Committee of European Banking Supervisors

CEBS

5 October 2007

Analytical report on prudential filters for regulatory capital

Key findings

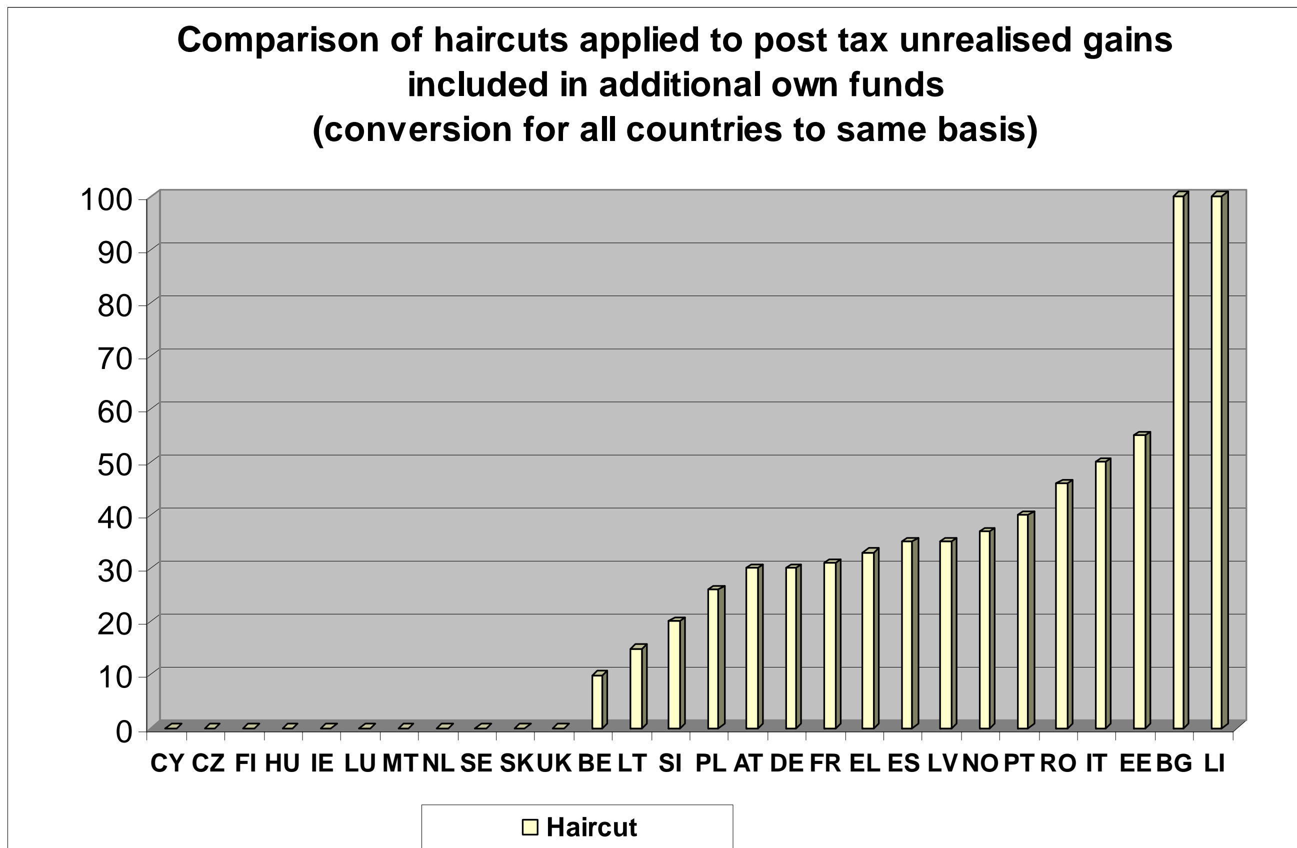
1. The key findings should be read in the context of the analytical report on prudential filters and against the background set out in the introduction as well as in the methodology.
2. The report comprises a qualitative analysis of how the CEBS guidelines and other prudential filters have been implemented, provides a quantitative analysis of the impact of the prudential filters and finally discusses the possible scope for further convergence.
3. In the qualitative part, which covers all EEA countries, the findings show that nearly all countries comply with the CEBS guidelines and the filters introduced by Directive 2006/48/CE.
4. This part of the analysis also reveals that compliance with the substance of the CEBS recommendations is total, with 2 exceptions. These occur with the following recommendations:
   - available-for-sale loans and receivables: complied with by 96.4% of countries.
   - investment properties: complied with by 92.9 % of all countries

	2007	**2005**
Compliance available-for-sale (AFS)	% of coverage (28 countries)	% of coverage (18 countries)
AFS equity instruments	100.0%	83.3%
AFS loans / receivables	96.4	88.9%
AFS other assets	100.0%	94.4
Compliance property assets		
Investment property	92.9%	72.2%
Property, plant, equipment	100.0%	94.4%

5. As shown in the previous table compliance with the CEBS guidelines has improved compared to the results of an earlier internal study.
6. Notwithstanding the high compliance, the guidelines provide some flexibility regarding their implementation. This room for manoeuvre has resulted in some diversity among countries, notably as concerns the treatment of unrealised gains.

7. The diversity regarding the treatment of unrealised gains (for all asset categories) arises from the differences observed across countries with respect to the part of unrealised gains that is included in additional own funds.

8. The table below illustrates the diversity of the treatments applied across EEA countries for unrealised gains related to AFS equity instruments, although similar observations have been made for property assets. It compares haircuts applied by countries - after conversion to the same (after tax) basis - to unrealised gains after tax included in additional own funds:



9. The analysis reveals various reasons and justifications for the choice made in a particular country, including varying degrees of prudential concern as well as the desire to align the treatment to the Basel I provision for revaluation reserves. Divergences regarding treatment on a pre- or post-tax basis in conjunction with varying corporate tax rates contribute further to the observed diversity.

10. Despite full compliance, diverging treatments can be observed for the CEBS recommendation on other available-for-sale assets (i.e. debt securities), with an almost equal division of countries between the two optional treatments. The division is explained to a large extent by the specifics of the national markets for debt securities and related aspects (such as whether markets are dominated by fixed-rate or variable-rate-instruments, on the depth of the markets for debt securities etc).

11. The prudential filters introduced by article 64 (4) of Directive 2006/48/CE – which neutralise gains and losses on cash flow hedges, other than cash flow hedges on available for sale assets as well as gains and losses resulting from valuing liabilities at fair value due to changes in their own credit standing - are complied with by 90.0 % of countries. They are not complied with:

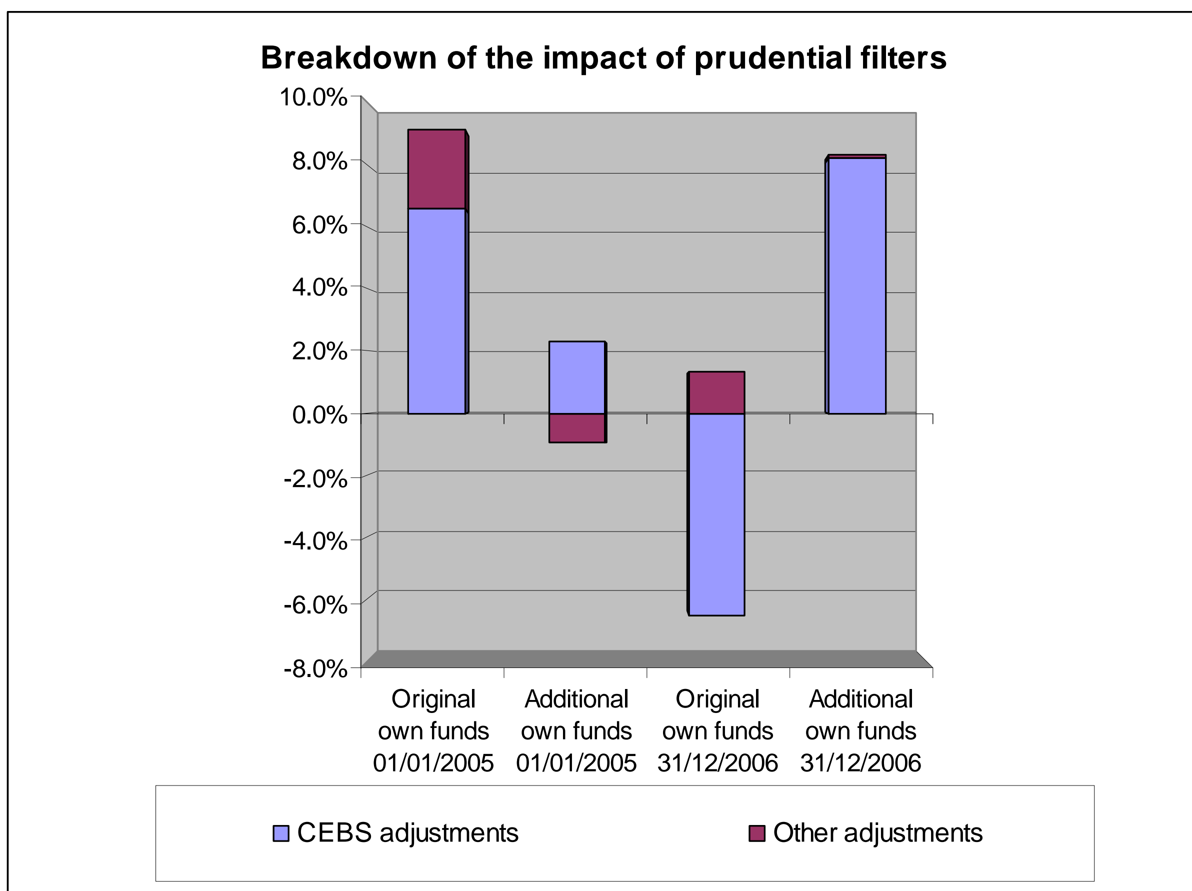
- by 3 countries in the case of the treatment for cash flow hedges; and

- by 2 countries in the case of the treatment foreseen for the gains and losses resulting from valuing liabilities at fair value due to changes in their credit standing.

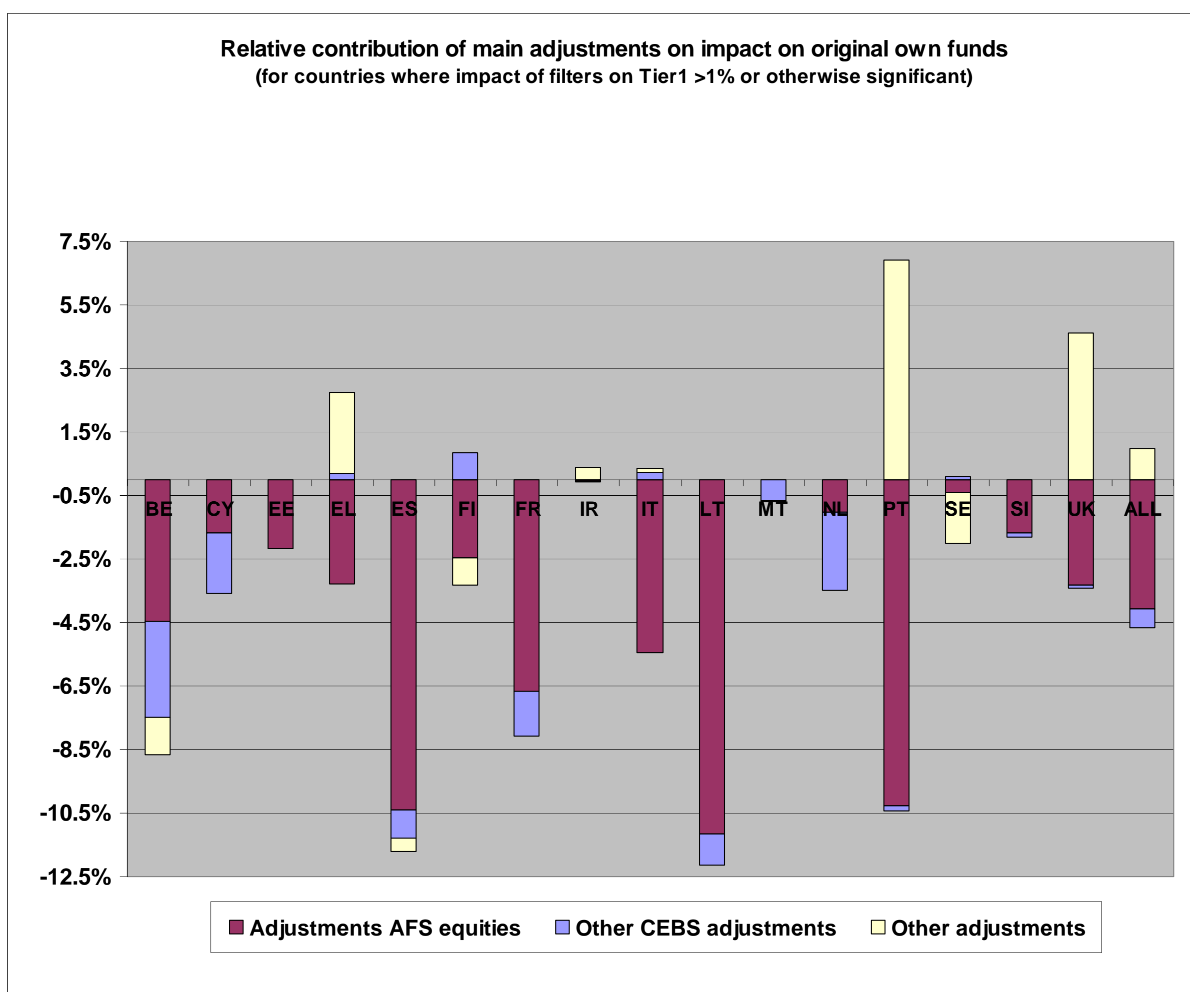
12. In addition to the prudential filters recommended by CEBS and those introduced by the Directive, there are other adjustments that have been introduced by countries. Most commonly these national filters aim to adjust for the impact of the accounting treatment of pension schemes, even though the analysis shows that the adjustments applied by a limited number of countries vary with respect to their objectives and type.

13. As concerns the quantitative part of the analysis, the data collected shows that prudential filters moderately reduce total eligible own funds by 0.9% and result in a 5.2% decrease in original own funds, mainly owing to the AFS equity instrument filter recommended by CEBS.

14. The following graph illustrates the differing quantitative impacts of prudential filters - in terms of direction and intensity - between their 'first-time' and on-going application, due to the fact that at the transition to IAS/IFRS a number of extraordinary impacts affected the level of institutions' consolidated reserves and minority interests, which are not representative of the impact of the prudential filters under 'normal' circumstances.



15. Notwithstanding the extraordinary impacts at the transition to IAS/IFRS, the biggest adjustments that have been observed (in both studies) relate to AFS equity instruments at aggregate level and, with some exceptions, also at national level. The following graph illustrates the relative share of the main adjustments to the overall impact on original own funds:



16. The graph also reveals that adjustments to the impacts of the accounting treatments of pension schemes represent the second most important adjustment from prudential filters at aggregate level and that this is due to the rather significant impact in a limited number of countries.

17. Based on the observations made in the context of the qualitative and quantitative analyses CEBS has identified some scope for further convergence in the following areas:

    1) in the context of the CEBS guidelines on prudential filters:

    - the treatment of unrealised gains (especially for AFS equity instruments, given that they account for the biggest adjustment);
    - the optional treatment available for other AFS assets (i.e. debt instruments);

    2) in other areas:

    - adjustments made for prudential reasons for pension schemes.

18. CEBS concluded that:

    - it will aim for further convergence regarding the treatment of unrealised gains in the context of the future discussion on the definition of capital;
    - it will monitor the developments related to the optional treatment available for other AFS assets and reconsider the issue if need be in the context of the discussion on the definition of capital;
    - further work is required to assess the need and the economic appropriateness of adjustments to regulatory figures related to IAS19.

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I. Introduction

19. As part of its 2007 work programme CEBS committed to follow up the work it had carried out back in 2005 on prudential filters and more particularly to prepare an analytical report on the implementation of the CEBS guidelines on prudential filters for regulatory capital.

20. The guidelines on prudential filters - hereinafter referred to as 'the CEBS guidelines' - were published in December 2004[1], following the introduction of the international financial reporting standards (IFRS) into the European Union's accounting regulation. The aim of the CEBS guidelines[2] is to maintain the definition and quality of regulatory capital for institutions using IFRS for prudential reporting, according to the current capital definition. They supplement the measures introduced by the European Commission in Article 64 (4) of Directive 2006/48/EC.[3]

21. This analytical report provides:

    - a qualitative analysis on how the CEBS guidelines, the provisions of article 64 (4) of Directive 2006/48/EC and other national prudential adjustments (affecting regulatory capital) have been implemented by members and how this compares to the situation in 2005; (chapter III)
    - an overview of the quantitative impact of the prudential filters to assess their efficiency in terms of eliminating unwanted changes in regulatory own funds arising from the introduction and application of IFRS (chapter IV)
    - a discussion of the possible scope for further convergence regarding the implementation of specific aspects of certain filters or regarding options provided in the guidelines. (chapter V)

22. While the outcome of the CEBS performance assessment shows that reactions to the guidelines on prudential filters have overall been fairly balanced and positive, industry representatives nevertheless stressed - during the 11 June hearing on own funds - the importance of a level-playing field in this area.

23. The report therefore also aims to assess the necessity for updating the CEBS guidelines in light of any recent developments or questions that have arisen in the implementation of the guidelines. To share the findings of the report and to deepen CEBS's understanding of any issues the industry may have, a public hearing on prudential filters has been scheduled for 16 October 2007.

24. This report remains grounded in the context of the current capital definition, while its findings might be useful from the perspective of a future redefinition of capital.

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[1] The CEBS guidelines on prudential filters for regulatory capital have been included in annex 1.

[2] The application of CEBS guidelines by members is voluntary.

[3] According to Article 64 (4) 'Credit institutions shall not include on own funds either the fair value reserves related to gains and losses on cash flow hedges of financial instruments measured at amortised cost, or any gains or losses on their liabilities valued at fair value that are due to changes in the credit institutions' own credit standing.'

II. Methodology

Implementation of guidelines

25. For the purposes of the qualitative analysis covering the implementation of the prudential filters, CEBS resorted to an updated questionnaire[4] it had already used to survey the guidelines' implementation for the internal study carried out in 2005.

26. Although the focus of this analysis is on the implementation of the CEBS guidelines the template goes beyond these recommendations and covers the adjustments introduced in Directive 2006/48/EC as well as areas that CEBS has referred to in its guidelines, albeit without recommending a specific treatment.

27. Moreover the survey questionnaire provides information on other country-specific filters or adjustments that members apply to accounting figures used to calculate regulatory own funds thus allowing an assessment of the need for an update of the guidelines to reflect recent developments. This data was supplemented in some areas with ad hoc information provided by members.

28. In the course of the analysis a distinction is made between formal compliance and compliance in substance. This distinction is made to take into account the specific situation of certain countries that do not follow the CEBS guidelines to the letter but where the economic or legal situation is such that the accounting impact a certain CEBS recommendation is aiming to address does not or cannot occur in practice.

Quantitative impact

29. For the assessment of the quantitative impact of the prudential filters the report draws heavily on the data collected for:

    - the 2004-2005 impact assessment study (published in February 2006)[5]; reference date: 31/12/2004-01/01/2005;
    - the report on own funds prepared in response to the European Commission's call for advice (published in June 2007)[6]; reference date: 31/12/2006.

30. The quantitative data have been provided by supervisory authorities on the basis of regular prudential reporting or by way of data collected directly from institutions. For the 2007 study the data was reported for each institution at the highest level of prudential consolidation within each jurisdiction.

31. To avoid double counting on an aggregate EU-wide basis, only the data reported by each country for the consolidated and solo levels has been included. Data for institutions which are supervised on a sub-consolidated basis have been excluded.

32. At individual country level the data covers the data reported on a solo (for standalone institutions), sub-consolidated and consolidated basis.

33. The impact of prudential filters is more appropriately assessed for institutions reporting in IFRS as filters do not apply in most cases to institutions reporting in

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[4] See annex 2

[5] See http://www.c-ebs.org/press/14022006.pdf.

[6] See http://www.c-ebs.org/Advice/documents/OF_analysis15062007.pdf.

local GAAP based on the Accounting Directives. For this reason, the quantitative analysis distinguishes between IFRS and non-IFRS institutions.[7]

34. The report does not address the quantitative impact of other adjustments to accounting equity previously introduced in the definition of regulatory capital, such as the deduction of goodwill and other intangibles.

35. The report does not exclusively use the terminology of Directive 2006/48/EC and Directive 2006/49/EC but also language commonly used by the markets. As the terminologies are not strictly identical, the report follows the Directives' terminology to the maximum extent possible even though it occasionally refers to 'Tiers' when analysing the adjustments made.

Coverage

36. The findings and conclusions included in the analytical report are in principle based on the data provided by all 30 EEA members[8] and therefore provide an almost complete overview of the current situation. While for the qualitative analysis all countries provided data regarding the implementation of the CEBS guidelines, IC only submitted summary quantitative data which did not allow determining the impact of prudential filters at national level.

37. When considering the report, it is important to bear in mind that the coverage in terms of countries and, at least for the impact analysis, the sample size for the countries varied from one exercise to the other. An overview of the differences has been included in the following table:

	2007	**2005**
Implementation study	30	18 (except AT, BG, DK, DE, HU, IC, LI, MT, PL, RO, SE, SI)
Impact analysis	29 (except IC)	18 (except AT, BE, BG, CZ, DK, DE, HU, IC, LI, MT, RO, SI)
Sample size in impact analysis	80% to 90% of banking and investment firms sector	On average 50% of banking sector alone

For the quantitative impact analysis it is also important to stress that the use of the prudential filters has changed in some of the countries since the first analysis was carried out.

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[7] IFRS institutions comprise only institutions using IFRS as endorsed by the EU. Institutions using local GAAP that are similar to IFRS have been included in the column "Non-IFRS institutions". CEBS prudential filters may also be applied to those institutions.

[8] Austria (AT), Belgium (BE), Bulgaria (BG), Cyprus (CY), Czech Republic (CZ), Germany (DE), Denmark (DK), Estonia, (EE), Greece (EL), Spain (ES), Finland (FI), France (FR), Hungary (HU), Iceland (IC), Ireland (IE), Italy (IT), Liechtenstein (LI), Lithuania (LT), Luxembourg (LU), Latvia (LV), Malta (MT), Netherlands (NL), Norway (NO), Poland (PO), Portugal (PT), Romania (RO), Sweden (SE), Slovenia (SI), Slovakia (SK), United Kingdom (UK).

III. Qualitative analysis: there is near total compliance with the CEBS guidelines and the filters introduced by Directive 2006/48/CE

III.1. CEBS guidelines: compliance has improved compared to the results of an earlier study, although the guidelines allow for some diversity regarding the treatment of unrealised gains

38. The 2005 exercise revealed that the CEBS guidelines were broadly applied by the 18 countries that participated in the survey, although there was further room for convergence: [9]

- some countries did not apply the CEBS guidelines; and
- there was some diversity with regard to the specific implementation of the guidelines.

39. With a total coverage[10] the 2007 study provides a comprehensive picture of the situation in the EEA and shows that there is a near total compliance with the CEBS recommendations (and the Directive provisions) and, overall, an improvement in comparison to the 2005 study. At the same time the more detailed analysis shows that diversity, mainly regarding the treatment of unrealised gains, remains.

40. The following table provides a general comparison of the compliance in substance with the CEBS guidelines between the 2007 and the 2005 exercises:

	2007	**2005**
Non-compliance available-for-sale (AFS)		
AFS equity instruments	0 (of 28)	3 (of 18): FI, CZ, SK
AFS loans / receivables	1 (of 28): HU	2 (of 18): LV, FI
AFS other assets	0 (of 28)	1 (of 18): LT
Non-compliance property assets		
Investment property	2 (of 28): FI, SK	5 (of 18): CZ, LV, FI, SK, UK,
Property, plant, equipment	0 (of 28)	1 (of 18): UK

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[9] Annex 3 contains the main conclusions of the 2005 report.

[10] While all 30 countries have provided the qualitative data, the study nevertheless only covers 28 countries:

As DK uses local GAAP for the calculation of regulatory own funds and notes that therefore the CEBS guidelines are not applied, it is only covered in the analysis of the implementation of adjustments introduced by Directive 2006/48/CE or any possible other national adjustments.

IC notes that IFRS are applied for prudential purposes and that the changes in own funds at the adoption of IFRS were so small that there was no perception of a need for prudential filters. As a consequence IC is excluded from the discussion covering the implementation of the CEBS guidelines and (as is the case with DK) is only covered in the analysis of the implementation of adjustments introduced by Directive 2006/48/CE or any possible other national adjustments.

The following points aim to clarify the situation in some other countries:

- In AT the indicated treatments will apply from 2008 onwards, while in DE, NO, PL and RO the guidelines have been applied in the course of 2007 which explains that for these latter countries the quantitative data does not show an impact from the CEBS recommended filters.
- HU has not implemented IFRS as a whole even though under the Hungarian Act on Accounting the use of an optional "fair value model" is allowed. The responses included in the discussion maps the treatment of related revaluation reserves to the CEBS guidelines.

41. For the detailed discussion of the implementation of the CEBS guidelines it should be borne in mind, as set out in chapter IV, that their implementation is in many countries directly related to the importance in qualitative terms of certain asset categories and to the quantitative impact that the CEBS guidelines aim to address. There are sometimes significant differences between countries regarding the use or the importance of certain asset categories which may justify certain national practices. To the extent that it contributes to the understanding of a country's specific situation the report provides the necessary background information.

III.1.a. AFS assets: all countries comply with the substance of the CEBS guidelines

CEBS guidelines recommend applying the following filters to the revaluation reserves on available-for-sale (AFS) assets:

- **for equity instruments: deduct unrealised losses after tax from original own funds and partially (i.e. at least net of tax effects) include unrealised gains in additional own funds ;**
- **for loans and receivables: neutralise unrealised gains and losses (after tax) - except for impairment-related losses - in own funds ;**
- **for other available-for-sale assets (i.e. debt securities): either apply the treatment for equity instruments or for loans and receivables.**

Generally, no adjustment should be applied to impairment losses

III.1.a.1. AFS equity instruments: total compliance constitutes an improvement, while some diversity regarding the treatment of unrealised gains remains

Comparison of non-compliance:

	2007	**2005**
AFS equity instruments		
Overall non-compliance:	0 (of 28)	3 (of 18): FI, CZ, SK
Treatment of unrealised losses:	0 (of 28)	3 (of 18): FI, CZ, SK
Treatment of unrealised gains	0 (of 28)	0 (of 18)

42. All countries that provided qualitative information regarding the implementation of the CEBS guidelines comply (in form and in substance) with the recommendation for revaluation reserves related to AFS equity instruments.

43. This situation constitutes an improvement as compared to the 2005 situation where 3 countries (CZ, FI and SK) did not comply with the CEBS recommendation.

44. While all 28 compliant countries deduct unrealised losses related to equity instruments classified as AFS from original own funds there is disparity regarding the treatment of unrealised gains.

Treatment of unrealised gains

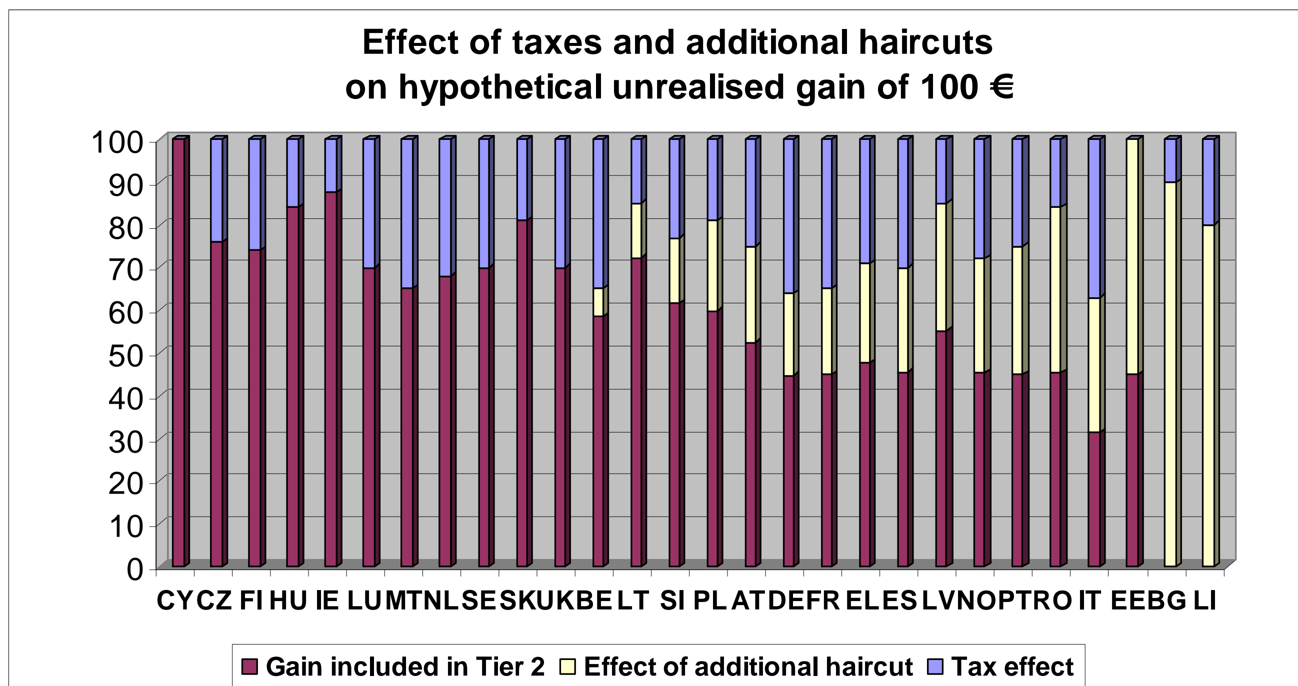
45. The CEBS guidelines recommend that 'unrealised gains should only partially be included in additional own funds before tax' and that, in that context, 'partially means that at least the tax effect should be taken into account'.

46. This has led to varying practices among countries: half of the countries include a certain percentage of unrealised gains before tax, while the other half includes the amount (or a part thereof) after deduction of taxes.

47. To allow for a comparison between countries the report calculates for all countries what in the following is referred to as an additional haircut on post-tax unrealised gains. This haircut designates for all countries the percentage by which unrealised gains are being reduced, after the deduction of any applicable taxes[11], to factor in aspects such as e.g. volatility concerns.

48. The analysis shows that countries apply the following additional post tax haircuts[12]:
    - 0%: 11 countries (CY, CZ, FI, HU, IE, LU, MT, NL, SE, SK, UK) [13];
    - 10-20%: 3 countries (BE: 10%, LT: 15%, SI: 20%);
    - 21-30%: 3 countries (PL: 26%, AT and DE: 30%);
    - 31-40%: 6 countries (FR: 31%, ES and LV: 35%, EL and NO: 37%, PT: 40%);
    - 41-55%: 3 countries (RO: 46%, IT: 50%, EE: 55%);
    - 100%: 2 countries (BG, LI).

49. This provides the following picture in terms of the effects of taxes and additional haircuts on a hypothetical unrealised gain of 100 €:



50. The average (i.e. arithmetic mean) of applied haircuts equals 24.9% for all 28 countries (or 41.% if one considers only the 17 countries that apply additional haircuts).

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[11] Annex 4 provides the tax rates used for the calculation of these haircuts and an example for the calculation of the post-tax haircut.

[12] Annex 5 provides a more detailed picture of the specific treatments applied in the respective countries. It should be noted that the post-tax calculation, while allowing for a comparison between countries, does not reflect perfectly the situation of cross-border banking groups, where different tax treatments may apply depending on the taxation arrangements in home and host countries.

[13] In CY the income tax rate is 10%, although there is a specific provision in the income tax law which states that such gains are taxed at 0% which explains that the amount after tax is equal to the amount before tax. HU does not take into account tax effects

51. Finally, 22 out of 28 countries apply a net approach in determining the adjustments to regulatory own funds, while only 4 (NL, PT, SI, SK) determine adjustments on an item-by-item basis.[14] IE does not specify a particular treatment but requires consistent application once an institution has made a choice.[15]

III.1.a.2. AFS loans and receivables: compliance has improved and nearly all countries respect the substance of the guideline

Comparison of non-compliance

	2007	2005
AFS loans and receivables:		
Non-compliance in form:	5 (of 28): AT, FI, HU, LV, MT.	2 (of 18): LV, FI
Non-compliance in substance:	1 (of 28): HU	

52. Of the 28 countries covered in the analysis, 5 countries (AT, FI, HU, LV, MT) are in formal terms not in compliance with the CEBS guidelines.

53. Of these 5 countries 4 (AT, FI, LV, MT) have explicitly mentioned that the use of the AFS category for loans and receivables is expected to be either very limited or entirely unused and that accordingly the choice of following the AFS equities treatment was made for practical reasons. As a consequence, the 'in substance non-compliance' with the CEBS recommended prudential filter is very low, with HU being the only country that does not impose any adjustments.

III.1.a.3. Other AFS assets: there is total compliance but nearly equal division of countries between the options provided in the guidelines

Comparison non-compliance

	2007	2005
Other AFS assets:		
Non-compliance in form	0 (of 28)	1 (of 18): LT

54. As concerns the treatment of other AFS assets such as debt instruments, all 28 countries comply with the CEBS recommendation with an almost equal distribution between the two alternatives provided in the guidelines:

- treatment as for AFS equity instruments: 15 countries (AT, BG, CY, DE, EE, ES, FI, HU, IT, LI, LV, LT, LU, MT, PT); in 2005: 8 countries;
- treatment as for AFS loans and receivables: 12 countries (BE, CZ, EL, FR, NL, NO, PL, RO, SI, SK, SE, UK), in 2005: 8 countries.

IE allows institutions to choose between the treatments but requires at the same time that the chosen option is consistently applied across the category.

[14] Application of the prudential adjustment on a net basis entails determining the difference between total unrealised gains for all AFS equity instruments and total unrealised losses. Application of the prudential adjustments on an item-by-item basis entails making an adjustment to regulatory own funds according to the situation of each individual instrument. France applies a variation of the net approach by calculating the adjustment on the basis of the difference between unrealised gains and losses per currency that the equity instruments are denominated in.

[15] HU did not provide any information on the treatment applied.

Treatment of unrealised gains

55. For those countries choosing the option for equity instruments, the treatment of unrealised gains is identical except for ES where a higher haircut (of 50%, compared to 35%) is applied. All countries (except PT) have opted for the net approach.

III.1.b. Property assets: compliance with the substance of the recommendations has improved, with some remaining diversity regarding the treatment of unrealised gains

CEBS recommends for revaluation reserves arising from fair valuing investment property or property plant and equipment to deduct unrealised losses (after tax) from original own funds and partially (i.e. at least net of tax effects) include (cumulative) unrealised gains in additional own funds.

III.1.b.1. Investment properties: compliance with the substance of the recommendation has improved with some remaining diversity regarding the treatment of unrealised gains

Comparison of non-compliance

	2007	2005
Investment property:		
Overall treatment		
Non-compliance in form:	4 (of 28): CZ, ES, FI, SK.	6 (of 18): CZ, ES, FI, LV, SK, UK.
Non-compliance in substance:	2 (of 28): FI, SK	4 (of 18): FI, LV, SK, UK.
Treatment unrealised losses:		
Non-compliance in form:	0 (of 28)	2 (of 18): ES, LV.
Non-compliance in substance:		1 (of 18): LV
Treatment unrealised gains;		
Non-compliance in form:	4 (of 28): CZ, ES, FI, SK.	6 (of 18): CZ, ES, FI, LV, SK, UK.
Non-compliance in substance:	2 (of 28): FI, SK.	3 (of 18): FI, SK, UK.

56. Out of 28 countries 4 (CZ, ES, FI, SK) do not formally comply with the CEBS guidelines for the treatment of unrealised gains arising from fair valuing investment properties.

57. In ES however, banks applying IFRS as endorsed by the EU are not permitted to measure investment properties with the revaluation method and consequently the use of a prudential filter is in practice not necessary. CZ indicated that banks do not use the FV measurement of investment property in practice.

58. FI and SK currently deviate from the CEBS guidelines in that they include unrealised gains (partially for FI (8%) and totally for SK) in original own funds.

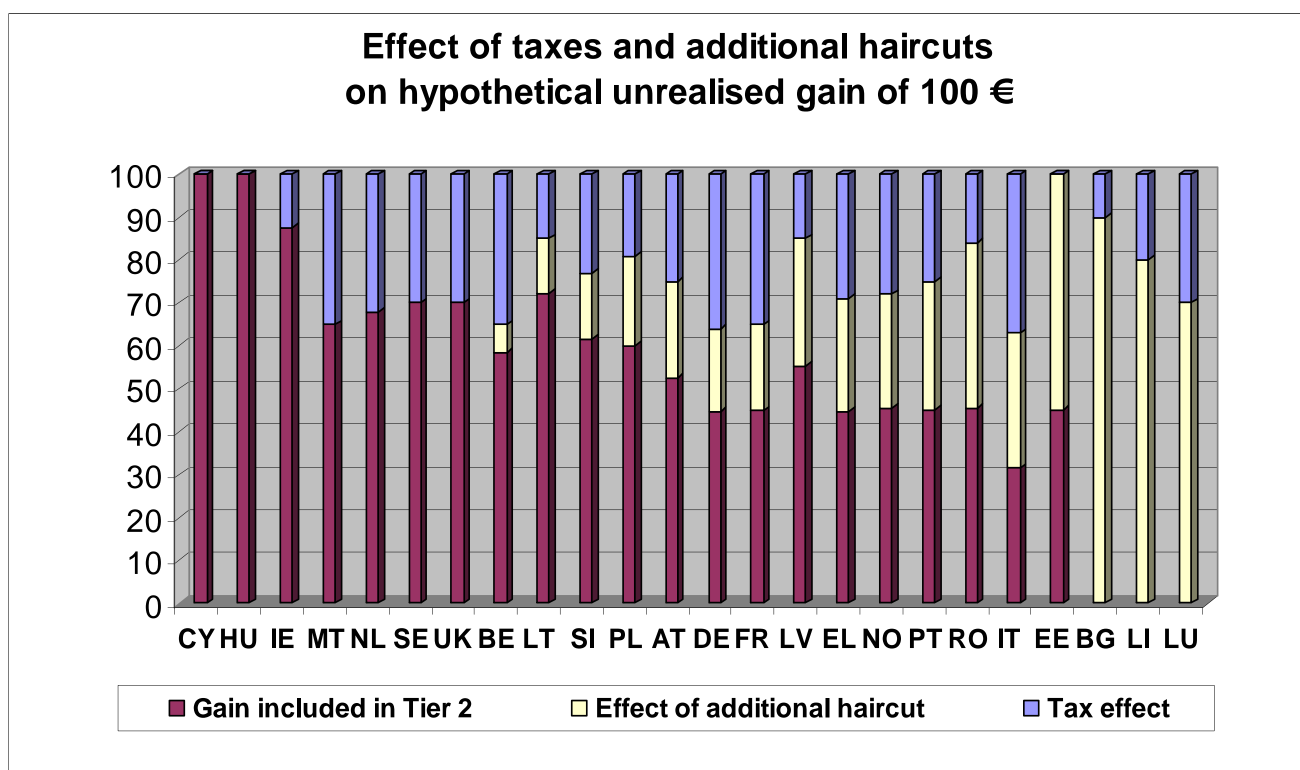
59. While 2 countries (LV, UK) have changed the treatment for investment properties since the first survey and thus are now in compliance with the CEBS guidelines, another country (SK) has indicated that it will change its legislation with the adoption of the Directive 2006/48 and therefore will ultimately also comply with the recommended treatment.

Treatment of unrealised gains

60. As regards the treatment of unrealised gains, the analysis shows that practices also vary among countries: they either apply a certain percentage of unrealised gains before tax or include the amount (or a part thereof) after deduction of taxes. The picture of applied additional post tax haircuts is the following:

- 0%: 7 countries (CY HU, IE, MT, NL, SE, UK) [16];
- 10-20%: 3 countries (BE: 10%, LT: 15%, SI: 20%);
- 21-30%: 3 countries (PL: 26%, AT and DE: 30%);
- 31-40%: 5 countries (FR: 31%, LV: 35%, EL and NO: 37%, PT: 40%);
- 41-55%: 3 countries (RO: 46%, IT: 50%, EE: 55%);
- 100%: 3 countries (BG, LI, LU).

61. This situation provides the following picture in terms of the effects of taxes and additional haircuts on a hypothetical unrealised gain of 100 €:



62. The average (i.e. arithmetic mean) of applied haircuts equals 31.8% for all 24 countries (or 44.8% if one considers only the 17 countries that apply additional haircuts).

[16] In CY, gains on the sale of property are not subject to income tax but to capital gains tax which is calculated at 20% of the difference between the sale price and the cost of acquisition adjusted by an indexation allowance. Banks calculate deferred tax on any unrealised gains from such items and the figure reported under prudential filters is the gain net of deferred tax. HU does not take into account tax effects.

63. A small majority of countries (13 vs. 12.) are imposing the net approach for investment properties as opposed to the item-by-item treatment. IE allows its institutions to choose either approach although it requires consistent use once the choice has been made. [17]

III.1.b.2. Property, plant and equipment: total compliance constitutes an improvement though the diversity regarding the treatment of unrealised gains remains

Comparison non-compliance

	2007	2005
Property, plant and equipment:		
Overall treatment:	0 (of 28)	1 (of 18): UK
Treatment unrealised losses:	0 (of 28)	1 (of 18): UK
Treatment unrealised gains;	0 (of 28)	0 (of 18)

64. All of the 28 countries that provided qualitative information are de facto in compliance with the CEBS guidelines for the treatment of unrealised gains related to property plant and equipment assets

65. In ES, as for investment properties, banks applying IFRS as endorsed by the EU are not permitted to measure property, plant and equipment with the revaluation method and consequently the use of a prudential filter is in practice not necessary.

66. Similar to investment properties, the UK has changed the treatment of property, plant and equipment since the first study and is now in compliance with the CEBS guidelines.

Treatment of unrealised gains

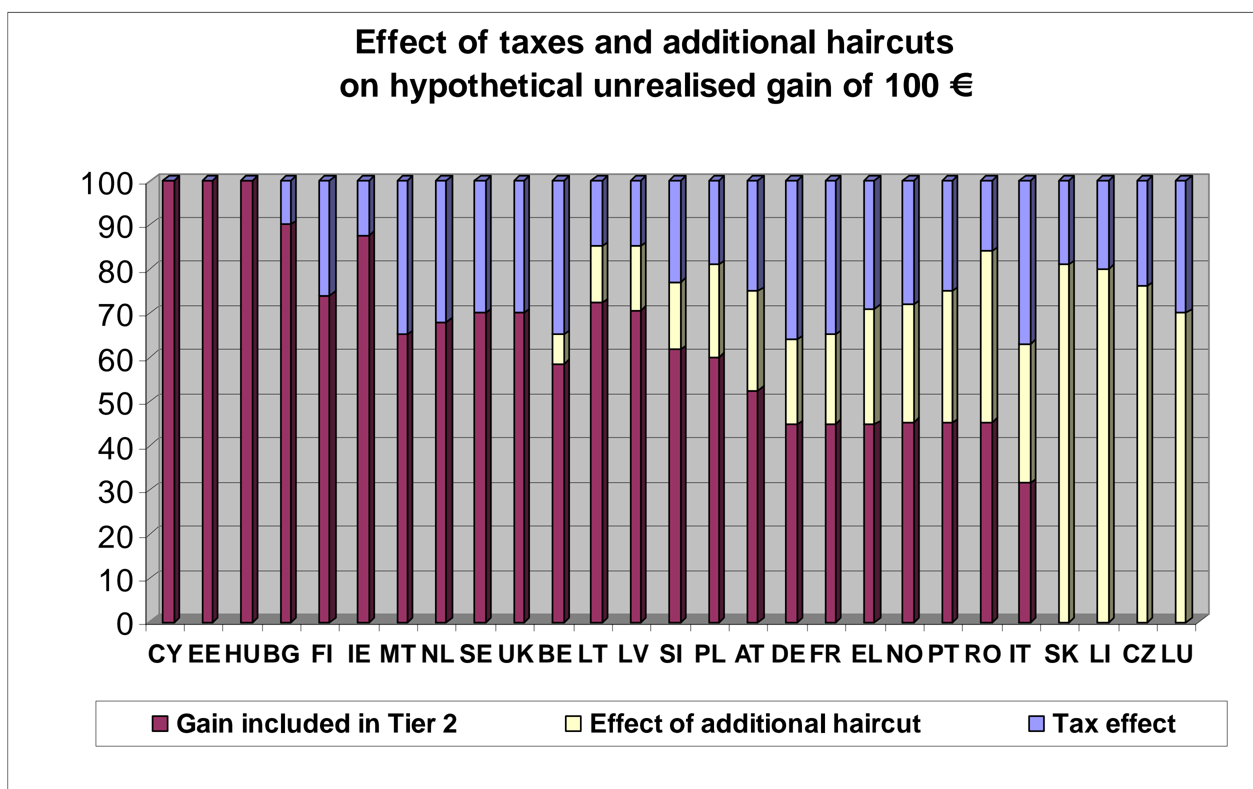
67. The analysis of the treatment of unrealised gains provides the following picture of applied additional post tax haircuts:

- 0%: 10 countries (BG, CY, EE, FI, HU, IE, MT, NL, SE, UK)[18];
- 10-20%: 4 countries (BE: 10%, LT: 15%, LV: 17%, SI: 20%);
- 21-30%: 3 countries (PL: 26%, AT and DE: 30%);
- 31-40%: 4 countries (FR: 31%, EL and NO: 37%, PT: 40%);
- 41-50%: 2 countries (RO: 46%, IT: 50%);
- 100%: 4 countries (CZ, LI, LU, SK).

68. This situation provides the following picture in terms of the effects of taxes and additional haircuts on a hypothetical unrealised gain of 100 €:

[17] The 12 countries applying an item-by-item approach are: BE, EE, EL, FI, FR, LU, NL, NO, PT, RO, SI, SK; while the 13 countries applying a net approach are: AT, BG, CY, CZ, DE, IT, LI, LV, LT, MT, PL, SE, UK. As previously mentioned investment properties are not permitted to be measured with the revaluation method in ES (and consequently the use of a prudential filter is in practice not necessary). HU did not provide any information on the applied treatment.

[18] Cf. footnote 16.



69. The average (i.e. arithmetic mean) of applied haircuts equals 29.2% for all 27 countries (or 46.4% if one considers only the 17 countries that apply additional haircuts).

70. A small majority of countries (13 vs. 12) are imposing the item-by-item treatment as opposed to the net approach. As for investment properties, IE allows its institutions to choose between the approaches although requiring consistent use once the choice has been made. [19]

III.2. Prudential filters introduced by article 64 (4) of Directive 2006/48/CE are not complied with by 3 countries

In addition to the CEBS guidelines, article 64 (4) of Directive 2006/48/EC formally introduces two mandatory prudential filters for institutions into EU legislation:

- **gains and losses on cash flow hedges, other than cash flow hedges on available for sale assets should be excluded from own funds;**
- **the consequences (gains and losses) resulting from valuing liabilities at fair value due to changes in their own credit standing should be excluded from own funds.**

[19] The 13 countries applying an item-by-item approach are: AT, BE, EE, EL, FI, FR, IE, LU, NL, NO, PT, RO, SI, while the 12 countries applying a net approach are: BG, CY, CZ, DE, IT, LI, LT, LV, MT, PL, SE, UK. As mentioned property, plant and equipment are not permitted to be measured with the revaluation method in ES (and consequently the use of a prudential filter is in practice not necessary). HU did not provide any information on the applied treatment.

Comparison of non-compliance

	2007	**2005**
CRD filters:		
Cash flow hedges: Non-compliance in form and in substance	3 (of 30): EE, HU, IC.	3 (of 18): EE, LV, LY
FVO: Own liabilities: Non-compliance in form: Non-compliance in substance:	3 (of 30): EE, HU, IC. 2 (of 30): HU, IC	1 (of 18): EE

71. 3 countries do not comply with the provisions of article 64 (4) of Directive 2006/48/EC[20]: EE, HU, IC.

72. EE and HU are non-compliant with the Cash Flow Hedge related provisions in that in both countries unrealised losses are deducted from Tier 1 whereas unrealised gains are included (by 45% for EE) in Tier 2; IC follows the accounting treatment.

73. With regard to gains and losses resulting from valuing liabilities at fair value due to changes in their own credit standing EE has noted that it will introduce the prescribed treatment for own credit risk from 2008 onwards.

The CEBS guidelines recommend for Cash flow hedges on available for sale assets that the treatment should be consistent with that of the reserve created for the relevant assets.

As regards the fair value option 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

Comparison of the application of filters

	2007	**2005**
Application of filters:		
Cash flow hedges (on AFS assets): - treatment as for asset:	18 (of 30): AT, BE, BG, CY, CZ, DE, FI, FR, HU, IT, LI, LV, LU, MT, NL, PL, PT, RO	12 (of 18): BE, CY, CZ, FI, FR, IT, LU, NL, NO, PT, SK, UK
- other	4 (of 29): EE, EL, IE, SE	

[20] This part of the analysis includes DK as well as IC and accordingly covers all 30 countries.

FVO: other than own credit-risk-related changes in liabilities		
- systematic filter	3 (of 30): EE, MT, PT	6 (of 18): CY, CZ, EE, FI, IT, PT,
- conditional filter:	5 (of 30): BE, EL, ES, FR, LU	2 (of 18): BE, ES
- undecided:	-	4 (of 18): EL, FR, LU, NO

74. As regards cash flow hedges on available for sale assets, 18 countries apply a treatment that is consistent with that of the reserve created for the relevant assets. 4 countries (EE, EL, IE, SE) neutralise unrealised gains and losses on these types of cash flow hedges, whereas 8 countries (DK, ES, IC, LT, NO, SI, SK, UK) do not apply any specific treatment.

75. Regarding gains and losses resulting other than from valuing liabilities at fair value due to changes in their own credit standing, only 3 countries (EE, MT, PT) apply systematic adjustments[21].

76. Another 5 countries mention that a filter could be considered if the supervisory guidance on the use of the fair value option for financial instruments by banks issued by the Basel Committee on Banking Supervision is not adhered to (BE, EL, ES, FR, LU).

III.3. Other prudential filters introduced by countries most commonly aim to make adjustments for the impact of the accounting treatment of pension schemes

The 2004 guidance states that CEBS encourages no changes (or further adjustments), for the time being, for existing intangible assets (including goodwill), deferred tax assets, pension cost, stock option costs and leasing, consideration should be given to the need for transitional/other arrangements to address the impact of the 'first time' adoption of the standards, or to accommodate particular national circumstances for the items mentioned.

III.3.a. Pension schemes: a limited number of countries apply various adjustments

Comparison of the application of filters:

	2007	2005
Adjustments to actuarial gains / surplus		
Neutralisation of actuarial gains	1 (of 30): FR	1 (of 18): FR
Neutralisation of surplus (asset recorded in balance sheet)	6 (of 30): FI, IE, MT, NO, SE, UK,	4 (of 18): FI, IE, NO, UK

[21] These adjustments include partial neutralisation (in PT for unrealised gains arising on loans and receivables designated under the option), application of a filter to certain instruments (in EE partial transfer of gains to Tier 2 for holdings in subsidiaries and associates not deducted from unconsolidated own funds by provision of Art 34 (2) last section of Directive 2006/48/CE) and a general filter (in MT partial transfer (65%) of gains to Tier 2).

Adjustments to actuarial losses / deficits		
Partial deduction of deficit (liability in balance sheet)	3 (of 30): IE, UK, SE	2 (of 18): IE, UK
Specific temporary treatment for first time application (to soften impact of actuarial losses)	3 (of 30): EL, NO, PT	2 (of 18): NO, PT

77. Many countries have noted that the effect of IAS 19 on accounting equity is immaterial and that adjustments to regulatory figures for prudential purposes are therefore not necessary or require further analysis regarding their economic appropriateness. Others note that the accounting treatment under IAS 19 of net pension assets or liabilities can lead to volatility and justifies specific treatments. The analysis reveals that for the 8 countries (EL, FR, IE, MT, NO, PT, SE, UK) that have introduced specific prudential filters in relation to pension schemes, there is some discrepancy as regards their objective.

78. In FR the adjustments aim to eliminate from regulatory capital the actuarial gains resulting from the 'first time' and on-going application of IAS 19. 6 countries (FI, IE, MT, NO, SE, UK) eliminate from regulatory capital the impact of plan-related surpluses recorded in the balance sheet.

79. As concerns adjustments relating to actuarial losses or to plan-related deficits, the analysis revealed that 6 countries apply such adjustments. In 3 cases (IE, SE, UK) these are made on an on-going basis to replace the accounting deficit with a measure that they believe better reflects the burden represented by a pension fund deficit. In the other 3 cases (EL, NO, PT) temporary adjustments are applied to soften the impact of actuarial losses on regulatory capital from the 'first time application' of IAS 19.

80. In 1 country (FR) additional adjustments are made to regulatory capital to ensure that actuarial losses are negatively impacting regulatory capital (irrespective of the underlying accounting treatment) of institutions in local GAAP, in order to preserve consistency with institutions applying IFRS.

81. While applied by a limited number of countries, this adjustment was the second biggest in absolute terms, according to the findings of the quantitative analysis included in paragraph 96 below.

III.3.b. Other prudential filters are not used very commonly across countries

82. Regarding other prudential filters, it is worth mentioning that 6 (of 30) countries (BE, LU, MT, NO, PT, SE) have introduced specific prudential filters in relation to deferred tax assets. In most of these countries (BE, LU, NO, PT, SE) this adjustment takes the form of a deduction of deferred tax assets (or a part thereof) from Tier 1.

83. As regard other national prudential filters applied by countries there are a limited number of different adjustments that are applied (by 4 countries). However, generally these adjustments are only applied by 1 or 2 countries at the same time.[22]

[22] Annex 6 lists these other adjustments applied by 4 members

IV. Quantitative analysis: prudential filters moderately reduce total eligible own funds by 0.9% and result in a 5.2% decrease in original own funds

IV.1. The recent quantitative survey of eligible own funds shows a reduction of total eligible own funds due to prudential filters by 0.9% and a decrease of original own funds by 5.2%, mainly due to the AFS equity instrument filter recommended by CEBS

84. The 2007 quantitative survey of eligible own funds shows an overall reduction of 0.9% in aggregated own funds (in the consolidated and solo data for IFRS institutions), compared to a reduction of 0.7 % for all institutions (both IFRS and non-IFRS institutions) and of 0.3% for non-IFRS institutions.

85. CEBS recommendations account for the biggest part of the impact of prudential filters and result in a shift of IFRS-related valuation differences from original to additional own funds. They cause a reduction of original own funds (for IFRS institutions) by 6.5 %, whereas other adjustments partly counteract this reduction with a 1.3% increase.

86. In comparison, the effect of the application of prudential filters in the 2005 exercise led to an increase of 'Total Own Funds' by 7.1%.[23] As for the 2007 analysis, the impact is explained by a shift of IFRS-related valuation differences from original to additional own funds.

	01/01/2005	31/12/2006	
	All data	IFRS data	Non-IFRS data
	% of impact*	% of impact*	% of impact*
Impact overall own funds	+7.1%	-0.9%	-0.3%
Impact original own funds	+9.1%	-5.2%	+0.0%**
attributable to: CEBS guidelines	+6.5	-6.5%	+0.0%
other adjustments	+2.6%	+1.3%	+0.1%
Impact additional own funds	+1.3%	+8.3%	-1.1%
attributable to: CEBS guidelines	+2.3%	+8.2%	0.0%
other adjustments	-1.0%	+0.1%	-1.1%

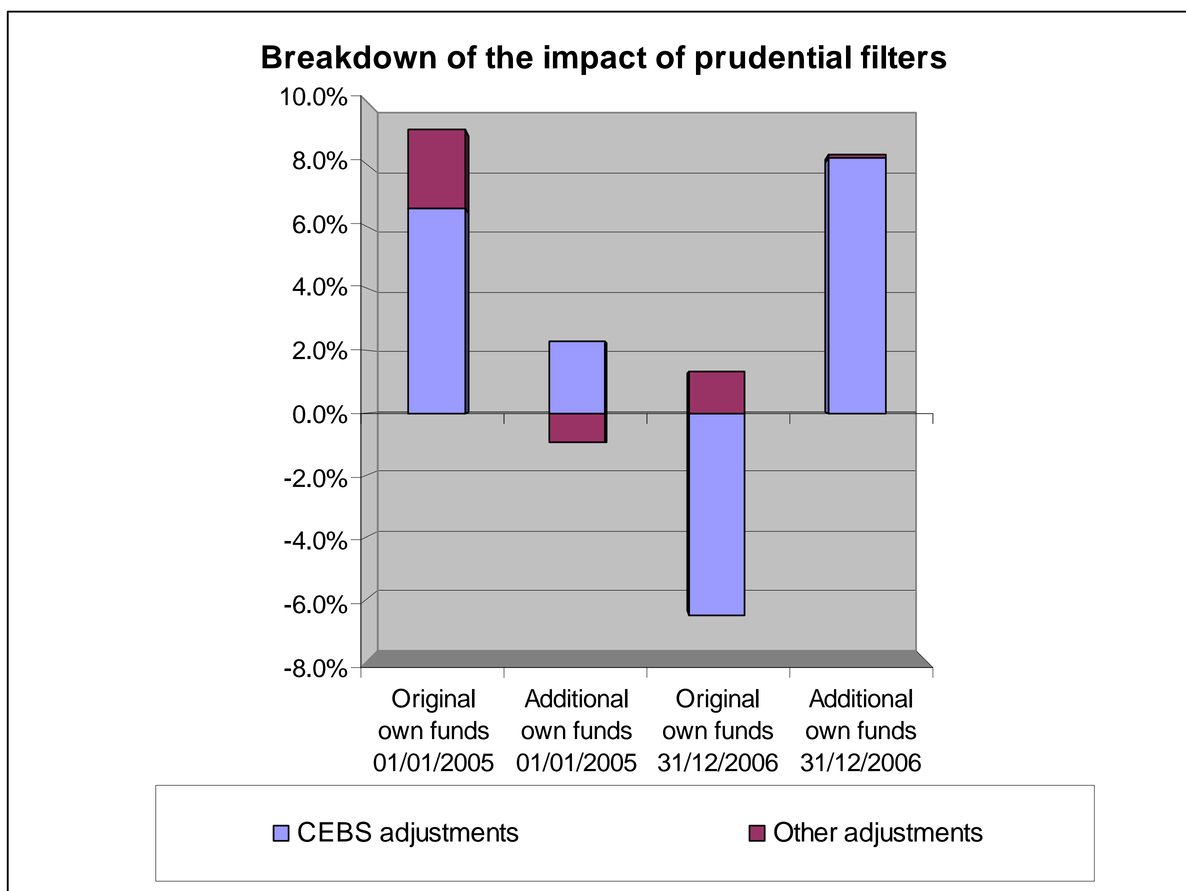
*The relative impacts (%) per point in time have been calculated in relation to the own funds category they refer to. The relative impact of original and of additional own funds therefore do not add up to the relative impact on overall own funds.

**The data inconsistencies in this table stem for the fact that in a few cases the sum of the elements in some countries do not exactly match the reported sub- or overall totals.

87. The following graph illustrates that the CEBS adjustments account for the largest shares of the impacts both on original and additional own funds in the two exercises. At the same time it can be observed that the sign of the impact

[23] Some prudence needs to be applied when comparing the data of the two quantitative analyses to the extent that both the coverage and the size of the samples differ. Indeed, as indicated in the table in paragraph 37, the latter exercise is both more comprehensive in the number of countries it covers as well as in the share of the financial sector. Moreover it should be borne in mind that the latter analysis covers both IFRS- and non IFRS banks whereas the earlier exercise's focus was limited mainly to IFRS banks.

changes for original own funds between the two exercises. This is mainly due to the fact that the data provided for 01/01/2005 included 'first time application' adjustments resulting from the changeover to IFRS, when the negative effect of removing valuation differences from original own funds was largely overcompensated by the positive impact of maintaining the previously existing prudential definition of debt and equity instruments and the related positive correction of original own funds as well as, in certain countries, the positive/negative adjustments made for pension schemes.



IV.2. The quantitative impact of prudential filters varies in terms of direction and intensity between their 'first-time' and on-going application

88. While the data collected in the 2004/2005 and 2007 exercises (in terms of quantity and time series) do not allow for an assessment of the volatility of regulatory own funds and the stabilising character of the prudential filters, they nevertheless provide a rough picture of the relative importance the prudential filters have had in terms of relative impacts on overall own funds and on the main own funds categories.

89. For further clarification, it is useful to make a distinction between the effects observed for the transition to IAS/IFRS (from 31/12/2004 to 01/01/2005) and the effects observed for subsequent periods.

90. The transition to IAS/IFRS led to a number of extraordinary impacts at the level of banks consolidated reserves and minority interests, which are not representative of the impact of the prudential filters under 'normal' circumstances. Among these are:

- the variation in reserves as a consequence of the 'first time application' of IAS/IFRS (mostly in relation to post employment obligations (which in

some cases are filtered), to property assets and to 'Funds for general banking risks');

- a decrease in minority interest; and
- the application of a CEBS recommendation which results in the continuation of the application of the prudential criteria for the distinction between equity and debt for the purposes of the determination of regulatory own funds.

91. The following table confirms that the relative impact of prudential filters on own funds was very weak at year-end 2004 and only reflects national filters that are in place in certain countries. The 2005 opening figures then reveal the significant increase in original own funds (explained in the previous paragraph) and a far weaker relative impact on additional own funds.

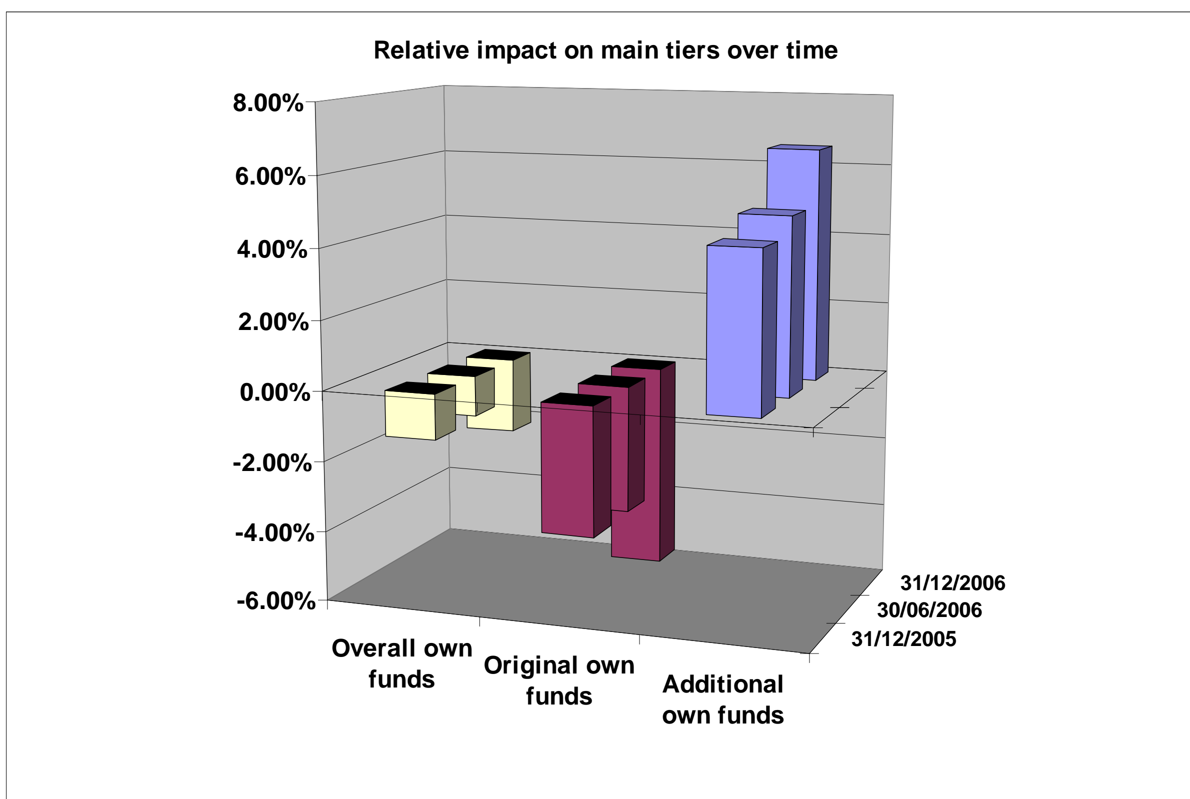
All 18 countries	**31/12/2004**	**01/01/2005**
Relative impact of prudential filters on overall own funds	**-0.3%**	**7.1%**
Relative impact of prudential filters on original own funds	**0.0%**	**9.1%**
Relative impact of prudential filters on additional own funds	**-1.1%**	**1.3%**

92. For the subsequent periods, the impacts of the adjustments can be assumed to be more typical and characteristic of the recent and current economic situation of sustained growth. A comparison of the relative impacts based on a sample comprising data received from a subset of (12) countries (that, in most cases, are comparable to the 31/12/2006 data), shows that the impact of the prudential filters on overall own funds results in a reduction ranging from -1.30% to -2.18%.[24]

Comparison of a subset of 12 countries	**31/12/2005**	**30/06/2006**	**31/12/2006**
Relative impact of prudential filters on overall own funds	**-1.30%**	**-1.16%**	**-2.18%**
Relative impact of prudential filters on original own funds	**-3.64%**	**-3.59%**	**-5.78%**
Relative impact of prudential filters on additional own funds	**4.48%**	**5.00%**	**6.55%**

93. As shown in the following graph the impacts on the main own funds categories for the additional time series are more or less in line with the overall findings of the 2007 quantitative survey even though they seem to indicate that the relative impacts at year-end 2006 are stronger than for the earlier observation points:

[24] The differences between the percentages included in this paragraph (and in the table that follows) and the data referred to in paragraph 86 can be explained by the fact that the present observations are based on a subset of only 12 countries.



IV.3. Adjustments made to AFS equity instruments are responsible for the biggest adjustments at aggregate level and, with some exceptions, at national level

Aggregate level

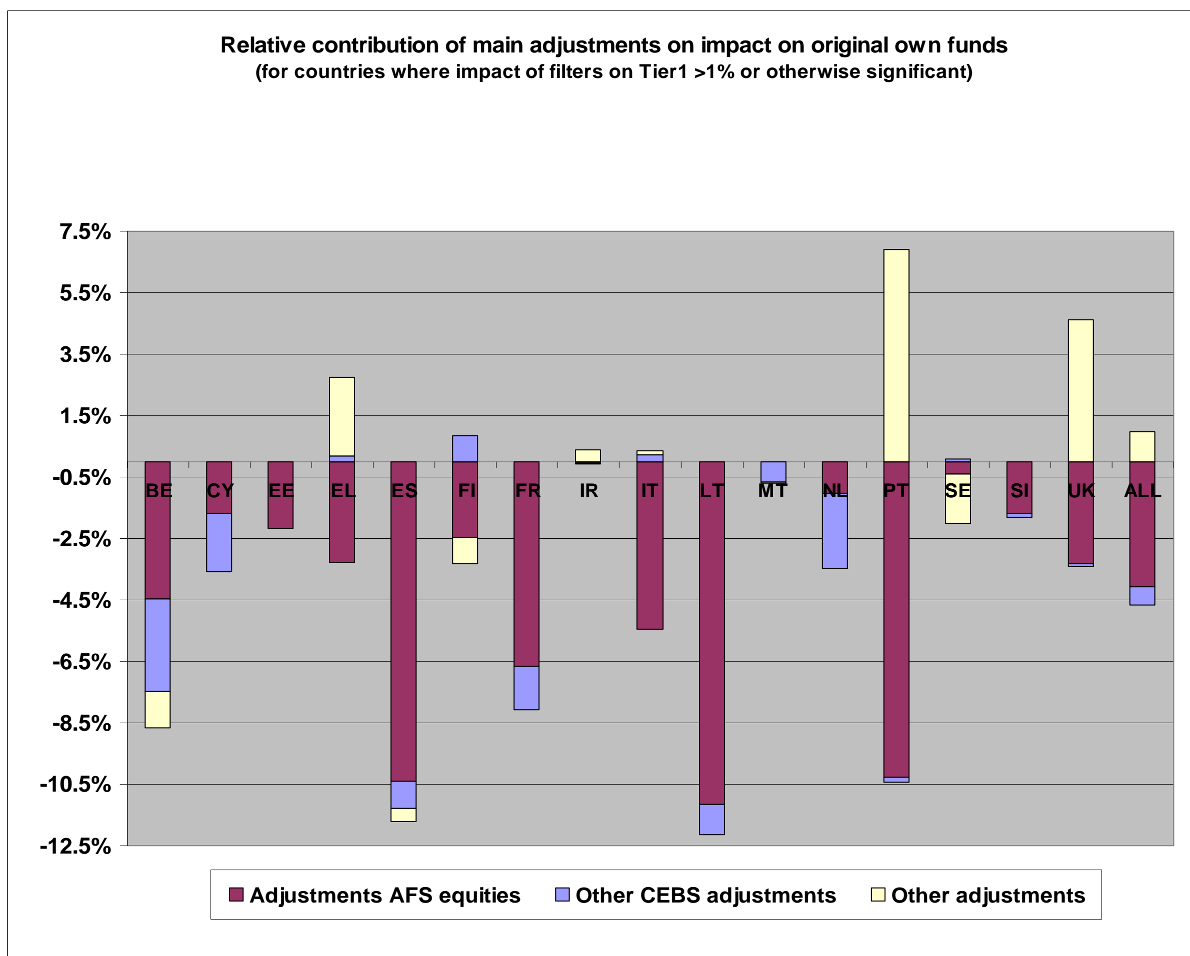
94. Other than the adjustments made to address impacts related to the transition to IAS/IFRS, the most prominent adjustment in the 2005 study were deductions relating to fair value revaluation reserves on available-for-sale equity instruments (and to a certain extent other debt instruments), which are partially transferred to additional own funds.

95. In the 2007 quantitative survey the adjustment made to filter positive valuation differences related to available for sale equity instruments proves to be the biggest adjustment in absolute and relative terms to original own funds. It removes 98.9% of the positive valuation differences for AFS equity instruments from Tier 1 and represents 109.5% of the impact on original own funds (for IFRS data) or 110 % of total adjustments to original own funds.

96. Adjustments to other valuation differences affecting the eligible reserves represent the second most important adjustment from prudential filters. These aim in most cases to adjust the impact of pension scheme accounting -albeit only reported in a limited number of countries (8) - they account for 26.2% of all adjustments to original own funds (compared to 28.0% reported by 5 countries in 2005).

National level (only for 2007)

97. At national level[25] the relative importance of the main adjustments in relation to the total impact on original own funds is as follows.

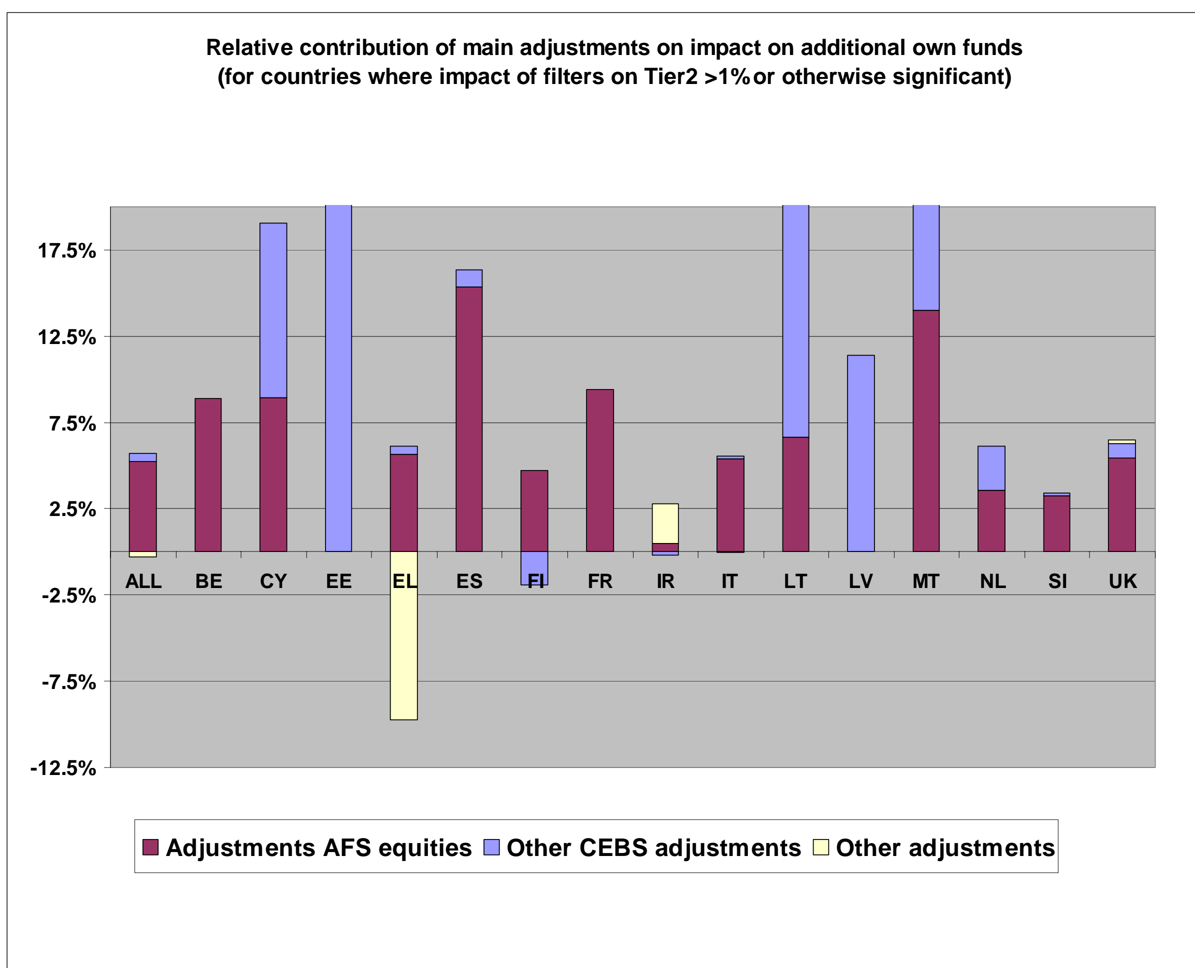


98. The graph illustrates that in most countries the biggest amount is related to adjustments made for AFS equity instruments valuation reserves. Indeed in 11 (BE, EE, EL, ES, FI, FR, IT, LT, PT, SI, UK) out of the 15 countries where (any type of) adjustments have been made to original own funds, those related to AFS-equity instruments account for at least 50%.

99. For other adjustments – which at closer look are mainly related to pension scheme adjustments - the quantitative data represented in the table indicates the diverging impact and importance of these adjustments across those countries where they are applied. In 2 countries (IE, UK) these adjustments are applied to replace the accounting deficit with a measure that they think better reflects the burden represented by a pension fund deficit. In others (EL, PT) they are made to correct on a transitional basis the impact related to the 'first time application' of IAS/IFRS (mostly relating to the treatment for pension schemes).

[25] In some countries no impact on own funds has been observed for various reasons: in 6 countries (AT, DE, HU, NO, PL, RO) the calculation of prudential own funds was, at the time of the data collection for the quantitative analysis based on national GAAP so that there was no need to apply the CEBS guidelines as of 31 December 2006. Since then, these countries, with the exception of AT and HU, have moved to IFRS for regulatory purposes and have accordingly introduced the CEBS guidelines (or, in the case of AT will introduce them by 2008). In 2 countries which calculate own funds on the basis of national GAAP (AT, NO), differences can be explained by national filters (for NO transitional adjustments to address pension obligations). The observations do not cover LU as IFRS institutions here only reported subconsolidated data, which is excluded from the analysis.

100. At national level the relative importance of the main two adjustments in relation to total adjustments to additional own funds are as follows:



101. As regards the driving factors for the impact on additional own funds the graph illustrates that again the biggest impact stems in the majority of countries (BE, ES, EL, FI, FR, IT, NL, SI, UK) from AFS equity instruments. A number of countries reported important impacts from other CEBS guidelines mainly due to property assets. In two countries (EL and IE) the biggest impact arises from adjustments made in relation to pension schemes (though they vary in the way they impact additional own funds).

V. Scope for convergence: the identified scope for further convergence in CEBS guidelines and for other adjustments is limited to a few specific areas

102. This chapter identifies the areas where there could be scope for possible convergence regarding the CEBS Guidelines on prudential filters or very specific aspects of certain recommendations or options included in them.

103. For the assessment of whether further efforts should be devoted by CEBS in achieving such convergence, the discussion relies on the findings of chapter III and IV of the present report. The areas thus identified are:

1) in the context of the CEBS guidelines on prudential filters (more specifically):

- the treatment of unrealised gains (especially for AFS equity instruments, given that they account for the biggest adjustment);
- the optional treatment available for other AFS assets (i.e. debt instruments);

2) in other areas:

- adjustments made for prudential reasons for pension schemes.

104. Under point 2) the ultimate aim could be to define a harmonised prudential treatment at CEBS level.

105. The following sections provide a number of possible avenues CEBS could adopt to increase convergence in the area of prudential filters. Before discussing possible detailed measures, the report raises the more fundamental question of the need for further work in this area and the related questions of timing and impact.

V.1. CEBS needs to determine a general approach for further convergence and the related timing

106. The discussions regarding the possible avenues for further convergence need to be coupled with considerations regarding the timing as well as the impact of any such actions.

107. Indeed timing considerations are important to avoid any agreed measures leading – in the short- or medium-term - to further divergence, e.g. as a result of limitations (in terms of speed, frequency, process or other) that countries may face with regard to their introduction into their respective national legislative or regulatory frameworks. Additionally, there is a need to assess the impact of any additional measures in order to avoid that the cost or administrative burden for banks or supervisors outweighs the related benefits.

108. Conversely, these considerations will also have to factor in the 'risks' (be it in terms of level-playing field or supervisory concerns) of not going forward.

109. Additionally, any discussion on further convergence on prudential filters needs to be put in the context of the work on the redefinition of capital and should take into account level-playing-field considerations with regard to with third countries.

V.2. The scope for further convergence regarding CEBS guidelines on prudential filters mainly relates to the treatment of unrealised gains

110. The analysis of the implementation of the CEBS guidelines on prudential filters has shown that there is a good deal of diversity regarding the specificities of the

treatment of unrealised gains across the asset categories covered by the CEBS recommendations (AFS assets, property assets).

111. While AFS equity instruments account in quantitative terms for by far the largest of all the adjustments made, there are arguments (such as avoidance of arbitrage, cherry-picking etc.) that justify that the discussion should not be limited to this category alone but cover also the treatment of unrealised gains across the asset categories covered by the same CEBS recommendation (AFS assets, property assets).

112. The other area identified is the optional treatment available for other AFS assets (i.e. debt instruments).

V.2.a. Treatment of unrealised gains

113. As regards the treatment of unrealised gains across the asset categories covered by the same CEBS recommendation (AFS assets, property assets), the detailed analysis has shown that most countries (except 2 in the case of investment property) are compliant with the CEBS guidelines insofar as they filter unrealised gains in original own funds.

114. However there is a diversity in the way countries apply the guideline regarding the inclusion of unrealised gains in additional own funds.

115. The CEBS recommendation specifies that unrealised gains should only partially be included in additional own funds before tax, and that partially in that context means that at least the tax effect should be taken into account.

116. This has led to a distinct split between countries that do apply a post-tax approach to the inclusion of unrealised gains into additional own funds and those that apply a pre-tax approach but incorporate the tax effect. While this distinction is only a matter of formal presentation, a harmonised approach would enhance comparability between member states.

117. Moreover, varying practices appear within both groups: some apply a haircut to (post tax) unrealised gains and others do not; for those applying a haircut there is some level of divergence as to the level of the applied haircut.

118. According to the information gathered from members, the rationale for choosing a certain treatment is based in most cases on the following factors:

- concerns of prudence (i.e. to address concerns regarding the volatility or reliability of market values, market liquidity and/or other aspects…); coupled with
- the desire to align the CEBS recommended treatment with the Basel I provision for revaluation reserves – which allows for the inclusion in Tier 2 of certain unrealised gains subject to a 55% discount[26].

119. A number of countries chose to adopt a Basel-1-compliant approach of including 45% of pre-tax unrealised gains in Tier2. In the context of the current

[26] The Comprehensive Version of Basel II foresees in paragraph 49 (vi) that 'These "latent" revaluation reserves [originally only on securities measured at historic cost] can be included among supplementary elements of capital since they can be used to absorb losses on a going-concern basis, provided they are subject to a substantial discount in order to reflect concerns both about market volatility and about the tax charge which would arise were such cases to be realised.' It goes on to say that 'A discount of 55% on the difference between the historic cost book value and market value is agreed to be appropriate in the light of these considerations.'

unharmonised regime of (corporate) tax rates in the EEA, this approach results in the current divergence of post-tax haircuts.

120. In the cases where no additional haircut is applied to the post-tax amount, it is felt that the shift of unrealised gains (net of tax effects) from original to additional own funds constitutes a sufficiently prudent measure.

121. To allow for a comparison between countries, the analysis compares post-tax haircuts calculated for all countries. It reveals that countries can be distinguished into four rough clusters, namely those applying:

Treatment of unrealised gains	**AFS equity instruments (28 countries)**	**Investment properties (24 countries)**	**Property, plant and equipment (27 countries)**
No haircut:	11 countries	7 countries	10 countries
Haircut between 10 and 30%:	6 countries	6 countries	7 countries
Haircut between 31 and 55%:	9 countries	8 countries	6 countries
Haircut of 100%	2 countries	3 countries	4 countries

122. The preceding overview shows that there is a slight variation regarding the size of the clusters for the different CEBS recommendations. It also shows that countries have chosen different treatments across asset categories (AFS assets, property assets) covered by the CEBS recommendations.

123. The following example illustrates how a simulation of harmonised haircuts for AFS equity instruments - in the example 0%, 33% and 50% - affects additional own funds (% variation) and the relative impact on additional own funds (%impact) in comparison to the data reported in the Own Funds report:

	Current situation (as per 2007 report)	***Situation with harmonised AFS equities (i.e same post-tax haircut)***		
		0%	***33%***	***50%***
% variation of additional own funds **(Amounts in billion €)**	**-** **(-)**	**1.3%** **(8.0)**	**-0.8%** **(-4.8)**	**-1.8%** **(-11.5)**
Total impact in % of Tier 2 (before filters) **(Amounts in billion €)**	**5.4%** **(31.9)**	**6.8%** **(40.0)**	**4.6%** **(27.1)**	**3.5%** **(20.5)**

124. Considering the varying haircuts applied to post-tax unrealised gains and the impact that harmonised haircuts would have on additional own funds, **CEBS will aim to push for further convergence in this area in the context of the future discussion on the definition of capital.**

125. 3 possible alternatives have been identified to take this issue forward:

A) all countries should apply one single treatment (no haircut or one to be determined) on post-tax unrealised gains;

or

B) the range of possible treatments of post-tax unrealised gains could be reduced to two (a minimum and a maximum haircut to be determined) and that all countries should apply either one or the other treatment;

or

C) the range of possible treatments of post-tax unrealised gains could be reduced by setting a minimum and a maximum haircut, with countries positioning themselves within the range between the two.

126. In taking this forward, any additional work will acknowledge that national market specificities for certain asset categories may warrant or even require more prudent– or even in exceptional cases less stringent - treatments for unrealised gains in some countries.

127. Consideration will also be given to achieving further convergence regarding a harmonised treatment of assets on an item-by-item vs. a net basis bearing in mind that this may imply in some cases changes to institutions' accounting systems.

V.2.b. Optional treatment available for other AFS assets (i.e. debt securities)

128. The detailed analysis of members' implementation of the CEBS recommendation for other AFS assets (which comprise largely AFS debt securities) shows that there is an almost even split between the two optional treatments. Indeed, 15 countries chose the treatment applied to AFS equity instruments over the treatment of loans and receivables (applied in 12 countries). 1 country leaves the choice - which then has to be applied consistently - to institutions.

129. According to the information gathered from members, the rationale for choosing a certain treatment is based, for countries opting for the equity instruments treatment, mainly on the following factors:

- economic similarity with equity instruments: instruments are quoted and marketable;
- prudence (due to the asymmetric filter);
- consistency with the treatment applied for AFS equity instruments.

130. For the countries opting for the loans and receivables treatments, the reasons appear to be the following:

- economic similarity with loans and receivables: instruments characterised by cash flows, maturities…;
- prudence (due to the nature of the unrealised gains and losses);
- consistency with the cash flow hedge treatment (for fixed interest rate instruments).

131. The discussions showed that both treatments are defensible and to a large extent justified in particular countries to fit specific national circumstances

(depending for example on whether markets are dominated by fixed-rate or variable-rate instruments and on the depth of the markets for debt securities…).

132. The quantitative analysis shows that, at least for the time being, the valuation differences and related adjustments are immaterial in comparison to other adjustments.

133. Against that background **CEBS considers it inappropriate at this stage to recommend one particular treatment (rather than another) or to eliminate one treatment. Rather CEBS will continue monitoring the issue and reconsider it if need be in the context of the discussion on the definition of capital.**

134. However, it should be noted that the application of the AFS loans and receivables treatment to AFS debt instruments (neutralisation of unrealised gains and losses) supposes that accounting regulations on impairment are applied in an appropriate way. Otherwise, the neutralisation of losses could have the effect of preventing the deduction of credit losses from the amount of regulatory capital of the institutions.

V.3. The identified scope for adjustments for pension schemes needs further analysis.

135. As regards the treatment of pension schemes the analysis has shown that the reasons for applying adjustments and their type are related to the pension regimes that are prevalent in countries as well as to the way that the pension schemes are accounted for.

136. It appears that prudential adjustments are less common in countries where the pension regime is predominantly based on defined contribution schemes. In countries where defined benefit schemes prevail adjustments appear to be more common.

137. At the same time the objectives of the adjustments made by countries vary. While a number of countries mainly intended to correct or dampen the negative impact that IAS 19 would have had at 'first time application', others aim to correct the accounting effect, or a part thereof, on an on-going basis.

138. In that context it is important to note that IAS 19 provides three different options for accounting for defined benefit schemes with significant differences in terms of impacts on an entity's balance sheet, equity and / or profit or loss account

139. The analysis revealed that there are differences regarding the part of the accounting impact that is being adjusted, with countries falling in the following categories:

- adjustments are made to actuarial gains (and to a lesser extent losses); and
- adjustments are made to defined benefit liabilities or assets.

140. While the quantitative information could be read to support harmonisation in this area, **CEBS considers that further work is required to assess the need and the economic appropriateness of adjustments to regulatory figures related to IAS 19, with due consideration given to aspects such as the materiality of the impact on accounting figures and volatility.**

Annexes

Annex 1: CEBS Guidelines on Prudential filters for regulatory capital

The CEBS guidelines on prudential filters for regulatory capital contain the following recommendations:

- For the revaluation reserves on available-for-sale assets the following filters shall apply:
    - for equities: deduct unrealised losses after tax from original own funds and partially (i.e. at least net of tax effects) include unrealised gains in additional own funds;
    - for loans and receivables: neutralise unrealized gains and losses (after tax) - except for impairment-related losses - in own funds;
    - for other available-for-sale assets (i.e. debt securities): either apply the treatment for equities or for loans and receivables.

Generally, no adjustment should be applied to impairment losses.

- For revaluation reserves arising from fair valuing investment property or property plant and equipment: deduct unrealised losses (after tax) from original own funds and partially (i.e. at least net of tax effects) include (cumulative) unrealised gains in additional own funds.[27]

In addition to the CEBS guidelines article 64(4) of Directive 2006/48/EC formally introduces two mandatory prudential filters for institutions into EU legislation:

- gains and losses on cash flow hedges, other than cash flow hedges on available for sale assets should be excluded from own funds[28];
- the consequences (gains and losses) resulting from valuing liabilities at fair value due to changes in their own credit standing should be excluded from own funds.

CEBS moreover recommends maintaining the current prudential classification or definition of the following:

- debt and equity: financial instruments can be included in own funds if they respect the criteria of the Directive on own funds regardless of the accounting classification; conversely some instruments booked in equity should be excluded from regulatory own funds or classified as hybrid original own funds or additional own funds;
- trading book;
- scope and method of consolidation: securitization transactions fulfilling the prudential definition of a true sale should follow the prudential principles regardless of the accounting treatment.

CEBS moreover notes that, in order to mirror the impact of prudential filters on own funds, national competent authorities may require adjustments to the

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[27] Members are also encouraged to consider the need for transferring unrealised gains, if any, resulting from the revaluation when applying the deemed cost method at the 'first time application'to properties from original own funds to additional own funds.

[28] For Cash flow hedges on available for sale assets the guidelines specify that the treatment should be consistent with that of the reserve created for the relevant assets.

balance sheet value of the exposures used in the computation of accounting-based risk weighted exposures.

No changes (or further adjustments) are encouraged, for the time being, for existing intangible assets (including goodwill), deferred tax assets, pension cost, stock option costs and leasing, consideration should be given to the need for transitional/other arrangements to address the impact of the 'first time adoption' of the standards, or to accommodate particular national circumstances for the items mentioned.

Annex 2: Template used for the collection of the qualitative data

STUDY ON THE IMPLEMENTATION OF CEBS GUIDELINES ON PRUDENTIAL FILTERS

Country:

Tax level %:

Applicable date for prudential filters:

Available for sale

			Tax treatment:				Tax treatment:	
	Unrealised gains			%	Unrealised losses			%
	Tier 1		Tier 2		Tier 1		Tier 2	
Equities								
Loans and receivables								
Other available for sale assets								
			Net vs. portfolio vs. Item basis:				Net vs. portfolio vs. Item basis:	

Investment Properties (IAS 40)

			Tax treatment:				Tax treatment:	
	Unrealised gains			%	Unrealised losses			%
	Tier 1		Tier 2		Tier 1		Tier 2	
Investment Properties (IAS 40)								
First time application (IAS 40)								
			Net vs. portfolio vs. Item basis:				Net vs. portfolio vs. Item basis:	

Comments : discount of 10 % in order to take into account volatility

Own Use Properties (IAS 16)

			Tax treatment:				Tax treatment:	
	Unrealised gains			%	Unrealised losses			%
	Tier 1		Tier 2		Tier 1		Tier 2	
Own Use properties (IAS 16)								
First time application (IAS 16)								
			Net vs. portfolio vs. Item basis:				Net vs. portfolio vs. Item basis:	

Fair value option

	Unrealised gains			%	Unrealised losses			%
	Tier 1		Tier 2		Tier 1		Tier 2	
Fair value option								
			Net vs. portfolio vs. Item basis:				Net vs. portfolio vs. Item basis:	

Cash Flow Hedge (CFH)

	Unrealised gains			%	Unrealised losses			%
	Tier 1		Tier 2		Tier 1		Tier 2	
CFH - Hedged item at amortised cost								
CFH - Hedged item AFS asset								

Pension plans

	Unrealised gains			%	Unrealised losses			%
	Tier 1		Tier 2		Tier 1		Tier 2	
Pensions plan								
First time application								
	Net vs. portfolio vs. Item basis:				Net vs. portfolio vs. Item basis:			

General provisions of Directive 86/635/EEC : Fund for general banking risks

	Tier 1		Tier 2	%
First time application				

Comments / *If a filter is applied, please specify:

Deferred tax assets

Tier 1		Tier 2	%

Other prudential filters

First time application (FTA)

(For items not already mentionned above)

General comments and impact of filters different from CEBS guidance:

Annex 3: Main conclusions of the 2005 Follow-up report on the implementation of CEBS Guidelines on prudential filters

An analysis of the 18 answers received points out that CEBS recommendations have favoured a homogenous application of prudential filters within European countries. However, a certain variety of prudential treatments remains in some area.

- **CEBS recommendations have favoured a homogenous application of prudential filters**

CEBS recommendations on Available for sale assets have been applied by a large number of respondents (from 13 to 16 out of 18) as far as equity instruments, loans and receivables and other available for sale assets (categories subjected to different prudential filters) are concerned. The same conclusion can be reached on cash flow hedges, funds for general banking risks and deferred tax assets.

- **A certain variety of prudential treatment remains in some areas**

On investment properties, five respondents include unrealised gains in tier 1, although CEBS recommended including them only partially in tier 2. In rare cases, unrealised losses on such items may not be deducted from tier 1. However, short term changes in national regulations are planned that may result in a more homogenous application of the filters in this area. The same comment, with fewer stated divergences, may be made on 'own use' properties.

A large variety of provisions apply to the fair value option. CEBS did not issue a recommendation on that item, since the IASB were still working on this provision. As the IASB is on the point of reaching a conclusion, the Basel Committee is contemplating the issuance of prudential guidance on that point.

Defined Benefit Pension plans are subject to various prudential treatments, especially when pension funds surpluses are concerned, as CEBS did not issue a recommendation for a prudential filter on that particular point (other than for transitional or to accommodate for particular national circumstances). For Defined Benefits Pension liabilities are also subject to various prudential treatments which may correspond to the need for transitional provisions and accommodation of particular national circumstances.

Annex 4 Overview of national corporate tax rates used for the calculation of the haircuts:

Country:	Tax level %:
Austria	25.0%
Belgium	35.0%
Bulgaria	10.0%
Cyprus	10.0%
Czech Rep	24.0%
Denmark	28.0%
Estonia	0.0%
Finland	26.0%
France	35.0%
Germany	36.0%
Greece	29.0%
Hungary	16.0%
Iceland	18.0%
Ireland	12.5%
Italy	37.3%
Latvia	15.0%
Liechtenstein	max 20.0%
Lithuania	15.0%
Luxembg	30.0%
Malta	35.0%
Netherlands	31.5%
Norway	28.0%
Poland	19.0%
Portugal	25.0%
Romania	16.0%
Slovakia	19.0%
Slovenia (N)	25.0%
Spain	30.0%
Sweden	30.0%
UK	30.0%

Example for the calculation of the post-tax haircut for a country applying a pre-tax treatment 45% of unrealised gains before tax in additional own funds. (The applicable corporate tax rate in country A is 20%.)

In this case 45 units of unrealised gain before tax of 100 would be included in additional own funds.

To determine the post-tax haircut one considers the amount by which the post tax gain (80 = 100 – (100 *20%) has been reduced compared to the amount included in additional own funds (45). This amount of 35 (80 – 45) in relation to the post-tax gain provides a post-tax haircut of 43,75% (=35/80*100).

Annex 5: Detailed information regarding the implementation of CEBS Guidelines on prudential filters:

From III.1.a.1. AFS equities

1) General compliance

Compliance (*incl. variations of CEBS filters)	**Non-compliance**
28 countries: AT, BG, BE, CZ, CY, DE, EE, EL, ES, FI, FR, HU, IE, IT, LI, LT, LU, LV, MT, NL, NO, PL, PT, RO, SE, SI, SK, UK	
Change from 2005 study: SK complies	

2) Treatment of unrealised gains:

No inclusion:	Inclusion in T2 before tax:	Inclusion in T2 after tax:
2: BG, LU	45%: 9 (DE, EE, EL, ES, FR, LV, NO, PT, RO) 60%: 1 (PL) 74%: 1 (FI) = 100% after) 100%: 1 (HU) Total: 12	50%: 1 (IT) 70%: 1 (AT) 80%: 1 (SI) 85%: 1 (LT) 90%: 1 (BE) 100%: 9 (CY, CZ, IE, LU, MT, NL, SE, SK, UK) Total: 14

Additional haircut applied on unrealised gains included in Tier 2 after deduction of taxes:	
• 0%: 11 (CY,CZ,FI,HU, IE, LU, MT, NL, SE, SK, UK) • 10%: 1 (BE) • 15%: 1 (LT) • 20%: 1 (SI) • 26%: 1 (PL) • 30%: 2 (AT, DE) • 31%: 1 (FR)	• 35%: 2 (ES, LV) • 37%: 2 (EL, NO) • 40%: 1 (PT) • 46%: 1 (RO) • 50%: 1 (IT) • 55%: 1 (EE) • 100%: 2(BG, LU)

3) Item-by-item vs. net approach

Item-by-item:	Net:	Not indicated:
4: (NL, PT, SI, SK)	22: (AT, BE, BG, CY, CZ, DE, EE, EL, ES, FI, FR*, IT, LI, LT, LV, LU, MT, NO, PL, RO, SE, UK) *: by currency	1 (HU) IE has not specified treatment for banks, but requires consistent application of one treatment once choice is made

From III.1.a.2. AFS loans and receivables

1) General compliance

Compliance (*incl. variations of CEBS filters)	**Non-compliance / Other**
23 countries: BE, BG*, CY, CZ, DE, EE, EL, ES, FR, IE, IT, LI*, LT, LU, NL, NO, PL, PT, RO, SE, SI, SK, UK	5 countries: (AT, FI, HU, LV, MT) In substance 1: HU

From III.1.a.3. AFS: other (i.e. debt instruments...)

1) General compliance

Compliance (*incl. variations of CEBS filters)	**Non-compliance /**
28 countries:	
- as equities: 15 countries (AT, BG, CY, DE, EE, ES, FI, HU, IT, LI, LV, LT, LU, MT, PT), ES applies different % for inclusion (35%), HU could be interpreted as using the equities approach. - as loans / receivables: 12 countries (BE, CZ, EL, FR, NL, NO, PL, RO, SI, SK, SE, UK) - IE: debt instrument can be treated as equities or loans and receivables, but Financial Regulator requires consistent application of one treatment (across the category) once choice is made.	

2) Treatment of unrealised gains for those opting for the equity treatment:

No inclusion:	Inclusion before tax:	Inclusion after tax:
2: BG, LI	35%: 1 (ES) 45%: 4 (DE, EE, LV, PT) 74%: 1 (FI) = 100% after) 100%: 1 (HU) Total: 7	50%: 1 (IT) 70%: 1 (AT) 85%: 1 (LT) 100%: 4 (CY, IE, LU, MT) Total: 7
Additional haircut on unrealised gains included in Tier 2 after deduction of taxes: as for the equity treatment except for ES where the haircut is increased to 50% To the extent that an Irish bank opts for the equity treatment, no additional haircut will be applied.		

3) Item-by-item vs. net

Item-by-item:	Net / portfolio:	Not indicated:
1: (PT)	14: (AT, BG, CY, DE, EE, ES, FI, IT, LI, LT, LU, LV, MT, SE)	IE gives choice, but requires consistent application of one treatment once choice is made

From III.1.b.1. Investment property

1) General compliance

Compliance **(*incl. variations of CEBS filters)**	**Non-compliance / Other**
24 countries: AT, BE, BG, CY, DE, EE, EL, FR, HU, IE, IT, LI, LV, LT, LU, MT, NL, NO, PL, PT, RO, SE, SI, UK	formally 4: CZ, ES, FI, SK in substance 2: FI, SK

2) Treatment of unrealised gains:

No inclusion:	Inclusion before tax:	Inclusion after tax:
3: BG, LI, LU.	45%: 8 (DE, EE, EL, FR, LV, NO, PT, RO) 60%: 1 (PL) 100%: 1 (HU) Total: 10	50%: 1 (IT) 70%: 1 (AT) 80%: 1 (SI) 85%: 1 (LT) 90%: 1 (BE) 100%: 6 (CY, IE, MT, NL, SE, UK) Total: 11
Inclusion in Tier 1: CZ, SK (100% after tax), FI (8% before tax)		

Additional haircut on unrealised gains included in Tier 2 after deduction of taxes:

- **0%**: 7 (CY, HU, IE, MT, NL, SE, UK)
- 10%: 1 (BE)
- 15%: 1 (LT)
- 20%: 1 (SI)
- 26%: 1 (PL)
- 30%: 2 (AT, DE)
- 31%: 1 (FR)
- 35%: 1 (LV)
- 37%: 2 (EL, NO)
- 40%: 1 (PT)
- 46%: 1 (RO)
- 50%: 1 (IT)
- 55%: 1 (EE)
- 100%: 3 (BG, LI, LU)

Countries applying haircuts: (17), average haircut%: 44.8%

Overall average haircut (24 countries): 31.8%

3) Item-by-item vs. net approach

Item-by-item:	Net / portfolio:	Not indicated / Not applicable
12: (BE, EE, EL, FI, FR, LU, NL, NO, PT, RO, SI, SK)	13: (AT, BG, CY, CZ, DE, IT, LI, LT, LV, MT, PL, SE, UK)	NI: 1 (HU) N/A: ES IE has not specified to banks which treatment to use.

From III.1.b.2. Property plant and equipment

1) General compliance

Compliance (*incl. variations of CEBS filters)	**Non-compliance/ Other**
27 countries: AT, BE, BG, CY, CZ, DE, EE, EL, FI, FR, HU, IE, IT, LI, LV, LT, LU, MT, NL, NO, PL, PT, RO, SE, SI, SK*, UK	ES (N/A)

2) Treatment of unrealised gains:

No inclusion:	Inclusion before tax:	Inclusion after tax:
4: CZ, LI, LU, SK	45%: 6 (DE, EL, FR, NO, PT, RO) 60%: 1 (PL) 70%: 1 (LV) 74%: 1 (FI) = 100% after 100%: 1 (HU) Total: 10	50%: 1 (IT) 70%: 1 (AT) 80%: 1 (SI) 85%: 1 (LT) 90%: 1 (BE) 100%: 8 (BG, CY, EE, IE, MT,NL,SE, UK) Total: 13

Additional haircut on unrealised gains included in Tier 2 after deduction of taxes::	
• 0%: 10 (BG, CY, EE, FI, HU, IE, MT, NL, SE, UK) • 10%: 1 (BE) • 15%: 1 (LT) • 17%: 1 (LV) • 20%: 1 (SI) • 26%: 1 (PL) • 30%: 2 (AT, DE)	• 31%: 1 (FR) • 37%: 2 (EL, NO) • 40%: 1 (PT) • 46%: 1 (RO) • 50%: 1 (IT) • 100%:4 (CZ, LI, LU, SK)
Countries applying haircuts (17): average haircuts%: 46.4% **Overall average haircut (27 countries):** 29.2%	

2) Item-by-item vs. net / portfolio

Item-by-item:	Portfolio:	Not indicated / Not applicable
13: (AT, BE, EE, EL, FI, FR, IE, LU, NL, NO, PT, RO, SI)	12: (BG, CY, CZ, DE, IT, LI, LT, LV, MT, PL, SE, UK)	NI: 1 (HU) N/A: 1 (ES) IE has not specified to banks which treatment to use.

Annex 6: Other prudential filters applied by countries

The following adjustments are being applied adjustments by only one or two countries at the same time:

- ES: non current assets held for sale reserves, except when the valuation differences are related to AFS equities and bonds;
- IT: put options on own capital instruments; fair value gains and losses on fair valued hybrid and subordinated debt instruments;
- LU: financial instrument (eligible for inclusion in Tier 1 or Tier 2 capital) valued at amortised cost and subject to a fair value hedge; and
- PT: unrealised gains and losses from cash flow hedge of forecast transactions; unrealised gains from loans and receivables classified as held for trading.