MINISTERSTWO FINANSÓW
DEPARTAMENT ROZWOJU RYNKU FINANSOWEGO

Warsaw, 23/04/2010

RESPONSE TO THE EUROPEAN COMMISSION DOCUMENT ON FURTHER POSSIBLE CHANGES TO THE CAPITAL REQUIREMENT DIRECTIVE (CRD)[1)]

General observations

Poland supports activities of the European Commission which are aimed at strengthening and stabilizing the financial system. It seems that it is a good time to analyze and use experiences deriving from the financial crisis to establish appropriate regulations. In this context it is important for Poland to take into account properly the scale of activity and complexity of the entities to be regulated applying the proportionality principle and adequate *vacatio legis* .

With reference to the scope of the proposed changes it seems to be very important to indicate very specifically by the European Commission: weaknesses in the functioning of the banking and financial systems, market failures that warrant regulatory intervention, the goals of specific regulatory tools as expressed in reference to the identified market failures.

Moreover in our opinion the new regulations should be effective and in the same time should not significantly affect into costs and profitability of the credit institutions and investment firms and shouldn't restrict competition, development and opportunities to support economic growth. We are of the opinion that more and more stringent requirements will not replace the real care about the quality of the assets.

Liquidity standards

Since 2007 Poland in relation to banks has four liquidity ratios rules at very detailed level. Two of them corresponding with LCR and NSFR. In general it is reasonable to introduce minimum standards for capital requirements for liquidity risk but in our opinion it should be considered the flexible measurement – should include local and individual specificity. It should be noted that "rigid" liquidity weights in relation to every position of the balance-sheet will increase the cost of liquidity. Therefore it seems that objective can be achieved if the ratios, like LCR, could be based on internal models of deposit base stability and the repayment of off-balance sheet liabilities. Of course, such models should be subject to quality requirements (based on backtesting) and deterministic criteria (ratios) and should be compared with results of such model application as stress-tests. With no doubt the credit institutions and investment firms should have enough time to adjust to the new liquidity regulations, so we propose long *vocatio legis* which will allow to reduce adjustment costs.

Question 1: *Comments are sought on the concept of the Liquidity Coverage Requirement and its likely impact on institutions' resilience to liquidity risk. Quantitative and qualitative evidence is also sought on the types and severity of liquidity stress experienced by institutions*

[1)] Paper was prepared with cooperation with Polish Financial Supervision Authority, National Bank of Poland, Association of Polish Banks, Chamber of Brokerage Houses, The National Depository for Securities.

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during the financial crisis and – in the light of that evidence – on the appropriateness of the tentative calibration in Annex I. In particular, we would be interested in learning how the pricing of banking products would be affected by this measure.

Concept of applying top-down short-term liquidity standards had already been implemented in the Polish banking system. Banks have been required to comply with the standard since July 2008, i.e. before the market crisis following the failure of Lehman Brothers. The basic difference between the Polish standards and the proposed Liquidity Coverage Requirement (LCR) lies in the assumptions concerning the value of funds that have to be covered with short-term liquid assets. Polish standards stipulate that the liquidity reserve is to cover liabilities regarded by a bank as unstable (based on analyses performed according to methodology approved by the supervisor, primarily in regard to determining the stable part of deposits, the so-called core deposits), whereas the LCR directly introduces parameters determining the liquidity outflows under a regulatory stress scenario. From the point of view of comparability and transparency, such a design of the LCR seems to be favourable. However, by introducing uniform levels of the outflow of funds, the LCR may be a worse gauge of individual liquidity risk in comparison with indicators that are largely based on calculations performed by individual institutions that take into account the specific character of both, their liquidity profile and the market on which they operate. The financial systems of the countries to be subject to the proposed arrangements vary substantially, in terms of the development and penetration of the banking system. A model taking into account the requirements of local supervisory authorities, arising out of their knowledge of the specificities of their markets, is a more favorable solution.

We would like also to point out that the restriction of the definition of liquid assets in conjunction with quite a ”shallow” market of Polish Treasury debt instruments will also result in bigger liquidity costs, which may seriously limit further economic growth. Therefore we present opinion that the offer of instruments meeting the requirements of a liquid instrument should be as wide as possible (e.g. the suggested changes in the methodology of short-term liquidity analyse and the maintenance of defined parameters will have a significant impact on the scope and scale of cooperative banks' activity). The removal of cooperative banks' funds from the stable liabilities of associating banks will block the operation of such associating banks, so discussion on the suggested changes should take into account the specific character of the cooperative banking sector, which is strong in terms of liquidity and where major liquid assets are deposits kept by cooperative banks with their associating banks.

A very important element of consultations should be QIS study and the analysis of scenarios with regard to the suggested changes in order to estimate how many institutions may have problems with fulfilling new capital requirements.

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

Experience gained during the crisis indicates that in the period of serious disturbances obtaining liquidity, even on markets that normally have a very high degree of liquidity, is difficult or sometimes even impossible, and that the central bank is the main source of liquidity. Therefore in our opinion at national level central bank, in cooperation with the supervisor, should decide which securities will be taken into account to measure LCR.

In general we are in favour of the limited liquidity buffer which include the highest quality assets. For sure buffer should include government securities and municipal bonds which are acceptable in transactions with central bank.

We would like to mention also that suggested changes may have an adverse impact on the development of the Polish corporate bond market. As an effect, given the small liquidity of that market, in the future it may be difficult allocate such instruments for the purpose of liquidity provisions.

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

It seems that buffer can include also securities with the high rating, and municipal bonds which are accepted in transactions with central bank.

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

Similarly as in the case of the Liquidity Coverage Requirement, the Net Stable Funding Requirement (NFSR) already has its equivalent in Polish supervision solutions since 2007. The difference between the Polish system and European Commission's proposals relates to the manner in which individual items of assets and liabilities are classified. The essential differences between the two are as follows:

- Polish standards stipulate that all assets not included in the liquidity reserve and not resulting from banking activities outside the wholesale financial market have to be covered by stable funds and regulatory capital; however, the proposed NFSR focuses on the maturity of assets, at the same time attributing various parameters of coverage by stable funds to different categories of these assets;
- Polish standards stipulate that a bank uses its own internal models (approved by the supervision authority) for calculating the amount of stable funds; whereas the proposed NFSR focuses on the maturity of liabilities, at the same time attributing uniform parameters of core deposits to various categories of liabilities with maturity of up to 1 year.

It seems that in case of countries with poorly developed securitisation and bank debt instruments' markets, the solutions set out in the Polish long-term liquidity standard are more appropriate - funding model consisting primarily of accumulating and rolling over (mainly current and short-term) deposits, with a marginal role of long-term liabilities and based on internal stability models subject to quality requirements (based on backtesting).

Present state of markets and models of banking activity in a number of countries (including Poland) does not allow them to rapidly meet the NFSR (preliminary simulations conducted by the National Bank of Poland show that the majority of Polish commercial banks would fail to comply with the NFSR as of the end of 2009). The need to comply with the NFSR in the present shape would involve very high costs that may negatively impact the financial position of a considerable group of domestic financial institutions. This standard should be designed with great caution, taking into account all relevant factors and adequate *vacation legis* principles. The NFSR will be especially difficult to fulfill by the specialized banks, such as mortgage banks and car banks, which finance their activities from the other sources than deposits.

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

The Commission's proposals may cause reduction of liquidity risk, but they may also increase banks' tendency to make more risky transactions of bigger expected return in order to cover additional liquidity costs resulting from the need to maintain bigger small-margin debt securities and a smaller margin on maturity transformation (in order to comply with the NFSR, banks will have to seek to convert their long-term loans into short-term ones, what may reduce the stability of funding of entities of the real economy, with potential negative effects for economic growth).

In our view the proposed arrangements should primarily affect retention of most stable funding sources, without excessively reducing loan supply.

We would like to also pay your attention to the fact, that credit institutions may trick to not exceed the threshold of 1 year.

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

Applying ratios set out in Annex II, credit institutions will prefer retail deposits and deposits of micro businesses (of course, the scale of such a phenomenon is mainly determined by a profile of a given bank) not because a ratio for retail deposits is high, but because a ratio for corporate deposits is very small (50%).

With regard to *required degree of coverage* factors, it seems that corporate bonds, covered bonds, municipal bonds should be include in Annex II with appropriate ratio.

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

With no doubt parameters should be known and shall be clear. As it was mentioned above, due to national specificities in our opinion national central bank in cooperation with national supervisors should have possibility to set up and verify liquidity standards at country level. There is also a need to establish precise provisions on interim periods. Banks should have time to adopt to new regulatory requirements. Amendments of rules should change the operation and scope of their business activity in an evolutionary manner. Organisations running their activity in accordance with the applicable law should not be subject to sudden regulatory changes.

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

In our view liquidity standards should be applied both: to parent entities on a consolidated level and to individual institutions (including subsidiaries) on a stand-alone level. National supervisory authorities must have the right to enforce standards on a stand-alone level irrespective of the terms referred to in par. 17, including the right to impose local liquidity standards on branches (the current Polish regulations also apply to cross-border branches). With no doubt supervision on liquidity requires appropriate instruments on national level.

Moreover the scope of application set out in par. 17 should be defined in a clear and simple manner, there shall be no doubts which entity (coming within a capital group) should calculate suggested measures individually and what should be included by a mother company in its calculation of measures. Additionally, the scope of application of suggested measures should be clearly defined by an entity's registered office (the same country, another EU country, non-EU country), in particular with regard to non-EU entities.

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

50K or 125K investment firms belonging to the banking group should be included in the scope of consolidated liquidity requirements of banking group. The possibility of transmission liquidity risk from the entities which are not subject of liquidity standards to the entities which are subject of the liquidity standards should be eliminated.
The scope of application of liquidity measures should not include companies whose activity does not cover the performance of financial services (e.g. developers) and which may be members of capital groups led by a mother financial company.

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

In relation to investment firms it seems that liquidity standards should cover only investment firms which have "initial capital" of EUR 730000. We suggest also to consider the possibility to exempt 730K investment firms by supervisor if those investment firms will prove that its liquidity risk is not significant. We also suggest to do quantitative impact study on all "sort" (not only 730K) of investment firms.

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

The liquidity standards in Poland, which have been in force since 2007, consider received liquidity lines as liquidity buffer. Therefore in our view it is reasonable to include this position in the liquidity buffer.

Moreover, irrespective of the approach to liquidity support from parent or affiliated entities, it is important to introduce the requirement of the diversification of sources of emergency liquidity (bank should have possibility to possess liquidity lines in many institution to diversify risk). In our view proposal referred to in par. 23 seems to be the best solution.

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

The host supervisor, on account of the stability of national financial system, must have the guaranteed right to perform liquidity supervision over a cross-border branch because it is necessary for ensuring financial stability in the host country. It is possible that home and host supervisors share tasks and prerogatives because of macro-prudential and micro-prudential importance.

Definition of capital

The proposed amendments toughening rules for types of instruments acceptable to define capitals may contribute to the drop of capital in institutions and worsening capital position of such institutions.

In our view the date of entering into force of the changes to the definition of capital shall be reconsidered. The currently proposed date (end of 2012) seems to be too early given the counter-cyclical measures proposed at the same time by the European Commission that will additionally increase the need for capital. Credit institutions and investment firms should have time to adjust to new regulatory requirements. Amendments should change the manner of operation and scope of business activity on an evolutionary basis. The enforcement of regulations, in particular, on solvency ratio should take into account time required to meet the new requirements. We point out that the present regulations on capital components bring about far-reaching legal and organisational consequences.

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

The proposed changes seems to be appropriate. The distinction between Tier 1 (*going concern capital*) and Tier 2 (*gone concern capital*) clearly draws a line between capital that may be used to absorb current losses and capital that may be used in case of a institution's insolvency.

However the drop of capital should be expected to be particularly apparent in the case of institutions with a significant share of instruments classified as supplementary funds in their capital structure. Thus, the proposed amendments may contribute to the drop of the solvency ratio. Such an effect may be additionally strengthened by the proposed elimination of Tier 3 capital. The implementation of that proposal will, for sure, cause that institutions will not be able to raise their equity with short-term capital.

In our view it should be specified more precisely whether "Net trading book profits" that are now comprised in Tier 3 will not be treated as a component of capital any more or whether they will be included in Tier 2.

In our view the separation of provisions on accounting for balance-sheet items to Tier 1 capital at cooperative banks shall be considered. In this case, changes may have a deeper impact on the shape of a capital base in the cooperative sector than in the sector of commercial banks. At present, the share fund is one of components of core funds of cooperative banks. It is necessary to explicitly include the share fund under Tier 1 components. From the point of view of the cooperative sector, it is a fundamental issue. Moreover it seems that subordinated loans in associated cooperative banks should also come within core Tier 1 since these banks do not operate on their own, are subject to a double control, and operate under association groups. In many cases subordinated loans constitute the basic element of their equity. Also bonds convertible into shares should come within Tier 1 funds given a right to convert them into shares of a given bank.

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

The proposal of Tier 1 seems to be reasonable. Tier 1 capital should comprise the highest quality capital and that share of Tier 1 in capitals should be considerable.

However credit institutions and investment firms should have possibility to gradually "withdraw" from the financial instruments which do not belong to Core Tier 1 any more.

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

To preserve an appropriate proportion between Core Tier 1 and non-Core Tier 1, it should be proposed that if losses are absorbed by Core Tier 1, a corresponding portion of non-Core Tier 1 is converted into Core Tier 1 capital. In addition, if supervisor demands it, the institution should increase Core Tier 1 and when the institution does not meet this obligation and does not issue additional equity capital, the supervisor should be entitled to demand conversion of a relevant portion of non-Core Tier 1 instrument into Core Tier 1.

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

From Poland's point of view implementing additional criteria does not seem necessary.

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

The proposed requirements seems to be appropriate.

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

There is a need for additional analyze in relation to unrealised gains and losses on financial instruments. It seems that unrealized gains on balance-sheet positions should be eliminated from Tier 1. This would strengthen the capital structure and would prevent "excessive" increase in capitals, the use of which, in principle, could not be possible to absorb losses if a recession or a crisis occurs.

We also would like to turn your attention to the fact that Tier 1 capital is deducted by a deferred tax. Various tax systems will have a different impact on the amount of such payables or receivables and it may significantly reduce their eligible equity.

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

As regards concentration limits, in the context of the suggested amendments to the definition of capital, it is suggested that nominal concentration thresholds of exposure should be left unchanged at 20% and 25%, while their calculation basis should be changed.

In accordance with proposals presented in the consultation document, the threshold will be calculated as 25% of own funds and not as the sum of own funds, Tier 2 supplementary capitals and Tier 3 supplementary capitals. The maintenance of the nominal threshold at the existing level and a change in the base thereof will result in artificial underestimation of capital requirement due to exceeding the concentration of exposure and large exposures, and the institutions' need to maintain higher capital to exceed such a limit, which, in certain cases, may be accompanied by a risk that capital adequacy standards will be violated.

It seems reasonable to change the nominal threshold (limit) of exposure and the limit of exposure concentration. Such a change should be based on a relevant quantitative analysis and sector data.

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

It is incomprehensible that on one hand the CRD IV propose to make the structure of capitals more clear (resignation from the upper and lower Tier 2 and Tier 3) and on the other hand CRD IV propose new structure and instruments which in fact cannot secure the capital base of credit institutions and investment firms.

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

In our view grandfathering arrangements in respect of hybrid instruments counted as capitals that do not meet CRD II requirements should not be changed. With regard to hybrid instruments that do not meet CRD IV requirements the dates of grandfathering them should be correlated with the dates proposed for hybrid instruments that do not meet CRD II requirements (among others, the final date by which these instruments may be included in capitals should follow the date as provided for in CRD II).

Leverage ratio

The European Commission has not determined which off-balance sheet assets should be included in the leverage ratio. The inclusion of off-balance sheet assets in the calculation of the leverage ratio should be driven by efforts to ensure international comparability of the ratio definition, particularly with respect to the American market.

It should be also taken into consideration that depending on the calibration of the leverage ratio, it may result in the need to reduce lending and/or opportunities for investing in debt securities and hedging positions with IR and FX derivatives, which would be unprofitable from the macroeconomic point of view.

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

It is expected that the new measure will be able to reduce the risk associated with transactions which cause the use of very high leverage.

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

The role of the leverage ratio should be to indicate the exposure a financial institution in terms of solvency to changes in the prices of assets. It seems that in construction of the leverage ratio should be included Core Tier 1 capital.

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

In our view leverage ratio should take into account balance and off-balance sheet position because it reflects the level of leverage ratio used by institutions .

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

The proposed approach seems to be correct.

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

It seems that it should be established the possibility to set up a longer time limit for the return to the required level of leverage ratio in the case when the violation of the limit is due to losses incurred by the institution than in the case when it is the result of too rapid exposure growth.

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

Appropriate calibration should be base on impact assessment process.

Counterparty credit risk

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

It seems that suggested approach is worth supporting however the concept presented in the document can have serious faults, is not easily understood and, because it has brought about many discussions in the Polish banking sector (vide: *comments of the Association of Polish Banks on the European Commission's document entitled possible further changes to the Capital Requirements Directive (CRD IV)*).

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Moreover in Poland the market of commercial/corporate debt instruments is not developed. Therefore it should be reconsidered if credit spread can be the basis for the calculation of CVA.

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

It seems that suggested approach shouldn't result in the unequal treatment of financial institutions. Potential higher capital requirements should be calculated on rating of financial institution and data of financial market from the crisis period.

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

It seems to be more realistic that the indicated period of 10 days should be extended.

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

There is no doubt that the appropriate level of transaction security should be enhanced. However in our view the risk weight of central counterparties should be 0% if the transactions meet defined criteria. Exposures to central counterparties (CCPs) is generally characterized by very slight risk so the risk weights higher than 0% for each exposure may have negative influence on financial market.

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

Strong standards for CCPs should be coherent with the standards developed by CPSS-IOSCO. There shouldn't be also differences in interpretation of strong standards between the jurisdictions.

Countercyclical measures

The need of the more stable long-term economic growth seems to be reasonable. The negative aspect is that the regulatory requirement in this matter (at least in the short term) generates costs for the regulated institution. Decreased profits, will reduce possibilities of falling it within capital, at the same time.

The further consequence of the proposal may be intensification, during the boom phase, of the processes of credit risk transfer from credit institutions to other financial institutions which regulatory burdens connected with bearing credit risk may turn out to be lower (the so-called cross-sectoral arbitrage). The currently observed low activity of the global securitisation market may increase as the economic growth accelerates, so the emergence of such phenomenon cannot be ruled out in the future. The above mentioned cross-sectoral arbitrage may reinforce banking sector stability, on one hand, but on the other hand it may weaken the stability of the financial system as a whole, as credit risk would be held in the portfolios of institutions whose experience in bearing such risk is smaller than that one of the banks. In this perspective, it seems that regulations proposed by the European Commission may prove to be effective on the assumption that credit risk transfer from credit institutions to other financial institutions will not be significant.

In our view it should be reconsidered whether the assessment of imbalances in the economy should involve the use of variables which are not only limited to banking sector exposure to risk but rather encompass the entirety of the economic situation, including the prices of assets and financial market tendencies.

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

The overall direction of the proposed changes should be assessed positively. Reduction of the volatility of institutions' earnings across the business cycle may contribute to an improvement in the stability of their operations and stabilisation of credit supply. It seems however that the details of the proposed solutions require further elaboration:

- if the new solutions proposed by the IASB enter into force (and so, from the perspective of financial reporting standards, impairment losses for financial instruments will be calculated using the *expected cash flow model*), the proposal of the Commission to use the *incurred loss model* to determine provisions created in a given year will reduce the transparency of the proposed solution and cause additional obstacles for financial institutions,
- values of PD and LGD parameters derived by the IRB method should accurately reflect the average values of these parameters across the business cycle (should include data from the period of economic slowdown, appropriate quantitative research),
- the calibration of the proposed mechanism for the institutions following the standardised approach should be consistent with the requirements imposed on the institutions following the Internal Ratings-Based approach.

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

Presented idea of establishing an additional capital buffer may cause that capital requirements on credit risk will be complicated and unclear. Moreover additional capital buffers may cause that bank's decisions will be more risky. The introduction of the counter-cyclical buffer may contribute to reducing the pro-cyclicality of banks' behaviour in good times. However, the level of capital is not the only factor encouraging banks to tighten their credit policies in the period of economic downturn (*vide:* Position of the National Bank of Poland). It also seems that the proposal enhance banks' resilience to economic downturn, but it will not decrease the pro-cyclicality of bank behaviour, especially in the period of good economic climate.

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

The list of items proposed by the European Commission seems accurate.

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

Regarding the time limit for achieving the capital buffer, it seems to be desirable that the CEBS/CESR should elaborate technical standards that could be a guidance for supervisory authorities in setting the time limits for institutions, which could help to ensure a level playing field and include appropriate approach to cooperative banks.

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

It should be many of macroeconomic variables however at this stage its difficult to define such a group. Variables should be identified by appropriate studies and analysis. Specificity of national conditions require that national authorities should have the possibility to react flexibly to the changing economic conditions.

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

Both solutions have advantage and disadvantage therefore it they shall be deemed being complementary. The advantage of the through-the-cycle provisioning is the possibility of more objective determination of its values and smaller need of discretionary intervention of the supervisory authorities into the operation of particular banks. The advantage of the counter-cyclical buffer is the enhanced resilience of banks to all kinds of risk that may be accumulated in a credit boom period.

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

The minimum capital requirements are cyclical in their nature. At the current stage, however, it is not possible to assess this phenomenon precisely . The whole economic cycle should be assessed in a stable regulatory environment. Moreover at this stage fully assessment of the cyclicality are blurred by amendments to CRD.

Systemically important financial institutions

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

The term of a systematically important financial institution does not present a simple and clear definition.

We would like to emphasize that in our opinion systemic importance should be considered both from the EU market perspective as well as from the local market perspective. Institutions which are not important (taking into account the size) for one market may have systemic importance for other smaller markets and affect their financial stability. In the case of developing markets (like Poland), the largest banks, thanks to diversification of assets and stable capital base, were able to absorb loss borne by crisis, which contributed to less severe crisis consequences for the local economy. The small and medium-sized banks were rather touched by the crisis. They had some liquidity problems and recorded high asset impairments. It is necessary to note that, in certain local markets, the biggest banks played another role during the crisis than in certain western countries.

The introduction of package of stricter prudential requirements aimed at SIFIs which in fact means unequal treatment of entities shall not have bad influence on competition across the EU market.

It seems that the number of factors relating to the size, operations, influence on markets could be considered. Therefore it should be considered to apply the criteria of the branch significance (art. 42a – CRD II), after appropriate adjustments, namely:

- market share of the institution in terms of deposit exceeds certain percentage level in the Member State/ EU;
- the likely impact of a suspension or closure of the operations of the credit institution on market liquidity and the payment and clearing and settlement systems in the Member State/ EU;

– the size and the importance of the institution in terms of number of clients within the context of the banking or financial system of the Member State/ EU.

Furthermore it seems that focus of attention should be:

– the possibility to substitute the elements of the financial system affected by crisis in the performance of important functions and in the provision of important financial services;
– the probability and potential scope of financial contagion effect among institutions;
– potential costs incurred by economies and limited access to financial services during systemic crises.

Regarding to the SIFI measuring it should be noted that appropriate changes addressing the existing vulnerabilities were introduced by CRD II, CRD III and are discussed in other chapters of CRD IV proposal. So the aim presented in section VI can be partly achieved by appropriate application of available current prudential framework.

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

It seems that more intense treatment by supervisors of these institutions should be coherent. Therefore it can be coordinated by the European Supervisory Authorities (ESA) and the European Systemic Risk Board (ESRB).

Single rule book

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

It shall be remembered that the financial markets differ significantly across Europe. The same products in different economic surrounding may bare different risks. It shall be reflected while constructing the supervisory requirements.
The other important thing is, that the financial stability has a national dimension, and for that reason the national supervisors, shall have the tools to react to some adverse developments.
The Pillar II is in our opinion not the best place to look for further harmonization. It was shaped to enable the supervisors to adjust their supervisory policy to particular credit institutions taking into account all necessary factors. Poland many times indicated this cocnerns during the negotiations of the Omnibus I directive while discussing the possibility of introduction of binding technical standard concerning Pillar II issues. We were of the opinion that, at this stage of building the European supervisor framework, introducing binding technical standards in Pillar II is too early.
We share the wives of Polish National Central Bank, that a compromise solution may be granting the national supervisor a right to use more restrictive solutions than those provided for in the CRD, under the condition that it presents the EBA with an adequate, convincing explanation, using the *comply or explain* principle, what is in line with de **Larosière** Group Report.
It seems also, that that the proposals of Polish National Central Bank for application of stricter national solutions are worth to be considered.

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

Because of the specific range of exposures secured by mortgages the Commission's proposal which indicates on the specific approach to the regulation that covers this type of assets is worth to be considered.

However, as the markets and legal systems differ significantly across Member States, we share the concerns of Polish National Central Bank that the introduction for the community market as a whole, uniform conditions the meeting of which would allow for the application of preferential risk weights for exposures secured by mortgages and, at the same time, maintain the risk at an acceptable level might be difficult, if not impossible.
It seems that among main indicators that could be binding for filling requirements that enable the application of the lower weight of risk, it is necessary to indicate LtV, DTI (debt to income), indexes of real estate prices.
We postulate also to keep in force the rule that excludes the preferential treatment of loans which are allocated for financing the purchase of real estates, where there is dependence between the revenue that property brings and the financial means of repayment (the debtor does not posses other sources of repayment than the income generated by this property).

Question 50: *What is your view of the suggested prudential treatment for exposures secured by mortgages on commercial real estate outlined above? What indicators and their respective values do you consider appropriate as possible preconditions for the application of the preferential treatment of exposures secured by mortgages on commercial real estate? In particular, are additional preconditions needed to ensure the soundness of this treatment? Do you believe that the existing preferential risk weight applied to exposures secured by mortgages on commercial real estate should be increased?*

Having similar concerns as mentioned above, concerning the diversity of European commercial real estate market, please note that in countries like Poland, where the market of commercial real estate might be still considered as a relatively young, there should be applied a special prudential approach regarding the exposures secured by this type of properties. It seems there is no reason for applying the lower risk weight for this type of exposures.
Among important factors that may be taken into account while implementing the preferential approach, are:

1. market transparency – the possibility of using the general accessible information regarding this market. In many countries there are general available building databases. The lack of transparency influences also on the deficiency of possibility to compare the profitability of investments in the commercial real estates with the alternative forms of investments of capital;
2. indexes of real estate prices which could enable instantly and continuously to inform about the state of growth in this market;
3. information accessibility regarding comparative real estates, what is crucial in the valuation of properties;
4. simple and transparent administrative procedures for instance: issuance of construction permit, system of land registration;
5. liquidity of the market. The low volume of transactions makes difficult to value a real estate and also makes difficult for banks to keep track of the value of a guarantee on the property;
6. the long term experience and possibility of taking into account economic cycles on the market of real estates;
7. the prices on the commercial real estate market are much more vulnerable for amplitudes fluctuation connected with the cycles on real estate market, than it has a place in the case of residual properties;
8. the level of recapture from real estate collateral. In the case of any difficulties with the sale of property that has been taken over by bank during the process of execution, it should have a reflection in the capital.

In the Commission's paper regarding the real estate market there has been outlined two terms – *long-established* and *well–developed* as required for application of preferential risk weight. It may be useful indicators, but they could obstruct for long time the possibility of preferential approach to the exposures secured by the commercial real estates. We think it would be desirable to define precisely those concepts.

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

We agree that this exposures shall be treated differently taking into account at least risk profile (the quality of residential loans is usually higher), the way of measurement and analyze of that risk.

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

We think it may be reasonable to introduce some measures that would help to address real lending throughout the economic cycle. In our opinion the second approach seems to be reasonable choice, however we are aware that it may be difficult, especially in the Member States where the real estate market is not fully developed, to obtain all necessary data.

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