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Ref.: BAN/HvD/LF/ID

Dear Sir or Madam,

Re: FEE Comments on the Commission Services Staff Working Document on Possible Further Changes to the Capital Requirements Directive (CRD) IV

- (1) FEE (the Federation of European Accountants) is pleased to provide you below with its comments on the further possible changes to Directives 2006/48/EC and 2006/49/EC (the "CRD IV proposals").
- (2) Our detailed comments on individual sections of the Commission's working document (including our responses to selected questions) are included as an Appendix to this letter. We have limited our comments to those sections and aspects of the CRD IV proposals, which we believe are most relevant to our professional area of expertise. In addition, we present some general comments that explain and provide background to our detailed positions below.

Impact Assessment

- (3) In the light of the legislative proposal that the Commission envisages to publish dealing with some or all of the areas discussed in the CRD IV proposals and the public consultation on amendments to the CRD that was conducted in July – September of 2009, we particularly support the initiative of carrying out an impact assessment to examine the anticipated effects of options for achieving the outlined policy objectives, since most of the proposals have significant effects on the banking sector and its proper assessment and calibration is vital for a successful reform agenda particularly where these proposals are combined with other financial reform initiatives.
- (4) In this context, we welcome the request of the Commission inviting CEBS to carry out the European Quantitative Impact Study to aid the assessment of the aggregate effect of the proposed revisions. We recognise like the Commission that such a proper qualitative impact study is absolutely imperative.

- (5) In particular, an impact assessment will be important to identify unanticipated or undesired practical consequences, which could impact the banks ability to lend and to intermediate financial flows within the economy. Our detailed comments below are made in that context.

General purpose financial reporting and regulatory reporting

- (6) We support the use of general purpose financial reporting for regulatory reporting purposes where it allows regulators to achieve their objective of ensuring financial stability. In our view, the primary role of financial reporting in financial stability is to restore market confidence with requirements aimed at providing transparency and a true and fair view on financial position at a particular date and performance within individual reporting periods. If additional requirements in significant areas are needed for the purpose of achieving financial stability, this should be ensured through divergent requirements in regulatory reporting outside of the general purpose financial statements (prudential filters) or alternatively in the notes to financial statements.

Level-playing-field

- (7) In order to avoid regulatory arbitrage and ensure level-playing-field for the banks within EU in the highly competitive and globalised banking sector, it would be vitally important to ensure that any significant changes to the CRD are closely aligned with the initiatives of the Basel Committee on Banking Supervision and their implementation in key economies. Furthermore, the CRD IV measures should be considered and assessed in the context of the comprehensive financial reform since the combined effects of all implemented proposals would exceed their simple addition.

For further information on this letter, please contact Leyre Fuertes, Project Manager.

Yours sincerely,



Hans van Damme
President

Section I: Liquidity standards

Liquidity coverage requirement

- (8) Regarding the proposed more extensive liquidity coverage requirement aimed at ensuring that institutions have sufficient high quality liquid assets to survive an acute stress scenario lasting for one month, we agree that this requirement will be useful to promote the short-term resilience of the liquidity risk profile of institutions.
- (9) We note in particular that the specified 30 day stress scenario proposed entails institution-specific but also systemic shocks built upon actual circumstances experienced in the global financial crisis which began in mid-2007, as listed in paragraph 5 of the CRD IV proposals.
- (10) In our opinion, these additional considerations to systemic shocks can be very relevant from a theoretical point of view. However, we are not sure that the circumstances listed will always result in models that best reflect the actual business and related risks of individual institutions. For this reason, we believe that the approach proposed might be too theoretical and as such there is a risk that it might not properly reflect the real circumstances of particular banking businesses in practice.

Scope of application

- (11) We note the proposal to waive the application of the requirements proposed to individual firms provided that it is possible to identify a set of institutions belonging to the same group to which the requirements can be meaningfully applied on a consolidated basis and when certain conditions are met, as detailed in paragraph 17 of the CRD IV proposals. While noting that these conditions will have to be elaborated further, we support this practical approach.

Section II: Definition of capital

Revision of the regulatory capital structure

Question 16: What are your views on the prudential appropriateness of eliminating the distinction between upper and lower Tier 2, and of eliminating Tier 3 capital?

- (12) In general, we welcome the proposal revising the capital structure to comprise two Tiers (Tier 1 and Tier 2), with the removal of Tier 3 and the split of Tier 1 into Core and Non-Core and support the clear split of the going concern and gone concern concepts. In our view, this revised regulatory capital structure will be more robust, simpler and hence easier to understand. However, uncertainties about the impact of the proposed structure are key factors for further consideration. A proper impact assessment in this area will be necessary to consider the effects of the proposed changes.
- (13) Regarding the elimination of Tier 3 capital, we think that the appropriateness of this proposal is very much dependant on its effects and on individual institutions that are currently using this capital tier. Both the timing of the implementation of the proposals and grandfathering arrangements will be critical. See also our comments under Question 24.

Question 17: Are the criteria proposed for Core Tier 1, non-Core Tier 1 and Tier 2 sufficiently robust and how might they be improved?

- (14) We have two main reservations regarding the criteria proposed to define the requirements to qualify for inclusion in each element of the revised capital structure.
- (15) One of the proposed eligibility criteria for Core Tier 1 capital is that “Distributions are paid only after all legal and contractual obligations have been met and payments on more senior capital instruments have been made. There are no preferential distributions, including in respect of other elements classified as the highest quality issued capital” (point 7 in Annex 4 of the CRD IV proposals). We question in particular the appropriateness of the prohibition of preferential distributions.
- (16) In our view, provided that payment of preferential dividends is the only condition (and advantage for preferential shareholders) for common shares dividend payout, we do not see any reason for exclusion of such capital from Tier 1, since as long as institutions have the capability to distribute dividends, they should be able to absorb losses regardless of the order of dividend payout.
- (17) Another of the proposed eligibility criteria for Core Tier 1 capital is that “The paid in amount is classified as equity under the relevant accounting standards” (point 10 in Annex 4 of the CRD IV proposals). We are not sure, provided the criterion quoted in paragraph 15 of this letter is met, whether the second criterion is necessary. In general, we note that a classification might be entirely appropriate for a regulatory point of view but not for accounting purposes.
- (18) Also, it would be helpful to clarify that there could be elements in equity classified under relevant accounting standards not necessarily included in Core Tier 1. In any case, we believe that if the condition explained above regarding the payment of preferential dividends is met, the additional criteria with the link to the relevant accounting standards is not necessary and might cause uneven level-playing-field due to differences in accounting standards. Furthermore, we stress that the IFRSs relevant for financial instruments and equity definitions are currently being reviewed and might be significantly amended.

Question 18: In order to ensure the effective loss absorbency of non-Core Tier 1 capital, would it be appropriate under certain circumstances to require the write down of the principal amount of an instrument or its conversion to a Core Tier 1 instrument? To what extent should the trigger for write-down / conversion be determined objectively or at the discretion of an institution or its supervisor?

- (19) In our view, we would not expect such write-downs/conversions to happen ordinarily.
- (20) However, should these be appropriate under certain circumstances, we believe that the supervisor should have the power to require them.
- (21) We note that such deductions performed for supervisory purposes should not affect the equity for general purpose financial reporting.

Question 19: Which of the prudential adjustments proposed have the greatest impact? What alternative, robust treatments might be considered and what is their prudential rationale?

Prudential filters and deductions

- (22) Regarding the prudential filters and deductions proposed to be made generally in respect of Core Tier 1 capital, we have the following comments on the potential filters and deductions that could apply (listed in Annex V of the CRD IV proposals).

Minority interests

- (23) The proposals specifically suggest that minority interests may not be included in Core Tier 1 capital. On consolidation, this proposal could result in a contradictory position if all risk-weighted assets of a particular subsidiary are being reflected in the formula but part of the related equity linked to those assets is not included as Core Tier 1 capital. In our view, it would be appropriate to allow the inclusion of minority interest as Core Tier 1 capital up to the level of capital needs created by the risk-weighted assets of the relevant subsidiary. This would ensure proper reflection of the loss absorption capacity of minority interest and disallow artificial minority interest transfer from well capitalised subsidiaries to other entities within the consolidated group.

Deferred tax assets

- (24) We noted the distinction made in the proposal between deferred tax assets that rely on future profitability of the institution to be realised (to be deducted from Core Tier 1) and deferred tax assets that do not rely on the future profitability of the institution to be realised.
- (25) In our view, the example provided as deferred tax asset, i.e. prepayments to tax authorities, might not be the most appropriate. In practice, prepayments to tax authorities should not be presented as deferred tax assets. It would be helpful to provide another example since recognised deferred tax assets are, at least by the IFRS definition, always dependent on future profitability of the institution.
- (26) Although we see conceptual merits to deducting from Core Tier 1 deferred tax assets that rely on future profitability, we point out that this would add a clear procyclical effect. We think that an impact assessment is needed in addition to a proper phasing of any proposals in this regard once introduced. Also, we think that whether the recognition rules in the context of general purpose financial reporting (probability assessment of realisation of deferred tax asset) are sufficient to ensure DTA recoverability.

Gains and losses due to changes in own credit risk on fair valued financial liabilities

- (27) Considering the expected proposals for the financial reporting treatment of own credit risk in financial liabilities leading to separation of “own credit risk” outside the statement of income, we consider as appropriate to isolate the changes in fair value of liabilities resulting from changes in the institution’s own credit risk and remove them from the regulatory capital.

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- (28) Saying that, we propose that the regulatory reporting relies in this case on the information from financial reporting, since own credit risk is inherent in the fair value of all financial liabilities and is subject to permanent development. Its exclusion in the case that its measurement is not available might easily become an onerous requirement, particularly in the measurement of trading liabilities that are readily tradeable on active markets.

Question 21: What are your views on the need for further review of the treatment of unrealised gains? What would be the most appropriate treatment of such gains?

- (29) We agree with the proposed inclusion of all unrealised gains and losses recognised on the balance sheet in Core Tier 1 and also agree with the proposed monitoring of the future development of IFRSs in this area as proposed in Annex V.
- (30) In addition, we agree with the proposed removal of the positive and negative cash flow reserve related to hedge accounting from Core Tier 1.

Implications for Large Exposures

Question 22: We would welcome comments on the appropriateness of reviewing the use of going concern Tier-1 capital for large exposures purposes. In this context, would it be necessary to review the basis of identification of large exposures (10% own funds) and the large exposures limit (25% own funds)?

- (31) The more stringent capital requirements on Tier-1 capital will reduce by itself the maximum limit for large exposures. The impact assessment that is envisaged to be carried out should focus on the issue of whether any further reductions would be appropriate.

Contingent capital

Question 23: What is your view of the purpose of contingent capital? What forms and triggers would be most appropriate?

- (32) We support the concept of contingent capital. In general, we would support the development of principles-based features for the conversion of instruments to core Tier 1 capital.
- (33) We also think that the treatment of contingent and convertible capital should be made clear as soon as possible, to mitigate any unnecessary uncertainty and should be reviewed based on the results of the impact assessment.

Question 24: How should the grandfathering requirements under CRD II interact with those for the new requirements? To what extent should the grandfathering provisions of CRD II be amended to bring them into line with those of the new capital requirements under CRD IV?

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- (34) Like in the case of the changes introduced and agreed by Member States and the European Parliament in September 2009 ('CRD II'), we think that for the CRD IV proposals it will be important to allow for grandfathering provisions to minimise disruption in the financial markets resulting from the revised definition of capital. For instance, the removal of Tier 3 capital when its amount is significant for a given institution should be carefully phased-in and proper transitional arrangements will be of particular importance.
- (35) In particular, we welcome the plan to define suitable arrangements for the phasing-in of the new capital requirements under CRD IV, as well as for the grandfathering of existing instruments (as detailed in paragraph 76 of the CRD IV proposals).

Section III: Leverage ratio

- (36) Our main concern regarding the proposed leverage ratio is ensuring that it is calculated consistently and implemented properly, since the more precisely this is defined the more closely it would be aligned with risk-weighted measurement.
- (37) Regarding the proposed design of leverage ratio (detailed in Annex VIII of the CRD IV proposals), we note that in the proposed approach for the derivatives, there is no recognition of netting arrangements. While we understand that this approach is designed to reflect the significantly varying extent of netting permitted for accounting purposes between accounting regimes, such provision could significantly increase the reported derivative positions of some banks. A global level-playing field (to be considered based on the differences in financial reporting) should represent a key consideration in the development of the final solution of this issue.
- (38) Because the leverage ratio requirement is considered to be less precise compared to the capital adequacy ratio requirement based on risk-weighted assets, in the case it is established, we would prefer the calibration designed in such a way that the leverage ratio represents a ceiling/back-stop that would only reduce exposures on the top of business cycle or address potential regulatory arbitrage possible under the capital adequacy rules due to unusual or irregular business models.

Section IV: Counterparty credit risk

Central counterparties

- (39) We agree that central counterparties (CCPs) could help reduce the systemic risk arising from derivative exposure. However, it will be necessary to see the results of the impact assessment in this area before such a conclusion can be reached.

Section V: Countercyclical measures

Through-the-cycle provisioning for expected credit losses

- (40) In our response to the Commission consultation on amendments to the CRD that was conducted in July – September of 2009, we presented a strong view that the proposals set out in relation to through-the-cycle provisioning (“TTC provisioning”) should remain in the prudential reporting domain and should not be reflected in the income statements or statements of other comprehensive income prepared on the basis of IFRS or local GAAP, as they do not allow to properly present the underlying performance of financial institutions to investors. If the proposed information is needed for the purpose of achieving financial stability, this should be ensured in regulatory reporting outside financial statements (prudential filters) or in the notes to the financial statements. We refer to paragraphs 6 and 7 of our covering letter where we stress the importance to retain transparency of financial reporting and level-playing-field for financial institutions competing on global financial markets. We also refer to the FEE Policy Statement of March 2009 “Dynamic Provisioning for Financial Instruments”.
- (41) The key technical issues why we consider the TTC provisioning model not suitable for general purpose financial reporting can be summarised as follows:
- (i) The TTC provisioning model in all versions may create day-one losses on inception of any new loan. Initial recognition of loans and receivables under IFRS is at fair value, so any model which requires recognition of a day-one loss would conflict with the measurement standard. It would also be very difficult to define in the accounting policies, disclosed in the notes, what the actual measurement basis of a loan at inception is.
 - (ii) The average duration of loan and receivables portfolios could be significantly shorter than the economic cycle. The TTC provisioning would establish buffers for loans which have not yet been granted and ignores the duration of loan portfolios, since the average duration of most loan and receivables portfolios is shorter than the economic cycle. It is our strong opinion that it is inappropriate to make provisions for loans which have not yet been granted.
 - (iii) TTC provisioning uses industry average losses which do not reflect the quality of the lending process and differences in the risk appetite of individual institutions as demonstrated by the quality of their loan portfolios. Users of general purpose financial statements rightly expect that the quality of a particular loan portfolio is reflected in the balance sheet and income statement of the reporting entity. Furthermore, it remains unclear how the proposals should be applied in the case of international operating banks in various countries and market segments.
 - (iv) The model is unclear regarding the critical question of when the through-the cycle provision is to be released/utilised. Although this is a key consideration also for prudential reporting, it is a condition-sine-qua-non for financial reporting. If the model would allow hiding deterioration of a loan portfolio of the reporting entity, which would be the case of most automatic release triggers, it would be unacceptable for financial reporting. If the release/utilisation would be based on a regulatory decision, it is unclear on what factors such decision would be based and we can hardly imagine that such decision would reflect the actual situation of each individual reporting entity.

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- (42) Furthermore, the proposal would put the regulated banks into unfavourable position vis-à-vis both the unregulated reporting entities in the EU and regulated banks outside the EU. Although this is also true in the case of regulatory reporting, this argument is significantly more relevant in the area of general purpose financial reporting, as clearly demonstrated in the current discussions about level-playing-field among EU and US financial institutions on the basis of IFRS and US GAAP, respectively.