INSTITUCIONES FINANCIERAS

18.8.2009

MFG

BANK OF SPAIN COMMENTS ON THE COMMISSION SERVICES STAFF WORKING DOCUMENT ON FURTHER POSSIBLE CHANGES TO CRD

In general, we welcome the proposal and agree with its objectives.

Nevertheless, we have concerns regarding the suitability of the simplification of the Bank Branch Account Directive (89/117/EEC) and consider that it is important to maintain this option in the Branch Accounts Directive and so do not support this Commission's proposal.

On the other hand, some concerns arisen regarding the suitability and effectiveness of some of the proposed amendments. In order to try to improve the proposal, we make the following comments (see below).

1. Section 1 and annex 1: through the cycle expected loss provisioning

The way in which the proposal is drafted (as a new article with a "prudential methodology" complementary of the current article 74 on the valuation of assets and off-balance-sheet items and with disclosures on its amount in Pillar 3) implies that the proposed "CRD dynamic provisioning" is a new prudential filter (i.e. its amount, if any, is deducted only from own founds).

The "CRD dynamic provision" should have amount only if the "collective allowances for incurred but not reported losses" recognized in the public financial statements are lower than the amount of the dynamic provisions calculated with the CRD prudential methodology. Nevertheless, the amount of the "CRD dynamic provision" should tend to be zero, because in words of the Commission's paper, the "working assumption is that such a prudential measure would in parallel become acceptable under international accounting standards, and would be built up "above the line and would therefore have an impact on accounting profit".

The ideal is that the new regulation of the IASB on impairment of financial assets allows the estimation of the credit losses of the banks in a forward –looking way making right the working assumption of the Commission. For that, the "Collective allowances for incurred but not reported losses" should be recognized timely. In that sense, experience shows that it is during upturns in the business cycle when many problematic loans are granted, as a consequence of the euphoria combined with pressure of competition and myopia as to the future of assets received as collateral. This implies that, from an accounting point of view, these collective allowances should be established during upturns in the business cycle because part of the loans granted will impair.

It must be clarified that the aforementioned experience regarding the granting of loans during upturns is not limited to the asset side of the balance sheet. It is of the utmost importance to bear in mind that the relevant underlying credit risk (relevant for the consideration of the "incurred but not reported losses") is found as well in off-balance sheet items such as financial guaranties and commitments.

As supervisors, we should try to do all necessary efforts to be sure that the IASB is sensible to the problematic of the credit losses in the banking business to avoid the necessity of deducting the "CRD dynamic provision" from regulatory capital. In any case, we see that the Commission proposal is a complementary measure to the accounting regulation that only should be applicable in case that this regulation fails to provide the adequate and timely allowances. In that sense, the Commission proposal could be considered as a second best.

The “CRD dynamic provision” only makes sense if its amount is deducted from own founds. The deduction should apply both at 'IRB banks' and 'standardized banks’.

The prudential methodology should allow the use of internal models previously validated by the supervisor, as it happens with IRB models. Internal models are especially necessary in this case if the methodology is expected to be used as reference for accounting purposes. Nevertheless, a standard approach is advisable because there are many entities that will not be able to develop internal methods or to estimate the parameters.

The CRD should only regulate that the relevant European supervisory body should establish the prudential methodology for estimating a dynamic provision for debt instruments and the credit risk of off-balance-sheet items. This methodology should be established once the IASB publishes its proposal on impairment losses to allow the comparison with the accounting figures.

Finally, it goes without saying that we prefer option 1 (the full Spanish model) rather than a simplified version. This is not only because we prefer “our” model, but also due to the fact that in not considering the α parameter, the simplified model fails to take into account the credit growth. Thus, the countercyclical impact of the simplified model is only linked to the effect of impairment of the credit portfolio. In a nutshell, a simplified model would have greater procyclical behaviour than option 1 model.

2. Section 2 and annex 2: specific incremental capital requirements for residential mortgages denominated in a foreign currency

We consider that specific incremental capital requirements for residential mortgages denominated in a foreign currency should be established, given the concerns and risks of this type of operations. Nevertheless, we have doubts about the risk weightings suggested will be effective in discouraging unsafe practices and irresponsible lending in foreign currency denominated housing loans. Particularly, the requirement of a risk weighting of 1250% involves a presumption that the value of the guarantee and the exposure is close to cero what does not look like realistic and appears excessive.

An exorbitant or punishing risk weighting could incentive lending institutions to design practices that weaken the effectiveness of the measure (for example, to tranche the loan in two pieces, a compliance mortgage loan –with a loan to value up to the maximum- and a non-guarantee exposure –for the excess over the maximum loan to value-) to avoid the extra capital requirement. This kind of practices could involve a more risky approach to this business what, finally in the practice, will prevent the aim of the measure from being completely fulfilled and will also contribute to an artificial weaken of the control of risks. .

3. Section 3 and annex 3: removal of national options and discretions in the CRD

In general, we support the amendments for a removal of national options and discretions included within the proposal..

Regarding the suggested prudential treatment for both residential and commercial real estate under the standard approach, in general, we support the harmonization of a maximum loan to value for a preferential treatment for exposures secured by mortgages and the conditions to give this treatment to exposures secured by mortgages on residential property let by the owner.

Nevertheless, regarding exposures secured by mortgages on residential property, we think that the amounts of the suggested maximum loan to value (40% of the market value of the property in question or 50% of the mortgage lending value) should be adequately justified. For the moment, without any strong evidence that supports the reliability of these figures, we considered them too high

We think that there are no available reliable data within the EU which give evidence that during a complete economic cycle the downturn in residential nominal market prices have gone down a 60%. By this reason and taking into account that exposures secured by mortgages on residential properties are long-term operations (more than one economic cycle could be involved), the proposed figures for the loan to value do not seem realistic.

The ongoing appraisal of the property required by the CRD also justifies a less stringent loan to value, given the fact that the reduced risk weighting will depend on the price of the property at any time. .

This proposed maximum loan to value could put in danger certain special purpose mortgages loans such as on residential property promoted with public aid. This notch of the residential market has a more stable performance of the prices and smaller PDs given its strict legal framework as beneficiary of public aid.

Finally, the impact of the proposed maximum loan to value could be especially inadequate for credit institutions and markets that works with other practices revealed as enough prudent during the recent crisis. This will be the case of Spanish mortgages loans market in which the use of a maximum loan to value of 80% of the market value of the property (jointly with prudent legally binding valuation rules) is accepted.

In general, we consider, as a lesson of the recent crisis, that better than a substantial reduction of the level of the maximum loan to value we have to follow the way of a more in depth analysis of the different risks of the different kind of exposures secured by mortgages on real estate properties in order to apply the more adequate risk weighting. Specially risky mortgage loans (as it has been done in this proposal with relation to residential mortgages denominated in a foreign currency and speculative real estate programs[1]), such as equity release on second residential properties or mortgages loans without the necessary documents, should be identified and excluded of this preferential treatment (by the way of establishing incremental capital requirements to the operations identified as especially risky by CEBS).

On the other hand, we have also concerns regarding the treatment of exposures secured by mortgages whose purpose is the acquisition of residential property with a high loan to value (over the binding harmonized maximum). Empirical data give evidence that the increases in the PD of these exposures, at least when the loan to value is greater than 90% of the market value, are exponential and do not work proportionally to the growth of the loan to value. By this reason, it will be more adequate that this non proportional treatment will be applied to the exposures with a loan to value over the harmonized amount (for example. a mortgage with a 100% loan to value should be risk weighted, at least, at 100%), more than a proportional increase in the average risk weighting of these exposures.

4. Section 4 and annex 4: simplification of the Bank Branch Account Directive (89/117/EEC)

We welcome legislative simplification. Nevertheless, particularly in this subject, we consider that this maximum information that the Directive 89/117/EEC permits to be required improve local market transparency and competition and level the playing field within national markets.

Given our experience, we do not support the conclusion of the Commission Services regarding depositors and creditors. Spain uses this national option for level playing field reasons. Complying with it has a minimum cost for the entities and yet the information is relevant for the rest of the market players (creditors –competitors- and clients –depositors-) that are able to follow and analyse the more or less aggressive commercial policies and strategies of all entities that operate in Spain. Thus, and for these purposes in a local market, the relevant information is that regarding the

[1] This term should be clarified or delimited in order to CEBS will be able to issue properly its guidelines.

performance of the individual branch and not that regarding the credit institution as a whole (relevant for the assessment of strengthen, solvency, leverage, etc.).

Spain therefore considers that it is important to maintain this option in the Branch Accounts Directive and so does not support the Commission's proposal.