BANCO DE **ESPAÑA**

Directorate General Banking Regulation
Financial Institutions Department

Re: Banco de España's contribution to the public consultation regarding further possible changes to the Capital Requirement Directive ("CRD")

Banking and Financial Conglomerates Unit
DG Internal Market and Services
European Commission
SPA2 4/29, BE-1049 Brussels

Ref.:

Madrid, 16 April 2010

The Banco de España appreciates the opportunity to contribute to the public consultation on the possible changes to the Capital Requirements Directive. In general terms, we welcome and support the proposal and agree with its objectives. We consider that the work being done at the Basel Committee level should be the base for the Commission proposal. We also support, in general terms, the comments already highlighted by CEBS on this proposal.

We have nevertheless some specific concerns regarding the suitability and effectiveness of some of the proposed amendments. We hereby attach some comments on these particular aspects in order to contribute to the improvement of the proposal.

We trust this is helpful.

Yours,

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BANCO DE **ESPAÑA**
Eurosistema

DIRECTORATE GENERAL BANKING REGULATION
FINANCIAL INSTITUTIONS DEPARTMENT

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BANCO DE ESPAÑA'S CONTRIBUTION TO THE PUBLIC CONSULTATION REGARDING THE COMMISSION SERVICES STAFF WORKING DOCUMENT ON FURTHER POSSIBLE CHANGES TO CAPITAL REQUIREMENTS DIRECTIVE

In general terms, Banco de España welcomes and supports the proposal. However, we have some concerns regarding the suitability and effectiveness of some of the proposed amendments. In order to try to improve the proposal, we would like to make the following specific comments.

We consider that the work being done at the Basel Committee level should be the base for the Commission proposal. Nevertheless, it is necessary to carry out an adequate calibration exercise at EU level and adjust the final proposal to the impact assessment's result.

Section I: Liquidity standards

The Banco de España favours a scope of application scheme as similar as possible to the current scope set in the CRD (individual and consolidated/subconsolidated level of application). Waivers should be applied for individual requirements provided certain conditions are fulfilled.

Regarding, home/host liquidity supervision responsibilities, if a common liquidity standard is applied, the current responsibility scheme could be modified, aligning the responsibility regimes of capital and liquidity. We do not oppose to give the responsibility of liquidity supervision to the home authority whenever a debate is open on the supervisory treatment for systemic branches, especially when they receive deposits from retail customers.

Additionally, regarding intra group exposures treatment, due to the importance of the issue we consider most suitable to wait for the QIS results in order to carry out an adequate analysis. Therefore, we think that the time for taking any decision about the proposed alternatives has not yet arrived.

Section II: Definition of capital

The Banco de España welcomes in general terms the proposals for the improvement of the definition of capital. We think that the Commission final proposal should be the same than that finally approved by the Basle Committee. A calibration exercise needs to be done, particularly in subjects as the deductions of minority interests and deferred tax assets, the level of minimum capital requirements and regarding the predominance test.

Core tier 1 capital

Nevertheless, regarding the definition of core tier 1 capital for non joint stock companies, we think that it should be clearly stated how to apply the criteria to such companies in order to guarantee that their specificities are taken into account and that they are applied with the same extend by all supervisors.

Regarding the deduction of minority interests and deferred taxes, we think that it should be adequately calibrate after the impact assessment exercise. The deduction of all the amount of minority interest is excessively penalizing and it would disincentive the capitalization of a subsidiary. The Banco de España considers that minority interests should be part of core tier 1 up to the requirements the subsidiaries generate.

In the case of deferred tax assets, the heterogeneity of the EU fiscal systems and the high probability of recuperation of them justify only their partial deduction. Only excesses over a limit should be penalized, for example deferred tax assets more than 15% of core tier 1.

With relation to unrealized gains, taking into account accounting rules and their stability and reliability, prudential filters should be applied. Thus, we will welcome an asymmetric treatment for gains and losses.

Non-core tier 1 capital

In relation with call options, we consider that they should be accepted in order to avoid expelling fixed income investors of hybrid markets, because they should be able to estimate their investment return flows.

Buy-backs within the first five years of issuance should also be permitted subject to prior supervisory approval and without prior replacement of the instrument with one of equivalent quality to give flexibility to the management of entities' own funds. It should also be clear that treasury operations are excluded of buy-backs regimen.

In the framework of an increase within the level of predominance test, we do not consider necessary a mandatory principal write-down or conversion feature for all non core tier 1 instruments. As Basel provides, we think that this feature should only be required for debt instruments. As equity instruments involve an agreement among shareholders, to hard the requirements for instruments qualify as equity will difficult their marketability as rescue capital.

Tier 2 capital

Regarding call options, we do not see sense to include this kind of feature within a dated instrument, as it can incentivize an early redemption of the instrument prior to the start of the amortization period without any kind of penalization. Nevertheless, this feature could be acceptable if the date of the call is treated as the maturity date for starting the amortization period during the last five years of life of the instrument. By this way, call options will be penalized and their effect on the level of own funds reduced.

We do not consider appropriate lock-in clauses mainly because of the legal uncertainty that they involved for fixed income investors which most probably would result in an increase of the instrument's cost.

Tier 3 capital

We support its elimination of own funds, given its minimum of quality.

Implications for large exposures

Basel has not yet dealt with this subject. Thus, any change within the EU would cause the playing field to become unleveled for international banks. In any case, we have no objections to review the use of going concern tier 1 capital for large exposures purposes if this change does not reduce the total amount of the large exposures allowed. Nevertheless, this subject could be studied and assessed in the future after a calibration exercise.

Contingent capital

Basel proposal on the subject is considered conceptually adequate. We consider that it should distinguish between the use of contingent capital instruments for gone concern capital instruments' definition (definition of regulatory capital of institutions) and for other uses such as to meet capital buffers or the sharing of losses by the going concern instruments' holders. This approach permits a better and more objective definition of trigger events and that the conversion could be at supervisory discretion.

In the design of its regulatory framework, no place should be left to financial engineering.

Implementation timing, grandfathering and transitional provisions

Grandfathering requirements should interact with those for the new requirements in a prudent manner and avoiding the maintenance of an unlevel playing field and capital of minor quality during a long term. We do not think that grandfathering provisions of CRD II must be amended to bring them into line with those of the new capital requirements under CRD IV; instead new grandfathering provisions should be included taking into account the grandfathering provisions already into force.

Section V: Countercyclical measures
Part 1

The current crisis has shown that after years of boom, hidden losses in banks' loan portfolios can be enormous and that, when it comes to reflecting them, it is better to avoid simplistic interpretations of credit risk. This fact calls for a provisioning system that recognizes credit losses in an early fashion taking into account both the behavior of credit risk over the business cycle and the behavior of banks when it comes to managing it.

In this sense, we agree that the current interpretation (and frequently practical use) of the incurred loss model is not consistent with the way in which banks manage credit risk, and therefore welcome the Commission's proposals to consider alternative models that would allow provisions for credit losses to be recognized earlier.

As opposed to this model, through the cycle provisions could provide a fair view of the real cost borne by banks because of credit losses. Additionally, by forcing bank managers to distribute credit losses along the life of the loans, through the cycle provisioning systems encourage adequate risk management.

The IASB's expected cash flow (ECF) model requires an earlier recognition of expected credit losses, and thus seems to reflect the economic reality of banks' lending activities better than the incurred loss approach. However, as discussed below (see answer to question 38) it brings about a number of drawbacks which should be considered. In any case, the final design of the model will determine the effective extent to which it will reflect credit risk borne and credit losses, so we welcome the proposal to wait for the IASB to complete the model before advancing in the consultation process, and the according extension of the comment period.

As regards the IRB expected loss model proposed by the Commission, we believe it takes on board the above mentioned rationale by considering not only the behaviour of credit risk over the business cycle but also how banks manage credit risk

Question 38
The Commission Services invite stakeholders to perform a comparative assessment of the three different methods (i.e. ECF, incurred loss and IRB expected loss if it could be used for financial reporting) for credit loss provisioning from 2002 onwards based on their own data.

It seems quite clear at this stage that the current incurred loss method of IAS 39 does not reflect the expected losses of a credit portfolio. Neither is it fully in line with the way in which banks manage credit risk, i.e. charging a risk premium for expected losses since inception at a portfolio level.

As regards the IASB ECF method, conceptually it achieves a more timely recognition of expected credit losses than the current incurred loss accounting model. However, a number of drawbacks should be considered:

- First of all, the operational complexities linked both to the determination of expected cash flows and to the fitting of open portfolios within the method should not be obviated.
- Additionally, the degree of timeliness in credit loss recognition will depend on an accurate application of credit risk factors based on long data series. In this sense, requiring banks to estimate expected losses for the remaining life of every single loan in the portfolio seems quite demanding (and possibly not feasible).
- From an economic reality standpoint, the requirement to re-measure the carrying value of all loans when expectations of loss change seems reasonable. However, the revision of expected cash flows cannot be treated equally for performing and non-performing loans. In the case of non-performing loans, the IASB model provides the best estimate of credit losses. However in the case of performing loans, a frequent revision of expected cash flows can lead to highly subjective estimates of losses, especially for long term cash flow estimates.
- The ECF method implies limiting the definition of amortized cost to information on interest accrual, thus concealing the important goal of providing insight on the asset's impairment.
- According to this method the level of provisions would depend on expected cash flows, which would likely be reviewed when economic trends change. This would lead to an increase in provisions when a downturn is starting and a decrease in provisions when the economy is beginning to recover, thus creating even more pro-cyclicality.

The approach proposed by the Commission (IRB expected loss model), which can be considered a version of a model similar to the generic provision implemented in Spain by the Banco de España, would entail estimating credit risk losses over the economic cycle. Unlike either a simplistic interpretation of the incurred loss model (current IAS 39) or the ECF model, this approach aims to explicitly recognize first of all that banks charge a risk premium for credit losses since inception, and secondly what seems to be the general behavior of banks during economic upturns or more generally when expanding the credit risk portfolio, i.e.: a) a perceived over-optimistic view on credit losses in its accounting figures; and b) an underestimation of credit risk caused by competitive pressure.

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

The Commission's proposal allows an adequate reflection of credit losses in the income statement over the whole economic cycle, and follows the January 2010 mandate from the Group of Central Bank Governors and Heads of Supervision by addressing the deficiencies of a strict application of the incurred loss model without moving to fair value.

Given that the model combines the expected loss and incurred loss components on a global basis, it promotes forward looking provisioning and early identification and recognition of credit losses.

Additionally, the necessary transparency is achieved by separating expected and incurred losses in two lines, thereby facilitating validation of loss estimates by auditors, supervisors and investors.

We share the need to distinguish between performing and non performing loans, and specifically the separation of expected losses stemming from the former and incurred losses from the latter. We also agree with the proposal's encouragement to use IRB parameters for provisioning purposes, since forcing banks to develop parallel systems to determine "accounting" expected losses would make no sense.

Section VII: Single rule book in banking

We consider that pillar 2 is not a sufficient tool to address specific negative circumstances that affect a whole financial system. Capital requirements must take into account these circumstances in order to avoid un-leveling the playing field. Pillar 2 must be only a tool in the hand of supervisors to address particular circumstances of an institution.

In general, we support a removal of national options and discretions.

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.

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 suggested figure of 80% for the loan to value could seem realistic.

The ongoing appraisal of the property required by the CRD also justifies not being too stringent regarding the loan to value ratio, given the fact that the reduced risk weighting will depend on the price of the property at any time.

In Spanish mortgages loans market, 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 we need to do 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 had been done in the consultative proposal conducted in July-September 2009 with relation to residential mortgages denominated in a foreign currency and speculative real estate programs), 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).

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, for exposures with a loan to value over the harmonized amount (for example. a mortgage with a 100% loan to value) their risk weighting should be, at least, at 100%.

The introduction of a specific maximum harmonized loan to income ratio could be also a good precondition for the preferential treatment. To this end, we consider prudent an amount close to 35%.

Regarding commercial real estate, we consider current LTV as adequate. An assessment of the appropriateness of the existing preferential risk weight applied to them could be done, taking into account the lessons of the recent crisis and for the exclusion of the more risky operations of this preferential treatment.

For both types of properties, the introduction of a hard test could be appropriated.

On the other hand, we do not see necessary the introduction of measures that would help to address real lending throughout the economic cycle, given the fact that the reduced risk weighting will depend on the price of the property at any time and the requirement of the CRD of an ongoing appraisal of the property. What will be necessary is the use of prudent legally binding valuation rules. We also consider that pillar 2 is not the more adequate framework for avoiding real state bubbles.