



LESSONS FROM THE CURRENT CRISIS FOR PRUDENTIAL REGULATION: INTRODUCING COUNTER-CYCLICALITY INTO BASEL II

AN ACCOUNTING PERSPECTIVE

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DEFINITIONS

INCURRED LOSS
(Current IFRS)

Provide only where there is objective evidence that a loss has occurred at reporting date

EXPECTED LOSS

Provide for all expected losses based on loans on balance sheet at reporting date. Expected loss based on conditions at reporting date.

FAIRVALUE

All loans recorded at fair value so includes expected loss at reporting date but also adjustments for other risks

**“THROUGH THE CYCLE”
PROVISIONING**

Any method that adjusts actual losses by an additional charge to reflect the average historical loan losses on the portfolio over an economic cycle

“DYNAMIC” PROVISIONING

Widely used phrase with no common definition

DIFFERENT OBJECTIVES OF PRUDENTIAL REGULATION AND ACCOUNTING STANDARDS

- Accounting standards seek to reflect performance over (typically) a one year horizon
 - i.e. Reflect effects within accounts as economic cycle changes
- Prudential regulation is focussed on stability
 - i.e. Inbuilt incentive to apply smoothing factor to impairment charges



WHAT IS CAPITAL FOR?

(1) A buffer for unexpected losses

Or

(2) To absorb fluctuations from both unexpected losses and volatility in expected losses

COMPATABILITY WITH ACCOUNTING FRAMEWORK - 1

- Incurred loss meets basic principle of recording events in the period in which they occur.
- Expected loss reflects conditions at the balance sheet date

Current accounting framework is a mixed model of historical cost and fair value so both incurred and expected loss can fit within it

COMPATABILITY WITH ACCOUNTING FRAMEWORK - 2

Through the cycle provisioning implies either or both

(1) Providing for loans not yet made

(2) Providing for future economic conditions

Both of these are incompatible with current accounting framework





CAN THE ACCOUNTING STANDARDS AND PRUDENTIAL

- Accounting GAAP Vs Regulatory GAAP?
- Same GAAP but different capital definitions?

A BALANCE SHEET RESERVING MODEL

- Calculate the accounting provision under either incurred or expected loss → Performance Statement
- Calculate the “Through the Cycle” provision adjustment → Reserves Allocation

The allocated reserve:

- Does not go through performance statement
- Is not part of Capital for Regulatory purposes



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