Basel 2 and IFRS concepts in Financial Institutions: Description, Similarities and Differences

March 26th, 2009

Agenda & Timing

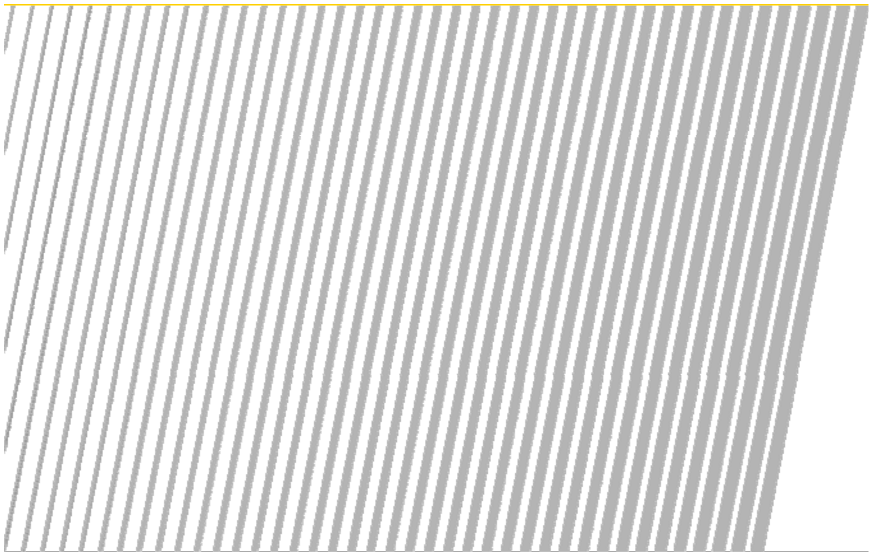
► Key objectives	10:55 – 11:00
► BASEL 2 – Description and Key Concepts	11:00 – 11:10
► IFRS – Description and Key Concepts	11:10 – 11:15
► IFRS versus Basel 2	11:15 – 11:25
► Questions	11:25 – 11:30

Key objectives

Key Objectives of the session

- Better understanding of Basel 2 concepts for non specialists
- Better understanding of IFRS concepts for non specialists
- Identification of links between IFRS and Basel 2

BASEL 2 – Description and Key concepts



BASEL 2 Framework - Description

- Intend to overcome 1988 Basel Accord (Basel I) weaknesses by developing a framework that would strengthen the soundness and the stability of the international banking system
- Provide a range of options/rules to determine the capital required to cover losses in case of extreme/unexpected events
- Based on three critical pillars:
  - Minimum capital requirements – Minimum capital required to face losses due to credit, market and operational risks
  - Supervisory review – Key principles of supervisory review, transparency and accountability and risk management guidance
  - Market discipline – Set of disclosure requirements which should help to inform market on banks exposure to critical risks

BASEL 2 Framework – Key objectives

- Main objectives of Basel 2 include:
  - Improving the stability of the banking system
  - Reducing level of competitive inequality among internationally active banks
  - Increasing link between capital and risks (i.e. explicitly taking into account credit, market and operational risks)

BASEL 2 has played a critical role in the subprime financial crisis …

Six main accusations are:

1. Average level of capital required is inadequate
2. Interaction between Basel 2 (mostly required Mark to Market valuation for market risks) and fair value accounting has caused remarkable losses
3. Capital requirements are pro-cyclical and tend to reinforce business cycles fluctuations
4. Assessment of credit risk is delegated to rating agencies subject to possible conflicts of interest
5. Key assumptions that Banks internal risk models are superior than others has proved wrong
6. New Basel Framework provide incentives to financial institutions to remove from their balance sheet some very risky exposures

Source: « The role of Basel 2 in the subprime financial crisis : Guilty or Not Guilty » Francesco Cannata, Mario Quaguariello

…Even if some of them are not well – founded

- By end of 2008, many banks were still applying Basel I. Therefore, some of the accusations are mainly due to Basel I (Accusation 1)
- Others are just general and cannot be directly linked to Basel 2 (Accusation 5)

Source: « The role of Basel 2 in the subprime financial crisis : Guilty or Not Guilty » Francesco Cannata, Mario Quaguariello

However, some aspects of Basel 2 required significant improvements…

On December 2009, the Basel Committee's has proposed new rules to strengthen the regulatory capital framework, for consultation and impact assessment by April 2010. Main adjustments proposed are listed below.

- ***Raising the quality, consistency and transparency of the capital base***
  - Predominant components of Tier 1 capital must be common shares and retained earnings
  - Tier 3 capital which were only available to cover market risks will be eliminated
- ***Enhancing risk coverage***
  - The Basel Committee is supporting the efforts of the Committee on Payments and Settlement Systems to establish stronger standards for central counterparties and exchanges
  - Banks must determine their capital requirement for counterparty credit risk using stressed inputs
  - Banks will be subject to a capital charge for mark-to-market losses due to a deterioration in the credit worthiness of a counterparty.
  - Banks with large and illiquid derivative exposures to a counterparty will have to apply longer margining periods as a basis for determining the regulatory capital requirement.
- ***Supplementing the risk-based capital requirement with a leverage ratio***
  - Put a floor under the build-up of leverage in the banking sector
  - Introduce additional safeguards against model risk and measurement error
- ***Reducing procyclicality and promoting countercyclical buffers***
  - *Forward looking provisioning:* supports the initiative of the IASB to move to an EL approach
  - *Capital conservation:* Build-up of adequate buffers above the minimum that can be drawn down in periods of stress
- ***Addressing systemic risk and interconnectedness***
- ***Introducing a global liquidity standard***

Source: « Strengthening the resilience of the banking sector» Basel committee and Banking supervisory , *December 2009*

IFRS – Description and Key concepts

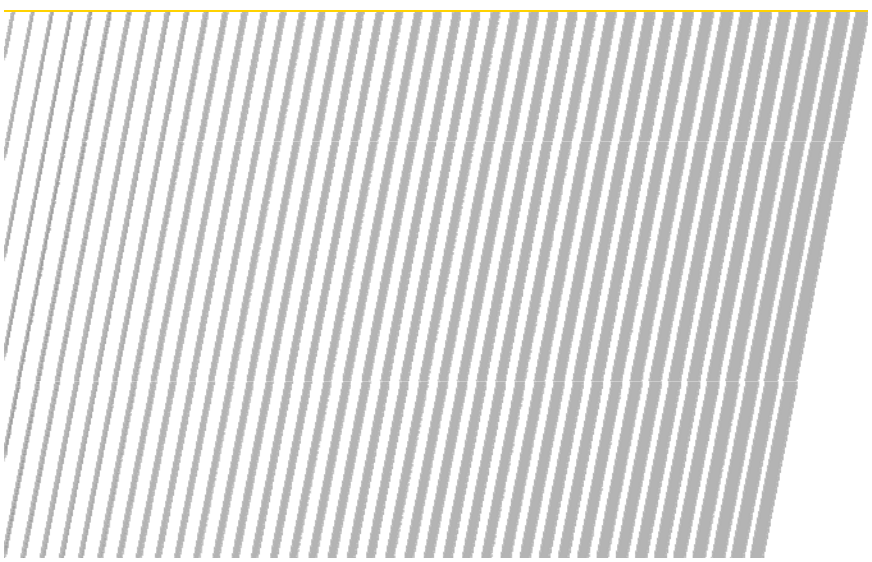
IFRS Framework - Description

- Developed and published by the International Accounting Standards Board (IASB)
- Set of global accounting standards used to produce financial statements and other financial reports for all profit oriented firms
- To be used by Canadian public firms to publish financial statements by 2011

IFRS Framework – Key objectives

- Improve transparency and comparability of financial information among international public firms
- Improve access to international capital, funding and investments opportunities

IFRS versus BASEL 2



Interaction between BASEL 2 and IFRS in Financial Institutions

BASEL 2 key concepts

- Aim to play a supervisor/prudential role
- Ensure banks have enough reserves, provisions or capital to preserve bank creditors in case of expected and unexpected losses
- Provide principles based guidelines for sound risk management

IFRS key concepts

- Aim to play an accounting role
- Ensure financial statements reflect adequately the losses/gains realized at the balance sheet date
- Most important standards for banks are IAS 39 (Guidelines on recognition and measurement of financial instruments), IAS 32 and IFRS 7 (Financial institutions presentation and disclosures)

Basel 2 and IFRS show some similarities…

- Both BASEL 2 and IFRS main objective is to provide market participants and supervisors transparent and accurate information regarding financial health adjusted for risk to the banks
- Both BASEL 2 and IFRS use the same type of data to achieve their key objectives
- IAS 39.AG92 recognizes the considerable synergies between IFRS and Basel II by acknowledging that, "formula-based approaches or statistical methods may be used to determine impairment losses in a group of financial assets"
- The Basel Committee strongly supports the initiative of the IASB to move from an incurred loss approach to an EL approach to estimate provisions.

… However, critical differences still exist in specific topics

- Capital definition
- Trading book definition
- Loss definition
- Securitizations
- Netting Assets/Liabilities
- Segment reporting
- Risk disclosure

26 October 2009 Page 15 Interaction between Basel 2 and IFRS concepts in Financial Institutions

Capital definition

To avoid disruptions in the quality of capital due to IFRS…

- IFRS (IAS 32) imply specific split between equity (owned funds) and liabilities (due funds)
- Regulatory capital (mainly driven by Basel accord) include elements which are in fact accounting liabilities according to IFRS:
  - Subordinated term debt - "it has been concluded that subordinated term debt instruments with a minimum original term to maturity of over five years may be included within the supplementary elements of capital, but only to a maximum of 50% of the core capital element and subject to adequate amortisation arrangements"
  - Hybrid debt capital instruments - "It has been agreed that, where these instruments have close similarities to equity, in particular when they are able to support losses on an on-going basis without triggering liquidation, they may be included in supplementary capital. In addition to perpetual preference shares carrying a cumulative fixed charge, the following instruments, for example, may qualify for inclusion: long-term preferred shares in Canada, titres participatifs and titres subordonnés à durée indéterminée in France, Genussscheine in Germany, perpetual debt instruments in the United Kingdom and mandatory convertible debt instruments in the United States."

… Supervisors have set up prudential filters

- Prudential filters key objective is to reconcile key gaps between regulatory capital and accounting capital. Key examples include:
  - Do not include in owned funds (accounting), fair value reserves related to P&L on cash flow hedges other than cash flow hedges on available for sales assets
  - Do not include in owned funds (accounting), P&L for changes of liabilities fair value due to changes in their owned credit standing

26 October 2009 Page 16 Interaction between Basel 2 and IFRS concepts in Financial Institutions

Trading books definition

- According to Basel 2 , “A trading book consists of positions in financial instruments and commodities held either with trading intent or in order to hedge other elements of the trading book. To be eligible for trading book capital treatment, financial instruments must either be free of any restrictive covenants on their tradability or able to be hedged completely. In addition, positions should be frequently and accurately valued, and the portfolio should be actively managed.”
- According to IFRS (IAS 30), “A trading book consists of positions in financial instruments Available for sales and Held for trading purpose meaning any assets where there is intention to sell.”

- Different “Banking/Trading” classification for accounting and regulatory purposes
- Loans to private equity include in Banking book for regulatory purpose and Trading book for accounting purpose
- All derivatives instruments include in Trading book for accounting purpose (i.e. classified as “Held to Maturity” financial instruments)
- Higher volatility of P/L in financial statements (accounting purpose) because Held –To-Maturity financial instruments could be based on fair value as of balance sheet date

Loss definition

- According to Basel 2 , a loss event occurs when either or both of two conditions are met: (1) The obligor is unlikely to pay its credit obligations or (2) the obligor is 90 days past due on any material obligation.
- According to IFRS, a loss event occurs when the difference between the present value of the expected cash flows, discounted at the effective interest rate, and the carrying value of the loan becomes negative.

- Basel II loss given default (LGD) factor include the capital costs whereas IFRS explicitly assumes that the discount rate to be used is the same “effective interest rate” used to recognize income on the asset before it was impaired

Securitization

- Basel 2 proposes under some conditions, the risk decreasing effect of securitizations. According to Basel 2, "Exclude securitized exposures from the calculation of risk weighted assets only if all of the following conditions have been met."
- IFRS 9 (IAS 39) requires significant transfer of risk to not recognize securitization exposures

- Some securitized exposures are included in balance sheet for accounting purpose whereas not taken into account in the calculation of regulatory capital
  - Special purpose vehicle (SPV) need to be consolidated in the financial statements if the bank owns majority of risk and return

Netting assets - liabilities

- Basel 2 recognizes under some conditions the Assets/Liabilities netting agreement. "Where banks have legally enforceable netting arrangements for loans and deposits, they may calculate capital requirements on the basis of net credit exposures subject to the conditions in paragraph 188." Paragraph 139
- IFRS (IAS 32) more rigorous for using assets/liabilities netting approach (e.g. financial assets and liabilities explicitly included in financial statements)

- Some assets excludes from risk weighted assets due to netting purpose while explicitly presented in financial statements
  - Assets /Liabilities financial derivatives

Segment reporting

- Basel 2 proposes eight business lines (segment) to calculate capital required to face losses due to operational risks: Corporate finance, Trading and sales, Retail banking, Commercial banking, Payment and settlement, Agency services, Asset management and Retail brokerage
- IFRS (IAS 14) requires the determination of primary business lines based on the company specific risk and return drivers and company internal management reporting

- Basel 2 and IFRS propose different business lines
- Need to set up a mapping program to align Basel 2 and IFRS segment identification

Risk disclosure (IFRS 7 versus Basel 2 Pillar 3)

Key Similarities

- Key objective to increase transparency of financial institutions through risk disclosure
- Emphasize on the importance of qualitative and quantitative risk information disclosure
- Require disclosure of risk mitigation techniques

Key Differences

- IFRS 7 disclosure requirements subject to audit which is not the case for Basel 2
- Specific disclosure required by Basel 2 for securitization exposures which is not the case with IFRS 7
- Basel 2 requires more normative disclosure requirements comparing to IFRS 7
- According to Basel 2, level of disclosure requirements depends on capital calculation approach (e.g. AIRB versus Standardized approach)

Questions ???