Comments

EBA Discussion Paper EBA/DP/2013/03
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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The **German Banking Industry Committee** is the joint committee operated by the central associations of the German banking industry. These associations are the Bundesverband der Deutschen Volksbanken und Raiffeisenbanken (BVR), for the cooperative banks, the Bundesverband deutscher Banken (BdB), for the private commercial banks, the Bundesverband Öffentlicher Banken Deutschlands (VÖB), for the public-sector banks, the Deutscher Sparkassen- und Giroverband (DSGV), for the savings banks finance group, and the Verband deutscher Pfandbriefbanken (vdp), for the Pfandbrief banks. Collectively, they represent more than 2,000 banks.

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Summary

- The basic approach of the Basel Committee on Banking Supervision, i.e. to take account of unrealised gains and losses fully in the common equity tier 1, is correct.
- The balance sheet of an institution presents its position truly and comprehensively.
- Asymmetrical filters only for unrealised gains would very much exaggerate risks and contradict the portfolio idea according to which value fluctuations compensate each other and risks are hedged against economically.
- For a more conservative supervisory examination, there are a number of approaches to addressing possible risks in the form of capital requirements and pillar II regulations; "white spots" such as interest rate risks and risks of difficult marketability are addressed by the BCBS and the EBA already by proposals regarding the hedging of interest rate risks and prudent valuation.

Taking account of the actually existing risks, we believe it is reasonable to do without any filters both for fair value items through profit and loss and for fair value items through OCI.

If we continued with, or introduced, filters for fair value items through OCI, as applied today in some jurisdictions, they would have to be applied — like today — to unrealised gains <u>and</u> losses. However, the treatment of unrealised losses is not covered by the EBA's work assignment according to Art. 80 Para. 4 CRR.

Based on the above comments, we have answered the questionnaire provided by EBA at II. below. At I., we have explained in detail why we believe it is reasonable to keep the CRR provisions to take account of unrealised gains <u>and</u> losses.

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I. Arguments in favour of keeping the CRR regulations

We welcome the differentiated look at and representation of the pros and cons of introducing an asymmetrical prudential filter for unrealised gains (Sections 4.2 and 4.3) provided in the present discussion paper of the EBA. The majority of the problems resulting from a selective non-consideration of items (asymmetrical prudential filter) when determining an institution's own funds are also appropriately examined.

We believe the basic approach of the Basel Committee on Banking Supervision (BCBS) to be correct to allocate "cumulated other income and other disclosed reserves allocated to the overall result" (marg. no. 52 of the new Basel framework [Basel III]) to common equity tier 1. In particular, it is correct "to not make adjustments to take account of unrealised gains or losses shown on the balance sheet when calculating the common equity tier 1" (footnote 10 of Basel III). It is certainly also correct "to keep an eye on the treatment of unrealised gains and, doing so, take account of the development of the accounting standards" (ibidem). However, new proposals of the Basel Committee regarding this are not available at the moment. Although developments regarding international accounting which may justify two-sided prudential filters, such as the delay (and revision) of the IFRS 9 which had been expected to come into effect for 2013 at the time Basel III was published or considerations regarding leasing accounting, have become visible since the publication of Basel III in December 2010, the European legislator has created reasonable transitional regulations (Art. 467 CRR) in respect of IFRS 9 in the Capital Requirements Directive (CRR), and other accounting standards have not yet been finalised.

We, therefore, urgently recommend to maintain the status quo of the CRR and, in compliance with the Basel framework, to not introduce a prudential filter for unrealised gains. Numerous reasons, some of which the EBA mentions in its discussion paper, speak against the introduction of a filter.

a) Loss absorption capability of unrealised gains

As we understand this, the supervisory authorities have considerable concerns that unrealised gains will not be available for loss absorption when they are needed (inter alia Para 16). From the supervisory authorities' point of view, there are two main drivers for these concerns:

1. Unrealised gains are subject to considerable fluctuation (inter alia Para 17).
2. Valuation on the balance sheet is too high (inter alia Para 18).

Re 1. – Fluctuation of the amounts of unrealised gains
We understand the EBA's representations to mean that there is concern that fluctuation of an institution's assets may have pro-cyclical effects both on its business activities and on the overall economy.

However, the introduction of asymmetrical filters would to a considerable extent intensify the pro-cyclicality (in a downturn). Indeed, all items of a (bank) balance sheet are subject to constant fluctuation — both the assets and the liabilities items. This is true not only for items which are measured at fair value but also to items which are measured at cost. In total, however, a major part of this fluctuation is equalised over the entire balance sheet. The fluctuations are not shown for at-cost items but very well for fair value items. To prohibit consideration of positive (fair) value developments for supervision purposes and at the same time have negative developments take full effect in respect of capital means to completely ignore these equalising effects.

With regard to hedge accounting, we agree to the EBA's statement (marg. no. 87) that application of a filter would be inappropriate. For economic hedges which do not meet the very specific requirements of IFRS hedge accounting but, nevertheless, serve to reduce risks, the introduction of a filter would be a disincentive contrary to prudent bank control because the introduction of a filter might rather keep institutions from making hedges. In this respect, we also see a fundamental conflict of goals with good risk management if the economically reasonable hedging of risks resulted in negative effects on the regulatory capital.

The exaggeration effects will be increased if, on top of this, set-off of unrealised gains and losses were restricted to individual items. Therefore, the EBA should make it clear that any examination of an institution's items is made at an appropriately consolidated net total bank level (total portfolio).

<u>Re 2. – Too high balance sheet valuation bases</u>
In addition to the value fluctuations of the items, the supervisory authorities seem to fear an incorrect valuation of the institution's assets. For a more conservative supervisory examination there might indeed remain some topics which lead to risks, or value fluctuations, regarding an institution's items. This includes (1) market price fluctuation, (2) price fluctuation due to the counterparty/credit risk, (3) interest rate risks and (4) risks from possible illiquidity of items.

However, the regulators already have realised and addressed these risks:

(1) Market price risks are addressed by the capital requirements of Basel III relating to such risks in the regulatory trading book. In so far as they occur in the banking book, they are addressed by the EBA's set of rules regarding prudent valuation which are currently being developed.
(2) Counterparty and credit risks are likewise addressed by the capital requirements of Basel III relating to such risks, both in the trading book and the banking book.
(3) Interest rate risks are indeed currently not yet covered by the capital requirements of pillar I of Basel III. However, the Basel Committee has also already attended to this issue and presented an appropriate paper for consultation a short time ago. Moreover, the interest rate risks are today already covered by the pillar II (capital) requirements.
(4) Risks from possible illiquidity of (e.g. very large) items are likewise covered by the EBA's proposals regarding prudent valuation.

Any risks of an institution which from the competent regulator's point of view are not appropriately taken into account in particular by the pillar I capital requirements of an institution are addressed by the supervisor by means of the pillar II requirements. All in all, therefore, all possible risk factors for an appropriate valuation of an institution's items are covered. Further regulation is not necessary and would lead to a (unreasonable) multiple allocation of risks.

b) Level playing field

Should a prudential filter for unrealised gains actually be introduced in the EU, this would mean substantial competitive disadvantages to the European banks. It cannot be understood why the European legislator would like to deviate from the Basel framework in this respect. To ensure a level playing field, the papers of the Basel Committee should be waited for and European solo efforts should be avoided.

c) Transparency

In particular, the status quo needs to be maintained, i.e. to take account of unrealised gains of fair value items through profit and loss in the common equity tier 1 — irrespective of their assignment to the regulatory trading or banking book or the application of hedge accounting. Otherwise, an institution's situation would be shown distortedly. For example, in particular investors would be unable to understand why performance-based compensation (e.g. in the form of dividends or bonuses for employees) are made from many items of the profit and loss account, while these items cannot be considered with regard to the regulatory capital.

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I. Answers to the questionnaire

Question 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.

1. General comment on the discussion paper:
We regret that the EBA does not regard the possibility of maintaining the status quo of the CRR — to do without prudential filters — as a possible course of action (Para 55). We interpret Article 80 Para. 4 CRR as a request to the EBA to give advice to the European Commission regarding the handling of unrealised gains reported at fair value on the balance sheet. In our opinion, comprehensive advice also includes an assessment of the status quo.

a) The status quo of the CRR should be maintained

We believe the basic approach of the Basel Committee on Banking Supervision (BCBS) to be correct to allocate "cumulated other income and other disclosed reserves allocated to the overall result" (marg. no. 52 of the new Basel framework [Basel III]) to common equity tier 1. In particular, it is correct "to not make adjustments to take account of unrealised gains or losses shown on the balance sheet when calculating the common equity tier 1" (footnote 10 of Basel III). It is certainly also correct "to keep an eye on the treatment of unrealised gains and, doing so, take account of the development of the accounting standards" (ibidem). However, new proposals of the Basel Committee regarding this are not available at the moment. Although developments regarding international accounting which may justify two-sided prudential filters, such as the delay (and revision) of the IFRS 9 which had been expected to come into effect for 2013 at the time Basel III was published or considerations regarding leasing accounting, have become visible since the publication of Basel III in December 2010, the European legislator has created reasonable transitional regulations (Art. 467 CRR) in respect of IFRS 9 in the Capital Requirements Directive (CRR), and other accounting standards have not yet been finalised.

Should a prudential filter for unrealised gains actually be introduced in the EU, this would mean substantial competitive disadvantages to the European banks. It cannot be understood why the European legislator would like to deviate from the Basel framework in this respect. To ensure a level playing field, the papers of the Basel Committee should be waited for and European solo efforts should be avoided.

We, therefore, urgently recommend to keep without change the provision of Article 35 CRR which enables full consideration of unrealised gains in the common equity tier 1, and in compliance with the Basel framework, to not introduce an asymmetrical prudential filter for unrealised gains.

In particular, the status quo needs to be maintained, i.e. to take account of fair value items through profit and loss in the common equity tier 1 — irrespective of their assignment to the regulatory trading or banking book or the application of hedge accounting. Otherwise, the result would be completely distorted representations e.g. in respect of the assessment of the distributable profit on the basis of the relevant accounting standard in interaction with regulatory restrictions. It would be difficult to communicate them to investors.

In so far, we also ask to clarify that

a) in accordance with Art. 468 CRR unrealised gains which are reported in the profit and loss account can be fully taken into account in the CET1 also under the CRR provisions from January 2014 on. (The only exception is "investment property". However, the formulation of the German text of the CRR regarding this is very difficult to understand and speaks of "(1) In deviation from Article 35, during the period from 1 January 2014 to 31 December 2017, institutions shall include in the calculation of their CET1 items only the applicable percentages of unrealised gains and losses related to assets or liabilities measured at fair value, and reported on the balance sheet, excluding the items specified in Article 33 and all other unrealised gains with the exception of those from investment property which are shown in the profit and loss account".);

b) the calculation regarding Art. 467 and 468 is done at the portfolio level, i.e. in total either unrealised gains or unrealised losses exist for an institution or a group of institutions.

Should the legislator, nevertheless, decide to introduce filters for unrealised gains which are shown in the OCI category (or revaluation reserve), they would necessarily have to be accompanied by appropriate filters for unrealised losses to prevent an excessively negative representation of an institution's situation. However, the treatment of unrealised losses is not covered by the EBA's work assignment according to Art. 80 Para. 4 CRR.

b) The intended goal is sufficiently provided for already by other regulations

Basic doubts about the correctness of the valuations and value representations on the balance sheet can be discerned from the EBA's statements. We do not share these doubts regarding the balance sheet figures. Rather, we are convinced that an institution's balance sheet presents its position truly and comprehensively. This is not only confirmed on a regular basis by the certified public accountant's audit report. Rather, the IFRS also provide for a determination of the fair value on the basis of the so-called exit price. This is the price that would be achieved at the valuation date if an asset were sold in the context of a usual transaction between market participants. Hence, the fair value already implies an actual ability to sell the underlying transaction. Moreover, the determination of the fair value is guided by a valuation hierarchy according to which the use of observable market prices or input factors is to be maximised. Also to be taken into account in this regard is the volume or extent of the activity on the markets where valuation parameters are observed. In this way, liquidity deductions are already made in the context of the valuation if an active market is non present. An arbitrary procedure

for the determination of the fair value is to the greatest extent ruled out by the extensive regulations that exist.

Also for the reasons stated above, we see no need to introduce a prudential filter for unrealised gains. The goals pursued by the present discussion paper are sufficiently provided for already by other regulations. This is true in particular with a view to the planned regulations regarding the prudent valuation of fair value items. Should a prudential filter for unrealised gains be introduced in addition to the prudent valuation, this would result in profound multiple burdens on the institutions in the form of higher deduction items for identical or similar banking supervision issues.

Furthermore, the frequently observed fundamental adjustment of the balance sheet figures for supervision purposes to a considerable extent promotes the non-transparency of the figures as no internal, and much less external, persons can understand the connection between the balance sheet figures and the supervisory figures. Although reconciliations as proposed in this respect by the EBA in marg. no. 38 might be made, they would be very complex and are likely to be hardly comprehensible.

In our opinion, the prudential concerns stated in chapter 4.2. can all be ascribed to doubts about the ability to sell and the risk of value fluctuations of the assets measured at fair value. However, this issue concerns all items measured at fair value and hence the effects not only on existing unrealised gains but also on potentially unrealised losses. These issues (may not be immediately available, may disappear, concerns on reliability, lack of an active market, ability to sell) are sufficiently being taken account of by Art. 34 CRR by the provisions regarding the "additional valuation adjustments". We, therefore, definitely reject a further regulation which single-sidedly refers to unrealised gains (also described in this way by the EBA in marg. nos. 24 and 30).

In its discussion paper, the EBA again and again sets forth itself that linking to unrealised gains was the wrong starting point and mentions the risk that securities might be sold for the purpose of realisation alone (and then possibly be bought back promptly). In the end, however, the institution's risk exposure would not have changed. Until these objections (seen by the EBA itself) have been solved, it is not appropriate to make respective deductions. The risks from economically open risk positions in respect of which market value changes result in single-sided losses are adequately covered by the relevant provisions regarding capital requirements or, in the case of interest rate risks, sufficiently provided for in the banking book by means of pillar II.

c) Threat of double burden and difficulties with implementation if an asymmetrical prudential filter is introduced

It is also not clear to us how the considerations presented can be applied to institutions that act under national accounting standards.

Finally, the precise interaction between the provisions regarding prudent valuation and the treatment of unrealised gains remains open. (For example, is a prudential filter applied to the prudent value?) In addition to expensive and intransparent set-off methods we primarily fear double capital deductions.

In so far, we would wish to have a coordinated approach of the two regulatory precaution concepts of prudent valuation and the treatment of unrealised gains. In the context of the examination of prudential filters for unrealised gains, we believe it to be necessary to observe the necessary overall bank control. In our opinion, the prudence principle is sufficiently guaranteed if exclusively a prudent valuation is made for hedging derivatives for basic trading book transactions which are included in the hedge accounting in accordance with IAS 39. The EBA should clarify this.

Prior to the possible introduction of a prudential filter, an impact study urgently needs to be conducted to enable an assessment of the burdens put on the credit institutions. At the same time, the institutions should be granted reasonable transitional periods during which they can gradually grow into the new deduction regulations.

2. Extent or starting point of the concrete proposals:

The assumptions regarding the accounting of financial instruments and their delimitation from the regulatory trading and banking book made in the discussion paper are represented incorrectly. This in particular applies to derivatives which, contrary to the EBA's statements, are for the main part assigned to the banking book. The EBA also ignores the fact that the institutions control their transactions at the portfolio level. Should a filter for unrealised gains be introduced, it has to be ensured at least that unrealised gains may be set off against unrealised losses at the highest portfolio level. A set-off of unrealised gains and losses should be possible at the group level but at least at the institution level. Otherwise, this would have serious consequences for the institutions' equity capital position.

Furthermore, at best the unrealised gains recorded in the OCI should be looked at. As the EBA annotates itself (marg. no. 97), both the unrealised and the realised gains are treated as having an effect on the net profit and loss. In so far, it is difficult to make a differentiation in the profit and loss account. This in particular applies to the derivatives listed in the trading book. Otherwise, an institution's position would be represented distortedly. For example, in particular investors would be unable to understand why distributions (e.g. in the form of dividends or bonuses for employees) are made from many items of the profit and loss account, while these items cannot be considered with regard to the regulatory capital. Cf. our comments on question 4.

Question 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?

The criteria used for the analysis of the possible treatments of unrealised gains are basically comprehensible. Due to the existing interdependencies with other regulations, it is from our point of view important in particular to take account of the interactions with the prudential capital resources requirements and the capital deduction for the prudent valuation of items measured at fair value.

However, the intention to realise gains (marg. no. 25 et seq.) should not play a role in the determination of whether or not unrealised gains can be taken into account for the regulatory capital. Especially in a restructuring case, the sale of items, e.g., is a possible course of action which usually even is stated in the restructuring plans. Moreover, a mixed business model is often applied to fixed-interest securities. In addition to receiving interest payments, these securities are basically available if additional liquid funds need to be provided. Therefore, these securities are liquid and usually can be sold at any time.

We cannot understand the concern or the statement that unrealised gains "may disappear" (inter alia marg. nos. 16 and 28). The main drivers of changes in the value of fair value items in the banking book are changed assessments of an item's probability to become bad debt or be lost and a changed level of the expected yield on the market (interest rate level). Both risks are already covered by capital requirements (interest rate risk in pillar II and in discussion in pillar I). In so far, the assessment in column 3, line 1, in marg. no. 40 is not appropriate.

The argument of column 1 in line 4 (values above the nominal amount melt away as the maturity date approaches) is likewise not reasonable. Higher market values (than the nominal value) result from general interest rate level, interest rate of the bond and risk of the bond. Reductions of the market value until the maturity date correspond to received (cash) interest paid on the bond. In so far, the unrealised gains are, to the contrary, gradually realised as time passes.

Finally, it is stated in the discussion paper (marg. no. 40) that consideration of the unrealised gains results in increased volatility of the capital and there is a danger of pro-cyclicality. However, this applies in equal measure to the unrealised losses. Moreover, non-consideration of the unrealised gains may even (e.g. in case of increased volatility of the markets) result in an increased volatility of the own funds because the balancing effect of the unrealised gains would be missing in that case. In our opinion, a prudential filter would hence not contribute to stabilising the banking sector but rather increase uncertainty.

Question 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?

In our opinion, a restriction of the analyses to one point of view (the banking supervisory view) is not sufficient. This leaves a number of problem areas out of consideration because in general the application of asymmetrical prudential filters causes substantial problems in respect of both their application to balance sheet categories (1) and their application to prudential categories (2):

(1) Many institutions hold substantial volumes of hedging derivatives in the banking book. These derivatives are used primarily for economic hedge relationships which are not intended for the hedge accounting within the meaning of IAS 39 because they do not meet the strict requirements of IAS 39 and hence cannot be included in the hedge accounting. According to IAS 39, they have to be assigned to the "held for trading" category as stand-alone derivatives although they have an economic hedge relationship because according to IFRS all derivatives (banking and trading book) are classified as held for trading.

    Furthermore, embedded derivatives that must be separated consisting of hybrid financial instruments are always classified as held for trading. In the case of a non-trading book institution, these derivatives typically account for the major part of the held for trading category. Other considerable trading assets or liabilities must on a regular basis not exist at non-trading book institutions. This fact is not sufficiently accounted for in the discussion paper.

    The valuation of underlying transactions in the context of a fair value control and hedges (derivatives) in economic hedge relationships acts in opposite direction and basically evens out, as in the case of hedge accounting transactions in accordance with IAS 39.

    If prudential filters were applied based on the accounting categories of instruments, we would assume that unrealised gains can be set off against unrealised losses at the level of the respective accounting category at the most. Since economic hedge derivatives are assigned to the hft category and the associated underlying transactions to the afs category or the fair value option, there would be no possibility to set off compensating unrealised valuation yields stemming from economic hedges and underlying transactions.

(2) If a prudential differentiation in the trading and the banking book (as proposed by the EBA) were made and prudential filters applied to banking book items, there would be other problems. The EBA proposes to apply the prudential filter on the basis of the banking supervision categories, i.e. banking book and trading book. This would result in

more and more diverging prudential and accounting depictions of exposures. Problems stemming from this are already discussed above (see I.) and have been seen by regulators when developing the CEBS-guidelines on prudential filters. What is more, further changes to the prudential framework will be needed once IFRS 9 is endorsed. There are even more problems resulting from the different treatment of unrealised gains and losses based on a balance sheet and a supervisory view. For example, profits and losses affecting net income (held for trading category) are each calculated and recorded on the profit and loss account as of the effective date ("year to date"). The result of this may be that the amount of the (regulatory law) deduction item ("life to date") is higher than the actual unrealised gain reported on the effective date. The case is different for financial instruments that are valued without effect on net income because the respective revaluation reserve is carried forward from effective date to effective date ("life to date"). From a concept point of view, it must, therefore, be rejected that unrealised gains from financial instruments affecting net income are discussed as part of a deduction item.

The application of hedge accounting already mentioned in marg. no. 54 and the use of the fair value option for portfolios of the regulatory banking book will in practice lead to considerable unrealised gains and losses which in total have not led to a change of capital but the gross amounts of which partly may be higher than the entire regulatory capital.

We see operational problems in particular in the case of transactions which in the accounting are assigned to the held for trading category but not to the trading book. For these items, as for the entire trading portfolio (cf. questions 9 and 18), the portion of the unrealised gains will usually be impossible or difficult to be determined.

Question 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?

According to the IFRS, all derivatives are assigned to the held for trading category, irrespective of whether they are assigned to the regulatory trading or banking book, and hence valued with an effect on net income. Derivatives may to a major extent be assigned to the banking book without being intended for hedge accounting. Accordingly, the assumption made in the discussion paper that derivatives are usually assigned to the trading book and only in exceptional cases (e.g. in the context of hedge accounting) to the banking book (cf. marg. no. 57) is not correct (see also our comments on question 3).

Banks control their market risk positions in the banking book at the macro-level and for this purpose conclude derivatives deals, among other deals, in the banking book. Since it is not in line with a bank's risk management to hedge its market risks — in particular the interest rate risks — at the individual transaction level, just part of the transactions are suitable for being

designated as an IFRS hedge relationship. For this reason, banks designate just part of the derivatives concluded in the banking book for an IFRS hedge relationship.

Due to the partly long terms and great volumes, high unrealised gains may result from the economic hedging derivatives (looked at on an instrument-by-instrument basis) which are opposed by high unrealised losses from opposed positions. Without consideration of the hedge relationship at the macro-level, serious effects on the prudential capital and a high capital volatility would result depending on the approach chosen.

Differences result for example from the portfolios which in terms of regulation have been redesignated from trading book to banking book, for instruments for which an assignment to the regulatory trading book is not possible due to regulatory provisions and from the trading portfolio of non-trading book institutions.

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

The facts stated in respect of question 4 will probably not change based on the already published rules regarding the general hedge relationships (primarily micro-hedge accounting). Although at the moment it is considered to allow macro-hedge accounting, the regulations regarding this have not yet been issued.

We believe there is an important interaction between prudential regulatory requirements and accounting standards that must be factored into the regulators' consideration before making any final decision on this topic. IFRS 9, the future accounting standard on financial instruments classification and measurement, is not yet final, but based on the current exposure drafts and IASB discussions, IFRS 9 is expected to narrow the definition of financial instruments that can be held at amortized cost, and therefore, increase in the classification of financial instruments at fair value through OCI ("FVOCI") and fair value through profit and loss ("FVPL"). Additionally, under IFRS 9, many instruments that are held for the purpose of collecting cash flows may be classified at FVOCI or FVPL because of terms that result in cash flows that are not solely payments of principle and interest. It's possible that this rule could increase the number of instruments classified as banking book for regulatory purposes, but held at fair value through profit and loss or FVOCI for accounting purposes.

In any case, due to the interdependency between IFRS 9 (that increases the scope of fair value classification) and solvency regulation we strongly urge the EBA to wait for the final issuance of IFRS 9 and to conduct an impact assessment with the industry before any decision regarding an asymmetric prudential filter is taken.

Question 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.

The EBA proposes to distinguish between interest bearing and non-interest bearing financial instruments and tangible assets. The assumption that these items will always be controlled separately is not always correct. To some extent, these items are controlled across boundaries, in particular because partly substantial dependencies of changes in value have shown. In so far, a differentiation by these categories appears to be inappropriate. Moreover, in the context of its analysis, the EBA assumes that derivatives are concluded in the trading book for purposes other than hedge accounting (marg. no. 57). This assumption is not correct. With regard to this, we refer to our comments regarding question 4.

Question 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?

The EBA is at best considering a set-off of unrealised gains and losses within a category of instruments. However, bank control is at the overall bank portfolio level. In our opinion, therefore, set-off at the highest portfolio level is absolutely necessary. Moreover, we speak out in favour of consolidating the portfolios at the group level. Otherwise, the institutions risk situation would be clearly exaggerated.

Question 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)?

We urgently advocate a portfolio-related application at the highest level. This is absolutely necessary in particular for the interest bearing instruments. Banks in particular control their interest risks at the macro-level and to this end also conclude derivatives in the banking book, i.e., the interest rate risks are usually hedged by means of opposing transactions.

All interest bearing instruments (securities, receivable, liabilities, derivatives) are usually included in the control irrespective of their IFRS category. Due to the asymmetrical valuation that results from the classification rules in accordance with the IFRS, the hedge relationship that results from the entirety of the items is initially not reflected in the IFRS result (irrespective of P&L or OCI reporting).

In order to make hedge relationships transparent in the IFRS statement, the IFRS, on the one hand, provide for the possibility of designating hedge relationships and, on the other, the fair value option, stating either accounting mismatch or control of a portfolio on a fair value basis as the reason. Irrespective of whether the hedge relationships are designated as IFRS hedge

relationships, whether they are reflected as economic hedge relationships based on the fair value option or whether, e.g., available for sale items are secured economically by means of derivatives in the banking book, high-volume long and short positions are opposing each other in items valued at full fair value or hedged fair value the unrealised results of which develop in different directions when the interest rate changes. This means that there is a direct connection between positive and negative value developments of interest bearing instruments which must necessarily be taken account of in the examination.

This would be ensured only by a portfolio-related application. In the context of an individual-transaction-related application, the economic hedge relationship would, in contrast, not be accounted for. The prudential capital would be substantially reduced and subjected to major fluctuation. Accordingly, the institutions would be compelled to sell on a regular basis items with unrealised gains and, partly, also items with losses in case of market fluctuations to eliminate uncontrollable capital fluctuation. In the case of severe market fluctuations, serious effects on the entire market might result because all banks would try to sell their positions.

We, therefore, urgently speak in favour of a set-off of unrealised gains and losses at the highest portfolio level.

Question 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.

Unrealised gains make up a substantial portion of the common equity tier 1. Surveys in the Member States have shown that almost the entire common equity tier 1 would be used up in case of an individual-transaction-related application.

The unrealised gains and losses for items of the trading portfolio cannot be reasonably calculated. In practice, the systems relevant to valuation do not carry the original acquisition costs because they are not required for the subsequent valuation.
However, the statements made here cannot replace a decided impact study by the EBA. The effects of the mechanisms proposed require an in-depth examination beforehand which must be made unbiased as to the results and sufficiently early before any planned implementation.

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

We urgently recommend to take account of unrealised gains in the regulatory capital. We cannot see a convincing reason why the capital from unrealised gains should be of a worse quality (see also our comments on question 2).

We feel that the cumulative application of a haircut considered by the EBA and the restriction of the unrealised gains recognised in the prudential capital to a certain percentage is clearly

too conservative. For reasons of consistency with the treatment of unrealised losses, we argue in favour of full recognition in the common equity tier 1.

Question 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?

From our point of view, haircuts are not appropriate. Their introduction would result in overlappings with the provisions regarding prudent valuation and to a double burden.

Question 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?

From our point of view, a restriction of the unrealised gains recognised in the prudential capital to a certain percentage is not appropriate. The items are valued extremely cautiously already by means of prudent valuation.

Question 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?

From our point of view, equity and borrowed capital instruments should be treated equally.

Shares in funds are a special case and are not examined by the EBA in the discussion paper.

These items basically are equity instruments. Where funds are consolidated on the balance sheet, they are deconsolidated for regulatory purposes and not reported with their individual assets but with their shares. Hence, the unrealised gain would have to be determined at the level of the fund, i.e. based on the fund's historical costs in comparison with its current fund price.

The question is how unrealised results for shares in special funds are to be determined which are transparent to the bank and for which sufficient information is available from the accounting to choose a more appropriate method. From our point of view, it would not be appropriate to determine unrealised gains on the basis of the historical costs of the fund shares in comparison with their current repurchase price. During the time a fund is held, which may be a considerable period, the securities contained in it are usually sold several times and associated unrealised results are realised. Accordingly, part of the value development of a fund is based on already realised value developments of the individual investments of the fund.

We, therefore, suggest to determine unrealised results on the basis of the unrealised results of the individual investments to determine the unrealised gains from shares in funds held in the banking book for which a look-through is possible. The interest rate risk from the individual

investments of a special fund is in many cases not hedged within the fund but in the banking book of the bank that holds the special fund. Control then is at the level of the interest book across all items. Where the interest bearing individual investments of special funds are controlled together with the direct investments of a bank, it should be possible to balance the resulting unrealised results together with the unrealised results from the other interest rate risk positions of the banking book.

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

Some institutions primarily do fair value hedge accounting instead of the cash-flow hedge accounting discussed in the discussion paper. Therefore, this accounting method, or examples of it, should likewise be examined.

Question 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?

We need to wait for the new regulations of the IFRS 9.

Question 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.

It is correct that in those cases in which the fair value option is applied due to accounting mismatch the items are items that represent an economic hedge.

In practice, a considerable portion of the items assigned to the regulatory banking book is also controlled on a fair value basis and the fair value option is used for this. These items are usually assigned to the banking book because it is not intended to sell them with a profit in the short term.

However, an economic hedge relationship also exists if interest bearing assets and liabilities are designated for the fair value option together with derivatives because they are part of the portfolio which the bank administers on a fair value basis. Here as well, the management approach is to control interest rate risks in the portfolio on a net basis. The assets and liabilities items designated in this way and the interest derivatives concluded for this form a net interest rate risk position and react in different directions to changes of the interest rate level.

Another essential case of the application of the fair value option are financial instruments with embedded derivatives. It would be consistent to treat these embedded derivatives analogous to the stand-alone or separated derivatives of the regulatory trading book of the held for trading category.

Irrespective of whether a position is a closed or a just partly closed interest rate risk position — as assumed for accounting mismatch in the discussion paper —, the value developments of the opposing long and short positions compensate each other at least to some extent. Since opposing positions have value developments that compensate each other, the compensated portion of the value development may be regarded as having been realised even if the positions have not yet been sold. If the interest rate risk position is not closed, this is reflected in a positive or negative unrealised result.

A bank's interest rate risks are controlled at the level of one or several interest books, usually independent of the relevant balance sheet category. For this reason, it should likewise be possible to balance unrealised gains and losses from interest instruments measured at fair value independent of the balance sheet category (in IFRS available for sale, fair value option, held for trading, hedge accounting) at the level of the interest books.

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

In our opinion, the statement about the use of the fair value option in relation to the entire financial assets is not reasonable because they are measured partly at fair value (e.g. afs) and partly at acquisition costs. A meaningful statement might, in contrast, be made in relation to the relevant balance sheet items (e.g. share of fair value items in the receivables from banks or customers).

However, the statements made here cannot substitute a decided impact study by the EBA. The effects of the mechanisms proposed require an in-depth examination beforehand which must be made unbiased as to the results and sufficiently early before any planned implementation.

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

We expressly welcome it that the EBA wishes to not apply a prudential filter to trading book items and, therefore, unrealised gains from financial instruments of the trading book can be fully considered in the common equity tier 1.

This is justified in so far as it is assumed in the context of the provisions regarding prudent valuation that the items of the trading book can be balanced quickly at the prudent value. For this, an additional valuation adjustment (AVA) is already deducted directly from the common equity tier 1. To make another deduction from the capital because gains may reduce while an item is held would contradict the prudent value approach. Moreover, the market risk of trading book items is to be hedged by means of capital.

However, the EBA would like to enable the supervisory authorities to limit the recognition of unrealised gains from financial instruments of the trading book to a certain percentage if they

are concerned about the amount of the unrealised gains in the trading book (marg. no. 100). We definitely reject this scope of discretion for reasons of a level playing field.

We reject a filter or the limitation (e.g. in the form of a cap) of recognition of unrealised gains in the CET1. It is of special importance to us that in addition to the unrealised results from the trading portfolio all results from other forms of economic hedging, in particular all forms of hedge accounting (macro and micro hedge accounting) and the fair value option, are not subjected to a filter and also not to a limitation by a cap. We also see a fundamental conflict of goals with good risk management if the economically reasonable hedging of risks would have negative consequences for the regulatory capital.

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

The regulatory technical standards regarding prudent valuation are to take account of the prudential concerns that unrealised gains might vanish due to market price uncertainty of the underlying transaction. Therefore, this capital deduction item is to remedy the insufficient reliability of the fair value for banking supervision purposes, similar to the prudential filter for unrealised gains. In the simplified flat-rate approach, reference is even made explicitly to the unrealised gains. In so far, unrealised gains are neutralised already partly by means of the AVA. In our opinion, there is a danger of double deduction of unrealised gains of banking book items. From our point of view, a multiple burden in the form of higher deduction items for identical or similar banking supervision issues is not comprehensible.

The provisions regarding prudent valuation are based on the assumption that items can as a rule be sold within a short time. One of the reasons the present discussion paper on unrealised gains gives to justify the deduction of unrealised gains is that the institutions precisely do not wish to, or cannot, sell their items and the gains from them vanish over time. Accordingly, the EBA assumes that the items are held. These two assumptions contradict each other. We, therefore, believe it is not appropriate to make a double deduction of capital, one with the assumption of a sale of the items at short notice and one with the reason that gains vanish over time.

Inconsistencies may likewise occur in those cases in which the prudent valuation method assumes the holding of the position. For example, AVAs are determined for the evening-up costs from derivative books at the portfolio level and thus on the basis of a net position. For the assumed holding of the underlying net position, an AVA for administrative costs incurred for this in the future needs to be applied. Therefore, determination of unrealised gains from derivatives in the banking book on an individual-transaction-related basis would be inconsistent.

Comments EBA Discussion Paper EBA/DP/2013/03
Technical advice to the Commission on possible treatments of unrealised gains measured at fair value under Article 80 of the Capital Requirements Regulation (CRR)

Question 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.

With regard to the unrealised gains for banking book items, there might be double deductions. We think this is not appropriate for the reasons stated at question 19.

Should, nevertheless, a prudential filter for unrealised gains be introduced in addition to prudent valuation, the amount of unrealised gains of the banking book remaining after set-off with the unrealised losses should be reduced by the AVAs assigned to them. A prudential filter should then be applied only to this positive difference. This would avoid double deductions. Otherwise, a profit would be deducted which has not occurred at all according to the EBA's calculation method.