

**COMMISSION de SURVEILLANCE
du SECTEUR FINANCIER**

In case of discrepancies between the French and the English text, the French text shall prevail

Luxembourg, 15 December 2008

To all Luxembourg law credit
institutions and branches of non-EU
credit institutions

CIRCULAR CSSF 08/386

**Re: Details on the use of the AGDL provision¹ and of the lump sum provision in
the published accounts of banks as at 31 December 2008**

Ladies and Gentlemen,

The purpose of this circular is to provide details on the use of the AGDL provision and of the lump sum provision in the published accounts of banks as at 31 December 2008 and to recall the reason for and the essentially prudential nature of these anti-cyclical provisions traditionally established in Luxembourg.

This circular relates to the accounts published under Lux GAAP, as opposed to Circular 08/377 which details the emergency measures taken at an international level in order to mitigate the consequences of the current financial market crisis under IFRS. Currently, the vast majority of banks in the financial centre still publish their accounts under Lux GAAP.

The banks having already adopted IFRS in 2007 for their published accounts and those considering adopting IFRS for the financial year end 2008 are requested to refer to point III. of this circular.

¹Association pour la Garantie des Dépôts, Luxembourg (Deposit Guarantee Association Luxembourg)

I. Reminder of the nature and objectives of the AGDL provision and of the lump sum provision

Setting up an AGDL provision and a lump sum provision represents in Luxembourg the practical application of an anti-cyclical risk provisioning policy which contributed to the stability of Luxembourg's financial system. Historically, these provisions are set up as a preventive measure in prosperous economic periods with the aim of using them in less favourable periods to face losses or possible insolvency situations.

1. The AGDL provision

The AGDL provision was introduced in 1991 following the default of the BCCI, for which a compensation payment by the AGDL was necessary. Pursuant to the Grand-ducal regulation of 21 December 1991 implementing article 167, subparagraph 1, number 5 of the law of 4 December 1967 on income tax, banks may set up provisions for their contribution to the AGDL in the context of an insolvency coverage by the latter. The maximum amount for the AGDL provision is of 10% of the amount of guaranteed cash deposits held by the bank in its own books and which are eligible for being covered in the context of the deposit guarantee scheme.

The CSSF noted, based on the statistics available, that the provisions set up by Luxembourg banks seem to correctly reflect the "AGDL risk" borne by the credit institution which will have to contribute to the guarantee. Thus, the AGDL provisions set up over the past years are, in general, sufficient to cover the advances to be paid by Luxembourg banks in the context of the unavailability of deposits of the Luxembourg subsidiaries of Icelandic banks, for which an application for suspension of payments had been lodged at the beginning of the month of October 2008.

2. The lump sum provision

The lump sum provision in its current form is based on the "Instructions of the *Directeur des Contributions*" dated 16 December 1997. As per this instruction, "the purpose of this provision is to cover risks which are likely to be incurred, but not yet identified when drawing up the balance sheet".

The lump sum provision is hence essentially prudential. This is also confirmed by the fact that it is calculated based on the risk weighted assets representing the denominator of the solvency ratio. Given the new solvency rules (Capital Requirements Directive (CRD) or "Basel II"), these risks include, in addition to credit risk and market risk, also operational risk. It should be noted that the lump sum provision is not included in own funds on which the solvency ratio calculation is based, but it is deducted from the risk weighted assets representing the denominator of the solvency ratio.

Experience shows that in many situations, Luxembourg banks have used the lump sum provision in the past to compensate financial losses which occurred during a financial year. The current turmoil on financial markets has brought about the release of the lump sum provision to cover losses in the securities portfolio.

II. Details on the use of the AGDL provision and the lump sum provision for banks publishing their accounts under Lux GAAP

1. Use of the AGDL provision

As regards the advances to be paid by the Luxembourg credit institutions in the context of the unavailability of deposits of Luxembourg banks, Luxembourg credit institutions must use the preventive provisions set up during the previous financial years in order to cover the intervention of the deposit guarantee scheme (AGDL).

This means that the institutions reduce the existing AGDL provision (included in the provisions) up to the amount of payments executed (without affecting the profit or loss account) and carry only a possible excess payment in the results.

Technically, banks publishing their accounts under Lux GAAP shall proceed as follows:

a. Where a provision is available:

The amount to be paid is registered through a credit in item 4 “Other liabilities” of the balance sheet and a debit in item 6.c “Provisions: other provisions” of the balance sheet; a possible additional payment to be made is registered through a debit in item 10 “Other operating charges” of the profit or loss account and a credit in item 4 “Other liabilities” of the balance sheet.

b. Where no provision is available:

The amount payable is registered through a debit in item 10 “Other operating charges” of the profit or loss account and a credit in item 4 “Other liabilities” of the balance sheet.

With the aim of ensuring the transparency required for this purpose, additional explanations must be provided in the management report and in the notes to the accounts to be published. These explanations must refer to this circular.

2. Use of the lump sum provision

As regards the impairment of the financial assets or other important losses linked to the current financial crisis, Luxembourg credit institutions must use the lump sum provision set up as a preventive measure during the previous financial years in order to cover losses in less favourable periods, with the aim of absorbing the impairment or other losses incurred, where these are substantial.

The CSSF may grant an exemption to this principle, on a case-by-case basis, where justified explanations are provided by the credit institution.

This means that the institutions compensate the impairment or other losses incurred which are registered in the profit or loss account through a reversal of the existing lump sum provision (recorded as a decrease in the risk assets or as a provision) to the extent concerned.

Technically, banks publishing their accounts under Lux GAAP shall proceed as follows:

- The impairment/losses recorded during the financial year are registered in the related item of the profit or loss account.
- The portion of the lump sum provision which is deemed to represent a “value adjustment” is reversed through a credit in item 12 “Value re-adjustments in respect of loans and advances and provisions for contingent liabilities and for commitments” of the profit or loss account and a debit in the related items of the balance sheet assets; the portion of the lump sum provision which is deemed to represent a “provision” is reversed through a credit in item 12 “Value re-adjustments in respect of loans and advances and provisions for contingent liabilities and commitments” or in another item of the profit or loss account, according to the type of loss to be compensated, and a debit in item 6.c “Provisions: other provisions” of the balance sheet liabilities.

With the aim of ensuring the transparency required for this purpose, additional explanations must be provided in the management report and in the notes to the accounts to be published. These explanations must refer to this circular.

III. Important comments concerning the banks having already adopted IFRS for their published accounts and those considering adopting IFRS for the financial year end 2008

1. Banks having already adopted IFRS for their published accounts in 2007

The limited number of banks which already publish their accounts under IFRS may, in consideration of the current status of IFRS, no longer use the prudential provisions previously set up under Lux GAAP and which had to be released to retained earnings in the IFRS opening balance sheet. These banks must hence book the AGDL advances as expenses for the current year, notwithstanding their previously set up AGDL provision. At the same time, these banks may no longer compensate the losses resulting from the current financial crisis by a release of the lump sum provision set up as a preventive measure during the previous financial years under Lux GAAP.

The banks concerned must clarify with the *Administration des Contributions directes* the tax treatment which shall apply to such bookings.

2. Banks considering adopting IFRS for their published accounts for the financial year end 2008

In consideration of the international efforts which analyse a better alignment of the accounting standards on the prudential rules governing the financial community and which consider in particular the possibility to set up, as a preventive measure, anti-cyclical provisions in favourable economic periods in order to be used as a safety net in less favourable periods, the CSSF considers that, in the current situation, it would be better for banks considering adopting IFRS for their published accounts in 2008, as adopted by the EU, to delay this transition until a clear and satisfactory solution is found at an international level. However, banks which are technically already prepared

for the transition to IFRS may opt for the Lux GAAP regime with IAS options accepted pursuant to the law of 17 June 1992 relating to the accounts of credit institutions, as amended, which allows them to draw up and present accounts based on IFRS while maintaining the prudential provisions accepted under Lux GAAP. In this case, the accounts published are prepared according to IFRS as adopted by the EU, except for the accounting principles relating to the accounting of the AGDL provision and the lump sum provision, and they correspond to the FINREP prudential financial reporting implemented by the CSSF.

The banks concerned must clarify with the *Administration des Contributions directes* the tax treatment which shall apply to the Lux GAAP regime with the chosen IAS options.

For any question concerning this circular, please contact Mrs Marguy MEHLING (tel: +352 26 25 1 214, e-mail: sge.marguy.mehling@cssf.lu).

Yours faithfully,

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