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Discussion Paper

Technical Advice to the Commission

on possible treatments of unrealised gains measured at fair value under Article 80 of the Capital Requirements Regulation (CRR)

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1. Responding to this Discussion Paper

The EBA invites comments on all proposals put forward in this paper and in particular on the specific questions stated in the boxes below (and in the Annex of this paper).

Comments are most helpful if they:

- respond to the question stated;
- indicate the specific point to which a comment relates;
- contain a clear rationale;
- provide evidence and, whenever possible, data to support the view expressed and to assess further the potential impacts of the proposal; and
- describe any alternatives the EBA should consider.

Submission of responses

To submit your comments, click on the 'send your comments' button on the consultation page by 27.09.2013. Please note that comments submitted after this deadline, or submitted via other means may not be processed.

Publication of responses

Please clearly indicate in the consultation form if you wish your comments to be disclosed or to be treated as confidential. A confidential response may be requested from us in accordance with the EBA's rules on public access to documents. We may consult you if we receive such a request. Any decision we make not to disclose the response is reviewable by the EBA's Board of Appeal and the European Ombudsman.

Data protection

The protection of individuals with regard to the processing of personal data by the EBA is based on Regulation (EC) N° 45/2001 of the European Parliament and of the Council of 18 December 2000 as implemented by the EBA in its implementing rules adopted by its Management Board. Further information on data protection can be found under the Legal notice section of the EBA website.

Disclaimer

The views expressed in this discussion paper are preliminary and will not bind in any way the EBA in the future development of the technical advice. They are aimed at eliciting discussion and gathering the stakeholders' opinion at an early stage of the process.

2. Executive Summary

Reasons for publication

Article 35 of Regulation 575/2013 (Capital Requirements Regulation - CRR) states that institutions shall not make adjustments to remove from their own funds unrealised gains or losses on their assets or liabilities measured at fair value. In this context, Article 80(4) of the CRR requires the EBA to provide technical advice to the Commission on possible treatments of unrealised gains measured at fair value other than including them in Common Equity Tier 1 without adjustment.

This discussion paper expresses the EBA's preliminary views on the above topic and aims at eliciting discussion and gathering the stakeholders' opinions at an early stage of the process. The input from stakeholders will assist in the development of the technical advice, to be provided to the European Commission (EC) by 1 January 2014. Any input and supportive data will be highly appreciated and kept confidential, where required.

Contents

This paper aims to provide considerations of the different policy options for the treatment of unrealised gains measured at fair value. This paper discusses the criteria that should be considered in the analysis of the policy options. It proposes to differentiate policy options between instruments depending on their characteristics and discusses the arguments in favour and against of each of the possible treatments of unrealised gains.

In the EBA's preliminary view the policy options proposed should be defined in a harmonised manner to achieve consistent application by institutions and help achieving a level playing field.

Next steps

Once the public consultation is finalised, the EBA will draft the technical advice that will need to be provided to the Commission by 1 January 2014.

3. Background and rationale

Article 80(4) of Regulation 575/2013 (Capital Requirements Regulation - CRR) states that *"the EBA shall provide technical advice to the [European] Commission by 1 January 2014 on possible treatments of unrealised gains measured at fair value other than including them in Common Equity Tier 1 without adjustment. Such recommendations shall take into account relevant developments in international accounting standards and international agreements on prudential standards for banks".*

Article 35 of the CRR states that institutions shall not make adjustments to remove from their own funds unrealised gains or losses on their assets or liabilities measured at fair value. The objective of this discussion paper is to gather stakeholders' views on possible alternative treatments for unrealised gains other than the treatment established in Article 35 of the CRR, and to gather the relevant quantitative data from banks on the possible impact of unrealised gains arising from some of the proposed policy options. The input received during the consultation would be used in the development of the technical advice to the European Commission (EC).

The CRR also establishes a transition period during which unrealised gains shall continue to be removed from Common Equity Tier 1 (CET1). In particular, Article 468 establishes that from the date of application of the CRR to 31 December 2014 all unrealised gains shall be removed from CET1. The CRR allows the recognition of unrealised gains after that date subject to the application of certain percentages. Therefore, there would be one year difference between the submission of the EBA technical advice (1 January 2014) and the date when unrealised gains may start to be recognised in CET1 under the CRR (1 January 2015). It is our understanding that during this period the EC would consider the technical advice with a view to assessing whether to require that institutions apply a different treatment for unrealised gains from the current CRR requirements.

The technical advice shall also take into account the fact that Article 467(2) of the CRR empowers the competent authorities, in cases where such treatment was applied before 1 January 2014, to allow institutions not to include in any element of own funds unrealised gains or losses on exposures to central governments classified in the "Available for Sale" category of EU-endorsed IAS 39, until the EC has adopted a regulation on the basis of Regulation 1606/2002 endorsing the IFRS replacing IAS 39. Therefore, competent authorities may decide to continue to apply current treatments for such unrealised gains. This advice will provide the EC with EBA's views on possible alternatives for the treatment of unrealised gains during this period as the IFRS 9 application date is not expected until at least 1 January 2015.

4. Discussion

4.1 Introduction

4.1.1 Scope of the requirements

1. The mandate of the CRR refers to “unrealised gains measured at fair value”. Unrealised losses, which are to be fully reflected in the regulatory capital of institutions under the CRR, are out the scope of this discussion paper in accordance with the mandate of article 80(4) of the CRR.

2. Unrealised gains (whose amount correspond to the positive difference between the current value of an item and its initial value on recognition in the relevant accounting category) may have different meanings to different users, such as gains not yet realised as cash or another asset (i.e. gains on items held at the reporting date), or gains recorded through ‘other comprehensive income’ (OCI) instead of the profit and loss account (P&L). According to Article 468 of the CRR *”...unrealised gains related to assets or liabilities measured at fair value and reported on the balance sheet, excluding those referred to in Article 33*[1] *and all other unrealised gains with the exception of those related to investment properties reported as part of the profit and loss account”*. This article therefore refers to unrealised gains arising within both P&L and OCI on items held as at the reporting date.

3. This discussion paper has included in its scope of analysis unrealised gains recognised on the face of both the profit or loss account and the balance sheet. It constitutes the EBA starting point in developing the policy options in this paper, thus excluding policy options and methodology to be applied under other definitions of ‘unrealised gains’.

4. As referred to in Article 80(4) of the CRR the intended scope of the technical advice covers all those items that are “measured at fair value”. Under current IAS 39 certain categories of financial instruments (held for trading and available for sale assets) are required to be measured at fair value. IFRS also provides the option to measure certain financial instruments (under the fair value option), investment properties and property, plant and equipment at fair value. Depending on the type of the asset or liability and the category where it is classified, the changes in the fair value may be recognised in P&L (held for trading, financial instruments under fair value option and investment properties) or in OCI (available for sale assets and property, plant and equipment).

5. Under national GAAPs, items measured at fair value may vary. In some countries, items measured at fair value are expected to be similar to those held at fair value under IFRS. In other countries, there may be lesser use of fair values under national GAAPs than would occur under IFRS.

6. The items included in the scope of this discussion paper include assets and liabilities measured at fair value under the local or international accounting requirements. Consideration is also given to expected developments in international accounting standards, including the implication from the

[1] Article 33 of the CRR refers to cash flow hedges and changes in the value of own liabilities

current proposals to replace IAS 39 by IFRS 9, and on international agreements on prudential standards for banks.

7. This discussion paper also considers the interaction between the accounting classification and the prudential classification of assets and liabilities in developing the various policy options.

4.1.2 Exceptions from the scope[2]

8. Intangible assets may be measured at fair value but as they are deducted from CET1, under Article 36(1b) of the CRR, the EBA has excluded them from the scope of the discussion paper and consequently from the technical advice.

9. The CRR also retains a prudential filter for unrealised gains and losses arising from cash flow hedges and for the changes in the value of liabilities (debt instruments and derivatives) due to changes in own credit risk (Article 33 of the CRR). The first filter has been introduced in the CRR in order to take into account the asymmetry in the accounting treatment of cash flow hedge transactions between the hedging instrument and the hedged item in cash flow hedges. The second is necessary to avoid the counter-intuitive effect that the level of own funds is conversely proportional to the credit quality of the institution itself. As these filters are prescribed by the CRR, the EBA has excluded them from the scope of the discussion paper and the technical advice.

10. Under IFRS, biological assets (IAS 41) and the exploration and evaluation of assets – mineral resources (IFRS 6) - are also measured at fair value but they are considered as not relevant for the technical advice.

Q1. Do you agree with the scope of the discussion paper for the technical advice? Are there other elements that should be covered? If yes, please state why

4.2 Methodology

11. The EBA has endeavoured to establish relevant criteria to assess the possible treatments of unrealised gains and to identify the implications from the respective options in the development of the technical advice to the EC.

12. In this discussion paper, the EBA has taken into account the following aspects:

- The quality and reliability of own funds and aspects that could be of a supervisory concern

[2] During the preparation of the discussion paper it was also considered that gains and losses recognised in OCI from defined benefit plans and from the translation of the financial statements of a foreign operation shall not be included in the scope as these items are not measured at fair value. Defined benefit pension fund assets recognised in the balance sheet (i.e. net of related liabilities) will be deducted from CET1 according to Art.36 (1e) of the CRR. Gains arising from the translation of the financial statements of a foreign operation have never been subject to prudential filters.

- Other criteria that need to be considered - including ability and intention to realise the gains, existing capital requirements, interaction with prudential valuation framework, levels of application of the prudential filters, behavioural consequences and transparency.

4.2.1 Quality and reliability of own funds and aspects that could be of a supervisory concern

13. As the mandate relates to unrealised gains included in the regulatory own funds, the first criteria considered by the EBA are those underpinning the definition of own funds.

14. Article 26(1) of the CRR states that CET1 items like retained earnings or accumulated other comprehensive income, shall be recognised only where they are available to the institution for unrestricted and immediate use to cover risks or losses as soon as these occur.

15. One of the main prudential concerns relating to unrealised gains on assets and liabilities measured at fair value is that they may not be immediately available to absorb losses when they arise if these unrealised gains disappeared subsequently to the reporting date due to negative movements of market prices of the underlying items.

16. From an accounting perspective, all gains may cover all losses resulting from the application of the relevant accounting framework. From a prudential perspective, it is expected that CET1 items are not only available to cover current losses, but also for the risk of future losses. Unrealised gains may disappear within a short period of time, in particular in a crisis situation, when at-risk positions will give rise to losses. Consequently, unrealised gains may not be available to cover the risk of future losses other than those which are simply reversals of the unrealised gains themselves.

17. Supervisors would be concerned if unrealised gains represent an important part of CET1 and thereby if the buffers that an entity was building during the economic upturns in order to withstand the losses during the downturns were to a large extent composed of unrealised gains. In addition, the potential reversal of unrealised gains may, in crisis situation, exacerbate pro-cyclicality.

18. There are also prudential concerns on the reliability of the fair value measurement of assets and liabilities. Quality and amount of regulatory own funds could be overstated depending on the reliability in the valuation of the fair valued assets and liabilities.

19. In view of the above, it may be justified from a prudential perspective not to take into account unrealised gains to assess the solvency position of an institution under a Pillar 1 approach.

4.2.2 Other criteria that need to be considered

20. The EBA has also considered other criteria that should be taken into account when developing options for treatments of unrealised gains in the regulatory capital of institutions.

4.2.2.1 Ability to realise the gains

21. An institution may realise the unrealised gains by selling the related assets, or by using an adequate hedging strategy, and the resulting gains will be recognised in CET1. An unrealised gain arises from fair value increases and therefore this gain represents a ‘realisable’ amount at the valuation date if it were crystallised immediately.

22. The ability to realise the gains will, however, depend on the nature of the underlying item and the current economic context. For instance, there may be constraints that prevent or limit the ability of an institution to realise the gains such as the lack of an active market or the existence of clauses that restrict the institution's ability to sell (a clause might not allow or impose significant penalties to investors if they want to exit before a specified time).

23. Unrealised gains are also subject to movements in the market price. In less liquid markets there is an additional risk that unrealised gains may not be available to absorb losses because the related assets may not be realised in the short term at the price expected by the institution. Thus, realisation of any gains from such investments at any time would be highly uncertain.

24. However, these concerns may be covered by the relevant accounting standards (for instance, IFRS 13[3]) and the upcoming requirements on Prudent Valuation established in Article 105 of the CRR.

4.2.2.2 Intention to realise the gains

25. Even if the market is liquid, an institution may not have the intention to realise the unrealised gain from an asset and the unrealised gain may disappear due to the volatility in market prices. For instance, management's objective may be to collect the cash flows of the assets and not to sell them in a short period of time. This can also be the case when the asset from which the unrealised gain arises is hedged making it difficult to discontinue the hedging relationship.

26. For banking book items, where assets are held with a longer term objective (i.e. investment bonds), the unrealised gains will decrease towards the face value of the debt instrument when it comes near maturity (assuming all other factors remained constant). The realisation of the gain may also have a negative tax effect or other consequences (including the impact on management's investment strategy) and thus there may be a disincentive for the institution to sell such items.

27. For trading book items, they are generally held with an intention to sell them in the short term. It could therefore be argued that there is a reasonable expectation that those gains would be realisable in the short term and available to absorb any losses other than in the case of extreme market falls occurring within the intermediate time horizon.

4.2.2.3 Capital requirements

28. The interaction with capital requirements should also be taken into account. To some extent, the risk that unrealised gains may disappear is covered by a capital requirement. This is mainly the case for items in the trading book which are subject to capital requirements covering general market and specific risks. This is less straightforward for assets which are included in the banking book where capital requirements focus on credit risk.

29. For items in the banking book, the supervisor may require additional own fund requirements in the supervisory assessment of the solvency position of an institution (Pillar 2 process) to take into

[3] IFRS 13 Fair value measurement contains principles to measure illiquid instruments at fair value. It also requires the fair value of an asset or a liability to take into account any restrictions on the sale or use of an asset (IFRS 13.11) along with the condition and location of an asset that a market participant might consider when pricing the asset or liability.

account that unrealised gains may disappear, although the Pillar 2 process may be seen as less systematic than the Pillar 1 adjustment.

4.2.2.4 Prudent Valuation framework

30. The reliability of fair values of assets and liabilities (and the unrealised gains arising thereof) is a prudential concern that may be covered by the upcoming RTS on Prudent Valuation. Applying an additional filter on unrealised gains may be seen as an alternative or complement to the Prudent Valuation requirements set out in the CRR only if those requirements are not considered sufficient to address concerns about reliability.

4.2.2.5 Level of application

31. The EBA has also considered the level at which a filter may be applied (i.e. instrument-by-instrument; or at a portfolio level) since the level of aggregation and diversification of investments within portfolios may have an impact on the level of unrealised gains to be filtered.

32. The level of application should be determined taking into account the principles underlying the definition of own funds (see above) but also (i) the potential impact on the amount and volatility of regulatory capital (for example, the effect of filtering unrealised gains on an instrument-by-instrument basis could be to reduce capital levels) and (ii) the potential impact on the behaviour of bank management. In order to provide a comprehensive discussion on the different policy options, it is important to understand the impact of the filters at each of these levels.

4.2.2.6 Behavioural consequences

33. The discussion paper considers if the introduction of a prudential filter on unrealised gains may have an influence on the banks' behaviour. Having an asymmetrical treatment between unrealised gains and losses may give an incentive to institutions to realise items with unrealised gains so as to avoid the capital impact associated with having to exclude those unrealised gains from capital for prudential purposes.

34. Furthermore, this could lead to a counterintuitive outcome. When a bank sells an asset at the balance sheet date and reacquires the asset immediately thereafter, the resulting realised gain under a filtered approach would be included in CET1 in contrast to when the bank had instead chosen not to sell and buy-back the item and still had an unrealised gain on its books. In such cases, the gains recognised in P&L or OCI and balance sheet values are the same but a different prudential outcome would arise. However, this assumes that the entity will be able and willing to sell and buy the same asset in order to realise the gain but this depends on the type of asset and the reasons to hold it.

35. Also, if institutions are incentivised to realise assets with significant unrealised gains, this may create tension in the financial markets and might exacerbate a crisis situation. This would be the case, for example during the financial crisis, if institutions would be incentivised to sell in large amounts their debt instruments with significant unrealised gains in a short space of time in order to compensate the unrealised losses arising on other debt instruments held at fair value. This may result in unfavourable market stability issues, although the impact will depend on whether the filter

is applied on an item-by-item or on a portfolio basis where it is possible to net unrealised gains with unrealised losses to some extent.

36. In addition, an asymmetrical treatment of unrealised losses and gains may incentivise institutions to change the duration of its investments in a certain portfolio so as to avoid the capital impact associated with having to exclude the unrealised gains from capital for prudential purposes. Generally, the impact of the asymmetry will depend on whether the filter is applied on an item-by-item or on a portfolio basis.

37. However, it should be noted that some countries currently apply an asymmetrical filter[4] and therefore it may not be a fundamental change to the current practice in those countries. Most countries apply the filter on a portfolio basis[5] while others may apply an item-by item approach on certain instruments or items.

4.2.2.7 Transparency

38. In many areas, the regulatory own funds are calculated with references to the financial statements. The EBA has considered whether the application of the proposed options on prudential filters would provide a strong link to the financial statements of institutions and would be sufficiently transparent for all stakeholders. Having a transparent link with the disclosed financial statements would help to ensure the credibility of the quality of the regulatory own funds. The regulatory capital reconciliation statement (as provided by the EBA in the draft ITS on Disclosure for Own Funds (EBA/ITS/2013/01) may provide one opportunity to make such a disclosure, as would capital disclosure requirements set out in international accounting standards (for example, IAS 1 paragraph 134).

39. Even if the unrealised gains are filtered from the regulatory own funds, some users of financial and regulatory capital statements may seek to adjust regulatory own funds to include those unrealised gains if they consider that it better reflects the capital of the business and the inherent volatility therein.

4.2.3 Summary of this section

40. Based on the discussion above, the table below summarises the arguments in favour or against the introduction of a prudential filter on unrealised gains.

Arguments in favour of the introduction of a prudential filter for unrealised gains	Arguments against the introduction of a prudential filter for unrealised gains
Unrealised gains may disappear and not be available to cover the losses when they arise, in particular in a crisis situation. Own funds should be available to absorb losses at any time.	In accounting terms, unrealised gains may cover any losses at the reporting date resulting from the application of the relevant accounting framework.
For debt instruments classified in the prudential	Even if this is not primarily the intention, the

[4] An asymmetrical filter refers to the inclusion in CET1 of unrealised losses and the derecognition of unrealised gains from CET1 (and may be included in Tier 2, at least partially).

[5] For investment properties and property, plant and equipment some countries apply an asymmetric filter on an item-by-item basis. This is also the case for AFS equity instruments where some countries apply it on an item-by-item basis.

banking book, the intention of the institution is, in general, not to realise the gains in the short term but to hold the items in order to collect the cash flows.	institution may decide to crystalise the gains by realising (or hedging) the assets. If the institution buys them back immediately, the economic situation of the institution will not change but the gains will be recognised in CET1 without restriction in Pillar 1.
For banking book items, the risk that the unrealised gains will disappear is not covered by a capital requirement.	For trading book items, the capital requirements cover the risk that the unrealised gains may disappear.
Even if the institution may realise the assets and crystalise the gains, this is not always possible in practice. For example, the assets may not be realised at the price expected by the institution due to lack of liquidity in markets, or uncertainty in the valuation.	The uncertainty in valuation should be covered by adjustment to the fair value and is also applicable for assets with unrealised losses. EBA is developing an RTS on Prudent Valuation.
On debt securities instruments, the unrealised gains will decrease towards the face value as the instruments mature when it will disappear.	A filter on unrealised gains may be seen as a simple tool to address market volatility if the level of deduction is not determined based on an assessment of the realisable value, market trends, etc. However, this concern may be addressed by applying different haircuts for unrealised gains due to different asset classes.
As the amounts of unrealised gains are subject to movements in the market prices, their recognition in regulatory capital might increase volatility of own funds. This may raise concerns about the procyclicality of the capital framework.	The introduction of a prudential filter for unrealised gains will result in an asymmetrical treatment with unrealised losses. This may also provide an incentive to the institution to realise the gains in order to compensate the impact of unrealised losses on their own funds or to change their investment policy (the impact will depend on whether the filters are applied on an item-by-item basis or on a portfolio basis). This may create additional tension in the markets if institutions are obliged to realise a large part of their assets in a short space of time.
Credibility of own funds, may be reduced if unrealised gains represent a substantial part of CET1.	It may be more transparent for market participants to follow the accounting treatment of unrealised gains, supported by the relevant disclosures of significant components of own funds (although this will depend on how users analyse this information). However, it should be taken into account that Pillar III/Disclosure requirements information will provide users with a reconciliation of accounting equity and regulatory own funds.

41. On this basis, there are prudential arguments to introduce a prudential filter on unrealised gains, being the most important the one that argue that unrealised gains may not be fully available to cover losses when needed. However, there are also some arguments to maintain the current rule in the CRR (no filter). If a filter is introduced in the capital framework, the design of this filter should take into account the potential drawbacks related to its application.

Q2. Do you agree with the description of the different criteria provided on this section in order to assess the possible treatments of unrealised gains? If not, please state why. Do you think there are other criteria that should be considered?

4.3 Interaction with developments in international agreements on prudential standards for banks

42. Article 80(4) states that the technical advice must consider developments in international agreements on prudential standards for banks. Since the Basel Committee published its Basel III proposal, there has not been significant development in the international prudential standards. It should be noted that a filter for unrealised gains would be inconsistent with Basel III as currently agreed and could therefore lead to level-playing field issues between European banks and non-European banks.

43. However, the Basel Committee also acknowledges that they will continue to review the appropriate treatment of unrealised gains, taking into account the evolution of the accounting framework[6].

44. The Basel Committee is also reviewing the requirements on the trading book, including the boundary between the trading book and the banking book and the possibility of introducing a capital charge for the interest rate risk in the banking book. The outcome from this review should also be taken into account for the decision to apply or not a filter.

45. The scope of this discussion paper is nevertheless limited to the application of filters on unrealised gains and does not take into account the advantage or disadvantage of setting capital requirements for all assets and liabilities measured at fair value for market risks compared to a filter on unrealised gains. If the EC considers this as a potential alternative, it should be underlined that the design of a capital requirement for market risk on banking book items will need more time in order to calibrate it adequately.

4.4 Interaction between the prudential rules and the accounting rules

46. Before analysing different policy options, the discussion paper considers the interaction between the prudential requirements and the accounting rules in developing policy options on unrealised gains. There are two alternatives that could be used as the basis for the prudential filter on unrealised gains arising from fair valued instruments:

- apply the filter based on the prudential categories of instruments
- apply the filter based on the accounting categories of instruments

[6] Footnote 10 of the Basel III text "There is no adjustment applied to remove from Common Equity Tier 1 unrealised gains or losses recognised on the balance sheet. Unrealised losses are subject to the transitional arrangements set out in paragraph 94 (c) and (d). The Committee will continue to review the appropriate treatment of unrealised gains, taking into account the evolution of the accounting framework."

47. For prudential and regulatory purposes, banks' assets/liabilities are generally grouped into the trading book or the banking book under the Basel Committee's standards and the CRR. The trading book category contain those assets/liabilities held that banks plan to actively trade or in order to hedge positions held with trading intent, while all other assets/liabilities (including investment properties and property, plant and equipment) are included in the banking book (i.e. a residual category). Due to different underlying economical assumptions, instruments in the trading and the banking book are regarded as being subject to different types of risk, and hence attract different capital measures[7] (e.g. market risk capital requirements on trading book assets).

48. The measurement of these instruments, at fair value or at amortised cost, depends on their accounting classification, which is different from the classification for prudential purposes. For example, under current IAS 39, financial instruments classified as held-for-trading (HFT) and available-for-sale (AFS) are measured at fair value, while instruments classified as loans and receivables (L&R) and held-to-maturity (HTM) are measured at amortised cost. In addition, IAS 39 permits entities to designate, at the time of acquisition or issuance, any financial asset or financial liability to be measured at fair value through profit or loss – i.e. fair value option - (even if the financial asset/liability would ordinarily, by its nature, be measured at amortised cost or at fair value but with changes in OCI) if certain conditions are met. Also, IFRS permits investment properties and own-used-properties to be held at cost, or at fair value. It should also be taken into account that the replacement of IAS 39 by IFRS 9 may change the classification and measurement of financial instruments.

49. Generally, trading book instruments are expected to be composed of financial instruments held for trading (with fair value changes through P&L) for accounting purposes. Similarly, banking book instruments are expected to be composed of loans and receivables, held-to-maturity investments (at amortised cost) and AFS assets (with fair value changes through OCI) given that they are not intended for active trading. However, there could be banking book instruments where the fair value option is applied for accounting purposes being the fair value changes recognised in P&L.

50. In these circumstances, any policy options to be applied based on prudential categories of instruments (e.g. banking versus trading book) will involve the identification of the unrealised gains arising from certain instruments in the bank's P&L or in OCI. This may raise concerns about the transparency of the own funds and the feasibility of filtering P&L as well as accumulated reserves (including OCI).

51. On the other hand, any policy options to be applied based on groups of assets under the accounting rules (e.g. AFS category) would need to be considered alongside the existing regulatory measures in place. For example, if AFS assets are classified in the prudential trading book (which is not expected to be a frequent situation), they are subject to the market risk capital requirements, which would not be applicable if those instruments were classified in the prudential banking book. Applying a filter on the AFS category will result in these AFS assets being subject to both market risk capital requirements as well as to a prudential filter (and will differ from the rest

[7] The distinction between the trading and the banking book means that there should be a distinction between positions subject to market risk and those positions that are not subject to market risk.

of AFS assets which are classified in the banking book where a market risk capital requirement is not applicable).[8]

52. There are arguments in favour of each approach as described in the following table. The arguments in favour of one basis also highlight the arguments against the other basis.

Arguments in favour of the prudential classification (e.g. trading book, banking book)	**Arguments in favour of the accounting classification (e.g. HFT, AFS)**
The prudential classification is in line with the solvency regulation where there is a distinction between assets and liabilities held with the intention to realise a gain in the short term (trading book) and other items where the intention is generally to hold the assets for a long period of time and to collect their related cash flows (banking book). This provides a more conceptual basis if different policy options are to be proposed on trading/banking book instruments.	Ease of reconciliation to the financial statements. The amounts of unrealised gains of a group of assets (e.g. AFS assets) could be directly obtained from the financial statements.
This approach provides a better level playing field between the EU institutions (even if they apply different accounting frameworks) as they are all subject to the same CRR/CRDIV rules.	Consistent with current practice on prudential filters (CEBS Guidelines) for institutions applying IAS 39 where the prudential filters are established based on the accounting categories of financial instruments.
This approach takes into account the existing capital requirements on the respective prudential books, hence allowing consistent treatment of assets which are included in the same prudential book. The risk of double-counting of capital requirements on a same instrument could be avoided.	
Accounting rules are subject to modification in the future (for example, with the likely introduction of IFRS 9 for financial instruments). Policy options on the prudential basis could be applied consistently between institutions irrespective of the applicable accounting framework.	

53. Based on the above discussion, the EBA has considered that the prudential classification of instruments is a more appropriate basis in developing policy options of prudential filters for unrealised gains. This will also be in line with the management intention as set out in the capital requirements regulation and it takes into account the different capital requirements.

[8] In addition, some bonds or equities classified as held for trading for accounting purposes may have been excluded from the prudential trading book in absence of liquid markets (and a change in the intention to sell the assets and realise a gain).

54. Nevertheless, the accounting requirements of assets or liabilities will still need to be assessed as it may result in a different policy option in some circumstances; for example, when hedge accounting is applied or when the fair value option is adopted to manage an accounting mismatch (see discussion in section 5.4.Interaction of a filter with IAS 39: Hedge accounting and fair value option).

Q3. Do you agree with the proposed approach based on the prudential classification (distinction between the trading and banking book) to analyse the different policy options? If not, please state why. Do you envisage any operational issue if the prudential approach is followed?

Q4. Do you have instruments that are classified as held for trading for accounting purposes included in the (regulatory) banking book or available for sale instruments classified as a position of the (regulatory) trading book? Could you quantify the relevance of these situations?

Q5. Do you see any differences in the analysis that should be taken into account with the requirements in the forthcoming IFRS 9?

5. Option analysis

55. This section explores the alternative policy options for the treatment of unrealised gains. It does not consider the inclusion of unrealised gains without adjustment in CET1 (the current treatment envisaged in the CRR) as an option given that Article 80(4) refers to treatments other that the current one. This policy options are developed based on the prudential framework classification (i.e. as a starting point distinguish between the trading and the banking book) of items measured at fair value.

56. The policy options may vary depending on the type of instruments or items and their classification for prudential purposes. This discussion paper considers the following categories separately:

- Interest bearing financial instruments at fair value: include debt securities, loans and advances and financial liabilities.
- Non-interest bearing financial instruments at fair value: include equities and liabilities linked to equities (short positions).
- Tangible assets at fair value: include Property, Plant and Equipment (PPE) and investment property.

57. In addition, it is considered that derivatives will be usually included in the trading book although in some circumstances may be included in the banking book (for instance, credit derivatives may be used as credit risk mitigation instrument in the banking book). Derivatives may also qualify for hedge accounting or may be part of the fair value option (if not separated from their host contract).

58. This discussion paper does not propose the offsetting of unrealised gains and losses arising from different categories of instruments (interest bearing financial instruments, non-interest bearing financial instruments and tangible assets) that are included in the same prudential book for the following reasons[9]:

- These instruments/items are generally managed separately by the institutions.
- Allowing offsetting between unrealised gains and losses in general may not be prudent.
- The policy options proposed may be different for each category considering the characteristics of the instruments/items (debt securities, equity or tangible assets).

59. This discussion paper considers different alternatives for the application of a filter on each category and also whether it should be applied on an item-by-item basis or on a portfolio basis.

Q6. Do you agree with the proposal to distinguish between different categories of instruments/items (interest bearing financial instruments, non-interest bearing financial

[9] It should be noted that 2004 CEBS Guidelines proposed a distinction for the available for sale category between equities, loans and receivables and other financial instruments (mainly debt securities). The CEBS Guidelines also proposed a prudential filter for investment properties and own used properties. Therefore, current practice in member states is to apply a filter taking into account the distinction put forward in CEBS Guidelines.

instruments and tangible assets) in analysing the different policy options? If not, please state why

5.1 Application of the policy option on an item-by-item or on a portfolio basis

60. In developing the policy options on each category, the EBA has considered whether unrealised losses on some financial instruments should be offset by unrealised gains on other financial instruments (and whether unrealised losses on investment properties or PPE should be offset by unrealised gains on other investment properties or PPE). There are two alternatives for each of the categories described in paragraph 56; either to apply the policy option on an instrument-by-instrument basis or to apply it on a portfolio basis.

61. For the item-by-item basis, each instrument shall be considered as an item. For the portfolio basis, the policy options can be applied with a different level of granularity; for example by making a distinction between sovereign bonds and non-sovereign bonds, by distinguishing between different currencies, etc.

62. There are different arguments in favour of each approach as described in the following table. The arguments in favour of one approach also highlight the arguments against the other approach.

Arguments in favour of an item-by-item approach	Arguments in favour of a portfolio approach
This is the most prudent approach as it does not allow the offset of unrealised gains and losses between instruments	If an item-by-item approach is used, institutions may be incentivised to sell and buy again the assets on which there are unrealised gains or to change investment strategies. In doing so, especially during a financial crisis, it may create additional tension on the financial markets and exacerbate a crisis situation.
Introduction of such filters on a portfolio basis could raise concerns as to whether the volatility and reliability of unrealised gains have been addressed.	A portfolio approach may be consistent with the way banks manage their financial instruments.
Gains of an instrument may disappear irrespective of the asset movements of another instrument.	It may encourage the diversification of banks' portfolios and therefore be reflective of risk mitigation benefits achieved through diversification.

63. It should be noticed that the concerns related to the item-by-item approach do not exist currently with the existing filters on unrealised gains because most countries apply them on a portfolio basis. This is the case for Available For Sale debt instruments and, in most cases, for Available For Sale equity instruments. For investment properties and property, plant and equipment there is more division between the use of the item-by-item and the portfolio basis for regulatory purposes.

64. Another consideration related to the level of application is that, institutions will in some cases, be applying fair value measurement requirements to groups of assets and liabilities where offsetting positions in market risk or counterparty credit risk already exist, as permitted under IFRS 13. In

other words, fair value measurement is often done based on the price applicable to net, rather than gross risk exposures. If an asymmetric approach were to be applied at an instrument-by-instrument basis it would be necessary for banks to alter their systems in order to calculate fair values on a gross basis.

Q7. Do you agree with the arguments in favour of an item-by-item basis or a portfolio basis? Are there other arguments that should be considered for the decision to apply the policy options on an item-by-item or on a portfolio basis?

Q8. Do you consider that the application of the policy options on an item-by-item or on a portfolio basis would be more justified for certain types of instruments/items than for others (for instance, debt securities, equity instruments, tangible assets)?

Q9. Please provide quantitative information about the difference between applying a filter on a portfolio basis or on an item-by-item basis and the impact of this difference in your capital ratios.

For instance, the amount of the cumulative net unrealised gains/losses for the current IFRS categories (AFS debt instruments, AFS equity instruments, investment properties and PPE) or in your national GAAP (also distinguishing between the trading and the banking book); the amount of the cumulative unrealised gains and the cumulative unrealised losses on an item-by-item basis; the importance of this amounts over CET1; and other quantitative information that you consider to be relevant for the technical advice and to support the assessment on whether an item-by-item or a portfolio approach should be applied.

5.2 Treatment of interest bearing financial instruments in the banking book (Investment portfolio)

65. Taking into account the aspects included in the methodology, there are some arguments that justify the introduction of a prudential adjustment for these instruments, notably:

- The management intention is primarily to the collect cash flows and not to realise gains in the short-term.
- For these instruments, such as debt securities, the unrealised gains will decrease over time towards the nominal value on redemption, assuming that all other factors affecting market value remain unchanged.
- There is no specific capital requirement for these items to alleviate concerns about the risk that unrealised gains may reduce or disappear.
- It may not be prudent to enable institutions to develop their activities on the basis of unrealised gains as there is significant uncertainty and volatility of these unrealised gains (to the extent where these are not addressed by the existing regulatory measures). Therefore, unrealised

gains recorded at a point in time may disappear if the values of the assets have moved unfavourably subsequently. This may happen within a short period of time.

66. On the other hand, introducing a filter may have an influence on the behaviour of the institutions and their investment strategies, and may incentivise them to sell items in order to realise gains and thereby offset the capital effect of the deduction of unrealised losses.

67. On this basis, this discussion paper proposes to consider different options to deal with unrealised gains arising from these instruments analysing the following options as well as the pros and cons of each of them:

- Option 1: No inclusion of unrealised gains in own funds
- Option 2: Partial inclusion of unrealised gains in own funds

5.2.1 Option 1: No inclusion of unrealised gains in own funds

68. Under this option unrealised gains will be completely filtered out from own funds. This constitutes the most prudent option and as explained in the previous section the level of prudence would also depend on whether the filter is applied on a portfolio basis or on an item-by-item basis.

Arguments in favour	Arguments against
It is the most prudent option. Unrealised gains would not be included in the capital buffers and minimum capital requirements as there is uncertainty about their ability to cover risks and future losses as well as their availability in crisis situation.	Filtering of unrealised gains may take management and supervisory focus off balance sheet valuations of such items in crisis situations and hide risks implicit in those positions.
In principle, it would reduce volatility in regulatory capital (more assessment is needed related to the different levels of application). Unrealised gains would not contribute to the increase of own funds and therefore would be less pro-cyclical.	In case of a recession, the existing unrealised gains will play the role of a counter-cyclical items.
It will encourage a level-playing field within the European Union as will harmonise the impact of the different accounting frameworks on the institutions' regulatory own funds(for instance, some national GAAPs require the use of a LOCOM method and therefore unrealised gains are not recognised).	There will be no level-playing field with non-EU institutions under the current Basel rules (see footnote 6 above).

5.2.2 Option 2: partial inclusion of the unrealised gains in own funds

69. It may be possible to partially recognise unrealised gains in own funds. This is a less prudent approach than option 1, but as explained in the methodology section, the EBA acknowledges that there are also some arguments to include some unrealised gains in own funds.

70. This option could be applied either on an item-by-item or on a portfolio basis. On a portfolio basis there is already a partial recognition of the unrealised gains up to the amount of the unrealised losses of the assets that are included in the same portfolio. On an item-by-item basis there is no compensation of unrealised losses with unrealised gains and, therefore, the partial recognition of unrealised gains in own funds could be more justifiable.

71. Partial recognition may also help to mitigate the concern that, unrealised gains may disappear and that it would not be prudent to have a large amount of own funds represented by those unrealised gains.

72. In order to implement a partial recognition in own funds, two potential approaches (potentially cumulative) could be envisaged:

- First adjustment: the unrealised gains could be subject to a haircut. This haircut enables, to some extent, to take into account the concerns on the recognition of unrealised gains. However, the extent of the haircut may differ depending on to which level of own funds it is applied, for example a higher haircut may be applied for unrealised gains included in CET1 than if they are to be included in T2. The extent of the haircut may also depend on whether the unrealised gains are identified on a portfolio or an item-by-item basis. Application of the policy option on a portfolio basis would require a higher haircut than on an item-by-item basis.
- Second adjustment: to limit the amount of the unrealised gains (after the first adjustment) to be recognised in own funds up to a certain percentage. Any excess amounts will be excluded from own funds. This second limit will mitigate the concern that unrealised gains could represent large proportion of own funds. A certain threshold may be defined in order to be applied to CET1, Total Tier1 or Total own funds. This threshold could nevertheless apply on the total amount of unrealised gains on all categories of assets and liabilities (including debt securities, equities and real estate).

73. If the partial recognition option was chosen, it would be advisable to propose a harmonised haircut across jurisdictions as currently different haircuts are applied by each jurisdiction at the European level which impairs comparability of banks' capital position across the EU.

74. With regard to the layer of own funds where the unrealised gains may be partially recognised, different possibilities may be envisaged:

- Partial inclusion in CET1;
- Partial inclusion in Additional Tier 1 (AT1); or
- Partial inclusion in Tier 2 (T2).

75. The recognition of unrealised gains in different layers of own funds may have different consequences. In general, it may be questionable whether bank's credit activities should be expanded based on these gains and in addition the expansion of the activity based on these gains may be pro-cyclical (to a different extent depending on which layer of own funds unrealised gains are partially recognised).

76. However, in case of a recession, unrealised gains would play the role of counter-cyclical items. Unrealised gains would contribute partially to the recovery of capital (depending on which layer of own funds they are recognised, to the partial recovery of CET1, AT1 or T2) if the fair value of the assets recover afterwards.

77. One additional aspect that should be considered is the level playing field that each of these approaches will introduce. On one hand, the partial inclusion of unrealised gains would ensure more level playing field between EU and not EU banks than would be the case if unrealised gains were not included in own funds (to different degrees depending on whether there is partial recognition in CET1, AT1 or T2 and the level of the haircut). However, at EU level, if unrealised gains are partially recognised in own funds, it may lead to competitive distortion for jurisdictions that apply local accounting principles that, generally, provide a lesser use of fair value measurement (for instance, some national GAAPs require the use of a LOCOM method and therefore unrealised gains are not recognised).

5.2.2.1 Partial inclusion in CET1

78. If unrealised gains were partially recognised in CET1, this would mean that capital buffers and minimum capital requirements may be covered, at least in part, by unrealised gains on which there is uncertainty about their ability to cover risks and future losses as well as their availability in crisis situations.

79. A reason for the partial recognition in CET1 is that it would lessen the concerns about the potential change in managements' behaviour.

5.2.2.2 Partial inclusion in AT1

80. If unrealised gains are partially recognised in AT1, unrealised gains will not count towards the capital buffers and minimum capital requirements. However, they will be able to contribute to the calculation of the leverage ratio or eligible capital.

81. As for the option of partial inclusion in CET1, the recognition of unrealised gains could be questioned as there is uncertainty about the ability of these gains to cover risk and future losses when needed.

82. A reason for partial recognition in AT1 is that it would lessen the concerns about the potential change in managements' behaviour.

5.2.2.3 Partial inclusion in T2

83. If unrealised gains are recognised in Tier 2, this would assume that these gains would be available in liquidation situations, however it is not evident that unrealised gains would be available in those situations. Whether or not unrealised gains would be available is likely to depend on the specifics of the liquidation, including the period over which items need to be realised, the existing economic circumstances etc. As such, under this option there remains uncertainty over the ability of gains to cover risk and future losses when needed.

84. In addition, partial inclusion in T2 is in line with one of the options in the current CEBS Guidelines (issued in 2004) on prudential filters.

Q10. Do you agree with the alternatives presented in this section? Do you have a preferred alternative? Please explain the reasons.

Q11. Do you agree that the haircut may be different depending on whether it affects the different layers of capital and also on whether the adjustment is applied on a portfolio or an item-by-item basis? Do you have a view regarding the level of the haircut?

Q12. Regarding the second adjustment (the threshold): do you agree to establish a limit to the recognition of unrealised gains in own funds? Do you have a view regarding the level of the threshold?

5.3 Treatment of non-interest bearing financial instruments in the banking book (investment in equities)

85. The arguments supporting a filter for interest bearing instruments (debt securities) are also generally applicable to equity instruments in the banking book. Nevertheless there are some differences that may be taken into account in the application and the design of the filter:

- The volatility of the market prices: equity prices may respond differently to quoted debt instruments. When compared with a debt instrument of the same issuer, they are expected to be more volatile and this may justify a more prudent approach.
- The behavioural consequences: equities do not have contractual cash flows and, in principle, it may be easier to realise the gains and buy back the same equities where these are liquid and actively trade as compared to debt securities. While consideration of other aspects cannot be disregarded (for instance, the size of the stake compared to the trade volume on the market) partial recognition of unrealised gains in own funds could be envisaged. In case of strategic investments, where the entity does not have the intention or ability to sell its investment and it could be more difficult to sell and buy back, there could be more reasons to apply a stricter approach.
- Capital requirements: if an IRB institution applies the VaR model approach or the simple risk weight method for equity exposures, it may be argued that the capital requirements cover sufficiently the market risk.
- Current practice for countries applying the asymmetrical filter for equity and debt securities: almost all EU countries applying an asymmetrical approach[10] for available for sale debt securities, apply the same haircut on the unrealised gains arising from both available for sale debt and equity securities.

[10] The asymmetrical approach refers to the recognition of unrealised losses and the filtering out of unrealised gains from CET1 and its partial recognition in Tier 2.

86. The basic approach for equity instruments/exposures could be to apply the same filters as for debt securities. However, it could be argued that:

- a stricter haircut or application on an instrument-by-instrument basis is required to take into account that equity prices may be more volatile although it may also be easier to sell and buy back equity instruments; and
- for institutions using the VaR model approach or the simple risk weight method for equities, the market risk may, to a certain extent, be covered.

Q13. Do you think equity and debt securities should be subject to the same policy options / treatment? Do you agree with the reasons provided in this section about the difference between equity and debt?

5.4 Interaction of a filter with IAS 39: Hedge accounting and fair value option

5.4.1 Hedge accounting

87. The EBA considered how unrealised gains on assets (or liabilities) should be calculated when they are hedged by a derivative (notably a cash flow hedge or fair value hedge) and hedge accounting is applied. The unrealised gain (or loss) on a hedged item should be determined taking into account the unrealised loss (or gain) on the hedging instrument. Applying a filter for unrealised gains in these circumstances may introduce a mismatch that the use of hedge accounting is trying to eliminate.

88. Under IAS 39, there are some specific conditions for the application of hedge accounting. One of these conditions is that "the hedge is expected to be highly effective in achieving offsetting changes in fair value or cash flows attributable to the hedged risk, consistently with the originally documented risk management strategy for that particular hedging relationship"[11]. Therefore, in principle it is expected that any ineffectiveness should be limited. However, those risks of the hedged item that are not hedged and the ineffective part of the hedge should be subject to the policy options described in the paper for those items.

89. If a filter is proposed, the consequences of this filter in conjunction with the current filter on cash flow hedges (Article 33 of the CRR) should be assessed as the filter on cash flow hedges currently applies to financial instruments that are not valued at fair value. If a filter is applied to unrealised gains on financial instruments measured at fair value, the offsetting of unrealised losses on the cash flow hedge instrument should also be derecognised.

Q14. Do you agree with the analysis for hedge accounting? Please provide quantitative

[11] IAS 39, paragraph 88.b)

information about the relevance of hedge ineffectiveness in hedge accounting

Q15. Do you see any difference in this analysis under the forthcoming hedge accounting requirements that the IASB is expect to publish in the second half of 2013?

5.4.2 Fair value option

90. According to IAS 39, financial assets and liabilities may be designated at initial recognition at fair value through P&L (fair value option) when:

- It eliminates or significantly reduces a measurement or recognition inconsistency (accounting mismatch): for example, where derivatives are used to hedge economically the risk of some assets and liabilities that do not qualify for hedge accounting. In this case, the non-derivative financial instrument would be measured at fair value through P&L. This option could also be used to avoid accounting mismatches between financial assets and liabilities that are non-derivatives.
- A group of financial assets, financial liabilities or both are managed on a fair value basis.
- Instruments with embedded derivatives in certain circumstances.

91. In general, if these financial assets and financial liabilities are included in the banking book, the unrealised gains should be subject to the policy option taken for items included in this prudential classification.

92. However, for financial instruments where the fair value option is applied to eliminate or significantly reduce an accounting mismatch, a potential option would be not to apply the filter to unrealised gains arising from these assets and liabilities (including the derivatives that qualify as held for trading and that are managed together with these assets and liabilities). The reason for not applying a filter is that unrealised gains and losses should be offset as both the asset and liability will be recorded at fair value.

93. If such an option is introduced, it should be conditional that the fair value option is effectively used as an economic hedge; and therefore to reduce accounting mismatches and such accounting treatment should not result in a large amount of unrealised gains which are not matched with unrealised losses. Under these conditions, the risk of arbitrage will be reduced.

94. The same analysis would apply under IFRS 9 as this Standard[12] in its current form retains the fair value option for accounting mismatches and, in the case of financial liabilities, for instruments managed on a fair value basis and instruments with embedded derivatives.

Q16. Do you agree with the analysis for fair value option accounting? Do you classify assets and liabilities managed on a fair value basis and financial instruments with embedded

[12] The IASB published in November 2012 an ED on Classification and Measurement: Limited Amendments to IFRS 9 which is currently being deliberated.

derivatives in the banking or the trading book? Please state the reasons for the classification.

Q17. Please provide quantitative information about the use of the fair value option

For instance, 1) the % of financial instruments measured according to the fair value option over total financial instruments; 2) the % of financial instruments measured according to the fair value option for: i) accounting mismatches; ii) management on a fair value basis; and iii) financial instruments with embedded derivatives; 3) the % of unrealised gains resulting from financial instruments measured according to the fair value option over CET1, AT1 and T2; and 4) the % of unrealised gains that do not match with unrealised losses, when using the fair value option to avoid accounting mismatches (this could also be compared to CET1, AT1 and T2).

5.5 Trading book financial instruments

95. The prudential trading book includes all positions in financial instruments and commodities held by an institution either with trading intent or in order to hedge positions held with trading intent. Trading intent shall be evidenced on the basis of the strategies, policies and procedures set up by the institution to manage the position or portfolio in accordance with Article 102 of the CRR.

96. Instruments classified in the prudential trading book will be usually measured at fair value and their changes in fair value would be recognised in the P&L.

97. The following aspects were considered in deciding whether there is a need to introduce any prudential filters for unrealised gains on trading book items. First, trading book items are subject to capital requirements for market risk with the objective to cover the volatility in the market value of these instruments. Second, trading book items are held with the intention to sell in the short term and therefore it does not seem appropriate to apply a prudential filter as those gains would be realised in the short term and would be effectively available to absorb any losses. Third, given that all realised and unrealised gains are recognised in the P&L, it would be difficult to identify realised gains from the unrealised gains[13] and would require maintaining the historic information that is needed for this purpose. Therefore, filtering unrealised gains on these items may be difficult. Lastly, the EBA is also developing RTS on Prudent Valuation to address the reliability of fair value positions, which is expected to include all trading book financial instruments (see section 5.6 on Prudent Valuation).

98. One possible concern of not having a filter for trading book unrealised gains while introducing such a filter on banking book items could be that banks may reclassify financial instruments from the banking book to the trading book. However, this will depend on the impact of the filter on banking book items (and if the filter is applied on a portfolio or on an item-by-item basis). The potential

[13] Other than for those items in level 3 of the fair value hierarchy that are still held at the balance sheet date, where IFRS 13 requires disclosures of gains in the period.

strengthening of the capital requirements on trading book items may also mitigate this risk. In addition, supervisors may require the prudential classification of an instrument if it does not meet anymore the trading book or the banking book definition. It should be noticed that current filter applied on AFS instruments, according to 2004 CEBS Guidelines, may also raise concerns about potential arbitrage.

99. In the absence of a filter, another concern is that unrealised gains on trading book items may represent a large amount of the own funds that may disappear and would not be fully available to cover losses when needed. Introducing a filter for this reason means that supervisors are concerned about the adequacy of the capital requirements on the trading book. Given current regulatory and supervisory tools, this concern should be addressed in the Pillar 2 process. It should be noted that the Basel Committee is currently reviewing the current capital requirements for the trading book and may probably strengthen the capital requirements on trading activities, depending on the outcome from the review.

100. For all the reasons above mentioned, the introduction of a filter in the trading book may not be appropriate. Nevertheless, where concerns remain for supervisors about the amount of unrealised gains in the trading book this may legitimate the consideration of a threshold similar to those proposed for banking book items.

Q18. Do you agree with the description provided in this section? Please provide quantitative information on the amount of unrealised gains included in the trading book

5.6 Interaction with Prudent Valuation

5.6.1 Scope of the prudent valuation standards

101. The EBA has published a Consultation Paper on a draft Regulatory Technical Standard (RTS) on Prudent Valuation (please see EBA CP/2013/28) according to the mandate of Article 105 of Regulation 575/2013 (CRR) setting out requirements relating to prudent valuation adjustments of fair value positions.

102. This draft RTS explains that Article 105 of the CRR refers to the prudent valuation standards being applicable to all trading book positions. However, Article 34 of the same Regulation requires that institutions shall apply the standards of Article 105 to all assets measured at fair value.

103. The combination of the above articles implies that the prudent valuation requirements in these RTS apply to all fair valued positions regardless of whether they are held in the trading book or banking book.

5.6.2 Objectives of the alternatives for unrealised gains treatment and prudent valuation methodology

104. The alternatives for the treatment of unrealised gains (prudential filters) described in this discussion paper implicitly cover several prudential concerns, the main of which being that unrealised gains may disappear due to negative movements of market prices of the underlying items. Other prudential concerns relate, for example, to the interaction with capital requirements, and the reliability of fair values.

105. The prudent valuation RTS objective is to address the reliability of fair values, being the concerns related to the possible implementation of prudential filters more embracing. In this sense, a prudential filter may represent a complement to the prudent valuation methodology.

5.6.3 Prudent valuation methodology

106. The draft RTS on prudent valuation proposed two approaches to calculate the prudent valuation adjustments:

a) Simplified approach: Institutions may apply the simplified approach if the sum of the absolute value of on- and off-balance-sheet fair valued assets and liabilities is less than €15bn. This approach calculates the required additional valuation adjustment (AVA's) that results from the sum of: (i) 25% of the net unrealised profit on financial instruments held at fair value; and (ii) 0,1% of the sum of the absolute value of on and off balance sheet fair value assets and liabilities.

b) Core approach: is a more granular approach and encompasses the calculation of additional valuation adjustments to several aspects that may influence the fair value measurement. In the case of lack of information about the characteristics of certain instruments that turns impossible the application of this approach, the institution may use a fallback approach[14].

5.6.4 Interaction between prudent valuation and the possible treatments of unrealised gains (prudential filters)

107. Regarding unrealised gains arising from financial instruments classified in the trading book, as the discussion paper is not proposing at this stage a filter for these items, no interaction with prudent valuation methodology needs to be addressed. If a filter were to be proposed for such items, consideration of the interaction would be necessary

108. However, for banking book items, there could be a risk of double deduction of an element of unrealised gains when computing CET1 if an adjustment is made under both the prudent valuation framework and a filter of unrealised gains to the same amount.

109. There are different aspects that could be considered in the possible interaction between prudent valuation and prudential filters:

a) Prudent valuation addresses the whole valuation of the assets/liabilities while the prudential filters discussed in this paper only apply for unrealised gains (notwithstanding the option to

[14] Under this fallback approach the AVA's corresponds to the sum of: (i) 100% of the net unrealised profit on the related financial instruments; and (ii) Either: 10% of the notional value of the related financial instruments in the case of derivatives, or 25% of the market value reduced by the amount determined in i) of the related financial instruments in the case of non-derivatives.

apply a prudential filter on a portfolio basis, which would allow the netting of unrealised gains and losses between instruments included in that portfolio).

b) The interaction between the prudential filters and the prudent valuation requirements (under the simplified approach, the core approach or the fallback approach).

c) The implication of the application of a filter on an item-by-item basis or on a portfolio basis when considered together with the prudent valuation adjustments.

d) Prudent valuation adjustments result in an adjustment to CET1. However, as discussed in this paper, prudential filters may result in a partial recognition of unrealised gains in CET1, in AT1 or in T2; or they may not be included in own funds at all.

5.6.5 Conclusion

110. If a prudential filter is applied on unrealised gains, the design of this filter should take into account the requirements on prudent valuation and, therefore, it should not lead to a double deduction of amounts already adjusted as a result of applying the prudent valuation requirements.

Q19. Do you think that there is a risk of double effect when applying a prudential filter and the requirements on prudent valuation?

Q20. Which are your views on the different issues described in point a) to d) of section 5.6.4? Please provide reasoning supporting your response

5.7 Investment Properties and Property, Plant and Equipment

111. IFRS permit investment properties and property, plant and equipment to be held at cost or at fair/revaluation value.

112. IAS 40 *Investment properties* defines investment property as property (land or a building – or a part of a building – or both) held (by the owner or by the lessee under a finance lease) to earn rentals or for capital appreciation or both, rather than for: a) use in the production or supply of goods or services or for administrative purposes; or b) sale in the ordinary course of the business[15]. For investment properties measured at fair value the changes in fair value are recognised in P&L.

113. For own use properties, plant and equipment, according to IAS 16, if the revaluation model is applied, the asset shall be carried at a revalued amount, being its fair value at the date of the revaluation less any subsequent accumulated depreciation and subsequent accumulated impairment losses[16]. If an asset's carrying amount is increased as a result of a revaluation, the increase shall be recognised in OCI (as opposed to P&L) and accumulated in equity under the

[15] IAS 40.5
[16] IAS 16.31

heading of revaluation surplus unless it reverses a revaluation decrease of the same asset previously recognised in P&L[17]. If an asset's carrying amount is decreased as a result of a revaluation, the decrease shall be recognised in P&L except where it reduces a credit balance existing in the revaluation surplus in respect of that asset in which case the decrease is recognised in OCI with a corresponding reduction of the amount accumulated in equity under the heading of revaluation surplus[18].

114. Currently, according to the CEBS Guidelines on prudential filters, countries may apply an asymmetrical approach; whereby unrealised gains are derecognised from CET1 and are partially recognised in T2. However, there is divergence in practice regarding the haircut applied for the recognition of unrealised gains in T2 and regarding the application of an item-by-item or a net approach.

115. Generally most banks measure investment properties and property, plant and equipment at cost. However, there are some banks which measure these assets at fair value. This raises the issue of level-playing field as banks measuring these assets at cost do not recognise the gains and, therefore, provides a reason to derecognise unrealised gains completely from CET1.

116. For both investment properties and own use properties, the argument in favour of taking into account unrealised gains (at least partially) is that there may exist large amounts of accumulated unrealised gains (which may have accumulated over a long period of time) and, therefore, market values may be considerably above original costs (this may particularly be the case for own-use properties that have been held and used for many years). However, given the absence of active liquid markets, it could be difficult for banks to realise the gains within a short period of time and, consequently, to absorb losses as soon as they occur. Therefore, it questions whether it would be consistent with Article 26 of the CRR.

117. For investment properties held to earn rentals, the rationale of the portfolio is broadly the same as for bond portfolios, i.e. steady cash flows, which would warrant the same treatment, but due to its lower liquidity it is a valid reason not to recognise such gains.

118. The liquidity issues (and also that some of this property could be held for own use and not for sale) might even suggest going for the more prudent item-by-item treatment.

119. In principle, it would seem preferable not to include in own funds the unrealised gains for investment properties and property, plant and equipment.

Q21. In case a prudential filter is applied, do you agree that unrealised gains on investment property and property, plant and equipment measured at fair value should not be included in own funds? If not, please state why

[17] IAS16.39
[18] IAS16.40

Q22. Do you think that there are more reasons to apply a filter on an item-by-item basis for tangible assets (investment properties or property, plant and equipment) than for the investment portfolio classified in the banking book? What would be the rationale to apply a prudential filter on a portfolio basis for tangible assets?

Annex - Summary of questions

1. **Do you agree with the scope of the discussion paper for the technical advice? Are there other elements that should be covered? If yes, please state why**

2. **Do you agree with the description of the different criteria provided on this section in order to assess the possible treatments of unrealised gains? If not, please state why. Do you think there are other criteria that should be considered?**

3. **Do you agree with the proposed approach based on the prudential classification (distinction between the trading and banking book) to analyse the different policy options? If not, please state why. Do you envisage any operational issue if the prudential approach is followed?**

4. **Do you have instruments that are classified as held for trading for accounting purposes included in the (regulatory) banking book or available for sale instruments classified as a position of the (regulatory) trading book? Could you quantify the relevance of these situations?**

5. **Do you see any differences in the analysis that should be taken into account with the requirements in the forthcoming IFRS 9?**

6. **Do you agree with the proposal to distinguish between different categories of instruments/items (interest bearing financial instruments, non-interest bearing financial instruments and tangible assets) in analysing the different policy options? If not, please state why**

7. **Do you agree with the arguments in favour of an item-by-item basis or a portfolio basis? Are there other arguments that should be considered for the decision to apply the policy options on an item-by-item or on a portfolio basis?**

8. **Do you consider that the application on an item-by-item or on a portfolio basis would be more justified for certain types of instruments/items than for others (for instance, debt securities, equity instruments, tangible assets)?**

9. **Please provide quantitative information about the difference between applying a filter on a portfolio basis or on an item-by-item basis and the impact of this difference in your capital ratios.**

10. **Do you agree with the alternatives presented in this section? Do you have a preferred alternative? Please explain the reasons.**

11. **Do you agree that the haircut may be different depending on whether it affects the different layers of capital and also on whether the adjustment is applied on a portfolio or an item-by-item basis? Do you have a view regarding the level of the haircut?**

12. **Regarding the second adjustment (the threshold): do you agree to establish a limit to the recognition of unrealised gains in own funds? Do you have a view regarding the level of the threshold?**

13. **Do you think equity and debt securities should be subject to the same policy options / treatment? Do you agree with the reasons provided in this section about the difference between equity and debt?**

14. **Do you agree with the analysis for hedge accounting? Please provide quantitative information about the relevance of hedge ineffectiveness in hedge accounting**

15. **Do you see any difference in this analysis under the forthcoming hedge accounting requirements that the IASB is expect to publish in the second half of 2013?**

16. **Do you agree with the analysis for fair value option accounting? Do you classify assets and liabilities managed on a fair value basis and financial instruments with embedded derivatives in the banking or the trading book? Please state the reasons for the classification**

17. **Please provide quantitative information about the use of the fair value option**

18. **Do you agree with the description provided in this section? Can you quantify the amount of unrealised gains included in the trading book?**

19. **Do you think that there is a risk of double effect when applying a prudential filter and the requirements on prudent valuation?**

20. **Which are your views on the different issues described in point a) to d) of section 5.6.4? Please provide reasoning supporting your response**

21. **In case a prudential filter is applied, do you agree that unrealised gains on investment property and property, plant and equipment measured at fair value should not be included in own funds? If not, please state why**

22. **Do you think that there are more reasons to apply a filter on an item-by-item basis for tangible assets (investment properties or property, plant and equipment) than for the investment portfolio classified in the banking book? What would be the rationale to apply a prudential filter on a portfolio basis for tangible assets?**