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Banking supervision
And Accounting issues Unit

The Director

Paris, September 27th 2013

EBA Consultation Unrealized Gains measured at fair value (EBA/DP/2013/03). - FBF Comments.

Dear Madam,

The French Banking Federation welcomes the opportunity to comment on the Discussion Paper relating to technical advice to the Commission on possible treatments of unrealized gains measured at fair value. (EBA/DP/2013/03).

We believe that the Discussion Paper (DP) provides a fair view and a fair analysis of the pros and the cons of introducing asymmetric prudential filters on unrealized gains within the mandate defined by the art 80§4 of the CRR, even though the scope of the DP has unfortunately not taken into consideration the inclusion of unrealized gains in CET1 without adjustment, which to our opinion is a relevant option.

The EBA's preliminary views on the introduction of a prudential filter for unrealised gains measured at fair value raise however great concerns, as EBA seems to consider that some kind of filters might be beneficial. **We strongly advocate on the contrary maintaining the BCBS status quo, as taken over by Article 35 of the CRR,** ie recognizing in CET1 100% of unrealized gains and losses on assets and liabilities measured at fair value except in the case of the items mentioned in Article 33. This opinion is based on the following grounds:

- The current accounting treatment of unrealized gains and losses is prudent, workable and transparent. Adjusting accounting figures for prudential purposes would seriously compromise the transparency of the data and the understandability of the data for investors.
- The introduction of the filter would lead to a double count of amounts already adjusted as a result of other regulation requirements.
- Some of the ways EBA is considering to introduce this additional filter could have significant drawbacks.

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The current accounting treatment of unrealized gains and losses is prudent, workable and transparent; it should not require prudential adjustements.

The DP expresses concerns about accounting data by stating that there are prudential concerns on the reliability of the fair value measurement of assets and liabilities. We cannot share this view which is confusing and not true. Bank's financial statements are established under IFRS rules and provide a fair view of its financial situation. Latent gains on non-interest bearing financial instruments, for instance, are mostly based on observable market prices (stock exchange) and AFS accounting has stringent depreciation criteria in case of significant loss in value which makes the determination of latent gains on those instruments quite reliable. If need be, appropriate allowances are recognized in order to mitigate valuation uncertainties. Besides, those statements are subject to the assessment and control and the opinion of the auditors who sign off the accounts.

Supervisory concerns have already been addressed by other regulations.

One concern from the EBA perspective is that regulatory own funds could be overstated on the basis of high fair valuation of assets and liabilities. This concern is already addressed by the requirement on prudent valuation. Making an adjustment under both the prudent valuation framework and the filter of unrealized gains would result in a double counting that would not be acceptable.

One other concern of the EBA is related to the fact that unrealized gains may disappear within a short period of time, in particular in a crisis situation. This is the definition of market risk. Unrealised gains on instruments included in the trading book already attract capital charge covering this market risk, as underlined in the DP. As regards the instruments in the banking book, the related unrealized gains taken into account regulatory wise gains would be included in the EAD of these instruments and would also attract their own capital requirements.

Several other risks exist that can put banks unrealised gains at risk, but all of them have already been addressed satisfactorily:

- Credit and counterparty risks in both the trading and the banking book have been extensively addressed as well under the Basel III capital requirements regime.
- Interest rate risk is, admittedly, not yet covered under the current Pillar 1 capital framework. The BCBS is, however, seeking to close this gap and has recently published a consultation paper to this effect. On top of that, it needs to be highlighted that interest rate risk is already covered by Pillar 2 requirements.
- Risks arising from the possible illiquidity of very large positions are covered by the EBA's proposals on prudent valuation.

If a bank is exposed to a risk which the competent authority is not convinced that it has sufficiently been addressed within the framework of the Pillar 1 capital requirements, it will be dealt with under Pillar 2.

Finally, we wish to underline that the treatment of unrealized gains and losses in an asymmetric way negates the positive impact of diversification, and of hedging relationships, which is at the very heart of the bank's management policies and of portfolio management. It substantially overstate the banks' risks, may distort the application of an effective risk management and is bound to create additional tension on the financial markets during financial crisis as it would give strong incitation to sell and buy assets on which there are unrealised gains.

Some of the ways EBA is considering to introduce this additional filter could have huge negative implications:

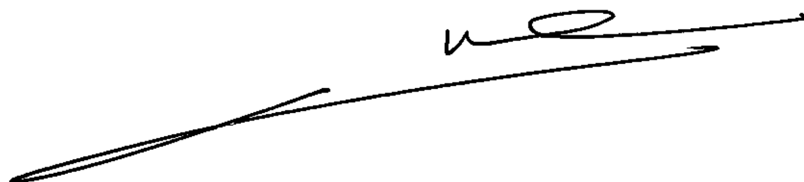
Applying an instrument by instrument approach would amplify the problems underlined above linked to treating unrealized gains and losses in an asymmetric way. It would create much more volatility in own funds than a portfolio approach and also be extremely burdensome and costly for banks as it would imply to modify their systems for reporting purposes only. The item-by-item approach is therefore not the most prudent one as stated in the DP, but the most contrary to the bank's management policies.

Though IFRS 9 is not finalized, it seems - based on the current ongoing discussions - that the disconnection between business intent and accounting valuation has good chances to increase after the implementation of IFRS9. The new fall back accounting category would indeed be fair value through P&L, and would include not only the trading assets but also various other ones. This would result in heavy retreatments in order to identify the trading assets. As such, applying a filter taking the accounting category would be extremely burdensome. EBA underlines in point 96 that a possible drawback to applying a filter on the prudential category could be the reclassification by banks of financial instruments to HFT, i.e. from the banking book to the trading book, in order to avoid the filter. This would however be risky: the HFT accounting is done from acquisition date onwards with very limited possible reclassification from HFT to AFS). This arbitrage possibility is therefore deemed to be remote.

Last but not least, level playing field issues between EU and non-EU banks (as mentioned in the DP) should also constitute a highly relevant criteria in this analysis given the importance on a consistent amongst jurisdictions and stable over time framework: non EU banks not applying a filter on their unrealized gains would stand better than European banks which would result in a competitive advantage in their favor.

We trust you find our comments useful and would be pleased to provide any further information you might require.

Yours sincerely,



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