from a prudential viewpoint,

which does not need to be reliant on or affect the content of financial statements. Indeed, any capital or reserving rules introduced to financial stability should not be tied to the rules to the financial statements as these will change over time, being driven by a different objective.

8. The references to international accounting standards (3.2) are unhelpful and in many cases misinformed. The International Accounting Standards Board's (IASB) final proposals are likely to be different to those being proposed by Commission staff. For example, under International Financial Reporting Standards (IFRS), the current discussions around impairment are that expected future cash flows would be estimated on loans when they are drawn and recognition of interest actually received in cash would be deferred to cover expected future losses. They do not build up a separate buffer or provision, but the loan balances are reduced by the payments which have not been recognised as interest income. In contrast, a through-the-cycle approach implies that all losses expected during the cycle will be included in the adjustment. For banks with short-term consumer loans on their books, losses arising through-the-cycle will include losses for loans which have not yet been advanced. Whilst it may be appropriate for regulatory purposes to adjust capital for these, a provision in the financial statements would be inappropriate. Indeed, the introduction of a formula-driven provisioning methodology by regulators into the financial statements would be inconsistent with the financial statements giving a true and fair view in accordance with accounting standards. So, for example, it is not the case that the current IASB proposals would replace the Alpha element of the Spanish model calculation, and nor do we think they should.

9. The paper generally does not distinguish between adjustments to reserves and provisions which, by contrast, affect performance reporting in terms of earnings, a matter we address at paragraph 20 below. This distinction is very important as it determines how earnings and gearing appear in the financial statements.

Concerns as to the meaning and application of the proposals

10. We have doubts about how meaningful the adjustment values will be. In particular, a formula-driven, non-discretionary 'one size fits all' approach is likely to give rise to adjustments which are not the most appropriate for the individual banks involved. We are not clear what information will be needed about how long an economic cycle is, or, if it is seen to vary, about how competent authorities in Member States or banks are to judge where in the cycle they are. How or by whom the cycles are to be determined for lending to countries outside the EU or EEA is also not mentioned.The paper appears to assume that trends will be gradual, and does not explain what the impact of sudden shifts will be on the methodology of building up and releasing reserves. These issues matter because inaccurate predictions around the ecomonic cycle will lead to inappropriate values for the adjustments.

11. Whilst we appreciate the need for action, we do not think it necessary that the EU pursue these proposals at the present time. Work is currently being done in this area under Basel and by the IASB, we recommend that the EU awaits the outcome of these bodies rather than taking unliateral action now.

12. A related problem with the proposals is that the scope is restricted to banks in Member States. We would recommend that rather than developing its own solution, the EU engages with an international approach focussed on revising the Basel requirements. It would be possible to develop flexible capital add-ons that could be released through-the-cycle, which would not affect the financial reports at all. In our view, this would be a much simpler way of achieving the Commission's objectives. Failing that, a reserving adjustment which was made as an allocation of total reserves, and which would not interfere with performance reporting, would be more acceptable than proposals which undermine the transparency of general purpose financial reporting. For IFRS reporters, such an allocation would fall to be disclosed under International Accounting Standard 1, as part of the capital disclosures required.

RESPONSES TO SPECIFIC QUESTIONS

Q1: What impact would the changes proposed in each section of this paper have on your activities or activities of firms in your jurisdiction, including costs linked to increase in regulatory capital and any other compliance costs?

13. We would need more information around implemention to assess the impact of the proposed changes in any detail. The proposed changes introduce new requirements which will clearly increase the costs incurred by credit institutions; it is certainly not possible to tell whether there will be any benefit to offset those costs in terms of increased stability as no convincing evidence of benefit is offered. See also our comments on the Spanish model in Question 8 below.

Q2: Do you have any views about any aggregate impact of the proposed changes to capital requirements?

14. We agree that all the proposed changes need to be considered in aggregate before they are finalised. As already noted, we think there are more efficient ways of meeting the objective of stabilising bank capital than the changes proposed here.

Q3: What is the optimal timing for these measures? Should their application be sequenced?

15. We do not consider that the changes proposed here need to be urgently implemented when we are at the bottom of the economic cycle, and agree with the paper that it would be better to introduce new measures when economies have recovered. This will also allow the Commission more time to ensure that any measures which are finally introduced are appropriate and workable: it will be very important to get these measures right, to avoid unintended collateral damage, so time should be taken over them.

Section 1 (Through-the-cycle expected loss provisioning)

Q4: The Commission services suggest that the through-the-cycle value adjustment should not count as regulatory capital (see ANNEX 1, suggested amendment to Article 57). Do you agree?

16. To the extent that the through-the-cycle value adjustment is aimed at increasing the level of capital held by banks, it would appear appropriate for the adjustment to form part of the calculation for regulatory capital rather than being excluded from the calculation. Our recommendation is that the Basel requirements are revised with counter-cyclical objectives in mind, which would mean no adjustment would be necessary in the financial statements (paragraph 11, above). Failing that, a reserving adjustment which was made as an allocation of total reserves would be acceptable. For IFRS reporters, such an allocation would fall to be disclosed under International Accounting Standard 1, as part of the capital disclosures required. The through-the-cycle value adjustment for prudential purposes should not affect the *provisions* in financial statements, which will have been calculated in accordance with relevant accounting standards. To adjust provisions for prudential purposes will unnecessarily undermine the transparency of general purpose financial reporting.

Q5: Should off-balance sheet items be captured under the formula for through-the-cycle expected loss provisioning, given that 'provisions' for off-balance sheet items are not recognised in all relevant accounting standards? Should only assets subject to an impairment test be subject to through-the-cycle expected loss provisioning? (See ANNEX 1, suggested Article 74a (2).)

17. We think that it would be consistent for any adjustment to capture the effects of changes in items which are off-balance sheet. We do not understand the reference to relevant accounting standards. Most accounting frameworks do require provisions to be made for onerous items, including those which are not on the balance sheet. For example under IFRS, IAS 37,

Provisions, Contingent Liabilities and Contigent Assets requires provisions to be made when an event has occurred which is expected to give rise to an outflow of resources. In reference to the drafting suggested, a specific list of financial instruments to which through-the-cycle expected loss provisioning will apply will be needed; it will not be sufficient to give a non-exhaustive list as in draft Article 150a in Annex 1.

18. Care will be needed to avoid double counting as through-the-cycle loss provisions are likely to take account of some off balance sheet items such as future loan commitments without the need for additional reserves.

Q6: At this point, the suggestion is not to include the option for competent authorities to allow internal methods to determine expected losses across an economic cycle. As an alternative to the regulatory approach to calculate counter-cyclical factors, would it be desirable to allow firms' internal methodologies (to be validated by supervisors)?

19. We think that the Commission should mirror the approach taken under Basel and allow internal methodologies as validated by supervisors. We do not think that regulators should calculate counter-cyclical factors for all banks under their supervision as it is less likely to result in individual banks making the adjustments appropriate to their particular portfolios and circumstances. If it is acceptable to use internal models for the centrally important capital calculations under Basel, it is hard to see why their use should be rejected here.

Q7: Should the exposure class of Article 86 (i.e. for credit institutions subject to the IRB approach) be used irrespective of the fact that the credit institution may be under the Standardised approach? It may be noted that a mapping between exposures class under the Standardised approach and under the IRB is already used in the prudential reporting system of some Member States. As an alternative, should countercyclical parameters be defined for the 16 exposures classes under the Standardised approach? (See ANNEX 1, suggested Article 74a (1).)

20. Granularity will be useful in assessing exposures, so the 16 exposure classes proposed under the Standardised approach may be more useful than the 7 categories listed at Article 86. A disadvantage is that more classes will be more complicated to operationalise. As we indicate in our response to question 6 above, we consider that banks should be able to use internal methodologies, in which case they should also identify the appropriate exposure classes themselves. For banks that do not already perform mapping, this will be a new regulatory requirement. If factors are calculated on a member state basis, exposures classes for each member state may be needed to properly apply the factors.

Q8: Please give your views on the following approaches:

1) the Spanish model of through-the-cycle expected loss provisioning;

2) a 'simplified' Spanish model.

In particular, we would welcome views on the relative merits of both options in terms of the building up of provisions in a graduated manner over time (See ANNEX 1, suggested Annex IXb).

21. The extent to which the Spanish model of through-the-cycle expected loss provisioning contributed to Spain's banks weathering the financial crisis better than the banks of other countries is, in our view, more limited than is sometimes assumed. Other regulations for Spanish banks, including those severely restricting their involvement in structured credit activities, will have played an important part in protecting the banking system.

22. It is unacceptable for provisions in the financial statements to be changed by these measures, and in our view neither option should be used for 'building up provisions in a graduated manner over time'. We are not opposed to properly calculated adjustments being made to a bank's total reserves and being shown as a note or on the face of the balance sheet (although

this is not our preferred solution). The difference is that provisions are calculated under accounting standards and affect the performance statement, whereas the make up of reserves is usually legally derived by jurisdiction, not prescribed by accounting standards, and appropriations between reserves rightly do not impact earnings.

23. As the Spanish model makes provisions which do affect the performance statement, we do not favour this approach. We think that, as a matter of calculation, the simplified approach achieves the objectives better. However the adjustment is calculated, it will be important to ensure the methodology avoids double counting, and does not include in any regulatory capital buffer amounts which have already been deducted from profit by way of an accounting provision.

Q9: Should new risk categories (as suggested above) be introduced along the lines of the Spanish system or, alternatively, should the current risk categories of the CRD (e.g. credit quality steps in Annex VI) be used? (See ANNEX 1, suggested Annex IXb.)

24. We would suggest that those banks using a standardised approach should use existing CRD categories and more sophisticated banks using their own models could use their own risk categories.

Q10: Is the 'location of the borrower' (as opposed to the booking of the exposure) the right approach, with a view to avoiding regulatory arbitrage? (see ANNEX 1, suggested Annex IXb 2).

25. We think that the location of the borrower is less open to regulatory arbitrage than the booking of the exposure and is also more practical to apply when exposures are booked in different locations. The existing framework already addresses what to do when there is a significant difference between the two.

Q11: Will the data to determine counter-cyclical factors be easily available?

26. Given the data is historical and needs to reflect many years' economic activity, there are some fundamental problems to address. Many Member States may not have kept records which would be useful in determining the factors. In addition, we envisage that those Member States which have not had open economies in the recent past will find it difficult to obtain data on an appropriate basis to determine counter-cyclical factors. It would not be appropriate to use data for periods when economies were closed or subject to central planning as this would lead to misleading results. Finding the right information for new products is also likely to be difficult.

Q12: Please give your views on the methodologies for calculating the through-the-cycle expected loss provisions at consolidated level. (See ANNEX 1, amended Article 73)

27. Our understanding is that separate calculations would be made at the consolidated level and for subsidiaries, and we think that this is the correct approach. The alternative approach would be to add together the different subsidiaries and eliminate intra-group balances and guarantees, but this would be more time-consuming.

Q13: Please give your views on the scope of disclosure requirements for through-the-cycle expected loss provisioning. (See Annex 1, suggested amendment to Annex XII (17).)

28. It would be useful to have more information about the objectives of the disclosures, including the intended audience, to respond to this question fully. Our initial view is that a lot of detailed information is being requested, and that presenting it clearly to readers will be difficult. We suggest that most users of these disclosures would find more summarised information more helpful in understanding the adjustment than those which are currently proposed.

Section 2 (Residential mortgages denominated in a foreign currency)

29. We do not have any direct answers to the questions raised, but would like to mention that in the UK, foreign currency denominated housing loans are almost exclusively made for second homes. The borrowers for such loans are thus more likely to have sufficient private wealth to withstand currency movements.

Section 3 (Removal of national options and discretions)

30. We have no comments to make on this section

Section 4 (Simplification of the Bank Branch Accounts Directive)

Q19: Do you agree that the Bank Branch accounts Directive 89/177/EEC should be amended so that Member States can no longer require the publication of additional information by branches or credit insitutions established in other Member States.

31. We would welcome this sensible amendment.

E claire.stone@icaew.com