



PRESS RELEASE

Europe's leading public financial institutions present proposals to foster long term investment

Investment is essential if Europe is to achieve its 2020 objectives and should be encouraged by adapting accounting standards and the financial regulatory environment to the specificities of long term investors, Europe's four leading public financial institutions argue in proposals made today.

The proposals were presented to European Internal Market and Services Commissioner Michel Barnier at a round-table on long term investment in Brussels organised by the four institutions: European Investment Bank (EIB), Caisse des Dépôts (CDC), Cassa Depositi e Prestiti (CDP) and KfW Bankengruppe (KfW).

The four institutions urged the European Commission to look more closely at Europe's long term investment needs and bring forward remedies to the barriers for long term investment that they have identified.

The proposals are based on the conclusions of a working group of experts that identified obstacles to the development of long-term investments in the current European financial regulatory framework. The experts designed proposals that could alleviate these drawbacks, in particular in the context of the reform package of the Basel Committee on capital and liquidity requirements (Basel III) and the new IFRS standard for reporting on financial instruments.

The Round-Table was organised in the presence of representatives of the European institutions (Commission, Parliament and Belgian Presidency of the Council) and of European SMEs and regulatory bodies. Speakers included EIB President Philippe Maystadt, CDC CEO Augustin de Romanet, CDP Chairman Franco Bassanini, CDP CEO Giovanni Gorno Tempini, KfW Senior Vice-President Lutz-Christian Funke and Jean-Paul Gauzès Member of the European Parliament.

All participants agreed long term investment - notably in knowledge-based industries, SMEs, low carbon emission projects and infrastructure projects - is crucial to meet the objectives of Europe's 2020 strategy.

Bruxelles, 30th September 2010

Press contacts

Caisse des Dépôts

Philippe Joyeux – Tel. 33 (1) 58 50 40 00

Philippe.joyeux@caissedesdepots.fr

European Investment Bank

Sabine Parisse - Tel. +352 621 459159

s.parisse@eib.org

KfW Bankengruppe

Dr. Michael Helbig- Tel.: +49 69 7431 2277

michael.helbig@kfw.de

Cassa Depositi e Prestiti spa

Lorella Campi - Tel: + 39 06 4221.2531/3407

39 3293604824

lorella.campi@cassaddpp.it



Brussels, September 20th 2010

Object: Proposals to adapt the EU's financial regulatory framework to long term investment's requirements

Dear Mr. Barnier,

Following our preliminary discussions on the promotion of long-term investment, four European financial institutions – namely the European Investment Bank, Caisse des Dépôts, Cassa Depositi e Prestiti and KfW Bankengruppe - wish to update you on their thinking about the ongoing financial regulation reforms and explore ways of cooperation with the European Commission on this issue.

We share the view that long term investment can contribute to a sustainable growth, employment and financial stability. We are referring, in particular, to investment in projects expected to generate a return potential only over ten to fifteen years (such as knowledge-based, low carbon emissions and infrastructure projects).

In that respect, we welcome the objectives set in the EU 2020 Strategy and the Monti report on the Internal Market strategy¹, but we would like to draw your attention on the fact that the prudential regulation and financial reporting standards, as currently discussed, do not fit with these objectives.

We also underline that these standards are likely to be regarded – by market participants and, in particular, by rating agencies – as part of banking best practices.

The specific regulatory status of each of the four institutions pertains to national and EU laws. Nevertheless, IFRS and Basel papers have impact on the long term or SME investment capabilities. In order to proactively contribute to the discussion, the four institutions wish to offer to your consideration a first technical contribution on the recent Basel Committee papers with the systemic scope of promoting long-term and SME investment in the economy. In particular, the four institutions deem that regulation should not include aspects that hinder the ability to undertake long-term or SME investments.

Michel Barnier
Commissioner for Internal Market and Services
European Commission

¹ « The key issue for Europe is how to raise new resources for medium and long term investments of European importance. One way to address the problem is to explore all combinations between public and private funding. (...) Another option is to improve the incentives for long term investors (financial institutions with a public mandate but also private investors, including pension funds) to direct their resources to long term infrastructure projects. (...) A reflection should be made on whether an ad hoc European legal framework should be developed for long term investors, with a view to encouraging their focus on infrastructure investments, while taking into account their specific characteristics and the variety of actors within such class of investors ».

Indeed, entities capable of retaining assets on a long term basis in spite of market fluctuations may be impeded by prudential and financial reporting rules which do not take into account their specificities (i.e. nature and quality of their resources, valuation of their assets over several years, counter-cyclical role, ...).

The proposals, annexed to this letter, are the product of a working group set up by our institutions at the beginning of 2009. They cover three main topics: liquidity, capital requirements and accounting standards (as summarised in Annex 1). They reflect and respond to discussions underway at the Basel Committee and the International Accounting Standards Board (IASB) and constitute a technical follow-up to the general paper on « *Proposals for a European long-term investment framework* » that has been sent to you on April 20th.

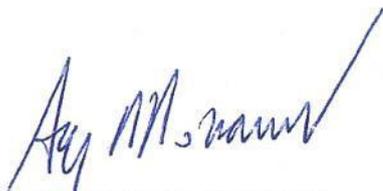
You have most kindly accepted to participate to the round-table we organise on **September 30th**, in Brussels, on the occasion of the EUROFI symposium and ECOFIN meeting. This round-table will gather leaders and experts from European long-term financial institutions as well as MEPs and representatives of other interested parties, such as the Basel Committee.

On this occasion we would like to present the results of our working group and invite the European Commission to launch a broader study – i.e. applicable to other types of long-term investors as well - on the promotion of long term investment around the following issues :

- assessment of the needs at the EU level for large scale investments in order to promote a sustainable recovery and fulfill EU 2020 objectives;
- identification of regulatory and financial obstacles to the attraction of long term savings and the development of long term investments;
- proposals or possible actions to undertake in order to foster this kind of investments.

We are very much looking forward seeing you on that occasion and thank you in advance for your time and attention and remain at your disposal for further information.

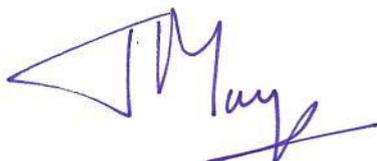
Yours sincerely,



Augustin de Romanet
CEO of Group Caisse des Dépôts



Franco Bassanini
President of Cassa Depositi e Prestiti



Philippe Maystadt
President of European Investment Bank



Ulrich Schroeder,
CEO of KfW Bankengruppe



Conclusions of European long-term financial institutions' working group on banking supervision

Annex 1: Synthesis of our proposals

Annex 2: Definitions

Annex 3: Academic research on long term investment

Annex 4: Numerical examples

Annex 5: Proposals on liquidity

Annex 6 : Proposals on capital requirements

Annex 7 : Proposals on accounting standards

Annex 8 : Working group on banking supervision – list of members

ANNEX 1:

PROPOSALS TO PROMOTE LONG TERM INVESTMENTS IN EUROPE

Europe's capability to embark on a new sustainable growth model, more inclusive and greener, has been dramatically diminished by the crisis. Today, as the macro-economic indicators are again improving, ways of financing a sustainable recovery constitute a challenge that still has to be addressed, all the more so as budgetary rooms of manoeuvre have been exhausted. Against this backdrop, long-term investors can make a significant contribution, as long as a regulatory framework that is more conducive to their intervention can be designed.

Long Term Investors (LTIs) are characterized by a low reliance on short term market liquidity thanks to stable resources, primarily regulated deposits, long term savings products (insurers, pension funds) and long term borrowing. Hence, they usually have a robust capital base, stemming from reserve accumulation, that enable them to absorb short-term fluctuations in financial markets (drawing on reserves in bad years and feeding them in good years).

As such :

- they have the ability to retain their assets longer than other market players, even in crisis periods, which has a counter-cyclical effect on financial markets;
- they can invest in - often illiquid - capital or debt instruments that yield a profitable return in the long run, issued by entities such as general interest utilities, infrastructure and innovation projects companies, renewable energies and SMEs funds;
- the quality of their liabilities is in general better than those of other financial investors
- their investments are typically carried out, with performance and risk targets, which are set at annual pro-rata levels of expected long term return for reporting purposes.

While not all types of long term investors are fully subject to IFRS and Basel Committee rules, the latter can have serious impact on their investment potential through at least two channels:

- LTI maximise their effectiveness if the banking system is ready to leverage their action on long term investment with a complementary attitude;
- historical experience suggests that market participants and rating agencies benchmark the capitalization of institutions with peculiar regulatory status vis-à-vis the Basel principles;

Indeed, entities capable of retaining assets on a long term basis in spite of market fluctuations would be handicapped by prudential and financial reporting rules which do not take into account their specificities.

In order to promote long term investment:

- 1- the quality of LTIs' liabilities should be reflected in the banking regulation's liquidity weighting system. Namely, lendings (or investments) addressed to LTIs should not be subject to the same liquidity counterparty requirements as other lendings (or investments);
- 2- capital requirements should be adapted to the fact that LTIs calculate and assess annual returns on the basis of the long term valuation of their assets and play that way a counter-cyclical role;
- 3- accounting standards should give more prominence to the business model criterion with regard to the classification and measurement of financial instruments and provide for a simplified hedge accounting model reflecting the economic reality of the risk management policy of the entity.

The Working Group on Banking Supervision gathering long term financial institutions (hereafter referred to as the « Working Group ») considers that the beneficial role of long term investors is conditioned by the prudential and accounting framework adaptations described below. Indeed, even if they are not fully subject to regulatory supervision based on the Basel Committee principles or financial reporting under International Financial Reporting Standards (IFRS), they wish to add to the debate with a systemic perspective, also taking into account the indirect effect of the evolving regulatory environment on their long term goals.

The regulatory status of each of the four institutions pertains to national and EU laws and therefore is not discussed in the present document. Nevertheless, IFRS and Basel papers are commented as they have impact on their long term investment capabilities.

With regard to the liquidity and capital reform package of the Basel Committee on Banking Supervision ("BCBS" or "Basel Committee"), the Working Group wants to emphasize that the BCBS should reach an agreement on the whole capital accord and create a climate in which the accord will be implemented by all addresses without hindering economic growth. The Working Group has concerns about the impact of the new regulation on smaller savings and cooperative banks, which might create difficult funding conditions for SMEs.. In this respect the Working Group would welcome the publication of the results of the last Quantitative Impact Study (QIS) and it would like the accord to be delivered in time for the next G20 summit in Korea (November 2010).

The proposals of the Working Group are based on the information published by the Basel Committee and the International Accounting Standards Board up to 31 August 2010. Hereafter is a summary of these proposals:

1. Liquidity requirements

The Working Group's proposals on liquidity requirements are detailed in Annex 5 of this document. Generally speaking, the Working Group believes that in an asset-liability management perspective, these proposals do not take into account the specific features of LTIs' liabilities.

LTIs have better quality financing instruments and less volatile resources than other financial institutions. In case of liquidity crisis, they benefit from "flight to quality" market behaviours (their liabilities are considered by investors as safer than bank liabilities), which give them more funding capabilities –contrary to banks.

Therefore, the Working Group underscores that a large amount of LTIs' financing sources should be considered as renewable whenever conducting a liquidity stress scenario. Also, for project financing credit lines, disbursement is conditioned by technical requirements related to the project progress. These facilities are indeed subject to lower disbursement risk than the one of classical banking revolving credits.

The LTIs balance sheet structure is adapted to long term investments. As LTIs short-term interbank funding is far less important than their stable, long-term funding, higher liquidity requirements for

long-term assets (more required stable funding) would be suited to their structure, provided that the quality of their funding is recognised.

For illustrative examples, please see Annex 4.

2. Capital requirements

The Working Group's proposals on Capital Requirements are detailed in Annex 6 of this document.

The Working Group is concerned by the potential pro-cyclical effects of some Basel Committee's proposals, which could be at odds with long term management goals and induce further pro-cyclicality. Indeed, the inclusion of unrealised gains and losses in the capital base, the deduction of deferred tax from the capital base and the additional capital charge for the counterparty risk (related to the evolution of credit spreads) would induce procyclicality.

The second important point concerns the way participations are treated. Namely the deduction of minority interests from the capital base and the deduction of the capital invested in other banks, financial institutions or insurance companies could generate a disadvantage for long term investments. The agreements of the Group of Governors and Heads of Supervision on the reform package on July, 26, 2010¹ indicate just a very small relief on that point, i.e. only minority interests in a subsidiary that is a bank will be partially recognized.

Lastly, it is important to emphasize that the leverage ratio should not become part of Basel's first Pillar, as it is merely a ratio of equity over nominal liabilities without any risk-weighting. As it is explicitly intended to be a non-risk based measure, it should be part of supervision but only as part of Pillar two.

For illustrative examples, please see Annex 4.

3. Accounting Standards

The Working Group's proposals on accounting standards are detailed in Annex 7 of this document.

As many other long-term investors, our long term financial institutions welcomed G20 conclusions calling for a valuation of financial instruments based on their liquidity and investors' holding horizons, taking into account valuation uncertainty.

However, the standard on financial instruments (IFRS 9), as published in November 2009, and the related proposals of the International Accounting Standards Board (IASB) on impairment and hedge accounting do not give enough prominence to the investor's holding horizon criterion.

- Classification and measurement of financial instruments

In order to achieve a true and fair representation of LTIs' business model, there is a need for an alternative to the classification requirements of IFRS 9. Accordingly, the Working Group suggests to introduce a third category for financial instruments that are held as investments in a medium or long term perspective besides the amortised cost and fair value through profit or loss categories. Financial instruments included in this category would be measured at the lowest between the acquisition cost and value in use.

Furthermore, the inclusion of the entity's own credit risk in the valuation of financial liabilities, as proposed by the IASB, could jeopardise the capital requirement ratio of reporting entities. Accordingly, the Working Group pleads in favour of a proposal whereby the fair value of financial

¹ <http://www.bis.org/press/p100726.htm>

liabilities would only incorporate the level of own credit risk observed at inception, thus avoiding undue volatility of own funds.

- Impairment

Generally speaking, the Working Group agrees on a « periodic expected loss » as a reasonable component of provisions for loan losses. However, it believes that, as it stands today, the IASB proposal does not address the difficulties attached to the particular situation of long-term investors as preparers of financial statements (e.g. limited availability of observed credit loss parameters, difficulty to define reliable credit loss expectations over a very long period of time).

- Hedge accounting

If the financial statements are to give a faithful representation of the entity's financial position, hedge accounting is not to be regarded as an exception to "normal accounting", but rather as the reference accounting technique used when there are both a mixed measurement issue and a risk reduction hedging policy.

In situations where the entity holds financial assets and liabilities with the objective of collecting their contractual cash flows, as most long term investors do, the Working Group strongly recommends a measurement of risk reduction that is consistent with this very business model and whereby the prominent metric is an assessment of the achievement of the risk management policy targets (such as the reduction of interest rate repricing gaps) and not the reduction of fair value sensitivity.

For illustrative examples, please see Annex 4.

ANNEX 2: DEFINITIONS

Long-term investment represents:

- An investment that has a long term horizon and that may contribute to a sustainable growth, employment and financial stability. The Working Group is referring, in particular, to investment in large scale projects which can express their return potential only over several years, such as knowledge and labour intensive general interest, low carbon or infrastructure projects.
- An investment that generates stable cash flows in the long run and thereby financially sustainable long-term risk-adjusted rate of return.
- An investment that may give a contribution to financial markets stability.

Long Term Investors:

In the present document, Long Term Investors are characterized by a low reliance on short term market liquidity thanks to stable resources, often made of regulated or guaranteed deposits, long term savings products (insurers, pension funds) or long term borrowing. They usually have a robust capital base, stemming mainly from reserve accumulation, that enables them to absorb short-term fluctuations in financial markets (drawing on reserves in bad years and feeding them in good years).

As such :

- they have the ability to retain their assets longer than other market players, even in crisis periods, which can play a counter-cyclical role on financial markets;
- they can invest in - often illiquid - capital or debt instruments that yield a profitable return in the long run such as those issued by companies operating in sectors like general interest utilities, infrastructures, innovation projects, renewable energies and the like;
- their liabilities differ in quality from the ones of other financial investors;
- their investments are typically carried out with performance and risk targets calculated on a long term basis.

Long Term Investors comprise major financial institutions financing economic development, sovereign wealth funds, pension funds, public retirement funds, insurance funds.

Example of Long-Term Investment Process:

« Primary investors »	Intermediaries	Issuers
<p>Who : Consumers, employees, individuals, etc.</p> <p>Objectives :</p> <ul style="list-style-type: none"> - Have retirement savings and a financial portfolio to be handed over, which does not lose its purchasing power; - Contributing to and benefiting from innovation and dynamic economic development ; - Having diversified savings vehicules that can be connected to one another (long horizon, business sectors with long cycles etc.). 	<p>Who : Pension funds, hedge funds, life insurance companies, sovereign funds, public financial institutions, development banks, etc.</p> <p>Regulatory framework :</p> <p>UCITS directive, CRD, IORP, Sovency II,</p> <p>IAS 39, 17, 19</p> <p>Management tools :</p> <ul style="list-style-type: none"> • Asset and liabilities management ; • Risk hedging financial instruments (rate Forex, counterparty, etc.) ; • Leverage effect or not. 	<p>Who :</p> <ul style="list-style-type: none"> • Structures carrying economic activities with long cycles : steel industry, motor industry, etc. • Structures carrying economic activities with very long cycles (transport, energy, urban infrastructures, ...) • Issuers looking for stable investments. <p>Investment vehicles :</p> <ul style="list-style-type: none"> • Equity investments ; • Bonds ; ...

Source : Eurofi, position paper on Long-Term Investment, September 2009

The approaches and, more specifically, the types of players that are active in markets for long-term investments are highly diverse. When analysing long-term investment it is therefore essential to start off from the specific goals pursued by the "primary" investors - in most cases savers and employees - and the added value they expect their intermediaries to deliver.

ANNEX 3:
ACADEMIC RESEARCH ON LTIs

- Aglietta M. and Rigot S. (2009): *Crise et rénovation de la finance*, Editions Odile Jacob
- Bassanini F. and Reviglio E. (2010) : *Reducing National Debt and Financing Long Term Investments for Sustainable Growth*, Astrid Rassegna n. 6/2010, available at www.astrid.eu.
- Bec F. et C. Gollier (2008) : *Assets Returns Volatility and Investment Horizon: The French Case*, Mimeo, Toulouse School of Economics.
- Berglöf, E., Thadden, E.-L. von (1994), Short-Term Versus Long-Term Interests: Capital Structure with Multiple Investors, *Quarterly Journal of Economics*, Vol. 109, No. 4 Nov. 1994, pp. 1055-1084.
- Campbell, J.Y., Viceira L.M. (2002), *Strategic Asset Allocation: Portfolio Choice for Long-Term Investors*, Oxford University Press.
- Garnier O. et D. Thesmar (2009) : *Épargner à long terme et maîtriser les risques financiers*, Rapport du CAE, n° 86, La Documentation française.
- Gollier C. (2001) : *The Economics of Risk and Time*, MIT Press.
- Gollier C. (2002) : *Time Diversification, Liquidity Constraints, and Decreasing Aversion to Risk on Wealth*, *Journal of Monetary Economics*, n° 49, pp. 1439-1459.
- Gollier C. (2008) : *Intergenerational Risk-Sharing and Risk-Taking of a Pension Fund*, *Journal of Public Economics*, vol. 92, n° 5-6, pp. 1463-1485.
- Gollier C., P-F. Koehl et J-C. Rochet (1997) : *Risk-Taking Behaviour with Expected Utility and Limited Liability: Applications to the Regulation of Financial Intermediaries*, *Journal of Risk and Insurance*, n° 64, pp. 347-370.
- Griffith-Jones S., Stiglitz J. et al (2009) : *Building on the counter-cyclical consensus: A policy agenda*. Columbia University. Paper prepared for the High-level Roundtable in Brussels on October 12, 2009, —Towards Basel III? Regulating the Banking Sector after the Crisis.
- Lob, H. (2007): Public development banks and prudential regulation, *Development and Finance*, n° 2, pp. 37-45.
- Lorenzi JH., Quinet A., Trainar P. (2010): Glachant J. *Investissements et investisseurs de long terme*, Conseil d'Analyse Economique, La Documentation Française.
- Pastré O., Chevalier JM, Griffith Jones S. et al (2009) : *Sovereign Wealth Funds, Special Issue 2009*, *Revue d'Economie Financière*, Association d'Economie Financière.
- Perée E. and Vällilä T. (2007): *A Primer on Public Investment in Europe, Old and New*, EIB Economic and Financial Reports Volume 01/2007.

ANNEX 4: NUMERICAL EXAMPLES

Minority interest

The purpose of this example is to illustrate the impact of minority interest deduction of the common equity component of tier 1. The deduction comes into play for the definition of common equity at a consolidated level.

If we take as an example a banking group with €20 billion of tier-1 equity (of which €5 billion are minority interests in a subsidiary that is not a bank) and €250 billion of Risk Weighted Assets (RWA), then its tier1 ratio is 8%.

According to the Basel Committee's proposal, minority interests in a subsidiary that is not a bank should be fully deducted. Common equity would be therefore, equal to €15 billion.

Under these assumptions, common equity ratio for the group would equal 6%.

Our proposal would be as follows:

1. either to deduct minority interest. But in that case, the corresponding proportion of subsidiaries risk exposures should also be deducted ; OR
2. if the common equity ratio is consistent with the fact that minority interests can absorb losses, then minority interests should not be deducted.

In both cases, the ratio would come back to 8% :

Ratio computation method	Capital (Bn €)	RWA (Bn €)	Ratio
Basel III proposal : Common equity / RWA	15	250	6%
Alternative 1 : (Common equity + minority interest) / RWA	20	250	8%
Alternative 2 : Common equity / residual RWA	15	187,50	8%

Unrealised loss on Available For Sale (AFS) portfolio

The purpose of this example is to illustrate the pro-cyclical aspect of taking into account unrealised losses in the common equity definition.

Assume Basel III common equity is equal to €17.5 billion, which includes €2.5 billion of unrealised losses, and RWA is equal €250 billion.

Under these assumptions, common equity ratio would equal 7% (17.5 / 250).

If unrealised losses are removed from common equity component, common equity ratio would equal 8%.

	Capital (Bn €)	Ratios
Basel III Common equity ratio	17,5	7%
Common equity excluding unrealised losses	20	8%

Taking into account unrealised losses in the common equity ratio is likely to increase capital requirement during financial stress periods; this is not consistent with the logic of long term investment, which entails the ability to hold assets in portfolio during economic downturns.

Liquidity coverage ratio

Assume the value of the stock of high quality liquid assets is € 20 billion. The net cash outflows over a 30-day time period equals € 20 billion, and among those outflows, wholesale debt with a maturity lower than one month is equal to € 2 billion.

Under Basel proposal, funding with a maturity lower than one month is part of the category “*Unsecured wholesale funding provided by other legal entity customers*”. Such a category has to be included with a 100% weight in the net cash out flow calculation.

Therefore, according to the Basel rules, the liquidity coverage ratio would be equal to 100% (€ 20 billion / € 20 billion).

Long Term Investors would find these rules penalising and would find it natural to conceive a more favourable treatment for this type funding. For instance, by assuming a weight of 50%, net cash outflows would decrease to € 19 billion and the ratio would increase up to 105% (€ 20 billion / € 19 billion).

Accounting norms (measurement)

Fair value accounting of an asset depicts its short-term market value, not its long-term fundamental value.

If a long-term investor holds a fixed income instrument (e.g. a fixed rate loan with 10 years remaining duration) for the purpose of gaining an interest rate margin of 0.30% over the cost of funding, it would like to depict the economic reality of a €300 million annual gain on €100 billion of assets held.

In the sensitivity analysis below, the Working Group takes the case that those assets are financed by stable long-term funding at floating rate and that the interest rate gaps are hedged by interest rate swaps.

Given that derivatives are required to be measured at fair value, a decrease of 1% of the absolute interest rate will provoke an (unrealised) accounting loss of €9.1 billion, which boils down to completely ignoring the €0.3 billion profit which is the information to be communicated to the investors and other stakeholders in the LTI, in accordance with its business model.

Even when using remedies such as the Fair Value Option, a rise of 0.10% in the spread between the valuation parameters of loans and swaps, will still provoke an (unrealised) accounting loss of approximately €950 million.

The investors and stakeholders in the LTI - who seek to discern trends in the yearly profit of the entity with a typical magnitude around tens of millions - will have difficulties discerning the "signal" of such trend within the "noise" of a volatility of the bottom line result which will run into the hundreds of millions and even billions.

Hence, the need for a set of accounting rules, including hedge accounting rules, that fully depict the profit as the difference between the long-term return on assets and the long-term cost of funding, excluding all short-term fair value variations.

ANNEX 5: PROPOSALS ON LIQUIDITY

Comments on the proposals for liquidity risk measurements, standards and monitoring which were amended by the agreements of the Group of Governors and Heads of Supervision on the reform package on July, 26, 2010^{2 3}

The specific nature of LTIs and their behaviour as investors is reflected by their liabilities, which are characterized by “flight to quality” dynamics in situations of generalized liquidity stress⁴. In other words, LTIs liabilities are considered safer than banks liabilities in periods of liquidity tension on the financial markets.

The credit and liquidity characteristics of LTIs liabilities are recognised by the Basel Committee. In most cases, under the Standardized Approach of Basel 2, banks are not required to hold any prudential capital vis-à-vis their holdings of LTIs bonds and the latter are considered to be eligible “liquid assets” for the calculation of the Liquidity Coverage Ratio. Therefore, the specific business model of LTIs is strongly influencing their approach to liquidity risk measurement and management.

It is recalled that LTIs are, generally speaking, not subject to regulatory supervision based on the Basel Committee principles. However, LTIs are aware that these principles, once introduced by the Basel Committee, tend to be used to measure the soundness of market participants, at least to some extent. So, the approach and the rules should take into account the specificities of LTIs in order to yield meaningful results.

A. Liquidity Framework

The BIS has published a consultation document in December 2009 "International framework for liquidity risk measurement, standards and monitoring". This paper follows the earlier publication "Principles for Sound Liquidity Risk Management and Supervision" published in September 2008 (<http://www.bis.org/publ/bcbs144.htm>). On July 26, 2010 the Group of Governors and Heads of Supervision published key agreements on the reform package, the final details of the reform will be issued later this year.

The proposal defines two new liquidity ratios:

- The Liquidity Ratio Coverage (LCR) 30 days ratio to ensure that banks could face a liquidity stress scenario for one month;
- The Net Stable Funding Ratio (NSFR) to measure the adequacy of long-term assets with long-term resources.

The text calls in addition to the production of four new indicators:

- Contractual Maturity Mismatch (mismatch of cash flows);
- Concentration of funding (by counterparty);

² [Http://www.bis.org/publ/bcbs165.htm](http://www.bis.org/publ/bcbs165.htm) / <http://www.bis.org/press/p100726.htm>

³ The proposals of the Working Group are based on the information published by the Basel Committee up to 31 August 2010

⁴ This phenomenon has been evident at the beginning of the acute phase of the sub-prime financial crisis in June 2007, when Credit Default Swap (CDS) spreads on European banks have substantially increased, while the credit spread quoted on LTIs issues has decreased.

- Unencumbered available assets: liquid assets;
- Market-related monitoring tools: use of market prices for the measurement of risk (eg price of CDS).

Herein is described how these specific indicators could be adapted to take into account the needs of the long-term investment, with a focus on the characteristics of LTIs, as defined above. LTIs can in fact offer a useful example of the way new regulations can influence the ability to undertake long term investments

1) The Liquidity Coverage Ratio (LCR)

1.a. Principles

LCR ratio compares the amount of unencumbered high quality liquid assets held by an institution that can be used to offset net cash outflows under a stress scenario in the short term following constraints determined by supervisors. The stress scenario involves both specific shocks to the institution and systemic shocks based on actual circumstances observed in the global financial crisis.

The scenario assumes:

- a significant downgrade in the rating of the institution (three notches);
On this point, the Working Group believes that as all LTIs are directly or indirectly guaranteed by their sovereign authorities, this downgrade would mean that sovereign authorities would meet a massive loss in their credit rating. This is very unlikely to happen in such a short period of time – one month - as suggested in the proposal. For LTIs, the Working Group suggests that a maximum of one notch downgrade should be simulated.
- a partial loss of deposits;
- the loss of unsecured financing;
- a significant increase of haircuts for secured financings;
- an increase in demand for collateral of derivatives and an important draw of lines of credit.

The objective of this measure is to establish a metric that would ensure that the institution maintains an adequate level of unencumbered high quality liquid assets, which can be liquidated to meet its liquidity needs, on a timescale of 30 days under a scenario of acute stress liquidity specified by supervisors. At a minimum, the stock of liquid assets should allow the bank to survive until day 30 of stress proposed scenario, when it is assumed that appropriate measures can be taken by management and / or supervisors.

1.b. Measure

The ratio is defined as follows:

$$LCR Ratio = \frac{\text{Stock of high quality liquid assets}}{\text{Net cash outflows over a 30-day time period}} > 100\%$$

For the calculation of **High Quality Liquid Assets (HQLA)**, a liquidity factor is associated with each class of securities, this factor is higher for the most liquid securities. The HQLA is then calculated as the weighted sum of the amounts by factors of liquidity.

With a factor of 100%:

- cash and central bank reserves;
- securities representing claims on or guaranteed by sovereigns, central banks, multilateral development banks, public sector entities;

The Working Group would like the norm to be more precise about the inclusion of public sector entities (PSEs) and multilateral banks. Indeed, the norm should clearly and explicitly specify that the financial instruments issued by state owned public institutions are included in the perimeter of high quality liquid assets. In the same way, the norm should clearly and explicitly specify that the financial instruments issued by Long Term Investment financial institutions, and especially LTIs, are included in the perimeter of high quality liquid assets.

- government or central bank debt issued in domestic currency.
On this point, the Working Group believes that it should be clarified that loans granted to public sector entities and paid by the central government are included. Indeed, state-guaranteed assets should be clearly included.

With a factor of 85%:

- liquid corporate securities rated AA- or higher;
- Covered bonds rated AA- or higher.
- Government and PSE assets qualifying for the 20% risk weighting under Basel II

These assets may not exceed a cap of 40% of the total stock of HQLA.

With a factor of 60%:

- liquid corporate securities rated from A to AA;
- Covered bonds rated from A-to AA-.

For the calculation of **Net Cash Outflow (NCO)**, a percentage of outflow is associated with each category of assets or liabilities:

Retail deposits:

- Retail deposits "stable": minimum 5%;
- Retail deposits "less stable": minimum 10%.
On deposits, the Working Group wants to underline that some LTIs do have specific state-regulated deposits, for example consignations or notaries transactions deposits. In fact, those deposits are regulated by law and are not comparable to corporate deposits or retail deposits. Indeed, their evolution is quite different from retail or corporate deposits while there is no possibility to claim those deposits in case of crisis or for any other reason than very specific regulated conditions : consignations can only be drawn in circumstances foreseen by the law; notary deposits can only be drawn at the conclusion of the real estate transaction. This is the reason why the Working Group considers that such deposits should be attributed a very low coefficient, even lower than the lower coefficient applied to retail deposits (i.e. 5%).

Funding non-collateralized:

- Stable, from small clients: Minimum 7.5%
- Less stable, from small clients: Minimum 15%
- Operational activities with financial institutions counterparties: 25%
- Deposits from (domestic and foreign) sovereigns, central banks, PSEs and non-financial corporates, unrelated operations: 75%
- Non-financial corporates and local authorities with operational links: 25% of deposits needed for Operational Purposes
- Other non-retail customers without operational link: 100%
- Unsecured wholesale funding provided by other legal entity customer : 100%

The Working Group considers that a lower weighting should be applied to the "Unsecured wholesale funding provided by other legal entity customers" for marketable securities issued by entities like LTIs (bonds and commercial papers). In other words, the fact that bonds and commercial papers issued by LTIs preserve and even increase their attractiveness in periods of market stress, should be recognised by a more favourable treatment of this

category of liabilities in the calculation of the short-term LCR as compared to what it is permitted to banks. In fact, the Working Group would like the norm to admit that a portion of LTIs commercial papers will be rolled out, and also a (smaller) part of bonds will be rolled out.

Another point is that LTIs do not have the concrete possibility of tracking bond counterparties. As such, based on the current version of the consultative paper, LTIs would find themselves in the situation of weighting at 100% practically all their liabilities that have maturity lower than one month, even where such liabilities could be held by retail investors for a sizeable portion.

Lines of Credit:

- Retail clients: 5% of lines
- Sovereign, central banks, PSEs and non-financial corporates, credit facilities: 10% of Outstanding lines
- Sovereigns, central banks, PSEs and non-financial corporates, liquidity facilities: 100% of Outstanding lines
- Other legal entity customers: 100% of Outstanding lines

Some specific commitments “at risk” of disbursement do not take the form of “revolving” credit lines. This is the case for example for a sizeable portion of committed credit facilities that have future already scheduled disbursements linked to the fulfilment of technical advancements on the financed project (e.g. project financing, infrastructure, constructions, etc.). The disbursements cannot be anticipated simply at the counterparty’s request. For this type of credit lines, the Working Group would like to take their specificities into account, and not disburse immediately the part that is positioned in the future.

- Other (guarantees, letters of credit, etc.): to be determined.

All Other Cashflows : 100%

2) The Net Stable Funding Ratio (NSFR)

2.a. Principles

The NSFR ratio measures the amount of longer term stable funding sources used by an institution compared to the profiles of liquid assets funded and drawings resulting from potential off-balance. The standard requires a minimum amount of funding that should be stable over a one year time based on factors of liquidity risk attributed to assets and off-balance sheet liquidity. The NSF ratio is designed to promote the long-term financing (ie maturity greater than one year) structural balance sheets of banks. After an “observation phase” to address unintended consequences on business models or funding structures, the NSFR shall be introduced by January 2018.

2.b. Measure

The ratio is defined as follows:

$$\text{NSFR Ratio} = \frac{\text{Available Amount of Stable Funding}}{\text{Required Amount of Stable Funding}} > 100\%$$

Definition of the Available Amount of Stable Funding (ASF):

In calculating the Available Amount of Stable Funding (ASF), a liquidity factor is associated with each category. The ASF is calculated as the weighted sum of the amounts by factors of liquidity

With a factor of 100%:

- Capital including Tier 1 and Tier 2;
- Funding with remaining maturity > 1 year.

The Working Group considers that also funding maturing in the year should be considered (with an appropriate percentage) for marketable securities issued by entities like LTIs (bonds and commercial papers). In other words, the fact that bonds and commercial papers issued by LTIs preserve and even increase their attractiveness in periods of market stress, should be recognised by a more favourable treatment of this category of liabilities in the calculation of the short-term LCR as compared to what it is permitted to banks. In fact, the Working Group would like the norm to admit that a portion of LTIs commercial papers will be rolled out, and also a (smaller) part of bonds will be rolled out.

With a factor of 90%:

- "Stable" Retail deposits
- Retail term deposits "stable" with a maturity of less than one year.

With a factor of 80%:

- Retail deposits "less stable";
- Retail term deposits "less stable", with a maturity of less than one year.

On deposits, the Working Group wants to underline that some LTIs do have specific state-regulated deposits, for example consignations or notaries transactions deposits. In fact, those deposits are regulated by law and are not comparable to corporate deposits nor retail deposits. Indeed, their evolution is quite different from retail or corporate deposits while there is no possibility to claim those deposits in case of crisis or for any other reason than very specific regulated conditions : consignations can only be drawn in circumstances foreseen by the law; notary deposits can only be drawn at the conclusion of the real estate transaction. This is the reason why we consider that such deposits should be attributed a very high coefficient, even higher than the highest coefficient applied to retail deposits (i.e. 90%).

With a factor of 50%:

- Corporate deposits with a maturity of less than one year.

Definition of the Required Stable Funding (RSF):

For the calculation of Stable Funding Required (RSF), a factor is associated with each asset class. The RSF is then calculated as the weighted sum of the amounts by liquidity factors.

With a factor of 0%:

- Cash;
- Assets + loans that do not qualify for the category mentioned below with a maturity < 1 year.

With a factor of 5%:

- Unencumbered marketable securities with a remaining maturity \geq one year with sovereign risk, central banks, BIS, IMF, EC, governmental agencies or multilateral development banks that are rated AA or higher and are assigned a weighting 0% under

Basel II standardized approach, provided that active repo markets exist for these securities.

LTI believe that the norm should clearly and explicitly specify that the financial instruments issued by state owned public institutions are included in the perimeter of high quality liquid assets.

In the same way, the norm should clearly and explicitly specify that the financial instruments issued by Long Term Investment financial institutions, and especially LTIs, are included in the perimeter of high quality liquid assets.

Members of the working group believe that bonds with a rating lower than AA should be taken into account, even with a larger haircut. Indeed, the NSFR ratio rules entail that the downgrading of the government paper public rating from AA to A requires to increase by 1900% (= 100% / 5% -1) the amount of medium-term funding necessary to keep them in portfolio.

With a factor of 20%:

- Unencumbered corporate bonds (or covered bonds) listed with a rating of AA or better and with an effective duration \geq one year and have an active and liquid market, including crisis scenario

With a factor of 50%:

- Quoted shares;
- Unencumbered corporate bonds (or covered bonds) rated at least AA rating with AA-and A between-and with an effective duration \geq one year and have an active and liquid market, including crisis scenario;
- Loans to non-financial corporate customers with maturity <1 year;
- Gold.

With a factor of 65% :

- Residential mortgages and other loans that would qualify for the 35% or better risk weight under Basel II

With a factor of 85%:

- Loans to retail customers, with maturity <1 year.

With a factor of 100%:

- All other assets.

Lines of credit and guarantees are weighted 10% or more depending on the regulators.

3) Other indicators required

The text proposes the establishment of four new reports to the attention of regulators:

1. contractual Maturity Mismatch;
2. concentration of funding;
3. available unencumbered assets;
4. market related monitoring tools.

- **Contractual Maturity Mismatch**

This is the gap of cash-flows (receivers and payers) estimates per time interval. It is suggested that these gaps occur for the following intervals: overnight, seven days, 14 days, 1, 2, 3 and 6 months, 1, 3, 5 and over 5 years.

These indicators are produced without assumptions included in the data, so that the regulator can build a global view and identify the banks outside of the normal.

Banks will also produce simulations under normal and stress scenario, the assumptions of the simulations to be discussed with regulators.

Banks must also be able to indicate how they intend to fill the maturity gaps, what will be challenged by regulators.

The Working Group believes that this type of analysis may be useful provided that the specificities of each business model are taken into consideration.

- **Concentration of funding**

The banks will give a list of counterparties for their significant funding scheme, that is to say, the counterparties providing more than 1% of their resources, and this by type of source of funding (such as overnight or on CD) . This indicator measures the concentrations of funding by counterparty.

It will also calculate this indicator by currency in order to discuss with the regulator solutions to put in place to manage liquidity gaps international currencies, and manage currency risk.

There is a real concern in the possibility to apply the monitoring tools based on “Concentration of funding”. Indeed, some problems do exist with respect to the possibility of identifying the actual funding counterparty for many types of debt (CPs or Bonds). As it is also recognised in the Basel Committee paper itself, it is not always possible to identify the counterparty holding the debt and this holds true in particular for institutions that fund themselves principally on the capital markets.

- **Available unencumbered assets**

The principle is to produce reports for the regulator on the available liquid assets, that is to say, the available assets that can be used as collateral on the secondary market and / or eligible to the central bank.

Banks will provide the amounts and main characteristics of these assets, including their currency and location, taking into account reasonable haircuts.

- **Market related monitoring tools**

Market data should be used by regulators to identify potential risks of liquidity.

This includes basically all the information needed to monitor equity markets, debt markets, currency markets, foreign exchange markets, commodity markets, and indices related to specific products.

Information specific to a particular relevant counterparty should also be reviewed in order to determine if the market is losing confidence in a particular institution or has identified risks at an institution. For this, information should be gathered on stock prices, CDS spreads, interbank market prices, costs of funding on the primary market, price changes on the secondary debt and the subordinated debt.

B. Synthesis

The Working Group believes that those ratios can not be calculated in the same manner (same weighting) whatever the managing intention is. In particular, the calculation should be different in case of long term investments in stocks. The Group also believes that those ratios should be adjusted according to the specific business model.

The main comments that the Working Group has on the impact of the Basel proposal on LTIs-like institutions are the following:

1) LTIs do have better quality of funding, and less volatile assets

LTIs are characterized by “flight to quality” dynamics in situations of generalized liquidity stress, so the Working Group asks to consider a significant part of the funding of long term investment as renewable in the calculation of the ratios (in particular the Working Group refers to the category “*Unsecured wholesale funding provided by other legal entity customers*”).

Some LTIs do have specific state-regulated deposits. The Working Group considers that such deposits are not volatile, and request that they should be attributed a very good coefficient, even better than the best coefficient of the norm (applied to retail deposits).

2) LTIs do have less volatile assets

For instance, LTIs do have specific commitments “at risk” of disbursement that do not take the form of “revolving”. Only a small portion of such facilities would be drawn by non-financial corporate counterparties. The Working Group requests to take this particularity into account and does not consider that 100% will be drawn immediately as specified in the document.

3) LTI are structured for long term investments

In fact, for LTIs, the short term inter-bank funding is accessory, compared to stable funding, and also in comparison with banks.

ANNEX 6 : PROPOSALS ON CAPITAL REQUIREMENTS

Comments on the Consultative Document “Strengthening the resilience of the banking sector” issued by the Basel Committee on Banking Supervision in December 2009 which was amended on July 2010 by the Consultative Document “Countercyclical capital buffer proposal” and the agreements of the Group of Governors and Heads of Supervision on the reform package on July, 26, 2010^{5, 6}

1. Comments on Capital Requirements

The changes proposed by the Basel Committee substantially alter the definition of regulatory capital and highlight the "core Tier 1 ratio" that should serve as a reference. In this new ratio, capital instruments which appear in the numerator will be the component "Common Equity" of Tier 1⁷ which is restricted to capital instruments best able to absorb losses. The denominator of the ratio remains the Risk Weighted Assets (RWA) and represents a multiple of the amount of capital required to deal with credit risks, market risks and operational risks.

The items in the category "common equity" are the capital (or the economic equivalent) and the reserves. Minority interests are excluded from this category. Most of prudential restatements and other deductions will be applied to the category "common equity".

Basel III clearly shows its determination to highlight the first ratio even though two other ratios are calculated: the ratio of Tier 1 (Tier 1/RWA) and the ratio of total capital (Tier 1 + Tier 2⁸) / RWA.

Limits that will be required for the three ratios are not yet known. Only for the Leverage Ratio, which is supposed to become part of Pillar one in 2018, a minimum Tier 1 ratio of 3% is proposed for the transition period.

Overall, the Working Group thinks that these proposals could lead to capital ratios more volatile and also more sensitive to the accounting methods. Hereafter, detailed comments on this section are listed. The Working Group wants to emphasize that Pillar one should concern only risk-sensitive measures, so that the Leverage Ratio should not migrate to Pillar one but remain a Pillar two measure.

Comment on § 85:

The Basel Committee proposes that the capital requirements will be expressed in terms of three capital ratios, associated to progressive limit levels. Thus, a financial institution that would not hold subordinated debt instruments should have a common equity ratio equal to the total capital ratio and

⁵ <http://www.bis.org/publ/bcbs164.htm> / <http://www.bis.org/publ/bcbs172.htm> / <http://www.bis.org/press/p100726.htm>

⁶ The proposals of the Working Group are based on the information published by the Basel Committee up to 31 August 2010

⁷ Tier 1 capital is composed of core capital which consists primarily of common stock and disclosed reserves and may also include non-redeemable non-cumulative preferred stock.

⁸ Tier 2 capital is composed of revaluation reserves, general provisions, hybrid instruments and subordinated term debt.

should have a common equity ratio above the total capital ratio limit even if the first ratio is fulfilled. This aspect appears paradoxical and could promote subordinated debt instruments. Also, the Working Group would like to underline that Basel Committee should clearly establish a hierarchy between the three ratios.

Comment on § 95:

The Basel Committee suggests in the consultative document that minority interest should not be eligible for the inclusion in the Common Equity Component of Tier 1. The agreements of the Group of Governors and Heads of Supervision on the reform package on July, 26, 2010⁹ indicate just a very small relief on that point, i.e. only minority interests in a subsidiary that is a bank will be recognised, with the exception of the excess capital above the minimum. The Basel Committee justifies the exclusion of minority interest in the category "Common equity" by the fact that while minority interest can support risks in the subsidiary to which it relates, it is not available to support risks in the group as a whole.

If the Common Equity Component of Tier 1 ratio is expected to become the reference ratio, it seems important to have a more equitable treatment of minority interests. Indeed, it would be very disadvantageous to deduce this component from the "common equity" and leave RWA unchanged.

Therefore, the Working Group recommends that either minority interests are deducted but also corresponding proportion of risk exposures of the subsidiaries are deducted, or the common equity ratio is consistent with the fact that minority interests can absorb losses and minority interests are not deducted.

Comment on § 96:

The Committee proposal suggests keeping in the common equity "component, unrealised gains and losses on debt instruments, loans and receivables, equities, own use properties and investment properties, recognised in the balance sheet". Thus, the committee will continue to review the appropriate treatment of unrealized gains.

If unrealised gain and loss on AFS portfolio remain in the "common equity", then unrealised gain and unrealised loss should have an equivalent treatment. Since unrealised gains increase RWA, it would be logical to have the same impact on the capital.

The proposal could increase volatility in regulatory capital, dealing with portfolios Available For Sale as if they were trading portfolios, which is less adequate with a long-term holding point of view, and increase pro-cyclicality.

This is the reason why the Working Group believes that unrealised gains or losses should not be included in the common equity. Instead, unrealised gains and losses should be taken into account when assessing capital adequacy under Pillar two.

Comment on § 97:

The Committee proposed in the consultative document that deferred tax assets (DTAs) which depend on future profitability should be deducted from the Common Equity component of Tier 1. The agreement of the Group of Governors and Heads of Supervision on the reform package on July, 26, 2010 indicates a limited recognition of DTAs that arise from timing differences. This recognition is capped at 10% of the bank's common equity component and the aggregate of DTAs,

⁹ <http://www.bis.org/press/p100726.htm>

significant investments in the common shares of unconsolidated financial institutions (see comment on § 100 below) and mortgage servicing rights is capped as well at 15% of its common equity component.

Prudential and forward looking provisioning leads to substantial DTAs. The proposed deduction entails wrong incentives and distorted competition due to differences in tax law. Moreover, tax credits increase when losses materialize during adverse cyclical phases, and for this reason the deduction has a pro-cyclical effect.

On the other hand, the DTAs derived from temporary differences vary with the tax laws of the states (for example on non-deductible provisions) and associate with prudential disadvantage a tax disadvantage.

Comment on § 100:

The Committee has proposed in the consultative document the deduction of “investments in the capital of other banks, other financial institutions and insurance entities where these fall outside of the regulatory scope of consolidation”. The agreement of the Group of Governors and Heads of Supervision on the reform package on July, 26, 2010 indicates a limited recognition of significant investments in the common shares of unconsolidated financial institutions (significant meaning more than 10% of the issued share capital). This recognition is capped at 10% of the bank’s common equity component and the aggregate of DTAs, significant investments in the common shares of unconsolidated financial institutions and mortgage servicing rights is capped as well at 15% of its common equity component.

The EU directive on financial conglomerates has introduced a specific prudential legislation for financial conglomerates to complete the prudential legislation applicable to credit institutions, insurance companies and investment companies. The Directive aims to ensure that financial conglomerates have adequate capital and eliminates the double counting of capital used simultaneously to cover the risk in different entities. Therefore we believe that the Committee’s proposal is not compliant with the purposes of this Directive.

Moreover, as to the investments in the capital of banking, financial and insurance entities which are outside the regulatory scope of consolidation, we believe that the deduction proposed is too penalizing especially for investment in insurance subsidiaries.

Comment on § 108:

In paragraph 108 the Committee sets out its proposal for amending the treatment of regulatory adjustments for certain exposures that are currently deducted 50% from Tier 1 Capital and 50% from Tier 2 Capital. According to the consultative paper “all deductions 50:50 from Tier 1 and Tier 2 capital will receive a 1250% risk weight”.

It would be more conservative and transparent to allow a full deduction of the exposure from the level of common equity, consistent with paragraphs 69 and 102 that regulate the application of provisions to cover expected losses.

Full deduction is by definition a more conservative approach, as it gives results that are equivalent to full provisioning and write-off of the exposure. Moreover this proposal penalizes institutions that exceed minimum capital requirements, since the 1250% risk weight causes a greater decline in the Tier 1 capital ratio than a straight deduction does for institutions that target a Tier 1 ratio over 8%.¹⁰

2. Comments on the Leverage Ratio proposal

The Committee has introduced a new ratio for assessing risks related to leverage.

¹⁰ For more details see <http://www.bis.org/publ/bcbs165/europeaninvestm.pdf> document

This ratio will be calculated from accounting data. Its implementation will require further clarification on the accounting regulations (IFRS or U.S. GAAP) and in particular for the inclusion of derivatives. The principle is that the capital shall be included into the numerator and the total amount of assets plus some off-balance sheet exposure will compose the denominator. Items to be included in the numerator and denominator are not yet defined precisely by the Committee, however in general terms:

- The numerator of the ratio will be constituted by the sub-compartment "common equity" or by the compartment "Tier 1" wide.
- The denominator is based on the value of assets, net of reserve; collateral is not considered. Moreover, the denominator includes repos & securities financing, CDS with a "loan equivalent amount" and some further off-balance sheet items (commitment of funding, guarantees).

Items deducted from the numerator will also be deducted from the denominator. The minimum rate required for the Leverage Ratio is 3%.

On general ground, the Working Group believes that the Leverage Ratio should not become part of Pillar one, since it is not a risk weighted measure.

Comment on § 202:

A limitation of the size of financial institutions by means of a non-risk-sensitive Leverage Ratio is not helpful with regard to the underlying rationale, i.e. reducing the risk of destabilising financial crises. By means of Basel II, the international regulatory frameworks for financial institutions took a deliberate step towards risk based regulatory systems. This was appropriate and reasonable because crude regulatory systems which are based on simple risk metrics proved to be too susceptible to mismanagement and regulatory cherry picking. Based on the foregoing, a non-risk sensitive Leverage Ratio within the framework of Pillar one regulation would be a retrograde step. This applies all the more because - even when seen in combination with other instruments - experience from the crisis does not evidence the benefit of a leverage ratio in a sufficiently convincing manner. There is no evidence for any systematic correlation between its leverage and an institution's susceptibility to crises.

However, a well conceived Leverage Ratio, in combination with other measures, might indeed be a meaningful tool within the framework of the Pillar two analysis. It could provide additional insight for the purposes of business and risk management.

One precondition for this is a globally uniform definition of "Leverage Ratio" (whilst not limited to, this particularly refers to the definition of the numerator, the definition of the denominator, consideration of off-balance sheet exposures, recognition of mitigating effects due to netting and risk mitigating assets) and a uniform treatment of this benchmark both under IFRS and under US GAAP. It is also indispensable that a Leverage Ratio does not produce any competitive distortion.

Furthermore, the Working Group would like to highlight that a Leverage Ratio which is geared towards limiting the size of institutions does not address the root cause: the importance of risks for the financial system does not exclusively depend on the size of individual institutions but is fundamentally shaped by interconnectedness, the degree of complexity and exposures. Hence, identifying the relevant systemic risks is crucial. This also includes those risks which are inherent in products or markets. Along with higher capital adequacy requirements for institutions presenting a higher risk for system stability, this also involves strengthening supervision, greater transparency of global financial flows and interrelations as well as stronger use of Central Counterparties (CCPs) along with real time settlement systems.

Comment on § 205:

The Leverage Ratio entails risks (i) of pro-cyclicality (losses reduce capital in downturns, thus increasing leverage, *ceteris paribus*), (ii) of undesired interaction with the risk-based framework and (iii) of regulatory arbitrage (for instance, by keeping equity slices in unconsolidated subsidiaries).

The proposal indicates that the Leverage Ratio will be, in the future, a tool of Pillar one. The binding aspect of the ratio will depend on the future limit that will be given. The main shortcoming is that it does not fully reflect banking risks which are strongly linked to the nature and complexity of banking operations.

The Working Group recommends not to define a minimum level for this ratio, but rather an alert level for it as a Pillar 2-only measure.

Comment on § 232:

The ratio shall be calculated as capital base divided by exposure, taking into account also off-balance sheet exposures.

With respect to the calculation technicalities, the proposal attributes a weight of 100% to the off-balance sheet exposures (e.g.: undisbursed loans, guarantees, etc...). The Working Group considers that many commitments do not take the form of “revolving” credit lines. As a matter of fact, a sizeable portion of committed credit facilities have scheduled disbursements linked to the fulfilment of technical advancements on the financed project (e.g. project financing, infrastructure, constructions, etc.). The disbursements cannot be anticipated simply at the counterparty’s request. On the other hand, credit facilities allotted to financial institutions could be drawn with very short notice. As such, a more granular approach that weighs off-balance sheet items as a function of their likelihood of disbursement would be welcome, in order to provide a more precise picture of the effective leverage. The agreements of the Group of Governors and Heads of Supervision on the reform package on July, 26, 2010 indicate only for unconditionally cancellable off-balance-sheet items the use of a credit conversion factor (10%).

3. Comments on Pro-cyclicality and Capital Buffers

The Committee proposal introduces some measures aimed at reducing the pro-cyclicality of current capital requirements and giving incentive to banks to retain capital buffers over the minimum capital requirements to address 4 key concerns:

– Cyclicity of minimum capital: The idea is to change the current risks weighted calculations by replacing the current 1-year probability of default with either the highest probability estimate applied by a bank historically to each of its exposure classes or either on the use of average of the probability of default for each exposure class. The Committee is still working on this proposal.

– Weak provisioning practices: The Committee supports the IASB initiative to move from an incurred loss approach to an expected loss approach. In order to eliminate a regulatory disincentive to stronger provisioning the Committee requires banks to fully deduct from Common Equity the excess of Expected Loss over provisions.

– Lack of regulatory incentives to capital conservation: A buffer range is established above the regulatory minimum capital requirement and capital distribution constraints will be imposed on the bank when capital levels fall within this range.

– Risk of excessive credit growth: Capital buffer range would increase if credit growth is perceived to be excessive based on macroeconomic indicators.

Comment on 239-242:

Pro-cyclicality has been a major amplificatory channel of shocks through the banking system. The Basel Committee proposes a series of measures to address pro-cyclicality without compromising risk sensitivity and to transform the Financial Institutions in shock absorbers rather than shock amplifiers. In particular the Committee proposes to use a “kind” of downturn PD or a through-the-cycle PD in the capital calculations. The impact study will test at least two proposals for deriving such PDs

- 1.) use of the highest average PD estimate applied by a bank historically to each of its exposure classes as a proxy for a downturn PD,

- 2.) use of an average of historic PD estimates for each exposure class.

Given that the function of most long term investors is to invest and provide funding to long term projects considered eligible based on financial and public utility criteria, the Working Group retains that the use of the average of historic PD estimates for each exposure class would give a better representation of the exposure, enhancing at the same time the anti-cyclical effect of long term investments.

As to the PD's, we observe that (i) Basel II foresees average through-the-cycle (TTC) PD's, in that PD's estimates must be a long run average of one-year default rates for borrowers in the same grade, and that (ii) under Basel II, a rating must represent the institution's assessment of the borrower's ability to perform despite adverse economic conditions or the occurrence of unexpected events.

The working Group believes that in practice the rating assignment might have been often carried out by banks with a point-in-time (PIT) perspective. At this regard, the Working Group emphasizes that, during the expansionary phase of the cycle, a strong pressure to use “benign” PD's regularly materializes in the credit markets. Supervisors should therefore monitor closely the PD's used by market players in order to avoid dangerous drifts. The correct use of TTC PD's allows in good times to build up reserves that can be used in bad times without squeezing the credit supply to the economy.

For these reasons, the Working Group would discard the stressed (or downturn) PD proposal.

Comment on § 244:

Basel II already envisages provisions to reduce pro-cyclicality, so that a proper implementation of those provisions would substantially reduce the scope of the problem. The Working Group acknowledges the stabilising effect of measures aimed at building up reserves during the expansionary phase of the cycle in order to use them in the contraction phase.

4. Comments on Counterparty credit risk (CCR)

The main features of the proposal are:

- Credit valuation adjustment (CVA) additional charge.
- A coefficient of 1.25 for exposures to financial institutions whose balance sheet value exceeds 100 billion or unregulated financial institutions.
- Incentives to use a clearing house by applying a capital charge extra for transactions that do not use CCP.
- Calculation of the extent of risk exposure (EPE) on data including a period of stress. The reform also highlights the back-testing to verify the adequacy of models.

Comments on CCR

Comment on § 125:

The CVA additional capital charge appears as a part of a double counting of the capital required to cover counterparty risk

Moreover, there is a further overlap for institutions adopting IRB methods for measuring counterparty risk. In this case, indeed, the CVA charge duplicates the effect of the maturity adjustment aimed at capturing the impact of migrations.

Finally, the Working Group wants to underline that this measure is pro-cyclical because it tends to reduce the available capital when market spreads are growing larger.

Comment on § 166:

The Working Group agrees with the view that CCPs will play an important role in the efforts to reduce systemic risk. It also agrees that CCPs need to have strong risk management procedures in place in order to achieve this goal. However, two main features will be crucial for the strength of the CCPs' risk management: 1. collateralization of risks introduced by its clearing members and 2. the base of clearing members.

With regard to point 1 above, collateralization, it should be made clear that LTIs should not be obliged to post collateral to CCPs. The posting of collateral by LTIs would not contribute to the strength of the CCPs' risk management. Thanks to their very high credit quality, LTIs are assigned a 0 % (or near to 0%) risk weight under current Basel rules. Therefore, the posting of collateral by LTIs would not mitigate counterparty risk but only impose disproportionate (and in fact, unnecessary) opportunity costs on LTIs. The interest earned by the CCP on the collateral will – under normal market circumstances - not compensate the LTIs' cost of providing collateral.

Obliging LTIs to post collateral with CCPs would also penalize most LTIs compared to the current market situation, as they are presently (in OTC markets) applying unilateral collateral agreements (i.e: receiving collateral, but not posting it thanks to their credit quality and their corresponding 0% or nearly 0% risk weight). LTIs could instead be obliged to supply the CCP with adequate cash/collateral only in case of need, e. g. when a CCP's default fund has to be used.

With respect to point 2 above, a broader member base, it is crucial that access to a CCP will be available on a non-discriminatory basis. This should include but not be limited to strict admission criteria for potential clearing members based on non-discriminatory, transparent and objective principles. Notwithstanding the aforesaid, it would also be beneficial for CCPs to count on a base of clearing members as large and diversified as possible in order to achieve effective risk diversification and thus utmost resilience in circumstances of default of one of its clearing members. However, based on market precedents, only large market-making inter-bank dealers seem to be likely to fulfil current standard admission criteria¹¹.

In addition, CCPs for credit derivatives should have robust capitalization, since default events can imply sudden jumps in mark-to-market valuations not fully offset by margin and, given the concentration of the market, the default of a market-maker can make it difficult for the CCP to auction off the defaulted party's portfolio to other dealers.

Therefore, a considerable part of market participants (potentially including LTIs) may not be able to become direct clearing member of a CCP, but would be forced to participate as a non-clearing member by using a clearing member as an intermediary.

Hence, to the extent that the non-clearing member is not exposed to a potential default of its clearing member, the 0% (or near to 0%) risk weight of the CCP should also be applicable for non-

¹¹ E.g. minimum size of the derivative portfolio, specific operational capabilities and the undertaking to participate in customary default management processes of a CCP.

clearing members. National lawmakers may need to implement enforceable rules on portability of positions and asset segregation in national insolvency laws to ensure that this is actually the case. Otherwise, vis-à-vis the current situation, non-clearing members would face a substantial concentration of risk due to the forced intermediation by a clearing member and increased costs (in particular, fees of the clearing member and cost of provision of collateral) without benefiting from the 0% (or near to 0%) risk weight of the CCP.

In conclusion, the relevant criteria to achieve a 0% (or near to 0%) risk weight for exposures by non-clearing members to the CCP clearing members should be laid down in the Basel Committee's guidelines.

ANNEX 7 : PROPOSALS ON ACCOUNTING STANDARDS

IFRS 9: proposals to reflect long-term investors' business model¹²

The objective of most long term investors is to generate steady returns by managing financial instruments for their contractual cash flows or by holding those assets for a long to medium term.

As of today this specific business model characterising most long term investors, and the business model criterion in general, is not sufficiently taken into account in the recent accounting and regulatory proposals.

Accordingly, the purpose of this document is to present the issues faced by European long-term investors in respect of the IASB recent proposals on financial instruments accounting (i.e. IFRS 9) and possible approaches to solve the reported issues.

The comments and proposals reported in this document, while reflecting the particular point of view of four long-term financial institutions, can contribute to improve the accounting principles also from the perspective of long term investors in general.

I. Classification and measurement of financial instruments

I. Issues

1.1 Prominence of the business model not reflected in IFRS 9

The members of the Working Group welcomed G20 conclusions calling for a valuation of financial instruments that should be based on their liquidity and investors' holding horizons, taking into account valuation uncertainty.

However, the Working Group believes that IFRS 9, as published in November 2009, does not give enough prominence to the investor's holding horizon criterion.

Hereafter are typical examples of situations where IFRS 9 does not achieve a fair representation of the long term investment business model:

- Where long term investment consists in holding a large portfolio of assets which is managed with a long term view, the aim of the entity will be to generate steady returns and thus contribute to a specific part of the financing of economic development. Under IFRS 9, equity instruments, hybrid instruments and subordinated instruments will be recognised at fair value through profit or loss, even if held on a long term basis in accordance with the business model of the holder. The proposed classification does not adequately reflect the purpose of the entity in holding the instrument thus leading to an unjustified volatility of the income statement.

Although the standard offers the possibility to make an irrevocable election to present in other comprehensive income fair value changes of an investment in an equity instrument, the prohibition to "recycle" fair value changes in profit or loss is inappropriate as it would be equivalent to denying the very concept of the income statement that is to be the best indicator of the entity's performance.

¹² The proposals of the Working Group are based on the information published by International Accounting Standards Board up to 31 August 2010

- Where long term investment consists in lending on a long term basis, the entity will usually issue bonds on the capital markets and disburse loans with the borrowings proceeds. The vast majority of both the assets and liabilities of such entity would consist of precisely these financial instruments.

In order to broadly match the interest rate reset dates (for fixed rate instruments, the maturity) and the currencies of assets and liabilities, the entity will enter into swap contracts that may or may not match a single asset or liability. More often the swaps will correct the net position of one “bucket” of assets and liabilities.

The entity will keep the swaps until maturity, according to its business model, and it will therefore manage the contractual cash flows of the swaps together with those of its borrowings and loans.

Under IFRS 9, in order to reduce the accounting mismatch arising as a consequence of measuring derivatives at fair value, the entity would be required to report loans/borrowings at fair value which is in contradiction with its business model. Instead such a mismatch should be compensated by the use of an appropriate hedge accounting model, as proposed later in this document.

1.2 Counterintuitive effects induced by the measurement of derivatives at fair value

Given that the IASB has several times stated that hedge accounting is to be considered as a departure of “normal” accounting, the measurement of derivatives at fair value required under “normal” accounting leads to counterintuitive effects.

Indeed, with regards to the needs of the analyst who wishes to discern the vulnerability of an entity to default of one or more counterparts to its derivatives, the IASB proposed approach under “normal” accounting for derivatives is counter-intuitive, paradoxical and does not result in a faithful representation of the credit risk faced by the reporting entity.

Indeed, when an entity reports a positive replacement value on its derivatives the entity’s own funds are increased. On the other hand, a negative replacement value results in a reduction of own funds. On this basis, one could conclude that the user of the financial statements would favour a situation whereby the entity reports a positive replacement value on its derivatives.

However, within a "contractual cash flow" business model, the resulting perception of the entity’s financial position is inappropriate, because within such model, the entity does not seek to realise fair value gains on its derivatives, but holds them for their cash flow characteristics.

Furthermore it might give a false sense of comfort towards those entities that report a positive replacement value. Indeed, those entities do have a credit risk towards their derivatives counterparts, while the ones reporting a negative replacement value do not.

1.3 Financial liabilities and Fair Value Option (FVO) – the “own credit risk” issue

In its Exposure Draft dated May 2010, the IASB proposes that for all financial liabilities designated under the FVO, an entity would be required to

- recognise the total fair value change in profit or loss; and
- recognise the portion attributable to changes in own credit risk in other comprehensive income (OCI) (with an offsetting entry to profit or loss).

On this basis, the volatility induced by own credit risk will continue to affect own funds where OCI changes will be directly reflected. As a consequence, the IASB proposal will still lead to volatility of the entity's own funds and possibly jeopardise its capital requirement ratio.

Furthermore, the proposed amendment to the FVO also needs to be considered in conjunction with developments currently taking place in the IASB project on Financial Statements Presentation.

Indeed, in its Exposure Draft proposing amendments to IAS 1 (May 2010), the IASB proposes to eliminate the current option available in paragraph 81 of IAS 1 which allows for the presentation of a separate income statement and statement of comprehensive income.

Consequently, OCI items (among which fair value changes attributable to own credit risk) would have to be presented in a single statement together with the result for the financial year. One can therefore wonder whether the proposed transfer of own credit risk changes to OCI will still help in providing a true and fair view of the entity's business model since the proposed presentation will imply having both the financial result and the "own credit risk" value presented on the same page.

With regards to hybrid financial liabilities, the Exposure Draft retains the current bifurcation possibility, which was however not maintained in IFRS 9 for financial assets. Bifurcation will enable the preparer to report its liabilities in line with the classification principles and without reporting undue volatility in profit and loss account induced by its own credit spread. As the cash flow of the host contract of the hybrid instrument are solely payments of principal and interest on the principal outstanding, the recognition at amortised cost is adequate. The embedded derivative would then be recognised consistently with the requirements for stand alone derivatives.

Finally, the own credit risk subject has to be considered together with the definition of a new hedge accounting model. Indeed, many entities have elected the Fair Value Option because of weaknesses in the current hedge accounting model of IAS 39. Consequently, in order for entities to have a better alternative to the Fair Value Option, there is a need for a more appropriate hedge accounting model to be developed.

2. Proposals

2.1 True and fair representation of long term investor's business model

- **Instrument characteristics criteria**

The IAS 39 provisions on hybrid financial instruments have been a successful approach to represent adequately determinable contractual cash flows which are managed on a cash flow basis (i.e. the host contract) and on the other hand to consider a possible variability of cash flows to be presented on a fair value basis (i.e. the embedded derivative).

Consequently, the current requirements of IAS 39 on embedded derivatives should be maintained and the opportunity for bifurcation extended to financial assets in order to treat financial assets and financial liabilities consistently. Those amended requirements could replace the "contractual cash flow" test currently required by IFRS 9 for hybrid financial assets.

- **Alternative to the IASB classification proposal**

When the business model of the long term investor involves the use of derivatives for hedging purposes, the best way to depict such situation is to use an appropriate hedge accounting methodology (refer to point 3 below).

With regards to business models where equity instruments are held on a long term basis, the mixed measurement model should be retained and include the following categories, based on a business model criterion:

- a) **Amortised cost category:** financial instruments that the entity holds (or issues) for the purpose of collecting (settling) contractual cash-flows.
- b) **Fair value through profit or loss category:** actively traded financial instruments which are held for trading purpose by the entity
- c) **A third category:** financial instruments that are held as investments in a medium or long term perspective or that do not meet the definition of either the amortised cost category or the fair value through profit or loss category.

For this third category, the measurement model should be based on the lowest of the acquisition cost or value in use, assessed according to the holding horizon and management judgment (with adjustments recognised through profit or loss).

An alternative approach could be a measurement at fair value, through other comprehensive income (with recycling in profit or loss). Under this alternative approach, the impairment model should consider the value in use, based on the holding horizon and on the management judgment.

Under the proposed approaches, reversal of impairment should be allowed.

In both approaches, the concept of “value in use” could be based on the one already defined in IAS 36.6, i.e. “*The value in use is the present value of the future cash flows expected to be derived from an asset*”.

In this specific case, the present value could be estimated taking into account the overall prospects of business development of the issuer and the holding horizon of the holder.

This estimate could be based on criteria such as the average quoted prices on a long period, the level of equity, the profitability or the forecast of profitability, the economic environment, etc...

- **Clarification of the reclassification requirement**

With respect to the classification of financial assets, the Working Group generally supports the business model as the primer criterion for classification. However the requirement for reclassification needs some more precision.

Indeed, in practice there may be sales out of a cash flow collecting portfolio with the aim to realise gains in a special market situation; however, the general aim of the portfolio, which is to collect cash flows in the long term, is still valid. In such situation, the need not to reclassify the entire portfolio should be made more explicit in paragraph B.5.9 of IFRS 9.

2.2 Financial liabilities and Fair Value Option (FVO) – the “own credit risk” issue

The volatility induced by the effect of own credit risk does not reflect the business model of the entity and does not lead to a faithful representation of its financial position.

Therefore, the Working Group disagrees with the proposals made by the IASB in its Exposure Draft published in May 2010 i.e. to have changes in own credit risk reported in other comprehensive income.

Instead, the fair value of financial liabilities should only incorporate the level of own credit risk observed at inception (an approach similar to the “frozen credit spread” method discussed by the IASB in October 2009). This revised approach for fair valuing liabilities would:

a) Provide a true and fair representation of the transaction dynamics by better aligning the hedged items with the hedging items. The act of designating a liability at fair value under the FVO would serve its original purpose under IFRS 9, i.e. reducing the accounting mismatch (up to the extent to which the risks intended to be covered are actually hedged), without polluting the picture by introducing an exposure to own credit risk factors which can neither be controlled nor hedged.

b) Respect the concept that the reporting entity is contractually bound to reimburse the initial amount of its liability, irrespective of what happens to its own credit quality in terms of likelihood or willingness to pay back the debt.

2.3 A well designed and simplified hedge accounting model

In case of mixed measurement, hedge accounting should be considered as the “normal accounting requirement” and no longer an “exception” as it is currently under IAS 39.

This requires a well designed and simplified hedge accounting model, along the lines presented later in this document.

3. *Transition requirements*

In the context of transition to the new accounting principles of IFRS 9, the Working Group strongly supports the IASB approach which opens the opportunity to reclassify financial liabilities and to revoke the previous designation to the FVO. However, the preparer should be able to revise all its previous decisions taking into consideration the overall framework of the new accounting requirements.

Therefore, transition requirements in IAS 39 and IFRS 9 should be modified to allow a reclassification both when a financial liability was designated as fair value through profit or loss to reduce an accounting mismatch (IAS39.9(b)(i)) but also when it was designated as fair value through profit or loss because it contained an embedded derivative (IAS39.11A).

II. Impairment

1. *Issues*

Generally speaking, a periodic Expected Loss is a reasonable component of provisions for loan losses.

However, as it stands today, the IASB Exposure Draft does not address the impediments attached to the particular situation of preparers committed to long term investment. For example:

- the limited availability of observed credit loss parameters over a time span equivalent to the future life of the loan, in particular in the case of loans subject to a particular creditor/debtor relationship or other “niche products”, rendering peer group comparison irrelevant and
- the difficulty to define valid credit loss expectations over a very long period of time and also allocate them correctly over each year until maturity.
- the inadequacy of the proposed amortisation method of initial expected loss through the effective interest rate followed by the immediate recognition of revisions to the Expected Loss.

2. Proposals

The Working Group proposes to recognise, on a portfolio basis, an annualised expected loss in a loan loss provision account which would include a minimum threshold of loan loss provision in case of reversals.

The determination of expected losses should be complemented by an adjustment based on expert estimates and should be amortised through the maturity of the instrument or portfolio. In that respect, the treatment of the initial expected loss and revisions to the expected loss should be consistent.

Finally, under the proposed approach, write-off would be recognised through the allowance account when related to expected losses while the part relating to unexpected losses would be recognised in profit or loss.

III. Hedge Accounting

Generally speaking, long term investors have an economic value that is best represented by their ability to generate steady returns. Therefore, analysts of long-term investors are interested in the long-term, recurring value drivers that impact future cash flows. Their goal is to project an underlying earnings figure that excludes one-off, non-recurring items such as interim fair value changes on derivatives that might never be realised. This makes the hedge accounting principles that neutralise such interim fair value changes even more important in the context of long-term investment.

It is important to emphasise that, if the financial statements are to give a faithful representation of the entity's financial position, hedge accounting is not to be regarded as an exception to "normal accounting" but rather as the accounting technique used when there is both mixed measurement and the achievement of risk reduction.

Furthermore, in situations where the entity holds financial assets and liabilities with the objective of collecting their contractual cash flows, as most long term investors do, the measurement of risk reduction should be consistent with this very business model through an assessment of the achievement of the entity's risk management policy targets and not restricted to the measurement of the reduction of fair value sensitivity.

Finally, the IASB needs to take into account the knock on effects of the other project phases. Indeed, the new hedge accounting requirements must be clearly articulated with the first phase of the project i.e. new categorisation of assets (and with the financial liabilities question) and not a "patch" of the existing requirements of cash flow hedge accounting. In particular, the IASB should analyse the practicability of designating as hedged item an investment in equity instruments (other than held for trading) accounted for in OCI (with no recycling of gains or losses).

1. Issues

1.1 Individual fair value hedge accounting model

In September 2009, the IASB tentatively agreed to replace fair value hedge accounting by permitting recognition outside profit or loss of gains and losses on financial instruments designated as hedging instruments (an approach similar to cash flow hedge accounting). Under this approach changes in the fair value of hedging instruments would be recognised in OCI (for the effective portion of the hedge) and the hedged item would not be re-measured.

In July 2010, in response to feedback received, the Board changed its tentative decision. According to the new approach the cumulative gain or loss on the hedged item attributable to the hedged risk will be presented as a separate line item in the balance sheet. That line item is

presented within assets (or liabilities) for those reporting periods for which the hedged item is an asset (or liability). The fair value changes of the hedging instrument and the hedged item attributable to the hedged risk are taken to other comprehensive income, and any ineffectiveness (i.e. any difference) is transferred immediately to profit or loss.

The latest changes in the tentative decision will much better reflect the economics of hedging activities in the balance sheet.

1.2 Portfolio hedge accounting model

Asset Liability Management (ALM) is concerned with managing risks and rewards in the context of the balance sheet structure. The most apparent risk in ALM is the interest rate risk which arises when assets and liabilities differ in terms of maturity, interest rate type and embedded options. To close maturity gaps between assets and liabilities, derivative instruments are used. Derivatives are - in contrast to most assets and liabilities - accounted at fair value through profit or loss. This leads to an accounting mismatch when hedge accounting is not applied. The current portfolio hedge accounting requirements are not fully compatible with the economic logic underlying the most common approaches to Asset and Liability Management (ALM).

The major features of the most common ALM methodologies which should be considered in developing a new portfolio hedge accounting approach are:

- assets and liabilities can be analysed based on outstanding notional amounts, on an amortisation scheme or on interest and principal payments. The analysis can generally be made on an aggregated basis. Usually the ability to identify single financial instruments is not a requirement;
- the analysis of assets and liabilities is generally based on a specific structure of time buckets;
- methods used to measure the interest rate risk vary from a gap analysis to sensitivity-measures like a present value of a basis point (PVBP) or an interest rate modelling combined with a VaR analysis;
- the identified gaps will be closed by derivative instruments. These are generally interest rate swaps but could also be cross currency swaps, inflation swaps, caps, floors, swaptions and other exotic products;
- the hedging derivatives generally link long term capital market transactions with short term money market transactions. The controlling of both parts of the balance sheet is often executed in different departments. Sometimes, for controlling purposes the hedging instrument might be split into two different components (e.g. floating leg and fixed leg) contributing to different controlling units.

2. Proposals

Both the individual and the portfolio fair value hedge accounting rules should allow to rely on internal controlling methods in order to prove effectiveness and to derive hedge results.

In addition, portfolio hedging of inflation risk should be explicitly allowed in the same way as portfolio hedging of interest rate risk.

2.1 Designation

For individual hedge accounting, the current designation requirements of IAS 39 are generally satisfactory, but could be enhanced with a proposal to designate portions of a derivative instrument

in a hedging relationship, whenever the changes in fair value of the designated portion can be reliably measured. As a matter of fact, beside the two exceptions that are currently allowed under IAS 39, there are a number of other cases in which it makes economic sense to designate a portion of a derivative instrument in an hedging relationship: for example, for a fixed-versus-floating interest rate swap, it is possible - by assuming offsetting exchanges of principal amounts - to reliably measure the changes in fair value of the fixed leg and those of the floating leg.

Furthermore, for portfolio hedging, a dynamic hedge designation should be allowed. This could be achieved if a hedge relationship is not constituted by documentation of the individual items but by documentation of well defined portfolios e.g. if there is a clear definition of an ALM portfolio every single transaction which falls into the definition of this portfolio should automatically be designated without a formal documentation of the individual item. This is a precondition to accurately account for ALM businesses where daily transactions are regularly involved. It is only by such an alignment of accounting requirements with the internal risk management strategy that economic effects can adequately be reflected in the Profit or Loss account.

2.2 Effectiveness test

Both for individual and portfolio hedge accounting, the following changes are proposed to the current IAS 39 hedge accounting requirements:

- effectiveness should be measured according to the risk management method chosen by the preparer to document the risk reduction: the chosen framework should be documented and have sound financial and statistical foundations. The application guidance should provide a non-exhaustive list of at least 4 to 5 admitted classes of methods (for example: Regression Analysis, volatility reduction, VaR reduction, Dollar Offset Ratio, comparison of bucketed sensitivities).
- the principle should state explicitly that the widely used Dollar Offset Ratio has no primacy, i.e. it is by no means the only admitted method nor the benchmark against which to judge the results of other methods.

In the case of portfolio hedging, in order to analyse the risk reducing effect of the hedging instruments, the risk of the hedged items should be measured at first stand alone and a second time in combination with the designated parts of the hedging instruments. As long as the risk of the combined position is less than the risk of the hedged items stand alone the hedge can be considered as effective.

If the combined risk exposure is less than the stand-alone risk exposure of the hedged items the difference can be allocated to the effect of the hedging activities. Hence, the fair value change of the hedging derivatives does represent the part of the fair value change of the hedged item attributable to the hedged risk. The hedge effectiveness is always 100%. Only in the case that the combined risk exposure exceeds the stand-alone exposure of the hedged items the derivatives can not be considered as hedging instruments and a compensating effect from hedged items should not be recognised.

The effectiveness test should consider the parts of the hedging derivative which are designated in the hedge relationship, i.e. if the entity designates the fixed leg to the 4 year investment it should measure effectiveness of the fixed leg in conjunction with the 4 year investment. In contrast the variable leg should not be considered, as long as this is documented in the hedge designation.

The method used to measure the risk exposure should be consistent with the internal risk management. If the preparer calculates a single measure for the risk exposure over all time buckets, then the minimum requirement should be a statistical or VaR analysis. If the preparer relies on different measures for each time bucket a gap analysis or a PVBP analysis is adequate.

Please note that even though the IASB has not yet published an Exposure Draft, it has tentatively agreed on 24 August 2010 on a hedge effectiveness testing approach. The main points are as follows:

- the objective of the effectiveness assessment will be to ensure that the hedging relationship will produce an unbiased result and minimise expected ineffectiveness.
- the effectiveness assessment would be forward looking and performed at inception and on an ongoing basis
- the type of assessment (quantitative or qualitative) would depend on the relevant characteristics of the hedging relationship and on the potential sources of ineffectiveness. The main source of information to perform the effectiveness assessment is entities' risk management.
- no particular methods for assessing hedge effectiveness would be prescribed.
- changes in the method for assessing effectiveness would be mandatory if there are unexpected sources of ineffectiveness.

2.3 Measurement of changes in fair value

In the case of individual fair value hedge accounting, the measurement framework should be similar to the one currently used in IAS 39 however with the following important changes.

- the same method used for measuring retrospective effectiveness should be used to calculate the change in fair value of the hedged item: the retrospective effectiveness test should lead to an effectiveness measure in the range 0.8-1.25, and the cumulative change in fair value of the hedged item should be calculated as the opposite of the fair value of the hedging derivative times the effectiveness measure.
- The use of the so-called hypothetical derivative simplification should be explicitly allowed not only for cash flow hedging, but also for fair value hedging.

In the case of portfolio fair value hedge accounting, since effectiveness would be 100% as long as risk-reduction is achieved, changes in the fair value of the hedged items would be the opposite of the fair value of the hedging derivatives.

ANNEX 8:
WORKING GROUP ON BANKING SUPERVISION
LIST OF MEMBERS

❖ **Caisse des Dépôts et Consignations (France)**

- **Anne Bauer**, ALM Project Manager
- **Vincent Brenelliere**, Head of Asset Liability Management
- **Jean-Marc Girard**, Head of Group Accounting Standards
- **Pierre-François Koehl**, Head of ALM/Funding
- **Christophe Bourdillon**, Permanent Representative to the EU
- **Lola Merveille**, Advisor

❖ **Cassa Depositi e Prestiti (Italy)**

- **Bernardo Bini Smaghi**, Head of Facilitated Credit and Economic Support
- **Vladimiro Ceci**, Head of Risk Management
- **Luca Lotti**, Risk Management Specialist
- **Andrea Novelli**, Head of Administration, Planning And Control
- **Edoardo Reviglio**, Chief Economist

❖ **European Investment Bank**

- **Giovanni Gentili**, Risk Management Analyst
- **Carlo Gobbi**, Risk Management Analyst
- **Marie-Carmen Gonzalez**, IFRS Analyst
- **Henricus Seerden**, Head of IFRS Division

❖ **KFW Bankengruppe (Germany)**

- **Dr. Harald Lob**, Group Head of Regulation
- **Sabine Glink-Hoffmann**, Vice President Regulatory Affairs
- **Cemil Kilic**, Group Head of Group Accounting
- **Carsten Lesche**, Group Head of Rating Systems and Risk Policies
- **Ingo Ostermann**, Group Head of Asset Liability Management