

BUFFERS, RESERVES AND PROVISIONING

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Outline

- History
- The Credit Crunch and the problem
- Proposals for change
 - Dynamic provisioning
 - Cycle reserve
 - FASB Staff Position
 - Profit appropriation method



History of Loan Loss Provisioning

- Hidden reserves
- Secret unprovided losses
- General provisions
- Incurred losses
- IASB amendments to IAS 39
- FASB staff positions



Credit Crunch & The Problem

- During boom low loss provisions
- Since credit crunch increase in loan provisions
- A pro-cyclical effect
- Underpricing of risks
- Over distribution of profits



Credit Crunch & The Problem

- The purpose of financial reporting
- The role of standard-setters v regulators
- The 'level playing field' internationally
- The resultant wide ranging debate is very helpful



Proposal For Change : Dynamic Provisioning

- Article by Jesus Saurina
- Non recognition of losses *certain* to be incurred
- Dynamic provisioning a way to cover these losses
- A collective assessment for impairment
- A backward-looking statistical model
- Transparent
- Must be above bottom line to display *true* financial position



Proposals for Change : Dynamic Provisioning – Some Counter Arguments

- Measurement – economic cycles v loss cycles
- Negative correlation between cash inflows and profits
- Appropriate standard to set requirements
- Statistical basis for calculation
- High degree of judgement about very uncertain future events
- A contribution to the problem – not a full fix
- Better left to the regulator
- Provision for loans yet to be made



Proposals for Change :

Non-Distributable Economic Cycle Reserve

- A transfer from unappropriated profits to a reserve
- In the hands of prudential regulator
- Not in profit & loss
- Leaves incurred loss method alone – relevant and reliable
- Covers all assets, not just amortised loans
- Transparent
- Avoids counter-intuitive provisions



Proposals for Change : Non-Distributable Economic Cycle Reserve Some Counter Arguments

- Does not provide properly against assets
- Not through profit & loss
- Will not have as much impact
- Too much responsibility for regulators



Proposals for Change : FASB Staff Position

- Applies to debt securities
- Onus of proof shifted
- Credit loss separated and in profit & loss
- More regular disclosures
- Should IASB follow?



Proposals for Change : Profit Appropriation Method

- A change in display
- A dynamic provision or economic cycle transfer is made
- The profit & loss accounts shows
- Net result
 - Dividend distribution
 - Transfer to economic cycle reserve
 - Transfer to other reserves
 - Transfer to unappropriated profits
 - Opening unappropriated profits
 - Closing unappropriated profits



Summary

- Aim is to avoid pro-cyclicality and encourage banks to set funds aside in boom times
- Major argument between dynamic provisioning, on the one hand, and economic cycle reserve or profit appropriation, on the other, turns on whether the adjustment should affect profit & loss and net assets, or not
- Whether it should affect profit & loss and net assets or not, depends on whether you think the adjustment is a real or certain loss, or a transfer to help avoid the excesses of pro-cyclicality



Summary (continued)

- All three proposals are for the long term and the next boom
- ‘Stress testing’ of banks being carried out, may help in the meantime.
- The desirability of adopting the FASB staff position depends on how the *level playing field versus proper due process and full context* arguments are viewed. This change is not necessarily related to pro-cyclicality

