

**ABI comments on Commission  
Services staff working  
document:  
"Possible further changes to the  
capital requirements  
Directive"**

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## Introduction

As a fundamental introduction to this document, emphasis is made of the importance that the new regulatory framework, undergoing consultation also by the Basel Committee, be applied and come into force in a harmonized manner at international level. Its application at purely European level would lead to a significantly unlevel playing field.

## 1. SECTION I

### Liquidity standards for credit institutions and investment firms

The Press Release accompanying the Paper's publication specifies that the Committee will put in place appropriate phase-in measures and **grandfathering arrangements** for a sufficiently long period to ensure a smooth transition to the new standards.

It is essential that a consultation process be organised on arrangements that the Committee will propose, particularly (i) on the **time-frame** within which banks will need to apply the new framework as well as (ii) on **transitional arrangements**. The implementation of the new requirements also needs to be strictly synchronised throughout the world to avoid substantial competitive distortions.

#### a) Liquidity Coverage Requirement

**Question 1:** Comments are sought on the concept of the Liquidity Coverage Requirement and its likely impact on institutions' resilience to liquidity risk. Quantitative and qualitative evidence is also sought on the types and severity of liquidity stress experienced by institutions during the financial crisis and – in the light of that evidence – on the appropriateness of the tentative calibration in Annex I. In particular, we would be interested in learning how the pricing of banking products would be affected by this measure.

We would like to underline that the new framework will result in a **higher demand for those assets which are eligible** for the liquidity buffers, particularly **sovereign debt**. This is likely to materially **decrease the demand for instruments issued by the private sector, also because** the mere circumstance that some asset classes are not included in the buffer will significantly remove incentives to hold these assets. In other words, one of the most obvious consequences of narrowing the eligible asset class is going to be the **widening of the gap between**

**different bond types**, both within the same bond class (i.e. on-the-run vs off-the-run government bonds) and between different bond classes (corporates vs governments). This could potentially lead to the generation, over time of two tiers of bonds: the first comprised of **highly liquid** and mostly government assets with a steady underlying demand, and the second of radically **less liquid** non-government or off-the-run government bonds.

Spreads between these classes would be wider than otherwise, and this would have an **impact on the funding costs of the "second tier" issuers**. This "crowding out" effect will **benefit government** and **penalize non-government – especially corporate – issuers**: the funds available to the latter issuers would be **scarcer and more expensive**.

The new framework, if a **wider buffer** as that one asked by ABI will not be created, may also have an unintended consequence should some **asset classes that are eligible for the liquidity buffer (particularly sovereign debt) become more scarce**.

Though in the current environment of significant government deficit such a consequence may seem unlikely, in the long term the hope is that the framework will result in recovery of the deficit. A **concentration issue** could also be triggered by the limited market diversity of **eligible securities**.

**Question 2:** In particular, views would be welcome on whether certain corporate and covered bonds should also be eligible for the buffer (see Annex I) and whether central bank eligibility should be mandatory for the buffer assets?

ABI does not consider central bank eligibility a mandatory characteristics for the buffer assets.

We are aware of the problems in terms of liquidity demonstrated by some financial assets issued by the private sector during the recent crisis. Nevertheless, we believe that the identification of eligible assets and of the relative weightings should be carefully re-assessed on the basis of the trade-off between the actual degree of liquidity – also in the light of the stressed situation – and the above mentioned needs for the efficient functioning of markets (the possibility of not excessively discouraging holding certain financial assets in the portfolio should not be undervalued, as an essential element to guarantee the **liquidity of the secondary market**, in turn an essential condition to **maximize the efficiency of the primary market**). In particular:

- **Listed shares included in market indices with a high level of capitalisation**, for which an RSF Factor of 50% is envisaged, **should also be able to be considered also for the purposes of the Liquidity Coverage Ratio (LCR)**; (Note that the maximum loss over the time

interval of one month during the crisis – September 2008 – of the main share indices was around 25/30%);

- For the purposes in question (one-month and twelve-month liquidity, and certainly not stability, requirements) we do not believe there are reasons for **the exclusion of shares of financial institutions** with the same high capitalisation requirements cited previously, which have demonstrated liquidity characteristics similar to the other shares, with the exception of a higher volatility, which could possibly justify a more prudential approach;

- **Monetary funds and bonds funds**, for which a 100% RSF Factor seems excessive, ought to be taken into consideration also for Liquidity Coverage Ratio (LCR) purposes. In this respect, we propose the adoption of a partial **breakdown method**<sup>1</sup>, In this manner the funds would be broken down into their base components as in the fund's prospectus. Afterwards, each component would be assigned the haircut envisaged in the European Commission's framework for the two indicators.

- As regards **unsubordinated debt securities issued by financial institutions with investment grade ratings** – which have also shown problems in terms of liquidity – nevertheless, we believe that the provision of adequate treatment for the purpose of **both indicators**, possibly accompanied by adequate **limits of concentration**, would be suitable to represent a prudential sale value also under stressed conditions similar to those experimented over the reference time horizons.

**Many of the perplexities illustrated** in the **two previous paragraphs** and others that **will be illustrated below** could be partially mitigated, at least with **regard to the LCR**, by envisaging that are adequately recognised in the so-called "wider buffer" the following:

- 1) **corporate and covered securities,**
- 2) **securities included in share indices, bank shares, fund constituents** - which after adequate allocation<sup>2</sup> are invested, by way of necessity or indirectly, in eligible securities of the "wider buffer" or "normal buffer" -, **unsubordinated debt securities issued by financial institutions and**
- 3) **central bank eligible but not marketable assets**

Furthermore, in the LCR, claims issued or guaranteed by sovereigns and other products the like are included in full in the liquidity buffer if they are assigned a 0% risk-weight under Basel II Standardised approach (rating at

<sup>1</sup> Like the one based on the Bank of Italy's "Prudential supervisory rules for banks" – Title II, Chapter 4 (Dec. 2006- n. 263) relating to market risks.

<sup>2</sup> For example, see the allocation methods envisaged in the Bank of Italy's "Prudential supervisory rules for banks" – Title II, Chapter 4 (Dec. 2006- n. 263) relating to market risks.

least AA-) whereas they are totally excluded if their risk-weighting is above this threshold. Concerning corporate bonds, however, the Paper proposes a more differentiated treatment which accepts that **second tier corporate bonds (rating between AA- and A-) are eligible for the liquidity buffer.**

a1) Therefore, **we request that within the scope of the LCR it is envisaged that** at least government-issued/-backed securities (and similar products) with a 20% risk weighting (A+ and A- ratings) **are included, with the appropriate treatment in the "wider buffer"**, as already envisaged for several corporate bonds.

a2) **As a fallback position**, we request a review of the metric of the LCR, according to that proposed by the **CEBS**. In this framework, the metric could be opened on **two sub-periods ("0-1week" - "1week-1month")** in order to envisage two different definitions of liquidity buffer as proposed by the CEBS in the Consultative Document published in July 2009. This had already been highlighted as important in the ABI Position Paper dated July 2009 insofar as it permits a differentiated definition of the assets eligible in the first and second time interval. In this case the assets referred to under point a1) above, together with those indicated under points 1, 2 and 3, could be included without further haircuts in the so-called "longer end" of the LCR (period of over 1 week), whilst it remains implicit that the "0-1 week" buffer should include the assets referred to in paragraphs 34.a, 34.b, 34.c and 34.d of the Basel Committee document and assets that are eligible but not negotiable (see below).

\*\*\*\*\*

On the issue of compulsory "central bank eligibility", the following illustration is given in contemplation of the value of such eligibility, albeit unrelated to the question of marketability

Many central banks (including the European Central Bank) typically provide their banking systems with liquidity via refinancing open market operations, i.e. against eligible collateral.

Since the provision of liquidity to banks is a key function of monetary policy and given that both the reserve requirements and the exogenous creation/destruction of monetary base depend on structural factors which tend to be sticky, under normal conditions -i.e., in the absence of a crisis- the overall amount of the outstanding refinancing open market operations is quite stable and predictable (although, of course, it may significantly differ from one jurisdiction to another). For the euro area, for example, such an amount would be (in a hypothetical normal situation) around 550 bln/€.

In other words, refinancing open market operations de facto represent a stable, and in many jurisdictions material, source of funding for the banking system. This source of funding should not be overlooked or "wasted" in the

design of the LCR and the NSFR. Since access to this funding is only against central bank eligible collateral, this means that both regulatory ratios should recognise at least "some" liquidity value to central bank eligible assets per se (even if they are not marketable).

One line of reasoning is to assume that each bank is consistently allocated a share of the outstanding central bank reverse-repo operations which equals its share in the system (e.g, its share in the overall reserve requirement, or in the total assets of the system). Consider, for example, a bank which represents 1% of the mandatory reserve requirement (or of total assets) in the euro area: this approach would imply that up to 5,5 bln/€ of the bank's central bank eligible assets (collateral value) would enter its LCR liquidity buffer and would be assigned a low (maybe 0%) RSF Factor under the NSFR framework – irrespective of whether such assets are marketable or not.

Note that this is the approach taken in the liquidity stress test over a six month horizon, recently proposed by the ESCB's Banking Supervision Committee.

With specific reference to covered bonds, we would like to point out that the resilience of such instruments under a liquidity point of view has been proved even in the highest peaks of financial turbulence. Furthermore, comparing the so called Fundamental Characteristics set in Section I (paragraph 8) to be possessed by the high quality liquid assets with the characteristics of the covered bond market, we register a perfect compliance for all of the 8 points mentioned (see table below).

Criterion	Applies to Covered Bonds
<b>1) Low credit and market risk</b> High credit standing of the issue Low degree of subordination  Low duration, low volatility, low inflation risk, convertible currency	Yes, given for the issue itself Yes, preferential claim on cover pool assets plus dual recourse Yes, in line and partly better than government bonds from Eurozone periphery
<b>2) Ease and certainty of valuation</b> Liquid asset pricing formula  Exotic product	Yes, majority is fixed or floating bonds, no model assumptions needed to price plain vanilla Covered Bonds No, track record since late 18th century
<b>3) Low correlation with risky asset</b> Wrong-way risk	No, as insolvency remoteness and special law ensure credit quality of cover pool. In contrast, correlation of 91% with government bonds
<b>4) Listed on exchange market</b>	Yes, although the majority of trading turnover does not necessarily take place there
<b>5) Active and sizable market</b> Outright sale and repo Market breadth and market depth	Yes, see appendix for overview of repo market Yes, is given, simply looking at involvement of Central Banks as market participants
<b>6) Committed Market Makers</b>	Yes, although Market Making is not enforceable
<b>7) Low market concentration</b>	Yes, given due to investor space ranging from large accounts to small asset managers, see e.g. granularity of order books
<b>8) Flight to quality</b>	Yes, firstly see high correlation with government bonds.

Covered Bonds in general play a vital, in some countries an absolute key role in domestic residential mortgage financing. Therefore, any distortion in the domestic Covered Bond market caused by a quick adoption of a new set of regulatory limitations influencing the investment behaviour of banks in Covered Bonds as well as the issuance activity of Covered Bonds by banks might consequently lead to highly adverse effects on domestic residential mortgage funding. This might feed through to either higher mortgage yields for retail customers, probably less competition in domestic mortgage markets as well as less choice with regard to the range of mortgage products being offered by banks.

As regards instead the possible specification of the Liquidity Coverage Requirement (Annex I), we also would like to point out that under the current proposal, credit institutions would be penalised for holding own covered bonds. However, it needs to be stressed that issuers quite frequently acquire own covered bonds in the market and thus improve the overall liquidity in their bonds, attracting more investors, etc.

Moreover, in our view, there is a fundamental conceptual problem when trying to assess to liquidity of any kind of bond by its bid/ask spread. As still the majority of bonds especially in the Credit universe is still traded in the

so-called phone trading and not on electronic platforms, it is by no means no a trivial task to determine the pricing source on which to base the assessment of bid/ask spreads. It is common business practice to quote different prices for bonds to different customers at the very same point of time. Therefore, the fair and objective observability of executable bond prices is questionable per se. In other words: It will almost be impossible to capture consistent and coherent bond prices for a market driven approach to determine the liquidity of a bond (i.e. the tradability of that particular bond) without a clear guidance of which pricing source to use. We support the Basel Committee in its approach to use market data in general but we must emphasize the complexity of putting in place a regulatory guideline of 50 basis points into daily business for banks.

That being said, we hope that the bid-ask spread requirement should be intended as applicable to specific segments of the covered bond market and not to single issuers. It would be inconceivable, for example, that one issuer in a particular country (e.g. Germany) having had a bid/ask spread above 50 bp in the past for a short amount of time might, could spoil the whole market for Pfandbrief. As many countries have supported banks in Europe, thereby also supporting covered bond issuing institution, a reference from one issuer to the national market as a whole would more or less lead to the exclusion of Covered Bonds as highly liquid asset as there are cases of troubled issuers in almost all relevant markets.

**Question 3:** Views are also sought on the possible implications of including various financial instruments in the buffer and of their tentative factors (see Annex I) for the primary and secondary markets in which these products are traded and their participants.

For matters relating to the primary and secondary markets please see the reply to Question 1.

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In addition to the replies to questions 1 to 3, for other LCR-related matters please see the ABI Technical Annex and note the following comments.

We ask that the term "**country**" or "**domestic**" in the various proposals referring to liquidity risk can be interpreted at the European level as synonymous of **Euro zone Area**.

We also highlight the absence of acknowledgment of the use of **internal models** for items without maturities and of uncertain use – in particular on-demand items and prepayments (the latter totally ignored) – for which it

would be desirable to use parameters calibrated on the specific characteristics of the local situation. In this regard, we would like to suggest the application of two different approaches:

- a standard one with the application of a fixed % on on-demand deposits;
- an advanced one, with the possibility, following the "validation" of the national Regulators, to use internal model on established and specific balance sheet items, such as in particular on-demand items, mortgages (prepayment effect) and implicit options.

Again, in any event, at least the portion of each deposit under the **guarantee threshold of the Interbank Fund** should be considered "stable deposits", with no other conditions.

The same European authorities raised said threshold – in the period of most stress of the recent crisis – agreeing therefore that up to said level, the recall of funds by customers did not occur even in a situation of tension.

Where Banking Protection Systems have been adopted by the cooperative network in accordance with article 80.8 of Directive 2006/48/EC, we ask that the entire total of deposits covered by the Guarantee be considered "stable deposits".

Lastly, we would like to ask the Commission to specify that **securities associated to hedging positions may be included as high quality liquid assets if the hedging made does not distort their liquid property** (absence of significant penalties for early extinction) and the hedging is functional to the sole management of the relative risks, regardless of the accounting regime to which the securities are subject.

Therefore, the interventions set in place by the intermediary with the objective of managing the overall risk to which the same is exposed (as in the case of hedging financial risks of high quality liquid assets) should not result in a penalisation as regards the assessment of counterbalance capacity.

## **b) Net Stable Funding Requirement**

**Question 4:** Comments are sought on the concept of the Net Stable Funding Requirement and its likely impact on institutions' resilience to liquidity risk. Quantitative and qualitative evidence is also sought on the types and severity of liquidity stress experienced by institutions during the financial crisis and – in the light of that evidence – on the appropriateness of the tentative calibration in Annex II. In particular, we would be interested in learning how the pricing of banking products would be affected by this measure.

**Question 5:** Comments are in particular sought on the merits of allowing less than 100% stable funding for commercial lending that has a contractual maturity of less than one year. Is it realistic to assume that lending is reduced under liquidity stress at the expense of risking established client relationships? Does such a differentiation between lending with more and with less than one year maturity set undesirable incentives that could discourage for instance long term funding of non-financial enterprises or encourage investment in marketable securities rather than loans?

Yes, it is realistic. In our view during a one year idiosyncratic crisis a bank will almost certainly adapt its business model (e.g. by scaling down its activities).

**Question 6:** Views are sought on possible implications of inclusion and tentative "availability factors" (see Annex II) pertaining to various sources of stable funding for respective markets and funding suppliers. Would there be any implications of the tentative required degree of coverage for various asset categories for respective bank clients?

\* \* \*

In addition to the reply to question 5, for other NSF-related matters please see the ABI Technical Annex and note the following comments.

For the Net Stable Funding (NSF) ratio, we also ask for a form of "**second tier**" for **sovereign securities with an above-zero weighting**, and propose that this case be allowed for on a specific line of the second table in Annex II.

**In addition** to the above proposal, we would like the **5%** line in the second table of Annex II to include the "**government or central bank debt issued in domestic currencies by the country in which the liquidity risk is being taken or the bank's home country**" substantially levelling the treatment of the situations to which it applies both as regards the LCR and the NSF. This is certainly important for banks, which with a prevalence of **home state** securities in their portfolios, would otherwise risk not seeing them recognised for NSF purposes unless they comply with the 0% risk weight rule.

Even though we agree with the introduction of a NSF ratio to be associated to a liquidity coverage ratio to avoid the so-called "cliff-effect", we also retain that it should not be set within the framework of a stress test analysis, given the structural nature of this indicator.

Therefore, **we would like to request the Committee to take into consideration a solution which, with the appropriate changes and reviews, would emulate Italian legislation on the transformation of**

**maturities in force until some years ago.** The latter did not envisage a stress test scenario (but an on-going concern scenario) and took a series of macro items into consideration that avoided problems of data retrieval, without undermining the merits of the ratio. **We are open to further exploration** on this front.

Rules on the transformation of maturities were established by the Bank of Italy in its Instructions (see Title IV, Chapter 7) and in later amendments introduced in Supervisory Bulletin no. 12/2003. In brief, two of the rules are designed to ensure an adequate balance between asset and liability items (for further details on transformation of maturities rules please see the ABI Technical Annex).

In the way it is set up, **the NSFR indicator in general proves particularly rigid and restrictive** in both the definition of the funding sources to be considered "stable" and in the coverage levels of the asset classes. For liabilities, there would need to be **greater differentiation** between the **funding values according to the various maturities** (e.g. more weighting for the long-term funding than for short-term funding) and **a portion of the interbank funding also considered "stable"** given the fact that, even during the most difficult moments of the recent crisis, the banks generally had continuous access to the interbank market – albeit on shorter term maturities. For assets, **short-term asset** financing with stable funding also appears as excessively expensive as does the timing defined in the proposal. It would therefore be necessary to aim for, if not complete exclusion, **at least a decrease in the roll over percentages, taking into account the systemic and idiosyncratic crisis context in which the indicator is defined.** Moreover, the full inclusion of all bank securities, along with the haircuts - fairly heavily sustained - on non-financial corporate securities, even if highly rated, among assets to be financed with stable funding – in line with the definition of liquidity buffer - would appear to be excessively damaging.

A second line of action that might resolve the dangers implicit in an NSF formulation that is too restrictive, binding and undifferentiated (with an increase in funding costs for the entire banking sector, diminishing role of the transformation of maturities, repercussions on the credit system in terms of both costs and volumes), **could therefore be that of allowing greater customisation of the indicator through the introduction of internal models that adequately reflect specific business needs**, the various business models and reference markets in which the bank operates, and in the framework of common guidelines that **maintain a level playing field at national and international level.**

With regard to the cooperative lending banks network, reference should be made to the comments provided in relation to the LCR, to the extent they may apply.

### c) Completeness of legislative approach

**Question 7:** Do you agree that all parameters should be transparently set at European level, possibly in the form of Technical Standards by the EBA where parameters need to reflect specific sub-categories of retail deposits?

Yes.

**Question 8:** In your view, what are the categories of deposits that require a different treatment from that in Annexes I and II and why? Please provide evidence relating to the behaviour of such deposits under stress.

### d) Scope of application

**Question 9:** Comments are sought on the scope of application as set out above and in particular on the criteria referred to in point 17 for both domestic entities and entities located in another Member State.

**Question 10:** Should entities other than credit institutions and 730K investment firms be subject to stand-alone liquidity standards? Should other entities be included in the scope of consolidated liquidity requirements of a banking group even if not subject to stand-alone liquidity standards (i.e. financial institutions or 50K or 125K investment firms)?

The new regulation, while making explicit reference to its application on a consolidated basis for all international banks, seems however to envisage its application at Legal Entities level.

We believe the **new regulation should be applied only at consolidated level**, not to discriminate between Groups who have dedicated individual legal entities to specific businesses, rather than sub-departments.

For banking groups, a group-wide liquidity risk management approach is extremely important for its efficiency and effectiveness. Within the same Group, the synergetic use of available resources to manage the funding requirements of the various activities related to different business models must therefore be recognized.

In any event, application on a consolidated basis should be recognised exclusively at least for all group members operating under a single jurisdiction (and therefore subject to supervision by a single authority), where necessary – at the request of the local supervisory authority – envisaging application on an individual basis only for entities operating under a jurisdiction different to that of the consolidated entity.

**Question 11:** Should the standard apply in a modified form to investment firms? Should all 730K investment firms be included in the scope, or are there some that should be exempted?

### e) Treatment of intra-group transactions and commitments

**Question 12:** Comments are sought on the different options and in particular for how they would operate for the treatment of intra-group loans and deposits and for intragroup commitments, respectively. Comments are also sought as to whether there should be a difference made between the liquidity coverage and the net stable funding ratio<sup>3</sup>.

Given the previously mentioned importance of a group-wide approach to guarantee the effectiveness and efficiency of liquidity risk management, it is considered that, where the envisaged LCR and NSFR requirements are not already applicable on a consolidated basis, the treatment illustrated in paragraph 23 should be guaranteed for intra-group relations for the purpose of both indicators.

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With regard to the banks belonging to the Italian co-operative bank network, it is believed that the stress hypotheses proposed with reference to the transactions (deposits, loans and commitments) between the same are based on assumptions which are very wide apart with respect to their business and organizational specificities. Within the sphere of the aforementioned network, the IInd level banks perform the important role of managers of the Category liquidity (in fact, the liquid funds of the BCC-CR are concentrated on them) and intermediaries vis-à-vis the regulation systems. By virtue of these operations, the IInd level banks hold specific liquidity reserves against the funding of the BCC-CR as well as available margins on credit facilities granted to the same.

Therefore, the handling of the transactions between Ist and IInd level banks proposed by the consultation document appears to be excessively penalizing since: (i) with regard to the cost incurred by the IInd level banks for holding additional liquidity reserves, there is not a corresponding symmetrical benefit for the Ist level banks who granted the credit facilities; (ii) it does not take into account the overall stability features of the funding of the Ist level banks, also attributable to the operating purposes of such funding; and (iii) it does not consider the effects of territorial, dimensional and operative diversification associated with the Ist level banks and therefore the reduced risk of simultaneous conduct by the same vis-à-vis the IInd level banks.

In a nutshell, the proposals formulated by the Commission aimed at avoiding excessive trust in wholesale type funding, especially if originating

<sup>3</sup> For instance in the sense that an entity that has received an overnight deposit from another group entity could be allowed to assume that that deposit would be rolled over during the 30 days stress, but that that same entity would not be allowed to treat any monies due to other group entities during a one year period as an element of stable funding.

from financial institutions, risk discouraging the current management mechanisms (of proven efficacy) centred on the liquidity at Category level and, therefore, producing serious impacts on the operations of the Ist and IInd level banks.

In light of these comments, it is requested that, for the LCR and the NSFR, a symmetrical handling be envisaged for the transactions (deposits, loan and commitments) which exist between the IInd level banks and the Ist level banks belonging to the network of co-operative banks, similar to that envisaged by paragraph 23 with reference to banking groups. Within this sphere, it is also believed that the effects of territorial, dimensional and operative diversification associated with the Ist level banks and, therefore, the reduced risk of simultaneous conduct must be considered (for example simultaneous pulling of all the credit facilities granted) by the same vis-à-vis the IInd level banks which perform the role of managers of the Category liquidity.

As a fallback position, it is requested that the symmetrical treatment indicated above be recognized in the presence of an institutional safeguard system established in compliance with Article 80.8 of the EU Directive 2006/48

#### **f) Supervisory responsibility for branch liquidity**

**Question 13:** Do stakeholders agree with the conclusion that for credit institutions with significant branches or cross-border services in another Member State, liquidity supervision should be the responsibility of the home Member State, in close collaboration with the host member States? Do you agree that separate liquidity standards at the level of branches could be lifted based on a harmonised standard and uniform reorganisation and winding-up procedures?

The proliferation of requests from different national authorities certainly does not facilitate matters. Coordination based on a single point of reference, the "home member state" authority, would be much better.

#### **g) Monitoring Tools**

**Question 14:** Comments are sought on the merit of using harmonised Monitoring Tools, either in the context of Supervisory Review or as mandatory elements of a supervisory reporting framework for liquidity risk. Comments are also sought on the individual tools listed in Annex III, their quality and possible alternatives or complements.

**Question 15:** What could be considered a meaningful approach for monitoring intraday liquidity risk?

Given the trade-off existing between the certainty of a figure (management vs. accounting) and the suitable frequency with which calculations should be updated (higher for LCR than for NSF), as well as the intrinsic structure of the two indicators (for the NSF, consolidated figures are no doubt more suitable than the simple aggregate figure, which instead is acceptable for the LCR) unlike the content of paragraph 132, we propose a sort of two-track approach.

The LCR could be required monthly, if necessary, also on management figures, while the NSF could be required with a maximum frequency of three months on accounting data, with a time gap between the closure of the quarter and the calculation date suitable for the production of consolidated accounting data.

For the NSFR it is considered that the calculation frequency might be calibrated on proportionality criteria, identifying a dual track method in terms of the calculation frequency, differentiated for the various banks so as to adequately reflect the complexity, dimension and specifics of the business activities, the adopted business model and risk management practices.

Furthermore, we would like to point out that the paper disregards basic application issues. What will happen if a bank falls short of its liquidity needs? It will not be able to make use of the assets that populate the buffer because it needs to keep those assets in its liquidity buffer at all times to meet regulatory requirements. The Paper does not suggest that there would be any way for the bank to get out of this situation.

To identify a meaningful ratio to address the potential intraday liquidity risk doesn't look appropriate. The intraday liquidity risk could be defined as the possibility that a bank is not able to fulfil timely its obligations. In particular this concept is linked to systemic relevant payments that may refer to cover debit positions in international or domestic payment systems both cash or securities. In Target 2, the Euro area gross settlement system, these critical payments are identified in Euro debit positions in CLSS (Continuous Linked Settlement System) and margin calls to be paid to Central Counterparties. Other relevant payments can be individually added as payments related to financial transaction that must be executed timely to avoid any potential reputational risk that can easily generate, as a consequence, inability to cover the overall funding risk of the bank. To deal with this temporary situations banks maintain an appropriate collateral buffer to have access to Central Banks intraday facilities that can be transformed in overnight funding source (ECB marginal lending facility) if the troubled situation lasts longer than the predicted possible intraday period. Operating in the stressed combined scenario called by consultation document doesn't change the potential behaviour of the individual banks. In

this respect the bank can easily use intraday with its Central Bank the eligible collateral that has to be maintained unencumbered to fulfil LCR obtaining intraday credit. This particular situation is furtherly strongly underlying the inconsistency of hypothesis of not considering the role of the Central Banks under the Basle defined stressed scenarios.

## 2. SECTION II

### Definition of capital

#### a) Revision of the regulatory capital structure

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

Despite having nothing against the elimination of the distinction between upper and lower Tier 2 instruments, as well as of Tier 3 capital, it is believed appropriate to point out that:

- the Upper Tier 2 instruments envisage a greater absorption of the losses than the Lower Tier 2 instruments;
- the reduction of the range of instruments which the issuers can offer investors may lead to greater difficulties for said issuers during the phase for obtaining financial resources.

This approach's impact could be significant if clauses for the Tier 2 instruments are introduced, such as in particular lock-in clauses, which, besides not being consistent with the gone concern aims of this capital component, would risk making these instruments somewhat unattractive for investors.

#### b) Proposed definition of Core Tier 1 Capital (and Prudential filters and deductions), Non-Core Tier 1 Capital and Tier 2 capital

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

ABI believes that some criteria envisaged in the consultative document for the Tier 1 and Tier 2 instruments can be improved with regard to certain points. For such purposes, a number of comments are presented below.

##### Core Tier 1 – Common equity

The European Commission's consultative document establishes (annex IV) the eligibility criteria for the inclusion of the capital instruments under common equity.

In general, the provision about computing instruments only as classified as equity under the relevant accounting standards imposes a link with the

IAS/IFRS rules that is currently being redefined and that is unclear on this issue.

Moreover, the "*perpetual*" concept considered in the consultation document is not compatible with the Italian regulations on shares. In merely formal terms, shares have the maturity of the issuer bank. This formal characteristic in any case does not impinge on the quality of the instrument from the supervisory point of view. There is no doubt that while the shares have a maturity date, they cannot be redeemable and they absorb losses to the greatest possible extent.

We therefore propose to integrate the additional principle of "maturity equal to the life of the issuer", as provided by Italian regulations.

Based on the consultation document, moreover, saving shares and privileged shares would not be computable in common equity in consideration of the clauses that prescribe the obligation to distribute dividends in the presence of profits and/or the priority upon liquidation over common shares, occasionally recognized them in the bylaws.

In our view, there are no juridical-formal or substantial grounds for the exclusion, because: i) such instruments represent a form of capital that is similar, if not more stable, than the form represented by common shares, as all rules of company law protecting the integrity of capital apply to them; ii) they fully support enterprise risk; iii) they are junior to hybrid instruments and iv) the capital privilege granted is absolutely immaterial and in any case linked to the presence of distributable profits.

The assessment of formal and substantial consistency between common shares, on one side, and saving and privileged shares, on the other, could be distorted in consideration of the existence, in other countries, of preference or preferred shares having the typical characteristics of hybrid instruments. In this regard, it should be stressed that in Italian law savings and privileged shares have different substance from the one recognized in international law. It should be recalled that, unlike other structure, the prerequisite for any payment is the existence of a distributable profit.

If savings and privileged shares are not included in Core Tier 1, a situation would be created in which their nominal value would be beyond common equity, whilst the share premium would in any event be classed in this component of the capital. Any share premium paid on subscription to such shares, forming part of the general share premium reserve (which also includes the share premium on ordinary shares), is by nature classifiable as common equity.

Therefore, a modification to the Commission's provisions is proposed, to include privileged and saving shares outright in the computation of common equity.

Should the proposed modification not be accepted, more specific corrections could be provided, enabling, for example, to include privileged and saving shares in common equity, deducing the component represented by privilege.

If there is no room for modification to the consultation text, lastly, a grandfathering discipline could be provided for such instruments. The consultation document allows to adopt this solution.

With reference to point 4 of the criteria for inclusion in common equity, it should be clarified that the sole objective of this provision is to exclude that, when new shares are issued, the legal prerequisite is created for the issuer bank to be certain that all or part of such new shares are bought back.

Italian laws discipline - introducing among other matters limits, shareholder meeting authorization requirements, market requirements for publicly traded companies, etc. - the buy-back of own shares and many banks (as well as many non banking companies) provided for the possibility of buying back own shares through resolutions of the shareholders' meeting which define the terms, times and procedures for the buy-back. The provisions of national laws with respect to own shares, and the adoption of a buy-back resolution in line with applicable company laws and regulations, should therefore not compromise the computability of shares in the common equity of banks.

With reference to point 5, we deem necessary to underline that the statement "*distributions are paid out of distributable items (retained earnings included)*" is not clear. If "distributable items" refers to items distributable to shareholders (i.e., profits plus distributable reserves), hybrids may be dilutive to ordinary shareholders, assuming that the wording "paid out of" means that once a payment is made on hybrids, the corresponding amount of distributable items will no longer be available for distributions to shareholders.

Thus, we propose to modify the text as follows: "*Distributions are paid out only if there are distributable items (retained earnings included)*".

Moreover, we observe that the sentence "*the level of distributions are not in any way tied or linked to the amount paid in at the issuance and are not subject to a cap*" would lead to exclude from common equity the categories of shares for which the bylaws of the issuer bank prescribes a dividend that represents a certain percentage of the nominal value (or of the subscription value, thus inclusive of the premium), possibly to differentiate such share categories from others and introduce a cascade of payments in profit distribution. In this regard, it is not readily apparent what supervisory aims would be frustrated by clauses of this nature, especially when payment of the dividend is discretionary.

Lastly, there is an additional critical profile relating to the fact that the common equity discipline does not take into account the peculiarity of the legal structure of cooperative credit banks and, consequently, of the shares they issue, which while they have different characteristics, are equivalent in quality to common shares.

For more details on the proposals pertaining to privileged and saving shares, please see the specific attachment.

#### Non core Tier 1 – Hybrid Capital

With regard to Non-Core Tier 1 instruments, it is deemed appropriate to propose a modification of certain criteria proposed in the consultative document (annex VI) for the purpose of maintaining the attractiveness of said instruments for investors in debt instruments (so-called “fixed income investors”), which represent the typical profile of the investors in such instruments.

In fact, it is necessary to take into consideration the difficulty for such investors in acquiring instruments in which remuneration is entirely left to the issuer's discretion and the consequent difficulty and costs in placing instruments with such characteristics.

In light of these considerations, we suggest the following modifications:

#### *Criterion 4: Duration*

We propose to eliminate the definition of “perpetual” or else to refer also to a maturity equal to the life of the issuer. This last concept was inserted, among others, in the feedback to the consultation paper no. 17 of CEBS of April 3, 2008. Moreover, the need is noted to maintain, consistently with the CEBS guidelines of last December, the possibility of issuing innovative Tier 1 instruments that have at least moderate incentive for redemption.

#### *Criterion 5, letter c, paragraph ii: Call option exercise*

Considering that by effect of the exercise of the call option, the issuer's capital ratios must not drop below the minimum values prescribed by current regulations, we propose to replace the words “well above”, whose meaning is hard to measure, with “in line” (or similar wording).

#### *Criterion 7: Dividend/Coupon discretion*

We note that the provision pertaining to full discretion in coupon payment (in addition, among other matters, to capital conservation requirements for the purposes of disciplining countercyclical buffers) makes non-core Tier 1 instruments very expensive.

In view of mitigating the cost of issuing Tier 1 instruments without thereby compromising loss absorption characteristics, we suggest eliminating the word "full" from point a).

With reference to point d), we ask to clarify whether the scope of this provision is simply that, in case of missed payment of the coupons on Tier 1 instruments, the sole limitation assumed by the bank is the one prescribed by the so-called dividend stopper clauses (whereby the possibility for the bank of distributing dividends to shareholders is limited).

To guarantee the seniority of hybrid instruments over shares, we also ask to confirm the possibility of introducing the obligation to pay interests in case if dividends are paid (dividend pusher).

It is also requested that the opportunity of introducing alternative mechanisms for the payment of the coupons such as ACSM (Alternative Coupon Satisfaction Mechanism or rather the use - for the payment of the coupons - of cash generated by capital increases or bonds issued with the same characteristics) be maintained.

*Criterion 8: Distributable items*

For non-core Tier 1 instruments, the sentence "Dividends/coupons must be paid out of distributable items" causes critical issues, if it must be construed in the sense of allowing payment of interest only on distributable profits. In this case, the following would be created: (i) a dilution for shareholders, and (ii) a reversal of the principle whereby hybrid instruments take priority over shares. In this case, payment of interest on hybrid instruments would alter profit distribution rules and, therefore, it would interfere with the operation of shares. On the other hand, the characteristics of payment flexibility that are typical of Tier 1 instruments can be achieved even if payments do not take place in such a way as to dilute profits.

In view of these observations, we propose mandatory payment of interest in the presence of distributable profits arising from the last approved financial year. In particular, we propose the following wording: "*Dividends/coupons must be paid only if there are distributable items*".

*Criterion 14:*

The maintenance of the possibility of issuing via Special Purpose Vehicles is proposed so as to maintain flexibility for the issuer when choosing, in line with what is generally envisaged by other European jurisdictions.

In conclusion, ABI shares the approach of the Commission on the aspects relating to the tax deductibility of the coupons, on the basis of which (paragraph 58) it is essentially recognized that any objective for the harmonization of the tax regulations on the subject could be pursued in a subsequent phase with respect to the definition of the capital requirements which is covered by the consultation in question and that, in general,

eligibility requirements of the hybrid instruments linked to the tax treatment of the same will not be envisaged.

#### Tier 2 capital

With reference to the eligibility criteria of the Tier 2 instruments (annex VII of the consultative document), firstly the possibility of envisaging a moderate incentive for the issuer to redeem is proposed (possibility excluded by criterion 4.c). In fact, it is believed that this approach may provide benefits in terms of balance between stability of the capital (the incentive would be moderate and, in any event, early redemption would be subject to the authorization of the Supervisory Authority) and risk undertaken by the investor.

Moreover, said approach would favour an alignment between the discipline of the banking and of the insurance industries. Within the recent CEIOPS recommendations (October 2009) on the eligibility criteria of own funds within the first level directive "Solvency 2", the possibility of a moderate incentive for redemption is provided for Tier 2 instruments. This alignment would therefore be functional with regard to the need for consistency between the banking and insurance legislation indicated by the same Commission (paragraph 38 of the consultative document) as well as by the Basel Committee in the document dated January 2010 ("Review of the differentiated nature and scope of financial regulation").

With specific reference to point 5, letter c, paragraph ii), we propose replacing the words "well above", concept that is uncertain and hard to measure, with other wording, e.g. "in line". Essentially, the issuer, by effect of the exercise of the call option, must present capital ratios at least in line with the mandatory minima prescribed by the supervisory regulations.

Moreover, early redemption shall be independent of economic convenience. This is because in many cases the reputational cost of failure to exercise a call option (for example in terms of deterioration of the ability to access the market) is greater with respect to the cost of potential refinancing.

With regard to point 8, we propose maintaining the current treatment (buy back without authorization up to 10% of each issue) and introducing an exemption for market making activities.

In conclusion, indication is made – with reference to paragraph 63 of the consultative document – of the importance of not introducing lock-in mechanisms for Tier 2 instruments, since these mechanisms would be superfluous and, above all else, inconsistent with the gone concern nature (capital in liquidation) of the Tier 2 capital.

Also, the "lock in" could apply only in the case of final redemption. In this circumstance, by effect of the regulatory amortization, the contribution of

the subordinated security for the purposes of Regulated Capital would only be 20% of nominal capital, based on the proposed contained in the consultative document. Therefore, the effect of the "lock in" mechanism would de facto be greatly limited.

Lastly, it could be worth clarifying whether, during their further study of Tier 2 instruments, the European Commission intends to assess the option of also introducing share conversion mechanisms for these instruments.

Such obligations should not be envisaged, given that the aim of these instruments is to absorb losses in "gone concern" scenarios (to protect the rights of depositors and holders of senior securities). We therefore do not understand the reasons behind the introduction of a share conversion mechanism for an issuer in liquidation.

Any share conversion mechanism could also potentially lead to a diluting effect on the issuer's shareholders, which those shareholders may not be willing to accept.

It is also considered that such obligations would in fact make Tier 2 instruments more similar to Tier 1 hybrids, further reducing the range of instruments available to issuers.

In any event, there would then be the risk of less appeal to the current base of Tier 2 instrument investors (in Italy normally retail investors), with a real possibility that the banks will not issue such instruments in future.

The investment flows could therefore shift to instruments issued by entities in other sectors, particularly insurance, for which at present no clauses for share conversion options are envisaged.

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

ABI appreciates the Commission's openness, indicated in paragraphs 50-53 of the consultative document, regarding the possibility of envisaging a temporary write down of the nominal value as a mechanism for absorbing losses, in line with the matters indicated by the CEBS in the guidelines concerning hybrid instruments published in December 2009. In this connection, it is hereby indicated that CEIOPS also envisaged the possibility of loss absorption mechanisms as an alternative to the mandatory conversion and the permanent write down.

The need to absorb the losses could in fact be usefully pursued by means of a temporary write down mechanism and the introduction of the write up mechanism.

If the reduction of the nominal value of the securities following the drop of the capital ratios under certain thresholds was permanent, by contrast there could be negative repercussions from the point of view of tax treatment of the related interest and income.

In detail, the circumstance that these securities – not classifiable on a statutory basis under bonds – cannot even be included in the tax notion of similar securities due to the termination of the unconditional obligation to pay on maturity a sum no less than the original capital, would lead to the application of the most burdensome regime envisaged for the so-called atypical securities.

A temporary write-down mechanism could meet loss absorption requirements “on a going concern basis” even in the case of write-down when the call option is exercised (point 11.b). The write-down occurs in a situation when the capital ratios of the bank deteriorate and are below certain percent thresholds. If this situation should occur, the bank could in no case exercise the call option because, as provided in point 5. paragraph ii, its exercise - always subject to the supervisory authority's authorization – is in any case subordinated to the circumstance that the bank “demonstrates that its capital position is [...] above the minimum capital requirements after the call option is exercised”.

In general, as above mentioned, the need to absorb losses “on a going concern basis” could be pursued with a temporary write-down of the nominal and with the additional provision of a write-up when the bank's capital ratios were to return above given percent thresholds. This subsequent write-up should presumably only take place with reference to the capital net of any subsequent capital increases so as to immunize the new shareholders against the effects of said write-up. If this should not be, the first portion of the capital increase would in fact be for the exclusive benefit of the holders of the hybrid instruments being marked down and this would make any recapitalization action more difficult and in any event more costly.

In conclusion, it is essential that an instrument for which the write-down occurred may be restored to its original nominal value. The Supervisory Authority's authorization for early redemption and the subordination rule applicable in case of liquidation represent the safeguards that enable to maintain the restoration characteristics without thereby compromising the substantial loss absorption characteristics postulated for Tier 1 instruments.

On the other hand, the aforesaid proposal is compatible with a modulation of the write-up that can also take place in compliance with the objective –

highlighted in CRD2 and in the CEBS guidelines – of “not hindering recapitalization”.

In this connection, ABI does not by contrast agree with the Commission’s comment, indicated in paragraph 53 of the consultative document, which seems to reveal the favour for a certain degree of discretion by the Supervisory Authority in assessing whether a conversion trigger in core Tier 1 has been touched or otherwise.

Accordingly, by contrast it is believed to be of particular relevance for the market that the triggers envisaged for the conversion of the hybrid instruments in core Tier 1 are fixed, as far as possible, in an objective and gaugeable manner. The presence of any form of discretion with regard to the triggers could in fact lead to significant uncertainties arising for the investors, de facto reducing the attractiveness of the instruments in question.

Furthermore, unlevel playing field situations could occur between the issuers at EU level in the event of differing assessments on the triggers by the national authorities.

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

Irrespective of the impact of the prudent measures proposed, ABI believes, as more fully specified further on, that it is of primary importance for the banking system to define specific grandfathering clauses in a short space of time on the regime applicable to new issues of Tier 1 hybrid instruments – with respect to which the consultative document does not provide specific indications – which also take into consideration the regulations already introduced by the 2009/111/EC (CRD 2) directive.

The absence of indications on the specific point led to a situation of uncertainty with significant impacts for the banking system in terms of the tracing of financial resources by way of regulatory capital.

This situation is particularly serious for Italian banks, considering the large quantity of call dates of both Tier 1 and Tier 2 instruments which are envisaged during 2010. The Italian banks are among those which have the greatest concentration of call dates this year with respect to other member nations and, consequently, are more greatly penalized by an unclear and non-immediate definition of the grandfathering. The aggregate total of call dates of the main Italian banking issues dedicated to domestic and international institutional investors, and thus non-retail, amounts to around Euro 7 billion.

In conclusion, it is believed appropriate to indicate that the timescale necessary for the preparation of the Quantitative Impact Study (QIS), launched last February, does not coincide with the market's need for certainty with regard to the impact of the new regulations.

With regard to the Italian banks, the greatest impacts concern DTAs, minority interests and equity investments in banks, finance and insurance companies.

### **1) DTA**

The proposal would significantly penalise Italian banks.

The recognition of DTA in financial statements is influenced by national tax laws and the accounting entry is not consistent at international level; any deduction from the common equity component (even if net of deferred tax liabilities, DTL) would, therefore, be contrary to one of the fundamental principles of the Committee proposal, namely the provision of standardised and harmonised supervisory regulations.

One of the weak elements of the current regulatory system is actually reported in the Consultative Document as follows: *"There is no harmonised list of regulatory adjustments. The way these adjustments are applied across Basel Committee countries varies substantially, undermining the consistency of the regulatory capital base"*.

With regard to the Italian situation, there are several peculiarities of Italian tax legislation that tend to amplify the differences between accounting profit and taxable income, with the consequent recognition of significant amounts of DTA.

The most significant of these are:

- non-deductible write-downs of receivables in the year;
- non-deductible provisions for risks and charges;
- alignment of goodwill<sup>4</sup>.

In the first two cases, an increase of DTAs would be recorded in times of economic recession, with the generation of a procyclical effect, also clearly opposed by the Committee.

<sup>4</sup> We retain that where deferred tax assets originate from the payment of a substitute tax, the same should be considered net of the tax paid as a strictly correlated event; the tax benefit for the bank is in fact the net amount between the deferred tax recognised and the substitute tax paid and any deduction of gross deferred tax would lead to a negative double counting.

We therefore propose to completely eliminate the deduction proposal, also in consideration of the fact that a specific test (probability test) is periodically conducted on deferred taxes aimed at assessing sustainability, as regards the bank's capacity to produce taxable income in the future and that civil legislation considers DTA components of available capital and doesn't envisage any constraint to the distribution of the profits related to it.

## **2) Minority interests**

We ask for the confirmation of the current provisions that consider minority interest in the calculation of group regulatory capital, as all assets in a consolidated balance sheet contribute to the calculation of risks (RWA). Again, in this case, we believe symmetry with financial statement standards to be fundamental. If the proposal is confirmed, minority interest must also then be excluded from the corresponding RWA.

Besides, the Committee's proposal, considered as a whole with that on the full deduction of equity investments in financial entities, would result in situations of contemporary deduction from the capital of the intermediary that holds the investment and from that of the investee company (double counting within the financial system).

Alternatively, we propose the grandfathering of the current situation for a reasonable period, and the end of which, we would maintain the contribution of minority interests to the common equity until the capital requirement as regards the subsidiary is reached. It is important to clarify whether the requirement should be calculated at individual level or as a contribution to the requirement at consolidated level, given the implications that this could have on operations (e.g. infragroup or even on business models). The component in excess should, in any event, be recognised in the capital components of the additional Tier 1 capital.

## **3) Equity investments in other banks, financial and insurance entities (and own shares)**

With regard to the deduction of equity investments in insurance entities, we would like to point out that the current regulations result in distortive effects on competition for conglomerates controlled by banks with respect to those controlled by insurance entities or holding companies, due to the higher capital requirement requested for those controlled by banks, on the basis of the same banking and insurance risk. This contravenes the principle of fair competition and the neutrality of organisational structures.

Whilst awaiting the alignment of supervisory regulations for the banking and insurance sectors, we trust that the new regulation does not envisage the deduction of equity investments in insurance companies.

In fact, while in general terms, we share the position of the Committee as regards the deduction of equity investments in bank and financial entities from the common equity component, in order to avoid situations of double counting of a bank's capital at system level, we likewise retain that this approach is valid and justified only with regard to the banking/financial system and, therefore, limited to investments included in said system, or in any event, to entities subject to the prudential rules dictated by the Committee.

The introduction of the deduction to insurance companies as well, rather than avoid double counting situations, would lead to a penalisation in terms of the overall capital of the banking system, insofar as said investments are outside the scope of the system, as well as being subject to prudential rules that are not consistent with those dictated by the Committee.

As a transitory measure, and only if the above proposal is not an option, we propose to deduct said investments to the extent of 50% from the common equity and 50% from Tier 2 capital, in line with that envisaged by current regulatory provisions<sup>5</sup>. This approach, without touching the provision of not deducting insurance investments up to 20%, is based on the idea of differentiating the implicit risks with respect to equity investments in banking and financial entities; in fact, equity investments in insurance entities, at banking system level, would appear to be more similar to those in industrial entities, for which, we would like to point out, no deduction is envisaged.

The option for a bank of not deduct shares held in other banking, financial and insurance entities, present in the trading portfolio and related to market-making activities, from the common equity component, should, in any event, be maintained for the following reasons:

- the shares are held to hedge trading positions on options on the same stock, therefore with a short-term horizon;
- current legislation in this regard is already restrictive, namely it envisages that the bank that requests exemption from the deduction obligation, as well as waiving its voting rights, also meets other requirements;
- for shares held to hedge trading positions on options on the same stock, the loss in value of the shares held in the trading portfolio would be offset by the profit on the options.

In any event, it should be clarified that the matter of deductions refers to own shares and to equity investments held in other banking, financial and

<sup>5</sup> (i) 50% deduction from Tier 1 capital and 50% from Tier 2 of equity investments in financial and credit entities that exceed 10% of the capital of the investee and of equity investments in insurance companies if such exceed 20% of the capital of the investee and if not acquired before 20 July 2006 and (ii), up to 31 December 2012, deduction from the sum of Tier 1 and Tier 2 capital of equity investments in insurance companies if such exceed 20% of the capital of the investee and if acquired before 20 July 2006.

insurance entities, only with regard to direct exposures (namely assumed through cash instruments or shares) and not to indirect exposures (e.g. *futures* on market indices, for the component corresponding to the weight of the share in the basket of the reference index), unless for the purposes of the prudential requirement, the look-through rule is applied. Alternatively, indirect exposures could be limited to relevant size direct equity investments.

Furthermore, we also believe that the maintenance of the current prudential treatment of subordinated insurance loan transactions is essential, or alternatively, the use of grandfathering (exemption from deduction) for existing transactions, which very often regard bilateral exposures that cannot be settled before the closure of the relationship with the counterparty in question.

**Question 20:** Are the proposed requirements in respect of calls for non-Core Tier 1 and Tier 2 sufficiently robust? Would it appropriate to apply in the CRD the same requirements to buy-backs as would apply to the call of such instruments? What restrictions on buy-backs should apply in respect of Core Tier 1 instruments?

We propose providing the possibility that Tier 1 instruments may include one or more call options solely at the issuer's discretion, to be exercised no sooner than 5 years from the issue date with the prior authorization of the Supervisory Authority and to include the possibility of early redemption before 5 years for regulatory or fiscal reasons (this possibility is not provided by the consultative document).

Authorization for redemption by the Supervisory Authority should allow a compromise between the need for the stability of Tier 1 instruments and the issuer's need to recall an instrument that is no longer efficient because of unforeseen changes to its fiscal, regulatory and/or accounting treatment.

Moreover, regardless of the economic attractiveness, early redemption shall be prevented only in case of capital ratios below the minimum requirements.

With reference then to the subject of the buybacks of Tier 1 instruments, the quantitative type limits envisaged by the CEBS in last December's guidelines are agreed on, aimed at permitting market making activities, with regard to hybrid instruments. In this connection, it is therefore proposed that the sum total of the instruments repurchased and held by the institution, for the purpose of market making, should never exceed 10% of the amount of the issue in question and 3% of the total amount of the hybrid instruments issued by the institution, whichever is the lower.

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

The full recognition of unrealised gains and losses from trading activities is proposed, with the possibility for the supervisory authorities to recognize just the gains relating to assets classified in the trading portfolio for supervisory purposes. This should be envisaged even in the case of a new definition of IAS 39 accounting categories for financial instruments.

### **c) Implications for Large Exposures**

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

We invite the Commission to delete the large exposure discipline once the package of reforms proposed by the Basel Committee will enter in force.

The new rules on the regulatory capital are indeed aimed at strengthening the resilience of the banking sector at global level; therefore we do not see anymore the need to maintain a set of rules which, in addition, constitute a form of overlap with the rules to face the concentration risks under the Pillar Two.

The large exposure discipline is a European set of rules which puts EU banks into a competitive disadvantage vis-à-vis the international competitors, would increase the cumulative burden of the reforms triggered by the recent crisis and, as a result, would hamper the EU banks' ability to finance the real economy. This is in conflict with the G20 aim to reach a single set of international harmonized rules.

If the Commission does not intend to delete the large exposure discipline once the package of reforms proposed by the Basel Committee will enter in force, we believe that the discipline of the large exposures needs to be re-gauged once the new rules on capital come into force.

In particular, with reference to which component of the capital to use for the purposes of identifying Large Exposures and the related limit, as already indicated with regard to the Leverage Ratio, the total regulatory capital is considered more appropriate. The adoption of a measure commensurate with just Tier I, would be excessively restrictive in consideration of the different risk associated with the nature of the exposures vis-à-vis the same counterpart, not necessarily attributable to just capital instruments or Tier I. If such hypotheses are not accepted, it is considered necessary to

proceed with a review of the parameters underlying the identification of the large exposures and the related limit. As a point of fact, the existing rules already sufficiently limit the significant risks which are monitored within the sphere of the regulations on credit risks. A reduction in the reference base not accompanied by an increase in the identification percentages and the limit of the significant exposures would in fact lead to a considerable reduction in the funding capacity of the main players in the economic system. Furthermore, it is believed appropriate to gauge the new levels on the basis of the results of an impact study, aimed at assessing the effects of the proposed change in the financial statements of the banks and on their ability to fund businesses. In any event, for the purpose of permitting the banks to align themselves with the new limit, grandfathering of the current situation for a suitable period would be desirable.

Finally, proportionality remains a principal consideration. We would welcome a clarification by the Commission that its proposed approach would not lead to authorities re-visiting the EUR 150m exemption for inter-bank exposures and the even harder to obtain "case by case" agreement to exposures beyond 100% of own funds, with the consequent risk that these provisions could be removed.

**d) Contingent capital, Minimum capital requirements and predominance, Implementation timing, grandfathering and transitional provisions, Disclosure**

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

We stress that the market for instruments such as contingent capital is not yet developed, so overly stringent guidelines could limit demand for them.

It is in any event believed that the features of the contingent capital instruments should identify instruments with specific features with respect to the other Tier 1 and Tier 2 instruments.

The contingent capital instruments could in fact represent a sort of 'buffer' to be used in the event of the insolvency of a bank with systemic significance: the conversion of these instruments into shares when the pre-established trigger goes off would in fact reduce the cost of a subsequent public intervention for the turnaround of said bank. Within this prospective, the contingent capital could therefore be considered to be a precious instrument also in terms of social utility.

It is important to emphasize how, also in this case, the triggers for the conversion of the contingent capital instruments into core tier 1 should be identified and assessed objectively and in a gaugeable manner, without envisaging margins of discretion. This is for the purpose of avoiding

uncertainties for issuers and investors – with a scant attractiveness of said instruments – as well as potential situations of an unlevel playing field at EU level.

In conclusion, within a Pillar 2 context (in which stress tests are also envisaged among other things), the opportunity of highlighting the contingent capital instruments could be considered also at the time of assessment of the capital adequacy, identifying specific eligibility criteria for said instruments.

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

With regard to the Tier 1 instruments issued up until 31 December 2010, ABI proposes to confirm, on a priority basis with respect to other fulfilments, the regulations on grandfathering already envisaged by Article 154.9 of the 2006/48/EC Directive, as amended by the afore-mentioned 2009/111/EC (CRD2) Directive. These regulations, as known, envisage that the instruments which by 31 December 2010 do not fall within the sphere of application of Article 57, letter a), or do not satisfy the criteria envisaged by Article 63 *bis* can be reckoned, under certain conditions, in the regulatory capital until 31 December 2040.

Moreover, this interpretation appears to be in line with the position of the CEBS<sup>6</sup> which provides the possibility of issuing hybrid Tier 1 securities with equal characteristics to those on the market until December 31, 2010.

With regard to Tier 2 instruments, for which a grandfathering clause is not by contrast envisaged under legislation, it is proposed that, in consideration of the significance of the amount of the outstanding issues of these instruments, regulations similar to those envisaged by CRD2 for Tier 1 be introduced. In other words, the Tier 2 instruments issued by December 31, 2010 should fall within the grandfathering scope and hence be computable, under certain conditions, in the regulatory capital of banks until their natural maturity which, looking at the Tier 2 instruments issued so far by Italian banks, would in any case precede December 31, 2040.

Additionally, to give certainties to banks and more in general to the markets about the various stages of construction of the new supervisory system, there should be a decision as to which treatment is to be applied to hybrid instruments in the period from December 31, 2010 (latest date for issuing hybrid Tier 1 instruments according to current regulations) to the date of

<sup>6</sup> "Implementation Guidelines for Hybrid Capital Instruments" – CEBS, December 10, 2009.

implementation of the regulatory framework illustrated in the consultative document (end 2012).

Taking into account the range of the measures on the capital outlined in the consultative document, it is believed that the grandfathering must also be extended to all the other elements of the regulatory framework which could be subject to review (minorities, limits, deductions, etc.) with specific application methods and timescales, so that the transition to the new regime takes place without the stability of the banking system being prejudiced.

### 3. SECTION III

#### Leverage ratio

**Question 25:** What should be the objective of a leverage ratio?

The leverage ratio should contribute towards containing the level of indebtedness in the periods of elevated economic growth and making up for any shortfalls or imperfections in the internal models for the assessment of the risk, in particular with regard to those developed for particularly complex or innovative financial products.

We believe that a leverage ratio should represent a final and not just transitory Pillar 2 measure, on the basis of which corrective managerial action and, in extreme cases, ad hoc interventions of the supervisory authority could be envisaged.

We would like to underline how the use of the leverage ratio measure within Pillar 2 must appropriately be associated to the adoption of uniform conduct by national Supervisory Authorities in Europe and internationally; the present of diversities in terms of activation times and the entity of corrective measures to be undertaken could have unfavourable repercussions on the achievement of a level playing field.

The possibility illustrated that this indicator could, after appropriate review and calibration, become a Pillar 1 measure, and therefore an integral part of the framework to define the capital requirements of a financial institution, would require, in fact, the structuring of the leverage ratio in a more "risk-based" mode, in order not to generate potential gaps between management measures and measures of regulatory supervision.

We also note that the definition of leverage ratio proposed has some inconsistencies with regard to the operational features of credit cooperative banks, given the objectives stated in paragraph 79 of the consultative document.

In particular, we draw attention to the following specific operational aspects:

- exposure of II level banks to central banks in terms of the indirect fulfilment of compulsory reserve obligations by credit cooperative banks (in the majority of cases, the latter utilise the central reference bank for this purpose);
- off-balance sheet transactions of II level banks in terms of available margins on credit lines granted by I level banks.

With regard to the first point, the provisions of the consultative document would appear to include said exposure in the calculation of total exposure,

even if high liquid assets are excluded from such. In the contrary, we believe that said exposure should be excluded from the calculation of the denominator of the ratio insofar as it is not relevant to the measurement of the degree of leverage of II level banks.

As regards credit lines granted by II level banks to credit cooperative banks, we note that the same fall within the scope of the set of instruments used by the former to centrally manage the liquidity of this category of banks. For this reasons, we believe that using a conversion factor of 100% (and, therefore, not considering the effects of territorial, dimensional and operational diversity of I level banks and the consequent reduced risk of simultaneous interventions by the same as regards II level banks) would lead, once again, to a distortion of the actual degree of leverage of II level banks. We therefore propose that the conversion factors provided by the standardised approach are used for these items.

Lastly, we would like to underline that the adoption of a "non-risk based" measure defined on the basis of the measurement of accounting exposure, requires the extended and harmonised application and use at international level in order to avoid any competitive distortions. Therefore the introduction of supervisory "adjustments" is needed able to effectively offset the differences in the accounting principles adopted in the different "jurisdictions".

**Question 26:** Which element of going concern capital do you consider would be a more appropriate basis for the leverage ratio? What is your rationale for this view?

With reference to what capital measure to use as the numerator of the ratio, we believe that Total capital is the most appropriate figure, precisely due to its effective capacity to cover potential losses. In any event, the use of Core Tier 1 capital appears to be too restrictive.

**Question 27:** What is your view on the proposed options for capturing the overall extent of an institution's derivatives business in the denominator of the leverage ratio?

With reference to the treatment of derivatives, we do not understand the reason for the exclusion of any form of risk mitigation (regulatory netting collateral, in the forms and means envisaged for the calculation of counterparty risk) from the calculation of the leverage ratio. We feel the need to underline that, during the crisis period, regulatory netting proved to be an effective instrument for limiting the propagation of the risk of insolvency of the banks.

In fact, it was actually during the crisis, when the insolvencies emerged, that the possibility of performing netting transactions between credit and

debit positions on derivative OTC contracts, asserting agreements entered into individually and at Group level, significantly lowered the probability that the incapacity of a party to fulfil its obligations could have repercussions on other financial intermediaries and thus compromise the stability of the entire financial system.

Therefore, we believe it reasonable to propose that, in the calculation of the Exposure, derivative contracts are calculated at their fair value, considering the effect of regulatory netting in accordance with the terms under which its is permitted by current prudential supervisory provisions.

If, alternatively, the Committee opts for the use of the fair value and of the "future credit exposure" (so-called "add on" credit), this magnitude would be mitigated by both the effect of the netting and by the effect of the collateral in line with the form and means currently permitted to determine counterparty risk for supervisory purposes.

Furthermore, it is emphasised how in the consideration of the netting or the contribution of the CRM techniques it is appropriate to refer to the regulatory rules and not to the accounting ones, in relation to the lack of consistency currently existing between the accounting rules adopted in different geographic areas. For example, in relation to OTC derivatives, US GAAP envisage the possibility of recognise the value of these contracts on a net basis with reference to the same counterpart or group of counterparts, on condition that a Master Netting Agreement exists. By contrast, IFRS concede the possibility of recognise the value of the OTC derivatives on a net basis under much more limited circumstances: in general, the existence of a Master Netting Agreement is a necessary condition, but not sufficient for highlighting the contribution of the netting in the financial statements.

**Question 28:** What is your view of the proposed approach to capturing leverage arising from credit derivatives?

We agree, for the purposes of the leverage ratio indicator, with the approach that written credit protection sold is included at notional value in the measurement of exposure, as incidentally mentioned in paragraph 206 of the Basel Consultative Document, as one of the key elements for the definition of the ratio (even though no form of recovery ratio is considered). On the other hand, we do not understand, the reason why the possibility of performing netting between protection purchases and sales has to be excluded, when, evidently, the premises exist (same underlying "reference entity", same "reference obligation", specularity of the "credit events" hedged by the protection and of other important contractual terms). In fact, imagining a situation in which a financial entity is called to honour financial commitments assumed with protection sales regarding a certain reference entity without being able to make the corresponding purchases would lead to the following scenario:

- a) a "credit event" for the "reference entity" occurs on which at least one protection sales contract is held and, at the same time,  
 b) a default event occurs jointly for all of the counterparties from which protection was purchased as the subject of potential netting with the written credit protection set forth in point a).

If we extend this example to a portfolio with protection sales on more than one reference entity, the scenario that occurs is that of a multiple joint default of all of the counterparties underlying the protection sales and at the same time of all of the counterparties from which the corresponding protection was purchased.

We believe that, even in the context of a serious financial crisis, this scenario is completely unrealistic, or outlines a situation of a systemic crisis such that even the measures adopted in this paper would not be sufficient to avoid its propagation. Above all, for extensive portfolios usually characterised by the presence of protection sales hedged by corresponding purchases from the same issuer, the above prescription is neither reasonable or acceptable.

Furthermore, as already emphasised, we retain the inclusion of 100% of the notional value of net sales acceptable, as long as limited to the case of single-name credit default swaps, while it cannot be considered reasonable for CDS with an underlying index, even more so if said index is widely diversified (e.g. ITRAXX). In said circumstance, in fact, the contractual obligation triggered by the credit event related to an entity included in the basket of names underlying the index is not equal to the notional value of the contract, but represents a fraction, correlated to the weight of the single component on the index. Again, including credit default swaps written on an index at 100% of their par value in the calculation of the exposure, even if net of any nettings with relative purchases, corresponds to a scenario in which all of the issuers included in the index would jointly suffer a credit event.

On the basis of the above considerations, we would like to make the following proposals:

- with regard to single-name credit default swaps, the application of the regulation proposed by the Committee of selling credit protection quantified on a net basis, allowing the possibility of netting with the corresponding bought credit protection, if specific requirements are met, such as the correspondence of the "reference entity" and other important contractual aspects;
- with regard to derivatives on widely diversified and liquid credit indices, we propose to apply the regulation envisaged by the Committee for the other credit derivatives (fair value criteria) and, therefore, for the purposes of calculating the leverage ratio, not to include them in credit derivatives. The definition of widely diversified index could be identified on the basis of the following criterion (already met by the main market indices):

- existence of a minimum number of components of the index (e.g.  $\geq 20$ );
- limited concentration, i.e. each component must not have a weight in the index above an established threshold (e.g.  $\leq 5\%$ ).

**Question 29:** How could the design of the leverage ratio ensure that it would act as an effective constraint only in benign economic conditions?

The need to gauge the indicator is agreed upon for the purpose of rendering it binding in just phases of elevated economic growth without this involving destabilizing processes of forced/accelerated deleveraging in periods of crisis. A possible solution could be that of rendering it effective only in the case that the bank reveals an increase in the exposures during the period (assets, derivatives and off-balance sheet items) or, alternatively, defining it gradually in relation to the growth rate of the exposures.

**Question 30:** What would be the appropriate calibration of a leverage ratio?

We believe that the indicator must be "calibrated" so that it is more stringent for the categories of intermediaries that most tend to exploit financial leverage and only in growth stages of the economy.

## 4. SECTION IV

### Counterparty credit risk - Possible amendments to the counterparty credit risk framework

- a) **Improved measurement/ revised metric to better address counterparty credit risk (including wrong-way risk, mark-to-market losses due to credit valuation adjustments, highly leveraged counterparties and firms' own estimate of Alpha)**

**Question 31:** Views are sought on the suggested approach regarding the improved measurement or revised metric to better address counterparty credit risk. With respect to suggestion to incorporate - as an interim measure - a simple capital add-on by means of calculating the loan-equivalent CVA charge, views are sought on the implications of using VaR models for these purposes instead.

We would like to highlight that, especially when using internal models, the preliminary results of the Quantitative Impact Study (QIS) show a significant increase in the capital requirements with respect to bilateral exposures due to the proposed calculation methodology that requires the application of multiplication factors thereby creating a multiple amplification on the final requirement.

We believe that the incentives to use IMM models instead of Loan Equivalent method to address counterparty risk, should be maintained. Actually an IMM based on VAR measure could in a more effective way:

- compute the credit exposure considering the volatility of the relevant underlying risk factors;
- capture diversification effects across different counterparties and between market factors and credit factors;
- account for maturity considering the effective maturity of the derivative exposures.

**Question 32:** Stakeholders are invited to express views on whether the use of own estimates of Alpha should continue to be permitted subject to supervisory approval and indicate any evidence in support of those views.

We request clarification as to whether "Stressed VAR" and Alfa increases are complementary or alternative. Any contemporary application could lead to technical difficulties in calibration and, most importantly, double counting.

- b) **A multiplier for the asset value correlation for large financial institutions**

**Question 33:** Views are sought on the suggested approach regarding the multiplier for the asset value correlation for large financial institutions, and in particular on the appropriate level of the proposed multiplier and the respective asset size threshold.

In addition, comments are sought on the appropriate definitions for regulated and unregulated financial intermediaries.

#### **c) Collateralised counterparties and margin period of risk**

**Question 34:** Views are sought on the suggested approach regarding collateralised counterparties and margin period of risk. Views are particularly sought on the appropriate level of the new haircuts to be applied to repo-style transactions of (eligible) securitisations. In this context, what types of securitisation positions can, in your view, be treated as eligible collateral for purposes of the calculation of the regulatory requirements? Any qualitative and/or quantitative evidence supporting your arguments would be greatly appreciated.

#### **d) Central counterparties**

**Question 35:** Views are sought on the suggested approach regarding central counterparties and on the appropriate level of the risk weights to be applied to collateral and mark to market exposures to CCPs (on the assumptions that the CCP is run to defined strict standards) and to exposures arising from guarantee fund contributions.

We believe that the zero-risk weighting of exposures in derivative contracts cleared by central counterparties provides in itself a strong incentive to use CCPs.

The introduction of further penalties for contracts cleared bilaterally could create excessive disparities in the treatment of the various types of contract (e.g. between those eligible to be cleared by CCPs and those not considered such), threatening the competitiveness of the financial market and compromising the capacity to efficiently manage the risks assumed.

**Question 36:** Views are sought on the risk management elements that should be addressed in the strong standards for CCPs to be used for regulatory capital purposes discussed above. Furthermore, stakeholders are invited to express their views whether the respective strong standards for CCPs to be used for regulatory capital purposes should be the same as the enhanced CPSS-IOSCO standards.

First of all it should be noted that imposing specific requirements might substantially affect compliance costs that the CCPs would have to incur.

Consequently it is necessary to conduct a careful cost and benefits analysis before adopting such measures.

We agree with the need to set organizational and operational requirements to regulate CCPs activity, given the risk inherent to the activity carried out by the CCPs and the potential systemic influence they can have.

To this end, the use of the CPSS-IOSCO requirements as a model to create a regulation for CCPs activity would be a good solution. Such requirements were made to harmonise CCP regulation in Member States and should be modified in such a way as to make them suitable for European CCPs activity that involves certain major systemic risks.

The implementation of an appropriate regulation for European CCPs could be inspired from national regulations on central counterparties in force in Member States. For example, Italian national legislation on central counterparties provides for, inter alia, organizational requirements such as minimum capitalization, adoption of margins, internal control systems, risk management measures and organizational tools for conflict of interest management.

#### **e) Enhanced counterparty credit risk management requirements**

**Question 37:** Views are sought on the suggested approach regarding enhanced counterparty credit risk management requirements.

Do the above proposed changes to the counterparty credit risk framework (in general, i.e. not only related to stress testing and backtesting) address fully the observed weaknesses in the area of risk measurement and management of the counterparty credit risk exposures (both bilateral and exposures to CCPs)?

Turning to more technical aspects, we also emphasise that for the purposes of calculating Exposure at Default (EAD) and the application of the Bond Equivalent method, **the contribution of the Credit Risk Mitigation technique, represented by collateral, cannot be ignored.** During the crisis, collateral, together with netting, proved to be a particularly effective tool to limit the spread of counterparty risk and to diminish the resurgence of systemic risks within the financial system. It was precisely in the period of the crisis that the management of collateral and in particular of high quality collateral, represented by cash, became extremely active and intense: more specifically, we refer to the frequency of collateral margination (for example from monthly to weekly, from weekly to daily) and to the reduction of the threshold above which the obligation to make payments is triggered. A revision in more restrictive terms of the conditions contained in the Credit Support Annexes has generally required very short timeframes, by virtue of the flexibility associated to the bilateral nature of

the agreements and the interest shown by the same counterparties to reinforce safeguards against counterparty risk.

In addition, with respect to the Bond Equivalent Method and for banks adopting non IMM based approaches, we are of the view that the maturity should be set a follows:

- for collateralized exposures, the maturity of the derivative exposure toward a counterparty should be equal to the margining period;
- in absence of collateral arrangements, the maturity of a derivative contract should be no longer than the break clause term, if stated in the contract, and the maturity of the overall derivative exposure toward a counterparty should be computed as the weighted average maturity of the contracts included in the exposure.

## 5. SECTION V

### Countercyclical measures

We believe it is premature at this time, on the basis of the information currently available, to define capital buffers. We agree the need to amend the accounting rules for including the expected losses in the provisioning.

#### **PART 1 - THROUGH-THE-CYCLE PROVISIONING FOR EXPECTED CREDIT LOSSES**

##### **a) Expected Cash Flow method (ECF), incurred loss and IRB expected loss**

**Question 38:** The Commission services invite stakeholders to perform a comparative assessment of the three different methods (ie ECF, incurred loss and IRB expected loss if it could be used for financial reporting) for credit loss provisioning from 2002 onwards based on their own data.

The comparative assessment and the results deriving from the application of the three different models will possibly be sent to the Commission directly by the banks, since this is sensitive and confidential information.

##### **b) Assessing through the cycle approaches**

**Question 39:** Views are sought on the suggested IRB based approach with respect to the through-the-cycle provisioning for expected losses as outlined above.

The model proposed by the EBF "ELLP model" (Expected loss through the life of the portfolio") is considered preferable.

Furthermore, it is hereby indicated that the need to determine additional countercyclical measures may only be established at a time subsequent to that when the reference accounting model is determined by the IASB.

In this connection, the need to pursue an alignment between accounting and regulatory rules, as well as the adoption of models which are not excessively sophisticated or complex, is depicted. This undertakes particular importance for the smaller banks, such as cooperative credit banks, which use the standardized method for regulatory purposes.

## PART 2 - CAPITAL BUFFERS AND THE CYCLICALITY OF MINIMUM REQUIREMENTS

### a) Capital Conservation Buffer and Counter-cyclical Buffer

**Question 40:** Do you agree with the proposed dual structure of the capital buffers? In particular, we would welcome your views on the effectiveness of the conservation buffer and the counter-cyclical buffer, separately and taken together, in terms of enhancing the resilience of banking sector going into economic downturn and ensuring the flow of bank credit to the "real economy" throughout economic cycle.

The first phase for the collation of data for drawing up the QIS reveals that the scarcity of available data sets serious limits with regard to the correct assessment of the cyclicity.

As shown in the Basel Consultative Document, there is a direct relationship and coherence between the use of risk-sensitive metrics and the cyclicity of capital requirements. In the light of the current state of the economic cycle, it is not yet possible to verify whether this phenomenon will necessarily translate into a contraction of the credit available to the economy in situations of increased counterparty risk.

We therefore believe it is premature at this time, on the basis of the information currently available, to define potential capital buffers. Only in the next few years will we be able to assess whether the current situation can be considered the negative stage of an economic cycle or as, more probably, an *outlier* that can instead be used as an indicator of a period of stress useful with the ambit of Pillar 2.

The Basel proposal appears to refer to the buffer related to "excessive credit growth" as an increase of the buffer related to the "credit conservation range". The two measures should therefore be seen in a single context.

Lastly, there are problems of interpretation regarding the periods of coexistence of the two measures: for example, it is not clear whether the conservation standards should be applied to the sum of the two buffers. In addition, for both, there is no indication of the computability of the capital held to cover the buffer for the purposes calculating the ratio and the quality of capital that should cover requirements.

**Question 41:** Which elements should be subject to distribution restrictions for both elements of the proposed capital buffers and why?

**Question 42:** What is the appropriate timing – following the breach of capital buffer targets – for the restriction to capital distributions to start? Should the time limits for reaching capital buffer targets be determined by supervisors on a case-by-case basis or harmonised across EU?

We believe that indicating the lack of distribution of profit as the main means to rebuild "depleted buffers" in preferential and coercive terms, is an inefficient constraint, as this measure – within the scope of Pillar 2 – represents, instead, the last to be taken after having checked whether the other solutions described by the legislator in the same section are feasible.

It would be preferable, instead, for the supervisory authorities to indicate a range to be reached/maintained in a defined time interval, leaving the intermediary the choice of which measures to take and how to graduate said measures (to be discussed with the supervisory authority as part of the "capital planning process").

In this way, a substantial role would also be assigned to the lever represented by "disclosure", where specific obligations to inform the market regarding levels of capitalisation and coherence with the requested buffers, as well as the action plans (reorganisation/optimisation of the credit portfolio, sales, capital increases etc.) to be implemented to respect the authority's deadlines would guarantee, through market regulations, a greater chance of success.

On the contrary, conditions could be created in which, to avoid restrictions to dividend distribution policies (which would have a direct impact on share prices) intermediaries use sudden/ad hoc measures on loans/RWA, emphasising procyclical dynamics.

Furthermore, it should be noted that targeted dividend distribution policies, even in contexts of non-optimal levels of capitalisation, can represent useful, if not indispensable, bases (prerequisites) for the success of future share capital increases.

For the reasons outlined above, this measure, at least in the early period of implementation of the new regulation, should only be envisaged within the scope of Pillar 2, changing the current rules to create a single framework able to regulate the capital adequacy of banks.

Lastly, we would like to mention the need for the proposals regarding buffers to take the peculiarities of models into due consideration, such as that of credit cooperatives, which already incorporate a capital conservation system represented by the obligation of allocating 70% of profits to a reserve and that have structural and legal limitations to their capacity to set in place share capital increases. Therefore, under these circumstances, we believe that the time limits for the recovery of the target buffer must be decided by the Supervisory Authority on a case-by-case basis.

**Question 43:** What is the most suitable macro variable (or group of variables) that may be used in the counter-cyclical buffer to measure the dynamics of macro-level risks pertinent to the banking sector activities?

At the moment, we are not able to indicate macro variables (or group of variables). In any case, we believe that, where possible, the indicators defined at jurisdiction level, should be gauged on the basis of the operating characteristics of the individual banks, such as, for example, the size and the lending context.

**Question 44:** What are the relative merits and drawbacks of capital buffers versus through-the-cycle provisioning for expected losses with respect to minimising procyclical effects of current EU banking regulation?

Mention is made of the inconsistency between the presence of countercyclical buffers and the mechanism for deducing the excess of the expected loss with respect to the provisions, which must be eliminated in the event that the additional capital requirements effectively activate.

#### **b) Cyclicity of the minimum requirement**

**Question 45:** Do you consider that it would be too early to fully assess the cyclicity of the minimum capital requirement?

As mentioned above, the first phase for the collation of data for drawing up the QIS reveals that the scarcity of available data sets serious limits with regard to the correct assessment of the cyclicity.

We think it is necessary to draw attention to the fact that there are already factors in the current regulatory system that contribute to mitigating the procyclical impact of Basel 2. We refer in particular to:

- the use of long-term time series to calibrate risk parameters (for the default rates);
- the use of "long-term" logic when determining the input factors needed to determine risk parameters;
- the use of "downturn" factors to estimate LGD;
- the use of a fixed percentage of Basel 1 as a floor for capital requirements.

Therefore, for many banks (particularly commercial banks), the safeguards already in place both in terms of capital buffers (total capital ratio > 8%) and in terms of the prudential nature of risk measurement metrics (long term data horizons to estimate PD, downturn LGD, etc..) would appear to have already acted as effective factors to limit procyclicality phenomena.

This means that the activation of new measures could introduce excessive restrictions to risk management, from a "non-sensitive risk" perspective.

## 6. SECTION VI

### Systemically important financial institutions

**Question 46:** What is your view of the most appropriate means of measuring and addressing systemic importance?

**Question 47:** How could the Commission services ensure a consistent prudential treatment of systemic importance across financial sectors and markets?

## 7. SECTION VII

### Single rule book

#### a) Areas where more stringent requirements are necessary

**Question 48:** In which areas are more stringent general requirements needed given national or other circumstances? Is Pillar 2 a sufficient tool to address specific negative circumstances at credit institutions and if not, how could it be strengthened?

#### b) Treatment of real estate lending

**Question 49:** What is your view of the suggested prudential treatment for exposures secured by mortgages on residential property outlined above? What indicators and their respective values do you consider appropriate as possible preconditions for the application of the preferential treatment of exposures secured by mortgages on residential property?

**Question 50:** What is your view of the suggested prudential treatment for exposures secured by mortgages on commercial real estate outlined above? What indicators and their respective values do you consider appropriate as possible preconditions for the application of the preferential treatment of exposures secured by mortgages on commercial real estate? In particular, are additional preconditions needed to ensure the soundness of this treatment? Do you believe that the existing preferential risk weight applied to exposures secured by mortgages on commercial real estate should be increased? For both questions, any qualitative and/or quantitative evidence supporting your arguments would be greatly appreciated.

**Question 51:** Should the prudential treatment for exposures secured by mortgages on residential property be different from the prudential treatment for exposures secured by mortgages on commercial real estate? If so, in which areas and why?

In principle, the European Commission's efforts aimed at further harmonizing the prudent rules with the end purpose of creating a single rule book are shared. Nonetheless, it is pointed out that the options and the national discretionary factors reflect the specificities of the products and the market conditions in the various countries; this takes on particular importance with reference to the real estate property market which does not appear to be sufficiently standardized at European level. Therefore, it is believed that the current regulations envisaged by EU Directive 2006/48 must continue to be applied. In this connection, it is highlighted that all the regulations established by the prudent legislation of the Bank of Italy for the exposures guaranteed by residential and commercial real estate properties, revealed themselves to be adequate within a prudent perspective consistent

with the characteristics of the Italian real estate property market also within a negative economic context such as the current one.

**Question 52:** What is your view of the merits of introducing measures that would help to address real lending throughout the economic cycle? Which measures could be used for such purposes? What is your view about the effectiveness of the possible measures outlined above?

It is believed that the hypothesised introduction of countercyclical measures with specific reference to the credit guaranteed by real estate properties is not appropriate in a context where other regulatory measures are envisaged aimed at reducing the procyclical nature of the banking activities.

**ABI comments on Commission Services staff working document:  
"Possible further changes to the capital requirements  
Directive"**

**Abi Technical attachment**

**Liquidity**

**April 2010**

Page	Paragraph	Document text	Comments, Queries, Proposals and Requests for reviewing the text alongside	Supporting documents (records, examples, literature, etc.)
<b>LIQUIDITY COVERAGE REQUIREMENT</b>				
STOCK OF HQLA				
		<p>Characteristics of high quality liquid assets:</p>	<p><b>Comment</b> The fundamental characteristics and the market-related characteristics described in the paragraph, despite being representative for the definition of marketable securities, are difficult to transpose in the form of objective and standard operating criteria. For example: what does central bank reserves mean? How can the market concentration be gauged quantitatively? Or: does the reference to "developed and recognised exchange markets" exclude the possibility of the presence of stable OTC listings?</p> <p><b>Proposal</b> We believe that it is indispensable, as is currently done weekly by the ECB, that a single body (or several bodies at individual jurisdiction level or unions of states in the case of the EU) produces a list of eligible securities with the related haircuts - also for the purpose of avoiding operating errors in the reporting of the criteria. It should be considered that the assessments requested are based on public data and therefore can be carried out for all the parties concerned by a single party, a circumstance which would facilitate the entire system. The identification of a single body worldwide would also</p>	<p>Remarks discussed at FBE level. It would be essential, therefore, for central banks to agree amongst themselves, as a basic principle, that each of them should be prepared to provide liquidity (subject to appropriate haircuts) if "good" collateral is available, irrespective of the location of the collateral. This means that, if no sufficient collateral were available at the host country's central bank, it should accept to provide liquidity to the bank on the basis of the collateral which the latter has made available to a central bank located in another country.  At the same time, work should be undertaken to</p>

<sup>1</sup> Since beginning of 2007 banks loans responding to specific criteria are eligible for ECB open market operations.

			<p>sort out level playing field issues: different nations, on this point, could norm in a different manner. Subordinately, several bodies at individual jurisdiction level could in any event sort out any differentiated assessments between banks in the same jurisdiction.</p> <p>The issue of a list or several lists should facilitate the retrieval of liquidity from a central bank also in the face of collateral present at another central bank (see alongside).</p> <p>The rationale of the equation liquidity = eligibility is based on the main feature of the Euro area financial system. The prominent role of Euro area banking loans to finance private sector (households and non financial corporate sector) and the lower recourse to external capital markets by banks is one of the factors which explains why the Eurosystem accepts a wide range of collaterals<sup>1</sup>. In addition, the existence of differences in the characteristics of governments bonds in the Euro-area from a liquidity as well as a risk perspective, together with the need to ensure a level playing field, contributes to explain a "wider" eligibility criteria compared to US. Last but not least, EU Treaty, banning monetary financing to the public sector, makes even more compelling the need to recourse to a wide range of collateral for the implementation of monetary policy</p>	<p>achieve a common definition of what "good" collateral means and, moreover, to allow for "good" collateral denominated in major foreign currencies to be more readily accepted as it is today.</p> <p>We, therefore, expect the final version of the Committee's Paper to provide an outlook of the work that the Basel Committee intends to undertake jointly with the central banking community in this area.</p>
	<p>ANNEX I: Possible specification of the Liquidity Coverage Requirement</p>	<p>Qualifying marketable securities from sovereigns, central credit institutions, public sector entities, and multi-lateral development banks that could receive a 0%</p>	<p><b>Query.</b> It is not clear in the text whether the category includes the issues of debt agencies guaranteed by sovereign states. Confirmation on the point would be desirable considering the relevance and the high liquidity of said issues on the Eurobond market (in particular, German securities: e.g. KfW)</p>	

	risk weight for credit risk under the standardised approach		
Annex I e Annex II	As far as External rating is concerned	<p><b>Query</b></p> <p>It is not clear whether the rating (or indirectly the risk-weight) refers to at least one ECAI or to the average of the rating expressed by several ECAI. In the event that possible non-agreeing opinions of several ECAI should be mediated according to the current rules - or in the case of two banks which each use only one ECAI but which are however different from each other, there could be the eventuality of the same asset completely eligible for one bank but totally non-eligible for the other. This consideration would also be in favour of a double tier for the sovereign securities like for the corporate securities or (for all the possible assets) an approach like that proposed by the CEBS July 2009.</p>	
<b>Cash Outflows over 30 days under the regulatory stress scenario, taking into account the earliest possible call or termination date for the funding</b>			
Annex I	"stable deposits that are both covered by an EEA deposit insurance scheme.."	<p><b>Query</b></p> <p>Is reference made here to the Guarantee of the Depositors by the Interbank Deposit Guarantee Fund (up to Euro 103,291.38 Euro)? Or is it necessary to refer to a different type of guarantee /insurance on the deposits?</p>	Italian Decree Law No. 659 dated 4 Dec. 1996
Annex I	"stable deposits that are both covered by an EEA deposit insurance scheme (or a non-EEA scheme recognised as effective by competent authorities) and are made in	<p><b>Comment</b></p> <p>In general, the rules provided for the estimation of outflows look too prescriptive and detailed. The implied necessary data-mining effort may be excessive, if compared to the expected results ( " - the depositors have other established relationships with the same bank which make deposit withdrawal highly unlikely; or          - the deposits are in transactional accounts (e.g. accounts where salaries are automatically</p>	

	<p>transaccional accounts (e.g. accounts where salaries are automatically credited) or the depositors have other established relationships with the same bank which make deposit withdrawal highly unlikely”</p> <p>“less stable retail deposits [additional sub-categories to be determined]”</p>	
	<p>credited).”). The potential inconsistency with the First Pillar legislation for retail exposures should be pointed out, with regard to which not only are specific splits not proposed, but indeed explicit reference is made to “all-in” or “in pool” handling. It is not clear why an all-in handling for the assets is permitted while by contrast a very in-depth analysis of the liabilities is required for the same customer.</p> <p><b>Queries</b></p> <p>a) It is important to precisely define the concept of “stable deposits” (e.g. is it necessary to have a mortgage loan or the crediting of the salary or are other forms possible?).</p> <p>b) The same naturally applies to “less stable deposits” when dealing with “high value deposits, deposits of sophisticated or high net worth individuals and deposits which can be withdrawn quickly (e.g. internet deposits)...as determined by each jurisdiction”.</p> <p>c) In the parts relating to the Retail deposit run-off, explicit reference is made to the handling of the bonds subscribed by retail;</p> <p><b>Proposal</b></p> <p>It is deemed appropriate that the stable component of the on-demand deposits can also be estimated by the individual institution, so that the features of each individual intermediary (traditional retail bank versus on-line bank) can be correctly reflected. Subordinately, in the event internal methods are not used, it would be appropriate to weigh the on-demand deposits of the commercial banks differently with respect to those made by the on-line banks. Specifically, since the deposits of the on-line banks can more easily be “withdrawn” by the customers with respect to those of the commercial banks, it is plausible to imagine a lower instability ratio for the latter.</p>	

Annex I	15% or higher for possible sub-categories	The percentage of 15% determines important volumes for commercial banks		
Annex I	other legal entity customers and sovereigns, central banks, and PSEs without operational relationships: 100%	<b>Query</b> Interpretative doubts arise on how to handle the market funding CD/CP, given the specificity of this market.		
Annex I	other legal entity customers and sovereigns, central banks, and PSEs without operational relationships: 100%	<b>Comment</b> The provisions risk having an extremely significant impact on the maturities within the month of the interbank market with the risk of an essential reduction in the related liquidity and therefore serious impacts on the ordinary operating of the system.  It should be recalled how, also during the more acute moments of the crisis, the Italian institutes generally were able to resort continually to the interbank market, also on shorter maturities. <b>Proposal 1</b> The provision of a weighting lower than 100% is hoped for, possibly with concentration limits, for all forms of loan received from financial institutions with a maturity of less than one month. <b>Proposal 2</b> With regard to the Italian market, it should also be specified in the text that the term fiduciaries does not include the "static" fiduciaries which could be placed on the same footing as HNWI.		
Annex I	other legal entity customers and sovereigns, central	<b>Comment</b> With regard to second level banks (e.g.: Iccrea Banca, Casse Centrali di Trento e di Bolzano, etc.),		

	<p>banks, and PSEs without operational relationships: 100%</p>	<p>the provision of a ratio of 100% against the funding from first level banks (BCC) could be extremely penalizing and not representative of the effective liquidity position. The short-term funding available at the second level banks, handled at centralized level, in fact represents the Category liquidity, with overall stability features which makes them similar to the customer deposits of the first level banks.</p> <p><b>Proposal</b> It is therefore proposed that a similar treatment be envisaged for the cooperative lending banks network to that indicated in the European Commission consultation paper (CRD IV) for the groups referred to in paragraph 23.</p> <p>Secondarily, we ask that such treatment is envisaged where a banking protection system has been adopted in accordance with article 80.8 of Directive 2006/48/EC.</p> <p>In the event that the above proposal cannot be accepted it is proposed that a specific ratio for this case be envisaged, similar to those envisaged in the Basel Committee Proposal at points 41 (b) and 48 for less stable deposits from retail and small business customers, equal to 15%</p>	
	<p>Annex I</p> <p>Secured funding</p>	<p><b>Comment</b> It is considered appropriate to introduce, in addition to the distinction by underlying type, a distinction of the handling by type of Counterpart as well.</p> <p>The point is crucial in particular with reference to the handling of the refinancing P/t with central banks, where a wider perimeter of eligibility than that of the Liquidity Buffer exists (e.g. Credit claims)</p> <p><b>Proposal</b> The run-off percentages of the collateralized funding could be further differentiated, besides by type of collateral, also by type of counterpart also</p>	

			envisaging intermediate values between the extremes 0%, 100%, e.g.:																	
			<table border="1"> <thead> <tr> <th></th> <th>Central Banks</th> <th>Wholesale</th> <th>Retail</th> </tr> </thead> <tbody> <tr> <td>Government securities</td> <td>%</td> <td>%</td> <td>%</td> </tr> <tr> <td>Other eligible assets c/o Central banks</td> <td>%</td> <td>%</td> <td>%</td> </tr> <tr> <td>Other assets</td> <td>%</td> <td>%</td> <td>%</td> </tr> </tbody> </table>		Central Banks	Wholesale	Retail	Government securities	%	%	%	Other eligible assets c/o Central banks	%	%	%	Other assets	%	%	%	
	Central Banks	Wholesale	Retail																	
Government securities	%	%	%																	
Other eligible assets c/o Central banks	%	%	%																	
Other assets	%	%	%																	
Annex I	a downgrade of up to 3-notches	<b>Query</b> It is not clear how the collateral must increase after the event.		Estimation methods with internal models or pre-established percentages																
Annex I	Market valuation changes on derivatives transactions requiring additional collateral/margin: treatment still to be determined	<b>Proposal</b> The point seems to refer to just collateralized exposures, since they are liable to determine collateral requests by the counterpart: it is necessary that this sphere of application be specified in the text.																		
Annex I	Currently undrawn portion of committed credit and liquidity facilities to: - retail clients - non-financial corporates; credit facilities	<b>Comment</b> Inconsistency between inflows and outflows. The application of run-off percentages on the part of the facility not yet used emerges as highly penalizing, given the possibility of revoking the facility or at least not permitting further drawing. <b>Proposal 1</b> Take the run off of retail clients and "non-financial corporates; credit facilities" and considerably reduce the percentages of non-financial corporates; liquidity facilities" and of other legal entity customers.																		

	<p><b>Proposal 2 (for second level banks)</b>          With regard to second level banks (e.g.: Iccrea Banca, Casse Centrali di Trento e di Bolzano, etc.), the provision of a ratio of 100% relating to the available margins on lines of liquidity to first level banks (BCC) would be extremely penalizing in relation to the territorial, dimensional and operating diversification of the Category banks and therefore to the scant probability of the occurrence of a simultaneous drawing of the facilities granted. Therefore, it is proposed that a specific ratio of 20% be envisaged for this case.</p>		
	<p><b>Queries</b>          Many queries emerged from the analysis of these paragraphs. In particular:</p> <ul style="list-style-type: none"> <li>○ some practical examples of committed credit lines and committed liquidity lines would be most welcome</li> <li>○ "Other cash outflows – Any other contractual cash outflows should be captured in this metric, such as principal and interest due and planned derivative payables": not easily and objectively quantifiable. In detail, it should be clarified whether, with regard to the flows of the derivatives, reference is only made to those determined with certainty (by date and amount) or also those uncertain (determined with certainty with regard to the date but not the amount).</li> </ul> <p><b>Proposal</b>          For the purpose of pursuing greater consistency in the application of these provisions (at international as well as domestic level) as well as facilitating the operative implementation, we propose - as has already been done for other parts of the document - drawing up a reference table/list with indication of</p>	<p>Currently undrawn portion of committed credit and liquidity facilities</p>	<p>Annex I</p>

			the types of handing for each case (possibly to be up-dated periodically).	
	Annex I	Cash Inflows Amounts receivable from retail counterparties  Amounts receivable from wholesale counterparties	It is not clear whether, in addition to the amounts relating to performing bonds maturing in the period, also those relating to amounts withdrawable on demand vis-à-vis the indicated parties can be considered available within the timescale of 30 days.  <b>Proposal</b> Confirmation in the sense indicated is hoped for	
<b>NET STABLE FUNDING REQUIREMENT</b>				
	Annex II	Net stable funding requirement	<p><b>Comment</b> Despite considering the introduction of a net stable funding requirement to be combined with a liquidity coverage ratio so as to avoid the so-called "cliff-effect" to be correct, we believe it is also appropriate not to frame it within a stress test analysis context given the structural nature of this indicator. Therefore, we would like to request the Committee to take into consideration a solution which, with the appropriate changes and reviews, would emulate Italian legislation on the transformation of maturities in force until some years ago. See right column.</p> <p><b>Proposal</b> <u>With regard to the cooperative lending banks network, to the extent that they may apply please refer to the considerations already expressed in relation to the LCR</u></p>	<p><b>References</b> The regulations with regard to the transformation of the due dates have been laid down by the Bank of Italy in its Instructions (see Section IV, part 7) and subsequent amendments introduced under the Supervisory Bulletin No. 12/2003. In short, there are two rules aimed at ensuring an adequate balancing of the maturities of the assets and liability items: 1): IMMOB + PART &lt;= PATRIM<sup>2</sup> (general limit on the undertaking of fixed assets and equity)</p>

<sup>2</sup> Where: **IMMOB** = Fixed assets; **PART** = Equity investments; **PATRIMON** = Equity.

			investments) 2): $ATTL + 0.5 (ATTM)$ $<= AV1 + FP + PASSL + 0.5 (PASSM) + 0.25 (PACBR+INTB)^3$ In essence, No. 2) makes it possible to finance the medium-term assets using short-term funding for a maximum percentage of 50% of the former and the long-term assets for a maximum percentage of 25%.
Annex II			<b>Query</b> What percentage are bonds issued by the Bank subject to?
Annex II	Sources of stable funding available for purposes of the requirement Availability Factor		<b>Query</b> There is no explicit reference to the handling of the securities subscribed by retail customers
Annex II	"...all other assets"		<b>Query</b> It appears as a residual item, whose content could be more fully clarified (for example: are real estate to be included?)
Annex II	Rated AA		<b>Query</b>

<sup>3</sup> Where: **ATTL** = Assets with a residual duration of over 5 years **ATTM** = Assets with a residual duration of over 18 months and equal to or less than 5 years; **AV1** = Surplus (positive or negative) deriving from the application of rule 1; **FP** = Permanent funds; **PASSL** = Liabilities with a residual duration of over 5 years; **PASSM** = Liabilities with a residual duration of over 18 months and equal to or less than 5 years; **PACBR** = Liabilities from customers with a residual duration equal to or less than 18 months; **INTB** = Interbank liabilities with duration established between 3 and 18 months (for example: certificates of deposit and restricted deposits).

		What else has to be done in the event of split rating?	
Annex II		<p><b>Query</b> Securitization transactions are not listed; therefore does a RMBS of home mortgage loans with AAA rating also fall within the RSF 100%?</p> <p><b>Query</b> Within which category must on-demand exposures to retail and non-financial corporate customers be placed for the calculation of the Net Stable Funding Ratio?</p> <p><b>Comment</b> Given the current NSFR scheme, on-demand loans could be included under the items "Loans to non-financial corporate clients having a residual maturity &lt; 1 yr" and "Loans to retail clients having a residual maturity &lt; 1 yr". However, the above items have been assigned percentages (50% and 85%) - representative of the portion to be financed with stable funding - which appear excessively high given the nature of the instrument. When determining the specific percentages, account must be taken of not just the behavioural hypotheses of rollover of the drawings, but it must also be considered that the bank, in a situation of stress, could decide to adapt its business model (e.g. by scaling down its activities).</p> <p><b>Proposal</b> In the event of use of internal models for LCR which estimate the on-demand loans which will fall due within the year in a percentage of x% and those which will fall due beyond the year in (1-x%), it is proposed that (1-x%) be the percentage to be used in place of 85%</p>	
Annex II	Argomento: Trattamento degli Impieghi a vista nel NSFR		

	Annex II	Listed equity	<p><b>Comment</b> We ask for confirmation that the “listed equity” are non included among assets to be financed with funding if durations are longer than one year. The listed equities, if not referring to equity investments, should be included (albeit with appropriate haircuts) among the liquid assets. Equal treatment should be reserved for corporate securities with a rating less than AA but investment grade and Gold.</p> <p><b>Proposal</b> Scale these groups of Assets to the RSF equating to 20%</p>	
	Annex II	Securities issued by banks	<p>On a similar basis to the matters indicated with regard to LCR, the request to fully finance beyond one year all the securities issued by banks or insurance companies appears excessive and could cause significant direct impacts on the market of the debt issued by the banks and on the liquidity situation of said banks.</p> <p><b>Proposal</b> The provision of a RSF Factor lower than 100% is hoped for, envisaging appropriate concentration limits, also with reference to rating classes.</p>	
	Annex II		<p><b>Comment</b> The classification of certain instruments among the cases considered less liquid does not appear to be entirely consistent.</p> <p><b>Proposal</b> A sole weighting at 50% for loans with a maturity of less than 1 year would be desirable, irrespective of the nature of the debtor</p>	
	Annex II	Table 2 - All other assets not included in	<p>It is not clear whether in this item the Fair Value of the derivatives recorded in the financial statements</p>	

		<p>the above categories: 100%</p>	<p>should be included. If yes, the value to be stated should certainly be the positive fair value net of the corresponding negative fair values, at least for the counterpart admitted to the regulatory netting. The netting also by similar types of trade or by segment or maturity would also be desirable. Note that, paradoxically, not permitting the netting for such purposes would require the banks to finance asset items which are already financed by corresponding and correlated liability items, using other sources.</p> <p><b>Proposal</b> (....) With reference to the positive fair value of derivatives included among the assets in accordance with the relevant accounting principles, the RSF Factor is applied to the difference, if positive, between (i) such amount and (ii) the corresponding negative fair value recorded among liabilities, when regulatory netting is allowed under the current Basel II framework.</p>	
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## Memorandum

### **Privileged and savings shares**

Privileged and savings shares represent equity instruments, suitable for achieving the full transfer of the business risk both in the event of insolvency of the issuing banks and if the business is a going-concern. Therefore, reasons do not exist for the exclusion of the privileged and savings shares from the primary component of banks' supervisory capital (so-called common equity).

### **Origin and features of the privileged shares and the savings shares**

Privileged shares are disciplined by Article 2351.2 of the Italian Civil Code, with regard to which:

*“Subject to the matters envisaged by special laws, the Articles of the statute can envisage the creation of shares without voting rights, with voting rights limited to specific matters, and with voting rights subordinate to the occurrence of particular conditions not merely potestative. The total value of these shares cannot exceed half the share capital”.*

Savings shares were introduced under Italian Law No. 216/74 and are now disciplined by Article 145 *et seq.* of the Consolidated Finance Law, with regard to which:

*“Italian companies with ordinary shares listed on organized markets in Italy or other European Union countries can issue shares lacking voting rights, endowed with particular privileges of an equity nature”.*

Privileged shares and savings shares, to a different extent, lack the right to vote. The former can participate and vote during extraordinary shareholders' meetings but not ordinary meetings (Article 2351.2, prior to the 2003 company law reform, in fact, envisaged that “The memorandum of Association can however establish that the privileged shares – during the allocation of the profit and the repayment of the capital at the time of winding-up of the company – have the right to vote only on the resolutions envisaged in Article 2365”); the latter, by contrast, completely lack the right to vote, except obviously during the special category shareholders' meetings, which we will return to shortly.

Both the categories of shares in question are, what is more, characterized by privileges on the allocation of the profits and may involve, among other things (if the Articles of the statute of the issuing bank lay down as such), a privilege on the final liquidation share.

The content of the privilege, the conditions, the limits, the formalities and the deadlines for its enforcement are in both cases disciplined by the issuer's Articles of Associations, to whose autonomy the legislator has completely entrusted the related discipline, even if, in practice, privileged and savings shares currently in circulation generally present features which are very similar, also because they are sharply influenced by the provisions previously in force.

Pursuant to legislation currently in force, shares with a limited vote (these include both the privileged shares and savings shares) cannot exceed half the share capital in total (in this connection see 2351.2 of the Italian Civil Code, already referred to, and Article 145.5 of the Consolidated Finance Law). Moreover, Article 145.5 of the Consolidated Finance Law makes sure that this proportion is also maintained in the event of share capital reductions due to losses.

By contrast, with regard to special category shareholders' meetings, it is important to indicate that Article 2376 of the Italian Civil Code envisages that the resolutions of the shareholders' meeting which prejudice the rights of one or more of the categories of shares (other than ordinary shares) which may have been issued, must also be approved by the special shareholders' meeting for those belonging to the category concerned. The same regulation is also present in letter b) of Article 146.1 of the Consolidated Finance Law, with reference to savings shares.

The tangible features of the privileged and savings shares will be illustrated in the following paragraphs, so as to then acknowledge the same features in light of the main criteria placed at the basis of the so-called common equity notion as per the consultative document published by the Basel Committee on 17 December 2009 entitled *Strengthening the resilience of the banking sector* (the "**Consultative Document**").

## 1. Dividends

As specified above, privileged and savings shares, with respect to ordinary shares, are characterized by a privilege on the distribution of the profits.

The privileges can be different: there is a "preference" privilege, when an increased percentage of dividend is allocated, and a "priority" privilege, when the right to be satisfied, up to a specific percentage, before the other categories of shares, is allocated. Generally, the savings shares in circulation, and also the privileged shares, present both types of privilege.

Even though there is no restriction in this sense, the amount of the economic privilege is generally commensurate to the par value of the privileged or savings shares and is expressed in percentage terms with respect to the latter.

The methods for paying the equity privilege to the privileged and savings shareholders are disciplined by the Articles of Association. As a rule, the payment is not subordinate to the will of the shareholders' meeting to distribute the profits or not and, therefore, the right to receive at least equity privilege arises, if there are distributable profits, automatically by virtue of the mere approval of the annual financial statements.

The equity privilege, as mentioned, is generally acknowledged on the distribution of the profits (it is necessary to specify that there is no legislative restriction in this sense, since Article 145 of the Consolidated Finance Law speaks generically of “[...] particular equity privileges”, so the privilege on the distribution of the profits is not a necessity, even if in practice it always applies); in the event of the absence of distributable profits, therefore, both the privileged shares and the savings ones do not have the right to any form of “mandatory” remuneration.

Furthermore, the equity privilege is as a rule accruable: in the event of non-payment due to the lack of distributable profits, in fact, the unpaid privilege accrues with the privileges for subsequent years. Usually, the period in which such accruing is permitted is limited to two accounting periods, and thus also on a consistent basis with prudent supervisory rules, which permit such accruing within the time-limits indicated.

It is important to highlight that, in the event of the distribution of reserves, privileged and savings shares participate in the related distribution together and *pari passu* with ordinary shares, without any preference or privilege. It follows that the privilege weighs in exclusively at the time of distribution of the profit for the year and does not lead to any equity alteration which has not been, possibly, laid down at the discretion of the bank and, possibly, only on a *pari passu* basis with respect to the ordinary shares.

On this point, an essential difference is noted between the structure of the remuneration of the privileged and savings shares and that envisaged for preference share-type instruments or hybrid instruments. In such categories of instruments, remuneration does not take place using the profit for the year or within the limits of the same (net of distributions to the shareholders), but by contrast is due in full in the presence of financial statements with a positive closing balance approved in the previous year and irrespective of the entity of the profit and its eventual distribution to the shareholders. It follows that privileged and savings shares have the same remunerative logic as ordinary shares, while preference shares and hybrid instruments have a remuneration structure essentially close to that of debt instruments.

## 2. Tax treatment

The dividends paid on privileged and savings shares are not deductible for the issuer and, from the point of view of the party perceiving the dividend, are taxed on a par with the dividends paid on ordinary shares.

The coupons paid on preference shares and hybrid instruments are deductible.

**3. Current regulatory treatment**

Privileged and savings shares are included in Tier 1 capital, in accordance with current legislation in force.

Preference shares and hybrid instruments issued by Italian banks are not included in Tier 1 capital.

**4. Accounting treatment**

Privileged and savings shares, within the limit of their par value, form part of the share capital of a bank also on the basis of the IFRS. Any share premium paid at the time of subscription, flows into the same reserve into which the share premium paid for the ordinary shares flows, without any distinction.

Preference shares and hybrid instruments are qualified as debt instruments.

**5. Redemption / maturity**

Privileged and savings shares have the same duration as the company and consequently the ordinary shares. These shares cannot be redeemed either upon the initiative of the issuer or the respective holders. The only method available to the issuer to redeem these shares is to further a public purchase offer or, in the event they are not listed, launch private negotiations with the related holders for the repurchase of said shares. In such cases, the price is determined on the basis of the listed prices registered by the market and/or the value of the company.

Preference shares and hybrid instruments in the respective regulations always envisage a call option pertaining to the issuer, after a certain period of time has elapsed.

**Correspondence of the criteria indicated by the Consultative Document for Common Equity**

Privileged and savings shares present features which in essence satisfy the criteria indicated in the Consultative Document in relation to so-called common equity.

Certain of the more significant aspects are examined below.

**1. Maturity/duration**

With regard to maturity/duration, the Consultative Document, for the purpose of inclusion under so-called common equity, requires that:

*“Principal is perpetual and never repaid outside of liquidation (setting aside discretionary repurchases or other means of effectively reducing capital in a discretionary manner that is allowable under National law)”* (criterion No. 3, section 87 of the Consultative Document);

*“The bank does nothing to create an expectation at issuance that the instrument will be bought back, redeemed or cancelled nor do the statutory or contractual terms provide any feature which might give rise to such an expectation”* (criterion No. 4, section 87 of the Consultative Document).

In light of the matters indicated in the previous section, it is clear that privileged and savings shares satisfy the criteria indicated above.

**2. Loss absorption**

With regard to loss absorption, the Consultative Document, for the purpose of inclusion under so-called common equity, requires that:

*“It is the issued capital that takes the first and proportionately greatest share of any losses as they occur. Within the highest quality capital, each instrument absorbs losses on a going concern basis proportionately and pari passu with all the others”* (criterion No. 8, section 87 of the Consultative Document).

Privileged and savings shares are subordinate to all the sources of funding other than ordinary shares and, above all else, are able to absorb the losses on a going-concern basis, so much so that these shares are included in the definition of significant capital pursuant to Articles 2446 and 2447 of the Italian Civil Code (respectively “Reduction of share capital due to losses” and “Reduction of share capital under the legal limit”).

In other words, it is true that the privileged and savings shares can be (and often in practice are) placed above ordinary shares in the absorption of the losses. It is also true, however, that the formalities by means of which the privileged and savings shares contribute towards the absorption of the losses are identical to those envisaged for the shares.

From this standpoint, privileged and savings shares are structurally subordinate with respect to preference shares and hybrid instruments, in the sense that they not only have a lower ranking in the event of liquidation, but absorb the losses on a going-concern basis in the same way that ordinary shares do, despite being able – if the Articles of Statute envisage as such – to be eroded straight after them.

### 3. Payment flexibility

With regard to payment flexibility, the Consultative Document, for the purpose of inclusion under so-called common equity, requires that:

*“there are no circumstances under which the distributions are obligatory. Non-payment is therefore not an event of default”* (criterion No. 6, section 87 of the Consultative Document);

*“Distributions are paid only after all legal and contractual obligations have been met and payments on more senior capital instruments have been made. This means that there are no preferential distributions, including in respect of other elements classified as the highest quality issued capital”* (criterion No. 7, Section 87 of the Consultative Document).

Reference should be made to the matters previously indicated with regard to dividends. Furthermore, it is specified that, with reference to criterion No. 6 indicated above, many of the Articles of Statute currently in force present - if distributable profits apply - a form of obligatory distribution in favour of the privileged and savings shareholders. In the majority of cases, in fact, the distribution of the privilege is not subordinate to the resolutions to distribute the profit adopted by the ordinary shareholders meeting but is carried out automatically following approval of the financial statements.

In any event, it is noted that:

- the obligatory nature of the payment applies in the presence of individual net profit for the period which can be distributed;
- privileged and savings shares cannot attack the reserves of the bank, with respect to which they have the same rights due to the ordinary shareholders;

- the possibility exists, in the presence of a difficult situation, that the bank's sovereign body (the shareholders' meeting) changes the Articles of Association and, with the approval of the special shareholders' meeting, limits the obligatory allocation of the privileged dividend.

### Essential differences with respect to preference shares and hybrid instruments

#### **1. Reference markets**

Savings shares, with the exception of certain cases, are listed on the organized market known as the "On-line Italian Stock Market", organized and managed by Borsa Italiana. The trading methods are the same as those envisaged for ordinary shares.

In the event of exclusion from trading, the Articles of Statute generally envisage that these shares are by way of obligation converted into ordinary shares of the issuer. Privileged shares are generally unlisted (in most cases because they are held by a restricted number of parties) but present (except in fact in the case of sufficient diffusion) all the features formally required by Borsa Italiana for being admitted to listing on its organized market.

Preference shares and hybrid instruments issued by Italian banks are traded over the counter (OTC), therefore outside organized markets or on markets which are not very liquid (typically the Luxembourg stock market).

#### **2. Legal differences with respect to preference shares and hybrid instruments**

If one looks at the applicative procedures with regard to Anglo-Saxon type preference shares (in this connection, consider the interpretation of this model in the context of issues made by companies established in Delaware and belonging to Italian banking groups) as well as hybrid instruments, it emerges that privileged or savings shares are different with respect to these instruments and, in particular, appear to be decidedly closer to ordinary shares than preference shares are.

Specifically, the following can be noted:

- privileged and savings shares absorb losses on a "gone concern" basis in the same way as ordinary shares;

- from the point of view of the absorption of the losses, privileged and savings shares absorb losses on a “going concern basis” in the same way as ordinary shares (in the absence of a differing specification in the Articles of Association, in the event of operating losses the par value of the privileged or savings shares drops on a *pari passu* basis with ordinary shares);
- with regard to continuity, privileged or savings shares are perpetual and can be repurchased under the same conditions envisaged for the repurchase of own shares;
- if one considers the return, the privileged dividend is paid using the individual profits for the year of the bank (and in fact, there is a dilution of the ordinary shareholders);
- a maximum proportion (50%) between ordinary shares and privileged or savings shares, is envisaged.

The afore-mentioned features are not necessarily seen in preference shares and hybrid instruments which, by contrast, are more similar with regard to the legal and, therefore, supervisory characteristics of debt instruments.

### Conclusions

In conclusion, in light of the matters previously indicated, it is believed that the inclusion of privileged and savings shares in categories different to so-called common equity would be excessively penalizing, considering the quality of the equity stake represented by the same.

The misalignment with respect to some of the criteria posed by the Consultative Document (essentially with regard to the flexibility of the payments and the degree of subordination) should not lead to placing these shares on the same footing as hybrid instruments, with respect to which privileged and savings shares without a doubt offer greater guarantees of solidity and with regard to quality are on the same footing as those offered by the ordinary capital.

Therefore, it is considered that action on the amendment proposal put forward by the Committee is necessary, so as to be able to include *per se* the privileged and savings shares in the calculation of the so-called common equity. If this amendment is not possible, one could at least envisage the introduction of more targeted corrections, which permit, for example, the inclusion of privileged and savings shares in the common equity, inferring the component represented by the privilege.

In the event that there is no room for an amendment of the text subject to consultation, account should at least be taken of the comments indicated above within the context of the grandfathering discipline, which the Consultative Document (point 84) submits for the attention of the national

regulators. Specifically, the temporary system should envisage the maintenance of the so-called common equity of the savings and privileged shares currently in circulation without time-limits. With regard to the quantitative limits, corporate regulations already lay down, as seen, that these special categories of shares cannot count for more than half of the bank's share capital, so that any further limitation in terms of ratio with the overall common equity would not be necessary.

However, it is as well to specify that the remarks made and the conclusions reached in this memorandum concern the treatment of privileged and savings shares within the limit of their par value, or rather the computability or otherwise in the common equity of the par value of the afore-mentioned shares; any share premium paid at the time of subscribing to these shares, included in the general share premium reserve, which also includes the share premium of the ordinary shares, is in fact included in the common equity due to its very nature. There are no reasons why the share premium of the privileged and savings shares should be treated differently to that of the ordinary shares, given that the typical rights of the privileged and savings shares (privilege on the profits and deferral of the losses) exclusively concern the par value of these shares and not the additional sums paid over by way of share premium at the time of subscription.