European Banking Federation

Chief Executive

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Email

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Mr Stefan INGVES
Chairman
Basel Committee

Email: Stefan.ingves@bis.org

***Subject*: Interaction of developments in the regulatory and accounting frameworks**

Dear Mr Ingves,

The European Banking Federation (EBF)[1] would like to draw your attention to the importance of examining the interaction of developments in the regulatory and accounting frameworks in order to avoid any unintended consequences. Two issues are of particular importance: the removal of the prudential filter for OCI (Other Comprehensive Income) and the new accounting expected loss impairment in combination with introduction of Basel III and the add-ons for G-SIFIs, which could have very significant impacts approaching a downturn.

OCI treatment under Basel III – removal of prudential filters

The Basel III proposes that the institutions shall consider, in order to determine their capital base, the accumulated other comprehensive income and other disclosed reserves. The removal of the (AFS) filter (Available-for-sale category fair valued through OCI) will therefore result in unrealized gains and losses on financial asset fair valued through OCI being included in regulatory capital.

While the Basel III framework envisages that the Basel Committee will continue to review the appropriate treatment of unrealized gains, taking into account the evolution of the accounting framework, national regulators are advancing with implementation of the Basel III provisions in question.

In some jurisdictions, the national implementation may result in a full deduction of unrealised losses from regulatory capital as of 1 January 2013.

[1] *Launched in 1960, the European Banking Federation is the voice of the European banking sector from the European Union and European Free Trade Association countries. The EBF represents the interests of almost 5000 banks, large and small, wholesale and retail, local and cross-border financial institutions. Together, these banks account for over 80% of the total assets and deposits and some 80% of all bank loans in the EU only.*
The EBF is committed to supporting EU policies to promote the single market in financial services in general and in banking activities in particular. It advocates free and fair competition in the EU and world markets and supports the banks' efforts to increase their efficiency and competitiveness.

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Inconsistency between the implementation date of IFRS 9 and Basel III

Under current IAS 39, assets classified in the "Available-for-sale" category are measured at fair value, with changes to fair value reported as a component of equity.

IFRS 9, as issued by the IASB in November 2009 for application by 1 January 2013, eliminated the AFS category. There are only two categories for debt securities; fair value through profit or loss and amortised cost. At the time the Basel III provisions were being developed, banks would have assumed that the elimination of the AFS filter would not affect banks' capital, since the AFS category would be eliminated at the same time as filter would be removed. After the adoption of IFRS 9 by IASB, the general view was that many vanilla AFS debt securities held for the collection of contractual cash flows would be measured at amortised cost under IFRS 9. As a result, IFRS banks made little objection to the Basel proposals at the time they were being considered.

However, the mandatory implementation date of IFRS 9 has been delayed by the IASB until 2015 and the standard is not yet endorsed for use in the European Union. In the view of EBF members, this results in significant unintended consequences in terms of volatility of capital, since the AFS category will remain in use until at least 2015. The unrealized gains or losses of the AFS portfolio would be adding pro-cyclicality and volatility to the capital requirements of banks during a window of at least three years. Therefore, there is a strong case for delaying the elimination of the AFS filter until the required implementation of IFRS 9.

The situation is further complicated by the recent decision of the IABS to reopen IFRS 9 and their tentative decision to include a third category for debt securities: fair value through OCI. Although there is much uncertainty at present as to what debt securities would be included in the category, the EBF remains supportive of the principles in the issued version of IFRS 9 which in its view would result in relatively few (if any) portfolios of debt securities being included in the fair value through OCI category. In particular, the banking industry believes that liquidity and balance sheet management portfolios will need to be assessed against the business model criterion and, where appropriate, accounted for at amortised cost where sales of financial assets occur for credit reasons or to match changes in expected duration of assets/liabilities gaps. More than an infrequent number of sales result in the entity assessing whether and how such sales are consistent with the objective of collecting contractual cash flows rather than invalidating the previous amortised cost accounting.

The EBF anticipates that removal of the filter in conjunction with a third category in IFRS 9 would result in less of a capital impact than the removal of the filter in conjunction with the continued application of IAS 39, subject to further decisions on the definition of Fair value through OCI.

The EBF therefore believes that any provisions proposing removal of the prudential filter should be delayed and in the period between the implementation of the Basel Framework and IFRS 9, unrealised gains or losses should remain under provisions equivalent to current national regulations. Such delay would also allow a closer examination of the possible impact that the removal of the filter may have, not only on regulatory capital but also on the behaviour of financial institutions. Once IFRS 9 is in place, EBF members believe that the prudential filter removal should follow the transitional arrangements as proposed in Basel III, consistently across jurisdictions, to ensure a level playing field.

Treatment of accounting impairment allowance

Unless changes are made to Basel III, it is expected that, to the extent accounting allowance is larger than Basel expected losses for IRB approach portfolios, there will be an add back to Tier 2 capital up to a maximum of 0.6% of credit risk-weighted assets. For other regulatory approaches, it may be possible to add back bucket 1 allowance to Tier 2 up to a maximum of 1.25% of credit risk-weighted risk assets calculated under the standardised approach, to some extent dependent on whether the accounting allowances are deemed to relate to unidentified losses.

Neither approach is helpful for key regulatory ratios which focus on core equity Tier 1 which will take the full impact of the increased provisions, with no add-back under Basel capital rules. As recession approaches, under the new regime, a bank's capital requirements would increase at the same time as its actual capital would decrease as a result of the accounting expected losses.

The EBF recommends that Basel considers the interaction between the accounting changes and Basel III capital requirements, to avoid any double counting as the extension of the scope of the expected losses resulting from the new impairment accounting principles must logically lead to a decrease in the amount of unexpected losses, which is the basis of capital requirements for credit risk. The EBF suggests that it would be appropriate for Basel to consult on its view on the interactions between the accounting expected loss, the Basel EL and RWA requirements, the buffers, including the counter cyclical buffer and the add on for G-SIFIs, as the accounting requirements develops.

The European Banking Federation thanks you in advance for your consideration. Should you require any further information the EBF would be glad to provide it.

Yours sincerely,

Guido Ravoet

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