Jack Middleton
Prudential Regulation and Risk
HM Treasury
1 Horse Guards Road
London SW1A 2HQ

4 September 2009

UK Response to the Commission Services Staff Working Document on further possible changes to Directives 2006/48/EC and 2006/49/EC ('the Capital Requirements Directive', 'CRD').

We welcome the opportunity to respond to the Commission Services Working Document on possible further changes to the CRD. We are supportive of the undertakings to:

- Mitigate excessive pro-cyclicality;
- Explore measures supplementary to the risk-based requirements of the CRD;
- Explore measures to ensure responsible lending and borrowing;
- Remove the exceptions, derogations and discretions which give rise to differences in national implementing legislation.

As stated in previous communications, the UK position is to seek, wherever possible, to achieve international convergence of regulatory standards. In practice this means ensuring EU proposals are aligned with Basel (BCBS) proposals. This approach prevents creating the possibility for regulatory arbitrage, avoids unnecessary burden on firms and protects the competitive position of the European Community.

This document sets out the UK position on each of the areas covered by the working document. Responses to the questions in the working document are contained in Annex I.

THROUGH-THE-CYCLE EXPECTED LOSS PROVISIONING

The UK has already supported the introduction of forward-looking provisioning, via the ECOFIN conclusions on pro-cyclicality (7 June 2009). The Commission proposal goes further than the Council conclusions by incorporating countercyclical factors into the calculation of provisions. We agree that a counter-cyclical measure for loan losses should be introduced, removing as far as possible the cyclicality in capital resources resulting from loan loss volatility through the cycle, although this is subject to important reservations, outlined below.

The UK would be opposed to an approach to accounting for a through-the-cycle reserve that is incompatible with IAS 39. Such an outcome is not only unnecessary but also counter-productive. In our view the specific means of representing through-the-cycle reserves in the accounts is not critical to its success in a regulatory sense. The substance of what the Commission wants can be achieved in a number of ways. Perhaps the most efficient would be that:

- the IASB works up the measurement aspects of its expected loss model;

- the Commission works up the measurement aspects of its through the cycle reserve; and
- both the Commission and the IASB cooperate on the interaction between the two models and on finding solutions for the transparent recognition and disclosure of the figures involved.

European banks could then continue to use EU adopted IFRS as their accounting standard thus reassuring global investors, while also ensuring that the efforts of bank regulators and accounting standards setters were properly harmonized for the public good. An alternative approach might be for the EC to add a mandated European through-the-cycle adjustment, set by prudential regulators, to work alongside but separately from the rewritten IAS 39. Complementary actions could ensure that this had the same practical effect as an accounting standard change (e.g. in limiting dividends). The UK would be happy to work with EC to assist in finding workable solutions.

The UK believes the EU will only achieve its desired policy outcomes by co-ordination between the IASB and the EU regulatory authorities (as encouraged by G20 and FSB), rather than by overriding global accounting standards. This is especially important as overriding global standards would reverse the long-standing EU and UK policies of adopting IASB standards and encouraging global convergence. This is particularly important as it comes at a time when the G20 has been urging greater convergence.

The types of approach we have outlined would preserve the independence of accounting standard setters and would be more consistent with our view of the respective roles of prudential regulation and accounting standards. We believe that the financial stability objective of incorporating a counter-cyclical factor should be achieved primarily through regulatory tools, whereas accounting standards should be set primarily with the objective of promoting transparent financial reporting. The key point is that both sets of rules need to be globally acceptable and need to be complementary rather than conflicting.

This approach is most compatible with Option 2, as set out in the working document.

RESIDENTIAL MORTGAGES DENOMINATED IN A FOREIGN CURRENCY

At this stage we are open, but not committed, to the proposals related to residential mortgages denominated in a foreign currency. As with all proposals there is the need for a full and thorough impact assessment and we advocate that this is undertaken prior to finalising measures in this area. We do not intend to comment further at this stage.

REMOVAL OF NATIONAL OPTIONS AND DISCRETIONS

We are supportive of a reduction in the number of national options and discretions within the CRD. Where there is a choice between "levelling up" and "levelling down" it is important that the more prudent treatment is applied to avoid a general reduction in regulatory standards across the EU.

We would however point to the advice given to the Commission by CEBS, and in particular the explicit recognition that there will still be a very small number of national discretions that remain justified on the basis of genuine differences in local market characteristics. The UK identifies the proposed treatments of real estate exposures as falling within this category (the annex to this document contains a table with comments on those national options and discretions we do not wish to be removed).

Analysis does point to higher loss rates for buy to let (BTL) mortgages so the UK is supportive of a more conservative treatment of these exposures. However, we are concerned that the criteria set out for determining the risk weight on BTL exposures - as well as commercial real estate - is very cyclical, as it requires the loss rates to be below a given percentage in every year. In a downturn it is unlikely this criteria will be met, which could lead to at least a doubling in capital requirements. Caution should be exercised before making changes that could have such a cyclical effect.

SIMPLIFICATION OF THE BANK BRANCH ACCOUNTS DIRECTIVE

The UK currently does not currently make use of the national option under discussion in this Directive.

FUTURE CONSULTATION ON LEVERAGE RATIO

We are disappointed that proposals on the development of a leverage ratio have not been included within the working document. Both the G20 London communiqué and the FSB Financial Stability Forum Recommendations and Principles to Strengthen Financial Systems (both 2nd April 2009) called for risk-based capital requirements to be supplemented by a simple, non-risk based measure to help contain the build up of leverage. We therefore urge the Commission to ensure proposals in this area do not become delayed.

AGGREGATE IMPACT OF AMENDMENTS TO CRD

We agree that the cumulative impact of the various amendments to capital requirements is likely to be substantial and could potentially have an impact on the levels of lending banks are able and willing to provide. We therefore fully support carrying out a separate assessment of the aggregate impact of the numerous revisions to the capital requirements.

Kind Regards

Jack Middleton
Head of Banking - Prudential Issues branch

Annex 1 – Answers to Questions in the Commission Services Working Document

We have provided answers to the questions that follow on the basis of the proposals as they have been presented in the working document. To the extent that the details of any agreed legislative proposal differ from those presented here we reserve the right to amend our answers accordingly.

Introduction

Question 1: What impact would the changes proposed in each section of this paper have on your activities or activities of firms in your jurisdiction, including costs linked to increase in regulatory capital and any other compliance costs?

For individual firms, the ability to pass through costs will depend on the state of competition in the relevant markets, and the privately optimal way of passing through costs will depend on the elasticity of demand in different markets. For social policy, the answers are not expected to seem hugely interesting, provided supply is not jeopardised or monopoly created.

As regards the specific changes proposed in each section of the consultation paper:

(i) Through-The-Cycle provisioning - given that the aim of this measure as stated in the consultation paper is to ensure banks provide for expected losses, then the impact should generally be more one of timing or smoothing of when banks put aside (or draw down) provisions or reserves based upon given expected losses, rather than requiring banks to pay for losses higher than expected over the cycle as a whole. However, the considerable operational requirements of such a proposal should not be overlooked - there will be a cost to firms to gather, collate and interpret the necessary data, and to authorities in establishing any 'alpha' and 'beta' factors, especially in Member States without existing central credit registers, such as the UK.

(ii) Residential mortgages denominated in a foreign currency – the UK does not have a view on the impact, as proportionately this is not a major issue for our institutions or market. However, the proposal might be expected to raise the costs and reduce supply of such mortgages considerably, to be offset against any anticipated net consumer protection benefits.

(iii) Removal of national options and discretions - the individual impact will be different for each individual option or discretion and should ideally be looked at on a case-by-case basis, such that it is difficult to assess any overall net impact (for both costs and benefits). Some changes will 'level-up' to a stricter requirement, whereas some may 'level-down' to a less prudent treatment. For example, the impact of some proposals - such as the effective raising of capital requirements for residential mortgages (through stricter LTV ratios etc) could increase the cost/restrict the supply of such loans unnecessarily; on the other hand, being required to introduce lower capital requirements for commercial real estate loans could lead to material additional prudential risk and subsequent wider detriment. The changes would create any costs for all institutions covered by the Directive but any benefits might be expected to accrue more to those institutions that operate on a cross border basis.

(iv) Simplification of the Branch Accounts Directive - the UK does not currently use the discretions concerned. However, removal in those jurisdictions where the relevant discretions are currently used might be expected to lead to a reduction in costs of the institutions concerned.

Question 2: Do you have any views about any aggregate impact of the proposed changes to capital requirements?

Overall, whilst the UK does not yet have any specific figures to offer, the aggregate effects, especially when CRD 4 change are taken on top of any CRD 3 measures, might be expected to be material.

Question 3: What is the optimal timing for these measures? Should their application be sequenced?

Given that the UK believes that the impact on output of the measures proposed is, collectively at least, far from trivial, the aggregate impact of the full range of measures proposed for raising prudential standards should indeed be reviewed and not all of the changes implemented until there is a clear emergence from recession.

Having said that, as regards the individual measures, those in CRD 3, namely for the trading book and securitisations, have been discussed both internationally and in the EU for some time and it is generally agreed that an increase in capital requirements in these areas is both justified and necessary; The UK would therefore suggest that the CRD 3 measures should not be delayed by any subsequent consideration of the aggregate impact of all the proposed changes to capital requirements as a whole, including CRD 4.

As regards through-the-cycle provisioning, the UK believes that it would be sensible to recommend that the implementation of any changes/measures linked to provisioning should be on hold until it becomes clear how provisioning is affected by changes in the accounting standards. The IASB has said that adoption will not be mandatory until 2012 at the earliest, so this seems like an appropriate minimum. But to be effective, we do need to ensure that institutions start building up the required buffer of provisions or reserves as near as possible to the start of the upturn.

Section 1 (Through-the-cycle expected loss provisioning)

Question 4: The Commission services suggest that the through-the-cycle value adjustment should not count as regulatory capital (see ANNEX 1, suggested amendment to Article 57). Do you agree?

Yes, we strongly support this approach, as otherwise it would not achieve the desired counter-cyclical effect.

Question 5: Should off-balance sheet items be captured under the formula for through-the-cycle expected loss provisioning, given that 'provisions' for off-balance sheet items are not recognised in all relevant accounting standards? Should only assets subject to an impairment test be subject to through-the-cycle expected loss provisioning? (See ANNEX 1, suggested Article 74a (2).)

We are supportive of the idea of extending the measure to certain off-balance sheet exposures, however, the proposed approach does not apply straightforwardly to such items. A number of issues arise:

i) the credit equivalent of loan commitments is generally well below the nominal value (because only a proportion will be drawn);

ii) there will be a need to find a method to express financial guarantees, endorsements and acceptances and off-balance sheet trade finance in a way that treats the credit risk comparably with loan and debt assets; and

iii) the treatment of derivatives varies across accounting regimes. Also, the exposure value of derivatives bears a potentially high non-linear relationship to the underlying assets on which the derivative is written.

For any extension to off-balance sheet exposures to be effective, such items must be clearly and exhaustively defined within any legal text. We believe that this complex area is best addressed through implementing measures.

We agree that through-the-cycle expected loss provisioning should be confined to assets subject to an impairment test.

Question 6: At this point, the suggestion is not to include the option for competent authorities to allow internal methods to determine expected losses across an economic cycle. As an alternative to the regulatory approach to calculate counter-cyclical factors, would it be desirable to allow firms' internal methodologies (to be validated by supervisors)?

We believe firms should be able to use internal models to determine expected losses across an economic cycle. Internal models are already used, with supervisory approval, to calculate capital requirements. However, we acknowledge that a second, standardised approach would still be needed for smaller or less sophisticated firms who would choose not to develop such models.

The UK would be opposed to an approach to accounting for a through-the-cycle reserve that is incompatible with IAS 39. Such an outcome is not only unnecessary but also counter-productive. In our view the specific means of representing through-the-cycle reserves in the accounts is not critical to its success in a regulatory sense. The substance of what the Commission wants can be achieved in a number of ways. Perhaps the most efficient would be that:

- the IASB works up the measurement aspects of its expected loss model;
- the Commission works up the measurement aspects of its through the cycle reserve; and
- both the Commission and the IASB cooperate on the interaction between the two models and on finding solutions for the transparent recognition and disclosure of the figures involved.

European banks could then continue to use EU adopted IFRS as their accounting standard thus reassuring global investors, while also ensuring that the efforts of bank regulators and accounting standards setters were properly harmonized for the public good. An alternative approach might be for the EC to add a mandated European through-the-cycle adjustment, set by prudential regulators, to work alongside but separately from the rewritten IAS 39. Complementary actions could ensure that this had the same practical effect as an accounting standard change (e.g. in limiting dividends). The UK would be happy to work with EC to assist in finding workable solutions.

Question 7: Should the exposure class of Article 86 (i.e. for credit institutions subject to the IRB approach) be used irrespective of the fact that the credit institution may be under the Standardised approach? It may be noted that a mapping between exposures class under the Standardised approach and under the IRB is already used in the prudential reporting system of some Member States. As an alternative, should countercyclical parameters be defined for the 16 exposures classes under the Standardised approach? (See ANNEX 1, suggested Article 74a (1).)

There is merit in aligning any further regulatory tools as much as possible with the existing prudential framework. Given our response above, we believe that it would be appropriate to base the approach on the 16 exposure classes under the standardized approach for those firms that do not adopt internal models, as this would give greater granularity and better reflect a firm's exposures. However consideration should be given to increasing greater granularity for the three categories of claims on corporates, retail and secured on real estate property as, in our experience these categories dominate exposures as a whole, and granularity within these is likely to be desirable.

Question 8: Please give your views on the following approaches: 1) the Spanish model of through-the-cycle expected loss provisioning; 2) a 'simplified' Spanish model. In particular, we would welcome views on the relative merits of both options in terms of the building up of provisions in a graduated manner over time (See ANNEX 1, suggested Annex IXb).

Were a system to be implemented, we would prefer a mechanism similar to the second option, which starts from the accounting provisions. This would make it easier to achieve transparency and allow users to "undo" the extra provision if needed.

Question 9: Should new risk categories (as suggested above) be introduced along the lines of the Spanish system or, alternatively, should the current risk categories of the CRD (e.g. credit quality steps in Annex VI) be used? (See ANNEX 1, suggested Annex IXb.)

We believe that there is merit in any proposed mechanism mirroring the existing prudential framework as closely as possible, and therefore we would prefer the current risk categories of the CRD.

Question 10: Is the 'location of the borrower' (as opposed to the booking of the exposure) the right approach, with a view to avoiding regulatory arbitrage? (See ANNEX 1, suggested Annex IXb 2.)

Firms must already have a method for identifying country risk under the capital framework. An extension of this approach would be appropriate. However, we believe that the "location of the borrower" is less vulnerable to regulatory arbitrage than the booking of the exposure.

Question 11: Will the data to determine counter-cyclical factors be easily available?

The UK does not have a credit register or other centralised database of loan information. Therefore, it would be challenging to develop the counter-cyclical factors.

Question 12: Please give your views on the methodologies for calculating the through-the-cycle expected loss provisions at consolidated level. (See ANNEX 1, amended Article 73.)

The methodology proposed in article 73 appears appropriate.

Question 13: Please give your views on the scope of disclosure requirements for through-the-cycle expected loss provisioning. (See ANNEX 1, suggested amendment to Annex XII (17).)

We believe that any measure must be fully transparent to enable users to understand its effect. With this in mind, the scope of disclosures appears suitable.

Section 2 (Residential mortgages denominated in a foreign currency)

Question 14: Do you consider that the risk weights suggested will be effective in discouraging unsafe practices and irresponsible lending in foreign currency denominated housing loans?

Question 15: Do you consider a loan to value ratio of 50% or less is sufficient objective evidence that the borrower has sufficient private wealth to withstand currency movements and potentially correlated movements in property prices?

In response to questions 14 & 15 we note that the market for residential mortgages denominated in a foreign currency is a niche market in the UK. Consequently we do not wish to comment further than to state that we understand the Commission's intention and note that these proposals would increase costs for providers within the UK market.

Section 3 (Removal of national options and discretions)

Question 16: Is this suggested scope of maximum harmonisation in 2006/48/EC and 2006/49/EC appropriate?

The Commission sets out its intention to remove regulatory additions (so called gold plating) in the areas of minimum capital requirements, large exposures and disclosure. We signalled our broad alignment with this policy by agreeing to the June 2009 ECOFIN conclusions to move towards a single rulebook, with a core set of EU wide rules. However, as set out in Recommendation 10 of the Larosiere report, Member States need to retain the ability to impose stricter capital requirements and/or adopt more stringent national regulatory measures considered to be domestically appropriate for safeguarding financial stability. In addition, UK policy is to consider setting higher capital requirements for systemically important banks. Thus the UK offers qualified support for the Commission's proposals on maximum harmonisation on the basis that the existing flexibility described here does not become constrained.

Question 17: Is the suggested prudential treatment for both residential and commercial real estate sufficiently sound?

See table below

Proposal	Objection
Residential Real-Estate Exposures – removal of national discretion on standard rules risk weights. Would lead to increase in capital requirements in the UK.	Analysis for the UK market demonstrates that the current retail mortgage capital requirement (a 35% risk weight where the loan-to-value (LTV) is less than 80%) is more than adequate to address the prudential risk. Any higher requirements, as proposed, could raise costs and have a detrimental effect on the residential mortgage market and economic activity, whilst putting smaller institutions (such as say mutual building societies) using the Standardised Approach at a competitive disadvantage (compared to larger institutions using IRB).
Commercial mortgages – removal of national discretion on standard rules risk weights. Would lead to decrease in capital requirements in the UK.	For the UK, commercial real estate exposures are risky and contributed to failings at two building societies, so we do not agree with the proposal that the Pillar 1 requirement for such exposures be eased, which we would see as amounting to a "levelling-down" of standards. If the alternative, of the higher standard (of no more generous treatment) for such exposures which the UK supports, is not be deemed applicable across all Member States because national real estate

	markets are indeed believed to be different, then the UK would suggest that national discretions be maintained in this area.
Bank exposures – all firms to be required to use the country assessment method instead of the credit assessment method	While we support greater harmonisation we don't believe the proposed policy amendment to risk weight exposures to institutions solely based on the strength of the sovereign is the correct one. The credit assessment method, which uses CRAs' ratings should be maintained; use of the country assessment method could, however, be permitted where CRA ratings are not available.
Specific risk charge for covered bonds: Article 19 para. 2 in re-cast CAD (2006/49/EC)	Notwithstanding the particular relative risk profile of covered bonds, the UK believes that it would be inappropriate at this point to remove the current discretion and so require all Member States to apply lower specific risk charges (through given percentage reductions) against such holdings. Rather, we believe that this treatment of covered bonds would be better considered alongside the fundamental review of the Trading Book about to commence in Basel. Otherwise there is a risk of being considered imprudent in reducing capital requirements to actual levels which might subsequently be regarded as too low

Question 18: Is the suggested timeline (2012) for a single definition of default (i.e. 90 days) appropriate?

The UK agrees with the advice given to the Commission by CEBS in October 2008, which states that this discretion could remain, albeit subject to a subsequent review clause. Therefore we believe that the suggested timeline (2012) for a single definition of default (i.e. 90 days) is inappropriate.

Presumably the intended motivation of the change would be to achieve a consistent definition of default. However consistency on the number of days past due is insufficient to achieve this, as there are other important factors which also affect the definition, such as the impact on the overall default definition of the "unlikely to pay" elements (which exist in addition to days past due).

Furthermore, (apart from in the case of PSEs under Foundation), the effect of imposing an earlier default definition is likely to be to reduce capital requirements. This is because of the interaction between the Probability of Default (PD) risk weight function and Loss Given Default (LGD) in the overall capital calculation. An earlier definition of default implies a greater number of cures, and thus a lower LGD. However, the impact of the reduction in LGD is greater than the impact in the increase in PD. As indicated, in general the UK does not support "levelling-down" as a means of achieving greater harmonisation.

Section 4 (Simplification of the Bank Branch Accounts Directive)

Question 19: Do you agree that the Bank Branch accounts Directive 89/117/EEC should be amended so that Member States can no longer require the publication of additional information by branches of credit institutions established in other Member States?

The UK currently does not currently make use of the national option under discussion in this Directive.