BANCO DE ESPAÑA

Preparing for the future: Where to now for regulation and supervision in the field of securities?

SESSION C: Accounting

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CESR's Conference on 23 February. Paris

Outline

- To be clear from the beginning, **in my view fair value is the best accounting standard** for providing final users of financial statements with relevant, reliable and comparable information
  - And all in all for promoting a better allocation of resources that internalises the information present in financial markets

- **But** as the current crisis in the international financial system has highlighted fair value has its own limitations. For this reason **it is necessary to improve fair value.**

Limitations of fair value

Subjectivity

(in the design of valuation models)

Volatility

(market conditions are taken in a specific time)

Excessive emphasis on the short term

(perverse incentives for bank managers)

The **crisis in the international financial system has highlighted these and other related shortcomings of fair value**

(Specially for complex products developed in recent years under the originate-to-distribute banking model)

Quantitative limitations

Models have not properly captured the characteristics of complex products and were design under benign economic conditions

Qualitative limitations:

Systems have not been well designed to verify and test the valuations made

Lack of transparency:

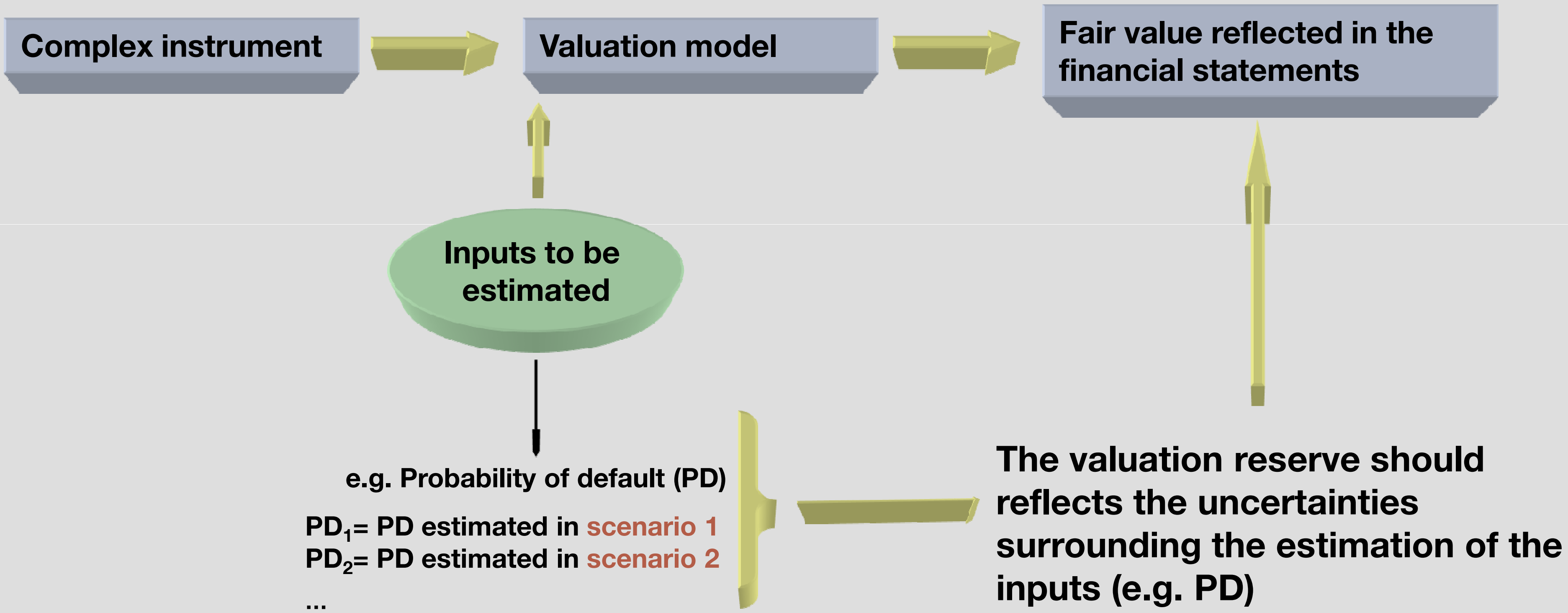
The information reported to the market does not appear to have been sufficient

Intensification of the procyclical behaviour of financial markets, because fair value have introduced incentives to increase leverage and mispricing risks

Improving fair value: valuation reserves

- Institutions could set aside **valuation reserves for those more complex structured products that are market-to-model**

- Valuation reserves would **recognise the uncertainty associated with the calculations of fair value under specific circumstances**



- They should be **objective, transparent, symmetrical and act at all times**

Improving fair value: dynamic provisions

- **Dynamic provisions should be considered as an approximation to the fair value of banks' loan portfolios**
  - **They mitigate the fact that, at good times of the economic cycle, risks are build up but are only disclose with a delay in the P&L account** of the financial institutions,
    - *It is not reasonable that investors should be surprised in the future by what is already known it is going to happen*
  - **They take into account the transition from collective assessment of impairment to individually identified losses**
  - … in other words, dynamic provisions **offer a truer and fairer view of financial institutions**
  - Moreover, and importantly, they **contribute to reduce the procyclicality of accounting rules**, and more general, the procyclical behaviour of financial market participants
    - *Reduce "excessive prociclicality"*
- Dynamic provisions, as valuation reserves, **should be objective and transparent**

Improving fair value: general principles

- **Search for better valuations**
  - Quantitative aspects of valuations models
  - More realistic view of the risks and benefits of the activity throughout the cycle
- **Minimise the procyclical impact induced by fair value**
  - Valuation reserves and dynamic provisions are two examples
- **Governance**
  - Qualitative aspects when implementing fair value are relevant (models should be tested by independent units etc.)
- **Transparency**
  - Investors need to have proper information (volume of exposures valued at fair value, valuation method and inputs etc.)

Implementation of IFRS

- The rationale behind **IFRS** is that the **information contained in the financial statements must be useful for market participants** in order to make their economic and investment decisions

- **I agree** with this general principle

- **But at the same** time I consider that **it is** not only desirable but also **necessary to minimise the coexistence of different accounting criteria depending on the final use of the financial information**
  - Tax legislation; solvency regulations; commercial law etc.

- **IFRS should act as an umbrella that gives a response to the various needs that the users of financial information may have**
  - Through the pertinent corrections, such as prudential filters

- **If it was not the case, there would be two major risks**
  - Inefficiency
  - Survival of the own IFRS framework

- **On the top of that, efficiency can be improved by offering integrated technological solutions: XBRL is a good example**

Conclusion

- **Fair value is the best accounting standard** for providing final users of financial statements with relevant, reliable and comparable information

- **But it is necessary to improve it, and objective and transparent valuation reserves and dynamic provisions can contribute to this process**

  - **To strengthen the relevance, reliability and comparability of information**
  - **To make it compatible with best practices in risk management**
  - **To minimise the "excessive procyclicality"** induced by accounting standards

- **Implementation of IFRS is also important**
  - Reduce the inefficiencies associated with the coexistence of multiple accounting rules depending on the final use of the financial information

Thank you for your attention