Vítor Constâncio: Introductory remarks at the fifth ECB conference on accounting, financial reporting and corporate governance for central banks

Introductory remarks by Mr Vítor Constâncio, Vice-President of the European Central Bank, at the fifth ECB conference on accounting, financial reporting and corporate governance for central banks, Frankfurt am Main, 21 June 2016.

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Good morning, Ladies and Gentlemen,

Welcome to the fifth ECB conference on accounting, financial reporting and corporate governance for central banks. This two-day conference is dedicated to the memory of Niall Merriman, Head of the ECB's Financial Reporting and Policy Division, who unexpectedly passed away in September 2015.

A special welcome and thank you to the distinguished speakers for sharing their thoughts on the topics covered today and tomorrow.

This conference is by now well established, as demonstrated by the great interest among central banks around the globe, and the ever increasing participation.

1. The conference is organised along four main themes:
2. Developments in international accounting standards;
3. Impact of accounting on financial regulation and supervisory reporting;
4. Managing risks on central bank balance sheets; and
5. Governance and financial reporting issues at central banks.

On the ***first topic***, the ECB has stepped up its efforts in monitoring international accounting developments over the last two years. There are two reasons underlying this.

First, as you certainly remember, the Single Supervisory Mechanism (SSM) became operational in November 2014. Accounting information forms the basis for various elements of prudential regulation and supervision. As already highlighted in an ECB report published in December 2006, a harmonised and comparable accounting framework is an important element for consistent supervision.[1]

After the eruption of the financial crisis in 2008, the G20 called for a single set of high quality global accounting standards in order to strengthen credibility and comparability of financial information. The main aim of this request was to alleviate risks in the financial sector and to help prevent future financial crises. Therefore, the ECB supports the recent activities of the IASB which are geared towards achieving this objective.

Second, the ECB has recently become more directly involved in the European process for adopting the International Financial Reporting Standards (IFRS). This is a major consequence of the Maystadt report on how to reinforce the EU's contribution to the IFRS Standards and improve the governance of the European institutions developing these standards.[2]

Since January 2015, the ECB has an observer status in both the new Board of the European Financial Reporting Advisory Group (EFRAG) and the related Technical Expert Group (TEG).

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1 ECB (2006), Assessment of accounting standards from a financial stability perspective.

2 Maystadt, P. (2013), Should IFRS Standards be more "European"?

The EFRAG is a private association that provides technical advice to the European Commission on the endorsement of IFRS Standards, as well as related interpretations issued by the International Financial Reporting Interpretations Committee (IFRIC). The ECB also participates in a number of other committees dealing with IFRS Standards, such as the IFRS Advisory Council, the Accounting Expert Group of the Basel Committee on Banking Supervision and the Accounting Subgroup of the European Banking Authority. Our aim is to ensure that coordinated positions of the ECB on relevant accounting matters are duly considered in the accounting standard-setting process.

The colleagues in ***session one*** will provide insights into the current challenges in relation to international accounting standard-setting, the role of international accounting standards in the EU as well as their formal adoption and implementation in the Single Market.

With respect to the ***second topic***, the impact of accounting on financial regulation and supervisory reporting, I have already touched upon the mounting relevance of the interaction between international accounting standards and prudential regulation and supervision following the creation of the Single Supervisory Mechanism. I will confine myself to a few remarks on two related matters:

- the issue of non-performing exposures (NPEs);[3] and
- the regulatory guidance on the new expected credit loss model and its interaction with prudential capital requirements.

The year 2015 was the first full operational year of the SSM. One of the first items on the SSM's task list was to follow up on the results of the 2014 comprehensive assessment. The comprehensive assessment helped us to identify problems on the balance sheets of the significant banks. One of the important outcomes was the scale of NPEs now classified using a harmonised definition. As you are aware, some euro area banks still have high levels of NPEs on their balance sheets.

In the euro area, the average ratio of NPEs for significant institutions stood at 7.1% at the end of 2015, which is high by international standards.[4]

For instance, a proxy for the ratio of NPEs in the US has continued to decline in recent years and amounts to only 1.5% at the end of 2015. A comprehensive policy response to the high levels of NPEs in Europe is necessary, and as part of that, the SSM is working to take stock of supervisory best practices. More action is needed to address shortcomings in insolvency, collateral and taxation frameworks.

Accounting standards are also important to address the issue. In the US, accounting standards require US banks to reduce, after six months, their NPEs to the market value of their collateral, if any. Balance sheets are therefore cleaned up of bad loans rather swiftly.

This illustrates how accounting standards interact with supervisory concerns. Until now, the incurred loss model has been applied under IFRS which does not impose a timely treatment of NPEs by the banks. As a consequence, NPEs accumulate in banks' balance sheets, consuming capital and not contributing to banks' profitability. The introduction of IFRS 9 as from 2018 will change this situation.

The ECB has already publicly expressed its support for a swift endorsement of IFRS 9. In our view, the new requirements for the classification, measurement and impairment of financial instruments, as well as the new general hedge accounting model, constitute an improvement over the previous requirements in IAS 39. Moreover, we believe that some aspects of the

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3 Non-performing exposures (NPEs) can be defined as impaired exposures and past due (> 90 days) exposures.

4 The ratio of non-performing loans refers to the ratio of non-performing loans to total gross loans.

new standard may be an improvement from a financial stability perspective. The merits of the new expected credit loss model will clearly depend on its proper and consistent implementation in the financial sector. In this perspective, it is important that more granular instructions are given by the standard-setters and regulatory authorities in order to ensure that the implementation of the new standard is not subject to different interpretations that would not respect a proper level playing field. At the same time, it will be crucial to monitor the application of IFRS 9 in order to ensure that there are no unintended cyclical consequences of its implementation.

In the US, the FASB just announced the approval of similar standards that nevertheless will only start to be applied in 2020. US banks have been critical of what will be a major change in frontloading provisions for credit risk. The introduction of both new standards will be a substantial change that will affect banks, already subject to more demanding regulation to which new features will continue to be added until year-end, albeit with the promise of not leading to a "significant increase in capital requirements", as stated by the Group of Governors and Heads of Supervision (GHOS).

In this same vein, regulators should monitor carefully the consequences of the new standards and, if need be, should consider an appropriate transition period from a prudential point of view. One must not forget the interaction of the new accounting rules under IFRS 9 and the solvency requirements for banks. The Basel Committee is currently doing some work in this area, to which the ECB contributes on an ongoing basis.

Against this background, the ECB also welcomes the Basel Committee's supervisory guidance on sound credit risk practices and the application of accounting impairment models based on expected credit losses.[5]

European banks will need to consider any possible impact of this guidance on their plans for the implementation of IFRS 9. Hence, we are confident that the guidance will achieve its stated objective and contribute to a consistent implementation of the expected credit loss model across European banks.

The second day of this conference will be devoted to "traditional" central bank topics – risk management and governance.

Proper risk management remains high on the agenda of central banks and is therefore the "guiding theme" of ***session three***. Due to extraordinary circumstances, such as persisting low inflation and its potential effect on investment behaviour, central banks worldwide have been forced to take extraordinary measures. For example, in the last year and in an attempt to secure a return of inflation to levels closer to 2% over the medium term, the Governing Council decided to expand its asset purchase programme. Under this programme, the target level for the combined monthly purchases of public and private sector securities is now €80 billion.

All these measures have and will continue to transform central bank balance sheets. In particular, central bank balance sheets have been expanded considerably which requires risk managers to pay special attention to possible medium- and long-term risks. For this reason, risk management is becoming an even more critical component of the ECB's and other central banks' daily activities.

Against this background, I am happy to welcome speakers from around the globe that will provide first-hand information about these extraordinary measures and how they may affect risk exposures and risk management of central banks worldwide.

Session four is dedicated to "governance and financial reporting issues at central banks". Discussions about the credibility of central banks have intensified over the last couple of

5 BCBS (2015), Guidance on credit risk and accounting for expected credit losses.

years. I will leave it to the speakers tomorrow to highlight the latest developments in these areas. I will just describe some specific elements of our recent internal reorganisation at the ECB which are geared towards improving the quality of our governance function.

Firstly, the ECB has created a new position in 2015, the Chief Services Officer (CSO), responsible for matters pertaining to administrative services, IT services, human resources and finance.

Secondly, the Executive Board of the ECB decided to create an independent Finance department, reporting to the CSO and responsible for budgeting and controlling, financial and cost accounting, financial reporting and procurement.

Finally, also in 2015, the ECB decided to establish a dedicated Compliance and Governance Office (CGO) as a key risk management control function to strengthen the ECB's governance framework. The purpose of this Office is to support the Executive Board in protecting the integrity and reputation of the ECB, to promote ethical standards of behaviour and to strengthen the ECB's accountability and transparency. To this end, the new CGO performs activities relating to the ECB's revised ethics framework and other governance activities.

Ladies and Gentlemen, the four sessions of today and tomorrow provide a representative sample of current key topics and challenges for central banks worldwide. I therefore wish you a productive and inspiring conference.