Federcasse comments on consultative documents issued by Basel Committee on Banking Supervision *"Strengthening the resilience of the banking sector"* and "*International framework for liquidity risk measurement, standards and monitoring"*

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GENERAL REMARKS

Italian Credit Co-operative banks (CCBs) appreciate the ongoing effort by the Committee for the definition of internationally harmonized measures to promote greater resilience of the banking sector to shocks arising from financial and economic crisis.

In this context, particular attention should be paid to achieving the right trade-off between the will to standardize the legislation and the need to take adequately into account national peculiarities.

Homogeneous rules applied in contexts characterized by widespread and significant heterogeneity in fact, could produce, contrary to its stated objective, an *unlevel playing field* (for example, with reference to proposals concerning the treatment of items relating to deferred tax assets given the peculiarities of the different national tax systems).

Similarly, the different characteristics of several legal categories of banking intermediaries should be properly considered.

We highlight the failure of the consultation document to consider the legal and operational characteristics of cooperative banks and their network, where I level banks (local retail banks) and II level banks (“central banks”) operate

The proposals cover a variety of complex legal fields. Their impact to both micro and systemic levels requires a careful analysis of the effective and ongoing implementation.
It seems fundamental to evaluate such changes as a whole, in order to have a good view of interactions among different rules and their total impact on both banks and real economy, in a short and long term perspective.

Since some of the proposals are only sketched, and the definition of the limits, minima and parameters must still determined it is difficult to formulate appropriate considerations. Therefore, we suggest to promote another public consultation after the proposal is fully defined.

"Strengthening the resilience of the banking sector"

I. RAISING QUALITY, CONSINSTENCY AND TRANSPARENCY OF THE CAPITAL BASE

1. *Grandfathering and transitional provisions*

The grandfathering provisions, included in paragraph 84 of the consultative document, determined important operational uncertainties which, if not addressed, may compromise the principle, stated in paragraph 69, of ensuring the adoption of new rules *"without aggravating near term stress"*.

In addition, the grandfathering proposals in paragraph 84 (*"… the Committee recommends that members consider the possibility of allowing the grandfathering of instruments which have already been issued by banks prior to the publication of this consultative document"*) are not compliant with the Directive 2009/111/EC (also known as CRD2) that, with respect to Tier 1 Capital instruments, contains specific grandfathering criteria (the instruments that before December 31th 2010 are not under the regulation of art. 57-a, or that does not meet with the art. 63-bis criteria, can be treated as non-core Tier 1 Capital until December 31th 2040).

In order to solve such a discrepancy and, at the same time, to ensure a proper transition to the new rules, we suggest maintaining the grandfathering and transition clauses as defined under CRD2, even with respect to Tier 2 Capital instruments.

Independently of our proposal, we ask for a clarification regarding the grandfathering rules and the transitional arrangements. Such a clarification would be welcome before the end of the new rules definition process, i.e. by the end of the year.

We observe that, according to the consultative document, the grandfathering provisions would be enforceable only for *"instruments which have already been issued by banks"*. Considering the broad and predictable impact of such new rules over regulatory capital, we believe that the grandfathering provisions should be extended to all the elements being overhauled (limits, regulatory adjustments, etc.). This should be achieved through such a timing and approaches that the transition to the new rules would be completed without affecting the banking system stability. This extension seems to be consistent with the provisions in paragraph 64.

2. Deduction of deferred net tax assets

The inclusion of deferred tax assets (DTA) in financial statements is affected by the differences in national fiscal regulation, which are not homogeneous worldwide. Deducting DTA from the Common Equity (even if net from deferred tax liabilities – DTL) would be in contrast with one of the principles set up by the Committee, i.e. internationally homogeneous rules.

In particular, we believe that this proposal would represent a significant and unwarranted penalization for CCBs as well as for the whole Italian banking system. In fact, the Italian fiscal

regulation amplifies the difference between the accounting profit and the tax base, generating the inclusion of significant amount of DTA.
For CCBs, DTA are particularly relevant with respect to:
- loan loss reserves;
- risk and non-deductible expenses provisions.

Moreover, in these cases, DTA usually rise during business cycle downturns with a corresponding procyclical impact over Common Equity. As a result, DTA deduction would cause procyclical effects over the *Core Tire 1 Capital*, which would be in contrast with another principle of the Committee, i.e. to limit pro-cyclicality of financial regulation.

Thus, we suggest to remove DTA deduction provisions from the consultative document. These provisions are periodically subject to a specific test assessing their recoverability based on assumptions and estimates of futures taxable profits, and the Italian company law considers DTA as part of the disposable capital without any limitations to the distribution of the related profits.

Subordinately, consistently with the level playing field principle, we suggest to deduct from the *Core Tire 1 Capital* only the common international components of the DTA (e.g. DTA resulting from annual losses) and then to exclude DTA referable to national fiscal regulation.

Should not any of the aforementioned proposals be accepted, we recommend to take into consideration a threshold amount – i.e. of 20% of *Common Equity* gross of the regulatory adjustments - above which DTA are deductible. This would permit: (i) that the deduction works only for prudentially important DTA; and (ii) that the distortions generated by the lack of homogeneity of national regulation are alleviated.

3. Common Equity

As a general remark, the choice of a principle-based approach for the definition of the components of the regulatory capital is appreciated.

Nevertheless, with respect to *Core Tier 1 Capital*, the Committee has opted for an approach which employ the common shares issued by the joint-stock companies as benchmark to determine the requirements that the capital instruments, issued by all categories of banks, must have to be included in such component of the regulatory capital.

The proposal to provide a sole list of eligibility criteria for the *core Tier 1* capital instruments responds to the double objective to homogenize at an International level the definition of *core Tier 1 Capital* and to assure that the same is composed by simple instruments, transparent and able to absorb losses on a going concern basis (and, thus, to exclude, from such component of the regulatory capital instruments which have evidenced not having such requirements during the recent financial crisis, such as the hybrid instruments of capital).

Nevertheless, the application *sic et simpliciter* of the proposed criteria does not permit to take into adequate account the peculiarities of different business and legal models, such as, the

model of the CCBs; in other words, such an application takes the risk to lead to the exclusion of the shares issued by the CCBs from the *Core Tier 1 Capital,* although in a prudential viewpoint such shares must be considered equivalent to the common shares.

We believe that a more neutral approach (and consistent with what has been announced by the Committee in the Press release of last September 7[1]) would've permitted to reach a better trade-off between the will to achieve the above mentioned objectives and the need to take into adequate consideration the legal and business peculiarities of the different juridical categories of banks.

In particular, the following criteria are improperly discriminatory for shares issued by the CCBs and may cause their unwarranted exclusion from the predominant component of Tier 1 Capital.

- the criteria 2, referred to the right of the members to their share of net assets in case of liquidation;
- the criteria 3, referred to the *permanence*;
- the criteria 5, referred to the flexibility of the payments;
- the criteria 8, referred to *loss absorbency.*

The criteria 2 and 8 can be treated jointly since the critical aspects regarding the compliance to such criteria of the shares issued by the CCBs can be brought back to the fact that reserves stemming from retained earning are totally indivisible.

Such peculiarity mirrors the function-objective of the CCBs which is not the maximization of the profit but to reach the mutualistic purposes to which the same reserves are permanently allocated, even in case of liquidation of the company.

We deem that in an optic to guarantee the creditors, - which should be coincident with the prudential point of view-, the fact that members have no right to reserves does not imply the loss of the characteristic of *full loss absorbency* of the shares issued by the CCBs either on a going concern basis, either on a gone concern basis.

As long as reserves are available, the annual losses have the same impact on the Common Equity either in the *joint-stock companies* and in the CCBs.

Having said that, we deem that the shares issued by the CCBs, on the light of the above-mentioned aspects, are equivalent to the common shares.

With respect to the criteria of *permanence*, as a preliminary remark, it must be noted that CCBs are characterized by the principle of "*open membership*" with limits to the nominal value of each single share and also with restrictions to the global nominal value of the shares which can be hold by each member.

[1] *"Appropriate principles will be developed for non-joint stock companies to ensure they hold comparable levels of high quality Tier 1 capital".*

On such a basis, the structure of the capital of the CCBs is characterized by an high granularity (the average amount of the share capital of each shareholder is relatively low while the number of members is relatively high).

Moreover, cooperative shares of CCBs are not listed and in case of exit of a member, he has right to the repayment of the nominal value of the shares plus the surcharge. Therefore, members' claims are not subject to market volatility and speculation, especially leveraged speculation by shortselling shares, is excluded.

The legislation and the statutes of the credit cooperative banks, provide also for a mechanisms aimed to assure the stability of the share capital; in particular in most of the cases where the holders can ask to withdraw from the company, the redemption is subject to an approval process wich provides the bank with the option to reject the holder's request with regard to the prudential situation of the bank.

Furthermore the share capital of the CCBs remained stable also in the context of the recent International crisis.

Therefore, on the light of the above considerations, we deem that also for the *permanence* criteria the quality of the shares of the CCBs is equivalent to the *common shares*.

The criteria of the flexibility of the payments requires, *inter alia*, the absence of a cap on the amounts of the profits which can be distributed to the owners of the capital instruments.

Our national legislation with respect to the CCBs provides for a cap on the amount of the net annual profits to be distributed to the members; nevertheless such a cap is applicable only to a residual share of the amount of profits to be allocated and it finds its ratio in the above-said mutualistic purposes of the CCBs.

In this respect, it must be noted that there is no evidence that such a cap is seen by the market as an obligation to distribute the dividends in a measure equal to the amount of the same cap and that, in general, a significant number of CCBs does not proceed to the distribution of dividends.

Moreover, we do not see any motivation of prudential nature to the requirement of the absence of a cap on the amount of the profits which can be distributed.

On the light of the above considerations, we deem that such criteria should not be applied to the CCBs since it is not relevant.

The Committee, in order to consider the specificity of the *non-joint stock companies* has introduced the footnote 19 at paragraph 87 of the consultation paper, entrusting in such a way to the national supervisory authorities the duty to evaluate the equivalence of the common shares to the capital instruments issued by such companies.

We believe and we wish that the provisions contained in the footnote 18, paragraph 87 of the consultation paper, can lead to an appropriate application of the above mentioned criteria to

the CCBs - i.e., with limited derogations in order to take into account the above-said peculiarities of the shares issued by the CCBs, which peculiarities, as already said, do not warrant a disparity in the prudential treatment with respect to the common shares.

Finally, we require that the above mentioned footnote is inserted in a specific paragraph of the text.

4. Revisions of Tier 2 hybrid capital instruments characteristics

With respect to the criterion 4.c (*"there are not incentives to redeem"*), we recommend to keep the possibility to allow a moderate incentive to early repayment. In effect, we believe that this approach would:

- be beneficial in balancing capital stability (in any case, the incentive would be moderate and the early repayment would be subject to prior supervisory approval) and investor risk;
- favour the alignment of banking regulation with insurance regulation.

With respect to point 5-c-ii, we suggest to substitute the words "well above" with the expression "in line".

As regard to point 8, we recommend to maintain the current rule (buy-back within 10% of the issuance without prior supervisory approval).

Finally, we do not share the hypothesis of introducing lock-in mechanisms on Tier 2 instruments because such instruments represent "gone concern capital" and in order to not compromise investors' preference and increase significantly interest expense for banks.

II. RISK COVERAGE

We believe that there is no need for punitive charges for contracts that are not CCP cleared. The zero risk weighting of CCP cleared contracts already offers a strong incentive to move to CCP.

It is not very clear, whether the banks using the standardised approach for credit risk should also calculate the capital requirement for the credit valuation adjustment.
Furthermore, for the cases where neither the CDS spread nor the bond spread is available, it is not clarified how the credit valuation adjustment should be calculated by the credit institutions.

As regard to *cliff effects* arising from the current regulation on Credit Risk Mitigation and credit derivatives, we fully agree with the proposal in pararagraph 198 and 199 to abolish the limitation of A- rating for eligible guarantors, both for the standardised approach and the foundation IRB approach, because the mentioned *cliff effects* can be very important for small banks.

Regarding the reliance on external credit rating we would like to highlighted that some national authorities, including Bank of Italy, already require an autonomous coherence analysis of external ratings with bank internal credit risk evaluations. We hope for a clarification on this provision with respect to what currently takes places accordingly with the current regulation.

III. LEVERAGE RATIO

We do not agree with the introduction of a non-risk based "backstop" measure complementary to the risk-based regulatory framework of Basel 2.
If the leverage ratio were introduced according to the definition of the consultative paper it should be:

- a measure of Pillar 2;
- “calibrated” so that it will be binding for the categories of intermediaries which tend to build up more leverage - in particular those most oriented to trading activities or specialized in innovative financial sectors - and only in phases of excessive economic growth.

As regards the capital measure, we considers the use of the total capital as more appropriate, due to its effectiveness to cover potential losses. In any case, considering *Core Tier 1 Capital* appears to be too restrictive.

In general, as pointed out in paragraph 219 of the consultation document, we recommend a close coherence between the criteria underlying the leverage ratio and those related to regulatory standards on liquidity risk. As provided by paragraph 218, namely that all assets, including those identified as high quality liquid assets, should be included in the denominator of the ratio appears to be inconsistent with the rules of composition of those regulatory standards that on the other hand require banks to hold such activities. The solution to this contradiction could be based on a hypothesis considered by the Committee, i.e. to eliminate the high quality liquid assets from the calculation of exposures considered for the leverage ratio.

In particular, we would like to point out that the definition of leverage ratio has some inconsistencies with the purposes stated in paragraph 204 of the consultation document with regard to the operational features of the Italian cooperative banks network.
In particular we point out the following features:

- II level banks (“central banks”) exposures to the European Central Bank (BCE) related to the fulfillment of minimum reserves indirectly by the CCBs (I level banks);
- off-balance sheet exposures of II level banks linked to the undrawn credit and liquidity facilities granted to I level banks.

Referring to the first point, what is determined by the consultation document seems to include these exposures in the calculation of total assets even in the case they are excluded from high quality liquid assets. Conversely, we believe that such exposures should be excluded from the calculation of the denominator of the ratio which are not relevant to measuring the leverage of II level banks.
With regard to credit and liquidity facilities granted by II Level banks to CCBs, we observe that they are part of the instruments through which the former manage, in a centralized manner, the

liquidity of the network as a whole. For this reason, we point out the consideration that using a credit conversion factor (CCF) of 100% (and therefore not considering the effects of geographical, size and operations diversification related to the I level banks and the consequent reduced risk of simultaneous behaviours by those towards II level banks) leads again to a distorted representation of the effective amount of leverage of II level banks. Therefore we propose that with regard to off-balance sheet items the conversion factors provided by the Standardised approach should be implemented.

IV. PROCYCLICALITY BUFFER

1. Forward looking provisioning

As a general remark, we agree with the Committee to require banks to put into effect countercyclical provisioning policies and to promote, in view of this, a change in current accounting rules in order to address the approach based on the concept of incurred losses.

However, it is noted that the methodology of calculation of the provisions, which the International Accounting Standards Board (IASB) is developing, has some major critical application for smaller banks, such as CCBs, and that use the standardized approach for credit risk. As a matter a fact, the proposal made by the IASB is particularly burdensome in its implementation and management.

Furthermore, we must stress that the model proposed by the IASB, as well as being overly complex, presumably will accentuate the procyclicality of provisions rather than limiting or resolving it, because it foresees that the effect of changes in expectations about future cash flows is included immediately in the income statement.

To this end, it is necessary to pursue a balance between accounting and prudential regulations and the adoption of models that are not excessively sophisticated and complex.

The hope is that the ongoing confrontation between the Committee and the IASB could achieve a solution characterized by greater operational simplicity compared to the method proposed by the IASB and consistent with the objective of reducing the cyclicality of provisions.

2. *Building buffers through capital conservation*

As regards to the *"additional supervisory discretion"* to impose time limits on bank operating within the buffer range to rebuilt it, we believes that it should be carried out by taking into account the legal peculiarities of cooperative banks, such as CCBs, and their structural limitations to increase capital (most of them are non listed companies). Otherwise, banks operating within the buffer limits, in order to reconstitute the latter in the timeframe specified by the supervisor, could be forced to quickly reduce lending/RWA, thus strengthening pro-cyclicality. Furthermore, it should also be taken into account that in several jurisdictions the law already provides a *"system of capital conservation"* for co-operative banks. For instance, CCBs

must allocate 70 per cent of yearly net profits to legal reserve (in order to increase and reinforce the capital).
Referring to the proposal of considering only the Tier 1 capital to cover the buffer, the Federcasse considers more appropriate to use the total regulatory capital, due to its effectiveness to cover potential losses.

3. *Excessive credit growth*

The consultation document considers the buffer related to the excessive credit growth as an increase of capital buffer range, established through the capital conservation proposal. We highlight some problems of interpretation for the period in which both measures coexist. In particular, is not clear whether the conservation standards should apply to the sum of the two buffers.
Regarding banks with purely domestic lending and especially local banks, such as CCBs, the excessive credit growth should take into account the economic conditions of limited geographical areas in which they operate.

"International framework for liquidity risk measurement, standards and monitoring"

1. *Field of application and transitional provision*

The proposals on liquidity risk envisages its application also to single legal entities.
The consultative document does not acknowledge the importance of using available resources at group level in order to manage funding needs related to different businesses. Furthermore, it is penalizing for groups who created single, specialized entities with respect to non legally autonomous divisions.
We believe that the proposed regulatory standards and monitoring tools should be applied on a consolidated basis.
Therefore, we suggest to modify paragraph 133 in order to maintain only the first sentence (*"the proposed standards and monitoring tools should be applied to all internationally active banks on a consolidated basis"*) with the addition of a further explanation on cases and/or applying conditions (e.g. different computation frequency of two regulatory standards, taking into account the proportionality principle) to non-internationally active banks.

The press release during the publication of the consultation paper stated 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."* Nonetheless, the paper does not contain any proposals on (*i*) the time-frame within which banks will need to apply the new framework and (*ii*) transitional arrangements.
Regulatory standards defined by the Committee is an important addition to Basel II framework. In fact, specific quantitative requirements for the liquidity risk have been proposed for the first time. Thus, it is essential to define appropriate rules with respect to the two points above mentioned before the conclusion of the new rules definition process (scheduled for the end of this year).

2. *Definition of high quality liquid assets*

We believe that the definition of high quality liquid assets referring to Liquidity Coverage Ratio (LCR) proposed is excessively restrictive. It could lead to negative consequences in terms of higher costs and funding availability of non government (in particular corporate) issuers.

The definition of liquidity buffer, moreover including high quality corporate bonds and covered bonds, could lead to a significant increase in demand for eligible assets (in particular sovereign assets). This route could lead to a major spread between such assets and less liquid securities (corporate for instance). Moreover, a further concentration of risks may arise from the weak diversification of the high liquid asset market.

We agree that Central Banks do not have to be considered lenders of first resort and so liquidity buffer have to be composed of assets which can be directly settled on the markets. Nevertheless, given the extent of the definition of high liquid assets would also relevantly

influence the policy of banks, our view is that part of them (at least) could be composed of eligible instruments for the Central Bank, even if not marketable.

On the whole, we suggest that the definition of high quality liquid assets would be carefully evaluated by the Committee in order to find a more balanced proportion among bank needs to maintain on the one hand fairly prudent liquidity buffer and on the other hand to guarantee market functioning and suitable credit flows to the economy.

Regarding the Net Stable Funding Ratio (NSFR), similar views could be expressed on assets to be assigned an appropriate RSF factor less than 100 per cent.

3. *Sovereign securities*

With specific regard to sovereign securities, we would like to highlight that the same securities are entirely included in liquidity buffer as long as they are assigned a 0% risk-weight under the current Basel II Standardised approach (which means an ECAI rating at least equal to AA-), while they are completely excluded if they exceed this level (with the exception, only for LCR, of “home country securities”). Conversely, as regards to high quality corporate bonds and covered bonds the consultation paper propose, if they were included in the buffer, a more differentiated management which also attributes a value in the computation of liquidity buffer to second level securities (i.e. rating between AA and A-) of such class.

Regarding LCR, we suggest to include at least “second tier” (i.e., whose rating ranges between A+ and A- with 20 per cent risk weight) government bonds in the liquidity buffer, with an appropriate haircut.

Furthermore, an analogous treatment for sovereign securities may also be taken into consideration in the NSFR framework. Therefore, we suggest to introduce:

a) a specific reference in table 2) of paragraph 89, regarding second tier sovereign bonds, with the indication of an appropriate RSF factor less than 100 per cent;
b) point d) of paragraph 34 in table 2 (5 per cent row) of paragraph 89 leveling the management of different situations for both LCR and NSFR.

4. Stable deposits

In relation to the definition of “stable deposits”, our view is that the portion of each deposit covered by deposit insurance scheme would have to be considered stable without further conditions defined by letter a) of paragraph 41 of consultation paper. Finally, in case of institutional protection systems created by cooperative networks in accordance with art. 80.8 of UE 2006/48 Directive, we request to consider as “stable deposits” the whole amount of guaranteed deposits.

5. The treatment of transactions within the network

Regarding the stress test scenario scheduled for LCR, we would like to point out extremely penalizing assumptions with asymmetric treatment of asset and liability items.

In particular, stress test hypotheses for transactions (deposits, loans and undrawn credit and liquidity facilities) between II level banks ("central banks") and I level retail banks (CCBs) of the network are based on inappropriate assumptions with respect to its operating features.
Within the network, II level banks provide wholesale services (e.g. payment and security services) to I level banks and manage, in a centralized manner, the liquidity of the network as a whole. Due to that operability, II level banks hold specific liquidity buffer facing the funding from CCBs as well as undrawn credit and liquidity facilities granted to them.
Therefore, the treatment of transactions between I and II level banks proposed by the consultation paper seems to be excessively penalizing: (i) it does not take into account general stability funding features within the network, in particular those provided by I level banks to II level banks; (ii) as regard to undrawn credit and liquidity facilities, it implies no suitable benefits for I level banks compared to costs to which II level banks incurred to hold additional liquidity buffers; and (iii) it does not consider the effects of geographical, dimensional and operating diversification related to I level banks and the consequent reduced risk of their simultaneous behaviour with respect to II level banks.

We share the Committee goal to reduce an excessive use of wholesale funding by banks, especially from other financial institutions. At the same time we would like to point out that such treatment of transactions within the network could create a disincentive for centralized mechanisms of liquidity management, which have been demonstrated their efficiency also in period of stress and which are actually used within the Italian Credito Cooperativo network.

Therefore, for both LCR and NSFR, we request to implement a specific treatment for transactions between I and II level of the network, in line with paragraph 23 of Consultation Paper by the European Commission "*Possible further changes to the capital requirements Directive"* referred to banking groups. In particular, we suggest:

- to treat deposits within the network as a stable funding base;
- as regards undrawn credit and liquidity facilities granted by II level banks to local retail banks, to apply a specific treatment so that local banks that have received those credit lines could assume they are always able to draw upon them and the "central banks" having granted them would assume liquidity outflows, the latter to be calculated by an appropriate weighting factor (e.g. 25%) in order to take into account the benefits of a well diversified network of local retail banks.

Subordinately, we recommend that the above treatment is recognise in case of institutional protection schemes created in accordance with art. 80.8 Directive 2006/48/EC.

6. Computation frequency and operating functioning of liquidity buffering

Given regulatory standard goals as well as the existence of a trade-off between data reliability and updating frequency of computations, our proposal is to create a sort of double procedure, differently from what reported in paragraph 132 of the consultation paper.

LCR would be requested each month, eventually also based on operating data, while NSFR each quarter based on accounting data (creating a sort of temporal gap between the end of quarter and the date of calculation, useful to produce reliable accounting data).

Finally, the consultation paper does not neglect fundamental points related to possible applications. What happens if a bank is not able to fulfil its liquidity needs? It could not use high liquid assets, because of meeting the LCR requirements of maintaining such assets. The consultation paper does not suggest solutions for this situation.