POSITION PAPER

# ESBG Position the EBA DP on technical advice on possible treatments of unrealised gains measured at fair value

## September 2013

ESBG

# Position on the EBA Discussion Paper on technical advice on possible treatments of unrealised gains measured at fair value (EBA/DP/2013/03)

The ESBG are grateful for the opportunity to provide input to the current discussion paper and hope that the responses outlined below are of assistance to the EBA in the preparation of its response to the European Commission.

**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.**

We are concerned that the approach of full or partial exclusion of unrealised gains contradicts the purpose of Article 35 CRR which states that "*Except in the case of the items referred to in Article 33, 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 second sentence of Article 80(4) explains that the current Discussion Paper on possible treatment of unrealised gains refers to *"relevant developments in international accounting standards and in international agreements on prudential standards for banks."* We question the relevance of raising this issue in the current environment as the implementation of IFRS 9 is unlikely to take place within the next 3 years. We believe that a step-by-step approach taking into consideration accounting developments based on further actions from the IASB in respect of IFRS 9 would be the most appropriate process. Therefore we would strongly urge the EBA to develop the treatment of unrealised gains by exchange of information with the relevant bodies in charge of the accounting treatment related to unrealised gains and losses.

We also want to bring to your attention our concern that different treatment of instruments measured at fair value between US GAAP and IFRS could result in further differences between prudent requirements within the European Union compared to the United States. As the CRR is already much more prudent than the original framework published by the Basel Committee we strongly question how additional differences in the regulation would allow for comparability. We therefore believe that the proposed approach contradicts one of the main aims of the Basel 3 framework, namely the level playing field.

Regulatory capital cannot be increased by unrealised gains on instruments used for hedging as potential unrealised gains on one side of the relationship are offset by losses on the other side of the relationship.

**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?**

We are not convinced that full or partial exclusion of unrealised gains would be appropriate for institutions within the European Union who apply the IFRS accounting principles:

- We believe that the treatment of unrealised gains for regulatory purposes during the discussion process regarding IFRS 9 is not appropriate as there are some doubts whether IFRS 9 will enter into force within the next 3 years. For the period ending 2017 unrealised

gains are excluded from the regulatory capital due to transitional requirements defined within Articles 467 and 468 of the CRR.

- We do not believe that the intention to exclude unrealised gains from the regulatory capital within the Basel 3 requirements for institutions located within the European Union would be appropriate as this approach is not in line with the key purpose of the Basel Committee to implement a global level playing field by setting out the global Basel framework.
- We fear that exclusion of unrealised gains by contemporary consideration of prudent valuation would lead to negative double-counting. Please note that exclusion of unrealised gains is already covered, at least partially, within the Consultation Paper on Prudent Valuation. We will return to this point in our answer to question 19.

**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?**

We understand the arguments for both prudential and accounting classification approaches.

A distinction between the trading and the banking book would be reasonable because there is a capital requirement for the market risk of the trading book instruments reflecting the potential downside-risk. From this point of view only banking book instruments which are not subject to similar capital requirements might be considered in need of potential filters for unrealised gains.

On the other hand, the approach using accounting classification ensures consistent reconciliation to financial statements and therefore an easily understandable translation from accounting figures to prudential filters within the disclosure requirements.

As we think that application of prudential filters on unrealised gains is not necessary prior to the introduction of IFRS 9 we would propose to address this question when the IFRS 9 requirements are in place.

**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?**

Some of our members hold economic hedges which are classified in the trading book for accounting purposes as it is not possible to provide the required documentation to classify them as a micro or macro hedge according to IAS 39.

Consequently, it is important for our affected members not to desynchronise the treatment of economic hedges where the hedged item is classified in a different book to the hedging instrument.

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

As there are still a lot of uncertainties regarding IFRS 9 we find it difficult to provide a meaningful comment on this question in the current situation.

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.**

We agree with this proposal.

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?**

We believe that the arguments are valid in principal. We however regard this approach as too prudent and we would prefer a portfolio approach. An item-by-item approach could lead to more volatility due to an increase in the realisations of unrealised gains.

If for example an institution sells an item at year-end, in order to avoid a regulatory capital impact due to the unrealised gains requirements, and then buys back the same instrument at the beginning of the following year the unrealised gains are realised and the regulatory capital contains 100% of the realised gain. However the risk linked to this instrument has not changed. Therefore an item-by-item approach would on the one hand lead to more volatility and on the other hand to a very high impact on regulatory capital.

Although the argument that gains on an instrument may disappear irrespective of the movement of another instrument is understandable we would argue that this line of argumentation also applies to unrealised losses which may also disappear irrespective of movements in other instruments. A line-by-line item determination of fair value gains and losses is also not in line with the business model of banks which follows a portfolio approach.

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)?**

An item-by-item approach would lead to an unrealistic high capital impact for derivatives. For derivatives a portfolio approach is therefore necessary. For debt instruments a portfolio approach is reasonable due to the fact that on the one hand unrealised gains will decrease towards the maturity but on the other hand unrealised losses may also decrease towards the maturity (leaving credit risk out of scope). For all other instruments we also plead for a portfolio approach.

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.**

It is not possible for us as an association to provide this information.

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

We do not agree with option 1 set out in paragraph 67 of the discussion paper. We believe that option 1 should not be considered in order to ensure:

- Global level playing field (EU/CRR vs. third countries)

- Best possible way of reconciliation and comparability of the accounting figures to regulatory (prudential) figures
- Avoidance of mismatch between the figures measured at fair value within the regulatory capital and those used for calculation of capital requirements
- Avoidance of any misunderstandings in analysing and comparing accounting figures to regulatory figures

Full exclusion of unrealised gains from own funds is not appropriate from our point of view.

Additionally we want to point out that option 2 is not in line with the above mentioned arguments, as the exclusion of unrealised gains contradicts the introduction of a global level playing field and the possibility to reconcile accounting to regulatory (prudent) figures and would therefore create a source of misunderstanding as well as misinterpretation.

As the competent local authorities could decide to require full or partial exclusion of unrealised gains from own funds during the transitional period from 2015 to 2017 (after full exclusion of unrealised gains in 2014) and subsequent treatment of unrealised gains will depend on IFRS 9 we question the need to require the proposed treatment at this point of time.

**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?**

We want to point out that the consideration of unrealised gains within different layers of capital in case of fully consolidated entities may impact on the calculation of eligible minorities.

We see no problem in cases where the unrealised gains are eligible within CET 1 when the entity is not 100% owned. In cases where the unrealised gains would be distributed to different levels of capital this would impact the parent as the tier 2 capital issued by the relevant subsidiary would lose eligibility.

We want to ask the EBA if this approach is appropriate as the issuance of tier 2 capital is a fundamental part of capital steering as well as capital planning. We believe that consideration of unrealised gains would lead to uncertainty regarding how to manage the capital of subsidiaries in case the issued amount of such instruments is not fully available at group-level.

We also believe that unrealised gains should be available as tier 1 as consideration within tier 2 is acceptable in respect of total own funds but not for reasons related to purposes of large exposure and/or leverage ratio.

**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?**

With reference to the calculation of eligible and non-eligible minority interests we want to point out that any type of haircut or partial exclusion would have an impact on the way minority excess-capital is calculated. Therefore, in case haircut or partial exclusion of unrealised gains would be relevant for calculation of own funds we want to ask the EBA to provide institutions with information on how the haircut or partial exclusion should be considered within the minority-calculation.

We also want to call attention to the fact that a haircut for unrealised gains is already in the scope of the proposal on prudent valuation. For institutions using the standard approach for calculation of capital deduction as defined within the consultation paper on prudent valuation, 25% of unrealised gains shall be excluded from the CET 1.

We doubt that this is an appropriate point in time to discuss a possible haircut on unrealised gains. As the transitional provisions for the treatment of unrealised gains according to Article 468 CRR requires a haircut by at least 20% on all unrealised gains for the years 2015-2017 (100% in 2014) we do not see any reason for additional limitations to unrealised gains within this period.

A possible haircut or partial exclusion of unrealised gains from own funds should be required appropriate by considering the development of the respective accounting principles. With respect to institutions calculating and reporting their own funds based on IFRS the further development of measurement rules, in particular the development of IFRS 9 implementation should be taken into consideration.

In summary we believe that it is not appropriate to finalise the definition at this moment in time in regards to transitional provisions on unrealised gains and further development of IFRS 9.

**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?**

We think that equity and debt securities should be subject to the same policy options / treatment. Although equity prices can be more volatile than prices of debt instruments, this additional risk is covered by larger risk weights for equity instruments in the banking book.

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

We particularly agree with the analysis in paragraph 88. The regulations for applying hedge accounting under IAS39 are very strict and it is expected that any ineffectiveness should be limited. Therefore we propose to filter out all unrealised gains on hedging instruments and also on the fair value changes attributable to the hedged risk as long as they are in an effective hedge relationship.

**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?**

No significant differences. EBA should deal with additional OCI item which arises when options are used as hedging instruments and time value from the options is separated from the hedging instrument.

**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**

Our members classify all financial instruments, which are held with trading intention, in the trading book. Nevertheless our members also hold financial instruments with embedded derivatives or financial instruments which are managed on a fair value basis but not held with

trading intention. These instruments are classified in the banking book. We support not to consider unrealised gains of all instruments in the FVO due to accounting mismatch, as these economic hedges should not result in a large amount of unrealised gains which are not matched with the corresponding unrealised losses.

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

We will not comment on this 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 will not comment on this question.

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

There would undoubtedly be a double effect when applying a prudential filter and the requirements on prudent valuations. The simplified approach would in particular lead to a double effect because net unrealised gains are the basis for the additional valuation adjustment calculation.

In general we would welcome if those two requirements could be combined.

**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**

a) *Prudent Valuation addresses the whole valuation of the assets/liabilities while the prudential filters discussed in this paper only for unrealised gains (notwithstanding the option to apply a prudential filter on a portfolio basis, which would allow the netting of unrealised gains and losses between instruments in that portfolio.):* The unrealised gains are also a part of the whole valuation of the assets and liabilities, therefore prudent valuation already addresses unrealised gains as well. We would argue for "either-or-decision" between prudent valuation and the treatment of unrealised gains. We, especially in the case of Trading Book assets and liabilities, plead for the option to follow only the requirements of the prudent valuation regime. If unrealised gains requirements are set for the banking book, we would recommend using the prudent valuation requirements only for the trading book in order to avoid double-counting.

b) *The interaction between the prudential filters and the prudent valuation requirements (under the simplified approach, the core approach or the fall-back approach):* Under the simplified approach and the fall-back approach, unrealised gains are already accounted for on a net basis. Therefore if an institution uses the simplified approach in the prudent valuation regime this circumstance should be accounted for in the unrealised gains regime. Institutions with net unrealised losses receive a favourable treatment in both the prudent valuation regime and the unrealised gains regime which is not understandable. The combination between potential future losses and unrealised gains is not documented. The core approach is not directly affected by net unrealised gains; nevertheless the aim of the core approach is the same as the aim of the simplified 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 adjustment:* As already mentioned an item-by-item approach

appears too prudent and should be avoided. A portfolio approach may deliver similar results as the simplified approach depending on the composition of the portfolios.

d) We will not comment on this item.

**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.**

This is currently not relevant as FV-measurement of investment property and property, plant and equipment is not applied by our members. With reference to our previous statements we want to point out that unrealised gains should not be excluded from the regulatory capital anyway. Therefore we are not in line with the argumentation to apply an additional filter on measurement on investment property and property, plant and equipment.

Furthermore we believe that FV-measurement of investment property and property, plant and equipment should be revised once IFRS 9 is in place.

**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?**

This is currently not relevant as FV-measurement of tangible assets is not applied by our members. With reference to our previous statements we want to point out that unrealised gains should not be excluded from the regulatory capital anyway. Therefore we are not in line with the argumentation to apply an additional filter on measurement on tangible assets.

Furthermore we want to reiterate our view that FV-measurement of tangible assets should be revised once IFRS 9 is in place.

**About ESBG (European Savings Banks Group)**

**ESBG – The European Voice of Savings and Retail Banking**

ESBG (European Savings Banks Group) is an international banking association that represents one of the largest European retail banking networks, comprising of approximately one-third of the retail banking market in Europe, with total assets of over €7,470 billion, non-bank deposits of €3,400 billion and non-bank loans of €4,000 billion (31 December 2010). It represents the interests of its members vis-à-vis the EU Institutions and generates, facilitates and manages high quality cross-border banking projects.

ESBG members are typically savings and retail banks or associations thereof. They are often organised in decentralised networks and offer their services throughout their region. ESBG member banks have reinvested responsibly in their region for many decades and are a distinct benchmark for corporate social responsibility activities throughout Europe and the world.

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