Advisory

Subject: **Regulatory Capital Treatment of Certain Significant Items for Basel I under the New Financial Instruments Accounting Standards**

Category: **Capital**

Date: **May 2006**

OSFI has considered the impact that certain items under the new Canadian Financial Instruments accounting standards will have on regulatory capital for deposit-taking institutions. Our consideration included extensive consultation with OSFI's regulated industries to understand impacts. This Advisory outlines OSFI's Basel I regulatory capital decisions on treatment arising from implementation of the new accounting standards. Basel II capital treatment will be made available in Basel II guidance.

Cash Flow Hedges

The accumulated net after tax unrealized fair value gains and losses arising from cash flow hedges will not be included as a capital element in the determination of regulatory capital (no reporting line appears in CAR).

Fair Value Hedges

As net income will include the unrealized gains and losses arising from fair value hedged items and hedges, these will be included in Tier 1 capital through Retained Earnings. No adjustment will be made for this accounting treatment because the gains and losses on the hedged and hedging items offset each other.

Available-for-Sale Instruments (AFS)

Impairment

Impairment losses on AFS instruments will be recognized in net income and, as a result, OSFI will not need to make an adjustment for this accounting treatment. However, impairment losses should not be netted against unrealized gains.

AFS Equities

At the financial statement reporting date, institutions should determine their net after tax gain/(loss) position in AFS Equities. Once determined, where the institution has an accumulated net after tax unrealized fair value loss, this amount will be deducted in the determination of Tier 1 capital. Accumulated net after tax unrealized fair value gains will be included in Tier 2A capital (new reporting lines included in CAR).

AFS Debt

None of the accumulated net after tax unrealized fair value gains/(losses) on AFS Debt will be included as a capital element in the determination of regulatory capital (no reporting line appears in CAR).

AFS Loans

Consistent with the capital treatment of AFS Debt, none of the accumulated net after tax unrealized fair value gains/(losses) on AFS Loans will be included as a capital element in the determination of regulatory capital (no reporting line appears in CAR).

Fair Value Option

Unrealized fair value gains and losses for items meeting the criteria in OSFI's Accounting Guideline D-10 Accounting for Financial Instruments Designated as Fair Value Option will be included in the determination of Tier 1 capital through Retained Earnings. Institutions are expected to meet OSFI's criteria in Accounting Guideline D-10, which includes the Basel Committee on Banking Supervision's guidance. Banks are expected to have in place appropriate risk management systems prior to initial application of the Fair Value Option for a particular activity or purpose and on an ongoing basis as per the Basel Committee on Banking Supervision's guidance. When OSFI brings any risk management and/or control deficiencies regarding the use of the Fair Value Option to the attention of management, we will consider the full range of supervisory measures at our disposal to ensure that deficiencies receive appropriate attention from management and are corrected in a timely manner.

Own Credit Risk

Accumulated net after tax fair value gains arising from changes to an institution's own credit risk under the Fair Value Option will be deducted in Tier 1 capital. Conversely, accumulated net after tax fair value losses from an institution's own credit risk under the Fair Value Option will be included in Tier 1 capital (new reporting line included in CAR).

Risk-Weighted Assets

OSFI has also considered the impact of the new Canadian Financial Instruments accounting standards on the basis for calculating risk-weighted assets under the Basel I capital adequacy requirements. Balance sheet values will be used to determine risk-weighted assets for AFS Equities, Cash Flow Hedges and for assets, other than loans, fair valued under Fair Value Hedges and the Fair Value Option. For AFS Debt and for loans fair valued using AFS, Fair Value Hedges and the Fair Value Option, amortized cost will be used as the basis to determine risk-weighted assets.

Assets to Capital Multiple (ACM)

Following Basel II implementation, OSFI plans to review the ACM. Until such time, OSFI will align the use of amortized cost for certain assets under the risk-weighted test and the ACM.

Trading Book/Banking Book

Regardless of accounting classifications, trading and banking book capital treatments remain the same as before implementation of the Canadian Financial Instruments accounting standards. Thus, banks are required to review the CAR guideline for banking book and market risk capital treatments.