

# Ministers of finance support introduction of dynamic provisioning into European banking legislation

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Brussels, 06/07/2009 (Agence Europe) - European ministers of finance will reach an agreement this Tuesday on the introduction into European banking legislation of "dynamic provisioning", in an effort to improve the fight against financial instability. In its provisional conclusions on the pro-cyclical effects of safeguard rules and accounting standards in force, they say that they are in favour of an instrument which, "consists in constituting provisions deducted from profits in good times for expected losses on loan portfolios". One ambassador, who said that there was consensus between member states on such an important subject added that, "certain safeguards or accounting standards highlight the (economic) tendency, whereas, during a crisis we want to find a way of

confronting cycle tendencies...A cycle is necessary for getting over future difficulties". The Commission will propose a revision in the direction of the Basle II directive in the autumn on capital bank requirements (EUROPE 9930).

The financial crisis demonstrated that certain safeguard and accounting rules tended to exacerbate difficulties experienced by financial institutions quoted on the stock exchange. For example, fair value of certain trading book assets may underestimate risk in good time and overestimate them when the economy picks up. In October 2008, the European Council demanded a far reaching rethink into accounting standards based on this principle (EUROPE 9763). The Economic and Financial Committee (EFC) examined this "pro-cyclical" concept for rules and submitted its report at the end of June on which the conclusions of European finance ministers will be based this Tuesday. This report is planning on four lines of action to reduce potential pro-cyclical effects of financial regulation: monitoring of systemic risk; the constitution of counter-cyclical buffers in the form of own funds and assets; improvement of accounting rules; establishment of a healthy framework for pay.

Dynamic provisioning. In its report, of which EUROPE received a copy, the EFC is of the opinion that it is necessary to modify the accounting rules used for the banking book and "a more forward-looking concept of expected credit loss, rather than limit provisions only to losses that have been incurred by the reporting date". Use of this concept would lead to increasing provisioning in good times when the risks accumulate, explained the same diplomatic source. Drawing on this analysis, ministers consider that taking into account expected losses would: help provide improved assessment of real profits in periods of growth; help adapt CEO bonuses; raise investor awareness over underlying risks. Ministers will be asking the organisations responsible to elaborate accounting standards and rules in this sense. The International Accounting Standards Board (IASB) has announced that an analysis of the issue will be published in October.

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The Ecofin Council is aware of the lack of work on the question and agrees on the need to "continue work in order to mitigate the pro-cyclical tendency by setting up counter-cyclical buffers in the form of own funds. According to the Ecofin Council, regulatory tools should not be perceived as new minimum requirements for own funds in order to allow the banks in periods of recession to use previously constituted provisions. The Ecofin Council also welcomed the efforts the Commission plans to use for installing a system based on simple measures and not risk. The approach based on own funds is being promoted by the United Kingdom. Germany would like the way in which ratings of financial securities are assessed and effect own fund requirements for credit institutions. Our diplomatic source said that it was not clear at this stage if a national or more European undertaking is required.

Measures outlined by ministers for fighting the pro-cyclical effect of rules included the repeated underlining of "monitoring systemic risk" at a macro-economic level, a task that the European Committee on systemic risk will carry out and whose creation has been announced as part of the reform of the European financial supervisory system (EUROPE 9925). The EFC, in this connection, is underlining cooperation in collecting and exchanging data between the agencies concerned, particularly by way of confidentiality agreements. Ministers will point

out that the payment systems have increased pro-cyclical effects by exacerbating excessive risk taking and short term thinking. They will take note of the Commission's wish to amend the Basle II directive. The EFC considers that this legislative revision to be imposed on the banks in order to have coherent remuneration policies and healthier risk management will give supervisors the power to demand that an institution takes corrective measures, including the imposition of penalties, financial or otherwise, on the banks that infringe the rules.

(M.B./trans/rh)

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