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Dear Sirs,

“Possible treatments of unrealized gains measured at fair value under Article 80 of the CRR”

I enclose The Royal Bank of Scotland Group's ('RBS') response to the above discussion paper and welcome the opportunity to comment. We note that Article 80(4) of the CRR requires the EBA to develop technical advice on the topic.

RBS is supportive of the general approach in article 35 of the CRR which 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.

That approach enables a symmetrical view to be achieved, and naturally applies the portfolio approach recognised through the financial statements, where a given risk may be mitigated through the use of diverse hedge strategies, many of which would not meet the cash flow hedging criteria of IFRS.

International Financial Reporting Standards make no distinction between realised and unrealised profits on financial instruments carried at fair value through profit and loss. UK companies will also consider the technical release issued jointly by the Institute of Chartered Accountants of England and Wales and the Institute of Chartered Accountants of Scotland (TECH 02/10: Guidance on the determination of unrealised profits and losses in the context of distributions under the Companies Act 2006) when making distributions. This guidance says that where items held at fair value are readily convertible to cash, any resulting profit or loss is regarded as realised. Consequently, realised and unrealised profits are not tracked in normal day to day operations.

Finally, we are also concerned that the methodology should be operationally feasible. We have not attempted to answer the quantitative questions because that would require a considerable resource effort, at a time when EU Institutions are focussed on timely implementation of the CRD.

We respond to the questions raised in the Appendix to this letter. We would be happy to elaborate further on any of the points made in this response and look forward to engaging with you on this topic. In the first instance, please address any enquiries to myself.

Yours faithfully



Rajan Kapoor
Group Chief Accountant

Appendix

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

The inclusion of unrealized gains recognized either in OCI or profit or loss ('P&L') generally would seem to be outwith article 468 of the CRR, as the transition rule in article 468 relates to the removal of the prudential filter for unrealized gains measured at fair value where such filters exist under current rules.

The current filter for unrealized gains recognized on investment property is thus correctly considered within this discussion paper. Other unrealized gains recognized in OCI are also correctly within the scope of the paper.

The requirement for EBA to provide technical advice is limited to possible treatments of unrealized gains measured at fair value, but we would recommend symmetric treatment of unrealized gains and unrealized losses.

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

We agree, in general, with the overview of the arguments in favour or against the introduction of a prudential filter on unrealized gains. Our view is that the arguments against a prudential filter outweigh the arguments for such a filter.

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

We do not agree with the proposal, as the hedging methods used for risk management of currency and interest rate risk on the non-Trading Book are necessarily similar to those on the Trading Book. Additionally, when the fundamental review of the Trading Book reaches a conclusion, it would be illogical to reverse out previous filters and implement new filters, as well as operationally difficult.

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

If an item was initially recognised as Held for Trading for accounting purposes but is no longer held with that intent, it will be moved (under strict controls) to the regulatory non-Trading Book (ie the regulatory Banking Book). It will not be redesignated for accounting. Similarly, a derivative held on the regulatory non-Trading Book will be designated Fair Value Through P&L, unless it is in a cash flow hedge.

We agree that there would not be any AFS instruments in the regulatory Trading Book.

We have not quantified these situations.

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

If the final IFRS 9 text confirms a restrictive approach to 'held to collect' instruments and the introduction of a third measurement category fair value through OCI ('FVOCI'), liquidity portfolios may be included in the FVOCI category. A filter on unrealized gains on assets held in the liquidity portfolio on the grounds that there are concerns about the availability of such gains to absorb losses when they occur seems to run counter to the requirements that these instruments are deemed to be high quality liquid assets, which is a very restricted category within the liquidity framework.

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

We consider that the key criteria should be based upon the management of assets by the Firm. We note that the current filter for unrealized gains recognized on investment property relates to an asset category generally separate from the other types, but do not agree that eg the interest bearing vs non interest bearing assets are managed separately (a deep discount bond could be hedged with an interest rate swap).

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

A portfolio approach is consistent with the management of assets and would lead to less volatility in own funds. We support the policy options based on a portfolio basis. We note that, using an item by item approach, given the significant amount of individual positions in financial instruments, will be extremely difficult and time consuming to apply.

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

As noted above, we consider that the portfolio approach is appropriate. The only exception to this might be in regard to property (tangible assets).

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

It will in certain instances not be possible to trace the unrealized gains and losses on an individual basis, especially when looking at liquid debt securities. We have not provided any quantitative information because any such assessment will require significant effort. This information is normally not collected.

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

We do not agree with the alternatives mentioned;

- unrealized gains and losses on assets and liabilities measured at fair value should not be adjusted;
- unrealized gains and losses need to be treated in a symmetric way.

We believe the arguments to implement a prudential filter for unrealized gains due to concerns about fair value measurement will be covered by the prudential valuation deduction.

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

We are not in favour of a hair cut in the prudential filter for unrealised results. A haircut to the fair value is already applied in the prudent valuation RTS.

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

We do not support a threshold to the recognition of unrealized gains in own funds.

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

Behavioural differences exist between equity and interest bearing instruments, but some interest bearing instruments (HQLA) will naturally be more liquid than most equity instruments. Even if a particular market is liquid, it should not be necessary to incur transaction costs to realize gains.

The fair value of both equity and debt instruments fall within the scope of the prudent valuation RTS. Thus we believe that the fair value and unrealized gains and losses are already covered.

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

The analysis for hedge accounting is correct.

However, because the criteria under IAS 39 are very strict, in practice prudent risk management requires economic hedging of risks within the portfolios designated for accounting purposes as Loans and Receivables and Available For Sale. The impact of such hedge instruments is already unsymmetrical with regard to the P&L. Cash flow hedges are currently subject to a filter. We suggest economic hedges be considered for inclusion if further prudential filters are proposed.

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

No, any requirement for a prudential filter for unrealized gains to cover perceived weaknesses in fair value measurement will be covered by the prudential valuation filter.

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

Unrealized gains and losses should be offset as both the asset and liability are recorded at fair value, and thus there is no requirement for a prudential filter.

Assets and liabilities managed on a fair value basis and financial instruments with embedded derivatives are included within the prudential Trading Book only when these meet the requirements of the Trading Book Policy Statement as required under both the existing Directives and CRD4.

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

This has not been done.

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

We agree that trading book positions should not fall under the prudential filter for unrealized gains. The implementation of the prudent value RTS prudential filter should also remove any requirement to apply such a filter to non-Trading Book positions.

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

Yes, we agree that the effect would be doubled for the non-Trading Book, if adjusted under both the prudent valuation filter and a possible unrealized gains filter.

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

Any prudential filter proposed should not lead to a double impact as a result of applying the prudent valuation requirements, and should treat unrealized gains and losses symmetrically.

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

This approach is consistent with the current filter applied.

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

No comment