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. Executive Summary and Policy Recommendations

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) CRR requires the EBA (European Banking Authority) to provide technical advice to the European Commission (EC) on possible treatments of unrealised gains measured at fair value other than including them in Common Equity Tier 1 (CET1).

The EBA published on 2 August 2013 a discussion paper with its preliminary views on possible treatments of unrealised gains and gathered the stakeholders’ input on this topic. The input received has assisted the EBA in the finalisation of this technical advice, to be provided to the European Commission by 1 January 2014.

Contents

According to the mandate of the CRR, the scope of the technical advice is limited to ‘unrealised gains measured at fair value’, and therefore ‘unrealised losses’ are excluded. In addition, the advice does not consider the inclusion of unrealised gains in CET1 without adjustment to be an option, given that the mandate refers to treatments other than the current one. The advice refers to ‘unrealised gains’ as those gains recognised in both the income statement and the statement of other comprehensive income arising from items reported at fair value on the balance sheet. Some instruments measured at fair value have been excluded from the advice, as they were either not considered relevant to the scope of the technical advice or already covered by a prudential filter under the CRR.

The EBA has analysed the opportunity to introduce a prudential filter for unrealised gains and, with the objective of ensuring a comprehensive assessment, has provided different criteria that should be considered in the analysis.

The advice explains the prudential concerns about unrealised gains, which are, in particular, that unrealised gains may not be immediately available to absorb losses, as they can disappear as a result of negative movements in market prices; that own funds could be overstated if the fair values on which unrealised gains are based are not reliable; and the possible pro-cyclical effects if CET1, and therefore if the capital buffers, are to a large extent composed of unrealised gains, which could reverse in a crisis situation and therefore exacerbate pro-cyclicality.

In addition, the advice enumerates other criteria which should also be considered when deciding on the appropriate policy option. These criteria include the ability of institutions to realise the gains of these assets, as this may be difficult in less liquid markets or if there are clauses that restrict institutions’ ability to sell the assets; the intention to realise the gains, in particular for instruments classified in the banking book, where, contrary to instruments included in the trading book, the intention is to hold them with a long-term objective; and the interaction of the unrealised gains with the
liquidity framework and capital requirements. As regards the latter, the technical advice notes that there is currently no requirement under Pillar 1 with regard to market risk of items included in the banking book, although the supervisor may require additional own funds for this risk under the Pillar 2 assessment. However, this assessment is generally done for the whole banking book and it is not necessarily homogeneous across Member States.

An important aspect that should be considered is the interaction with the prudent valuation requirements, as double counting of the same risk should be avoided. From a conceptual perspective, prudent valuation addresses the supervisory concern over the reliability of the valuation, which is an issue of particular relevance for illiquid instruments, as they may not be realisable in the short term at the price expected by the institution. However, a prudential filter addresses additional supervisory concerns such as the possibility of unrealised gains disappearing as a result of negative movements in market prices, which may not be adequately covered by capital requirements. In this regard, the EBA is currently developing regulatory technical standards (RTS) on prudent valuation, which will also take into account the results of a quantitative impact study carried out by the EBA which will provide some information about the impact on own funds of the prudent valuation proposal. In case a prudential filter would be introduced, the interaction between the two prudential frameworks would need to be further assessed.

The advice also takes into account the interaction between prudential requirements and accounting rules in developing policy options. In this regard, the EBA proposes to distinguish between the banking and the trading book in its analysis of the different policy options, as this distinction will take into account the different capital requirements that apply for the banking book and the trading book. The accounting requirements will still need to be assessed, in particular when hedge accounting or the fair value option is applied.

With regard to the trading book, the advice takes into account several aspects: the existence of capital requirements for market risk; the intention to sell these instruments in the short term; and the difficulty of differentiating between realised and unrealised gains. In addition to these requirements, prudent valuation requirements are also applied.

With regard to unrealised gains from banking book positions, the advice proposes to differentiate for analysis purposes between interest-bearing financial instruments (e.g. debt instruments), non-interest-bearing financial instruments (e.g. equity) and tangible assets. Derivatives are addressed separately and they are not included in the portfolios previously identified.

For the categories of instruments included in the banking book, it is relevant to consider whether the different policy options should be applied on a portfolio basis or on an item-by-item basis, as the capital impact would be different. The advice illustrates the arguments in favour of and against the application of each of the approaches, and, although an item-by-item approach might appear to be more prudent, a portfolio approach would be in line with the way in which these instruments are managed (applies to financial instruments).

Tangible assets are analysed separately, but for interest-bearing and non-interest-bearing financial instruments it could be argued that there are reasons for and against applying the same policy
options, as, while equity instruments may be more volatile, it may also be easier to sell and buy them, and capital requirements may sufficiently cover the market risk.

For banking book items, the advice considers different policy options. The options range from no inclusion of unrealised gains in own funds to a partial recognition in CET1, Additional Tier 1 (AT1) or Tier 2 (T2). In the case of partial recognition, further consideration is included in the technical advice regarding the application of a possible haircut. The EBA considers that, if the Commission proposes to introduce a filter, it would be advisable to propose a harmonised haircut across jurisdictions to enhance the comparability of banks’ capital position at the European level.

The advice also provides an analysis of the interaction of a prudential filter with the current IAS 39 requirements for hedge accounting and for the fair value option. Under hedge accounting, any ineffectiveness is expected to be limited, and therefore a filter for unrealised gains may introduce the kind of mismatch that the use of hedge accounting is intended to eliminate. Therefore, only the risk of the hedged item that is not hedged and the ineffective part of the hedge relationship should be subject to the policy options applicable for items included in the banking book. Similarly, when the fair value option is applied, it could also be considered that there is an offset between the unrealised gains and losses of the instruments included in this category and that, therefore, a prudential filter would need to be applied (if at all) only to the net unrealised gain resulting from the application of the fair value option.

Finally, for tangible assets, the advice acknowledges as an argument against the introduction of a filter that there may be large amounts of accumulated unrealised gains. However, the absence of liquid markets for these assets is an argument that justifies the introduction of a prudential filter. In addition, in the case of own use properties, these are not expected to be sold very frequently. The application of a prudential filter for tangible assets may be more justifiable on an item-by-item basis than on a portfolio basis, as these assets are generally less liquid than financial instruments.

Summary of the views received during the Consultation

Respondents did not support the introduction of a filter for unrealised gains. The main arguments for no filtering were that there is a risk of double counting of the same risks - already addressed through accounting standards (IFRS) and capital requirements (Prudent Valuation, Pillar 1 and Pillar 2 requirements) - and that it will result in asymmetrical treatment of gains and losses, being inconsistent with risk management practices as it will not allow the offsetting gains and losses. In addition, respondents’ also expressed their concerns that a filter could be inconsistent with ensuring a level playing field between European and non-European banks as Basel III has removed this prudential filter.

A more detailed summary of the responses received during the consultation and the EBA response to the stakeholders’ comments can be found in the annex of this document.

Following from the above, some recommendations to the European Commission on possible treatments of unrealised gains are provided in the following section.
Policy Recommendations

Based on the analysis carried out in the technical advice on these criteria, the EBA believes that unrealised gains may disappear quickly as a result of market conditions and show significant volatility. Consequently, it may be justified to develop a specific treatment for unrealised gains as opposed to other items of CET1. Furthermore, depending on the economic environment, unrealised gains may represent a relevant part of institutions’ own funds, which could be an issue of concern for banking supervisors. The risk that the amount of unrealised gains will change over time as a result of modification of asset prices is not covered by the capital framework for items in the banking book (i.e. no regulatory capital held for market risk in the banking book under Pillar I requirements) contrary to the capital requirements applicable to trading book items.

Therefore, while further developments in this regard are still on-going (for example, initiatives on the boundary of the trading book and on capital requirements for the banking book), there are prudential arguments that would justify derecognising unrealised gains related to banking book items in CET1 via the introduction of prudential filters. This would also be in line with the current prudential filters applied by Member States to exclude unrealised gains from CET1 (which may be partially included in Tier 2).

Notwithstanding the previous arguments, other aspects may need some attention.

The derecognition of unrealised gains would be inconsistent with ensuring a level playing field between European and non-European banks (considering that this would be a departure from current Basel III rules). However, it should also be considered that the Basel Committee on Banking Supervision will continue to review the appropriate treatment of unrealised gains taking into account the evolution of the accounting framework.

Introducing an asymmetrical prudential filter would also entail behavioural consequences. Having an asymmetrical filter between unrealised gains and losses could be an incentive to institutions to realise items with unrealised gains in order to avoid the capital impact associated with having to exclude those unrealised gains from capital for prudential purposes. This could also lead to a counterintuitive outcome, as a different prudential outcome will arise depending on the decision of an entity either to sell an asset and reacquire it immediately afterwards, in order to realise the gains, or to hold the asset and therefore keep recognising the unrealised gains. Additionally, according to the views expressed by respondents, a filter on unrealised gains may disincentivise entities from undertaking ‘economic hedges’ and may increase the volatility of capital. However, there could also be prudential concerns regarding the risk of arbitrage if the link between the hedging and the hedged instruments is not sufficiently clear and documented.

Taking into account all these considerations, if the Commission decides to introduce a prudential filter, there are some aspects which may deserve particular attention and further analysis:

- The developments in the Basel Committee on Banking Supervision in different areas, in particular the initiatives on the fundamental review of the trading book (i.e. the boundary between the trading book and the banking book) and on capital requirements for interest rate risk and credit spread risk in the banking book will need to be monitored. In addition, attention
should be granted to future possible work on the treatment of unrealised gains as such. The EBA will follow these developments and bring its contribution as appropriate.

- The interaction with the final forthcoming EBA proposals on prudent valuation will need to be further considered in the assessment on possible treatments of unrealised gains.
- In the recent years, the financial crisis may have kept unrealised gains as a low percentage of own funds, however, as markets are recovering we could expect the recognition by banks of higher amounts of unrealised gains. In this regard, the EBA will monitor the evolution of unrealised gains in banks' balance sheet and as a percentage of CET1.

Taking into consideration all the previous arguments, the EBA still see merits in recommending the introduction of prudential filters for unrealised gains. If the Commission decides to introduce a prudential filter, the EBA will work closely in all the aspects mentioned above with the Commission to assess how they could be appropriately considered in any legislative proposal.

In addition, in relation to the different issues assessed in the advice, the EBA would like to provide the following views for consideration alongside an introduction of prudential filters for unrealised gains:

- While for banking book items there are some prudential concerns that could justify the introduction of a prudential filter, this is not necessarily the case for items classified in the trading book.

- The policy options should be applied on a portfolio basis for financial instruments. This could also reduce the prudential concerns arising as a result of the application of an asymmetrical filter, bearing in mind that unrealised losses for certain assets will already be offset by unrealised gains on other assets within the same portfolio.

- There is not sufficient reason to apply a different prudential filter for interest-bearing and non-interest-bearing financial instruments.

- For investment properties and property, plant and equipment (PPE), it would seem preferable to identify unrealised gains and losses separately by applying an item-by-item approach, and not to include in own funds the unrealised gains.
2. 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 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 CRR also establishes a transition period during which unrealised gains shall continue to be removed from CET1. In particular, Article 468 establishes that from the date of application of the CRR to 31 December 2014 unrealised gains related to assets or liabilities measured at fair value and reported on the balance sheet (excluding those referred to in Article 33) and unrealised gains related to investment properties measured at fair value and reported as part of the profit and loss account (P&L) 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 will be 1 year 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 will 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) 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 International Financial Reporting Standard (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 the 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.

The EBA published a discussion paper on the technical advice on 2 August 2013, with the objective of gathering stakeholders’ views on possible alternative treatments to the one established in Article 35 CRR. The input received has been used in the finalisation of the technical advice. A summary of the responses can be found in the annex.
3. Technical advice

3.1 Introduction

3.1.1 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 outside the scope of this technical advice, in accordance with the mandate of Article 80(4) CRR.

2. Unrealised gains (which 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 P&L. According to Article 468 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’. It is implicit from this that the CRR considers unrealised gains to arise on fair value positions on the balance sheet irrespective of whether those gains have been recognised in the statement of OCI or the P&L (as is the case for investment properties).

3. This technical advice has included in its scope of analysis unrealised gains recognised in both the income statement (P&L) and the statement of OCI arising from items reported at fair value on the balance sheet in accordance with the mandate as set out in Article 80(4) CRR subject to the exceptions noted under section 3.1.2 below. This constitutes the EBA’s 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) CRR the intended scope of the technical advice covers items that are ‘measured at fair value’. Under current IAS 39, certain categories of financial instruments (held for trading (HFT) and ‘available for sale’ (AFS) assets) are required to be measured at fair value. IFRS also provide the option to measure certain financial instruments (under the fair value option), investment properties and PPE at fair value. Depending on the type of asset or liability and the category in which it is classified, the changes in fair value may be recognised in P&L (HFT assets, financial instruments under the fair value option and investment properties) or in OCI (AFS assets, and PPE).

5. Under national generally accepted accounting principles (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 less use of fair value under national GAAPs than would occur under IFRS.

(1) Article 33 CRR refers to cash flow hedges and changes in the value of own liabilities.
6. The items included in the scope of this technical advice include assets and liabilities measured at fair value under local or international accounting requirements. Consideration is also given to expected developments in international accounting standards, including the implication of the current proposals to replace IAS 39 by IFRS 9, and in international agreements on prudential standards for banks.

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

3.1.2 Exceptions from the scope (a)

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

9. The CRR also retains a prudential filter for unrealised gains and losses arising from cash flow hedges and for changes in the value of liabilities (debt instruments and derivatives) due to changes in own credit risk (Article 33 CRR). The first filter was 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. 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 technical advice.

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

3.2 Methodology

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

12. In this technical advice, the EBA has taken into account the following aspects:

- the quality and reliability of own funds and aspects that could be of supervisory concern;

(a) During the preparation of the technical advice, 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 on the balance-sheet (i.e. net of related liabilities) will be deducted from CET1 according to Article 36 (1e) 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, interaction with the liquidity framework, existing capital requirements, interaction with the prudential valuation framework, levels of application of the prudential filters, behavioural consequences, transparency and the implications for a level playing field.

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

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

14. Article 26(1) CRR states that CET1 items such as retained earnings or accumulated OCI 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 subsequent to the reporting date as a result of negative movements in the 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 available to cover not only current losses but also 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 therefore if the buffers that an entity was building during an economic upturn in order to withstand losses during a downturn were to a large extent composed of unrealised gains. In addition, the potential reversal of unrealised gains may, in a crisis situation, exacerbate pro-cyclicality.

18. There are also prudential concerns about 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 of the valuation of the fair value assets and liabilities.

19. In view of the above, it is justified from a prudential perspective to consider whether it is appropriate not to take into account unrealised gains when assessing the solvency position of an institution under a Pillar 1 approach.

3.2.2 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.
3.2.2.1 Ability to realise the gains

21. An institution may realise its unrealised gains by selling the related assets, or by using an adequate hedging strategy. 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 depend on the nature of the underlying item and the current economic context. For instance, unrealised gains arising from an item that is actively traded in a recognised exchange might be realisable immediately, while in other cases there might 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 on 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 market prices might not be truly representative and that realisation of gains from such investments at any time would be uncertain because the related assets might not be realised in the short term at the price expected by the institution.

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 CRR.

3.2.2.2 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 of 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, such as credit risk, illiquidity, etc., remain constant). The realisation of the gain may also have a negative tax effect or other consequences (including the impact on the 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 the intention to sell them in the short term. It could therefore be argued that there is a reasonable expectation that those gains will be realisable in the short term and available to absorb any losses other than in the case of extreme market falls occurring in the short term.

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(3) IFRS 13 Fair-value measurement has arrived at 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.
3.2.2.3. Interaction with the liquidity framework

28. In addition, the liquidity framework requirements may be counterintuitive to the introduction of a prudential filter to unrealised gains. The liquidity framework (Article 412 CRR) requires banks to hold high-quality liquid assets. These assets may be classified in the fair value through OCI category and imposing a filter on the grounds that there are concerns about the availability of realising the gains on these assets may be seen as contrary to the requirements for these assets in the liquidity framework. However, the eligibility of assets for the liquidity coverage requirements is subject to a regular review (every month under the Basel III requirements), and therefore the composition of the liquidity buffer and the amount of the unrealised gains could potentially change. The fact that some assets are included in the liquidity buffer does not necessarily mean that the assets are not held mainly for investment purposes, although they may be used in case of a liquidity need. Therefore, the inclusion of the assets in the liquidity buffer does not itself prevent us from considering policy options other than the inclusion of unrealised gains arising on such items in the regulatory capital calculation. Liquidity is a dynamic concept that requires banks’ on-going review and monitoring. Furthermore, while the liquidity coverage requirements do not cover all assets (only those assets which are eligible) this technical advice covers both assets that may be and may not be included in the liquidity coverage requirements.

3.2.2.4 Capital requirements

29. 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 and specific market risks. This is less straightforward for assets which are included in the banking book, where capital requirements focus on credit risk (except for foreign exchange risk and commodities risk, where positions in the banking book are subject to market risk).

30. For items in the banking book, market risk (with the exception of foreign exchange risk and commodities risk) is not subject to a capital requirement under Pillar 1, although the supervisor may assess under Pillar 2 the extent to which banking book items are subject to market risk. It is a common supervisory practice under supervisory review processes to assess the level of interest rate risk, and to some extent the spread risk, for banking book items. In addition, 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 account that unrealised gains may disappear. However, the assessment of interest rate risk is made generally on the whole banking book and not only on items at fair value, and the methodology for measuring market risk of the banking book is not necessary homogeneous under Pillar 2. The Pillar 2 process may also be seen as less systematic and transparent than a Pillar 1 adjustment.
3.2.2.5 Prudent valuation framework

31. The reliability of fair values of assets and liabilities (and the unrealised gains arising therefrom) is a prudential concern that may be covered by the upcoming RTS on prudent valuation. Applying an additional filter to 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.

32. Prudent valuation addresses the supervisory concern over the reliability of valuations, which is an issue of particular relevance for illiquid instruments, as they may not be realisable in the short term at the price expected by the institution. However, a prudential filter addresses additional supervisory concerns, such as the possibility that unrealised gains may disappear as a result of negative movements in market prices which may not be adequately covered by capital requirements, and also concerns about the amount of own funds represented by these gains.

33. As the policy options set out in this technical advice could apply to both items subject to a prudent valuation adjustment (PVA) and items not subject to this adjustment, it is important that the interaction with the prudent valuation framework is properly considered. For example, where a PVA is made to the value of an item, it will be important that a policy option on unrealised gains, if applied, does not lead to a double deduction of some or all of the gain. In this regard, the EBA is currently developing RTS on prudent valuation, which will also take into account the results of a quantitative impact study that is being carried out by the EBA, which will provide information about the impact on own funds of the prudent valuation proposal.

3.2.2.6 Level of application

34. 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.

35. 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 banks’ management.

3.2.2.7 Behavioural consequences

36. The technical advice 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 in order to avoid the capital impact associated with having to exclude those unrealised gains from capital for prudential purposes.
37. 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 a case where a 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 would depend on the type of asset and the reasons for holding it.

38. 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 for 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.

39. In addition, an asymmetrical treatment of unrealised losses and gains may incentivise institutions to change the duration of their investments in a certain portfolio in order 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.

40. However, it should be noted that some countries currently apply an asymmetrical filter (\textsuperscript{4}), and therefore it may not be a fundamental change to the current practice in those countries. Most countries apply such filters on a portfolio basis \textsuperscript{5}, whereas others may apply them following an item-by-item approach to certain instruments or items.

41. Another behavioural consideration is that of firms' approaches to hedging. In some cases, hedge accounting will be applied and the effect of a filter will be more clearly identifiable. Hedge accounting is discussed in more detail in section 4.4 below. However, it is more difficult to consider the effect on so-called 'economic hedges' where firms have chosen not to apply hedge accounting due to the associated accounting requirements (for example, documentation requirements, effectiveness testing, etc.). Banks allege that such economic hedges can be part of their risk management activities. If an asymmetric prudential filter on unrealised gains is introduced, the possible result could act as a disincentive for firms to undertake such hedged strategies, and could consequently lead to an increase in the volatility of capital \textsuperscript{6}. However, there is also risk of arbitrage if the link between the hedging and the hedged instruments is not sufficiently clear and documented.

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

\textsuperscript{5} For investment properties and property, plant and equipment, some countries apply an asymmetrical 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.

\textsuperscript{6} It should also be noted that the current filter on AFS bonds and AFS equities applied by many EU countries may also be a disincentive for firms to undertake these hedge strategies.
3.2.2.8 Transparency

42. In many areas, regulatory own funds are calculated with reference to the financial statements. The EBA has considered whether or not 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 regulatory own funds. The regulatory capital reconciliation statement (as provided by the EBA in the draft implementing technical standards (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).

43. Even if the unrealised gains are filtered from 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 thereof.

3.2.2.9. Level playing field

44. The Basel III framework removes the prudential filters for unrealised gains and, therefore, the introduction of a filter for unrealised gains in the EU framework would be inconsistent with Basel III as currently agreed and could lead to level playing field issues between European and non-European banks.

45. However, within European banks, prudential filters might support a level playing field. This is especially true for banks applying those national GAAPs which do not measure their assets and liabilities at fair value or which prohibit the recognition of unrealised gains for accounting purposes.

3.2.3 Summary of this section

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

<table>
<thead>
<tr>
<th>Arguments in favour of the introduction of a prudential filter on unrealised gains</th>
<th>Arguments against the introduction of a prudential filter on unrealised gains</th>
</tr>
</thead>
<tbody>
<tr>
<td>Unrealised gains may disappear and not be available to cover losses when they arise, in particular in a crisis situation. Own funds should be available to absorb losses at any time.</td>
<td>In accounting terms, unrealised gains may cover any losses at the reporting date resulting from the application of the relevant accounting framework.</td>
</tr>
<tr>
<td>For debt instruments classified in the prudential 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.</td>
<td>Even if this is not primarily the intention, the institution may decide to realise the gains by selling (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.</td>
</tr>
</tbody>
</table>
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 sell the assets and realise the gains, this is not always possible in practice. For example, the assets may not be realised at the price expected by the institution because of lack of liquidity in markets or uncertainty in the valuation. | Uncertainty in valuation should be covered by an adjustment to the fair value and is also applicable for assets with unrealised losses. The EBA is developing RTS on prudent valuation.

| On debt securities, over time the unrealised gains will decrease towards zero as the fair value trends towards the face value at maturity (provided that the factors affecting the valuation remain unchanged). | 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 arising from different asset classes.

| As the amounts of unrealised gains are subject to movements in market prices, their recognition in regulatory capital might increase the volatility of own funds. This may raise concerns about the pro-cyclicality of the capital framework. | The introduction of a prudential filter for unrealised gains will result in an asymmetrical treatment for unrealised losses. This may also provide an incentive to the institution to realise the gains in order to compensate for the impact of unrealised losses on their own funds or to change its 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.

| Within European banks, prudential filters might support a level playing field. This is especially true for banks applying those national GAAPs which do not measure their assets and liabilities at fair value or which prohibit the recognition of unrealised gains for accounting purposes. | The introduction of a filter would have consequences for a level playing field between European and non-European banks, taking into consideration Basel III as currently agreed. |
47. On this basis, there are prudential arguments for introducing a prudential filter on unrealised gains, the most important being that unrealised gains may not be fully available to cover losses when needed. However, there are also some arguments for maintaining the current rule in the CRR (no filter). If a filter is introduced into the capital framework, the design of this filter should take into account the potential drawbacks related to its application.

3.3 Interaction with developments in international accounting standards and international agreements on prudential standards for banks

48. Article 80(4) CRR 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 have been no significant developments in the international prudential standards.

49. Basel III removes the prudential filters for unrealised gains. 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 (\(^1\)).

50. 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 of this review should also be taken into account for the decision of whether or not to apply a filter.

51. The scope of this technical advice is nevertheless limited to the application of filters to unrealised gains and does not take into account the advantages and disadvantages of setting capital requirements for all assets and liabilities measured at fair value for market risks compared with 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 to be calibrated adequately.

52. With regard to accounting standards, the International Accounting Standards Board (IASB) is currently undertaking the replacement of IAS 39, Financial Instruments. The IASB has divided the replacement of this standard into three phases: Phase I, Classification and Measurement; Phase II, Impairment; and Phase III, Hedge Accounting. On Phase I, the IASB published IFRS 9 in November 2009; it contained requirements for financial assets and added requirements for financial liabilities in October 2010. In November 2012, the IASB published some limited amendments to IFRS 9, which are currently under discussion, regarding the categories of financial instruments. As a result of these developments, it may be that the IASB will keep three categories for the classification of financial instruments (amortised cost, fair value through OCI and fair value through P&L). However, there may be differences in the assets that are currently classified in the AFS category and those that would be classified in the fair value through OCI category, as the

\(^1\) 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.’
classification criteria will be different. This advice should be provided to the European Commission by 1 January 2014 and therefore cannot anticipate the outcome of IFRS 9.

53. As explained in the next section, it should be taken into account that the advice has been developed considering the prudential framework as the appropriate basis for developing the policy options and therefore has limited interaction with developments in accounting standards. In any case, it should be noted that, according to Article 80(3)(b) CRR, the EBA shall provide technical advice to the Commission on any significant changes it considers to be required to the definition of own funds as a result of changes in the relevant accounting standards.

3.4 Interaction between the prudential rules and the accounting rules

54. Before analysing different policy options, the technical advice considers the interaction between the prudential requirements and the accounting rules in developing policy options on realised gains. There are two alternatives that have been used as the basis for considering a prudential filter on realised gains arising from fair value instruments:

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

55. For prudential and regulatory purposes, banks’ assets/liabilities are generally grouped into the trading book and the banking book under the Basel Committee’s standards and the CRR. The trading book category contains those assets/liabilities held that banks plan to actively trade or use in order to hedge positions held with trading intent, while all other assets/liabilities (including investment properties and PPE) are included in the banking book (i.e. a residual category). Because of different underlying economic 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 (e.g. market risk capital requirements on trading book assets).

56. 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 and available for sale 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 P&L – 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 permit investment properties and own use 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.

\(^{(6)}\) 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. For instance, foreign exchange risk and commodity risk are subject to capital requirements for market risk.
57. Generally, trading book instruments are expected to be composed of HFT financial instruments (with fair value changes through P&L) for accounting purposes. Similarly, banking book instruments are expected to be composed of L&R, HTM investments (at amortised cost) and AFS assets (with fair value changes through OCI), given that they are not intended for active trading. In addition, there could be banking book instruments where the fair value option is applied for accounting purposes, with the fair value changes recognised in P&L.

58. In these circumstances, any policy options to be applied based on prudential categories of instruments (i.e. 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 (e.g. fair value option or AFS assets). This may raise concerns about the transparency of own funds and the feasibility of filtering P&L as well as accumulated reserves (including the OCI reserve). Regarding the transparency of own funds, it may be possible that some financial instruments classified in an accounting category will be classified for prudential purposes partially in the trading book and partially in the banking book. This would mean that an entity would need to identify those gains and losses that arise from the trading and the banking book. Regarding the feasibility of applying a filter, there are some operational issues involved in the application of a filter in P&L. While the OCI reserve is cumulative and therefore provides the amount of unrealised gains throughout the years (net unrealised losses and gains), the P&L is a year to date amount. For instruments at fair value through P&L, the P&L does not provide the cumulative result (a loss in one year will not compensate for a gain the year after). Therefore, an entity would need to track for these instruments the gains that have been recognised in P&L during the years, and that would form part of the accumulated reserves. This should, however, be easier where firms have gains which affect the OCI reserve, as the balance on the reserve will be adjusted when items affecting OCI are disposed of (in P&L, the gain is recognised as it arises, and so no such adjustment is required at disposal).

59. Irrespective of the primary basis on which any policy options are to be applied (i.e. primarily based on prudential treatment or accounting classification, e.g. AFS category), it will be necessary to consider both the accounting basis and the relevant 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 market risk capital requirements, which would not be applicable if those instruments were classified in the prudential banking book. Applying a filter to the AFS category will result in these AFS assets being subject both to market risk capital requirements and to a prudential filter (and they will differ from the rest of the AFS assets, which will be classified in the banking book where a market risk capital requirement is not applicable) (9).

60. 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.

(9) In addition, some bonds or equities classified as held for trading for accounting purposes may have been excluded from the prudential trading book in the absence of liquid markets (and a change in the intention to sell the assets and realise a gain).
### Arguments in favour of the prudential classification (i.e. trading book, banking book)

- 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.
- This approach provides a more level playing field between the EU institutions (even if they apply different accounting frameworks), as they are all subject to the same CRR/CRD IV rules.
- 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 the 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.

### Arguments in favour of the accounting classification (i.e. HFT, AFS, etc.)

- Ease of reconciliation with the financial statements. The amounts of unrealised gains of a group of assets (e.g. AFS assets) could be directly obtained from financial statements.
- 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.

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

62. Nevertheless, the accounting requirements of assets or liabilities will still need to be assessed, as they 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 (see discussion in section 4.4, ‘Interaction of a filter with IAS 39: Hedge Accounting, and the fair value option’). In addition, operational considerations for instruments measured at fair value with changes in P&L should be taken into account (see paragraph 58 above).
4. Option analysis

63. 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 than the current one. These policy options are developed based on the prudential framework classification (i.e. as a starting point, distinguishing between the trading and the banking book) of items measured at fair value.

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

- interest-bearing financial instruments at fair value, including debt securities, loans and advances, and financial liabilities;
- non-interest-bearing financial instruments at fair value, including equities and liabilities linked to equities (short positions);
- tangible assets at fair value, including PPE and investment property.

65. In addition, it is considered that derivatives will usually be included in the trading book, although in some circumstances they may be included in the banking book (for instance, credit derivatives may be used as a 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).

66. This technical advice does not propose as a policy option 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:

- 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).

67. Alternatively, this technical advice could have been developed considering all financial instruments included in the banking book together and separately from the instruments included in the trading book. However, the EBA has preferred to distinguish between instruments included in the banking or the trading book. For those instruments included in the banking book, the EBA has proposed to separate them into interest-bearing financial instruments, non-interest-bearing financial instruments, and non-interest-bearing financial instruments (short positions).

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(10) It should be noted that the 2004 CEBS Guidelines proposed a distinction for the AFS category between equities, L&R and other financial instruments (mainly debt securities). The CEBS Guidelines also proposed a prudential filter for investment properties and own use 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 as the EBA has considered that these instruments are generally managed separately by institutions.

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

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

69. 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 64: either to apply the policy option on an instrument-by-instrument basis or to apply it on a portfolio basis.

70. 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.

71. 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.

<table>
<thead>
<tr>
<th>Arguments in favour of an item-by-item approach</th>
<th>Arguments in favour of a portfolio approach</th>
</tr>
</thead>
<tbody>
<tr>
<td>This is the most prudent approach, as it does not allow the offsetting of unrealised gains and losses between instruments.</td>
<td>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, they may create additional tension on the financial markets and exacerbate a crisis situation.</td>
</tr>
<tr>
<td>The introduction of such filters on a portfolio basis could raise concerns about whether the volatility and reliability of unrealised gains have been addressed.</td>
<td>A portfolio approach may be consistent with the way banks manage their financial instruments.</td>
</tr>
<tr>
<td>Gains of an instrument may disappear irrespective of the asset movements of another instrument.</td>
<td>It may encourage the diversification of banks’ portfolios and therefore be reflective of risk mitigation benefits achieved through diversification.</td>
</tr>
</tbody>
</table>

72. 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 AFS debt instruments and, in most cases, for AFS equity instruments. For investment properties and PPE, there is more division between the use of the item-by-item and the portfolio basis for regulatory purposes.

73. 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.

4.2 Treatment of interest-bearing financial instruments in the banking book (investment portfolio)

74. Taking into account the aspects included in the methodology, there are some arguments that are supportive of 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 possibility that unrealised gains may reduce or disappear. There could be some requirements for market risk in Pillar 2, but, as mentioned in paragraph 30, the assessment of market risk under Pillar II, notably the interest rate risk, focuses on the whole banking book and not only on items at fair value, and it is not directly linked to unrealised gains.
- 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 that 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.

75. 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. In addition, some operational issues may arise for those instruments measured at fair value through P&L in the banking book (e.g. the fair value option), as the cumulative unrealised gain will need to be tracked.

76. On this basis, this technical advice considers different options to deal with unrealised gains arising from these instruments, analysing the following options and 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

4.2.1 Option 1: no inclusion of unrealised gains in own funds

77. 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. If the policy options are applied on a portfolio basis, there will already be 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.

<table>
<thead>
<tr>
<th>Arguments in favour of Option 1</th>
<th>Arguments against Option 1</th>
</tr>
</thead>
<tbody>
<tr>
<td>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.</td>
<td>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.</td>
</tr>
<tr>
<td>In principle, it would reduce the volatility of regulatory capital. Unrealised gains would not contribute to the increase of own funds and therefore would be less pro-cyclical.</td>
<td>In case of a recession, the existing unrealised gains will play the role of counter-cyclical items.</td>
</tr>
<tr>
<td>It will encourage a level playing field within the European Union, as it 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).</td>
<td>There will be no level playing field with non-EU institutions under the current Basel rules (however, see footnote 7 above).</td>
</tr>
<tr>
<td>If unrealised gains are calculated on a portfolio basis, they are already taken into account up to the amount of unrealised losses and mitigate concerns related to an asymmetrical treatment of unrealised losses and gains.</td>
<td>If a filter is applied on an item-by-item basis, the impact on own funds will be higher, as unrealised gains will not offset the impact of unrealised losses.</td>
</tr>
</tbody>
</table>

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

78. 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 for including some unrealised gains in own funds.

79. 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.

80. 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.

81. 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 would allay, to some extent, the concerns about the recognition of unrealised gains. However, the extent of the haircut might differ depending on to which level of own funds it was applied; for example, a higher haircut might be applied for unrealised gains included in CET1 than if they were to be included in T2. The extent of the haircut might also depend on whether the unrealised gains were identified on a portfolio or on an item-by-item basis. Application of the policy option on a portfolio basis would require a higher haircut than would be required on an item-by-item basis.

- **Second adjustment**: the amount of the unrealised gains (after the first adjustment) to be recognised in own funds could be limited to a certain percentage. Any excess amounts would be excluded from own funds. This second limit would mitigate the concern that unrealised gains could represent a large proportion of own funds. A certain threshold could be defined, to be applied to CET1, Total Tier 1 or total own funds. This threshold could nevertheless apply to the total amount of unrealised gains in all categories of assets and liabilities (including debt securities, equities and real estate) or only to certain categories (for instance debt and equity securities).

82. If the partial recognition option were 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 positions across the EU.

83. 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 AT1; or
- partial inclusion in T2.

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

85. However, in the 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 in which layer
86. One additional aspect that should be considered is the consequences for a level playing field that each of these approaches would entail. On the one hand, the partial inclusion of unrealised gains would ensure a more level playing field between EU and non-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 on 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 for 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).

4.2.2.1 Partial inclusion in CET1

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

88. A reason for the partial recognition in CET1 is that it would lessen concerns about the potential change in managements’ behaviour and also about the asymmetry with regard to unrealised losses. In addition, it could lessen concerns resulting from an unlevel playing field between EU and non-EU banks.

89. It should be noted that in the case of the application of the policy options on a portfolio basis, there would already be a partial recognition of the unrealised gains in CET1, up to the amount of the unrealised losses of the assets included in the same portfolio.

4.2.2.2 Partial inclusion in AT1

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

91. 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.

92. A reason for partial recognition in AT1 is that it would lessen concerns about the potential change in managements’ behaviour.
4.2.2.3 Partial inclusion in T2

93. If unrealised gains were 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. Therefore, under this option there remains uncertainty about the ability of gains to cover risk and future losses when needed.

94. Partial inclusion in T2 is in line with one of the options in the current CEBS Guidelines (issued in 2004) on prudential filters.

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

95. 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 design of the filter:

- The volatility of 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 traded as compared to debt securities. While consideration of other aspects cannot be disregarded (for instance, the size of the stake compared with the trade volume on the market), partial recognition of unrealised gains in own funds could be envisaged. In the 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 sufficiently cover the market risk.

- Current practice for countries applying the asymmetrical filter for equity and debt securities: almost all EU countries applying an asymmetrical approach (11) for AFS debt securities apply the same haircut to unrealised gains arising from both AFS debt and equity securities.

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

(11) The asymmetrical approach refers to the recognition of unrealised losses and the filtering out of unrealised gains from CET1 and their partial recognition in Tier 2.
• a stricter haircut or application on an instrument-by-instrument basis is required to take into account the fact 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.

4.4 Interaction of a filter with IAS 39: Hedge Accounting, and the fair value option

4.4.1 Hedge accounting

97. 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 of the kind that the use of hedge accounting is trying to eliminate.

98. 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’ (\(^{12}\)). 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.

99. If a filter is proposed, the consequences of this filter in conjunction with the current filter on cash flow hedges (Article 33 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.

100. In some cases, institutions argue that, instead of accounting hedges, they may apply ‘economic hedges’ as part of their risk management practices. According to this reasoning, they would have derivatives which would be hedging instruments classified as available for sale or designated at fair value through P&L. Therefore, a filter on the unrealised gains of those assets may act as a disincentive for firms to undertake such economic hedges and could increase the volatility of own funds. However, there is clearly a risk of arbitrage if the link between the hedging and the hedged instruments is not sufficiently clear and documented. For instance, entities could choose to offset losses in derivatives with gains in AFS assets and therefore not apply a filter even if the risk

\(^{12}\) IAS 39, paragraph 88(b)
management policies do not link these two instruments. This risk is material, in particular because neither the accounting framework nor the regulatory framework (CRR) defines or sets specific requirements for economic hedges. Therefore, any policy option aimed at addressing such hedges would need to be designed to minimise this risk. It could also be considered whether there is a need to explore further banks’ practices in relation to economic hedges. In addition, there are some operational issues (e.g. tracking of the accumulated unrealised gains and losses of the instruments recognised in the P&L) that should be considered in some cases, as the change of the fair value of the derivatives will be recognised in P&L.

4.4.2 Fair value option

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

- They eliminate or significantly reduce 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 have embedded derivatives in certain circumstances.

102. 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.

103. 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) to the extent of the unrealised losses recognised on the corresponding instrument. 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.

104. If such an option is introduced, it should be conditional that the fair value option is effectively used as an economic hedge, and therefore 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. However, in line with the proposal for the ineffective part of a hedge in the previous section, it could also be considered that the net unrealised gain resulting from the application of the fair value option should be subject to a filter. In addition, it could be considered whether this approach should be extended when the fair value option is applied in the case of a group of financial assets, financial liabilities or both managed on a fair value basis, or in
the case of instruments with embedded derivatives (which could also include derivatives held for trading hedging instruments with embedded derivatives).

105. The same analysis would apply under IFRS 9, as this standard (13) in its current form retains the fair value option for accounting mismatches. The other two considerations in the application of IAS 39, fair value option of instruments managed on a fair value basis and instruments with embedded derivatives, are not relevant under IFRS 9 for financial assets due to the changes in the approach to classification.

4.5 Trading book financial instruments

106. 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 CRR.

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

108. 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 of covering the volatility of 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 effectively be available to absorb any losses. Third, given that all realised and unrealised gains are recognised in the P&L, it could be difficult to differentiate realised gains from the unrealised gains (14) and would require maintaining the historic information that is needed for this purpose. Therefore, filtering unrealised gains on these items may be difficult. Finally, the EBA is also developing RTS on prudent valuation to address the uncertainty around the valuation of fair value positions, which is expected to include all trading book and banking book fair value financial instruments (see section 4.6 on prudent valuation).

109. One possible concern about not having a filter for trading book unrealised gains while introducing such a filter for 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 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 no longer meets the trading book or the banking book definition. It should be noticed that the current

(13) The IASB published, in November 2012, an exposure draft entitled ‘Classification and measurement: limited amendments to IFRS 9’, which is currently being deliberated.

(14) 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.
filter applied to AFS instruments, according to 2004 CEBS Guidelines, may also raise concerns about potential arbitrage.

110. In the absence of a filter, another concern is that unrealised gains on trading book items may represent a large amount of 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 reviewing the current capital requirements for the trading book and with the objective of strengthening the capital requirements on trading activities, depending on the outcome from the review.

4.6 Interaction with prudent valuation

4.6.1 Scope of the prudent valuation standards

111. The EBA has published a Consultation Paper on a draft RTS on prudent valuation (please see EBA CP/2013/28) in accordance with the mandate of Article 105 of Regulation 575/2013 (CRR), setting out requirements relating to prudent valuation adjustments of fair-value positions.

112. Article 105 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.

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

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

114. The alternatives for the treatment of unrealised gains (prudential filters) described in this technical advice implicitly cover several prudential concerns, the main such concern being that unrealised gains may disappear as a result of negative movements in the market prices of the underlying items. Other prudential concerns relate, for example, to the interaction with capital requirements, and the reliability of fair values.

115. The objective of the prudent valuation RTS is to address the reliability of fair values, while the concerns related to the possible implementation of prudential filters on unrealised gains are considered to be wider. In this sense, a prudential filter may represent a complement to the prudent valuation methodology.
4.6.3 Prudent valuation methodology

116. The draft RTS on prudent valuation proposes 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-value assets and liabilities is less than EUR 15 billion. This approach calculates the required additional valuation adjustment (AVA) 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**: this is a more granular approach and encompasses the calculation of AVAs for several aspects that may influence the fair value measurement. In the case of a lack of information about the characteristics of certain instruments that makes the application of this approach impossible, the institution may use a fall-back approach.\(^{(15)}\)

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

117. Regarding unrealised gains arising from financial instruments classified in the trading book, as the technical advice is not at this stage proposing 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.

118. 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 for unrealised gains.

119. If a prudential filter is applied to 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.

120. When analysing the implementation of each approach envisaged in the prudent valuation methodology in conjunction with prudential filters, some practical aspects should be considered. In the following paragraphs, the main characteristics of each approach when assessing a possible interaction with a prudential filter are described:

a) **Under the simplified approach**\(^{(16)}\), the calculation is performed considering the totality of the trading and banking book items and therefore there is no allocation of AVAs on an item-by-

\(^{(15)}\) Under this fallback approach, the ARA 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.

\(^{(16)}\) The same analysis would apply under the fall-back approach in which 100% of the unrealised gains and losses are adjusted and, consequently, not counted for CET1.
item basis or on a certain portfolio basis (for example, a portfolio corresponding to a certain type of instrument). However, the technical advice proposes the application of the policy options to certain portfolios of the banking book.

The explanatory note to Article 5 of the draft RTS on prudent valuation states the following: ‘Unrealised gains and losses that are not included in the regulatory capital (for example, currently, those on Available for Sale assets) should not be included in this calculation’. Therefore, there will be no interaction, as only those net gains that have not been filtered out will be included in the calculation for prudent valuation.

b) With regard to the core approach, if the definition of this portfolio is the same for the application of both prudent valuation adjustment and prudential filters, there could be a double deduction when computing CET1.

121. This analysis has been provided taking into account the current Consultation Paper on prudent valuation. However, it should be noted that the prudent valuation methodology is currently under discussion. The final RTS on prudent valuation will be delivered to the Commission by June 2014 and therefore the Commission needs to consider the developments in the prudent valuation RTS for its final assessment of its response in the area of prudential filters.

4.7 Investment properties and property, plant and equipment

122. IFRS permit investment properties and PPE to be held at cost or at fair/revaluation value.

123. 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 purpose, or b) sale in the ordinary course of the business (17). For investment properties measured at fair value, the changes in fair value are recognised in P&L.

124. 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 (18). 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 heading of revaluation surplus unless it reverses a revaluation decrease of the same asset previously recognised in P&L (19). 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

(17) IAS 40(5)
(18) IAS 16(31)
(19) IAS16(39)
recognised in OCI with a corresponding reduction of the amount accumulated in equity under the heading of revaluation surplus \(^{(20)}\).

125. 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 portfolio approach.

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

127. 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 (particularly in the case of 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 if required to make payment on obligations arising in the event of loss. In addition, own use properties are part of the main operations of a firm and therefore they are not expected to be sold very frequently and it is questionable whether such gains would be realised through a sale.

128. 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. However, their lower liquidity is a valid reason not to recognise such gains.

129. To sum up, for tangible assets it may be more justified to apply an item-by-item approach than a portfolio approach, as these assets are generally less liquid than financial instruments (and also because some of this property could be held for own use and not for sale) and are often diverse in terms of location etc., and in principle, therefore, the offsetting of the unrealised losses and unrealised gains of these assets may be less appropriate.

\(^{(20)}\) IAS16(40)
Annex – Summary of the responses received

1. The EBA published, on 2 August 2013, a discussion paper with preliminary views on possible treatments of unrealised gains measured at fair value in order to gather the stakeholders’ input on this topic at an early stage of the process. The consultation period ran for 8 weeks, until 27 September 2013.

2. Ten responses were received, of which eight were published on the EBA website. The EBA has considered carefully all the responses received. In many cases, the responses mentioned that the discussion paper presented a comprehensive view of the pros and cons of the proposed options, while they also highlighted some areas that needed to be developed further. Changes to the technical advice have been incorporated as a result of the responses received during the public consultation.

3. In the feedback received, all respondents supported no filtering of unrealised gains and some of them expressed the view that the advice should consider as a policy option the possibility of not applying a filter. The main arguments for no filtering were that there is a risk of double counting of the same risks – already addressed through accounting standards (IFRS) and capital requirements (prudent valuation, Pillar 1 and Pillar 2 requirements) – and that the asymmetrical treatment of gains and losses would exaggerate risks, inconsistently with good risk management practices, as it will not allow the offsetting of gains and losses. There were also concerns about the transparency of the filters and the difficulty for users of understanding the differences between the accounting and the prudential figures.

4. Respondents would prefer to postpone the discussion on filters until after the finalisation of IFRS 9, which is expected in 3 years, and in the meantime the transitional measures of the CRR require the inclusion of unrealised gains (those recognised in OCI and/or those relating to investment properties which are measured at fair value through P&L) according to a certain range of percentages. Regarding the possible impact that may arise from IASB hedge accounting (Phase 3) requirements to be published by the end of 2013, the respondents did not anticipate any impact. Respondents have also suggested some dialogue with the accounting standard setters and also the performance of an impact assessment on certain areas of the advice.

5. Additionally, some respondents requested further clarification on the scope of the paper. Some of them would limit the scope to unrealised gains recognised in OCI and tangible assets measured at fair value. This would be in line with their interpretation of the transitional requirements of Article 468 of the CRR and also with Basel III, which refers to ‘accumulated other comprehensive income and other disclosed reserves’.

6. With regard to Basel III, many respondents were concerned that any filter might be inconsistent with ensuring a level playing field between EU and non-EU banks, as Basel III removes the prudential filters. Also, a filter on unrealised gains generated from items held in a bank’s liquidity portfolio which would be measured at fair value through OCI and qualify for the application of a prudential filter could be inconsistent with the Basel liquidity framework requirements, where only
high-quality liquid assets are eligible and where the assets are supposed to enable institutions to face liquidity needs.

7. Respondents believed that the accounting standards and the prudential framework already address the concerns expressed in the discussion paper. They mentioned the current proposals being developed by the EBA on prudent valuation. With regard to the trading book, they referred to the capital requirements for market risk. They also mentioned that for credit and counterparty risk there are capital requirements for the trading and the banking book. Finally, they referred to Pillar 2 as a way of imposing additional capital and also to the coverage in Pillar 2 of the interest rate risk in the banking book. Some respondents have also commented that if a filter is applied it should also be taken into account in the exposure values.

8. Respondents had mixed views on whether to follow the prudential or the accounting classification in applying the different policy options. While the prudential classification ensures that capital requirements are taken into account, it would be more difficult to reconcile with the accounting figures. The accounting classification would not take into account the capital requirements and would not recognise ‘economic hedges’.

9. In addition, respondents had concerns about the feasibility of applying a filter to instruments measured at fair value with changes recognised in P&L.

10. All respondents supported the application of a prudential filter (if any) on a portfolio basis and they supported the identification of portfolios based on how financial instruments are risk-managed. Applying a prudential filter on a portfolio basis would be in line with existing prudential filters, encourage diversification and create less volatility of own funds (compared with a prudential filter on an item-by-item approach). Although respondents have not provided quantitative data, some have said that the impact will be material. Most respondents also supported the application of the same policy options for both debt and equity instruments based on how these exposures are managed. Some respondents have referred to the application of the proposals to the highest portfolio level.

11. If a prudential filter on unrealised gains were to be applied, most respondents argued, such a filter would need to be symmetrical and a partial inclusion in CET1 is the preferred option. Respondents did not support the application of a haircut or a threshold. In this context, some constituents have referred to the treatment of minority interest.

12. All respondents supported the exclusion of the trading book positions from the scope of the application of any prudential filter on unrealised gains, based on the fact that the prudential concerns are already mainly addressed through the capital requirements and the EBA proposals on prudent valuation. Some respondents have also said that they see very limited risk of arbitrage by transferring assets from the banking book to the trading book.

13. Respondents agreed with the analysis of the discussion paper on hedge accounting. However, they would like to extend the analysis to economic hedges. In an economic hedge, a derivative would be classified as held for trading for accounting purposes, while for prudential purposes it could be classified in the banking book (if there were no trading intent). These transactions do not qualify for hedge accounting, because they do not meet the required criteria under IAS 39 to
be accounted as such. However, the purpose of these positions is to reduce the financial institution’s risk exposure and any gains from the hedging derivative instrument could be partially or fully offset (depending on the hedge effectiveness) by respective losses from the hedged item. Therefore, a filter for the unrealised gains of instruments measured at fair value through OCI will not take into consideration economic hedges. Some respondents have asked for a similar filter to the one existing in the CRR for cash flow hedges.

14. Respondents would like to exclude the fair value option from the application of any policy option. In general, they agreed with the analysis in the discussion paper on the use of the fair value option for accounting mismatches. However, they considered that economically the same position arises when instruments are managed on a fair value basis. They considered that the fair value option is used for economic hedges, and therefore unrealised gains and losses offset each other. Respondents also considered the tracking of unrealised gains recognised in P&L on a non-cumulative basis challenging.

15. Respondents believed that there is an interaction between prudent valuation and prudential filters. In principle, they believed that the concerns expressed in the discussion paper are covered by capital requirements and prudent valuation.

16. Respondents did not support the application of a prudential filter to investment property and to PPE. A prudential filter (if any) on an item-by-item basis for the unrealised gains from these assets might be justified, since these assets are not financial instruments and they fall outside the scope of capital requirements for financial instruments. Some also consider the possibility of applying a filter on an item-by–item basis if the nature of the assets is different or when the assets support the main activities of the institution.

EBA response to the comments received during the consultation

1. The EBA has carefully considered the feedback received during the public consultation. The technical advice has been clarified and further developed in some particular areas in order to take into account the input received from stakeholders and also to enhance its quality.

2. In response to the several comments received regarding the appropriateness or otherwise of the timing of a discussion of a prudential filter on financial instruments, given that IFRS 9 is not yet finalised, the EBA understands this concern. However, as is explicitly stated in the mandate of Article 80(4) CRR, the technical advice for possible treatments of unrealised gains shall be provided to the European Commission by 1 January 2014. In addition, it should be noted that, according to Article 80(3)(b) CRR, the EBA shall provide technical advice to the Commission on any significant changes it considers to be required to the definition of own funds as a result of changes in the relevant accounting standards and, therefore, once IFRS 9 is finalised, depending on the final outcome, the advice of the EBA may be required. Finally, it should be noted that the EBA has developed its proposed policy options for prudential filters on unrealised gains on the basis of the prudential classification of instruments (which has been considered as a more appropriate basis than the accounting classification). This should allow a consistent
application of the policy options, irrespective of the applicable accounting framework and its possible modification.

3. With regard to the comments received about the scope being too broad, Article 80(4) CRR does not specify specific types or classes of instruments from which unrealised gains should derive. For that reason, in the discussion of the policy options all unrealised gains from instruments at fair value are considered, including both OCI and P&L. Additionally, the technical advice has been amended to clarify that the transitional requirements of Article 468 CRR apply to unrealised gains related to assets and liabilities measured at fair value and reported on the balance sheet (excluding those referred to in Article 33) and unrealised gains related to investment properties measured at fair value and reported as part of the P&L.

4. The EBA has also included in paragraph 44 of the technical advice an argument about the possible creation of an unlevel playing field between EU banks and non-EU banks applying Basel III if a prudential filter is applied within EU. The discussion paper considered this aspect, but not as part of the section containing the arguments in favour of and against the introduction of a filter.

5. With regard to the possible counterintuitive effects of applying a prudential filter on unrealised gains on instruments which are considered to be high-quality liquid assets in accordance with Basel liquidity framework requirements, the EBA considers that the inclusion of instruments in the liquidity buffer is not sufficient to justify not proposing any policy option for the treatment of unrealised gains. It should be noted that the liquidity framework and the solvency framework do not have the same purposes and rely on different rationales. The EBA has also incorporated this issue into paragraph 28, as an aspect of the criteria that should be taken into account when developing policy options.

6. The interaction between prudent valuation and prudential filters and the risk of double counting of the same risks by imposing capital requirements on risks which are already covered in accounting standards and other prudential requirements (Pillar 1 and 2 and prudent valuation) are explained in several places in the technical advice. Indeed, for trading book positions, the prudential concerns are already covered through existing prudential requirements. However, the technical advice examines also whether unrealised gains from financial instruments in the banking book could give rise to risks which are not covered by existing prudential requirements, since these exposures would not be subject to capital requirements for market risk. Additionally, the EBA considers that the risks from these positions cannot be directly linked to the existing Pillar 2 requirements, which, in addition, may be seen as less systematic than the Pillar 1 adjustments.

7. The EBA has proposed consideration of the application of a prudential filter in line with the distinction between banking and trading book positions of the prudential framework. This would take into consideration the different capital requirements for these positions, which was something supported by some of the respondents.

8. In line with the respondents’ support for the application of a prudential filter (if any) on a portfolio basis, the EBA considers in the technical advice the use of such a basis. This approach would
be consistent with the way financial instruments are risk-managed, as well as with the approach used in applying existing prudential filters. The EBA also discussed the possibilities of applying the same policy options for both debt and equity instruments based on how these exposures are managed.

9. In response to the respondents’ support for excluding economic hedges from the application of a prudential filter, the technical advice has been amended to consider that, besides accounting hedges, economic hedges could also be part of banks’ risk management activities. However, the advice also points out the risk of arbitrage if the link between the hedging and the hedged instruments is not sufficiently clear and documented. In addition, it may be challenging for institutions to quantify the cumulative net unrealised gains/losses of these instruments.

10. The technical advice considers partial recognition of unrealised gains in CET1 as an alternative, in line with the response received from respondents.

11. In response to respondents’ support for exclusion of all financial instruments measured using the fair value option, for reasons other than accounting mismatches, the technical advice has been amended. The EBA considers that these financial instruments could behave similarly to economic hedges. However, the EBA also noted that net unrealised gains as a result of the fair value option could be subject to a filter in line with the requirements for the ineffective part on hedge accounting.

12. Regarding the application of a prudential filter to unrealised gains from investment property and to PPE, following the feedback from respondents, a new sentence has been included to take into consideration that, in the case of PPE, these assets are part of the main operations of a financial institution. Additionally, the arguments in favour of the application of prudential filters on an item-by-item approach were amended based on the feedback received that these assets are less liquid than financial instruments and are not typically managed on a net basis.