RIA Knowledge Transfer and Capacity Building Program

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COMISIA DE SUPRAVEGHERE A ASIGURĂRILOR

Regulatory Impact Assessment*

- Main Findings and Policy Recommendations -

IFRS Provisioning SPI Project

National Bank of Romania
November 1, 2007

(*)= based on Draft Impact Assessment Guidelines prepared by CESR, CEBS, CEIOPS

Working Group Composition

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Problem identification

Two regulatory failures:

1) The current provisioning NBR Regulation no. 5/2002 is ***not allowing for a calculation of provisions based on a true and fair value of assets (as determined, for example, under International Financial Reporting Standards)****.*

The regulatory framework should be reconsidered in order to ensure a more accurate measure of credit risk.

2) Also, at present, banks calculate provisions based on International Financial Reporting Standards (IFRS) for reporting to mother entities.

This situation leads to ***double reporting costs by banks*** *and* ***different profitability results****.*

Policy objective

To make prudential requirements more sensitive to fair value of financial assets.

<u>Stakeholders' positions related to policy objective</u>:

- *NBR: a sound and prudent credit risk management*
- *Banks: a framework that allows a sound risk management and minimizes compliance costs*
- *MEF: a regulatory framework with a neutral (or positive) impact on the state budget (at present, provisions are fully deductible, thus affecting the level of taxable profit).*

Main Questions To Explore

1. Is the current level of RAS-provisions in accordance with the needs of a sound risk management system and of financial stability?
   - Rationale for regulatory intervention

2. How best to link the prudential framework to IFRS accounting to meet the purpose of having a sound bank risk management?
   - Regulatory design options

3. What regulatory options could minimize the possible negative impact on the state budget?
   - Costs/benefits for stakeholders

Policy options

Option 1:

“Do nothing” option in terms of accounting standards – keep the current calculation of provisions based on RAS

- with NBR Regulation no. 5/2002 unchanged or
- with amendment of NBR Regulation no. 5/2002.

Option 2:

a) Elaboration of the new IFRS provisioning regulatory framework that will apply to credit institutions once they receive approval from NBR Supervision Department on IFRS provisioning internal models;
b) Amendment of current NBR provisioning regulations (Regulation no. 5/2002) as a transition (and RAS disincentive) rule.

Option 3:

Application of the new IFRS provisioning regulation starting with a determined point in time (e.g., starting with 2010).

Stakeholders consulted

A tri-partite working group (NBR, MEF and banks) designed the 13-page 10-question impact assessment questionnaire that was sent to all banks.

Responses received from 19 banks.

NBR sent anonymous responses to SPI Secretariat for processing and assessment.

Main Feedback

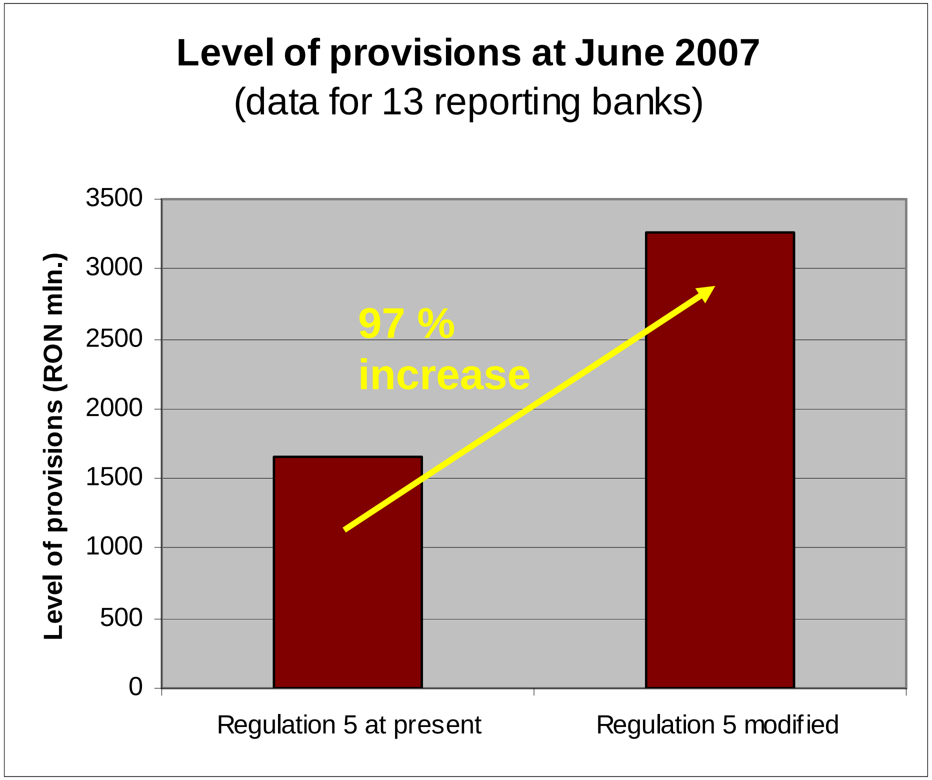
- Current Regulation 5 does not provide satisfactory measure of loan loss risk
  - Loan loss risks are understated
  - Tighter Regulation 5 is an option
- IFRS data adequate to meet prudential requirements with no adjustments
- Costs and net income are restated in transition from RAS to IFRS accounting
  - Shareholder and tax implications
  - Perhaps a temporary effect (limited data)?

Option 1 Discussion

“No accounting standards changes”

- To calibrate Regulation 5 to better reflect the actual risks carried by banks would entail almost a doubling of the loan loss reserve.

➢ The cost of tightening Regulation 5 is very high

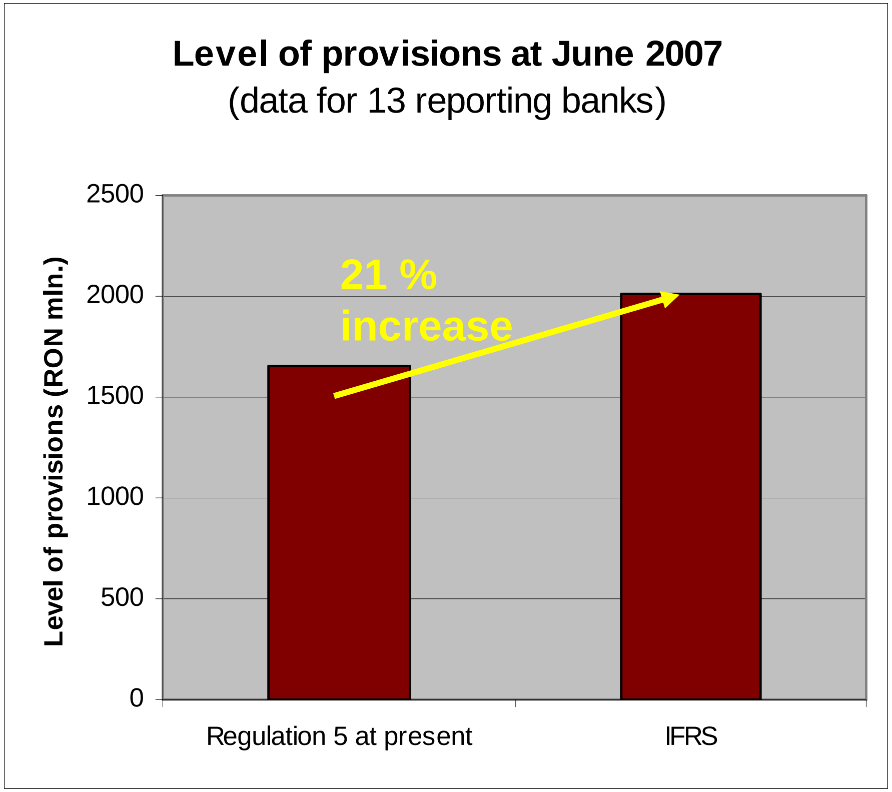


Option 2 Discussion

"IFRS Provisions + RAS disincentives"

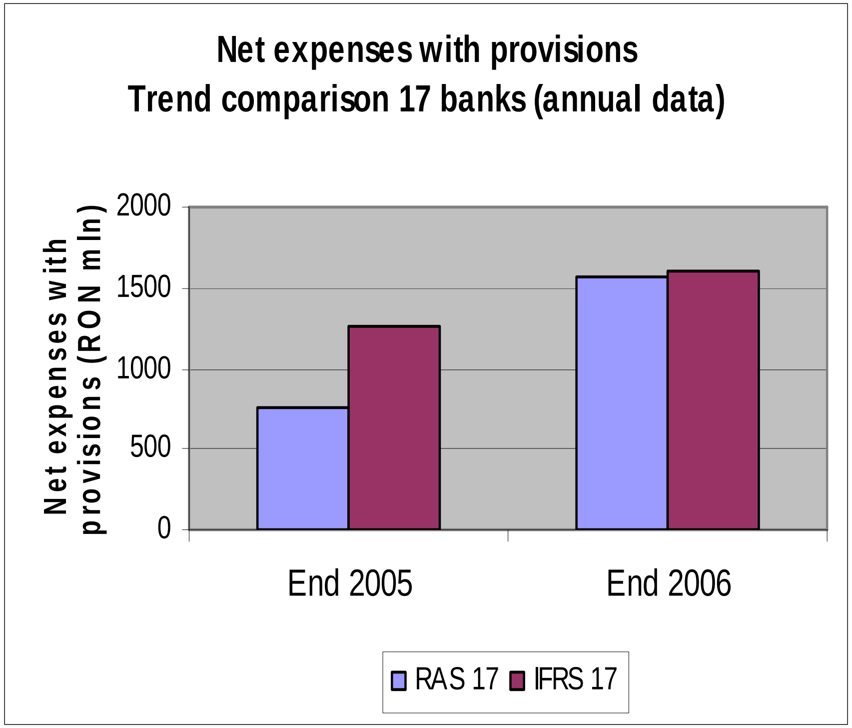
- IFRS use would allow to reach adequate calibration of provisions at reasonable cost to shareholders and MEF.
- To promote IFRS use, a tighter Regulation 5 could be introduced in the interim.

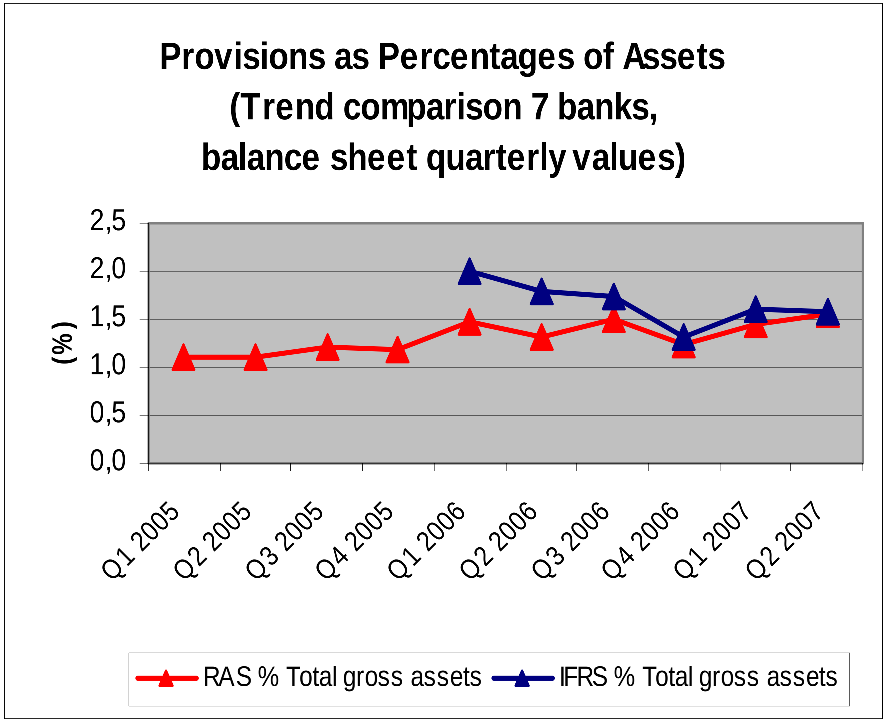
➢ Can IFRS conversion be timed to minimize costs to shareholders and MEF?



Option 2 Discussion (II)

Other important findings from survey with banks:



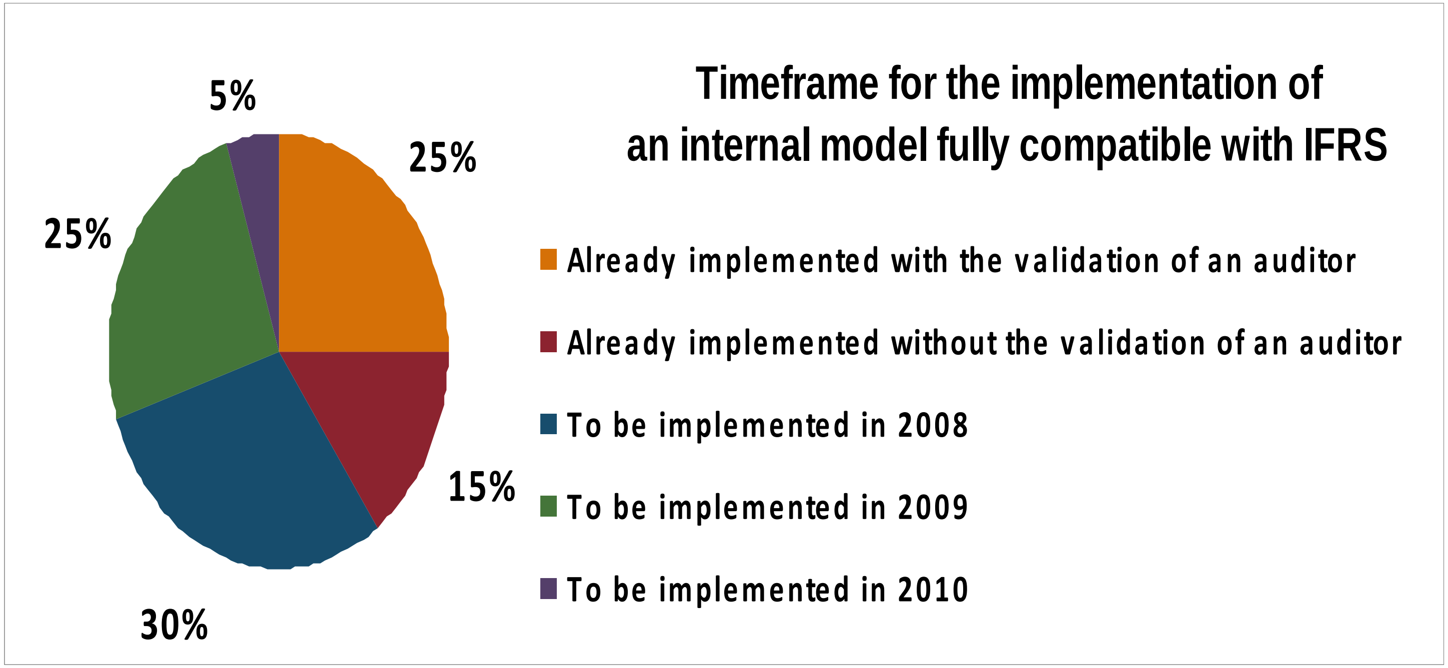


Conclusion: Provisions are already substantially similar for banks well advanced in applying IFRS provisioning requirements, reflecting single management prudential standards.

Option 3 Discussion

"Deferred IFRS Provisions"

- 70% of the banks expect to implement IFRS by 2008.
- 95% of the banks expect to implement IFRS by 2009.
- ➢ Regulations should support sound market practices.



Comparison of the options

"No accounting standards changes " (RAS & Regulation 5 modified)

Everything else being equal, progressively stricter prudential treatment of collateral under current Regulation 5 will create larger RAS provisioning for Romanian banks. The total additional provisioning requirement for a sample of 13 banks is estimated to total RON 1.6 billion. The tax revenue loss of this measure for this sample is RON 240 million (June 2007).

IFRS provisioning regulation

Implementation of IFRS provisioning requirements would allow a substantial reduction in this tax impact. Assuming a parallel introduction of the new IFRS Provisioning Regulation with the modified Regulation 5, enforcement of the former would generate tax revenue loss of RON 60 million for the same sample of 13 banks (June 2007) (one-fourth of Regulation 5 modified).

Policy Recommendations

❖"Doing nothing" is too costly

❖Immediate IFRS adoption not feasible

- Costly (Regulation 5 modified)
- Ahead of market developments

❖Deferred IFRS adoption desirable

- Enforcement: 2010
- No adverse tax implications.