1 November 2007

Summary of the CEBS public hearing on prudential filters

16 October 2007, London

In accordance its 2007 work programme CEBS committed to follow up the work it had carried out back in 2005 on prudential filters and more particularly to prepare an analytical report on the implementation of the CEBS guidelines on prudential filters for regulatory capital

In order to ensure that the conclusions of the report, which had been published in early October, are in line with the views of the banking community CEBS decided to present and discuss the report and its conclusions at a public hearing which was held on 16 October in London.

The event gathered a broad range of market participants - including investment banks, commercial banks and trade associations - from various countries.

The discussion focussed first on the findings of the report as well as on the issues regarding the current filters before participants reactions were sought regarding the way forward proposed by CEBS and on possible future developments in this area.

Discussion of the findings of the report

Participants were in general rather supportive of the conclusions CEBS has drawn in the report and agreed that:

- the filters work adequately,
- they are material and sufficiently significant
- they present some flexibility which led to divergence in the areas
    - of unrealised gains and their treatment in additional own funds, and;
    - of other available for sale assets (i.e. debt securities);

The question was raised whether the quantitative part of the study had also considered the effect of interest movements on the impact of the prudential filters. It was noted that since the introduction of the CEBS prudential filters movements in interest rates had not been material enough to allow for a thorough analysis of their impact.

Issues regarding the current filters

With regard to the treatment of unrealised gains it was moreover mentioned that differences in national tax regimes should not result in competitive distortions.

Another aspect that needs to be taken into consideration relates to the divergence in approaches – i.e. net or item-by-item - that had been observed with respect to the determination of that part of unrealised gains that can be included in additional own funds.

It was also suggested that CEBS addresses the inconsistency arising from the fact that for some assets - such as investment in financial institutions that are classified as available-for-sale - unrealised gains can be included in (additional) own funds while at the same time the holding as such has to be deducted in accordance with the provisions of article 66 of Directive 2006/48/CE

Participants also pointed to the divergence of treatments of intangibles assets and in particular to the fact that in some countries 'new intangibles' are not deducted. More generally it was felt that similarly than for the elements included in regulatory own funds, deductions should be made net of foreseeable taxes rather than on a gross basis.

Reactions regarding the proposed way forward

Although some participants noted that ideally the same adjustment would be applied to all institutions, the general feeling was that - given cost / benefit considerations - no measures are necessary in the short-term and that further alignment should be achieved in the context of the re-definition of capital.

As concerns the areas of divergence and in particular the treatment of unrealised gains in additional own funds, CEBS or regulators in general were encouraged to consider carefully what constitutes 'good' capital and develop appropriate qualitative criteria that can be applied in an uniform and consistent manner and that avoid arbitrage possibilities within different asset categories. To the extent that additional haircuts would be applied their rationale should be well-founded and clearly explained.

CEBS was encouraged that in taking the topics further consideration should not only be given to regulatory capital but also to risk-weighted assets to ensure that any asymmetric treatment is avoided. It was noted that with the potential increased use of the fair value option it is important to ensure consistency of treatments between different asset categories and to avoid any scope for 'arbitrage'.

CEBS representatives noted that CEBS guidelines do already recognise the importance of the issue by foreseeing that competent authorities may, in order to mirror the impact of prudential filters on own funds, require some adjustments to the balance sheet value of the exposures used in the computation of an institution's risk weighted exposures based on accounting figures. They also acknowledged that in future discussions such consistency issues should be carefully considered.

Other differences, such as those observed for the determination of the part of unrealised gains that can be included in additional own funds should also be addressed (i.e. need for consideration of an harmonised treatment about the level of haircut) .

As concerns adjustments for pension schemes, participants agreed that CEBS should continue to study this issue further in order to ensure that the effects of the accounting are well understood. At the same time CEBS should in taking this issue further bear in mind national specificities in the pension regimes as well as level-playing field issues with respect to third countries.

Suggestions for future developments

Regarding future developments, the importance of identifying the right criteria for regulatory capital and related application guidance was underlined again. In doing that, supervisors should not refrain from questioning whether the currently applied criteria, i.e. permanence, loss absorption and flexibility of payments are still valid and workable in the context of changing accounting frameworks.

In most cases the preference seemed to be that IFRS is used as a basis and that adjustments are applied to make up for different treatment in the prudential context. Consideration should notably be given to the need for a different scope of consolidation for prudential purposes.

While there was agreement that prudential adjustments are justifiable in some cases, it was felt that their impact should remain independent of the accounting methods chosen by an institution.

Participants acknowledged that a different treatment between capital gains arising from financial instruments and valuation reserves related to non-financial instruments could be justified. In addition there may be sufficient reason to maintain a specific treatment for valuation differences reflecting changes in the own credit of an entities financial liabilities or for the impact of hedge accounting.

It was also suggested that in their future work supervisors consider not only the filters developed by CEBS but also take a look at 'earlier filters' enshrined in the CRD: i.e. the scope of application / consolidation as well as deductions of certain elements from own funds.

As mentioned before, asymmetries between treatments applied to the denominator and to the numerator should be avoided to the largest extent possible.

The idea was put forward that it could be worthwhile considering further to what extent alternative approaches are feasible. It was thus suggested that the question of prudential adjustments could be factored into institutions' economic capital models whereas simpler 'mechanic' prudential filters may continue to be applied to institutions that continue to apply simpler approaches.

Supervisors were also encouraged to envisage making capital adjustments for prudential purposes within the context of pillar 2.

Participants also underlined the importance that the discussions on the re-definition of capital are closely coordinated with the Basel Committee and that these discussions should also aim at eliminating differences in other areas - such as in the context of securitisation for example. Additionally some participants suggested that further consideration could be given to an harmonised treatment between the banking and the insurance industry.

Conclusions

The current CEBS prudential filters are appropriate and working satisfactorily.

The observed differences (mainly relating to the treatment of unrealised gains in additional own funds) should be addressed even though the majority felt that any short- or medium-term changes would cause more burden in terms of system changes than benefits from reduced competitive differences.

For future overhaul of the own funds definitions it is important to identify the right criteria for regulatory capital that, given the objectives of prudential supervision, could differ from the principles developed for financial reporting purposes, although supervisors should strive to keep a strong link between the accounting and regulatory capital and make adjustments only where they are justified for prudential reasons.

Some commentators also encouraged supervisors to consider possible alternatives for example through adjustments in Pillar 2.

Moreover currently observed asymmetries regarding adjustments to denominator and to the numerator should be eliminated when they exist.