EUROPEAN CENTRAL BANK
BANKING SUPERVISION

Andrea ENRIA
Chair of the Supervisory Board

Mr Luke Ming Flanagan
Member of the European Parliament
European Parliament
60, rue Wiertz
B-1047 Brussels

Frankfurt am Main, 16 April 2019

Re: Your letter (QZ026)

Honourable Member of the European Parliament, dear Mr Flanagan,

Thank you for your letter on banks' loss recognition from an accounting perspective, which was passed on to me by Mr Roberto Gualtieri, Chairman of the Committee on Economic and Monetary Affairs, accompanied by a cover letter dated 19 March 2019.

Since the launch of European banking supervision in 2014, the ECB has welcomed the replacement of International Accounting Standard (IAS) 39 with International Financial Reporting Standard (IFRS) 9, which takes a more forward-looking approach to the estimation of loan losses.

As early as 2001, the ECB called for the introduction of "dynamic provisioning", which entails recognising losses on a proportion of the loan portfolio that is expected to deteriorate in the future, with the aim of overcoming the risk that expected credit losses remain hidden until signs of deterioration are evident.[1]

In 2006, the ECB reiterated that the incurred loss approach under IAS 39 would mean that credit risks would not be recognised through provisions until a fairly late stage, and highlighted the benefits, from a financial stability perspective, of a forward-looking approach which, by contrast, would take into account highly probable risks, either estimated on a statistical basis or based on rational forecasts for a specific sector or geographical area.[2] The ECB's views concurred with those generally shared by the accounting sector and research community, based on how IAS 39 was designed and applied in practice.

With regard to your second and third questions on the ECB's role in the delayed recognition of credit losses under IAS 39, let me first clarify that the ECB has no powers to set accounting standards. The IFRS are developed by an independent London-based body, the International Accounting Standards Board, and then

[1] Fair value accounting in the banking sector (European Central Bank, 2001): https://www.ecb.europa.eu/pub/pdf/other/notefairvalueacc011108en.pdf

[2] Assessment of accounting standards from a financial stability perspective (European Central Bank, 2006): https://www.ecb.europa.eu/pub/pdf/other/assessmentaccountingstandards2006en.pdf

endorsed in the European Union.[3] The ECB does not have any accounting enforcement powers either; it relies on banks' auditors to verify the accuracy of loan loss provisions in the financial statements. In other words, the ECB has neither a direct nor an indirect role in approving the accounting practices applied to banks' financial statements.

On assuming its role as a prudential supervisor in November 2014, the ECB performed an extensive asset quality review that represented a financial health check, from a prudential perspective, of 130 banks in the euro area, covering approximately 82% of total bank assets.[4] The asset quality review resulted in aggregate adjustments of €47.5 billion to participating banks' asset carrying values as of 31 December 2013. In many cases, banks chose to reflect these adjustments in their financial statements. This clean-up was the first step towards sufficient provisioning, which as of 2018 also includes the forward-looking view on credit risk as a consequence of the introduction of IFRS 9.

Since IFRS 9 has an impact on accounting results which form the basis for the calculation of prudential capital requirements, ECB Banking Supervision included IFRS 9 in its supervisory priorities for 2016 and 2017 and conducted a thematic review in order to assess the banks' preparedness for the implementation of the new standard. On 30 November 2017, the ECB published a report on this review describing the key challenges faced by banks and the main areas where improvements were still needed.[5] A major concern, which is also shared by many auditors, is that IFRS 9 currently leaves some leeway and lacks clear technical specifications in areas of high importance to prudential supervision and financial stability. There is room for improvement in the valuation of forward-looking loan loss provisions and the allocation of loans into the three stages of credit deterioration. Another concern is the wide range of justifications used by some banks to reclassify sovereign bonds between the "at cost" and the "at fair value" category to achieve immediate increases in equity.

Subject to its prudential mandate, ECB Banking Supervision will observe the progress made by banks in implementing the remedial actions that they were asked to take.

Yours sincerely,

[signed]

Andrea Enria

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3 Under Regulation (EC) No 1606/2002 of the European Parliament and of the Council of 19 July 2002.

4 https://www.bankingsupervision.europa.eu/banking/tasks/comprehensive_assessment/2014/html/index.en.html

5 https://www.bankingsupervision.europa.eu/press/letterstobanks/shared/pdf/2017/ssm.reportlsi_2017.en.pdf