Committee of European Banking Supervisors

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Press Release

GUIDELINES ON PRUDENTIAL FILTERS FOR REGULATORY CAPITAL

From beginning of 2005 European listed companies, at the minimum, will have to publish consolidated financial statements based on the new International Financial Reporting Standards (IFRS) rules. In response to a request from the Banking Advisory Committee, CEBS has proposed its first set of technical advice to the European Commission on the use of prudential filters in the context of the new IFRS rules and the Recasting Directive 2000/12/EC (Capital Requirements Directive), applicable 1st January 2007 onwards.

CEBS has further developed the filters and the final advice from CEBS may be considered by the European Commission at a later stage for incorporation into the Capital Requirements Directive via the appropriate legislative procedure and following the required prior call for advice by the Banking Advisory Committee and full industry consultation. In the meantime, CEBS has agreed to adopt the guidelines on prudential filters that will be applied on a best efforts basis by national supervisors to institutions which use IFRS for their prudential returns. The guidelines will be implemented in accordance with national procedures, and that CEBS will monitor the application thereof. For consistiency purposes national authorities may consider the need to apply the guidelines to institutions following national GAAP to the extent that they are similar to IFRS. As IFRS will come into force on 1st January 2005, CEBS is not in a position to undertake a public consultation. However, national competent authorities have been asked to undertake a consultation in their country.

In order to reach a common level playing field across Europe and G10 countries CEBS proposals are, on purpose, in line with the Basel Committee's work on the same subject. The objective of the guidelines is to maintain the current definition - and quality - of regulatory capital.

CEBS has made the following proposals on the use of prudential filters in the context of the new IFRS:

1. To apply the following adjustments and prudential filters on own funds of institutions:

- Institutions shall not include in own funds the fair value reserves related to gains and losses on cash flow hedges, other than cash flow hedges on available for sale assets where the treatment should be consistent with that of the reserve created for the relevant assets.
- Institutions shall not include in own funds the consequences (gains and losses) resulting from valuing liabilities at fair value that are due to changes in their own credit standing. CEBS is aware that the Fair Value Option is not, under the EU carved out version, currently available on liabilities.

2. As a general principle, no filter should apply to impairment losses which, therefore, should flow through original own funds.

3. For the revaluation reserves on available-for-sale assets the following filters shall apply:

- for equities, unrealised losses should be deducted after tax from original own funds and unrealised gains should only partially be included in additional own funds before tax. Partially means that at least the tax effect should be taken into account;
- for loans and receivables, included in the available-for-sale category, the unrealised gains and losses, apart from those related to impairment, are neutralised in own funds after tax;
- for the other available-for-sale assets, two methods can be applied, either that applied to equities or that applied to loans and receivables.

4. To keep the current prudential classification or definition of :

- Debt and equity, as CEBS is of the opinion that issued financial instruments can be included in own funds if they respect the criteria of the directive on own funds regardless of the accounting classification and for the amount which would exist if no separation between liabilities and equity had been made. Competent authorities should also have the possibility to exclude from regulatory capital some instruments booked in equity or to classify these instruments as hybrid original own funds or additional own funds.
- The trading book, as CEBS considers that the accounting classification of items as trading should not be carried through to prudential regulation.

On the treatment of revaluation reserves arising from fair valuing investment property or property plant and equipment, CEBS encourages national competent authorities to apply the following treatment:

- unrealised losses should be deducted after tax from original own funds;
- cumulative unrealised gains should only partially be included in additional own funds before tax. Partially means that at least the tax effect should be taken into account;
- additionally national competent authorities are encouraged to consider the need for transferring unrealised gains, if any, resulting from the first time application of the cost method to properties from original own funds to additional own funds.

CEBS does not plan to encourage national competent authorities to make adjustments in some areas, although consideration should be given to the need for any transitional/other arrangements for the first time adoption of the standards, or to accommodate particular national circumstances. For existing intangible assets, including goodwill, and deferred tax assets the current regulatory capital treatment may continue. For pension costs, stock option costs and leasing the result of not making regulatory capital adjustments will be the reflection, in regulatory capital, of their impact on profit and loss, following the adoption of the applicable IFRS.

As a general principle CEBS encourages disclosures by an institution, to its supervisor, of the impact of the use of the fair value option. This disclosure particularly applies in the current context of the carved out version of IAS 39 to the fair value option on financial assets. Competent authorities may consider the need for further prudential filters in this area, otherwise inclusion of the fair value results in original own funds will be allowed.

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

Regarding scope and method of consolidation, CEBS acknowledges the fact that securitisation transactions fulfilling the prudential definition of a true sale should follow the prudential principles regardless of the accounting treatment.

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