



# 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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