ABI 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"

April 2010

Contents

ABI 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"

Introduction and summary

The proposals to amend the legislation encompass a vast series of complex regulatory spheres. Their individual and, all the more so, joint impact makes a careful analysis of their effective implementation methods, their sequence and, in general, the possible effects correlated to their eventual applicability in a macro-economic context such as the current one, indispensable. Furthermore, due to the uncertainty present in some areas, it would be important to foresee a second assessment/consultation in agreement with the industry.

A careful preliminary assessment is necessary of the impact of the new proposals not only on the stability and profitability of the individual intermediaries, but also on the Italian and international macro-economic picture.

Particular attention will have to be paid to the trade-off between the will to standardize the legislation and the need to take adequate account, when defining the international regulations, of the national peculiarities. Standardized legislation within contexts which are still varied risks causing an unlevel playing field, contrary to the declared objective.

It is hoped that there will be wide compliance at international level with the new framework and that its enforcement will be harmonized.

Furthermore, in order to ensure a level playing field between banks and non-banking intermediaries, it is necessary to extend the most stringent prudent rules in question also to the latter, on the basis of the supervisory principle, generally accepted, that equivalent activities must be subject to rules, also prudent supervisory ones, which are standard, irrespective of the type of party supervised and using the same implementation terms. Already at present, any legislative misalignments existing between banks and non-banking intermediaries, which provide the latter with a competitive advantage, do not appear justifiable.

Likewise, in the consultative document the legal and operating singularities of the co-operative banks and their network organization are not appropriately interpreted.

The definition of a single and global regulatory context is supplemented in the enhancement of the European supervisory system via the creation of

the ESAs; this will make it possible to effectively reduce inconsistencies and duplications.

Going back to the aspects mentioned at the beginning, it is important to consider that the application of the new legislation during a phase of slow emergence from the crisis could have negative effects which are somewhat inconsistent with the real objectives of the review underway, with consequences on lending and on the customer relationship. Irrespective of the macro-economic context, the same cost of the funding would inevitably be influenced by the introduction of new restrictions on the funding instruments with repercussions on the pricing of the loans.

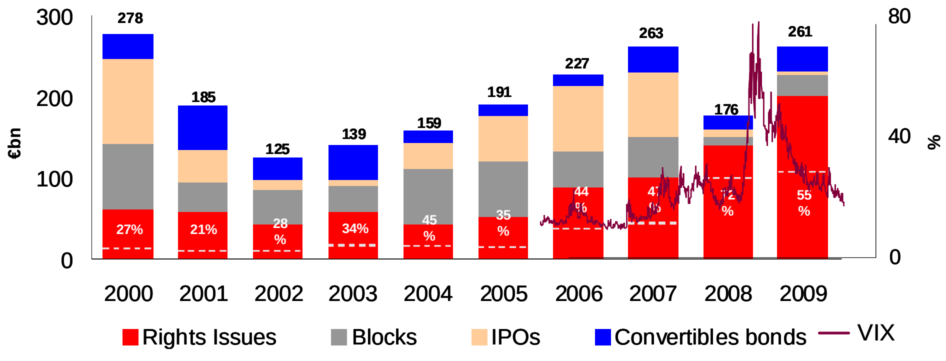
Therefore, the grandfathering clauses will be of primary importance, with respect to which the consultation document does not provide specific indications and, in the event of Tier 1 hybrid instruments, appears to be in contrast with the matters envisaged by Directive 2009/111 (so-called CRD2).

The lack in the consultative document of indications on the computability limits of the elements of the equity which the banks will be required to observe over the next few years makes it difficult, in general, to formulate comments with regard to the proposals represented in said document.

If, as seems to emerge from the consultative document, the Committee's approach is to tend towards greater recourse to share-based instruments, doubts arise with regard to the ability of the market to absorb consistent flows of these securities over the next few years.

As indicated in the graph, the percentage of equity issues by issuers of financials increased considerably over the last few years within a situation of growing volatility of the market prices which, by contrast, drastically reduced access to the market by the corporate issuers via IPO transactions. Within the current context characterized by minor volatility, the corporate issuers will return to the equity market offering capital instruments to investors which will be "in competition" with the hybrid instruments offered by the issuers of financials. Rules which are too severe would penalize the marketability of the hybrid instruments offered by the banks which would risk being cannibalized by the equity instruments issued by corporate issuers.

ECM transaction volumes in Europe since 2000 (€bn)



% shows proportion of rights issues executed by Banks & Insurers

Sources: Bloomberg, Dealogic as of 12 January 2010

Therefore, it is proposed, on a priority basis with respect to other fulfilments, that the regulation on grandfathering envisaged by CRD2 be confirmed and the regime which will apply to issues until the date of implementation of the new legislation be clarified.

Taking into account the national specificities and the various legal categories of the banking intermediaries, it is necessary that the new proposals lead to an improved quality of the capital without necessarily imposing penalization on instruments which in the Italian context can essentially be placed on the same footing as the elements indicated as reckonable (e.g. savings shares, privileged shares and the shares of co-operative banks).

It is also proposed that certain criteria be changed, as considered in the consultative document for the financial instruments which are included under Tier 1 additional going concern capital, for the purpose of maintaining the attractiveness of the instruments for “fixed income” investors. In fact, the typical profile of the investors in Tier 1 instruments is generally represented by investors in debt instruments.

With regard to Tier 2 instruments, among other things it is proposed not to introduce lock-in mechanisms, in consideration of the “gone concern” nature (Capital in Liquidation) of these instruments.

With reference then to contingent capital instruments, it is considered inopportune to introduce guidelines which are too stringent which could limit demand for the same, bearing in mind that the market for these instruments is not yet developed.

Furthermore, the deduction from Common equity of the minority interests and equity investments in banks, financial and insurance companies would be particularly penalizing and would also lead to distortive effects on the

competition between financial conglomerates and, within the banking groups, possible inefficiencies in the allocation of the capital.

Furthermore, of fundamental importance for Italy is the computability of the items relating to prepaid taxation, mainly generated by the peculiarities of the tax system (e.g. those originated by the writedown of receivables, the alignment of the goodwill and the provisions to the Reserve for risks and charges).

The complexity of the legislation in question and the need to reduce undesired effects implies the central nature of the QIS. Only after the analysis of the results of the QIS, will it be possible to fully define the new provisions to be followed by their gradual introduction.

It would also be advisable to define a sole timetable at global level, (not only for the European Union or the Euro Zone), aimed at harmonizing the sequence of the enforcement of the legislation on a consistent basis with the timescales and the methods for the introduction of European legislation already approved. It is also important to envisage occasions for verification with regard to the effective implementation of the new legislation in the jurisdictions concerned so as to monitor the progressive and standardized implementation thereof.

Reference is also made to the need to pursue an alignment with accounting legislation, so as to render the legislative innovations consistent with the financial statement figures.

Faced with potentially greater stability of the system, the costs incurred by the banks and, lastly, by the economy will foreseeably rise, with an overall deterioration in the efficiency of the financial intermediation process.

It is considered fundamental that the focus remains to be the supervision on a consolidated basis. In fact, given the structure of multipurpose groups which characterizes the Italian banking system, the Italian banks are led to request (first of all, for the liquidity ratios) application of the legislation in question at just consolidated level and not also at individual level, also so as to safeguard the division, and the related specialization, both with regard to the activities carried out and the funding methods.

As for the Counterpart Risk, it is agreed that the use of central counterparts (CCPs) for the discipline of OTC financial derivatives could reduce the risk associated with these instruments.

It is however believed that the zero-risk weighting of the exposures in derivative contracts disciplined via a central counterpart already in itself represents a strong incentive for the use of the CCPs and therefore the opinion on the proposal to introduce further penalization for contracts regulated bilaterally is not shared (in particular, the forecasts of the

stressed Expected Positive Exposure – EPE - and the add-on for Credit Valuation Adjustment risk CVA).

This would have the effect of creating inequality in the treatment between various types of contracts, undermining the competitiveness of the financial market and would compromise the ability of the intermediaries to efficiently handle the risks undertaken.
In fact, use of the central counterparts inevitably requires a process for the standardization of the contractual features of the derivatives, which, if excessive, would risk making these instruments less effective.

With regard to the proposals in the Liquidity Risk field, many of the perplexities which arose during the analysis of the proposal could partly be mitigated at least with reference to the Liquidity Coverage Ratio, foreseeing that certain types of asset - such as corporate bonds, covered bonds, securities included in share indexes, bank shares, non-subordinate bank debt securities and certain sovereign securities – are, having certain characteristics, adequately recognized (in the so-called "wider buffer" making the necessary changes to the consultative document).
While deeming the introduction of a Net Stable Funding ratio to be correct, it is also considered appropriate not to set it within a stress test analysis context given the structural nature of this indicator.

Accordingly, it is proposed to the Committee that a solution be taken into consideration which, by means of the appropriate changes and reviews, follows the Italian legislation on the transformation of the maturities in force up until a few years ago. This did not envisage a stress test scenario (but an on-going concern scenario) and took into consideration a series of macro items which avoid problems relating to the tracing of data without invalidating the quality of the ratio. With regard to this approach, possibly to be investigated, there is room for in-depth analysis.

Again with regard to Net Stable Funding, recognition similar to that required in similar cases for the Liquidity Coverage Ratio is requested for sovereign securities with a non-maximum quality: in particular, it is requested that the recognition be disengaged from the related risk weight in the event that this involves debt securities issued by the home country of the financial institutions involved in the creation of the buffer.

In conclusion, it is observed that the measures proposed by the Committee in terms of liquidity requirements do not take into account the operating features of the network systems such as that of the co-operative banks, where Ist and IInd level banks operate, involved with the latter in an important role for managing the liquidity and the related risk within said network. Specifically, the Consultation Paper published by the European Commission "Possible further changes to the capital requirements Directive" in acknowledging a specific handling of the intercompany relationships, does

not envisage similar proposals with regard to the afore-mentioned bank networks.

It is of fundamental importance that, after the introduction of the new provisions, adequate incentives remain for the use of the advanced methods for the determination of the minimum capital requirements.

Over the next few weeks - on the basis of joint analysis currently underway at the EBF - the Association will carry out assessments on the macro-economic impact, with particular regard to the repercussions on economic growth and employment. These will take into account the micro data (QIS) which the individual banks are making available at present.

A) Quality of capital

1. Grandfathering

We propose to envisage, on a priority basis with respect to other fulfilments, a precise and sustainable mechanism for the transition to the new rules. In particular, for Tier 1 instruments we propose to confirm the discipline on grandfathering previously introduced by directive 2009/111/EC and to introduce a similar provision for Tier 2 instruments. Subsequently, we request identification of the regime to be applied to hybrid instruments up until the date of implementation of the proposed regulatory framework

The grandfathering provisions contained in the consultative document (in particular at paragraphs 64 and 84) are believed to have created operating uncertainties[1] that have, de facto, stopped the market for these instruments.

More specifically, it is noted that the introduction of the reference of the publication date of the Consultative Document (December 17, 2009) has created a contradiction with Directive 2009/111 (so-called CRD2) which provides a grandfathering for instruments already issued as of December 31, 2010.

In particular, these provisions, with regard to hybrid Tier 1 instruments, seem to be in contrast with Article 154, Paragraph 9 of Directive 2006/48/EC, as amended by the aforementioned Directive 2009/111, which already established grandfathering criteria for such instruments (the instruments that by December 31, 2010 do not fall within the scope of Article 57, letter a), or do not meet the criteria set out by Article 63-bis are computable, under certain conditions, in the regulatory capital until December 31, 2040).

In our opinion, the issue should be overcome by giving precedence to the solution already adopted (by law) with CRD 2. As regards, we propose to confirm, on a priority basis with respect to other fulfilments, the grandfathering clause provided by CRD2.

[1] From S&P's Document of 9/02/2010 "*Assumptions: Implications Of The December 2009 Basel III Proposals For Our Bank Hybrid Criteria: "The "Basel III" proposals indicate that regulators will not "grandfather" any instruments issued after Dec. 17, 2009. Accordingly, we will not assign "equity credit" to any bank hybrids issued after Dec. 17, 2009 unless it is clear that the instrument will continue to be included in regulatory capital when the Basel III rules come into effect.*"

Moreover, this interpretation appears to be in line with the position of the CEBS[2] which provides the possibility of issuing hybrid Tier 1 securities with equal characteristics to those on the market until December 31, 2010.

With reference to Tier 2 instruments, we note that CRD2 does not contain any grandfather regulation. Tier 2 instruments, therefore, would be subject to the provisions of paragraph 84 of the consultative document, on the basis of which grandfathering will not be applied to instruments issued after 17 December 2009.

Considering the sizable outstanding amount of said instruments issued in recent years by banks, we propose providing a grandfathering clause in this case as well.

In particular, consistently with the proposal for Tier 1 instruments, we propose introducing a grandfathering clause similar to the one introduced by the aforementioned Directive 2009/111. 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.

The impasse determined by the afore-mentioned operational uncertainties is depriving the banking system access to considerable sources of its own funds.

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.

For this reason, we hope for a clarification on these provisions in advance with respect to the definition of the set of regulations expected by year end.

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

---

[2] "*Implementation Guidelines for Hybrid Capital Instruments*" – CEBS, December 10, 2009.

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

We also observe that, according to paragraphs 64 and 84, the sole scope of the grandfathering provisions would be "instruments which have already been issued by banks". Taking into account the breadth of the intervention on capital outlined in the consultative document, we deem that grandfathering should also be extended to the other elements of the regulatory framework that could be subject to revision (minorities, limits, deductions, …) with specific procedures and application times, so that the transition to the new treatment would take place without compromising the stability of the banking system. Such an extension also appears to be in line with Paragraph 64 of the consultative document.

Lastly, we observe that the Consultation Paper published by the European Commission last February 26 on "Possible further changes to the capital requirements Directive", to be implemented by the end of 2012, provides no indication on grandfathering.

2. *Deductions of net DTA (deduction of Deferred Tax Assets net of Deferred Tax Liabilities)*

We ask to remove the deduction proposal.

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[3].

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.

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.

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

We ask to maintain the option for the a bank of not deduct shares in the trading portfolio and related to market making activities. With reference to equity investments in insurance entities we ask to: i) align the supervisory rules between the banking and insurance sectors and in the meantime to foresee the non-deductibility of these investments; ii) alternatively, deduct such investments to the extent of 50% from the common equity and 50% from Tier 2 capital.

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

[3] 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.

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[4]. This approach, without touching the prevision 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 the 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 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

[4] (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.

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.

4. Minority interests

We ask: i) to confirm current provisions; alternatively, ii) to maintain the contribution of minority interests to the common equity until the capital requirement as regards the subsidiary is reached; iii) if the Committee's proposal is confirmed, the exclusion of the minority interests deducted from the corresponding RWA.

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.

5. Common equity

We propose changes to the criteria for inclusion in common equity aimed to include privileged and savings shares within the scope of this capital component, if necessary through targeted corrections, or to envisage grandfathering for said instruments. We also point out that as the common equity discipline is focused on the legal model of so-called joint stock companies, it does not take the peculiarities of the legal structure of credit cooperative banks into due account

The Committee establishes the criteria (listed in the table per paragraph 87) for the inclusion of capital instruments in the 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 an 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 Committee'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 (point 84) 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.

6. Review of the characteristics of hybrid Tier 1 instruments

We propose several changes to the criteria envisaged for the computability of Tier 1 hybrid instruments regarding, inter alia, the definition of "perpetual", the exercise of call options, buybacks and the absorption of losses, in order to maintain the "marketability" of said instruments for investors in debt instruments

We propose a modification of certain criteria considered in the consultative document 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: Call option exercise
We propose providing the possibility that such 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.

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 6: Buy back
We propose to define quantitative limits to allow market making in line with the provisions of the CEBS guidelines: "It is proposed that repurchased instruments held by the institution for market making purposes shall not at any time account for more than either 10% of the relevant issue or 3% of the total amount of all outstanding hybrid instruments issued by the institution, whichever of the two limits is the lowest". In this regard, we point out that also the aforesaid European Commission Consultation Paper on the possible further modifications to the discipline of bank capital requirements (so-called CRD4) has not denied this possibility.

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 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 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 11: Loss Absorption
It should be specified that the write-down provided in the consultative document as a loss absorption mechanism is temporary in nature. The need to absorb losses could be pursued through a temporary write-down mechanism and the introduction of a write-up mechanism in liquidation.

It should also be noted that if the reduction in the nominal value of the instruments as a result of the capital ratios' drop below certain thresholds (still to be set) were permanent, there could be negative implications for purposes of the tax treatment of the relative interest and income.

In fact, the circumstance that said instruments – not classifiable for civil law purposes as bonds – cannot even be included in the fiscal notion of similar securities as failure to comply with the unconditional obligation to pay at maturity an amount that is not lower than the original capital, would entail the application of the more onerous regime envisaged for so-called atypical securities.

On this issue, we also point out that temporary write-down mechanisms are provided by the CEBS guidelines and that CEIOPS has also provided the possibility of alternative loss absorption mechanisms to mandatory obligation and permanent write-down.

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. Said subsequent write-up should presumably take place only referring to capital net of any subsequent share capital increases in order to immunise new shareholders from the effects of said write-up. If this were not the case, the first portion of the share capital increase would be to the sole benefit of holders of hybrid instruments, the subject of the mark-down and this would make any recapitalisation more difficult and in any event more expensive.

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".

Criterion 14:

We propose to maintain the possibility of issuing through Special Purpose Vehicles in order to maintain flexibility of choice for the issuer, in line with what is generally envisaged by other European jurisdictions.

7. Review of the characteristics of hybrid Tier 2 instruments

We propose several changes to the criteria for the computability of Tier 2 instruments regarding, inter alia, the possibility of a moderate incentive to redeem by the issuer, the possibility to buy-back such instruments for market-making purposes, as well as the elimination of lock-in mechanisms, in order to render said instruments efficient and coherent with the "gone concern" nature of Tier 2 hybrid instruments

With reference to the criterion that does not allow computing instruments characterized by incentives to redeem in Tier 2 instruments, we propose maintaining a moderate incentive to redeem by the issuer. We deem that this approach can provide benefits in terms of balance between capital stability (the incentive would be moderate and, in any case, early redemption would be subject to the authorization of the Supervisory Authority) and investor's risk.

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 be functional with the need – viewed with favour by the Basel Committee in the January 2010 document ("*Review of the differentiated nature and scope of financial regulation*") - to avoid unjustified differences between banking and insurance regulations.

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 minima requirements 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.

Lastly, with reference to the hypothesized introduction of lock-in mechanisms for Tier 2 instruments, we deem such mechanisms to be superfluous and they should not be introduced.

The Basel Committee introduces the concept of Going Concert Capital and Gone Concern Capital. Since Tier 2 is Gone Concern capital, there is no reason to introduce lock-in mechanisms.

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.

8. Contingent Capital

We make some observations on the opportunity of avoiding, for the moment, excessively strict guidelines on contingent capital instruments. We also propose not to introduce clauses for the conversion of Tier 2 instruments into shares, given the "gone concern" nature of the same

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 should also be clarified whether, within the scope of more thorough analysis on contingent and convertible capital the Basel Committee intends to assess the opportunity of introducing conversion obligations also in the case of Tier 2 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.

This consideration also pertains to mechanisms for loss absorption by write-down, of which we emphasis (even if only for the sake of a complete analysis) their incompatibility with the structural nature of "gone concern capital" of Tier 2 instruments.

9. Shortfall stock deduction of write-offs with respect to expected losses

We agree with the new deduction rule, although onerous (100% from Tier 1 capital). It is obviously intended net of the tax effect.
We believe it would be reasonable to introduce, in parallel, the inclusion of any positive balance (excess provisioning) in the calculation of the regulatory capital.
The regulatory treatment of the difference between financial statement write-offs and expected losses should be reconsidered on the basis of the amendments made to IAS/IFRS regarding the provisioning of receivables.

10. Surplus of defined benefit pension funds

We retain, in line with IAS/IFRS, that on the basis of the terms and conditions of the plan and of the statutory provisions in force in the jurisdiction in which the plan operates, it should be established “who” has the availability of any surplus (company or subscribers).

* * *

Technical annex 1 also contains further comments, requests for clarification and proposals for changes to the consultative document.

* * *

B) Counterparty risk

We agree with the incentive to use contracts cleared by central counterparties implicit in the zero-risk weighting of exposures, but we do not agree with the proposal to introduce further penalties for contracts cleared bilaterally that would undermine the competitiveness of the financial market and compromise its capacity to efficiently manage the risks assumed

a) We request confirmation of the circumstance of the **review of standardised methods and of the present value** subsequent to the calibration, as well as the **identification of the parties to the current document**, which are envisaged **to be applied also by non Internal Model Method (IMM) and non Internal Ratings Based (IRB) intermediaries.**

b) As regards derivative instruments, one of the main topics of the new proposal of the Committee as regards Counterparty Risk, we believe it is important to mention, first and foremost, that derivative instruments start out as risk management instruments. As such, they represent an indispensable instrument for investors to pursue their investment strategies and for companies to correctly manage business risk. Where used for hedging – and not for speculation – purposes, said instruments have enabled risks deriving, inter alia, from high levels of market uncertainty and volatility, to be controlled and reduced. The negative repercussions on the stability of the financial markets that derivative instruments may have had during the recent crisis, therefore, are the result of a use other than that of the main function of said instruments, and also excessive. It is important to draw attention to this aspect, insofar as we are convinced that any proposal for the regulation of the use of Over-The-Counter (OTC) derivatives cannot ignore this fundamental premise.

Having said that, **we generally agree with the intention** of the European and international supervisory and regulatory authorities **to encourage the use of central counterparties (CCPs) to guarantee OTC derivative financial instruments**, as the central counterparty would help to improve efficiency by reducing the counterparty risk implicit in the use of said instruments.

Firstly, it should be considered that, as the regulatory process to define a discipline for CCPs is currently underway, we do not have **material indications as to how many CCPs there will be, on how they will function,** what types of derivatives they will be able to manage, what effective guarantee to be able to substitute the current OTC market they will be able to give and with what timing and costs.

Whilst waiting to clarify these aspects, in order to allow the banks to be able to plan and assess the development of their transactions, not only on their own behalf, but also on behalf of their corporate customers, **we request that transactions in OTC derivatives are not excessively penalised, in terms of risk weighting.**

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. However, the shared proposal to restrict said treatment to positions held vis-à-vis CCPs that respect the high organisational and risk management requirements envisaged by CPSS-IOSCO Standards, is in itself a restrictive move.

We therefore agree with the idea of attributing a zero-risk weighting to derivatives cleared by CCPs, leaving a higher weighting for derivatives that are not cleared by central counterparties, **but we do not support the proposal to introduce further penalties for contracts cleared bilaterally (in particular the envisaged** stressed Expected Potential Exposure - **EPE and the add-on** for Credit Valuation Adjustment - **CVA risk**).

We would like to highlight that 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 (especially when using internal models) the application of multiplication factors thereby creating a multiple amplification on the final requirement.

These penalties would 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 of the same to efficiently manage the risks assumed.

Moreover, this additional burden could impact on the hedging activity of non-financial companies. These companies hedge their risks subscribing derivatives contracts with intermediaries and generally need “customised” contacts in order to achieve “complete” hedging results. On one hand, contract standardization, that is an essential requirement to settle CCPs, could partially reduce the ability of companies to efficiently hedge risks by means of said contracts. On the other hand, companies could be discouraged to subscribe with banks bilateral contracts that, due to the possible imposition of higher capital requirements, could be more expensive. Therefore non financial companies’ effective implementation of hedging policies for undertaken risks could be more difficult.

c) 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 insurgence 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.

Therefore, subordinately to the proposal to not envisaging penalties on capital requirements as regards bilateral transactions in OTC derivatives, we request the following:

- For the purposes of calculating EAD, the possibility of considering the mitigating effect of using cash collateral and other forms of guarantee, in addition to netting, in the manner consented by the current provisions of Basel II;

- Confirmation, as regards the Maturity of Bond Equivalents and with reference to exposures in derivatives hedged by collateral, of the possibility to determine the maturity on the basis of the contractual margination time of the same collateral (e.g. one week).

d) We request confirmation that the add-on on CVA risk is only used to estimate unexpected losses.

e) We also ask whether, in the case of the “direct” or “indirect” membership of a Multilateral Clearing House for OTC derivatives, it is possible to use the zero weighting for exposure and collateral[5].

f) Lastly, as regards the use of ratings provided by the ECAI and, in particular, the assessment activities that would be requested of intermediaries regarding (i) the correctness of the weights applied to “unrated” exposures as well as (ii) the quality of unsolicited ratings with respect to solicited ratings, we draw attention to the fact that several national Supervisory Authorities, such as for example the Bank of Italy, already require banks that use external ratings to regularly conduct an

[5] For example, the SwapClear Client service of the LCH.Clearnet Group, which can be accessed both as a member (“direct” membership) and as a client (“indirect” membership, accessing the instrument clearing service through a Broker, who is a full authorised member).

independent assessment of coherence between the external ratings and internal creditworthiness judgments. We therefore ask ourselves what the impact of the proposal would be with respect to what is already performed by intermediaries under current legislation.

* * *

Technical annex 1 contains further requests for clarification/proposals for changes to the consultative document.

C) Leverage Ratio

We ask: i) that the leverage ratio is a Pillar 2 measure; ii) the introduction of supervisory “adjustments” to offset the differences in the accounting standards; iii) a strict correlation between the criteria underlying the leverage ratio and those of liquidity indicators. With reference to the definition of the ratio, we ask that the numerator is represented by the total capital and, in the denominator, off balance sheet items are included by applying the regulatory netting and collateral rules.

1. *Characteristics of the indicator*

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 standards adopted in the different jurisdictions.

With reference to the content of paragraph 205 of the consultative document, we believe that a leverage ratio defined in this way 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.

In any event, a quantitative indication of the level that the Committee intends to set as the minimum value to be met for said measure must be proposed as soon as possible. Similarly, it needs to be clarified how said ratio should act in the different stages of the economic cycle.

Similarly, it is not clear which intermediaries are included in the scope of application (“total limited number of intermediaries”), nor the means of application (“only in growth stages of the economy”), nor whether said measure should be applied only at consolidated level.

In respect, 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. However, this should not involve 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, derivates and off-balance sheet items) or, alternatively, defining it gradually in relation to the growth rate of the exposures.

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.

We agree with the fact that the leverage ratio should be appropriately disclosed within the ambit of Pillar 3.

As underlined in the consultative document in question (par. 219), we recommend a strict correlation between the criteria underlying the leverage ratio and those of liquidity indicators. The proposal envisaged in par. 218, namely that all assets, including high quality liquid assets, should be included in the denominator of the ratio expressly contradicts that envisaged as regards liquidity indicators which, instead, encourage banks to hold said assets. The simplest solution could be that of eliminating the high liquid assets from the calculation of the exposures considered for the leverage ratio.

It can be observed, in addition, 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.

2. *Off-balance sheet items*

a) *Derivative instruments*

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 (for the reasons illustrated in the paragraph on Counterparty Risk), 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.

With reference to credit derivatives, the proposal made by the Basel Committee to use a conversion factor of 100% of the notional value for protection sales, based on the similarity between selling protection and providing a guarantee, is accompanied by the prescription of the non-admissibility of the netting between the protection purchased and sold, insofar as this practice is retained inconsistent with the treatment of credit risk mitigation for on-balance sheet items.
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 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. >=20);
  - limited concentration, i.e. each component must not have a weight in the index above an established threshold (e.g.<= 5%).

b) *Securitisations*

The Committee does not appear to make any distinction between the cases in which the Originator preserves a significant part of the credit risk of the underlying portfolio, through, for example, the purchase of junior notes issued by the securitisation vehicle, and cases in which the exposure to said risk is mitigated by the circumstance that the same notes are sold on the

market and/or in any event forms of credit protection are present (through for example, credit default swaps).

We propose, therefore that, with regard to some cases of transactions such as synthetic exposures towards securitisation vehicles, the application of a coefficient corresponding to a fraction of the value of the underlying portfolio is applied.

Lastly, in addition to the introduction of netting between items, it should be confirm the exclusion of cash from Total Assets and the exclusion of the items already deducted from the numerator.

* * *

Technical annex 1 also contains further comments, requests for clarification and proposals for changes to the consultative document.

D) Countercyclical buffers

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

The measures aim to limit the degree of procyclicality of the financial sector are less consolidated than the others and still require further exploration by the Basel Committee.

We therefore believe it is premature to define capital buffers on the basis of the information currently available. 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.

We also draw attention to how the results of the QIS for the calculation of the countercyclical buffers (average PD and downturn PD) must be considered taking into account the inexistence of sufficient time series of the PDs. Data related to periods prior to the authorisation of the Regulator to use advanced models will in fact be reconstructed on the basis of assumptions that will not show the effects resulting from changes in scope or of the models used.

Nonetheless, we have made several observations below regarding the individual instruments indicated in the Consultative Document.

1. *Cyclicality of the minimum requirement*

As shown in the Consultative Document, there is a direct relationship and coherence between the use of risk-sensitive metrics and the cyclicality 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 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. With reference to the impact study, the Consultative Document makes two proposals. The first regards the adoption of the downturn PD, calculated as the maximum PD observed in the available time series, the second regards the use of the average "historic" PD.

The aim of these proposals, by stabilising the volatility of PDs, is to dampen the procyclical effects of requirements and represents, in reality, a simplified but distorted way of reproducing the effects of a rating through the cycle system. The use of this system would, in fact, enable requirements to be stabilised while maintaining the sensitivity of the portfolio to risk.

Vice versa, the measures proposed, although mitigating the volatility of requirements, tend to crystallise credit quality throughout the whole economic cycle, neglecting the risk-sensitive nature of the parameters used in risk management models, threatening, in this way, one of the cornerstones of Basel 2, which sees the development of "risk sensitive" parameters and their use for the granting of loans, in risk management, in the internal allocation of capital and in the bank's governance functions, as a fundamental requisite also for the purposes of corroborating internal models. Alternatively, in order to maintain the managerial use of ratings (use tests) effective, it would be necessary to introduce a dichotomy between "regulatory" PD (generally through-the-cycle) and "managerial" PD (generally point-in-time), a circumstance whose regulatory compliance does not appear to be taken for granted.

In any event, we draw attention to how complicated it is to imagine the calculation of average PD and downturn PD using an entire economic cycle, given the unavailability of times series of comparable PD, compliant with Basel 2 over such a long time interval.

It is not clear whether this measure falls within the ambit of Pillar 1 or Pillar 2. In the first case, to avoid an excessive increase of minimum requirements, we believe it necessary to calibrate the Scaling Factor based on a long-term average PD. If the buffer in question falls, instead, within the scope of Pillar 2, the interrelations with the other countercyclical

measures need to be appropriately defined, in particular with the buffers linked to the minimum Capital Conservation Ratio.

The supervisory authorities should, in any event, adopt a flexible approach, particularly as regards the philosophy underlying the rating systems used by the various banks, which should be assessed on a case-by-case basis, so that they don't generate unjustified disparities in treatment. Banks that demonstrate that they have adopted through-the-cycle rating systems to calculate capital should be able to be exempted from the application of the correction, which would, on the other hand, have a greater impact on banks with point-in-time rating systems. In any event, the correction should be calibrated on a prudential average rather than a stress situation.

Alternatively, to circumvent problems related to the availability of time series data, central banks could propose a coefficient (multiplier), calculated on system data, that each bank should adapt to its own level of cyclicality (quantified statistically or by means of quantitative/qualitative questionnaires).

2. *Forward looking provisioning*

We agree with the Committee's intention to support the IASB initiative to adopt an expected loss approach" and to "promote an EL approach that captures actual losses more transparently and is also less procyclical than the current 'incurred loss' approach.

However, in order to be able to express an opinion on the proposal, we feel the need to have more elements on the changes to accounting standards and their adoption at national level in the various countries, also considering the different tax regimes currently in force.

Furthermore, it should be noted that the model proposed by the IASB, as well as being excessively complex, does not resolve the procyclicality issue, instead it will presumably accentuate it, insofar as it envisages that the effect of changes in expectations of expected future cash flows are recorded immediately in the income statement.

As indicated in the Consultative Document, the application of the "expected loss" concept must ensure that provisions reflect all of the losses of the existing portfolio, expected over the entire life of the portfolio, on the basis of a more extended set of information that than applied in the "incurred loss" approach.

This approach does not necessarily guarantee coherence with the objective of reducing procyclicality. In fact, if "point-in-time" logic is used for the valuation of provisions, there is a risk of potentially highly volatile "expected losses". To reduce the cyclical impact on capital, the metric of the EL with

which provisions are to be estimated, must be calculated using through-the-cycle logic, consistent with the criteria proposed for the estimation of PDs.

While we agree with the aim of the Basel Committee's position supporting the introduction of impairment rules based on the expected loss model, it raises some potential critical issues in terms of its application by smaller banks, such as cooperative credit banks, which use the standardised method for prudential purposes; the IASB's proposal would be particularly onerous to implement and manage.

In any case it is important to clarify, aiming to avoid double counting between the income statement and regulatory capital, the link between the use of a downturn PD for capital buffers and the use of EL to calculate provisions for accounting purposes.

In fact, the potential use also for the provisioning of a downturn PD (that can even be defined as "stress' if calibrated to the maximum levels consequent of the current economic cycle), would imply provisions at higher levels than the expected average levels. The result would be that the provisions would partially cover also unexpected losses that, instead, would be covered by regulatory capital.

In addition, if capital requirements and risks are measured by means of "stressed" risk factors (PD and LGD, in primis) the definition of "capital contingency" measures by the management would be useless insofar as the capital would also cover the impact of stress.

Lastly, we would like to emphasise how the proposal to deduct any shortfall of the stock of provisions to expected loss from Tier 1 capital (rather than the present deduction of 50% from Tier 1 capital and 50% from Tier 2 capital), justly motivated by the need to discourage the underestimation of adjustments, further accentuates the asymmetry with respect to the treatment of a positive balance of the stock of provisions for expected losses (within the scope of Tier 2). In this regard, we believe it would be reasonable to symmetrically introduce (as already mentioned in the section regarding the quality of capital) the inclusion in the calculation of any positive balance (excess provisioning).

This correction system, which is consistent with the current "incurred loss" approach, should, in any event, be reconsidered as a function of the changes made to IAS/IFRS as regards credit provisioning.

3. *Building buffers through capital conservation*

We would like to underline the need to clarify whether the envisaged provisions in terms of buffers are an alternative or in parallel to the provisions regarding the internal process to assess capital adequacy (ICAAP – Pillar 2 of Basel II).

The situation described in the Consultative Document poses delicate problems of interpretation for the system between the proposed regulations and those already in force regarding Pillar 2, where, in reality, the banks design processes, methodologies and tools to establish capital adequacy using different means with respect to that envisaged in Pillar 1. The rationale, which emerged at the time of the issue of Basel II regulations, is underlined by the capacity of the banks, particularly those with the most sophisticated approaches, to be able to implement more advanced tools to determine total internal capital and total capital, able to encompass a wider array of risks and financial sources/requirements that could not be identified with the standard rules of Pillar 1.

If the aim of the new regulation is effectively that of setting more stringent and more detailed capital requirements and/or compulsory limits, in line with the same, the current approach that entails envisaging, alongside precise capital requirements that however encourage the use of internal models, the independent assessment of the intermediary of its own capital adequacy, should be abandoned. However, this would mean revoking the principle, recently confirmed and cited above, of the need to have two pillars, both used to judge the degree of the bank's capital solidity, but using different tools, in order to ensure, internally and as regards the market, that – whatever the evaluation "metre" adopted – the overall judgment resulting from Pillar 2 either reinforces that already indicated by the first or highlights any problem areas to be remedied by appropriate action to rebuild capital adequacy.

Also with regard to the provisions – again introduced by the Consultative Document – regarding the measures that banks should adopt if said buffers are deemed to be insufficient, the same need to be highly coordinated with the current rules of Pillar 2. In fact, while we agree with the objective indicated (the establishment of capital buffers in "benign periods", to be reduced in the event of losses in periods of crisis), 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 indispensible, 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.

4. *Excessive credit growth*

The approach outlined would be difficult to apply in such a way as to guarantee equity between the various jurisdictions, as it depends on not necessarily robust macroeconomic analyses (the correlation between credit volumes and depth of the crisis must be demonstrated in a rigorous way) and explicitly contains an element of national discretionary power in the choice of the variables that determine the threshold for the activation of the additional buffer.

Furthermore, further discretionary margins are envisaged for national supervisory authorities, which can increase or reduce the amount of the buffer on the basis of general information. From the perspective of the stakeholders, said discretionary power generates further uncertainty as to the return on their investment, which goes beyond information that can be obtained, for example, from business plans.

Similarly, remember that underlying the excessive credit growth there is the assumption of perfect correlation between risk of recession implicit in the use of the downturn PD in the calculation of the minimum capital requirement, which could lead to excessive prudence.

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.

Furthermore, the use of information provided directly by the intermediary must be envisaged ("which supervisors and central banks will be able to consider in the context of the circumstances which prevail at the time").

On the other hand, the regulation 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.

Furthermore, 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.

With regard to the provision of considering Tier 1 capital only as the only "ingredient" of the buffers, we believe it is more coherent to permit the banks to use instruments (such as for example, soft mandatory bonds) which, although not initially having the traits of high quality capital, may be subsequently converted into capital (in other words, a sort of contingent capital). In this way, the range of instruments that could be used and the chances of success of their placement on the market would be greater, at conditions that are not prohibitive for the intermediary.

This proposal would be consistent with the timing of the process of rebuilding the capital buffer (the use of which can only be verified in the most acute phases of an economic crisis), when the economic cycle is in an improvement phase and recovery is envisaged in the near future, a period in which these instruments may taken on a temporary "relative or partial" nature of equity.

* * *

Technical annex 1 also contains further comments, requests for clarification and proposals for changes to the consultative document.

E) Liquidity

0. *Scope of application and transitional arrangements*

In order to facilitate efficacy and efficiency of liquidity risk management an application solely at consolidated level is required.

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.

It is therefore desirable that paragraph 133 is amended, providing only the first part of the statement ("the proposed standards and monitoring tools should be applied to all internationally active banks on a consolidated basis") and clarifying the **procedures that would apply to non-internationally** active banks with reference to the principle of **proportionality**.

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.

1. *Undesirable global effects consequent to the restriction of assets eligible for the liquidity buffer*

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 may also have an unintended consequence should some **asset classes that are eligible for the liquidity buffer (particularly sovereign debt) become scarce**. Though in the current environment of significant government deficit such a consequence may seem unlikely, in the long term the hope is that a recovery of the deficit will be realized. **A concentration issue** could also be triggered by the limited market diversification of eligible securities.

Furthermore, as the proposals result in **reducing the maturity transformation** role of banks, other market players will step in to substitute banks for this necessary function in the economy, which means that maturity transformation would largely no longer be supervised as it would take place outside the banking industry and, consequently, outside of the supervisory framework, without access to banking safety nets (liquidity buffers, access to central banks…).

2. *Instruments issued by the private sector*

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 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**[6], 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 Basel Committee'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.

3. ***Proposal of a solution: wider buffer or, secondarily, longer end***

In order to avoid an excessive cost of funding and an insufficient availability of assets for the establishment of the current buffers, the creation of a wider buffer is required.

Many of the perplexities illustrated in the **two previous paragraphs** and others that **will be illustrated below** could be partially mitigated, at

[6] 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.

least with **regard to the LCR**, by a "wider buffer", to be defined by changing the terms of paragraphs 35 et seq. to include in the liquidity buffer:

- the **securities** referred to in paragraph 36 (**corporate**) and paragraph 37 (**covered**),
- the cases illustrated in the previous paragraph (**securities** included **in share indices**, **bank shares**, fund constituents - which after adequate allocation[7] 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 certain sovereign securities (as proposed in paragraph 4 below) and the like
- central bank eligible but non marketable assets, to the extent described under paragraph 5.

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 paragraph 29 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.

Moreover, in our view, there is a fundamental problem when trying to assess to liquidity of any kind of bond by its bid/ask spread. As still the majority of covered bonds 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, also considered that it is common business practice to quote different prices for bonds to different customers at the very same point of time. Therefore, it will almost be impossible to capture consistent and coherent bond prices for a market driven approach to determine the liquidity of a 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

[7] 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.

50 bp in the past for a short amount of time might, could spoil the whole market for Pfandbrief.

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[8]. In this case, the assets set forth in **paragraphs 2**, and **4** of this document along with those of **paragraphs 36** and **37** of the Consultative Document, **could be included without further haircuts in the so-called “longer end” of the LCR** (period of over one week), whilst **it remains implicit** that the “0-1 week” buffer includes 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 marketable to the extent indicated in **paragraph 5** of this paper.

As explained before, the Committee proposal to define a single-tiered (one month) survival period and to restrict the composition of the buffer only to cash and cash-near assets (mostly, governments bonds) would have distortionary impacts on the bond markets and **would imply higher costs for banks, with potential negative effects on their lending activities**.

We ask that the term “country” in the various proposals referring to liquidity risk (like in paragraph 34.d) can be interpreted at the European level as synonymous of Euro zone Area.

4. *Specific aspects linked to the sovereign rating*

Request for recognition in the LCR and in the NSF of sovereign securities with a rating of between AA- and A-. Protection in the NSF of the sovereign securities of the home country.

[8] *ABI PP October 2009* “We believe that, as envisaged in the proposed guidelines, the concept of liquidity buffer should be developed over a two-phase (one week and one month) survival period and a corresponding two-tiered definition of eligible assets, with only cash and cash-near assets1 qualifying for the shorter end of the survival period and a broader set of liquid assets allowed for the longer end. The alternative choice of defining a single-tiered (one month) survival period and restricting the composition of the buffer only to cash and cash-near assets (mostly, governments bonds) would distort the bond markets and entail higher costs for banks, as well as potentially negatively affect their lending.

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 least AA-) whereas they are totally excluded if their risk-weighting is above this threshold (paragraph 34 point c of the Basel Consultative Document). 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** (paragraph 35 of the Basel Consultative Document).

a1) Therefore (in line with paragraph 3), **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 a relaxation of the eligibility criteria for the LCR could be acceptable, that leads to the wide inclusion of sovereign securities with risk-weights of above 0% (regardless of the relation between the issuing country and the bank that holds them in its portfolio) at least for the "**longer end**" of the LCR, as per the CEBS proposal dated July 2009**.**

Securities issued or guaranteed by sovereigns and the like are similarly penalised with respect to corporate bonds within the framework of the Net Stable Funding Ratio, too. While two tiers of corporate bonds benefit from Required Stable Funding Factors lower than 100% (the second tier including bonds rated at least A-), only sovereign securities and the like which have a rating of at least AA and a 0% risk-weight share a similar benefit. it is hereby proposed that the benefit is extended -with an appropriate Required Stable Funding Factor below 100%- at least to a second tier of 20% risk weighted sovereign securities and the like.

b) for this reason, it is hereby proposed that the benefit is extended -with an appropriate Required Stable Funding Factor below 100% - at least to a second tier of 20% risk weighted **sovereign securities and the like**, by adding an ad-hoc row to Table 2 under §89.

c) In addition to proposal b) **we request that point d) of paragraph 34 is added to table 2) of paragraph 89 on the 5% line,** 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.

5. *Central bank assets that are eligible but not marketable*

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.

6. *Other matters regarding the LCR*

a) With reference to stress scenarios, we note **extremely penalising assumptions** with an **asymmetrical treatment of assets and liabilities**:

- Liabilities: the substantial closure of the wholesale market is envisaged and of significant percentages of customer run-off;
- In particular, the envisaged 100% weighting of unsecured wholesale funding (point 55) risks having an extremely significant impact on interbank market amounts due within 1 month, with the danger of a substantial decrease in related liquidity and therefore a serious impact on regular system trading. It should also be pointed out that, even during the most precarious moments of the crisis, Italian banks generally had continuous access to the interbank market, albeit with shorter terms.Assets: the lack of repayment of on-demand loans and further draw downs of not only committed lines but also of revocable lines are envisaged.

b) 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.

c) Again, in any event, at least the **portion of each deposit under the guarantee threshold of the Interbank Fund should be considered "stable** deposits", even independently to the application of the other conditions envisaged in 41 a).

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.

d) We would like to ask the Committee 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.

e) 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) existing 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 afore-mentioned 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 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, as specified further on, for 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 section 23 of the Consultation Paper published by the European Commission "Possible further changes to the capital requirements Directive" 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.

7. *Other matters regarding the NSF ratio*

It is not considered appropriate to set the NSF within a stress test analysis context. Proposed review of Italian legislation on transformation of the maturities.

a) 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.

Legislation on the transformation of maturities, although no longer in force since 2006, in reality continues to be benchmark for liquidity risk management, a situation which has no doubt contributed to the reduced impact of the liquidity crisis on Italian banks.

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.**

b) It is unclear whether, under the item "**all other assets**" the fair value of the derivatives recognised on the balance sheet should be considered.

If the answer is affirmative, the value to be considered should be that of the positive fair value net of the corresponding values of negative fair value, at least for the counterparties admitted to regulatory netting.

The netting of other similar types of trade, either by sector or by maturity would also be desirable.

Note that, paradoxically, not allowing netting for these purposes would require banks to fund asset items that are already funded by corresponding and correlated passive items, with other sources. For example, a derivative with a positive fair value hedged specularly with an identical derivative with a negative fair value, would, if netting is excluded, have to be included under the items to be funded, while its is already naturally funded by the corresponding derivative in liabilities.

c) With regard to the cooperative lending banks network, our considerations are similar to those expressed in point e) of the previous paragraph.

8. *Frequency of calculation and functioning of liquidity buffers*

Request for differentiation, between LCR and NSF, in terms of frequency of the calculation and reference data. Proportionality principle for the NSF.

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 that 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.

9. *Joint assessment with all of the other new provisions currently being drawn up*

Finally, the effect of any liquidity buffers should be seen in conjunction with other capital requirements including plans for a leverage ratio and dynamic provisioning which will further compete for capital funding.

* * *

<u>**See technical annex 2 for further important request for amendments to the Consultative Document, as well as for several questions/comments not included for the sake of brevity in the PP.**</u>

ABI Associazione Bancaria Italiana

ABI Comments on Consultative Document issued by Basel Committee on Banking Supervision "Strengthening the resilience of the banking sector"

Technical attachment No. 1

April 2010

A. QUALITY OF CAPITAL

Page	Paragraph	Document text	Comments or amended version of the text	Supporting documents (records, examples, literature, etc.)
Tier 1 – other elements				
Grandfathering and transitional provisions				
17	84	*Given the significant changes proposed to the definition of capital, 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*"	See Section A, paragraph 1 of the ABI position paper	
Proposed harmonised structure of capital				
Criteria governing inclusion in the Common Equity component of Tier 1				
18	87	Characteristics of instruments for inclusion in 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. 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.	
18	87	Shares without voting rights (savings or privileged shares)	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 an 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	

19	87		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 Committee'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 (point 84) allows to adopt this solution. **point 4:** 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. **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.	
Criteria for inclusion in Tier I *Additional Going Concern Capital*				
19	88		We propose a modification of certain criteria considered in the consultative document 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. With reference to the criteria for the inclusion of instruments in Tier 1 – Additional Going Concern, we state the following:	
20	See Table		**<u>Point 4</u>** 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. **<u>Point 5: Call Option</u>** We propose providing the possibility that such 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. **<u>Point 5 lett. c.2</u>** 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). Substantially, after the exercise of the call option, the issuer must not have worsened capital requirements. **<u>Point 6: Buy back</u>** We propose to define quantitative limits to allow market making in line with the provisions of the CEBS guidelines: "It is proposed that repurchased instruments held by the institution for market making purposes shall not at any time account for more than either 10% of the relevant issue or 3% of the total amount of all outstanding hybrid instruments issued by the institution, whichever of the two limits is the lowest". In this regard, we point out that also the aforesaid European Commission Consultation Paper on the possible further modifications to the discipline of bank capital requirements (so-called CRD4) has not denied this possibility. **<u>Point 7: Dividend/coupon discretion</u>** 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 Tier 1 instruments very expensive. **Point 7 lett. a** 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). **Point 7 lett. d** 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. **<u>Point 8 – Distributable items</u>** For 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	The CEBS envisages forms of ACSM (**Alternative** *Coupon Satisfaction Mechanism*), namely using the cash generated by share capital increases or from the issue of bonds with the same characteristics for coupon payment

			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". **Point 11: Loss Absorption** It should be specified that the write-down provided in the consultative document as a loss absorption mechanism is temporary in nature. The need to absorb losses could be pursued through a temporary write-down mechanism and the introduction of a write-up mechanism in liquidation. It should also be noted that if the reduction in the nominal value of the instruments as a result of the capital ratios' drop below certain thresholds (still to be set) were permanent, there could be negative implications for purposes of the tax treatment of the relative interest and income. In fact, the circumstance that said instruments – not classifiable for civil law purposes as bonds – cannot even be included in the fiscal notion of similar securities as failure to comply with the unconditional obligation to pay at maturity an amount that is not lower than the original capital, would entail the application of the more onerous regime envisaged for so-called atypical securities. On this issue, we also point out that temporary write-down mechanisms are provided by the CEBS guidelines and that CEIOPS has also provided the possibility of	

			alternative loss absorption mechanisms to mandatory obligation and permanent write-down. 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 in which 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.c paragraph ii, its exercise - always subject to the Supervisory authority's authorization – is in any event 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 value and with the additional provision of a write-up when the bank's capital ratios were to return above given percent thresholds. Said subsequent write-up should presumably take place only referring to capital net of any subsequent share capital increases in order to immunise new shareholders from the effects of said write-up. If this were not the case, the first portion of the share capital increase would be to the sole benefit of holders of hybrid instruments, the subject of the mark-down and this would make any recapitalisation more difficult and in any event more expensive. 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”. **Point 14** We propose to maintain the possibility of issuing through Special Purpose Vehicles in order to maintain flexibility of choice for the issuer, in line with what is generally envisaged by other European jurisdictions.	
Criteria for inclusion in Tier 2 *Gone concern capital*				
21	90	Characteristics of instruments for inclusion in Tier 2 capital	With regard to the criteria for inclusion of instruments in Tier 2 capital, we would like to make the following comments: **<u>Point 4, lett. c (no incentives to redeem)</u>** With reference to the criterion that does not allow the inclusion of instruments characterized by incentives to redeem in Tier 2 capital, we propose maintaining a moderate incentive to redeem by the issuer. We deem that this approach can provide benefits in terms of balance between capital stability (the incentive would be moderate and, in any case, early redemption would be subject to the authorization of the Supervisory Authority) and investor's risk. Moreover, said approach would favour an alignment between the discipline of the banking and of the insurance industries. In 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 be functional with the need – viewed with favour by the Basel Committee in the January 2010 document ("Review of the differentiated nature and scope of financial regulation") - to avoid unjustified differences between banking and insurance regulations. **<u>Point 5, lett. c, paragraph ii)</u>** We propose replacing the words "well above", a 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 minima requirements 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. **<u>Point 8</u>** We propose maintaining the current treatment (buy back without authorization up to 10% of each issue) and introducing an exemption for market making activities.	
22	91	"The Committee will discuss concrete proposals in this area at its July 2010 meeting, dedicated to the role of convertibility, including as possible entry criteria to Tier	We stress that the market for instruments such as contingent capital is not yet developed, so overly stringent guidelines could limit demand for the same. It should also be clarified whether, within the scope of more thorough analysis on contingent and convertible capital, the Basel Committee intends to assess the opportunity of introducing conversion obligations also in the case of Tier 2 instruments.	

		1 and/or Tier 2 capital ...”	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. This consideration also pertains to mechanisms for loss absorption by write-down, of which we emphasise (even if only for the sake of a complete analysis) their incompatibility with the structural nature of "gone concern capital" of Tier 2 instruments.	
	92	Lock-in mechanism	With reference to the proposed introduction of lock-in mechanisms for Tier 2 instruments, we deem such mechanisms to be superfluous and they should not be introduced. The Basel Committee introduces the concept of going	

			concern capital (capital in business continuity) and gone concern capital (capital in liquidation). Since Tier 2 is gone concern capital, there is no reason to introduce lock-in mechanisms. Also, the "lock in" could apply only in the case of final redemption. In this circumstance, by effect of regulatory amortization, the contribution of the subordinated security for the purposes of Regulated Capital would only be 20% of nominal capital, based on the proposals contained in the consultative document. Therefore, the effect of the "lock in" mechanism would *de facto* be greatly limited.	

Minority interest				
23	95	Minority Interests	For comments and proposals, see paragraph 4, section A of the PP	
Unrealised gains and losses on debt instruments, loans and receivables, equities, own use properties and investment properties				
23	96	Unrealised gains and losses on debt instruments, loans and receivables, equities, own use properties and investment properties	We propose the full recognition of valuation gains or losses resulting from trading activities, with the possibility for the supervisory authorities to derecognise gains from non-trading activities even if classified as such in the financial statements. This should be envisaged even in the case of a new definition of IAS 39 accounting categories for financial instruments. As regards equity investments in banks, financial and insurance entities, we request clarification as to whether valuation reserves should be deducted from capital.	
Deferred tax assets				
24	98	Deferred tax assets	For comments and proposals, see paragraph 2, section A of the PP	

Investments in own shares (treasury stock)				
24	100	Investment in own shares "Banks should look through holdings of index securities to deduct exposures to own shares"	This is an approach with a high degree of operational complexity. It could lead to a high degree of variability in Capital adjustments.	
Investments in the capital of certain banking, financial and insurance entities which are outside the regulatory scope of consolidation				
25	101	*"If the bank has holdings of common stock in other financial institutions which in aggregate exceed 10% of the bank's common equity (after applying all other regulatory adjustments to common equity) then the amount above 10% is required to be deducted".*	For comments and proposals, see paragraph 3, section A of the PP	Current legislation envisages a net distinction between a financial entity and an insurance entity. Insurances entities would appear to be included in the definition of Financial Institution unless there is a different degree of correlation of insurance risk with lower "double gearing" profiles. The maintenance of the 20% threshold is in line with the definition of "significant influence" given by IAS 28 (par.6) and with that envisaged as regards the definition of equity investment given in Italian Legislative Decree no.142/2005 regarding financial conglomerates.
25	101	*Trading & market making instruments issued by banks, financial and insurance entities*	For comments and proposals, see paragraph 3, section A of the PP	We draw attention to the distinctive nature of the Italian index (FTSE MIB) with respect to indices of other European stock

				markets, for which the weighting attributable to bank, financial and insurance issuers corresponds to around 44%, compared to around 30% of the DJ Euro Stoxx 50 index.
24-25	101	“All holdings of capital which form part of a reciprocal cross holding agreement or are investments in affiliated institutions (e.g. sister companies) are to be deducted in full on a corresponding basis”	The specific meaning of holdings which are the subject of reciprocal cross holding agreements or are investments in "affiliated institutions" needs to be clarified. The concept of “relevant exposures” needs to be better clarified.	
Shortfall of the stock of provisions to expected losses				
25	102	Shortfall of the stock of provisions to expected losses (shortfall reserve)	We agree with the new deduction rule, although onerous (100% from Tier 1 capital). It is obviously intended net of the tax effect. We believe it would be reasonable to introduce, in parallel, the calculation of any positive balance (excess provisioning). The regulatory treatment of the difference between financial statement write-offs and expected losses should be reconsidered on the basis of the amendments made to IAS/IFRS regarding the provisioning of receivables. Any overlaps with rules regarding countercyclical provisions are to be avoided.	
Defined benefit pension fund assets and liabilities				
26	106	Defined benefit pension plans	We hope for clarification regarding the type of pension plans and the assets of the plan of interest in this case.	
Remaining 50:50 deductions				
27	108	Remaining	Maintaining the current alternative of a 1.250% weighting	

		deductions, previously 50% from Tier 1 and 50% from Tier 2	needs to be evaluated (e.g.: exposures towards securitisations without ratings). Furthermore, the parallel drawn between the future capital requirement and the weighting is not clear (1.250% refers to 8%)	

B. Counterparty risk

Page	Paragraph	Document text	Comments or amended version of the text	Supporting documents (records, examples, literature, etc.)
32	122	*"...The internal model must employ current market data to compute current exposures. When using historical data to estimate volatility and correlations, at least three years of historical data must be used and must be updated quarterly or more frequently if market conditions warrant. The data should cover a full range of economic conditions, such as a full business cycle. The model must also employ data from a three-year period that includes the one-year stressed period that is used for the market risk Stressed VaR calculation for credit assets.."*	**Comment** We envisage potential difficulties in reconstructing the three year period that includes the one year stressed period: the matter is important to the various underlying instruments of derivative instruments whose data retrieval and historicisation could be difficult. **Query** Furthermore, it is not clear how any users of IMM that are not at the same time validated on market risk models could identify the "three year period that includes the one year stressed period". **Query** In more general terms is not clear why we should use the same time reference period for the "stressed EPE" and the "stressed VAR": we note that worst case VAR's scenarios are not the same as worst case EPE's scenarios (that is more sensitive to MtM increase). In other terms it will be simpler and effective a selection of scenarios / periods with a particular impact for the bank, or the use of different scenarios for "stressed EPE" and "stressed VAR".	
33-34	125	"*In addition to the*	Prior to other matters that will be illustrated afterwards:	

		capital requirements for counterparty risk determined based on the standardised or internal ratings-based (IRB) approaches for credit risk, a bank must calculate an additional capital charge to cover mark-to-market unexpected counterparty risk losses. This additional charge must be calculated by treating counterparty exposures as bond equivalents, and is determined by applying the applicable regulatory market risk charge to such bond-equivalents, after excluding the Incremental Risk Charge (IRC)."	• When calculating the required add-on for CVA risk (bond equivalent method) reference is only made to OTC derivatives; does this imply that in the construction of bond equivalents, SFT (repurchase agreements?) transactions are not considered and that therefore the add-on requirement does not regard SFT?
			• Accordingly, if it is confirmed that SFT are included in the add-on requirements, it should be clarified if for EAD (for banks that use the CEM and not IMM method) do you mean the exposure value (e. g. the exposure value less the value of the guarantee with volatility adjustments).
			
			For banks that apply the Standard Method, we would like to have details of the manner in which the add-on capital requirement is estimated as regards the CVA through the bond-equivalent method and details of the manner in which the following are calculated (**see also section B.c of the PP)**:
			• Exposure At Default (EAD) of the bond equivalent to be used to estimate the add-on requirement, for which, in particular, we request (**Proposals**):
			  o confirmation of the application of benefits resulting from netting agreements according to the current provisions of Basel II (regulatory netting), allowing therefore netting between exposures with a positive fair value and exposures with a negative fair value towards the same counterparty and/or the same group of counterparties;
			  o the express introduction of the possibility of considering the mitigating effect of using cash collateral and other forms of guarantee, in the manner consented by the current provisions of Basel 2, in the calculation of EAD;
			  o the possibility of considering the fair value and not also future credit exposure in the	

			calculation of EAD; o Lastly, we request confirmation of the need to consider the net exposure in Securities Financing Transactions (SFT); • the *maturity* del *bond equivalent*, for which, in particular, we request confirmation: o whether, for derivative exposures hedged by collateral, it is possible to define the collateral marginalisation schedule (for example one week) as maturity; o of the possibility of using the weighted average maturity of exposures towards the counterparty as envisaged in the same paragraph regardless of the existence of Master Netting Agreements.	
35	131	*"The Committee concluded that it is extremely difficult to address general wrong-way risk through explicit capital charges and that implicit coverage of this risk through the Alpha multiplier is currently the best available option."*	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.	
36	134	*"A bank must have policies acceptable to its supervisor regarding the treatment of individual entities in a connected group including circumstances under which the same*	**Proposal** We propose to use the scope of consolidation of financial statements as a criterion to identify connections between counterparties for the purposes of wrong way risk.	

		rating may or may not be assigned to some or all related entities."		
40-41	150-153	*"Increase the margin period of risk.."*	**Comment** We envisage a fundamental difficulty in the possibility of discriminating instruments such as OTC derivatives by "degree of liquidity" as the same are by definition not very liquid. For this reason, parametering the margin period to the different levels of liquidity could be difficult. Moreover, the proposed increase to 20 days for the margin period of risk on the whole netting set appears to be extremely penalizing if the number of OTC derivatives that are considered "illiquid" is marginal compared to the whole netting set (i.e. 3 illiquid deals with respect to 1000 deals' netting set). **Proposal** We therefore propose increasing the margin period of risk to 20 days only for netting sets where the portion of "illiquid" OTC derivatives is significant or, in the alternative, to apply the proposed increased margin period of risk only to "illiquid" contracts of the netting set.	
48	173	*"Banks must have a comprehensive stress testing program for counterparty credit risk…"*	**Comment** The text proposes to detail the quantitative aspects of the stress test exercise already mentioned in a generic way in the legislation in force. A detailed list then follows, which covers the whole of page 48 and which comprises 7 bullet points, containing precise specifications on the type of scenario, the manner of aggregation of results and the frequency with which said tests should be carried out. The implementation of the regulation formulated in this way could easily lead to the development of a programme of hypertrophic and chaotic stress tests, with little or no use for the risk management. **Proposal** It would be useful to introduce clear specifications on the need to identify a few significant stress test scenarios for each financial institution, to be conducted frequently and	

			to be reported to the senior management with top priority.	
50	174-176	*"Back-testing..."*	**Query** The manner in which a backtesting exercise on EPE (comparison between volatilities?) is to be conducted needs to be clarified. Relations with backtesting on the Probability of Default - PD (difficult to carry out, due to the limited number of defaults of institutional counterparties).	
57	192-194	*"Incentive to avoid getting exposures rated..."*	**Comment** Although we fully agree with the reasons that led the Basel Committee to formulate the cited proposal, we believe it is important to underline how, for numerous banks that use the standard method to calculate the capital requirement against credit risk, the presence of customers whose external rating is not used for the calculation of capital requirements stems from the fact that only a very small (often insignificant) percentage of its customers have an external rating issued by an ECAI recognised by the Supervisory Authority and used by said bank. The existence of an insignificant percentage of customers with an external rating makes mapping between internal creditworthiness ratings and external ratings extremely difficult, and, consequently, performing the requested check, for which customers without ratings are correctly associated to a weighting coefficient of 100%. **Proposal (see section B.f of the PP)** The cited grounds (together with the fact that several national Supervisory Authorities, such as for example the Bank of Italy, have already requested the banks that use external ratings to continuously conduct an independent assessment of coherence between the external ratings and internal creditworthiness judgments), lead us to request the removal of the indicated amendment proposal.	

C. Leverage ratio

Netting				
62	Leverage Ratio – Exposure. Measure –b. Netting (par.214-216; 226-228)		For comments and proposals see paragraph 1, section C of the PP	
62	Par. 212	*Relationship with accounting*	At present, some accounting representations (e.g. RE.PO and derivatives) tend to "inflate" balance sheet assets. We hope the possibility of applying netting is envisaged.	
62	Par. 214 and foll.	*Netting/ Derivatives*	For comments and proposals see paragraph 2 a), section C of the PP	
62	Par. 214 and foll.	*Netting/ Derivatives*	Some operations, especially on CDS ITRAX entail the opening of contracts with the opposite sign to the same index and very often with the same counterparty.	We propose to consider the net balance of the position on the same index for the purpose of quantifying protection sales, given that the risk of losses only exists if the following events occur at the same time: 1. Default of the underlying; 2. Default of the counterparty that sold protection
63	Par. 224	*Leverage Ratio – Exposure Measure/ Securitization* *"According to the treatment provided for credit risk mitigation, synthetic (or unfunded) securitisations do*	For comments and proposals see paragraph 2 b), section C of the PP	

		not reduce the exposures amount of the underlying portfolios".		
64	Par. 232	*Leverage Ratio – Off balance sheet items*	This paragraph combines, on one side purely "financial" instruments (e.g. *credit substitutes* and *commitments*) with others of a "commercial" nature (*acceptances, trade letter of credits* and, partially *standby* LCs), on the other side, it groups instruments that represent a "certain" commitment (*commitments*, *acceptances*, etc) with others that represent a conditioned commitment (in particular *trade letter* of *credits*, which transform into a commitment only when the exporter makes the export and presents compliant documents). We believe it to be penalising to consider off-balance sheet commitments, of a certain and financial nature, together with commitments of a commercial nature (where there is by definition an underlying counterparty who in the first instance will be called to render his service, and where the bank, therefore, has a subsidiary commitment), and in particular those that have not yet been transformed into a certain commitment (therefore *trade letter of credits*, with respect for example to acceptances). A penalisation of said instruments, which play a fundamental role in the regulation of commercial cross border transactions, could have negative repercussions, both in terms of cost and in terms of credit availability, on the flows of commercial trade between countries.	Note that ASF-IFSA international financial services trade association is drawing up a position paper highlighting the same problem areas.

D. COUNTERCYCLICAL BUFFERS

Page	Paragraph	Document text	Comments or amended version of the text	Supporting documents (records, examples, literature, etc.)
Cyclicality of the minimum requirement				
			For comments and proposals, see paragraph 1, section D of the PP	
Forward looking provisioning				
			For comments and proposals, see paragraph 2, section D of the PP	
Building buffers through capital conservation				
			For comments and proposals, see paragraph 3, section D of the PP	
68	249	"Items subject to distribution restrictions. The items in question are ordinary dividends, repurchases of own shares, <u>discretionary payments on Tier 1 capital</u> and <u>discretionary staff bonuses to employees</u>"	Tier 1: The instruments (still to "build") would not only be characterised by "fully discretional" coupons (page 15 par. 76), but would also be included within the limits of the Buffer, presumably making the instrument even more onerous. Restrictions to "distributions" also regard "discretionary" "staff" bonuses. The scope of application of the measure needs clarification (extent of the definition of staff), as well checking coherence with the proposal of the FSB in terms of the review of compensation practices.	
69	258	"if a bank suffers losses such that its capital level falls to a level above the minimum requirement equal to x% ..the bank would be required to conserve y% of its earnings in the <u>subsequent financial year</u>	The role of the profits of the current year is to be clarified (se also note 17 page 17 of the consultation document) in the calculation of ratios (and consequently of buffers). If not considered (net of dividends), the dynamics would always be one year behind.	If in the year x the buffer is low, the profits of year x + 1 should be retained to the measure of an established %. In the event, for example of the disposal of assets (and therefore extraordinary gains) in year x + 1, the % might not be representative (i.e. a lower % could be sufficient to satisfy the requirements of the buffer).

70	258	Table	Envisaging an initial bracket with an MCCR of 100%, which therefore translates into the impossibility of any distribution for those parties that find themselves in this situation, translates, in reality, into a rise in the minimum capital requirement, an intention expressly excluded from the document in point 257.	The maximum value of the Minimum Capital Conservation Ratio should be in any event below 100%.
70	259	Elements subject to the restriction on distributions	The disbursement of items that are not tax-deductible (dividends) and of items that are (partially) deductible (bonuses) are treated in the same way. We believe that the minimum conservation ratios should necessarily refers to amounts net of the tax effect envisaged in each jurisdiction for the various items.	
70	259	"Calibration: this will be considered as part of the wider exercise to re-calibrate the capital framework. The guiding principle will be that the buffer must be large enough to enable banks to remain above the minimum requirement in the face of losses expected to be incurred in a feasibly severe downturn… "	It is not clear if the calibration is specific for each bank or unique for the whole banking system. Furthermore, it is not clear if the conservation range will be expressed as a function of the minimum requirements. In this case, the measurement of the same must be carefully assessed given the option of using PD downturn or PD average to calculate requirements.	
Excessive credit growth				
			For comments and proposals see paragraph 4, section D of the PP	

ABI Comments on Consultative Document issued by Basel Committee on Banking Supervision "International framework for liquidity risk measurement, standards and monitoring"

Technical attachment No. 2

April 2010

E) Liquidity

Page	Paragraph	Document text	Comments, Queries, Proposals and Requests for reviewing the text alongside	Supporting documents (records, examples, literature, etc.)
2 31	5 133	Scope of application "It should be stressed that the standards establish minimum levels of liquidity for internationally active banks." "The proposed standards and monitoring tools should be applied to all internationally active banks (…..)"	The legislation should only be applied at consolidated level, also for the purpose of not discriminating between parties who have dedicated individual corporate entities to the performance of specific activities rather than divisional units (multi-purpose groups Vs. multi-divisional model) In fact, given the control at consolidated level, the group must be permitted to make synergic use of the resources available within the same for the financing of the various activities relating to the different business models present. **Proposal 1** (also see paragraph 0 Section E of the PP) With regard to the application at individual or consolidated level, it is required that juts the first part of paragraph 133 or rather: "The proposed standards and monitoring tools should be applied to all internationally active banks on a consolidated basis." **Proposal 2** (also see paragraph 0 Section E of the PP) It is then necessary to identify - also taking into account the proportionality principle - the transfer at European level of the application by the internationally active banks (in the wording of the Basel Committee) to all the European Banks.	

LIQUIDITY COVERAGE RATIO				
5	20	Liquidity coverage ratio - Definition of the metric -	**Proposal** See paragraph 3 Section E of the Position Paper (PP)	
6 9/10	22 27 34/35/36/37	"The scenario proposed for this standard entails a combined idiosyncratic and market-wide shock"	**Comment** The stress scenario considered is not very realistic when hypothesizing that every event which has occurred in the recent crisis shows up again at the same time vis-à-vis all the institutes.	
STOCK OF HQLA				
7/8	29	Characteristics of high quality liquid assets:	**Comment** 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? **Proposal** 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	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

[1] Since beginning of 2007 banks loans responding to specific criteria are eligible for ECB open market operations.

			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 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. 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). 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[1]. 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	central bank located in another country. At the same time, work should be undertaken to 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. 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.
8	32	"The stock of liquid assets should not be co-mingled with or	**Proposal** See paragraph 6.d Section E of the PP.	

		used as hedges on trading positions, (…..)”		
Pg.9	Par.32	“The stock of liquid assets … should be managed with the clear and sole intent for use as a source of contingent funds.”	**Query** It is not clear what exclusive use as a source of “contingent funds” means: is it possible to carry out trading on the portfolio or are only repos permitted?	
9	34	Specific aspects linked to sovereign rating	**Proposals** See paragraph 4 Section E of the PP .	
9	34	“(c) Marketable securities representing claims on or claims guaranteed by sovereigns, central banks, non-central government public sector entities (PSEs), the Bank for International Settlements, the International Monetary Fund, the European Commission, or multilateral development banks as long as all the following criteria are met:” (…..)	**Query**. 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)	
10	36	“…Not issued by a bank investment or	Also see paragraph 2 Section E of the PP.	-

		insurance firm... ”		
Page10	Par. 36 and 37		**Comments** The haircut passes from 20% of the securities up to AA to 40% for the securities up to A-: if a security passes from AA to AA- the jump is considerable. Monitoring the bid-ask spreads for 10 years is difficult to implement. **Proposal** The two points above strengthen the remarks already present in paragraph 29 and therefore lean towards the issue of a specific list by the supervisory authorities for the assets as per points 36 and 37 of the document under consultation. The list should be sufficiently granular so as to avoid cliff effects. In the event that the proposal of the 0-1w/1w-1m should be accepted, the lists should be two.	The list of the securities of the ECB could be taken as reference in terms of granularity and the taking into consideration of the maturity of the securities as well.
10	34 and 36	“0% risk weight” “..assets have a credit assessment by a recognized ECAI of at least AA...”	**Query** 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 - according to paragraph 34 or paragraph 36 – 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.	
NET CASH OUTFLOWS				
11	41(a)	“...the portion of deposits which are	**Query** Is reference made here to the Guarantee of the	Italian Decree Law No. 659 dated 4 Dec. 1996

		covered by an effective deposit insurance scheme…”	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?	
11	41-70		**Comment** 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 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. **Queries on paragraphs 41 to 44** 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?). This is above all else when reference is made to “other established relationships with the same bank…”, “deposits are in transactional accounts”. 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”. c) In the parts relating to the Retail deposit run-off,	

			explicit reference is made to the handling of the bonds subscribed by retail; **Proposal 1** (Also see paragraph 6.c Section E of the PP) At least the fraction of each deposit lower than the guarantee threshold of the Interbank Fund should be considered to be "stable deposits", also irrespective of the recurrence of the other conditions envisaged under 41 a). The same European authorities have raised this threshold - in the period of greatest stress during the recent crisis – therefore agreeing that up to that level the recall of the funds by the customers is not triggered off in moments of tension. Therefore, the text could be changed to (a) *Stable deposits, 7.5% and higher -* Stable deposits will receive at least a 7.5% run-off factor in each jurisdiction and refer to the portion of deposits which are covered by an effective deposit insurance scheme ~~and~~ or where: – 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 credited). **Proposal 2** (Also see paragraph 6.b Section E of the PP) 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.	
11	42	Highest percentage	The percentage of 15% determines important volumes for commercial banks	
11 and 18	Page 11 (Note at foot of page 12) Page 18 (paragraph 70)	Note 12: “Where applicable, cash inflows and outflows should include earned interest which is expected to be received during the time horizon” Paragraph 70: “...such as principal and interest due..”	**Proposal** For the purpose of greater simplification and practicality in calculating the LCR, we proposal not making the inclusion of the interest component in the calculation of the cash flows mandatory, in light of the fact that generally the positive interest component is greater than the negative one. The text of the two references alongside should therefore be eliminated	
13	48	Small business customer	**Comment** As already mentioned previously also with reference to the non-harmonization with the provisions of Pillar 1, it may be difficult to identify the items relating to this category in IT systems	
14	55	Unsecured wholesale funding provided by other legal entity customers: 100%	**Query** Interpretative doubts arise on how to handle the market funding CD/CP, given the specificity of this market.	
14	55	“The run-off factor for these funds is set at 100% and consists of deposits and other extensions of funds made by financial institutions (including	**Comment** 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.	

		banks, securities firms, insurance companies, multilateral development banks etc), fiduciaries, beneficiaries, conduits and special purpose vehicles, sovereigns and central banks, public sector entities; affiliated entities of the bank and other entities not included in the prior three categories."	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. **Proposal 1** 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. **Proposal 2** 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.	
14	55 (d)	Unsecured wholesale funding provided by other legal entity customers: 100%	**Comment** 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% 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. **Proposal** 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. 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. In the event that the above proposal cannot be	

<table>
<tr><td></td><td></td><td></td><td>accepted it is proposed that a specific ratio for this case be envisaged, similar to those envisaged in points 41 (b) and 48 for less stable deposits from retail and small business customers, equal to 15%</td><td></td></tr>
<tr><td>14</td><td>56</td><td>“All notes, bonds and other debt securities are included in this category unless the counterparty is known to be a retail customer, a small business customer or a non-financial corporate customer, in which case the funding can be included in the related categories.”</td><td>Query
This point needs clarification regarding the types of securities reference is made to.</td><td></td></tr>
<tr><td>14</td><td>57-59</td><td>Secured funding run-off</td><td>Comment
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.
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)

Proposal
The run–off percentages of the collateralized funding could be further differentiated, besides by type of collateral, also by type of counterpart also envisaging intermediate values between the extremes 0%, 100%, e.g.:
<table><tr><td></td><td>Central Banks</td><td>Wholesale</td><td>Retail</td></tr></table></td><td></td></tr>
</table>

<table>
<tr><td></td><td></td><td></td><td><table><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></table></td><td></td></tr>
<tr><td>15</td><td>60</td><td>3 notch-downgrade</td><td>Query
It is not clear how the collateral must increase after the event.</td><td>Estimation methods with internal models or pre-established percentages</td></tr>
<tr><td>15</td><td>62</td><td>“Increased liquidity needs related to market valuation changes on derivative transactions – (% determined at national discretion). As market practice requires full collateralisation of mark to market exposures on derivative transactions, banks face potentially substantial liquidity risk exposures to these valuation changes. Notional supervisors will work with supervised institutions in their jurisdictions to determine the liquidity risk impact of this factor and the resulting stock of high quality</td><td>Proposal
The point seems to refer to just collateralized exposures, since they are liable to determine collateral requests by the counterparts: it is necessary that this sphere of application be specified in the text.</td><td></td></tr>
</table>

		liquid assets that should accordingly be maintained. Supervisors should disclose their requirements publicly.”		
16	66		**Comment** Inconsistency between the two paragraphs 66 and 76. 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. **Proposal 1** Take the run off points a) and b) to 0% and considerably reduce the percentages of points c) and d) **Proposal 2 (for second level banks)** 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.	
17	From 66 to 70		**Queries** Many queries emerged from the analysis of these paragraphs. In particular: o 66, (b) & (c) &(d): some practical examples of committed credit lines and committed liquidity lines would be most welcome o 69, “Unconditionally revocable "uncommitted" credit and liquidity facilities”:	

			it should be clarified if this includes all the revocable lines o 69, "Potential requests for debt repurchases of the bank's own debt….": clarify more fully o 69, "For issuers with an affiliated dealer or market maker, there may be ….": clarify more fully o 70, "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, is 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). **Proposal** 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 the types of handing for each case (possibly to be up-dated periodically).	
18	72	Monitor concentration of expected inflows...	Method to be defined	Identification of significant percentages
19	73/74.		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.	

			Proposal Confirmation in the sense indicated is hoped for	
19	76	"No lines of credit, liquidity facilities or other contingent funding facilities that the bank holds at other institutions for its own purposes are assumed to be able to be drawn."	**Proposal** It is 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. 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. In the event that the above proposal cannot be accepted with regard to first level banks belonging to a Category with a second level institute, a ratio of 50% is proposed for credit facilities available to the pertinent second level institute. In the presence of recognised crossover guarantee mechanisms, a ratio of 100% is proposed.	
19	77	Other cash inflows	**Proposal** For greater clarity, the symmetry with respect to the definition used for the "other cash inflows" under point 70 should be made clear. The text should be aligned: "Any other contractual cash inflows should be included, such as planned derivative receivables"	
NET STABLE FUNDING RATIO				
19		Net stable funding ratio	**Comment** In general, the indicator, as it is set, does not acknowledge value to long-term funding vis-à-vis medium-term funding, spreading it all in any event over the year. Short-term assets are also included among the items to be financed with stable funding	**References** The regulations with regard to the transformation of the due dates have been laid down by the Bank of Italy

			(100% interbank assets, 85% retail assets and 50% non-financial corporate assets). It reduces the value of the interbank funding, if not for the financing of highly liquid assets, squeezing the activities for the transformation of the due dates carried out by the banks to the minimum. **Comment** Despite considering the introduction of a net stable funding ratio 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. **Proposal** (See paragraph 7.a section E of the PP) 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	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 <= PATRIM[2] (general limit on the undertaking of fixed assets and 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

[2] Where: **IMMOB** = Fixed assets; **PART** = Equity investments; **PATRIMON** = Equity.

[3] 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).

				percentage of 25%.
21	86		**Query** What percentage are bonds issued by the Bank subject to?	
21	86 (table 1)	"The total amount of capital, including both Tier 1 and Tier 2 as defined in existing global capital standards issued by the Committee."	**Comment/Query** Is it correct to use the definition of global capital standards, issued by the Committee, for liquidity risk purposes or is it better to use an "ad hoc" definition of capital, more liquidity/ balance sheet oriented ?	
21-22	86	Components of Available Stable Funding and Associated ASF Factors	**Query** There is no explicit reference to the handling of the securities subscribed by retail customers	
	Table 1 vs. Table 2	Handling asymmetries for certain types of product	**Comment/Proposal** Pay and receive derivatives in the NSFR: the receive leg is weighed at 0% (all other liabilities, page 22 in table 1), while the pay leg is weighed at 100% (in all other assets, page 23 of Table 2), it would be better to weigh the net flow	
23	89 - table 2	"...all other assets"	**Query** It appears as a residual item, whose content could be more fully clarified (for example: are real estate to be included?)	
23	89	Rated AA	**Query** What else has to be done in the event of split rating?	
23	89		**Query** Securitization transactions are not listed; therefore does a RMBS of home mortgage loans with AAA rating also fall within the RSF 100%?	
	Table 2	Subject: Handing of on-demand loans in the	**Query** Within which category must on-demand exposures	

		NSFR	to retail and non-financial corporate customers be placed for the calculation of the Net Stable Funding Ratio? **Comment** Given the current NSFR scheme, on-demand loans could be included under the items "Loans to non-financial corporate clients having a residual maturity < 1 yr" and "Loans to retail clients having a residual maturity < 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 revoke the credit facilities granted and request the repayment of the funds. **Proposal** 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%	
23	89	Composition of Asset Categories and Associated RSF Factors	**Comment** The inclusion of the "listed equity" among assets to be financed with funding if durations are longer than one year, appears to be too restrictive. 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. **Proposal** Scale these groups of Assets to the RSF equating to 20%	
23	89	Composition of Asset Categories and Associated RSF Factors	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. **Proposal** The provision of a RSF Factor lower than 100% is hoped for, envisaging appropriate concentration limits, also with reference to rating classes.	
23	89	Table 2	**Comment** The classification of certain instruments among the cases considered less liquid does not appear to be entirely consistent. **Proposal** 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	
23	89	Specific aspects linked to the sovereign rating	**Proposals** (See paragraph 4.b and 4.c section E of the PP)	
23	89	Table 2 - All other assets: 100%	It is not clear whether in this item the Fair Value of the derivatives recorded in the financial statements 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 counterparts 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. **Proposal** (…..) 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.	
23	Note No. 26		**Comment** Although the margining of the derivatives can be a structural activity for some institutes (to be financed therefore with stable sources), at general level it seems excessive to include securities used as collateral in the derivatives transactions in the definition of encumbered assets to be financed beyond one year. **Proposal** It is proposed that the note be amended as follows: “Assets posted as collateral for derivative transactions are deemed to be unencumbered for up to 50% of their amount”.	

24	91- table 3	"non contractual obligations"	**Comment** This seems to be a delicate point especially in relation to the stocks of bond funding on customers, Where a formal commitment to repurchase does not exist, the definition of not excessively severe percentages becomes necessary (these are commitments not envisaged contractually). The aspect of "consistency" of handling between the various countries is also delicate.	

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).

<u>Origin and features of the privileged shares and the savings shares</u>

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.

Preferencce 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.

<u>Correspondence of the criteria indicated by the Consultative Document for Common Equity</u>

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.

<u>Essential differences with respect to preference shares and hybrid instruments</u>

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.