

GUIDELINES ON PRUDENTIAL FILTERS FOR REGULATORY CAPITAL

From January 1st, 2005 European listed companies, at the minimum, will have to publish consolidated financial statements based on the new International Financial Reporting Standards (IFRS) rules. The IFRS accounting developments may affect the magnitude, the quality and volatility of banks' available regulatory capital. As accounting numbers remain the basis for the computation of prudential ratios, this change will have a significant impact on the solvency ratios and, primarily, on the content of own funds.

In response to a request from the Banking Advisory Committee, CEBS has proposed to the European Commission on 19 October 2004 a first set of technical advice on the use of prudential filters in the context of the new IFRS and the proposed Capital Requirements Directive. In addition to the prudential filters proposed to the European Commission, CEBS has developed supplementary prudential filters. CEBS suggests member states to apply the guidelines to institutions applying IFRS for prudential purposes in order to avoid any unwanted change likely to be introduced by the new accounting rules; and that CEBS monitors the application thereof. For consistency purposes, CEBS also encourages member states to consider the need to apply the guidelines to institutions following national GAAP to the extent that they are similar to IFRS.

As the Recasting Directive 2000/12/EC will only be applicable 1st January 2007 onwards, *in the meantime*, it is the intention of CEBS members to apply CEBS guidelines on prudential filters on a best effort basis for their IFRS based prudential returns on a voluntary and national basis, implemented in accordance with national procedures.

Accounting changes that will have an impact on *Own funds* have been prioritised. In this regard, the objective of the prudential filters should be to maintain the current definition - and quality - of regulatory capital for those institutions applying IFRS, or institutions following national GAAP to the extent that they are similar to IFRS, for prudential purposes.

In order to reach a common level playing field across Europe and G10 countries CEBS proposals on prudential filters are in line with the Basel Committee's work on the same subject

CEBS Guidelines on the Use of Prudential Filters in the Context of the New IFRS

CEBS proposes the following adjustments and prudential filters on institutions' own funds:

The boundary between debt and equity

Two significant issues related to the distinction between debt and equity arise from IAS 32. Firstly, some instruments classified as eligible regulatory capital under the current solvency directive will be reclassified as liabilities under this new accounting standard. Shares in co-operative entities and certain preferred shares are likely to be affected. Secondly, some liabilities with embedded derivatives that are not classified as accounting capital today may contain an equity-type embedded derivative which will be, in the future, automatically classified as equity. For example, shares in co-operative entities would continue to qualify as capital, and the equity component of a liability which is not currently included in capital will continue to be excluded.

In this context, the CEBS recommends continuing the current prudential treatment in determining the classification of instruments for regulatory capital purposes. CEBS opinion is that issued financial instruments can be included in own funds if they respect the criteria of the directive on own funds regardless of the classification in the new IFRS and for the amount which would exist if no separation between liabilities

and equity had been made. Furthermore, competent authorities should have the possibility to exclude from regulatory capital some instruments booked in equity or to classify these instruments as hybrid original own funds or additional own funds.

Available-for-sale

The available-for-sale portfolio comprises equities, loans and receivables as well as other financial instruments (other available-for-sale assets). CEBS proposes that for fair value revaluation reserves on available-for-sale assets the following prudential filters shall apply:

- For equities, unrealised losses should be deducted after tax from original own funds and unrealised gains should only partially be included in additional own funds before tax.
- For loans and receivables, the unrealised gains and losses, apart from those related to impairment, are neutralised in own funds after tax.
- For other available for sale assets, (for example debt securities, financial instruments subject to interest rate risk) two methods can be applied. According to the first one, items classified in this portfolio should be treated as equities, under the second method; they should be treated as loans and receivables. As a related issue, CEBS considers that there should be a consistent treatment of gains and losses resulting from a transaction whereby a cash flow hedge is created for an available for sale instrument: i.e. if the gains on the hedged item are recognised in additional own funds, so should the results of the corresponding cash flow hedging derivative.

As a general principle, no regulatory adjustments should be made to impairment losses. Impairment related to credit risks should always be taken into account via the profit and loss account and therefore deducted from original own funds. Any additional supervisory formal recommendation or requirement regarding credit risk impairment should also be deducted from original own funds.

In the context of prudential filters partially means that at least the tax effect should be taken into account.

Fair value option

A specific case can be made on the impact of the fair value option on a credit institution's liabilities that are due to changes in the institution's own credit standing as defined in IAS 32.

In accordance with the proposal of the Basel Committee, CEBS proposes as a general principle, that institutions make adequate disclosure to their supervisors with regard to the quantitative impact of the use of the fair value option on the carrying value of financial assets on the balance sheet and on retained earnings. It applies in particular to the fair value option on financial assets as a result of the version of IAS 39 endorsed by the European Commission. In such a case, national competent authorities may decide whether prudential filters are needed; otherwise inclusion in original own funds will be allowed.

CEBS proposes exclusion from own funds of any cumulative unrealised gains and losses arising from changes in an institution's own credit standing as a result of the potential future application to liabilities of the fair value option. The Fair Value Option is of course currently not available for financial liabilities under the EU carved out version of IAS 39.

Cash flow hedges

CEBS proposes that institutions shall not include in own funds the fair value reserves related to cash flow hedges of financial instruments measured at amortised cost and forecast transactions other than cash flow hedges on available for sale assets where the treatment should be consistent with that of the reserve created for the relevant assets. There should be a consistent treatment of gains and losses resulting from a transaction whereby a cash flow hedge is created for an available for sale instrument: i.e. if the gains of the hedged item are recognised in additional own funds, so should the results of the corresponding cash flow hedge.

On investment properties and own use properties

For investment properties and own use properties (property plant and equipment) valued under the fair value model, CEBS proposes to deduct cumulative unrealised losses from original own funds and to partially include in additional own funds cumulative unrealised gains. In the context of prudential filters, partially means that at least the tax effect should be taken into account.

In general there is no need for regulatory adjustments in cases where the cost method is applied. However, national competent authorities are encouraged to consider the need for transferring unrealised gains, if any, resulting from the first time application of the cost method to properties from original own funds to additional own funds.

Securitisation

CEBS acknowledges the fact that securitisation transactions fulfilling the criteria of the directives should follow the revised prudential framework regardless of the accounting treatment

Risk weighted assets

In order to mirror the impact of prudential filters on own funds, national competent authorities may require some adjustments to the balance sheet value of the exposures used in the computation of an institution's risk weighted exposures based on accounting numbers.

Current prudential classification and definition

IFRS may change the current prudential classification of financials instruments and have consequences on the boundary between trading and banking books, even if this has no impact in the amount of own funds. CEBS considers that the impact on the classification of items should not be carried through to prudential regulation and proposes accordingly to keep the current prudential definition of the trading portfolio.

No need for prudential filters in other areas

For the time being, CEBS does not intend to encourage national competent authorities to apply any adjustments or prudential filters on existing intangible assets, including goodwill, deferred tax assets, pension cost, stock option costs and leasing, given that the impact on own funds of the application of IFRS is inexistent or small or given that the new accounting treatment is considered more prudent than before. For existing intangible assets, including goodwill, and deferred tax assets the current regulatory capital treatment may continue. For pension costs, stock option costs and leasing no regulatory capital adjustments will be applied in regulatory capital and accordingly the adoption of IFRS will impact on profit and loss. However, consideration should be given to the need for any transitional/other arrangements for the first time adoption of the standards, or to accommodate particular national circumstances for the mentioned items.

Scope and method of consolidation

Consideration of the scope and methods of consolidation is still underway. The outcome of this exercise and possible proposals will be communicated subsequently.

Reminder

The prudential filters discussed in this report should be considered as CEBS guidelines until the Recasting Directive 2000/12 comes into force. In this intermediate period the prudential filters should be implemented in line with national procedures and should be applied on a best efforts basis by national competent authorities. It is CEBS intention to monitor the application of the guidelines.