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Banking and Financial Supervision
Regulations and Supervisory Policies Department

Bank of Italy response to the EU Commission Consultation regarding further possible changes to the Capital Requirements Directive (CRD)

Introduction

1. On 26th February the European Commission (EC) published its Consultation Document (CD) concerning possible further amendments to the CRD.
2. Bank of Italy (BoI) shares the main aspects of the CD, which are largely in line with the Consultative Papers published by the Basle Committee on Banking Supervision (BCBS) in December 2009. In the following paragraphs specific comments on some aspects of the CD are offered for consideration.
3. Before addressing the single issues, BoI wishes to express concerns for the consequences for the EU intermediaries stemming from different implementation of the new framework in the non-EU jurisdictions. In this respect, BoI believes that the legislative process in all the main financial areas should be defined along the same timeline as in the EU and that the relevant authorities be fully committed to give consistent application to the new rules. The Commission might fruitfully engage in a dialogue with other main jurisdictions in order to make sure that implementation is as synchronised as possible.

SECTION I – Liquidity standards

Scope of application

4. BoI agrees with the proposal of the EC to define the scope of application of the two new requirements upon a combination of a stand-alone basis plus a consolidated level. The BCBS standards will be applied at the consolidated level for internationally active banks but are designed in a way to be applied also to individual firms. For internationally active EU banks the new standards will be applied at the parent level; in our view it is crucial to add another tier of protection against liquidity shocks also at the level of individual firms and within a regulatory framework fully harmonised at the EU level. However, as to the Net Stable Funding Ratio, BoI believes that a possible application of the NSFR only at consolidated level could be considered on the basis of the EU QIS carried out by CEBS .
5. BoI shares the stance adopted by the EC that the application of the two ratios could be waived by competent authorities at the solo level when certain conditions are met by the credit institutions belonging to the same group. However, the possibility to waive the application of the requirements at the solo level should be accompanied by the possibility to require the application at the sub-consolidated national level, in the case the parent company in that Member State is itself a subsidiary of a bank in another Member State.
6. In this respect, BoI welcomes the proposal to waive the requirements at the solo level for legal entities that are located in other Member States and subject to the consolidated liquidity standards. To this end, the EC should introduce the provision that binding technical standards shall be developed by the EBA.

7. In the case the subsidiaries operate in the same Member State of the parent bank, the supervisory authority should be given more flexibility in deciding the appropriate level of application of the new requirements (sub-consolidated or stand-alone levels), especially as far as the NSFR is concerned.
8. Moreover, BoI believes that the CD should make a more explicit reference to the role that colleges of supervisors can play in the decision making process. The application of a waiver to a single entity of a group cannot be dealt with only on a bilateral basis between the home and the host supervisors, since such a decision is likely to have an impact on the allocation of the liquidity in other entities of the group. Colleges should be seen as the appropriate coordination structure for reaching a joint assessment and decision on the matter based upon the EBA's technical standards.
9. In the case of disagreement, the supervisors of the subsidiaries in question would take the final decision as to whether each subsidiary should be subject to the liquidity standard on a sub-consolidated or a stand-alone basis. The EBA might be called upon to settle a disagreement in accordance with Article 11 of the draft Regulation for its establishment.

Supervisory responsibility for branch liquidity

10. BoI shares the stance of the CD according to which the establishment of uniform liquidity standards in the EU would achieve the essential harmonisation on the basis of which mutual recognition is possible and supervisory responsibility for liquidity supervision could be entrusted to the home supervisor; this change in the allocation of responsibilities should be based upon a reinforced collaboration between home and host supervisors.
11. BOI believes that the cooperation among home and host supervisors of branches is essential to ensure an efficient supervision of credit institutions operating in other Member States through branches. In this respect, the proposals put forward by the CD move into the right direction.
12. BoI believes that the proposal to modify the allocation of supervisory responsibilities should be framed in a more comprehensive modification of the EU regulatory framework. In this respect, it is important to carry out further work in order to clarify the scope of the powers available for host supervisors of branches in emergency situations, to enhance the information sharing in going concern situations between home and host supervisors and to enlarge the scope of the joint decision within colleges to all Pillar 2 related issues, including liquidity risk management.
13. These measures should be accompanied by the provisions that EBA should: i) develop binding technical standards on all these matters; ii) have an enhanced role in settling disputes between supervisors in the case of disagreements.

Liquidity Coverage Requirement

14. BoI believes that the definition of the buffer should be adjusted so as to take into consideration also private debt, including covered bonds and high quality corporate bonds. BoI shares the view that regulation should create strong incentives for institutions to strengthen their funding profile but, at the same time, should not be overly restrictive due to possible negative macro-economic impacts. It is necessary to take into account the high impact for national and international money and bond markets as well as the high

implementation costs for banks, should the narrow definition of liquid assets be adopted for the liquidity coverage ratio.

SECTION II – Definition of capital

Proposed definition of Core Tier 1 capital

15. BoI shares the definition of capital proposed by the CD, which is largely compliant with the BCBS proposal.
16. However, the EC could consider, in drafting the final proposal, to rely more extensively on the CEBS guidelines on art. 57a, which provide a detailed guidance on the implementation of the current CRD provisions as amended by the CRD 2.
17. This is the case, for example, of the treatment of non-joint stock companies (NJS). The current wording of paragraph 44 (b) – which resembles footnote 19 on the Basel proposal – seems to limit the equivalence assessment to the loss absorption features, whereas the mentioned CEBS guidelines on the implementation of art. 57a, on the basis of recital 4 of CRD 2, has adopted a more prudential approach, making it clear that NJS capital needs to meet also criteria related to permanence and flexibility of payments.
18. To this end, BoI suggests to maintain the current wording of recital 4 of CRD 2 as it is.

Non-core Tier 1 Capital

19. BoI supports any further consideration on the need for all non-Core Tier 1 instruments (both equities and liabilities) to have a mandatory principal write-down or conversion mechanisms. In any case, should the requirement be kept only for liabilities, this should not be limited to cases where the assessment as liabilities is made for insolvency law purposes, as currently stated by the CD (paragraph 52).

Prudential filters and deductions

20. BoI agrees with the CD that – in line with the BCBS package - prudential filters and deductions shall be applied to Core Tier 1 capital and that the overall effect of the proposed treatment of the prudential adjustments has to be assessed once the outcome of the EU QIS is fully available.
21. However, BoI has some concerns as to the potential alternative approaches to the treatment of certain elements, including: minority interests; deferred tax assets; investment in other institutions and insurance companies; unrealised gains and losses; stock surplus.

    Minority interests

22. The exclusion of the full amount of minority interests from Core Tier 1 capital calculated on a consolidated basis is not justified. Since minorities can be used to offset losses faced by the subsidiaries, they should be included in the common equity calculated at the consolidated level to the extent they cover capital requirements related to those subsidiaries.

    Deferred Tax Assets (DTA)

23. The application of the full deduction treatment for DTA raises several concerns. By their own nature, DTA reflect different domestic tax regimes which is difficult to harmonise in the short run. As a consequence, the suggested prudential treatment would penalise banks in countries with a stricter tax regulation.

24. In order to mitigate the differences existing in the tax regulations across jurisdictions, we propose: i) the adoption for prudential purposes of a netting mechanism wider than that followed in the accounting, offsetting overall DTA with overall DTL; ii) the introduction of a provision allowing banks to deduct only the net DTA amount exceeding a certain threshold (e.g. 10 per cent) of common stock and reserves before the application of relevant prudential filters and deductions.

25. It is worth considering that the introduction of such a threshold would be consistent with the possible transferability of DTA to any acquiring bank that intervenes in a crisis affecting the reporting bank.

Investments in other institutions and insurance companies

26. The definition of participation differs across Member States and between the banking and the insurance sectors. Full deduction of participations in insurance companies without full harmonization could undermine the level playing field.

27. Therefore, BoI recommends that the Commission takes into account the results of the work stream undertaken by CEBS and CEIOPS to achieve further convergence in this field in view of a revision of Directive 2002/87/EC when redesigning the existing treatment of such participations, in order to reduce significantly the number of the available prudential treatments.

28. BoI believes that participations assigning the control in insurance undertakings may not be deducted from the banking group’s Core Tier 1 provided that: i) the banking group is part of a wider conglomerate structure; ii) the conglomerate calculates the overall capital adequacy requirement using the full consolidation method.

Unrealised gains and losses on debt instruments

29. The inclusion of unrealised gains without any limit in the Core Tier 1 raises concerns, since unrealised gains are not permanent nor are they loss absorbent. Unless the accounting treatment is strengthened in the context of the revision of the accounting discipline for financial instruments, a prudential filter should be introduced.

Stock surplus

30. BoI is concerned with the exclusion of stock surplus from common equity if the related instrument is not eligible in common equity. It should be clarified that if the share premium relating to shares excluded from the predominant form of capital has no privilege in the absorption of losses (i.e. the privilege is limited only to the nominal value of the instruments), there is no reason for not including that stock surplus in common equity.

Implementation timing, grandfathering and transitional provisions

31. BoI believes that appropriate grandfathering and transitional provisions should be defined.

32. The current regulatory framework in the EU is provided by the CRD2, which has to be implemented by the end of 2010. These provisions introduce grandfathering arrangements

with respect to instruments issued before 31.12.2010, which do not meet eligibility criteria under art. 57a or the eligibility criteria and quantitative limits under art. 63a; both categories of instruments are grandfathered as non core tier 1 "hybrids".

33. The provisions on grandfathering in the BCBS CP are rather vague as to the scope and the timeline and need to be further specified on the basis of the outcome of the QIS. The cut-off date for instruments eligible for grandfathering is set on the date of the publication of the Basel consultation document (17.12.2009).

34. The lack of coordination between the different disciplines is creating uncertainty in the market and might give rise to opportunistic behaviours by intermediaries trying to exploit the differences.

35. For this reason, BoI believes that it is crucial to ensure consistency and avoid regulatory arbitrage in the implementation of CRD 2 grandfathering provisions taking into consideration the forthcoming legislative changes brought about by the CRD 4.

36. BoI believes that concrete proposals cannot be detailed before the outcome of the EU QIS is available and fully analysed and that CEBS is in the best position to elaborate such a proposal.

37. The following policy choices should be defined in this respect:

Differentiation of transitional provisions

38. BoI believes that the transitional provisions should be differentiated in order to take into account the specific characteristics of the different capital related instruments. In our view, capital instruments should deserve specific and more articulated grandfathering provisions that would minimize the potential impact on financial markets; other capital-related measures (e.g. deferred tax assets, investments in financial institutions, unrealised gains on available-for-sale exposures), would require simpler transitional provisions, which should identify a pre-determined period of time beyond which the new rules will be fully implemented.

Cut-off dates

39. The Basel Committee has set the publication date of its Consultative Paper as the cut-off date for the instruments to be grandfathered in order to minimise arbitrage opportunities. However, it may turn out that it is legally difficult to set such date before the official implementation date: banks and investors would not become fully aware of the new prudential treatment before the implementation date, due to lack of "legally-approved" rules and, where needed, the relevant implementation guidelines. Such issues are especially relevant in the EU context, where a legally binding provision on grandfathering of capital instruments issued before year end 2010 is already provided for by the CRD 2.

40. A possible way to strike the right balance between the two concerns (i.e. arbitrage vs. legal certainty) might be to provide a different <u>cut-off date (with respect to that one currently foreseen in the BCBS Consultative Paper) complemented with a sub-set of quantitative limits</u> applicable to grandfathered instruments only. These limits could also be reduced to zero over time in order to allow for a gradual phasing-out of these instruments.

Length of the grandfathering period

41. Several options can be considered:

- Grandfathering until the first call date: this would allow existing instruments to count as eligible capital up to the point in time that the bank is first able to redeem the instrument. It effectively makes instruments with a call feature dated, whether or not there is an incentive to redeem. We could however consider it further because it might reduce the concentration of early termination dates, since the first call-date may vary across different issuances. Possible complementary measures would include prior supervisory approval – which does not however address the treatment of instruments without a call – and the requirement to replace any grandfathered instrument subject to the call with contracts that comply with the new rules;
- Gradual "amortisation plan": the existing instruments would gradually lose their eligibility over a certain period of time. We believe the effectiveness of this option could be increased by the introduction of additional quantitative limits, e.g. grandfathered instruments cannot represent more that x% of tier 1 at the implementation date and should be reduced to y% and 0% within an appropriate period of time.
- We could also consider further differentiation of grandfathering periods according to the type of capital instruments (e.g. longer for perpetual and shorter for instruments with step-up features).

Capital instruments subscribed by governments

42. The treatment of capital instruments issued by several EU banks during the crisis and subscribed by governments deserves specific attention. They were designed according to the current regulatory framework which did not provide for a discipline of capital as detailed and rigorous as the proposed new rules do. Most of them (if not all) deliberately contained either explicit or implicit incentives to an early redemption (e.g. step-ups, call options for the issuer), in order to facilitate the end of state intervention as soon as the market conditions make it possible.
43. Many such clauses were welcomed (if not required) by the EC when assessing the compliance of the schemes with the EU competition framework. Most of these instruments probably do not meet the new requirements, at least in terms of permanence; many of them might even prove not compliant with the CRD 2 and therefore be grandfathered as Tier 1 hybrids.
44. BoI believes that a specific transitional regime for such instruments should be defined to be closely coordinated with the exit strategy; a suitable solution might provide for a reduction in their eligibility over time in order to incentivize their redemption and/or substitution with compliant instruments within a predefined time horizon.
45. In order to manage smoothly the transition to the final regime and prevent their disqualification as a consequence of the CRD 2 implementation, the EC might consider amending the current CRD 2 grandfathering for instruments to be considered as capital (art. 57a) by providing that they keep their current status and are not downgraded to non core tier 1 hybrids for some time.
46. The need to provide clarity to market participants suggests to introduce such a change – if deemed appropriate – as soon as possible: an amendment to the CRD 3 could be the most appropriate mean to achieve the objective.

SECTION III – Leverage ratio

47. BoI believes that the introduction of the Leverage Ratio (LR) as a supplementary measure of the risk-based capital requirements can contribute to preventing the build-up of an excessive leverage in the banking sector, as well as represent an additional safeguard against model risks and potential measurement errors in the risk-based capital requirements.

48. BoI also recognises that the effectiveness of the measure, in terms of appropriate interaction with the risk-based measure and right functioning along the economic cycle, will rely on the final design of the ratio and on the calibration of the threshold.

49. BoI shares the decision to include in the LR the total banks' exposures (on and off-balance), measured on a gross basis and following – as far as possible – the relevant accounting principles. In this respect, BoI fully supports the proposed options aimed at adjusting for material differences in accounting regimes and shares the need to closely monitor the relevant developments in accounting standards, in order to assess their potential impact on the design of the LR.

50. BoI supports the migration of the LR to a Pillar 1 treatment which could be preceded by a careful calibration and review of the measure, with the aim to ensure the aforementioned objectives of appropriate interaction with the risk-based measure and right functioning along the economic cycle.

SECTION V – Countercyclical measures

TTC provisioning for expected credit losses

51. The BoI appreciates the initiative of the EC, in so far as it contributes to the international debate on the development of a new provisioning model which overcomes the shortcomings of the current incurred losses model. However, one has to take into account the concurrent initiative of the BCBS which is aimed at elaborating a practical proposal to be presented to international accounting standard setters and supervisors.

52. The first best would be to incorporate in the new standard on impairment the suggestions elaborated by the BCBS. This would realise a perfect matching between accounting and prudential regimes (i.e. the built up of possible additional reserves for unexpected losses would be addressed outside the financial statements, with capital buffers). As a second best, if the IASB would stick on the ECF as designed in the Exposure Draft, it should be evaluated the opportunity to intervene at European level with a complementary measure.

53. The BoI sees a risk of overlapping between the EC's and the IASB's proposal. Moreover, the IASB's proposal – based on the IRB approach – supposes that provisions are determined on the basis of through-the-cycle parameters calculated on 1 year holding period and not over the life of the loan portfolio. This appears not compatible with accounting standards. In addition, the approach proposed by the Commission compares annual flows of expected losses (1 year) with actual losses, without taking into consideration the adequacy of the stock of general provisions in comparison with the expected losses over the residual life of loans.

54. It is important that, in order to ensure that provisions built up according to the EC's proposal are not aimed to create a capital buffer, annual allowances should be established at a level which cover only the average historical observed losses and not downturn losses. This means that the concrete specification of the model is crucial, in order to avoid interferences with the prudential framework; at the same time the change in the

accounting provisioning model would require consistent amendments of current rules on the regulatory capital calculation.

55. Provisions should be estimated considering the current composition of the loan portfolio (without taking into account future lending) and the relative risk profile. Credit risk should encompass both on and off balance sheet items.

56. As far as standardised banks are concerned the treatment proposed does not take into account that many banks could use for internal management purposes an assessment of credit losses based on PD and LGD. In addition, the proposed use of EL that are embedded in risk-weights laid down in Annex VI of the CRD are less representative of the credit risk underlying the bank's specific portfolios.

Capital buffers and the cyclicality of minimum requirements

57. The countercyclical package proposed in the CD is in line with the proposals put forward by the BCBS.

58. However, BoI is concerned that the first component of the Basle package (i.e., smoothing the minimum required capital, MRC) is only described at the very end of the CD, as a complementary and not as an essential element of the whole reform package.

59. BoI sees two main shortcomings in this way to proceed. Firstly, we strongly maintain that the CD should consider as an integral part of the proposed CRD revisions a proposal that has been endorsed by CEBS and included in the BCBS' Consultation Document by initiative of EU members. Second, more importantly, we believe that the capital conservation buffer may have undesired effects if not properly complemented by a tool for smoothing MRC fluctuations (i.e. banks using Through the Cycle PDs would be required to hold higher buffers than those using the Point in Time the ones).

60. Therefore, BoI strongly suggests to consider "smoothing the MRC" mechanism as a necessary first building block of any countercyclical toolkit.

61. In terms of interaction of the different components, BoI sees room for a rationalization of the package, avoiding overlaps among different tools. While this is clearly an issue for the BCBS, a common EU stance can be a good starting point. In particular, as currently presented, the capital conservation buffer is primarily a tool for defining supervisory prompt corrective actions and does not seem to determine any countercyclical benefit.

62. In that respect, the countercyclical and the capital conservation buffers can be probably packed into a single tool (BoI would combine the mechanism of building-up/releasing designed for the countercyclical buffer and the rules on dividends put forward in the capital conservation buffer).

63. In the balance between rules and discretion, the CD – consistently with the Basle package – seems to favour a more judgmental approach. BoI wonders whether this may threaten the homogeneous implementation across jurisdictions and provide incentives to some competition in laxity. At least in Europe, a stronger harmonization can be probably pursued along with a rigorous and credible peer review. BoI wonders whether the European Systemic Risk Board could provide the appropriate setting for such review.

64. As far as the variables to be used are concerned, BoI supports the approach being developed by the BCBS. In case additional work for the EU countries were deemed necessary, it can be conducted by CEBS and BSC.

65. The goal of the countercyclical buffer is an important one. The attempt of adding a macroprudential perspective in capital regulation is very welcome. On the other hand, methodological challenges are relevant and the actual functioning and impact of such a tool is an open issue. In that respect, a testing period – during which the approach is adopted in a more flexible way (for instance, banks are encouraged but not obliged to meet the countercyclical buffer) – may help fine-tune the proposal. Again, the ESRB could provide the appropriate setting for coordinating such testing at the EU level.