Klaas Knot: Financial stability through transparent reporting

Speech by Mr Klaas Knot, President of the Netherlands Bank, at the "International Financial Reporting Standards" conference, Amsterdam, 27 June 2013.

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Ladies and gentlemen,

I would like to talk to you about the role accounting standards fulfil in micro- and macro-prudential supervision of the financial sector. From experience I know that the accounting domain, the prudential domain and financial stability cannot be seen separately.

The discussion about this subject has been going on for quite some time. But I've always contributed to this debate from a supervisory perspective. And so I will today.

The main thread of the debate has always been "unexpected losses versus expected losses".

In other words: losses we cannot see coming versus the net present value of predictable future losses. The question for us is: how to translate the prudential notion of expected and unexpected losses to day-to-day accounting practises?

I have two messages:

The first: Accounting standards should be designed to reflect expected losses, no more and no less than that. And own funds should be designed to absorb unexpected losses.

The second: Financial reporting and financial stability supplement one another. They are like a horse and carriage.

I believe a combination of transparent capital requirements and accounting concepts based on expected losses, would boost trust in financial institutions and thus improve financial stability.

Now, it's a known fact that the ancient Egyptians were aware that every good seven-year period would be followed by a bad seven-year period. Seven years of favourable weather conditions would be followed by seven years of either too little or too much rain. It's why they saved grain during the seven good years. This old wisdom would serve the financial sector well too.

Stockpiling the metaphorical granary when harvests are good is sound financial policy.

So, how does this translate to financial reporting and capital requirements? Well, in the debate, prudential regulators are often accused of building in unexpected losses in loan loss provisions.

I think, though, that the facts tell a different story. Let's look at the Basel Committee for instance. It distinguishes between expected and unexpected losses. It argues that capital requirements should be robust enough to cover unexpected losses. And the Basel Committee welcomes that the IASB is considering including the expected loss notion in their new financial instruments standard, IFRS 9.

With a few hundred accounting experts here in the audience, I won't need to explain why a bank that maintains adequate loan loss allowances and robust capital buffers, is doing itself a favour. This serves that bank as well as financial stability.

As to the capital buffers, I take it that most of you are aware that both Basel III and Solvency II contain stricter requirements for buffers than the former versions of these solvency regimes.

For banks, Basel III specifies that the minimum levels be increased and expanded with so-called capital conservation and countercyclical buffers. Capital conservation buffers are to be built specifically in good times, through profit retention.

And countercyclical buffers are meant to be created in times of rapid credit growth, when banks extend a lot of new loans.

For we know that, more often than not, such periods are followed by a prolonged financial downturn.

As far as the supervisory requirements are concerned, it is the explicit aim that the granaries be filled during the good years. Supervisors play a crucial role in ensuring that banks comply with this requirement.

But there's an important role for accounting standard setters here, too. For I would argue in favour of maximum transparency about these buffers. And it wouldn't surprise me in the least if the IASB chose to include disclosure requirements about own funds in their standards, for instance in IAS 1.

Now let me turn to financial stability. Obviously, economies are cyclical: every upward trend is followed by a downward one. And vice-versa.

Given the current negative sentiment, trust in banks has turned sour. To illustrate this, we only need to look at the price-to-book ratios of many banks.

The figures are telling us things are not well. Among a number of reasons why price-to-book ratios are this low, is that investors are still expecting hidden losses to appear.

They believe the banks have not yet put these future losses in the books and are thus sceptical about their financial health. For when part of the capital will be used to absorb expected losses, they know that less will be available for unexpected losses.

Whether these investors are right is irrelevant. What is relevant is that this fear stems from knowing that banks apply the incurred loss-model.

The impairment requirements in the current standard, IAS 39, are just not sufficiently forward-looking. This is not just their perception; it's mine too.

In terms of the grain metaphor, that's like having a well-filled granary built on soggy soil and knowing that the grain is leaking away through cracks in the foundation.

This makes for a deadlock between investors and banks – one that can have adverse consequences for financial institutions, governments and national economies, as we have witnessed in recent years.

In my view, it's therefore highly advisable that we make the impairment requirements in the new accounting standard forward-looking. High-quality accounting standards should form the foundation on which these capital buffers are based. Sound reporting will increase *trust* in the institution.

There are those that think it unwise to estimate future losses, as these estimates are subjective and imprecise. I would disagree for two reasons:

First, expected losses can be described in such concrete words that they can be properly reported by the reporting entity and subsequently verified by the auditor. And, second, I believe that the current incurred loss model is more subjective than people tend to think.

To illustrate the subjective character of the current incurred loss model, I can draw from our experience at the Dutch Central Bank.

We are currently executing a so-called Asset Quality Review. In this review we're also evaluating the processes that lead to adequate levels of loan loss provisioning.

What we are seeing is that different banks use different interpretations for similar loans. Apparently, there's already room for a certain degree of subjectivity. I'm not too worried about this subjectivity. Preparing financial statements has always carried some measure of subjectivity and this will remain so.

I agree with those who say that *too much* subjectivity will foster "gaming of the system". In order to control this subjectivity, I would welcome that the new IASB standard, IFRS 9, clearly defines those relevant forward-looking elements.

For me the proof of the pudding would be preparers and auditors saying that the new forward-looking requirements cannot be ignored when calculating the expected loss allowance accounts.

So far, I concentrated on the impairment requirements to be included in IFRS 9. But IFRS 9 also contains other elements that are quite relevant to us. These are the classification and measurement sections. Let me also say a few words about these. It's generally accepted that a bank's economic value is determined by its cash flows. Accounting standards should reflect this. That's why I am in favour of introducing the business model criterion.

If the bank's business is trading, then the Fair Value-method would give a good estimate of future cash flows. If the bank specialises in hold-to-collect management of financial instruments, then unrealised gains should not be part of its own funds.

Obviously, I'm implicitly referring to the revision of standards for financial instruments: the conversion of IAS 39 to IFRS 9. I'm glad we are converting, as the new standard is a big improvement.

For the resulting simplicity will not only help to tell a clear story, but also enhance financial stability. And this is just what the main categories "amortised cost" and "fair value through profit or loss" will do.

I know, of course, that the IASB is considering introducing a third category, the so-called Fair Value Through Other Comprehensive Income, or FVOCI.

I've been told that this new category resembles an old one, the Available-for-Sale category. The very category that caused a lot of uncertainty during the crisis.

I would therefore advise the Board to see to it that this third category is made subject to robust conditions, to ensure that this regulation leaves no leeway for arbitraging.

Finally, I would say that converting from incurred loss to expected loss would greatly improve things. As I said earlier, accounting principles should take into account expected losses as soon as they are perceptible. This means that the expected loss notion becomes part of the amortised cost principle.

And I view this notion as quite similar to fair value notions that include losses in market indices. These also tend to bear a forward-looking element. To some this may come as a surprise, but in my mind both approaches would give us very clear estimates of possible credit risk losses. And, of course, this would serve financial stability.

The IASB has been working on the conversion from IAS 39 to IFRS 9 for a while now. I look forward to its swift implementation.

In closing, I would like to leave you with three basic principles:

One: *Transparent reporting of expected and unexpected losses contributes to financial stability*. We should make buffers in own funds for unexpected losses and book in the expected losses as part of the new amortised cost valuation method.

Two: *Prudential regulators and accounting standard setters such as the IASB share an interest*. Prudential regulators promote sound risk management practices – and accounting standard setters promote sound financial reporting. Both are prerequisites for a sound banking system and, consequently, for financial stability.

I therefore call upon the IASB to continue its cooperation with the regulators, including the Basel Committee.

Three: *The expected loss model must be included in the IFRS 9 standard for financial instruments* – as soon as possible, I would add.

Ladies and gentlemen,

Let the granaries of the world be filled to the rafters with grain of excellent quality. And let the fields be ready to bear more great harvests. Once everyone sees how well the farmers are prepared for the lean years ahead they will happily go about their business. They will trust the stability of the system that keeps them fed.

I thank you for your time and will now happily take some of your questions.