

# PRUDENTIAL FILTERS. ADJUSTMENTS TO THE EQUITY BASED ON CONSOLIDATED FINANCIAL STATEMENTS AS PER IFRS.

## INTRODUCTION

Capital market-orientated banks which have to prepare their consolidated financial statements as per IFRS and banks which voluntarily prepare consolidated financial statements under IFRSs have, since 01/01/2007, been able to determine the level of equity based on consolidated figures as per their consolidated financial statements under IFRSs (option under Sec. 10a(7) German Banking Act (KWG))<sup>1</sup>. Regulatory law originally provides for the mandatory ascertainment of the level of equity based on a consolidated balance sheet under IFRSs at the latest after a five-year period has expired since the consolidated financial statements in accordance with IFRSs were prepared for the first time<sup>2</sup>. Until 31/12/2015 the level of equity can be ascertained using the "aggregation method"<sup>3</sup>, in line with the provisional regulation of Sec. 64h(4) German Banking Act (KWG). Such transition period should, however, be reduced upon the CRD IV/CRR coming into force. Presently, until 31/12/2013, banks are offered the concession of applying the aggregation method in line with the bill on the implementation of the CRD IV/CRR. Once the aggregation method on determining the equity capital requirements is abolished, and when calculating the equity capital requirements of the Group based on consolidated financial statements under IFRSs, it is necessary to apply prudential filters. In this way, the regulatory equity concept that creditors need to be protected under the German Commercial Code (HGB) is supposed to continue to be maintained.

In this regard, the Consolidated Financial Statements Reconciliation Regulation (KonÜV) has been adopted in Germany as an adjustment measure. This regulation is derived from the CEBS<sup>4</sup> proposals on adjusting the regulatory equity capital vis-à-vis certain measurement effects in the consolidated financial statements under IFRSs. Firstly, the prudential filters in accordance with the Consolidated Financial Statements Reconciliation Regulation are examined more closely below in conjunction with the current developments in regulatory legislation and in German GAAP accounting policies. This is followed by an explanation of the revision of the prudential filters in

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<sup>1</sup> If the banks are not obliged to prepare an consolidated balance sheet under IFRSs or do not do so on a voluntary basis, the equity is determined on the basis of consolidated financial statements or interim financial statements, as per the German Commercial Code (HGB).

<sup>2</sup> Cf. Sec. 10a(7) sentence 1 German Banking Act. The interim financial statements prepared in the case of the latter covering less than a year can, as per Sec. 10(3) and 10a(10) German Banking Act, be drawn upon to determine the equity level. These interim financial statements are to be subjected to review.

<sup>3</sup> Cf. Sec. 10a(6) German Banking Act

<sup>4</sup> Cf. Guidelines on Prudential Filter for Regulatory Capital, CEBS, 2004

the EU regulation (CRR). The account of the development of the prudential filters from the national Consolidated Financial Statements Reconciliation Regulation rules to the CRR serves to provide a comparison of the contents of the current and future statutory foundations.

## MOTIVATION FOR THE PRUDENTIAL FILTERS

The differences between the German Commercial Code and IFRS/IAS in regard to recognition standards and measurement rules have significant repercussions on the level of the equity derived from the latter. The following differences in regard to the accounting policies applied are recognised in the equity on the balance sheet:

- In the consolidated balance sheet under IFRS, the valuation gains in the case of financial instruments of available-for-sale financial assets
- Gains and losses arising from measuring financial liabilities resulting from changes in the bank's own credit rating

lead to not all equity components under German GAAP being recognised (e.g. gains recognised through profit or loss). Consequently, adjustment items, namely the prudential filters, need to be recognised in the process of the deriving the regulatory equity capital on the basis of the consolidated balance sheet under IFRSs<sup>5</sup>.

In 2004, in its corresponding guidelines the CEBS published corresponding rules for adjustments to be made to the equity reported in consolidated financial statements prepared as per IFRSs. By applying the prudential filters, the market fluctuations in the equity positions as per IFRS are supposed to be accommodated. Consequently, the existing concept under German GAAP of equity defined at prudential level can also be retained when opting for preparing consolidated financial statements under IFRS. The influences counteracting this concept are neutralised. The latter is essentially aimed at preserving the risk buffer and loss absorption function of the equity defined at prudential level.

Only the equity items are affected by applying the prudential filters. The CEBS's proposals or the regulations in the Consolidated Financial Statements Reconciliation Regulation do not include any statements in regard to the amounts to be recognised regarding the risk positions.

The objective of the prudential filters is to be able to determine the level of equity at prudential level largely independently of the respective financial accounting approach taken. In this way, competitive distortions are avoided, especially for banks operating internationally, through it being easier to compare the figures and statements.

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<sup>5</sup> Further one-off effects on the regulatory capital based on consolidated financial statements under IFRSs are not explained in this article.

## PRUDENTIAL FILTERS AS PER THE CONSOLIDATED FINANCIAL STATEMENTS RECONCILIATION REGULATION

In Germany, the adjustment measures for implementing the CEBS' recommendations have been laid down in the Consolidated Financial Statements Reconciliation Regulation. This regulation complements Sec. 10a German Banking Act in ascertaining the consolidated regulatory capital of banking and financial holding groups, comprising the following adjustments of the equity under IFRSs when determining the regulatory tier 1 capital and tier 2 capital<sup>6 7</sup>.

Tier 1 capital	Revaluation surplus of available-for-sale financial instruments	Art. 2 Consolidated Financial Statements Reconciliation Regulation
	Revaluation surplus in the case of owner-occupied land and buildings	Art. 3 Consolidated Financial Statements Reconciliation Regulation
	Cash flow hedge reserve	Art. 5 Consolidated Financial Statements Reconciliation Regulation
	Unrealised gains from land and buildings held as financial investments (investment property)	Art. 3 Consolidated Financial Statements Reconciliation Regulation
	Unrealised gains from a change in the bank's own credit rating (fair value option)	Art. 6 Consolidated Financial Statements Reconciliation Regulation
Tier 2 capital	Unrealised gains from available-for-sale financial instruments	Art. 2 Consolidated Financial Statements Reconciliation Regulation
	Unrealised gains in the case of owner-occupied land and buildings	Art. 3 Consolidated Financial Statements Reconciliation Regulation
	Unrealised gains from held-to-maturity financial instruments	Art. 4 Consolidated Financial Statements Reconciliation Regulation

Consequently, the aim is regulating to what extent, in the case of consolidated financial statements under IFRSs, valuation gains or "unrealised gains" reported in the equity on the balance sheet can be recognised in the tier 2 capital at prudential level. According to the regulatory provisions currently applicable, the latter may not be taken into consideration as tier 1 capital at prudential level. Furthermore, it is regulated which equity effects need to be fully neutralised from the equity defined at prudential level when opting to prepare consolidated financial statements as per IFRSs.

<sup>6</sup> The measurement effects when determining the regulatory capital are taken into account on the Q UEB Solvability Report Sheet.

<sup>7</sup> Art. 7 Consolidated Financial Statements Reconciliation Regulation is concerned with subordinated companies consolidated via the equity method. Treating such shareholdings leads to a synchronisation with the aggregation method and does not constitute a provisional or adjustment measure. (Cf. deductible items pursuant to Sec. 10(6) sentence 1 German Banking Act.) In this respect, reference is made to the article "Regulatory Consolidation under the influence of international accounting" in this edition of "Banking Secrecy".

The treatment of fair value gains and losses from financial instruments classified as "available-for-sale (AFS)" is shown in Art. 2 of the Consolidated Financial Statements Reconciliation Regulation. According to Art. 2(1) of the Consolidated Financial Statements Reconciliation Regulation, the positive revaluation surplus before deferred taxes may be recognised in the tier 2 capital at a maximum of 45 per cent of the difference between the cost and the fair values. A negative balance arising from the cost and the lower value is, as per the requirement as per Art. 2(2) of the Consolidated Financial Statements Reconciliation Regulation, to be deducted from the tier 1 capital after taking into account deferred taxes. The balance specified is entered into the revaluation surplus as a measurement result of a bank portfolio not affecting net income.

Unrealised gains and unrealised losses from financial instruments in the category "Loans and Receivables" (LaR) entered in the accounts as not affecting net income may, as per Art. 2(3) of the Consolidated Financial Statements Reconciliation Regulation<sup>8</sup>, not be allocated to equity. Taking such unrealised gains and losses into account would, in the opinion of the supervisory authority, bring about great uncertainty, as the market prices necessary for calculating the fair value of loans and other receivables are frequently not available, and therefore corresponding measurement models need to be drawn upon.

According to Art. 3(1) of the Consolidated Financial Statements Reconciliation Regulation, the undisclosed reserves of owner-occupied property held as a financial investment (investment property) recognised as revaluation surplus are to be treated in the same way when determining the regulatory capital. A bank may as an option, as per IAS 16 and IAS 40, carry out the measurement of owner-occupied property held as a financial investment (investment property), applying the fair value. In the event of exercising such an option, gains and losses arising from the change in the fair value are to be recognised directly in the retained earnings. In accordance with Art. 3(2) of the Consolidated Financial Statements Reconciliation Regulation, the fair value gains from land and property after deferred taxes, which are held as financial investments, taken into account as affecting net income need to be deducted in their entirety from the tier 1 capital. These amounts can instead be added to the tier 2 capital before deferred taxes, recognising them at 45 per cent of their amount, as unrealised reserves. The positive amount arising from the revaluation model as per IAS 16.31 for owner-occupied property can be added to the tier 2 capital at 45 per cent, taking into account the tax deferral. According to Art. 3(2) sentence 3 Consolidated Financial Statements Reconciliation Regulation, the losses from the property entered as affecting net income always need to be deducted in full from the tier 1 capital, however, after deferred taxes.

The unrealised reserves of the financial instruments in the held-to-maturity (HtM)<sup>9</sup>

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<sup>8</sup> The financial assets in the available-for-sale measurement category available for sale are those non-derivative financial assets which do not have to be allocated to the other categories (LaR, HtM and AFV) (as per IAS 39.9).

<sup>9</sup> The financial investments in the HtM measurement category held to final maturity are non-derivative financial assets involving fixed or determinable payments, as well as a fixed term as per IAS 39.9.

category may, as per Art. 4 Consolidated Financial Statements Reconciliation Regulation, be added to the tier 2 capital in the amount of 45 per cent of the difference between the book value and the fair value. However, the unrealised reserves of securities which can be allocated to the "LaR" category can accordingly not be taken into consideration.

Effects on equity arising from cash flow hedges entered in the revaluation surplus not affecting net income are, as per Art. 5(1) Consolidated Financial Statements Reconciliation Regulation, to be eliminated from the tier 1 capital.

In Sec. 6 Consolidated Financial Statements Reconciliation Regulation the treatment of the effects on equity arising from a change in the bank's own credit risk is regulated. This is necessary, as changes in the credit rating of issuing banks may lead to an increase or reduction in the equity. Such effects on equity materialise once a balancing procedure affecting net income is carried out for the bank's own issuance of debt (liabilities), and thus the fair value option under IAS 39.9 applied. A deterioration in the bank's credit rating leads to a valuation gain affecting net income, as the value of its own liabilities drops. In contrast, if the credit risk is assessed to be lower, that results in a holding loss. Such changes in market value resulting from a shift in the credit rating of the banks preparing the balance sheets are, as per Art. 6 Consolidated Financial Statements Reconciliation Regulation, not to be taken into account when determining the equity. The resulting changes in the retained earnings are to be deducted from or added to the tier 1 capital.

## PRUDENTIAL FILTERS FOLLOWING IMPLEMENTATION OF CRD IV/CRR

Upon the regulatory changes in CRD IV/CRR coming into force as at 1 January 2013, the present-day form of the prudential filters will change, since, due to these new regulations at European level, the current national requirements of the Consolidated Financial Statements Reconciliation Regulation will be dispensed with. The prudential filters to be applied will in future be applied in a uniform manner throughout the EU in Arts. 29 to 32 of the CRR. Such EU requirements should be drawn upon directly within the scope of transitioning to IFRS regarding the method of determining the equity. The adjustment items for determining the equity are, as per the CRR, exclusively to be deducted from the tier 1 capital.

The following points are to be adjusted when determining the equity:

- An increase in the equity based on the IFRS financial accounting standard arising from securitised assets
- Revaluation surplus from gains and losses arising from cash flow hedges to hedge financial instruments not measured at fair value
- Measurement effects arising from the changes in the bank's own credit risk
- Additional fair value adjustments of financial instruments.

Accordingly, the unrealised gains and losses arising from fair value measurement are to be treated in a similar way as when balancing the accounts according to IFRSs ((Art. 32 CRR). However, the effects on equity resulting from the change in the bank's own credit risk and from cash flow hedges need to be filtered out of the tier 1 capital. As per Art. 31 of the CRR, a new position, "Additional valuation allowances", should be subsumed under the term "Prudential filters". Accordingly, necessary additional valuation allowances of the assets measured at fair value are to be deducted from the core tier 1 capital. In order to ascertain the additional valuation allowances necessary, the supervisory authority makes reference to Art. 100 of the CRR, which elaborates on the requirements for a prudent measurement of the trading book positions in more detail. Art. 100 of the CRR requires daily measurement of the trading book positions at market prices. Should the measurement at market prices not be possible, banks may alternatively undertake a prudent model-based measurement. For prudent model-based determining of the position values, the banks need to engage in ongoing price checks. In that regard, if there is a lack of independent sources for pricing, under certain circumstances appropriate value adjustments may be taken into consideration. In particular, banks have also introduced methods of adjusting the current measurement of less liquid positions. Such adjustments are, in that respect, if necessary to be undertaken in addition to the valuation allowances for the positions required for accounting purposes. As already mentioned above, the resulting adjustments are to be deducted from the core tier 1 capital as additional valuation allowances required.

In the table below, the requirements regarding prudential filters as per the Consolidated Financial Statements Reconciliation Regulation are compared with the new regulations of the CRR. In that respect, it is to be emphasised that, except for exceptions as per Art. 30 of the CRR, no further valuation adjustments arising from unrealised gains and losses recognised at fair value are to be undertaken. This constitutes a major difference to the provision currently still applicable concerning the adjustment measures within the scope of determining equity of banking groups.

Deducting components of the equity	Describing the positions	EU regulation (CRR)	Current national requirement
	Securitised assets	Art. 29	Sec. 10 (3a) sentence 4 in conjunction with Sec. 10 (2a) sentence 1 German Banking Act
	Cash flow hedge reserve	Art. 30	Sec. 5 Consolidated Financial Statements Reconciliation Regulation
	Unrealised gains and loss at fair value	Art. 32 (no measurement adjustments)	Sec. 2-4 Consolidated Financial Statements Reconciliation

			Regulation (recognition of savings in time as tier 2 capital)
	Changes in value arising from the change in the bank's own credit rating (fair value option)	Art. 30	Sec. 6 Consolidated Financial Statements Reconciliation Regulation
Deduction of core tier 1 capital	Additional valuation allowances	Art. 31 (additional adjustment items based on measurement adjustments for less liquid positions)	Not regulated

Besides the changes resulting from the CRD IV/CRR, the introduction of IFRS 9, which will replace Standard IAS 39, will have further impact to be taken into account when determining the regulatory equity in future.

## IMPACT OF IFRS 9

The date of IFRS 9 "Financial Instruments" coming into force has been postponed from 2013 to 2015. Firstly, this means that the transition of the banking group reporting to IFRS, inclusive of taking into account the prudential filter as per the current legal position (IAS 39), has to be carried out by 31/12/2013. Secondly, the banks need to take care to ensure that the impact of IFRS 9 coming into force on the equity, in conjunction with the modified requirements of the CRD IV/CRR vis-à-vis prudential filters, are taken into consideration in good time.

According to IFRS 9, financial instruments may only be recognised based on two measurement categories: at amortised cost or at fair value. Which of the two measurement methods is applied depends upon the business model pursued, i.e. whether it is aimed at generating contractual cash flows or rather gains through fast-track trading with financial instruments. The two measurement methods have a direct impact upon calculating the prudential filters: The change in the classification of financial instruments as per IFRS 9 may lead to a greater fluctuations in value in the valuation surplus, which then needs to be eliminated again by applying the prudential filters.

## SUMMARY/OUTLOOK

With the introduction of the prudential filter effects from the fair value measurement as per the international accounting standards are supposed to be neutralised, so that,

in this way, the existing concept of the equity under regulatory law can be maintained. Banks which transition the determination of their equity under supervisory law on the basis of consolidated financial statements under IFRSs should therefore include the topic of the prudential filters in the current IFRS (especially IFRS 9) and CRD IV/CRR implementation projects, in order to be able to assess the resulting impact upon the equity ratio, as well as, if applicable, business models, in good time.

Originally, the aim of introducing the prudential filters was to neutralise the effects of measurement of the IFRS regulations. As per the requirements of the CRR, the measurement adjustments of reserves recognised at fair value will no longer be undertaken, save for in the case of a few exceptions (Art. 30 CRR). In this regard, particular attention should be paid to the final version of the CRR.

The challenge will be to tackle the different tasks of the project in an interdisciplinary way, viz. by the Accounts Depts. and the regulatory reporting offices of companies co-operating, so that an integrated understanding of the interdependencies is obtained, as well as an integrated solution worked out.



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