



Australian Prudential Regulation Authority

Adoption of International Financial Reporting Standards

Prudential approach I Fair value and other issues

Discussion Paper

24th February 2005

Background

Australian reporting entities are adopting Australian equivalents of International Financial Reporting Standards (IFRS) for reporting periods beginning on or after 1 January 2005. The accounting standards that apply are available from the Australian Accounting Standards Board's (AASB) website (www.aasb.com.au).

APRA is taking a measured approach to evaluating the financial and prudential implications of IFRS for APRA-regulated industries. This includes considering the position of other prudential standard-setters and regulatory bodies as well as concurrent regulatory developments such as general insurance reform and the introduction of the Basel II Framework.

In November 2004, APRA issued an Overview Paper, *Adoption of International Financial Reporting Standards - Prudential Implications*, in which it indicated that it would consult extensively with regulated institutions to better understand the quantitative impact of IFRS. Since the Overview Paper was issued, there have been a number of international developments with regard to IFRS and international regulators have provided a greater degree of certainty on the capital treatment of certain items under IFRS. APRA has taken these recent developments into account.

APRA's objective in its approach to IFRS is to align its prudential and reporting standards with Australian accounting standards and principles to the extent practicable, as the latter provide a widely accepted basis for the recognition and measurement of assets, liabilities, equity, revenue and expenses.

In certain circumstances, however, APRA's prudential framework will depart from accounting standards. APRA's prudential framework and supervisory approach is forward-looking and primarily risk-based, with a focus on an institution's ability to meet its financial promises to beneficiaries (ie depositors and policyholders) even in adverse circumstances. General purpose financial reports, however, are focussed on evaluating the interests of economic owners of an institution on a going concern basis and reporting on past transactions and events.

The impact of IFRS is not uniform across APRA-regulated industries and institutions. In particular, Australia already has a market value based approach for both general purpose financial reporting and prudential requirements in the general insurance and life insurance industries which approximates, in most instances, the fair value approach encouraged by IFRS. As discussed in the Overview Paper, the adoption of IFRS is expected to have the most impact on authorised deposit-taking institutions (ADIs).

The changes to Australian accounting standards that flow from the adoption of IFRS, if left unadjusted, would automatically flow through to APRA's prudential and reporting framework. APRA will maintain the intent and integrity of its existing framework until it has the opportunity to consider the prudential implications of IFRS and to clarify its prudential approach. APRA is making appropriate determinations to achieve this.

Invitation to comment

This Discussion Paper sets out how APRA proposes to address the prudential implications of a number of specific IFRS-related changes to Australian accounting standards. These are:

- fair value measurement;
- non-accrual loans and deferred acquisition costs;

- treatment of hedges;
- available for sale financial assets;
- property;
- excess of market value over net assets (EMVONA);
- loan loss provisioning;
- employer sponsored defined benefit superannuation plans; and
- other issues

APRA's intention is that these proposals will take effect from 1 January 2006. Appropriate transitional arrangements will be allowed for materially affected entities.

A subsequent Discussion Paper will deal with the treatment of eligible Tier 1 capital instruments and securitisation. The two Papers will be followed by consultation on changes to prudential standards and prudential rules made under the *Banking Act 1959*, the *Insurance Act 1973* and the *Life Insurance Act 1995*, and reporting standards made under the *Financial Sector (Collection of Data) Act 2001*.

There are other areas where the prudential implications of IFRS will be better understood once IFRS has been implemented. These areas include AASB 2 *Share based payments*; AASB 3 *Business Combinations*; AASB 117 *Leases*; AASB 131 *Interests in Joint Ventures*; AASB 132 *Financial Instruments: Disclosure and Presentation*; AASB 136 *Impairment of Assets* and AASB 137 *Provisions, Contingent Liabilities and Contingent Assets*. For prudential purposes, APRA proposes to follow the accounting approach in these areas for the present but will monitor the effects of these IFRS changes and consult where appropriate.

APRA welcomes comments on the proposals in this Discussion Paper, which should be submitted via email no later than 29th April 2005 to:

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1. SUMMARY OF PROPOSED PRUDENTIAL APPROACH

1. Fair value measurement

As an initial measure, ADIs will need to identify and report to APRA the impact of the use of the fair value option on the carrying value of financial instruments and unrealised gains and losses accumulated in retained earnings. APRA proposes to restrict the use of fair values for illiquid financial instruments (loans, receivables and other illiquid instruments) in the banking book. ADIs will also be required to eliminate from regulatory capital any unrealised fair value gains and losses arising from changes in an ADI's own creditworthiness as a result of applying the fair value option to its liabilities.

APRA is liaising with the Life Insurance Actuarial Standards Board (LIASB) to determine the most appropriate approach for life insurers and friendly societies.

In the case of general insurers, APRA proposes to retain its current valuation methodologies.

2. Non-accrual loans and deferred acquisition costs (DAC)

APRA intends to retain its existing treatment for the recognition of interest revenue on non-accrual loans for the ADI industry.

APRA does not intend to change its current approach to DAC assets for general insurers.

3. Treatment of hedges

Under AASB 139, cumulative gains and losses on cash flow hedges that are effective are recognised directly in equity. For regulatory capital purposes, APRA proposes to exclude these cumulative gains and losses from the definition of Tier 1 and Tier 2 capital. APRA will not adjust the accounting treatment of other hedges and will not make changes to the definition of the trading book and to the regulatory capital treatment of derivatives.

4. Available for sale assets

APRA proposes that ADIs continue to record loans and receivables at amortised cost. The existing regulatory capital treatment for revaluation reserves recognised in Upper Tier 2 capital will continue to apply to quoted readily marketable securities (debt and equity) recorded in the available for sale assets category.

5. Property

For ADIs, APRA proposes to introduce a consistent regulatory capital treatment for owner-occupied and investment property. An amount of 45 per cent of pre-tax revaluation reserves on owner-occupied property or fair value gains on investment property will be allowed in Upper Tier 2 capital, if APRA's requirements are met.

6. Excess of market value over net assets (EMVONA)

APRA proposes to remove all components of EMVONA as an asset for regulatory capital purposes.

7. Loan loss provisioning

APRA proposes that ADIs should hold a “General Reserve for Credit losses” for inclusion in Upper Tier 2 capital, subject to a maximum of 1.25 per cent of total risk-weighted exposures.

8. Employer sponsored defined benefit surpluses and deficits

APRA proposes that employer sponsored defined benefit fund surpluses and deficits be recognised on a gross basis for prudential purposes. APRA proposes not to recognise superannuation fund surpluses in Tier 1 capital and to recognise superannuation fund deficits as a liability for regulatory capital purposes.

2. PRUDENTIAL ISSUES

2.1. Fair value measurement

2.1.1. The issues

Australian accounting standards in place prior to the implementation of IFRS lacked specific guidance on the measurement of financial assets and liabilities. Financial assets of ADIs have generally been recognised at historical cost or amortised cost¹ unless these assets were trading assets, which were “marked-to-market” (a close approximation to “fair value”). Financial liabilities of ADIs have generally been recognised at amortised cost. At present, Australian general and life insurers operate in a net market value based environment that closely approximates fair value in most instances. APRA’s current prudential approach has been broadly based on this accounting framework.

AASB 139 *Financial Instruments: Recognition and Measurement* applies a mixed measurement model to financial assets and liabilities. AASB 139 classifies financial assets into four categories:

- financial assets that are held for trading or otherwise designated at fair value through profit or loss;
- held to maturity assets (measured at amortised cost);
- loans and receivables (measured at amortised cost); and
- available for sale assets (measured at fair value with adjustments to equity).

Financial liabilities, on the other hand, are generally to be recognised at amortised cost using the effective interest rate method², although AASB 139 does allow them to be designated at fair value through profit and loss.³

This mixed measurement model allows some financial assets and liabilities to be measured at fair value and other financial assets and liabilities at amortised cost.

The fair value option

An entity may designate, at inception, any financial asset or liability to be measured at fair value, with gains or losses in fair value flowing through the profit and loss account (the fair value option). In the case of ADIs, this will have consequences for the measurement of retained earnings and, hence, Tier 1 capital.

The fair value option has been the subject of ongoing international debate for some time now. The International Accounting Standards Board (IASB) is currently considering

¹ The amortised cost of a financial asset or financial liability is the amount at which the financial asset or financial liability is measured at initial recognition minus principal repayments, plus or minus the cumulative amortisation (using the effective interest method) of any difference between that initial amount and the maturity amount, and minus any reduction (directly or through the use of an allowance account) for impairment or uncollectability. See AASB 139.

² The effective interest method is a method of calculating the amortised cost of a financial asset or a financial liability and of allocating the interest income or interest expense over the relevant period. The effective interest rate is the rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial instrument (or, when appropriate, a shorter period) to the net carrying amount of the financial asset or financial liability. See AASB 139.

³ See AASB 139 (paragraph 47) for financial liabilities that are not measured at amortised cost.

proposals to restrict the scope of application of the fair value option and at least one jurisdiction, the European Union, has carved out the fair value option from its version of IFRS standards. The Basel Committee on Banking Supervision (Basel Committee) has, as an initial measure, encouraged supervisors to consider requiring their banks to track and report the impact on the carrying value of financial instruments and unrealised gains and losses accumulated in retained earnings related to any use of the fair value option⁴.

International banking regulators are agreed on the prudential treatment of one specific application of the fair value option. This relates to any gains and losses arising from changes in an institution's own creditworthiness as a result of applying the fair value option to its liabilities.⁵ The Basel Committee believes that the inclusion of these gains and losses in regulatory capital raises significant supervisory concerns and is of the view that they should be excluded.⁶

APRA also has concerns about the application of the fair value option to financial assets and liabilities of ADIs whose fair value is not verifiable. This would be the case for instruments which do not have observable market prices arising from active markets. Loans and receivables are the obvious example but other illiquid instruments in the banking book could be cause for concern if they cannot be reliably measured at fair value.⁷

For life and general insurers, the option to measure financial assets and liabilities at fair value is broadly consistent with the current net market value based approach. However, it is possible that some assets previously measured at net market value (essentially those not backing policy liabilities) may not, in the future, be measured at fair value. The treatment by life insurers and friendly societies of assets not measured at fair value is being considered by the LIASB in liaison with APRA.

The fair value option would appear to have no material impact on general insurers. General insurers report to APRA on a prospective basis, whereas accounting standards adopt a deferral and matching basis.

2.1.2. APRA's proposed approach

APRA will continue to consider the prudential implications of the fair value option and international regulatory precedent as it is established. In the interim, APRA's proposed approach in the case of ADIs is to:

- continue to recognise loans and receivables at amortised cost;
- not allow the fair value option to be applied to illiquid financial instruments in the banking book. APRA is seeking comment on this position from ADIs, which are requested to provide specific details on the nature of the illiquid instruments and to quantify the impact on capital;

⁴ BIS Press Release, "Capital treatment of certain items under IFRS", 15 December 2004.

⁵ The fair value of debt instruments issued by an entity could change whenever its credit ratings change. A deterioration in an entity's credit standing, for example, could cause the price of debt issued by the entity to fall. This could result in a decrease in the liability with an accounting gain being recognised in the current year's profit and loss statement (Tier 1 capital). Similarly, an increase in the credit rating could result in an increase in the fair value of liabilities. This would result in a loss being recognised in the current year's profit and loss statement (Tier 1 capital).

⁶ BIS Press Release, "Regulatory changes in light of forthcoming changes in accounting standards", 8 June 2004.

⁷ An illiquid financial instrument is a financial instrument without a verifiable fair value. If fair values can be credibly inferred, they can be acceptable. Examples include where there exists a similar financial instrument that actually trades in a liquid market, or where an illiquid financial instrument can be rigorously broken down into components for which prices can be taken from liquid markets or from sound valuation approaches.

- follow the Basel Committee approach and eliminate, for regulatory capital purposes, unrealised fair value gains and losses arising from changes in an ADI's own creditworthiness; and
- as an initial measure, require ADIs to identify and report to APRA the impact of the use of the fair value option on the carrying value of financial instruments and the unrealised gains and losses accumulated in retained earnings. APRA will develop templates and instructions for this tracking exercise.

In the case of general insurers, APRA proposes to retain its current valuation methodologies. For life insurers and friendly societies, it proposes to follow the treatment emerging from its liaison with the LIASB.

2.2. Non-accrual loans and deferred acquisition costs

2.2.1 The issues

As noted above, AASB 139 requires the value of assets and liabilities measured at amortised cost to be determined using only the effective interest rate method. This method takes into account transactions costs, including fees and commissions paid to agents, advisers, brokers and dealers, levies by regulatory agencies and securities exchanges, and transfer tax and duties. Transactions costs arise across all APRA-regulated industries. In general and life insurance, some transaction costs are referred to as acquisition costs, which may either be deferred or expensed.

For the ADI industry, the effective interest rate method in AASB 139 is potentially inconsistent with APRA's current treatment of revenue recognition for non-accrual loans in *APS 220 Credit Quality*.

The effective interest rate method allows interest on non-accrual loans to be included as part of the cash flow to determine the amortised cost. Current market practice is aligned with the prudential requirement in APS 220 for recognising interest revenue on non-accrual items:

“When an impaired asset is classified as non-accrual, an ADI should cease to recognise interest and other income earned but not yet received. Any accrued but unpaid interest and other income should generally be reversed back to the last reporting date or the date when interest and other income was last paid, whichever is more recent. Unpaid interest or other income dating back prior to the last reporting date should be reviewed to establish ultimate collectability and a provision against loss raised as appropriate.” (paragraph 7)

For general insurers, accounting requirements prior to IFRS specifically state that acquisition costs are incurred in obtaining and recording policies of insurance. These transaction costs include commission or brokerage paid to agents or brokers for obtaining business for the insurer, selling and underwriting costs such as advertising and risk assessment, the administrative costs of recording policy information and premium collection costs. Deferred acquisition costs (DAC) are required to be amortised over the period of expected benefit, but there is no specific basis of amortisation. Accordingly, the straight line or the effective interest method may be used for amortisation of these costs. The revised AASB 1023 *General Insurance Contracts* requires the amortisation of DAC in accordance with the expected pattern of incidence of risk under the related general insurance contract.

For general insurers, DAC assets are not recognised for prudential purposes and are excluded from the calculation of Tier 1 capital. A change to the basis for amortisation of DAC assets does not, therefore, have prudential implications.

For life insurers, acquisition expenses have in the past been fully expensed. However, the calculation of policy liabilities was effectively reduced to the extent that acquisition expenses were expected to be recovered from future revenues. Under the revised AASB 1038 *Life Insurance Contracts*, investment contracts (ie contracts issued by a life insurer that do not meet the definition of an insurance contract) will no longer be subject to this accounting treatment. Investment contracts that contain a management services component are subject to AASB 118 *Revenue*.

Under AASB 118, a DAC asset may be recognised on the balance sheet to the extent that relevant acquisition expenses that are allowed to be deferred can be recovered from future management services revenues. This asset may be amortised consistent with the straight line amortisation of DAC by general insurers, rather than in accordance with the expected future pattern of revenues (which is the current life insurance practice). The acquisition costs need to be incremental (effectively excluding overheads). Hence, the level of acquisition costs able to be deferred will be less than is allowed in the current liability calculations for life insurers. Where AASB 118 is applied to the amortisation of acquisition costs for life investment contracts, the impacts will be:

- recognition of a DAC asset on the balance sheet (rather than as an offset to the liability);
- a lower level of DAC than is implicit in existing liability calculations; and
- amortisation of the DAC asset in a manner which may differ from that implicit in existing liability calculations.

2.2.2 APRA's proposed approach

APRA intends to retain its existing treatment for the recognition of interest revenue on non-accrual loans for the ADI industry. APRA also does not intend to change its current approach to DAC assets for general insurers.

APRA is discussing with the LIASB whether the prudential reporting requirements for life insurers should allow DAC to be presented as an asset or continue to be held as an offset to liabilities. APRA's aim is to achieve a prudential outcome that is broadly equivalent to the *status quo*. The results of recent analysis of the effects of IFRS on life insurers and friendly societies will be considered. If DAC is to be treated as an asset, the solvency and capital adequacy standards will need to be amended accordingly. Further papers on this issue will be released by the LIASB.

2.3 Treatment of hedges

2.3.1 The issues

Australian accounting standards applying prior to the implementation of IFRS lacked a detailed and rigorous framework for designating assets and liabilities as hedges, and for classifying hedge transactions.

AASB 139 identifies four types of hedge transactions and specifies their accounting treatment. The four types are:

- fair value hedges⁸;
- cash flow hedges⁹;
- hedge of a net investment; and
- portfolio hedge of interest rate risk.

In practice, a fair value hedge is used to offset fair value changes in an asset, liability or firm commitment. Cash flow hedges are used to hedge cash flows of a forecasted transaction or an existing floating rate asset or liability, which would be measured at amortised cost.

AASB 139 also introduces specific qualification requirements for these types of hedge transactions. It requires that the hedging relationship be defined by designation and properly documented, be reliably measurable and actually effective at inception of the hedge transaction and throughout its life. A hedge is regarded as effective if 80 to 125 per cent of the hedged risk on a hedged item is offset by changes in the fair value or cash flows of the hedging instrument. Ineffective hedges are recognised immediately in the profit or loss account.

In the case of fair value hedges, fair value gains or losses on the hedging instrument as a result of market price changes are recognised in profit or loss, together with the offsetting change in the fair value of the hedged item. The effect is that the changes in fair value on both the hedged item and the hedging instrument are recognised in the same period and any ineffectiveness of the hedge is recognised in profit or loss.

In the case of cash flow hedges, however, the AASB 139 accounting rules require the portion of the fair value gain or loss on the cash flow hedging instrument that is determined to be an effective hedge to be recorded in equity, with no corresponding loss or gain recorded against the hedged exposure. As a result, the movements in the hedging instrument and the hedged item do not offset each other. This asymmetry in the treatment of cash flow hedges is a prudential concern because it leads to spurious volatility in accounting measures of equity and in regulatory capital. The Basel Committee has recommended excluding from the definition of regulatory capital cumulative fair value gains and losses on cash flow hedges that are recognised directly in equity.¹⁰

2.3.2 APRA's proposed approach

APRA proposes to:

- follow the Basel Committee recommendation¹¹ in not making adjustments to the definition of the trading book for purposes of APS 113 *Capital Adequacy: Market Risk*;
- leave the AASB 139 treatment of fair value hedges, hedge of a net investment and portfolio hedges of interest rate risk unchanged;

⁸ A fair value hedge is a hedge of the exposure to changes in fair value of a recognised asset or liability or an unrecognised firm commitment, or an identified portion of such an asset, liability or firm commitment, that is attributable to a particular risk and could affect profit or loss (AASB 139, paragraph 86).

⁹ A cash flow hedge is defined as a hedge of the exposure to variability in cash flows that (a) is attributable to a particular risk associated with a recognised asset or liability (such as all or some future payments on variable rate debt) or a highly probably forecast transaction and (b) could affect profit or loss (AASB 139, paragraph 86).

¹⁰ BIS Press Release "Regulatory capital in light of forthcoming changes in accounting standards", 8 June 2004.

¹¹ BIS Press Release "Capital treatment of certain items under IFRS", 20 July 2004

- adopt the approach recommended by the Basel Committee on the treatment of cash flow hedges for regulatory capital purposes. This means that cumulative gains and losses on cash flow hedges that are recognised directly in equity will be excluded from the definition of Tier 1 and Tier 2 capital; and
- apply the current method with respect to the calculation of counterparty risk for derivatives - i.e., the amount to be risk-weighted for a derivative will continue to be the loan equivalent amount of the derivative¹². This method is likely to be amended under the Basel II Framework.

2.4 Available for sale assets

2.4.1 The issues

Under AASB 139, available for sale assets are those non-derivative financial assets that are designated as available for sale or that are not classified as loans and receivables, held to maturity investments or financial assets designated at fair value through profit or loss.¹³ The available for sale category can include equities, debt securities, loans and receivables. Available for sale assets are measured at fair value with gains and losses recognised directly in equity using a revaluation reserve. This revaluation reserve is transferred to the profit and loss account when the asset is sold or impaired.

From a prudential perspective, the issue is whether such revaluation reserves should be allowed to flow through to regulatory capital. Some of the assets (eg loans) may not be actively traded and hence a recorded unrealised gain may not be of sufficient quality to absorb losses and to be included in regulatory capital.

The Basel Committee has provided some guidance on the issue by allowing partial recognition of unrealised gains on available for sale equities in Tier 2 capital.¹⁴ It suggests that the level of partial recognition could be set, for example, by using the figure of 45 per cent of 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 encourages supervisors to exclude unrealised gains and losses on loans designated as available for sale from the definition of Tier 1 and Tier 2 capital.

APRA's current prudential regime for ADIs provides a prudential treatment for revaluation reserves for quoted readily marketable securities (both debt and equity). Specifically, AGN 111.2 *Tier 2 Capital* allows 45 per cent of the net revaluation surplus for such securities to be included in Upper Tier 2 capital, provided the securities meet the following conditions:

- the securities must be directly held by an ADI or one of its entities at Level 2;
- the reserves must be shown as a component of equity in the statement of financial position; and
- the reserves must incorporate the amount of any diminution in the value of the securities (ie the reserves must be net of any devaluations).

¹² The loan equivalent amount of a derivative is the positive fair value of the derivative plus an additional amount for the potential future exposure. This potential future exposure is the notional amount of the derivative multiplied by an add-on factor.

¹³ AASB 139, paragraph 9.

¹⁴ BIS Press Release, "Capital treatment of certain items under IFRS", 15 December 2004.

For general insurers, the treatment of revaluation reserves for available for sale assets is not explicit in the current prudential standards, with the result that such reserves form part of Tier 1 capital. APRA's Discussion Paper, *Prudential Supervision of General Insurance - Stage 2 Reforms*, released in November 2003, proposed that APRA align these aspects of the definition of capital for general insurers with that in place for ADIs. Consideration of this issue is not yet complete.

For life insurers and friendly societies, all available for sale assets are currently valued at net market value, which is a close approximation to fair value.

2.4.2 APRA's proposed approach

APRA proposes to maintain the *status quo* for ADIs in respect of available for sale financial assets. APRA would continue to require loans and receivables to be recorded at amortised cost. It would also continue to allow 45 per cent of net revaluation surpluses on quoted readily marketable securities designated as available for sale assets to be included in Upper Tier 2 capital, if the conditions in AGN 111.2 are met.

The Basel Committee has stated that "it is appropriate to deduct from tier 1 capital any cumulative unrealised losses below the cost of available-for-sale securities". APRA agrees with this view. Any cumulative losses in excess of the revaluation reserve for available for sale assets should be deducted from Tier 1 capital.

As a general principle across all asset categories, APRA proposes not to allow any regulatory adjustment for impairment losses. Those losses should always be taken into account via profit or loss and deducted from Tier 1 capital. Impairment losses on available for sale assets should not be netted against an unrealised gain that is reflected directly in revaluation reserve.

APRA is proposing a consistent treatment between the prudential treatment of the revaluation reserves and the exposure to be risk-weighted. If gains and losses on an exposure are added or subtracted from regulatory capital, it would be appropriate to add or subtract them from the exposure amount to be risk-weighted as well. If the gains or losses are only partially included in regulatory capital, APRA will require that the gross amount is added to or subtracted from the exposure. In other words, the book value may be used for risk-weighting the exposure.

APRA is also proposing 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. For available for sale assets, the gains on the hedged item are recognised in Upper Tier 2 capital and the losses on the hedging instrument should also be recognised as an as Upper Tier 2 capital. 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 should be excluded for regulatory capital purposes.

2.5 Property

2.5.1 The issues

Australian accounting requirements prior to the implementation of IFRS did not draw a distinction between owner-occupied (or "own use") and investment property. IFRS draws this distinction and prescribes specific accounting treatments for owner-occupied property and investment property.

For owner-occupied property, AASB 116 *Property, Plant and Equipment* allows a choice between the “cost model” and the “revaluation model”. The latter allows revaluations of such property, with unrealised gains and losses resulting from revaluations recorded directly in equity in a revaluation reserve. An annual depreciation charge is usually recognised in profit and loss.

AASB 140 *Investment Property* deals with investment property and allows a choice between the “cost model” and the “fair value model”. Under the latter model, the fair value of a property must represent market conditions as at the reporting date. Fair value gains or losses flow through profit or loss (Tier 1 capital), a treatment that has some similarity with the fair value option for financial instruments. Whatever accounting policy is chosen must apply to all of an entity’s investment property.

APRA currently allows 100 per cent of post-tax revaluations on owner-occupied property in Upper Tier 2 capital for ADIs if certain conditions are met. The conditions require that:

- the premises must be owned by an ADI or one of its entities at Level 2;
- the reserves must be shown as a component of equity in the statement of financial position;
- the revaluations must be conducted regularly and subject to an audit or review consistent with Australian Accounting and Auditing Standards; and
- the amount of reserves to be included in Upper Tier 2 capital must incorporate the full effect of any diminution in the values of premises (i.e., the reserves must be net of any devaluations) and should allow for expected realisation costs and associated taxes.

APRA’s current prudential regime does not provide any guidance on the treatment of investment property.

The Basel Committee has suggested that supervisors should be cautious in allowing partial recognition of unrealised gains on both owner-occupied and investment property in Tier 2 capital. It suggests that the level of partial inclusion could be set in a manner similar to that for available for sale equities. That is, the amount that could be allowed would be 45 per cent of pre-tax asset revaluations in Upper Tier 2 capital.

2.5.2 APRA’s proposed approach

APRA proposes to introduce a consistent approach to the regulatory capital treatment for owner-occupied and investment property by ADIs, and one that would be in line with the Basel Committee’s approach. For ADIs that choose the “revaluation” model for owner-occupied property and the “fair value model” for investment property, an amount of 45 per cent of pre-tax asset revaluations would be allowed in Upper Tier 2 capital, if the existing conditions are met. In the case of owner-occupied property, losses that are recognised in the profit and loss account must not be netted against unrealised gains that are reflected directly in revaluation reserve.

For ADIs that choose the “cost model” in both cases, no adjustment to regulatory capital is needed. However, APRA proposes to allow unrealised gains resulting from the first-time application of the cost method to both owner-occupied and investment property to be included in Upper Tier 2 capital, but will require ADIs to disclose the amount of such gains on transition to IFRS.

2.6 Excess of market value over net assets (EMVONA)

2.6.1 The issues

EMVONA is the excess of the net market value of an interest in a subsidiary over the net amount of the subsidiary's assets and liabilities. EMVONA arises in consolidated financial reports of life insurers and investments by life insurers in subsidiaries. Accounting rules in place prior to the implementation of IFRS required the recognition of EMVONA as a separate asset in the consolidated balance sheet of the life insurer or of an ADI that has a life insurance subsidiary (or subsidiaries).

On acquisition of a financial services subsidiary by a life insurer, the net market value of the subsidiary usually comprises:

- the value of business in force (VBIF), which is the net present value of the expected distributable profits of business in force at that time; plus
- the value of new business (VNB), which is the net present value of the expected distributable profits of business expected to be written over future periods of time; plus
- net tangible assets.

For a consolidated ADI, VBIF is currently treated as a tangible asset when an ADI owns a life insurance entity that forms part of the group. VNB is currently required to be deducted from Tier 1 capital whereas VBIF and net tangible assets are currently deducted from the total capital base, and therefore available for inclusion in Tier 1 capital. Under APRA's prudential framework for ADIs, intangible assets are inadmissible assets for capital adequacy purposes and are deducted from Tier 1 capital.

The revised AASB 1038 *Life Insurance Contracts* does not recognise EMVONA as an asset on the consolidated balance sheet of the life insurer. VBIF is treated as an internally generated intangible asset that cannot be recognised under IFRS (AASB 138 *Intangible Assets*) and normal consolidation requirements apply. EMVONA would have to be deducted from Tier 1 rather than total capital on IFRS adoption.

For ADIs having life insurance entities within the group, first-time adoption of IFRS will result in the removal of EMVONA as an asset, through a write-off to retained earnings (Tier 1 capital). Historically, APRA has allowed the deduction of VBIF from total capital so long as it satisfied the definition of tangible assets within the existing accounting standards. In prior instructions APRA has stated that:

“The VBIF must be accepted as a tangible asset by the relevant accounting bodies at all times and not only at the time of acquisition. Should VBIF not be accepted as a tangible asset by the relevant accounting bodies and/or ASIC, then it should be treated as goodwill [for capital purposes].”

A flow-on effect from the new Basel II Framework is that net tangible assets currently deducted from the total capital base will be deducted equally from Tier 1 and Tier 2 capital. This charge would be in addition to the write-off of VBIF against retained earnings (Tier 1 capital) on first-time adoption of IFRS. Affected entities will need to consider this aspect as part of their capital management plans and the process of transition to IFRS and Basel II.

For life insurers, all assets, including interests in subsidiaries, are measured at net market value (i.e. effectively including EMVONA) but are then subject to the relevant valuation and inadmissibility rules under the solvency, capital adequacy and management capital standards.

2.6.2 APRA's proposed approach

APRA proposes to remove all components of EMVONA as an asset for regulatory capital purposes.

For life insurers, the impact of EMVONA on the consolidated accounts does not give rise to prudential issues, since prudential standards are based on unconsolidated accounts. APRA is liaising with the LIASB to discuss the appropriate measurement of interests in subsidiaries which are not backing policy liabilities and the appropriate treatment of EMVONA in determining the solvency and capital adequacy reserves for inadmissible assets, having regard to its treatment in other APRA-regulated industries.

2.7 Loan loss provisioning

2.7.1 The issues

General provisions provide a buffer against future deterioration in loan quality, but one that is not generally available to support incurred and incurred but not reported losses. These losses which can be ascribed to individual facilities or portfolios are covered by specific provisions. Accounting standards in place prior to implementation of IFRS have allowed ADIs to raise general provisions for future and expected loan losses.

APS 220 *Credit Quality* encourages an ADI to hold a level of general and specific provisions at least sufficient to absorb estimated losses associated with the credit portfolio. An ADI has two options to calculate its specific provisions: an internal-model-based approach (set out in AGN 220.2) and a prescribed approach (set out in AGN 220.3). Regardless of the option chosen, an ADI is also required to establish adequate general provisions to cover losses known to exist in a credit portfolio but which cannot be ascribed to individual facilities or portfolios. Under the current prudential framework, APRA has set a benchmark of 0.5 per cent of total risk-weighted credit risk assets against which it will assess the adequacy of an ADI's general provisions.

AASB 139 requires provisions for impairment to be recognised on an incurred and incurred-but-not reported basis. Hence, it allows specific provisions for impairment on loan portfolios but not general provisions for expected but not incurred losses. Entities will therefore need to reclassify a portion of general provisions as specific provisions (if they are raised to cover incurred and incurred-but-not-reported losses) and/or release the excess provision into retained earnings. This is in effect a reclassification of Upper Tier 2 capital to Tier 1 capital on IFRS adoption, which has prudential implications.

The extinguishing of general provisions on IFRS adoption and the subsequent payment of dividends from retained earnings could lead to a decline in the overall capital position of ADIs. ADIs operating near their minimum capital target may need to raise additional capital to ensure that they meet their target.

APRA notes that the Basel Committee is working with the IASB to reconcile loan loss provisioning estimates under IFRS and the Basel II Framework.

2.7.2 APRA's proposed approach

For the time being, APRA intends to replicate its current prudential approach to provisioning, in a format that is consistent with IFRS requirements. To achieve this, general provisions will become a reserve within equity.

APRA proposes that, for regulatory capital reporting, ADIs should create a general provision as an equity reserve called "General Reserve for Credit Losses". This equity reserve would be created from retained earnings using an appropriation account and should be calculated in accordance with APRA's current prudential requirements.

The amount held in the General Reserve for Credit Losses will be deducted from Tier 1 and added to Upper Tier 2 capital for prudential purposes. The amount included in Upper Tier 2 capital should be net of any associated deferred tax asset on a gross basis¹⁵ and limited to a maximum of 1.25 per cent of total risk-weighted exposures (AGN 111.2). APRA is not proposing any changes to its prudential approach to the calculation of specific provisions.

2.8 Employer sponsored defined benefit superannuation plans

2.8.1 The issues

Prior to the implementation of IFRS there was no prescribed accounting treatment for surpluses and deficits in an employer sponsored defined benefit superannuation plan. AASB 119 *Employee Benefits* requires the net of accrued surpluses and deficits in such plans to be recognised on the statement of financial position when IFRS is initially adopted¹⁶ and subsequent net movements in plan asset or liabilities to be recorded in the profit and loss statement¹⁷.

From a prudential perspective, issues arise over the ownership of a surplus of a defined benefit plan and the treatment of surpluses and deficits in determining regulatory capital.

The beneficial ownership of a surplus in a defined benefit superannuation plan is not straightforward and can depend on the specific terms of the trust deed and the trustee's duties and responsibilities, both under common law and statute. A surplus may revert to the members of the plan, or it may be the property of the plan itself (and by extension the trustee of the plan) and thus be available for distribution between members and employers. Alternatively, the surplus may not belong to anyone, in which case its ownership remains legally uncertain.

Under the *Superannuation Industry (Supervision) Act 1993* (the SIS Act), trustees must resolve any conflicts of interest in favour of members. This increases the probability that any notional surplus will be unavailable to an employer sponsor, particularly if the employer sponsor is in financial difficulties or has failed. Recent case law suggests that it is difficult to presume that an employer sponsor has an unfettered ownership claim on the surplus in a plan in Australia. As a result, APRA's view is that a surplus recognised on an

¹⁵ Future income tax benefits are deferred tax assets under IFRS.

¹⁶ AASB 119 requires the Projected Unit Cost method (accrued benefit method) to be used for determining the present value of defined benefit obligations (paragraph 64).

¹⁷ The requirements in AASB 119 may be revised as a result of international developments in 2005. The current proposal being considered is to allow an additional option whereby the movement due to actuarial gains and losses is charged to Retained Earnings (Tier 1 capital). As both current year's earnings and retained earnings are Tier 1 capital items the overall capital outcome is likely to be unaltered as a result of this proposal. In addition, the AASB has recently decided to reinstate the corridor option under AASB 119.

employer sponsor's balance sheet should not be assumed to be an amount owned by the employer sponsor, and therefore it is inappropriate to include this surplus in calculations of regulatory capital.

Even if the employer sponsor can establish an ownership interest, there is a question about whether the surplus can be readily realised in the short term. The SIS Act places specific restrictions on amounts paid by an employer sponsored fund to an employer sponsor (see Section 117). Immediate access would generally require either the winding-up of the plan or agreement from the trustee to a return of the surplus. Either course of action is likely to take time, particularly if opposed by members, given the responsibilities of trustees under the SIS Act to act in the best interests of members. In practice, the most likely way an employer sponsor could realise the benefit of any surplus is to run the surplus down over time via a full or partial contributions holiday. The employer sponsor would, in effect, be realising the benefit of a prepaid expense over time.

In contrast, APRA believes it is appropriate for an employer sponsor to deduct from regulatory capital any deficit in a defined benefit superannuation plan. This reflects the responsibility of the employer sponsor to ensure that the plan is in a position to meet its promises to beneficiaries.

Under the SIS legislation, defined benefit superannuation plans must be actuarially reviewed at a minimum of every three years. The actuarial report of the review must recommend the employer contribution rates for the next three years sufficient to maintain the plan in a satisfactory financial position. The funding and solvency requirements in the SIS Regulations administered by APRA contain two solvency measures. The first is "technical insolvency" where assets are less than minimum requisite benefits¹⁸. The second is "unsatisfactory financial position" where assets are less than vested benefits¹⁹. Although the SIS legislation provides for periods of up to five years for technical insolvency to be remedied, APRA has indicated that it would generally expect employer sponsors to correct deficits more promptly. Employer sponsors must contribute at an agreed minimum contribution rate to correct deficits within the period agreed with the trustee or with APRA.

Beyond these statutory requirements, there are additional obligations on an employer to ensure funding in excess of vested benefits. Many funds provide retrenchment benefits in excess of the voluntary withdrawal benefits represented by the amount of vested benefits. APRA's primary concern is to ensure that an APRA-regulated superannuation fund has sufficient assets available to satisfy its obligations to members if the fund were placed in run-off, due perhaps to the employer sponsor's business being placed in some form of statutory administration or liquidation. The employer sponsor would need to ensure it can fund obligations to meet employee entitlements, including those funded through a superannuation plan.

In addition to any immediate requirement to pay retrenchment benefits through the superannuation fund, it may be argued that the employer sponsor has a constructive obligation to provide for the accrued retirement benefits of employees which they have earned by virtue of their past service. That is, the superannuation plan deficit represents a debt owed by the employer-sponsor to the employees, and that obligation does not necessarily disappear if the employer is in a court-determined process of wind-up. On that

¹⁸ Minimum requisite benefit is a benefit certified by an actuary of a defined benefit superannuation plan as being the minimum benefit for a member.

¹⁹ "Vested benefit" is the value of the benefit which would be payable if a member voluntarily left employment at balance date and received their vested entitlement.

view, it would be appropriate that any deficit in the funding of that obligation be recognised for prudential purposes, even though it may not be a legal obligation.

The recognition of surpluses and deficits in employer sponsored superannuation plans also raises other issues. IFRS allows for the netting off of surpluses and deficits across different schemes on first time adoption, on the (implicit) presumption that a surplus in one scheme can be used to meet a deficit in another²⁰. On the basis of the arguments above, APRA does not believe that this is a reasonable presumption for prudential purposes. In APRA's view, it would be more appropriate to calculate the surplus/deficit by scheme and, for regulatory capital purposes, record as a liability the aggregate of deficits²¹.

2.8.2 APRA's proposed approach

APRA has reconsidered its approach to defined benefit superannuation fund surpluses and deficits in the light of IFRS adoption. APRA proposes not to recognise superannuation fund surpluses in Tier 1 capital and to recognise the gross aggregate of superannuation fund deficits as a liability for regulatory capital purposes²². As a consequence, the capital position of employer sponsors with defined benefit superannuation funds in surplus will be unchanged but the Tier 1 position for employer sponsors with defined benefit superannuation funds in deficit will be reduced by the extent of the deficit²³.

The "corridor" approach proposed in AASB 119 *Employee Benefits* will not be allowed for regulatory capital purposes.

APRA is willing to recognise a defined benefit superannuation fund surplus as an asset for regulatory capital purposes in those circumstances where an employer sponsor is able to demonstrate unrestricted and unfettered access to the fund surplus in a timely manner. APRA is unaware of any superannuation fund in Australia which would meet these criteria but this may occur in overseas arrangements.

2.9. Other issues

2.9.1 Bid and ask prices

The fair value of financial assets and liabilities is determined in accordance with the fair value measurement hierarchy in AASB 139. This requires the use of bid and ask prices to determine the fair value of financial instruments. Current practice is to use mid-point prices for such instruments, with allowance for realisation costs in the case of insurance. In the interests of reducing reporting burden for ADIs, APRA will accept the use of bid and ask prices for prudential purposes. APRA is liaising with the LIASB to determine the most appropriate approach for life insurers. APRA will then review the use of bid and ask prices in general insurance in light of the outcome of the discussions with the LIASB.

2.9.2 Regular way purchases and sales of financial assets

²⁰ See IFRS 1 *First Time adoption of Australian Equivalents to International Financial Reporting Standards* (IG 18).

²¹ Under IFRS, entities will need to apply a range of steps to each material defined benefit plan (see AASB 119, paragraph 50) and determine the deficits and surpluses separately. Consequently, the accounting for deficits and surpluses on a gross basis for APRA purposes is unlikely to lead to an additional burden for regulated entities.

²² APRA's proposed approach is to not allow netting of superannuation surpluses and deficits across different schemes.

²³ The apparent asymmetric approach of excluding surpluses but charging deficits is not unusual. APRA already adopts an asymmetric approach with other assets such as quoted readily marketable securities, where losses are deducted immediately but 45 per cent of unrealised gains count towards Tier 2 capital.

Contracts for the purchase or sale of financial assets that require delivery of the assets within the time-frame generally established by regulation or convention in a specific market place (sometimes called a “regular way” contract) are financial instruments under AASB 139. AASB 139 allows regular way purchases or sales of financial assets to be accounted as financial instruments using trade date or settlement date accounting.

The trade date is the date that an entity commits itself to purchase or sell an asset. The settlement date is the date that an asset is delivered to or by an entity. Although existing market practices might vary between trade and settlement date accounting, APRA will continue to require trade date accounting for regular way purchases and sales.

2.9.3. Capitalised expenses for ADIs

When loans are measured at amortised cost, the effective interest rate method in AASB 139 takes into account transaction costs as part of the estimated future cash flows over the expected life of the assets. A shorter period may be applied where appropriate. Transaction costs are directly expensed under IFRS whenever financial assets or financial liabilities are measured at fair value through profit or loss. Under IFRS, therefore, selected transaction costs may be expensed in some instances and capitalised in others.

APRA’s policy after 1 July 2004 requires ADIs to deduct from Tier 1 capital, in accordance with APS 111 (paragraph 9), any capitalised loan/lease origination fees and commissions paid to originators and brokers and any capitalised costs associated with debt raisings. APRA intends to retain its current treatment of capitalised expenses for ADIs on implementation of IFRS.

2.10 Effective dates and transition arrangements

Subject to the consultation process, the effective date for the changes to APRA’s prudential requirements proposed in this Discussion Paper is intended to be 1 January 2006. Where feasible, changes will be effective immediately on commencement.

APRA is prepared to consider transition arrangements for individual entities if the net effects of its proposals would result in more than a one percentage point reduction in the entity’s capital base or Tier 1 capital ratio. Such entities will be required to submit a transition plan that will bring them into compliance with APRA’s prudential requirements as soon as possible.