IV. Prudential Filter
Agenda

- Prudential Filter – the idea behind the concept
- Prudential Filter – the guidelines
  - Basel Committee on Banking Supervision
  - Committee of European Banking Supervisors
- Prudential Filters
- National Implementation – the German case
- The impact of Prudential Filter
- An Outlook – accounting developments and a new definition of capital
Prudential Filter  
the idea behind the concept (1)

» Application of IFRS  
   EU – IAS-Regulation: 2005 consolidated accounts of publicly traded companies

» Unchanged Definition of Own Funds for supervisory purposes

» Accounting numbers remain basis for computation of prudential ratios and content of regulatory capital

» Requirements of Own Funds for supervisory purposes
   • reliability
   • permanence
   • loss absorbency

» IFRS – affect magnitude, quality and volatility of capital

» Prudential Filter:  
  Adjustments of accounting results to maintain the current definition and quality of regulatory capital
Prudential Filter
the idea behind the concept (2)

» IFRS-related effects and Prudential Filter

Fair Value Accounting

IFRS-Capital

Prudential Filter

Regulatory Capital under National GAAP

Regulatory Capital after Prudential Filter
Prudential Filter
the idea behind the concept (3)

- There are still other accounting effects that affect the definition and quality of own funds for regulatory purposes
  - Deferred tax assets
  - Intangible assets (including goodwill)
  - ...

- Prudential Filter may affect a good portion of the balance sheet:

<table>
<thead>
<tr>
<th>Assets Side</th>
<th>Annual financial statement</th>
<th>Liabilities Side</th>
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<tbody>
<tr>
<td>Cash</td>
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<td>Liabilities</td>
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<td>Financial instruments</td>
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<td>Accruals</td>
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<td>- AfS</td>
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<td>- HtM / LaR</td>
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<td></td>
<td>Intangibles</td>
<td>- OCI</td>
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<td>Deferred taxes</td>
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</tbody>
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Prudential Filter – the guidelines (1)

BCBS

» Basel Committee on Banking Supervision issued 3 Press Releases in 2004
  • Considering potential impact of IFRS on regulatory capital
» 8 June 2004
  • Cash flow hedge reserve
  • Own credit risk as regards applying the fair value option
» 20 July 2004
  • Equity/liability classification
  • Intangible assets, including goodwill
  • Deferred tax assets
  • Pension costs
  • Stock option costs
  • Leasing
» 15 December 2004
  • Available for Sale financial instruments
  • Own-used and investment properties
Prudential Filter – the guidelines (2)  
CEBS (a)

- CEBS Guidelines on Prudential Filters for Regulatory Purposes  
  21 December 2004
  - In line with BCBS proposals to reach common level playing field across Europe and G 10 countries
  - To be applied by member states on a best effort basis by national supervisors
  - To be implemented in accordance with national procedures
  - To be monitored by CEBS
  - For consistency purposes to consider the need to apply the guidelines to institutions following national GAAP to the extent similar to IFRS
Prudential Filter – the guidelines (3) CEBS (b)

» CEBS Guidelines on Prudential Filters for Regulatory Purposes
  • Cash flow hedge reserve
  • Own credit risk
  • Available-for-sale
    - Equities
    - Loan and Receivables
    - Other AfS-assets (i.e. debt instruments)
  • Own used and investment properties

» Capital Requirements Directive – Art. 64 paragraph 4 CRD
  • As in CEBS guidelines but mandatory
    - Cash flow hedge reserve
    - Own credit risk as regards the Fair Value Option (FVO)
Prudential Filter – the guidelines (4)
CEBS (c)

» CEBS Guidelines on Prudential Filters for Regulatory Purposes
  • Keep the current prudential classification or definition of
    - debt and equity
    - Trading book
  • Make no change for
    - Intangible assets, including goodwill
    - Deferred tax assets
  • No regulatory capital adjustment for
    - Pension cost
    - Stock option costs
    - Leasing

» CEBS encourages disclosures by institutions to supervisors on the impact of the use of the fair value option

» To mirror the impact of prudential filters on own funds, some adjustments to balance sheet value of the respective exposures may be required
Hedged item in a cash flow hedge is a future transaction or a financial instrument on balance but without valuation adjustment as regards the designation as hedged item.

The effective part of fair value change in the hedging instrument (hedging derivative) is booked as a cash flow hedge reserve in OCI.

Hence, the cash flow hedge reserve shows the effective portion of an economically closed hedging relationship but only for one leg of that respective relationship.

As such the cash flow hedge reserve should not be added to regulatory capital (deduction !)

Is the hedged item an AfS-Financial Instrument, both valuation reserves in OCI have to be treated consistently.
Prudential Filter (2) 
Own Credit Risk in Application of FVO

» Fair value measurement of own liabilities leads to the recognition of adjustments of the own credit standing in the value of liabilities

» This recognition in the fair value has a corresponding impact on the P/L and as such on the reported capital

» In the case of a deterioration of the own credit standing this results in an increase of capital

» This paradoxical effect on capital has to be eliminated in regulatory capital (deduction of a gain / addition of a loss)
Prudential Filter (3) Available for Sale (a)

- Available for Sale Financial Instruments are diverse according to IAS 39
  - Equity Instruments
  - Loans and Receivables
  - Other AfS = debt Instruments
- Fair value changes are recognised directly in equity (OCI) as a valuation reserve
- Fair value changes from AfS-Financial Instruments are not realised
- Hence, quality requirements to regulatory capital are not fully met
- Therefore valuation reserve should as a principle only be recognised as additional capital (tier 2)
- No regulatory adjustments for impairment losses (recognised in P/L)
Prudential Filter (4) Available for Sale (b)

» Differentiation between instruments within AfS
  • Equity Instruments
    - Valuation reserves to be deducted from capital and added at least partly in tier 2 capital
    - Partly means that at least the tax effect has to be taken into account as a minimum
    - Deduction of any unrealised loss from tier 1 capital
  • Loans and Receivables
    - No inclusion of any unrealised gains or losses in regulatory capital
  • Other AfS: debt instruments
    - To be decided whether to treat in the manner of equity or LaR
Prudential Filter (5) Available for Sale (c)

» Is the AfS-Financial Instrument designated as the hedged item within a cash flow hedge relationship, both valuation reserves in OCI have to be treated consistently

» Questions to be answered
  • Treatment of debt instruments
  • Haircut to be applied on gains included in tier 2 capital
  • Portfolio-approach or item by item-approach
  • Consistent application in the case of a cash flow hedge
  • Application of prudential filter in the case of reclassification
Prudential Filter (6)
Properties

» Own used (IAS 16) and Investment Properties (IAS 40)
» Valuation with Fair Value is one option (cost accounting is the other)
» IAS 16 (property plant and equipment) – Own Used Properties
  • Fair value changes through OCI
  • Treatment as AfS Financial Instruments
» IAS 40 – Investment Properties
  • Fair Value changes through P/L
  • Deduction of fair value changes from tier 1 capital
  • Inclusion of these fair value changes partly in tier 2 capital (as AfS Financial instruments)
» Deduction of cumulative unrealised losses when valued under the fair value model from tier 1 capital on both cases
National Implementation

» BCBS as well as CEBS Guidelines are only recommendations
  • Not binding
  • Encourages national supervisory authorities

» Where IFRS accounting or comparable national GAAP is applied prudential filter might be necessary
  • To avoid unwanted change likely to be introduced by IFRS accounting
  • Affects level of capital and capital volatility

» Establishment in national law might be necessary
  • Depends on legal system/framework
  • Law
  • Ordinance / Executive Order
  • Directive of Supervisory Authority
  • Need for an integration in supervisory reporting
National Implementation
The German case

» Article 10a Paragraph 7 German Banking Act (Kreditwesengesetz – KWG)
  • Consolidated minimum capital requirements might be applied on the basis of consolidated accounts
  • For publicly traded companies this is an IFRS financial statement

» Article 10a Paragraph 9 German Banking Act
  • In the case of Art.10a Para.7 German Banking Act the Federal Ministry of Finance is authorised to decree a respective ordinance

» Ordinance: Konzernabschlußüberleitungsverordnung (KonÜV)
  • Prudential filter as proposed by CEBS guidelines
  • Specified for
    - Own credit risk – for all financial liabilities at fair value
    - AfS – portfolio approach; debt instruments as LaR; 55 % pre-tax haircut
  • Supplementary / additional Prudential Filter
    - Held-to-Maturity are treated as AfS
    - Associates (at equity) – similar to AfS treatment
The Impact of Prudential Filter (1)

» Report on Prudential Filter by CEBS (5 October 2007)
  • Qualitative analysis of how the guidelines have been implemented
  • Quantitative analysis of the impact of Prudential Filter

» Differences in implementation
  • Treatment of unrealised gains/losses on AfS debt instruments
  • AfS: differences in haircuts applied to unrealised gains included in additional own funds (tier 2)
    - Varying levels of prudential concerns
    - Desire to align Basel I treatment
    - Pre- and post tax approaches
    - Different tax levels
    - Post tax haircuts range from 0% to 100%
  • AfS: differences regards the application of a portfolio-approach or an item by item-approach

» Differences because of supplementary Prudential Filter
  • e.g. for pension schemes
  • e.g. for the Fair Value Option
The Impact of Prudential Filter (2)

» Quantitative Impact of Prudential Filter
  • Analysis shows that Prudential Filter as per 12/31/2006
    - moderately reduce total eligible own funds by 0.9 %
    - decrease original own funds by 5.2 %
  • Analysis shows that Prudential Filter as per 12/31/2006 result in an increase of 8.3 % of additional own funds
  • Analysis shows a shift of IFRS-related valuation differences from original to additional own funds from
  • Main driver is the Prudential Filter to AfS equity

» CEBS Report do not allow for an assessment of volatility of regulatory capital and as such the stabilising character of Prudential Filters
Outlook (1)  
new definition of capital

» Integration of Prudential Filter in the definition of capital
» Goodwill and other intangibles
» Investment in own shares
» Deferred tax assets
» Shortfall of the stock of provisions to expected losses (for IRB banks)
» Unrealised gains and losses in debt instruments, LaR, equities, own used properties and investment properties
  • asymmetric filter for gains and losses
  • question of level (1, 2, 3) in the fair value hierarchy of applied fair values
» Cash flow hedge reserves
» Gains and losses due to changes in own credit risk on fair valued financial liabilities
» Defined benefit pension fund assets and liabilities
Outlook (2)
accounting developments

» IASB: IAS 39-Replacement Project

» Phase 1: Classification and Measurement (IFRS 9)
  • Issued on 12th November 2009
  • 2 Classes-Approach deletes AfS-Category
  • Liabilities scoped out of IFRS 9
    - Classification and Measurement of Liabilities is now a subset of Phase 1 (will be issued later)
    - idea of ‘frozen credit spread’ may solve the problem of own credit risk at least to a certain extent

» Phase 2: Impairment
  • ED/2009/12 issued on 5th November 2009
  • Expected loss model

» Phase 3: Hedge Accounting
  • Concentration on cash flow hedge accounting
  • ED expected shortly (December 2009)