Capital treatment of certain items under IFRS

15 December 2004

Further to its press releases of 8 June and 20 July, the Basel Committee on Banking Supervision (the Committee) has considered additional issues related to the potential impact on regulatory capital of the implementation of certain International Financial Reporting Standards (IFRS). The Committee encourages national supervisors in jurisdictions implementing IFRS to consider the following points.

The Committee's intention to carry out a review of the definition of regulatory capital at a later stage is explained in paragraph 17 of the "International Convergence of Capital Measurement and Capital Standards: A Revised Framework" (Revised Framework) published on 26 June 2004.

Available-for-sale instruments

Under IAS 39, the cumulative fair value gains and losses on available-for-sale instruments are recognised directly in equity, while impairment losses on these instruments are recognised in the profit and loss account.

- The Committee believes that there should be no regulatory adjustments made to impairment losses; as such, the result is a reduction in Tier 1 capital. Impairment losses should also not be netted against an unrealised gain that is reflected directly in equity.
- The Committee encourages national supervisors to consider excluding unrealised gains and losses on loans designated as available-for-sale from the regulatory definition of Tier 1 and Tier 2 capital.
- The Committee feels that it may be appropriate for national supervisors to allow partial recognition of unrealised gains on available-for-sale equity securities in Tier 2 capital. The level of partial recognition could be set, for example, by using the 55% haircut applied to latent revaluation reserves as described in the 1988 Basel Capital Accord or by considering the amount of gain after the effect of taxes. The Committee also believes it appropriate to deduct from Tier 1 capital any cumulative unrealised losses below the cost of available-for-sale equity securities.
- Supervisors should decide whether to treat unrealised gains and losses on available-for-sale debt securities in the same manner as on loans or equity securities.

In cases where unrealised gains are not included in regulatory capital but are recognised directly in equity on a post-tax basis for

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List of 2004 press releases

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accounting purposes, national supervisors may wish to consider reversing - for the calculation of regulatory capital - any deferred tax liabilities arising from such gains.

On a related issue, the Committee also encourages national supervisors to consider a consistent treatment of gains and losses resulting from a transaction in which a cash flow hedge is created for an available-for-sale instrument or a forecast transaction. In other words, if the gains on the hedged item are recognised in Tier 2 capital, the losses on the hedging instrument could be recognised as an adjustment to Tier 2 capital; conversely, if the gains and losses on the hedged item are not recognised for capital purposes, the losses and gains on the hedging instrument could also be excluded. Similarly, in the case of cash flow hedges of forecast transactions, since forecast transactions themselves are not recognised on the balance sheet, the cumulative gains and losses on the hedging instrument that are recognised directly in equity could also be excluded for regulatory capital purposes.

Own-use and investment properties

In the context of IAS 16 and IAS 40, in cases where the fair value model is applied, the Committee feels that caution should be exercised if national supervisors allow partial recognition of unrealised gains on both own-use and investment property in Tier 2 capital. The level of partial inclusion could be set in a similar manner as for available-for-sale equity securities. The Committee encourages supervisors to consider deducting any cumulative losses below the depreciated cost value from Tier 1 capital for both own-use and investment property. In the case of own-use property, it also encourages supervisors to consider not allowing the netting of losses that are recognised in the profit and loss account against unrealised gains that are reflected directly in equity.

In cases where the cost method is applied, the Committee believes that there is no need to adjust regulatory capital. A possible exception may arise, however, with respect to unrealised gains resulting from the first-time application of the cost method on both own-use and investment property. National supervisors may wish to consider allowing such gains in Tier 2 capital and to require banks to disclose the amount of such gains.

Exposure measurement

As a general rule, the Committee encourages national supervisors to consider defining the exposure amount of an asset for the purpose of calculating risk weighted assets such that it is no less than the amount by which the bank's regulatory capital would be reduced if the exposure were fully written off. This rule would be especially relevant for available-for-sale instruments and properties under the fair value model.

Scope of consolidation, derecognition and securitisation

The Committee has received questions on the relationship between the securitisation treatment under the Revised Framework and the scope of consolidation and derecognition under IFRS. It is the Committee's view that the securitisation treatment contained in the Revised Framework should be seen as independent of a transaction's accounting treatment.

The fair value option

The Committee will continue to consider the potential effects of the use of the fair value option under IAS 39. Banks are reminded that regulatory capital measures adopted by national supervisors in the interim with respect to this option may be subject to change, once the IASB has finalised the accounting treatment of this option. In the meantime, as it stated in its 20 July press release, the Committee encourages national supervisors in jurisdictions implementing IFRS to consider requiring their banks to track and report the impact on the carrying value of financial instruments and the unrealised gains and losses accumulated in retained earnings related to any use of the fair value option that may be available.
