convergence

SPI Project:

Loan Loss Provisioning in view of IFRS application

Regulatory Impact Assessment

Approach Note

Background* - 1

Currently, most of the Romanian banks calculate provisions both according to NBR Regulation no. 5/2002 and to IFRS, for reporting to their mother entities.

Under Regulation no. 5/2002, provisions are calculated at individual level, for exposures classified in 5 categories (upon debt service, financial standing and legal status criteria), after deducting the collateral, and by applying the corresponding provisioning ratios. The exposures classified as loss are 100% provisioned and registered off balance sheet.

Under IFRS provisions are calculated both at individual and at portfolio level (based on loss and recovery historical rates), using a 10 categories classification, based on additional criteria such as commercial and ownership status. The exposures classified as “loss” are kept in the balance and not provisioned 100% (recognizing thus the collateral quality). The provisions are actually calculated as the net present value of future recoveries, discounted at the original effective interest rates on the loans.

Banks generally appreciated that provisions calculated under IFRS at portfolio level were higher than the ones calculated according to NBR regulation, although in some cases NBR methodology results in higher provisions(**).

*= Drawn from the Project Working Group ToR
**= According to Roland Berger study developed for RZB Romania, BRD – GSG and Bancpost.

Background* - 2

The loan loss provisions are considered deductible for the calculation of the profit before taxation only up to the limits given by the NBR regulation.

In case the provisions are over passing the limits fiscally recognized, there is a temporary deductible difference for which a deferred tax asset is to be recognized only under IAS 12 conditions.

The double calculation and reporting results in increased reporting and compliance costs and the unclear fiscal treatment of the provisions calculated under IFRS determines a high level of operational risk.

This duplication will continue after Basel II implementation and the tax problems will persist unless the related regulations change in order to align economic, prudential, and tax treatment of credit risk.

II - Project Objective

Prepare a summary document on a feasible update of NBR prudential standards to reflect new accounting standards that would meet both business reality and supervisory objectives.

*= Drawn from the Project Working Group ToR

Economic impact assessment - 1

i – General section

A	Banks with majority foreign capital (#)	24
B	Net assets 2005 of an intermediate bank of Roland Berger sample (RON, Mln)	11,000
C	Net assets in 2005 of banks with majority foreign capital (RON, Mln) (**)	70,092
D	Weight of the average RB bank out of overall bank affected (%) [B/C]	16%

Economic impact assessment - 2

ii – Compliance section

E	Full time Equivalent needed over a year by a RB-sample bank to comply with RAS, under current framework(# FTE)	6.3
F	Full time Equivalent needed over a year by a RB-sample bank to comply with IFRS, under current Framework (# FTE) (*)	1.4
G	Average annual gross salary of a bank staff (RON)	59,840
H	Correction factor to shift from 3-bank sample to all banks involved (%)	-15%
I	FTE needed over a year by each bank to comply with RAS, under current framework (# FTE) [E+(E*H)]	5.4
J	FTE needed over a year by each bank to comply with IFRS, under current framework (# FTE) [F+(F*H)]	1.2

Economic impact assessment - 3

ii – Compliance section

K	FTE needed over a year by each bank to comply with RAS and IFRS, under current framework (# FTE) [I+J]	6.5
L	Current regulation: Overall annual costs borne by all international banks to comply with RAS and IFRS (Mln, EUR) [A*G*K]	9.4
M	Reduction of overall FTE to comply with RAS and IFRS due to improvement of regulation	30%
N	**Overall annual costs saved by all international banks to comply with RAS and IFRS [L*M]**	
	1-year horizon: (Mln, RON)	2.2
	5-year horizon: present value, (Mln, RON)	11.5

Economic impact assessment - 4

iii – Tax section

O	Average annual net provision expenses/bank Under RAS (Mln, RON)	62.3
P	Average annual net provision expenses/bank Under IFRS (Mln, RON)	68.6
Q	Banking industry: Overall annual net provision expenses under RAS (Mln, RON) [O/D]	397.0
R	Banking industry: Overall annual net provision expenses under IFRS (Mln, RON) [O/D]	437.0
T	**Annual accounting edge (Mln, EUR) [R-Q]**	
	1-year horizon: (Mln, RON)	40
	5-year horizon: present value, (Mln, RON)	165

Analytics - 1

Banks with majority foreign capial (#)	a)	24
Net assets 2005 of an intermediate bank of Roland Berger sample (Mln, RON)	b)	11,000
Net assets in 2005 of banks with majority foreign capital (RON, Mln)	c)	70,092
Net assets of a Roland Berger benchmark bank vs Banks with majority foreign capital (%)	d)=b/c	16%
Compliance perspective		
FTE over a year needed by a bank to comply with RAS, under current framework	e)	6.3
FTE over a year needed by a bank to comply with IFRS, under current framework	f)	1.4
Average annual gross salary of a bank staff	g)	59,840
Factor of corretion to shift from 3-banks sample to all banks involved (%) (***)	h)	-15%
FTE over a year needed by a bank to comply with RAS, under current framework (# FTE)	i)=e+(e*h)	5.4
FTE over a year needed by a bank to comply with IFRS, under current framework (# FTE)	j)=f+(f*h)	1.2
FTE over a year needed by a bank to comply with RAS and IFRS, under current framework (# FTE)	k)=i+j	6.5
Current regulation: overall annual costs borne by all international banks to comply with RAS and IFRS (Mln,	l)=a*g*k	**9.4**
Reduction of overall FTE to comply with RAS and IFRS due to improvement of regulation	m)	*30%*
Scenario: overall annual costs saved by all international banks to comply with RAS and IFRS (Mln, RON)	n)=l*m	**2.82**

Tax perspective		
Average annual net provision expenses/bank under RAS (Mln, RON)	o)	62.3
Average annual net provision expenses/bank under IFRS (Mln, RON)	p)	68.6
Banking industry: overall annual net provision expenses under RAS (Mln, RON)	q)=o/d	397.0
Banking industry: overall annual net provision expenses under IFRS (Mln, RON)	r)=p/d	437.4
Annual accounting edge (Mln, RON)	s)=r-q	**40.4**

	2007	2008	2009	2010	2011	5 years
PV - Scenario: overall annual costs saved by all international banks to comply with RAS and IFRS	2.6	2.5	2.3	2.1	2.0	**11.5**
PV - Annual accounting edge (Mln, RON)	37.7	35.2	32.9	30.7	28.7	**165.1**

Discount rate (%)	7.10%				
Discount factor	0.93371	0.87181	0.81401	0.76005	0.70966

Analytics - 2

Data and assumptions:

a) Banks with majority foreign capial (#)		24
Source: NBR, Annual Report 2005, p. 35		
b) Net assets 2005 of an intermediate bank of Roland Berger sample (Mln, RON)		11,000
(Based on Annual reports of the banks belonging to the Roland Berger sample)		
c) Net assets in 2005 of banks with majority foreign capital (RON, Mln)		*70,092*
Source: NBR, Annual Report 2005, p. 35		
Compliance perspective		
d) FTE over a year needed by a bank to comply with RAS, under current framework		6.3
Source: Roland Berger Study. It makes reference to a bank with HQ and 307 branches		
e) FTE over a year needed by a bank to comply with IFRS, under current framework(*)		1.4
Source: Roland Berger Study. It makes reference to a bank with HQ and 307 branches		
f) Average annual gross salary of a bank staff		
Source: Roland Berger.	EUR	17,000
	RON	59,840
g) Factor of corretion to shift from 3-banks sample to all banks involved (%)		-15%
h) Reduction of overall FTE to comply with RAS and IFRS due to improvement of regulation (%)		30%
Tax perspective		
i) Average annual net provision expenses/bank under RAS		
Source: Roland Berger Study. It makes reference to a bank with HQ and 307 branches		
	Mln, EUR	17.7
	Mln, RON	62.3
j) Average annual net provision expenses/bank under IFRS		
Source: Roland Berger Study. It makes reference to a bank with HQ and 307 branches		
	Mln, EUR	19.5
	Mln, RON	68.6