



**COUNCIL OF
THE EUROPEAN UNION**



Council conclusions on pro-cyclicality

*2954th ECONOMIC and FINANCIAL AFFAIRS
Brussels, 7 July 2009*

The Council adopted the following conclusions:

- "1. Following up to the Informal Ecofin of September 2008, the EFC mandated a Working Group on pro-cyclicality (WGPC) to contribute to the work ongoing at international level and, inter alia, determine how and with which tools the EU could take into account matters identified by the Financial Stability Board (FSB) and reflect to develop the macro-prudential orientation in supervision. The WGPC has now finalised its Report, which presents potential policy responses to reduce pro-cyclicality in the financial sector. In the meantime, the Declaration of the G-20 summit of November 2008 invited international bodies to address pro-cyclicality, by mitigating it in regulatory policy and also reviewing how valuation and leverage, bank capital, compensation schemes and provisioning practices may exacerbate cyclical trends. These objectives have been reiterated at the last G-20 Summit in April 2009 and underscored by the 18-19 June 2009 European Council.

P R E S S

2. The Council WELCOMES the report of the WGPC, which focuses on four main policy responses with a view to reducing potential pro-cyclical effects of financial regulation and developing counter-cyclical measures, namely: i) the monitoring of system-wide risks; ii) the building of counter-cyclical buffers through capital and provisions; iii) the improvement of accounting rules, and iv) the establishment of a sound framework for remuneration schemes. The report centres on developing a macro-prudential approach, including by building in automatic stabilisers into the regulation and better informing about the basis for discretionary supervisory measures and changes in regulation through enhanced monitoring.

3. The Council AGREES on the need to monitor system-wide risks and to ensure that appropriate tools and methods are in place to further develop a macro-prudential monitoring. The Council STRESSES that such an approach will only be effective if recommendations based on such monitoring are translated into concrete policy actions where appropriate. The ESRB (European Systemic Risk Board), which will be put in place following the guidance received from the Ecofin and European Council of June, will have an important role to play in this respect.

4. The Council AGREES that the absence of counter-cyclical buffers and the lack of flexibility of accounting rules in allowing for through-the-cycle provisioning have been important factors in the amplification of the financial crisis. The Council UNDERSCORES the urgency and importance of addressing these issues.

5. The Council SUPPORTS the introduction of forward looking provisioning, which consists in constituting provisions deducted from profits in good times for expected losses on loan portfolios, and which would contribute to limiting pro-cyclicality (including the development of models for dynamic provisioning). Accounting standards, such as IFRS, currently do not allow for the recognition of expected losses. The IASB will publish an exposure draft dealing with the provisioning issue, including consideration of an expected loss model, by October 2009. Allowing for the recognition of expected losses would ensure the build up of provisions in good times, which can be used in downturns; would contribute to a better assessment of real profits in good times; adjust managerial incentives in relation to remuneration make investors more aware of the underlying risks and further enhance consistency between accounting and prudential rules. In line with the recommendations of the G-20 London Summit and calls from banking supervisors and the FSB to standard setters, the Council therefore CONSIDERS that standard setters should give priority to amending current accounting rules and allowing for more flexibility for provisioning expected losses.

6. While the application of such provisioning will be an important step forward, it may not be enough as provisioning for losses in the loan portfolio may not be sufficiently large and buffers are also needed against fluctuations in the value of financial assets. The Council therefore AGREES that further work is necessary to mitigate pro-cyclicality by creating counter-cyclical capital buffers, i.e. to be raised in good times and to be drawn down in downturns. It is important that counter-cyclical capital buffers are not perceived as new minimum capital levels when conditions deteriorate and that they do not count towards eligible regulatory capital, so as to allow banks in downturns to draw on buffers previously built up in good times. CEBS, CEIOPS and the Basel Committee are working on proposals. The Council also WELCOMES efforts envisaged by the Commission in view of introducing simple non-risk based metrics which could limit unsustainable balance sheet growth and help in addressing pro-cyclicality.

7. While recognising the benefits of the fair value principle, the crisis has highlighted that the current valuation of certain financial assets (in the trading book) may understate risks in good times and overstate them in downturns, for instance when 1) financial instruments not suitable for fair value are fair valued, 2) market prices are used when markets are illiquid and 3) modelled prices rely too much on illiquid market prices. Mark-to-market valuation of many categories of financial instruments should be reviewed and adjusted as appropriate, particularly taking into account the uncertainty of valuations, the reality of the business model of banks, the holding horizons and the actual liquidity of markets. The Council SUPPORTS such views and the objective of a amendment of the relevant accounting rules, also recalling the objective to achieve a single set of standards at global level and to improve the governance of the standard setting process.

8. The Council WELCOMES the commitment by the IASB to promptly review the accounting rules on impaired financial instruments. To this end, and to ensure equivalence treatment with US financial institutions, the Council URGES the IASB to amend IAS39 quickly and in time for the preparation of the 2009 year-end financial statements, including all the issues identified by the Commission in October 2008. In addition, the Council URGES the IASB to perform a more comprehensive review of IAS39, as a second step, taking into account the objective of achieving global convergence on the accounting for financial instruments, as reflected in the G-20 communiqué.

9. The Council **ACKNOWLEDGES** that remuneration schemes of financial firms have been a source of pro-cyclicality, due to inappropriate incentives, short-termism and inadequate capture of risk. The Council **WELCOMES** the works conducted at international level by the FSB, as well as the CEBS high-level principles for remuneration policy and the recent Commission's recommendations. The Council **URGES** Member States to implement these recommendations in view of addressing such shortcomings, by strengthening the link between performance and pay, by promoting a balance between long and short term performance criteria and by enhancing the governance of the remuneration process and **NOTES** the Commissions' intention to come forward with amendments to the Capital Requirements Directive (CRD) on remuneration in the banking sector, which should be fully in line with ongoing works at international level.

 10. Beyond the measures that aim at preventing future pro-cyclicality in financial markets, the Council is aware of the need to continue developing short-term measures to overcome the current crisis. The Council calls on the Commission and the Member States to accelerate their work and make rapid progress on countering the pro-cyclical effects of regulatory standards, e.g. as regards capital requirements and impaired assets.

 11. The Council **INVITES** the European Commission to come forward with proposals to pursue these objectives and address pro-cyclicality, in coordination with the developments ongoing at international level."
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