

POSITION PAPER



**ESBG Response to
Commission services staff working document from
February 2010 on possible further changes to the
Capital Requirements Directive (“CRD 4”)**

European Savings Banks Group Register ID 8765978796-80

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I. Preliminary remarks

The European Savings Banks Group (ESBG) welcomes the opportunity to comment on the Commission Services Staff Working Document on possible further changes to the CRD, published on 26 February 2010 (further referred to as “CRD 4 proposals”).

Before entering into the discussion of the Commission’s concrete proposals, ESBG would like to comment on some important aspects of the methodology followed and the approach taken in the ongoing review of the CRD.

a) Concern about the volume and pace of regulatory change

ESBG supports the international and European efforts to repair the financial regulatory framework with a view to render it safer and more resilient. Most of the regulatory repair measures put forward by policy makers in response to the crisis appear to have a sound motivation when looked at individually, however it is essential that their effects be considered in the broader context of the overall regulatory reforms that are envisaged.

There are some serious concerns as regards the pace and volume of the envisaged regulatory changes:

- There is a very high degree of **uncertainty** in the financial markets given the unpredictable outcome of the regulatory reforms. The banking industry is currently faced with multiple regulatory proposals stemming from different sources. Each of the envisaged regulatory changes will most probably entail a significant increase in the level of capital required for banks or otherwise the deployment of significant resources by institutions. The cumulative impact of the measures put forward since the financial crisis is at present assessed and most of the proposals currently on the table will be subject to further details and calibration once the results of the quantitative impact analysis will become available. The banking industry is actively involved in such ongoing impact analysis, whilst having to cope with major uncertainties as regards the final regulatory output. Such uncertainties impinge to a large extent on the way day-to-day banking business is carried out and on the planning of activities.
- The **speed** by which the new measures are devised and adopted is unprecedented. This confirms that the regulatory framework allows for swift adaptation in case of need. However, there are strong concerns that quicker decision-making occurs at the expense of the quality of the regulatory output. Too often during the past two years, regulatory proposals were not accompanied by thorough studies as to their suitability, justification, impact and cost-benefit analysis. Consultation processes, if any, were reduced to minimum periods, and stakeholders have been overwhelmed with questions from various sources. Now is the time to ensure that this pattern will not repeat itself.
- There is a real risk of moving towards **over-regulation**. Such an outcome would result in a significant misallocation of resources, entail enormous costs and create a burden not only for financial institutions but also for the whole economy.



- This large amount of regulatory reforms paradoxically puts a **heavier burden on the retail banking sector**, which was the most resilient during the crisis. Investment banking might be hit hard by the proposed regulatory package, yet this business model has a clear advantage: a capacity to react and adjust the business mix more quickly. Instead retail banks will find it more difficult to mitigate the impact, as they have much lower flexibility in adapting their business model and their restricted capability of passing regulatory costs because they operate in a highly competitive environment. Also, it should be reminded that retail banks are driven by the business-needs of their customers, which renders cost optimisation through redesign of the business model and reconfiguration of operations more difficult.

b) Consultation Procedure

ESBG would like to highlight that the period for providing feed-back has been inadequately short (i.e. 1 ½ month) given the high relevance of the issues at hand for the banking industry. The topics addressed under the CRD 4 proposals are part of the long-term adjustments of the financial framework. While we understand the need to keep the momentum of the debate, the present rush and time pressure are exaggerated and can prove harmful to the overall outcome. Alignment with the deadline for the Basel Committee's consultation is not pertinent, as the Commission's proposals differ from the latter and address EU specificities. The potentially major impact of the rules proposed requires that the Commission's ideas be thoroughly discussed. ESBG underlines the importance of a substantial dialogue between the industry and policy-makers for adopting high quality and effective legislation, and urges therefore the Commission to observe the Better Regulation Principles.

ESBG notes that the consultation documents issued by the Commission do not contain some key elements and figures that would give substance to the concepts developed in the papers. Without clarity on calibration no full feed-back can be given. Therefore, ESBG warns that this response is only a preliminary assessment of proposals, which have not been substantially fleshed-out. A final assessment hinges on a final complete and concrete proposal.

In this context the current consultation has to be seen only as a pre-consultation. ESBG looks forward to a future consultation on the actual proposals, which should be based on the results of the comprehensive impact assessments.

c) Need for clarification

Apart from the missing details of some of the concrete proposals that are expected to be disclosed once the results of the impact assessment will be available, ESBG considers that it is imperative that the Commission clarifies two more fundamental aspects of the proposal.

First, ESBG observes that there is no clear objective of the proposals as regards the expected overall amount of capital in the system. The proposals only generically refer to the intention to raise the quality, consistency and transparency of the capital base. By contrast, when discussing CRD/Basel 2, it was clear from the outset that the overall aim was to maintain the existing amount of capital in the system, but to redistribute it so that it was held in accordance with risk. In the absence of such stated objective during the present consultation exercise, it is impossible to assess the internal coherence of the current proposals. Hence, we invite the Commission to make public its intentions.

Second, ESBG takes the view that it should be explicit, which concrete proposals fit into Pillar 1 (CVA, asset correlation) and which should come under Pillar 2 (any form of capital add-on). This is



particularly important in view of consistent implementation, and especially for ensuring that all regulators have access to the same regulatory toolkit.

d) Risk-sensitivity

ESBG generally welcomes the ongoing review of the Basel II capital framework, in view of correcting the weaknesses made apparent by the crisis. At the same time, it is important to recognise that not all aspects of Basel II should be questioned; Basel II has represented a significant step forward as compared to Basel I, which has helped many firms to improve their risk management practices.

A particularly positive aspect of Basel II is the risk sensitive approach it takes; ESBG upholds that risk sensitivity should remain the basis of any future prudential regulation applicable to the financial sector. In fact, what is needed is not less risk sensitivity, but rather *more* accurate risk-based assessments in the supervisory process.

e) Impact assessment and calibration

As already indicated above, conducting an overall cumulative impact assessment is crucial. ESBG is confident that regulators will very seriously analyse the results of the ongoing Quantitative Impact Study (QIS) and impact assessments and appropriately calibrate the proposed measures.

ESBG would like to highlight that it is important that the impact assessment incorporates a macro-economic assessment of the effects on the whole economy, as well as on specific sectors. This should necessarily include also a thorough analysis of the effects of the proposals on smaller banks. It should appropriately acknowledge as well structural differences and specificities in the national financial markets all over the world. Furthermore, it has to duly consider the differences between good banking practices and bad banking practices and between different business models.

ESBG would also like to draw attention to the fact that the EU impact assessment will be conducted in parallel with the Basel Committee's QIS, but including a sample of institutions – namely small and less complex institutions – that will not be accounted for by the Basel Committee. This could lead to substantial differences in the results that might trigger divergent approaches. ESBG urges the European decision-makers to be transparent about these differences and to duly address the specificities in the European market.

Appropriate calibration is key to the success of the proposed regulatory reforms. It can be done only on the basis of the results of a trustworthy impact study. Calibration is critical for the quality of the new rules and their ability to address the current failures; inappropriate calibration has the potential to massively harm not only banks but also the wider economy.

f) Grandfathering and transitional arrangements

In view of the far-reaching consequences that the envisaged measures will have on the financial sector and herewith on the financing of the economy, ESBG calls for appropriate transitional, phase-in and grandfathering arrangements. Such arrangements should in particular account for the following aspects:

- Economic recovery: phase-in, grandfathering and transitional arrangements are vital in order to avoid disrupting the markets and the economy, and to ensure smooth and sustainable recovery. Such arrangements have to pay due account to the fact that the crisis affected differently



different types of financial institutions and manifested itself in different ways and to a different extent in the various EU Member States.

- Cumulative impact assessment: the transitional arrangements should be defined in function of the cumulative impact assessments to be conducted by the Basel Committee and the European Commission/CEBS, aiming at establishing acceptable transition periods in view of avoiding massive disruptions in the markets.
- Legal certainty: Implementation timelines and transitional and grandfathering clauses in the CRD II were a core issue at the time of the negotiations and have already created expectations and directed accordingly the actions and forward planning by those affected. Legal certainty needs to be preserved, and no contradictory messages should be sent out to the industry. The CRD IV proposals should – as a minimum – preserve the grandfathering and transitional arrangements foreseen in the CRD II. Yet, given the substantial overall implications of regulatory capital reforms, it appears reasonable that even longer transition and grandfathering periods be taken into consideration.
- No retroactivity: It is of utmost importance to ensure that none of the new rules is applied retroactively, for instance as suggested by the Basel Committee in its proposals: as of the date of the issuance of the proposals – 17 December 2009. Capital, which complies with the currently applicable legal requirements should continue to be attributable to the relevant capital categories as long as it is issued before the new regime enters into force.



Section I - Liquidity Standards

I. General ESBG comments

The liquidity standards discussed by the European Commission build on the proposals put forward for consultation by the Basel Committee on Banking Supervision in December 2009¹. The goal of these proposals is to increase financial stability by reducing the potential for a future liquidity crisis. This is to be achieved by improving credit institutions' liquidity management, namely by setting unprecedented regulatory standards which shall a) ensure greater robustness of banks to sudden adverse conditions (Liquidity Coverage Requirement, LCR) and b) improve resilience over the longer term and prevent problematic mismatches between the maturity of funding and assets (Net Stable Funding Requirement, NSF).

Both standards would be worded as requirements that banks have to fulfil at all times. The Commission points out that, should banks fail to meet these requirements under stress, compliance would need to be restored over a short timeframe, where a restoration plan would be designed and followed up on by competent authorities.

ESBG generally agrees with the Commission taking up the Basel Committee's approach in the development of binding rules for liquidity management and with the rationale to increase short-term and long-term resilience to liquidity risk. If properly designed and used, rules to improve liquidity management have the potential to correct many of the weaknesses which contributed to the 2008/09 crisis.

Yet ESBG is doubtful whether a quantitative liquidity regulation based on the proposed measures will fulfill its goal to create higher resilience towards liquidity stress. In particular, a minimum amount of liquid assets, to be maintained at all times, will de facto not constitute a buffer – unless an effective mechanism for running down the buffer in acute liquidity situations is established. Furthermore, the proposed framework takes liquidity self-sufficiency as a point of departure and stipulates that banks should disregard any kind of central bank support in their liquidity planning, even when faced with a severe long-term crisis. In addition, the choice of a one-size-fits-all approach neglects the importance of bank and market specific characteristics.

As regards the details of the proposals put forward by the Commission, ESBG has serious concerns on many important aspects, also addressing certain issues which are not part of the original Basel proposals. It stands to fear that present shortcomings or biases, if left uncorrected, will lead to severe unintended consequences.

A. Core problems identified by ESBG:

On the approach taken:

1. The Commission echoes the Basel proposal and therefore takes a one-size-fits-all approach. Accordingly, the proposals on the table are not adequate for retail banks, which, however, form a significant part of the European banking sector.

¹ Basel Consultation on an "International framework for liquidity risk measurement, standards and monitoring" (December 2009)



2. At present the proposal does not sufficiently take into account the different associations in which institutions may be organised. Decentralized organisation forms, as a distinct characteristic of the European retail banking market, do not find appropriate consideration in the proposed concept. For instance, depending on the association among decentralised institutions, a special role can be played by a central institution, with which the other institutions are associated in a network in accordance with legal or statutory provisions and which is responsible for the balance of liquidity or handling of payments within the group. In such a setting, and in context of the calculation of the mandatory ratios of the NSF and the LCR, application on a consolidated level only is appropriate.
3. There is a lack of clarity in how far the Commission favours the form of technical standards by the EBA over a concrete stipulation of regulatory standards within an amended CRD. While the latter appears to be the scope of the discussion document, in relation to question (7) the Commission indicates room for the alternative (i.e. technical standards by the EBA). ESBG is of the opinion that whatever the solution opted for, it is important leave sufficient room for banks' individual assessment of their specific liquidity risk under the supervision of competent supervisors. This also means that the objective pursued should not be to set all parameters at European level.
4. Public disclosure of banks' LCR, NSF and monitoring metrics is ill-advised since any publicly observed unfavourable change of these ratios may trigger liquidity runs and chain reactions on markets. This would undermine resilience to liquidity risk, instead of strengthening it.

On the construction of the requirements:

5. For both proposed requirements (LCR and NSF) the stress scenarios are excessively severe. The scenarios combine several stress factors in a way which is neither evidence-based nor probable. Here, the assumption that during a systemic crisis central banks would not play their assigned role as lenders of last resort is unrealistic and undermines financial stability.
6. For both proposed standards there are too many blanks or still undefined aspects. Without more and clearer information banks cannot give a conclusive assessment or quantify the effect of the regulation.
7. For both proposed regulatory standards, the stress-related assumed cash outflows/ discounts on availability of funding are exaggerated for important asset and liability categories. This results partly from the excessive severity of the stress test, partly from 'miscalibration' and partly from 'misconstruction' of the asset/liability categories.
8. For the LCR, the set of assets eligible to be counted as coverage is excessively restricted.

On the overall effect of the regulation:

9. The regulation sets out to reduce maturity mismatches within large international financial institutions and results in impeding all maturity transformation. This undermines the stable and sustainable business model of retail banks. Such an outcome will lead to greater financial and economic instability, not to greater stability.
10. The regulation proposal sets volumes of liquidity/funding that have to be held at all times. This will lead to increased competition for eligible liquid assets and funding. At the same time it



blocks a great amount of balance sheet capacity at the cost of lending to banks, corporates and households. It may also pressure banks to engage in riskier activities in order to generate necessary returns.

11. If banks' LCR may not sink below the prescribed standard, the stock of high quality liquid assets held to comply with the LCR does not constitute a 'buffer' to mitigate 'real-life' emergencies. Rather, banks will be forced to earmark additional liquidity for 'real-life' liquidity purposes. This will even intensify the struggle for highly liquid assets and block even more balance sheet capacity, further making long-term commitments to the real economy unattractive – or even unfeasible. ESBG therefore welcomes that the Commission appears to consider the possibility to allow for temporary drops of the LCR below 100%, but requests more clarity on the envisaged mechanism.
12. The adverse effect on long-term commitments and bank lending is amplified by underestimating the stability of retail deposits as a source of funding. De facto the regulation penalizes retail banking activities. It creates great uncertainties concerning the financing of the real economy.
13. The introduction of the LCR will lead to distortions on asset markets, which are worsened by the excessively restricted set of assets eligible for being counted as coverage. Demand for assets which are treated less favourably by the regulation will decrease, leading to unpredictable declines in prices. On the other hand, prices will increase drastically for those assets made attractive/necessary by the regulation. Asset prices will become a less useful signal on underlying economic fundamentals.
14. ESBG decidedly warns against combining liquidity standards of the form presently discussed with a leverage ratio. Especially the high quality liquid assets required by the LCR will already take up significant balance sheet capacity, while at the same time yielding only low returns. Further limiting banks' balance sheet size by tying it directly to capital puts exaggerated limits to banks' ability to lend and generate necessary returns. ESBG also points out that LCR and leverage ratio are conceptually inconsistent, since a leverage ratio is not risk based, and will therefore not even recognize the low level of risk associated with those assets which banks will be explicitly required to hold to fulfil a regulatory liquidity standard. Should the leverage ratio (in spite of its serious disadvantages) become reality, it is vital that the assets held in context of the LCR be *not* included among the factors contributing to an institution's leverage.

From these points it is obvious that there is great danger of “overshooting”, especially in the retail banking area. For this reason we expect the regulation, as it currently is proposed, to significantly reduce retail banks' ability to lend to the real economy.

B. ESBG views on effect on retail banking

ESBG shares the objectives of the Commission to increase the robustness of banks' liquidity management and to prevent dangerous maturity mismatches, especially as regards activities on wholesale financial markets. However, in their current form, the measures on the table are set to become harmful regulatory hurdles for a business model which has a completely different focus, and which furthermore proved among the safest during the crisis.



a. Side-effects of the Liquidity Coverage Requirement

ESBG is very apprehensive of the combined effects of the narrow definition of eligible high quality liquid assets in combination with the prescribed run-off rates for funding. In particular for traditional retail banks the current proposal will hit banks twice:

- The assumed run-off rates for retail deposits are excessive and hence significantly undermine traditional retail banks' funding side. Not only would the competition for retail deposits become very heated, aggravating the disadvantages of traditional 'comprehensive banks' vis-à-vis their large competitors, for instance those aggressively competing via internet banking facilities. The current proposals could furthermore force regionally oriented retail banks to seek extra (and otherwise unneeded) funding on wholesale markets, which may not even be compatible with their business models.
- The effect of the treatment of retail and SME deposits becomes even more aggravated by the fact that retail banks' main assets, i.e. loans to the real economy are not considered among the stock of liquid high quality assets. Hence traditional retail banks may be forced to drastically reduce lending, and credit/liquidity commitments.

Taken together, it stands to fear that the current proposals will put great strain on regionally oriented and traditional retail banks and will undermine their ability to fulfil their role as lenders to the regional and local economy. However, regulators must be aware that it is precisely the traditional retail banking model which has proven stable and sustainable during the crisis and forms a cornerstone for economic prosperity in many markets.

b. Side-effects of the Net Stable Funding Requirement

A NSF of 100% questions the very core principle of banking, which is maturity transformation (and which implies at least some liquidity risk).

In this context, ESBG needs to highlight that as a result of the assumptions for the NSF, three standard retail banking activities (deposit taking, lending to households and loans to businesses) are severely penalized. The resulting constellation is dangerous:

- On the one hand the stability of traditional retail banks' funding source (retail deposits) is underestimated, reducing its potential to serve as 'available stable funding'.
- On the other hand traditional retail banks' main assets (long-term loans to the real economy and to households) require an excessive amount of net stable funding.

A direct effect may well be that for traditional retail banks, engaging in long-term commitments towards corporate customers may become very expensive in 'required funding terms'. As a consequence, given that a large part of banks' portfolio cannot be re-priced, banks will have the incentive to run down their loan books and to reduce overall lending. However, discouraging long-term commitments or making them much more expensive would have grave effects on the wider economy and on those, especially smaller enterprises, for which long-term bank loans are a vital source of financing.



Furthermore, the present discouraging treatment of very safe assets may increase the impulse for banks to turn to very high risk activities in order to generate return. Equally, this outcome may lead to dynamics where fierce competition for retail banking deposits makes them a less stable funding source. This being said, from a macroeconomic perspective it is not even clear whether in all markets the amount of stable funding required will actually be available.

As a consequence of limiting the maturity transformation role of banks, other – unregulated – market players can be expected to take up this role and to substitute banks for this necessary function in the economy. Hence the maturity transformation would to a greater extent take place outside the supervised sector: the associated risks will escape supervisory oversight and will fall outside the safety net for society that supervision provides.

C. ESBG views on possible solutions and next steps

In part the above problems arise because the underlying proposal by the Basel Committee is specifically directed at large international financial institutions. The Commission needs to be aware of the dangers implied by uncritically adopting the Basel proposals well beyond their scope – i.e. in a much more diversified environment. In particular, in their present form the discussed measures are grossly inadequate for the European banking sector, and in particular for those (often smaller) institutions with a strong focus on retail banking at a regional level. There are two remedies for this problem:

- If regulators insist that the liquidity measures have to become regulatory standards, then the standards need to be fine-tuned in order to become applicable to all banks in all countries.
- Alternatively, only minimum standards should be established under “Pillar I”, to be complemented by bank-specific liquidity tests (under the control of supervisory authorities), which for instance could include internal models. ESBG strongly favours this approach, which is supported by the guidelines developed by the Committee European Banking Supervisors (CEBS).

As regards the next steps, ESBG stresses that the discussed liquidity requirements are only part of a much wider initiative to overhaul and improve the regulatory framework (as also obvious from the Commission’s discussion document). Before going any further stakeholders’ comments to the entire reform package need to be taken into account. Then the priority is to gain more certainty on the inter-linkages among and the cumulative impact of the different reform proposals. In this context, ESBG welcomes the role of the Committee of European Banking Supervisors (CEBS) to investigating the aggregated effect of the proposed revisions and urges the European Commission to engage in an assessment of the macroeconomic impact. ESBG also stresses that a conclusive round of consultation can only be launched once there is clarity on the wider impact of the reform package.

As regards the application within institutions, ESBG stresses that the requirements should only apply at group level and should not unnecessarily restrict the transfer of liquidity within a banking group. Indeed, we would underline that the 2008/09 crisis has demonstrated the importance of banking groups being able to balance overall group liquidity demand among the different group members.

Furthermore it is essential that the Commission will soon give reliable and detailed information on the transition process, including the questions of timing and treatment of banks’ existing assets and liabilities. Here ESBG points out that a timely discussion with stakeholders is vital to ensure a smooth



transition to the new standards. We also stress that institutions need to be given certainty as soon as possible regarding the details of the phasing-in measures and grandfathering arrangements.

The question on whether the banks' LCR and NSF should be publicly disclosed appears open. While ESBG can understand the reasoning behind this requirement, we strongly advise against it for two reasons. Firstly, public disclosure is generally based on figures, which are at least a few months old. Since the liquidity situation itself changes continuously, the published figures will be outdated already at publication. Hence the disclosed information of very simple metrics and figures will be misleading. Secondly, we need to warn that a public disclosure requirement could actually lead to greater instability. In particular there is the risk that the market may misunderstand the effects of business cycle volatility and interpret them as first signs of bank specific problems. Also, if, for whichever reason, the disclosed LCR and NSF are observed to decline and to approach the Basel limits, the market reaction could lead to trigger runs and draw-downs.

II. ESBG replies to the Commission's questions

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 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.

ESBG remarks on the concept of the LCR

The LCR is designed to prevent a recurring of the problems arising from the sudden drying up of bank liquidity experienced during the 2008/09 crisis. This is a goal ESBG fully supports.

As a concept, the LCR, like the underlying Basel proposal, seeks to counteract the tendency – observed at some banks – to hold insufficient liquidity (also in form of highly liquid assets) to be robust to instabilities or shortfalls of funding, which proved highly problematic especially if there was a strong reliance on short term funding. ESBG recognizes the need to prevent such overly 'optimistic' liquidity management, and thinks that this can indeed be addressed by the currently proposed concept of an LCR.

However, ESBG also detects a significant weakness in the LCR approach, in the sense that it imposes great limitations on banks' business activities, irrespectively on whether the business model is robust to liquidity risk or not. In fact, the current proposal neglects that especially for banks with a strong focus on retail banking and financing via retail deposits, liquidity risk has not been a substantial threat even during the peaks of the crisis. Therefore, for a large part of the banking sector, given their very business model, there is not even a need to increase resilience to liquidity risk. It is therefore striking that the current LCR concept completely lacks the necessary sensitivity to bank specific factors and bank specific risk.

The present concept of the LCR therefore is a 'one-size fits all' concept, biased to address specific shortcomings observed in a part of the banking sector with certain similarities in their business models. This bias is understandable for the Basel proposal (given the Basel Committee's specific target group of large international banks) but is not appropriate in any regulatory proposal eventually put forward by



the European Commission, which after all has to develop unbiased and adequate regulation for the entire European banking sector.

As regards the Commission's objective that the LCR should create a 'buffer', ESBG points out that the very purpose of a buffer is to be run down under adverse conditions. As long as the LCR is to be maintained at all times, the prescribed stock of liquid assets cannot be considered a buffer, since it cannot be used to mitigate stress which materializes in reality. ESBG therefore welcomes that the Commission appears to consider the possibility to allow for temporary drops of the LCR below 100%, but requests more clarity on the envisaged mechanism.

ESBG recognises that currency denominations of liquid assets and projected funding outflows can play a role in the effectiveness of the LCR. Here ESBG appreciates that the Commission does not envisage to impose separate LCRs according to currency, and that instead supervisors will check the adequacy of currency distribution within the composition of the LCR (§ 6).

Apart from these conceptual weaknesses of the LCR, ESBG has important concerns relating to various aspects of the proposal currently on the table, in particular since several assumptions are not evidence based.

ESBG remarks on the appropriateness of the tentative calibration of the LCR

i. Remarks on stress scenario prescribed

The imposed stress conditions have vital implications for the calibration of the components of the LCR and will have a great impact on banks' balance sheet decisions. Consequently, a misspecification of the scenario will be highly problematic. ESBG has significant doubts on several aspects of the present stress scenario:

- The approach taken is very conservative and the prescribed stress scenario is unrealistically harsh, adding a market wide shock to a deep and sudden idiosyncratic crisis at the bank itself. This combination is very improbable; not even during the 2008/09 financial crisis did such a situation materialize for most banks (while, of course, for those banks which indeed underwent a similar experience, the arising liquidity problems were extremely severe).
- Imposing a three-notch downgrade in the institution's public credit rating within 30 days is very drastic. Assuming that such a downgrade would happen out of the blue and without any regard to the bank's business model, exposures and general soundness does not seem realistic. In addition, the impact of such a downgrade on the bank's funding possibilities strongly depends on its current credit rating. Hence this aspect of the stress scenario is overly simplistic and ignores the importance of a bank's specific characteristics.
- Also, it is not foreseen that banks have access to liquidity support from central banks – a requirement which runs contrary to central banks' function as lenders of last resort. This assumption is improbable in situations where the worst case scenarios accumulate, as they do in the prescribed stress scenario, which after all entails systemic-crisis driven bank runs. This does not imply that central bank liquidity support should be treated as an option to increase the LCR, but it underlines that there is significant overshooting as regards the severity of the currently imposed stress scenario.



Given all these weaknesses, ESBG fails to see why there should not be room to introduce more bank and market specific stress scenarios, of course depending on the approval of the competent supervisors.

Remarks on the eligible high quality liquid assets (HQLAs)

ESBG agrees that, in order to fulfil their purpose, HQLAs should unite certain fundamental and market-related characteristics: low credit and market risk, ease and certainty of valuation, low correlation with risky assets, listed on a developed and recognized exchange market, an active and sizable market, presence of committed market makers, low market concentration, flight to quality (§ 8). Consequently banks need to cover stressed net outflows of funds by holding a stock of liquid assets that should easily and immediately be converted into cash at little or no loss of value.

Presently included (provided certain conditions are met) and fully recognized are: cash; central bank reserves (to the extent that they can be drawn down in times of stress) and marketable securities representing claims on or claims guaranteed by sovereigns, central banks, non-central government public sector entities (PSEs), the Bank for International Settlements, the International Monetary Fund, the European Commission, or multilateral development banks. In addition, the Commission considers whether up to half of the HQLAs can be formed by corporate bonds (unless issued by a bank, investment or insurance firm) and covered bonds (not issued by the bank itself), which, however, receive substantial haircuts and have to fulfil a series of requirements in line with the asset characteristics listed above (Annex 1).

Furthermore, the Commission names as an additional condition (§ 7) that such high quality liquid assets should also be eligible as collateral for central bank credit operations (unless in a given market the set of eligible collateral is restricted to very specific assets only). ESBG follows the reasoning behind this requirement but points out two related inconsistencies in this context: First, imposing eligibility to central bank collateral frameworks is inconsistent with the stress scenario's assumption that central banks as lenders of last resort do not play a mitigating role. Second, if eligibility as central bank collateral becomes a criterion, then the 50% limit and the very high haircuts on corporate and covered bonds are inconsistent with the very recognition that eligibility as central bank collateral eligibility makes assets highly liquid even in times of market stress. In this context ESBG wonders whether haircuts similar to the ones applied by the ECB in context of its liquidity facilities would not be more suitable.

While ESBG appreciates and shares the reasoning behind holding sufficient highly liquid assets, ESBG emphasizes that the range of the concrete assets which the Commission proposes for HQLAs is far too restrictive, even in the more generous version which allows for the inclusion of certain corporate bonds and covered bonds. Indeed, the strong focus on cash, central bank reserves and public sector debt (or public sector guaranteed debt) underestimates the liquidity of many forms of private sector issued instruments (especially if they meet the requirement of eligibility as collateral to central banks).

ESBG urges the Commission to take a more generous approach than currently envisaged. Otherwise the ensuing dynamics will have a significant and disruptive impact on banks' business models on the one hand and on asset markets on the other hand:

- Even for certain (potentially) eligible assets, some of the required conditions pose an exaggerated hurdle. For instance, the requirement to demonstrate for corporate bonds and covered bonds that they have a "proven record as reliable source of liquidity" is difficult to meet in general, and would exclude newly issued products – an effect that cannot have been intended. In addition while the



requirement of low spreads is reasonable, it is exaggerated to ask for documentation of the bid-ask-yield spread for ten years.

- The current proposal not only affects banks' liquidity management but also their profitability, since it forces banks to hold more eligible sovereign debt (or similar assets), which, given its low risk, also yields low-return. This effect will be amplified since regulation induced increase in demand will lower returns even more.
- Even in the somewhat more generous definition of HQLAs, the range of eligible assets is still so small as to be incompatible with the diversity in banks' funding sources. While the wording in the EC's document is not clear (referring only to corporate bonds not issued 'by institutions') the Basel proposals, on which the EC extensively draws, explicitly exclude corporate bonds issued by banks, investment or insurance firms. We assume that this is also the meaning of the Commission. It is ESBG's great concern that the exclusion of bank-issued corporate bonds from the HQLAs may make them less attractive for other financial institutions and can severely impede banks' funding possibilities, especially since banks are significant holders of financial sector debt (an effect which is augmented also by the treatment of retail banking deposits in the NSF, discussed below). Shrinking the group of investors in bank bonds (thereby also increasing their price) cannot be the goal of the Commission.
- Most likely banks will focus on HQLAs in their own currency. Here the narrow definition of HQLAs can lead to at least three different problems:
 - o There will be jurisdictions with very sound public finances and very low levels of public debt, where available HQLAs (where sovereign debt plays an important role), will probably not cover national banks' needs.
 - o In other jurisdictions, national sovereign debt may not have a 0% Basel risk weight, equally leading to a shortage of HQLAs available to the national banking sector (as a side-effect, it will make financing of public debt for those countries more difficult and increase the spread between the rates payable on the national debt of different countries; current events lead to the question whether this would be desirable from a macroeconomic point of view).
 - o Furthermore, what will happen if countries' risk ratings are downgraded?
- For asset markets there will be a substantial disruption of the risk-and-price-based equilibrium of supply and demand: the regulation will lead to a material surge in demand by banks for HQLA eligible assets, whereas the demand for other, ineligible assets most likely will diminish. These price changes will be independent of economic fundamentals, and for assets issued in the future these regulation effects will be priced in at issuance. As a result, the value of asset prices as information on asset quality and risk will be greatly impeded.
- For the real economy, issuing non-HQLA eligible debt may become substantially more expensive, since the regulation increases banks' opportunity cost of holding non-HQLA debt. This can have a significant adverse effect for the financing of industry and larger enterprises.
- The restrictiveness of the regulation may even undermine its own objective: If banks all over the world (or in this case, at least all over the EU) have to hold significant amounts of the HQLA eligible assets, this may actually reduce the liquidity of these assets in reality. Conversely, should a systemic crisis really occur again, in order to cover liquidity outflows all – or at least a very large number of – banks would be selling very similar/or even the same types of assets at the same time. While it is not even clear whether there would be sufficient buyers in such a scenario, it is already



obvious that at least asset prices would tumble. In such a situation the specified LCR would be self-defeating.

ESBG would also like to point out that the restricted list of HQLAs is a direct consequence of the overshooting of the assumed stress scenario. Decreasing the severity of the stress scenario to levels of stress which are more realistic and which banks should indeed be expected to withstand alone could already solve a lot of the problems listed above.

ESBG would particularly recommend as more adequate the assumption of only an idiosyncratic bank specific stress scenario (i.e. without the systemic or market driven assumption). This would have the additional benefit that HQLAs could include high quality and highly liquid corporate bonds, and that the additional haircuts to all eligible corporate bonds and covered bonds would not be necessary.

Remarks on the assumption on net cash outflows

The net cash outflows against which banks need to hold sufficient HQLAs is calculated as the cumulative expected cash outflows minus cumulative expected cash inflows arising in the specified stress scenario in the time period under consideration. Cumulative expected cash outflows are calculated by multiplying outstanding balances of various categories or types of liabilities by assumed percentages that are expected to roll-off, and by multiplying specified draw-down amounts to various off-balance sheet commitments. Cumulative expected cash inflows are calculated by multiplying amounts receivable by a percentage that reflects expected inflow under the stress scenario.

In the discussion document, the Commission sets values for these percentages, where ESBG has the following concerns:

On cash outflows

As a general comment, ESBG would like to stress that the Commission's assumptions on cash outflows are overly conservative. Furthermore, should the Commission recognise that, as argued above, the stress scenario is too stringent and improbable, it naturally follows that the out-flow rates have to be adjusted accordingly (this point relates mainly to those ratios which are driven by the systemic crisis characteristics of the stress-assumptions). ESBG also would like to point out that, in any case, the run-off rates should not exceed the rates observed during the 2008/09 crisis.

More specifically ESBG has the following concerns:

On run-off rates of retail and SME deposits:

ESBG understands the importance of taking into account a possible 'bank-run like scenario' by depositors. Yet the current proposal is problematic:

- The current 'run-off' ratios (7.5% - 15%) are too high and not realistic in a 30 day horizon for any reasonable stress situation. Furthermore, they penalize the business model of smaller and regionally active institutions, which draw a lot of their funding from retail deposits and invest them into low-risk lending to the real economy.
- While ESBG welcomes that the Commission recognizes the importance of coverage by a (valid) deposit insurance scheme, the distinction between 'stable' and 'less stable' retail deposits is still not clear. For instance, would 'pure' savings accounts (i.e. not 'transactional accounts') not be



recognized as ‘stable’, even if covered by a deposit insurance scheme? Such an interpretation would indeed be highly problematic and unrealistically harsh.

- The cap of eligible SME deposits (currently € 1million) is arbitrary and overly restrictive.

ESBG would propose to reconsider the level of the run-off rates and to define as ‘stable’ all accounts which are covered by a deposit guarantee scheme, since this will strongly influence customers’ decision to leave their money at the bank. For SME also larger deposits should be admitted in this category (and not be treated like wholesale deposits).

On run-off rates for wholesale funding:

In order to apply the ‘stable’ run-off rate (25%) to deposits and other extensions of funds made by non-financial corporate customers (other than SMEs), sovereigns, central banks and public sector entities, banks generally have to show that such deposits are needed for operational purposes. ESBG stresses that this requirement is not acceptable – especially for smaller banks –, as it de facto imposes on banks to investigate into the cash-management of their customers and apply the ‘run-off rate’ on a case-by-case basis.

Therefore, ESBG strongly urges to apply the run-off rate of 25% to all such funding, in particular as for accounts reflecting a ‘non-operational relationship’ the run-off rate of 75% is already greatly exaggerated.

Draws on committed credit and liquidity facilities:

The Commission’s proposal assumes that committed liquidity facilities to non-financial corporate customers will be fully (i.e. to 100%) drawn down. ESBG believes this to be excessive, even if a systemic crisis would cause liquidity hoarding by the wider economy. Furthermore, if left unchanged, this assumption may easily lead to an outcome where banks will either stop writing commitments or significantly increase charges.

On cash inflows

Lines of credit, liquidity facilities etc:

It is assumed that neither credit nor liquidity lines a bank has with other institutions will be drawn upon under the stress scenario. ESBG points out that this treatment of possible cash inflows is inconsistent with the treatment of outflows, i.e. the draw-on rates assumed for the corresponding facilities provided by the bank itself (see above). This is an unfounded assumption which artificially increases outflows versus inflows and discourages the granting of credit lines by banks. This point therefore needs to be corrected.

ESBG remarks on effect on the pricing of banking products

ESBG is very apprehensive that the presently discussed measures will drive up prices of retail banking products, and especially of long-term loans to the real economy. This is mainly due to the overly narrow definition of eligible HQLAs and the excessive run-off rates for funding. This will drive up interest rates and bank fees due to four main channels:



- competition for retail bank deposits will become even more fierce. Hence funding via retail deposits will become more expensive for banks and lead to greater pressure for higher returns;
- long-term commitments to the real economy become very expensive for banks in terms of HQLA's (i.e the excessive draw-down rate of liquidity facilities to corporate customers);
- long-term loans to the real economy are not counted among the HQLA's, which increases their opportunity cost (given banks' limited balance sheet capacity);
- Since assets qualifying as HQLAs typically yield very low returns (and since the LCR will effectively make demand for such assets inelastic), banks will need to generate higher returns from their other assets, which means: either new and riskier activities or higher charges for their current customers (affecting households and corporate clients alike).

ESBG remarks on the likely impact on institutions' resilience to liquidity risk

As evident from our previous comments, the main concern of ESBG is not that the LCR will fail in its objective to increase banks' resilience to liquidity risk. For this very narrowly defined objective, of course, the success of the LCR will depend on some caveats: firstly, it is critical that distortions to asset markets are within limits. Secondly, it is critical to keep in mind that the LCR can be self-defeating: the stricter is the limitation of assets eligible as HQLAs, the greater is the probability that in a real systemic stress situation, prices and markets for those very assets may collapse if a large number of banks has to sell the same assets at the same time.

ESBG would also like to reiterate that for a large part of the European banking sector, and especially for banks with a strong focus on retail banking and financing via retail deposits, liquidity risk has not been a substantial threat even during the peaks of the crisis. Therefore, for a large part of the sector, given their very business model, there is not even a need to increase resilience to liquidity risk, especially not by introducing rather drastic measures.

On this basis, ESBG is highly concerned that in its present form the LCR will overshoot its objective: It sets out to make some business models more resilient to liquidity risk by blocking significant balance sheet capacity for all institutions in order to provide for the event of unrealistically high liquidity outflows. This will greatly impede lending to the real economy, especially since long-term commitments and loans are not eligible even under the more generous definition of HQLAs.

As a result, as regards 'non-resilient' banks, the outcome of the LCR may indeed be positive, but ESBG is apprehensive of significant negative effects on the large majority of 'already resilient' banks and, more indirectly, on the real economy.

<p>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?</p>

ESBG remarks on the eligibility of certain corporate and covered bonds for the buffer

ESBG strongly supports the inclusion of certain covered bonds and corporate bonds into the stock of HQLAs (i.e. the Commission's concept of 'buffer'). This is the more necessary since in some countries government debt may be scarce. Furthermore, the proposed regulation on liquidity (in itself and in



combination with the other forthcoming regulations) is likely to give banks an incentive to shrink their loan portfolios. The negative impact of these incentives will be less painful for banks and economy alike if covered bonds and corporate bonds are included in eligible assets.

As regards covered bonds, ESBG would emphasize that they qualify very well for the purpose of the 'buffer', since they are backed by a rigorous legislation guaranteeing that the bonds always are backed by collateral in high quality assets. As this collateral is ring fenced, it could also be considered to let covered bonds qualify as liquid assets in the institution that has issued the bonds: It is evident that both the market and the rating agencies regard covered bonds as an asset that is significantly different than other debt issued by the issuing institution. Covered bonds are differently priced and rated than other debt issued by the issuing institution and are also in general much more liquid. In addition, the special covered bond legislation also creates special procedures that make it possible to continue to service the covered bond holders in case the issuer runs into bankruptcy.

ESBG argues furthermore that the eligibility should be extended beyond the corporate and covered bonds currently envisaged by the Commission. Pending a due revision of the currently exaggerated stress scenario, also the inclusion of corporate bonds issued by financial institutions should be seriously considered. Corporate bonds issued by credit institutions have similar risk properties as corporate bonds issued by non-financial firms. Also, we have observed functioning repo-markets for such papers even during the crisis. Therefore we advocate that such papers should become eligible as HQLAs, receiving the same treatment as other corporate bonds.

As noted in relation to Question 1, the current set of eligible assets is far too narrow (even if the Commission takes a more generous approach). Only if the range of eligible assets becomes adequately realistic is it possible to reduce the dismal effects on asset markets and availability of wholesale funding on the one hand, and the otherwise inevitable reduction in lending to the real economy.

ESBG remarks on the necessity of central bank eligibility for the buffer assets

ESBG agrees that central bank eligibility greatly contributes to the liquidity and price stability of assets. On this basis introducing central bank eligibility as an additional criterion appears justified.

Nevertheless, such a requirement needs to take into account that in some countries, e.g. Estonia, the central bank does not act as lender of last resort.

However, if central bank eligibility becomes a required characteristic, then other restrictive conditions of the present proposal should be dropped and the range of eligible assets should certainly be extended. The reason is that, to a high degree, central bank eligibility alone already guarantees the liquidity of the 'buffer assets', so that the desired outcome of holding such buffers would already be achieved. For the same reason, the maximum share of eligible corporate and covered bonds should be increased and the very high haircuts should be replaced by less pessimistic assumptions.

Furthermore, introducing central bank eligibility would also recognize the vital function of central banks as lenders of last resort, which is completely neglected in the current specification of the stress scenario.

Question 3: 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.



Given the magnitude of the identified present shortcomings ESBG welcomes that the Commission recognizes the need for further analysis of the trade-off between the severity of the stress scenario and the definition of the stock of liquid assets.

ESBG foresees that assets included in the buffer will meet a higher demand which may improve liquidity. Yet at the same time the market turnover in these instruments may decrease since it can be expected that trading in the bank's liquidity portfolios (to be kept separately from the ordinary trading and repo activities of the bank), will be significantly lower than for assets held outside the liquidity portfolios.

ESBG supports an investigation into broadening the asset base for the buffer, as long as liquidity and price stability are sufficiently warranted. ESBG also would like to stress that the larger the set of eligible assets, the smaller will be the distortion in the markets for such assets.

Question 4: 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.

ESBG remarks on the concept of the NSF

The NSF has the purpose to promote more medium and long-term funding of the assets of banking organizations. This, too, is a goal ESBG fully supports. Indeed, the crisis has shown that it is necessary to give many banks the incentive to structurally change their liquidity risk profiles and to reduce excessive short-term funding in favour of more stable, longer-term funding. In itself, the objective to “ensure that investment banking inventories, off-balance sheet exposures, securitisation pipelines and other assets and activities are funded with at least a minimum amount of stable liabilities in relation to their liquidity risk profiles”² is valid.

However, the inherent danger in the NSF concept is that, as such, it goes against the very core principle of banking, which is maturity transformation. This means that, unless carefully calibrated, it will have an effect well beyond the intended scope. This danger has not been sufficiently recognized and counteracted by policy makers. It even becomes more severe by the current one-size-fits-all approach, which is not by far adequate for the various business models coexisting in the financial sector.

Another conceptual weakness lies in the arbitrary choice of the time-horizon (one year), where a more gradual approach – i.e. including in the assessment the stability of funding for six months and 18 months – could help reduce potential ‘cliff effects’ and would yield a more representative picture.

Furthermore, the current set-up ignores that in reality, within one year of experiencing bank-specific stress, banks may already have made some mitigating changes in their business model or activities.

In addition ESBG urges to consider business model specific elements in the assumed stress scenario instead of insisting on a one-size-fits-all approach. Here the use of internal models and contributions by national supervisors would be a great improvement.

² Basel consultation on an “international framework for liquidity risk measurement, standards and monitoring” (December 2009)



ESBG remarks on the appropriateness of the calibration

As a general remark, ESBG stresses that the treatment of assets and liabilities needs to be much more granular. In particular the categories ‘other assets’ and ‘other liabilities’ need to be more detailed, with fine tuned ‘availability’ or ‘required’ factors. Furthermore ESBG sees no justification why in the category of ‘required funding’, better quality low risk assets should be treated in the same way as long-term risky assets. In fact, since the current calibration does not at all take into account the flexibility of local loan markets and the credit quality of credit customers, it will not reflect the ‘real’ liquidity of a bank’s loan portfolio.

All in all ESBG has great concerns on the calibration put forward. As a general comment, the uniform, strict run-off and draw-down factors cannot be considered evidenced based and do not reflect correctly the general behaviour of retail and wholesale clients experienced during the recent crisis.

On the derivation of ‘available stable funding factors’:

ESBG finds it exaggerated to assume zero rollover for inter-bank deposits maturing within one year. Such a drastic shutdown of wholesale funding over one year does not appear evidence based. We therefore strongly object especially to the inclusion of secured inter-bank deposits among the ‘other liability categories’ receiving a 0% availability factor.

ESBG also is extremely concerned with the low availability factors assumed for retail and small business deposits maturing within one year or without specified maturities. A total loss of 15-30% (i.e. a 70-85% availability factor) is not evidence based. This is a critical point since the present calibration will have a detrimental effect for institutions that draw strongly on such deposits for funding. It furthermore is not consistent with the recognition that retail deposits are among the most stable sources of funding and the general observation that bank-client relationships tend to be very stable especially for retail clients.

An unintended consequence of such a scenario also is that even 100% deposit funded retail banks would have to resort to wholesale markets in order to obtain extra funding, which for their real business they would not even need. ESBG therefore strongly urges the Commission to reconsider these ‘run-off’ factors. Furthermore, given the current ineligibility of bank debt for HQLA’s (prescribed for the LCR), it is not even sure whether there would be sufficient demand on wholesale markets in order to provide the substantial amount of additional long-term funding needed.

On the derivation of ‘required stable funding factors’:

ESBG understands that the Commission is concerned with securing long-term stable funding for long-term assets, the more so if the assets concerned are found to be (relatively) illiquid. However, the current focus on liquidity and maturity implies that important banking activities are assigned disproportionate funding requirements.

This is a critical – and harmful – shortcoming. Especially the proposed treatment of long-term corporate lending is very harsh (included among ‘other assets’ with a 100% RSF factor). Equally included in this category are long-term loans to retail clients, and hence for instance mortgage loans. Such required stable funding demands may even discourage retail banks from keeping such assets on their balance sheets or from committing to long-term corporate loans in the future. These effects



cannot have been intended by regulators given the experiences made during the last two years. Furthermore it is problematic that even for loans to retail and corporate clients that mature within one year, the amount of required stable funding is very high.

ESBG remarks on the effect on the pricing of banking products

As a result of the current specification of the NSF, three standard retail banking activities (deposit taking, lending to households and loans to businesses) are severely penalized, since at present the NSF penalizes *all* maturity transformation.

It is very likely that this will lead to higher prices especially of long-term commitments and long-term loans to households and the real economy. For instance residential mortgages (which are very safe, but mainly long-term) will need to be counterbalanced by very strictly defined stable funding. The same is true for long-term loans to SMEs.

As a result, large long-term loan portfolios (i.e. with maturity of more than one year) will become unattractive or even unaffordable for banks, irrespective of associated risks or underlying collateral. This will lead to typical retail borrowers facing price increases for three reasons:

- The supply of long-term loans will decrease, since banks are restricted by additional limits as regards their lending capacity.
- Banks will ask for higher rates in order to cover the costs arising from the achieving the 'required stable funding', as well as in order to compensate for the increased opportunity costs of providing a long-term loans as opposed to investing in short term assets.
- Banks may also increase the interest rates on their (remaining) loans in order to compensate for the comparatively low yields from the liquid securities they may need to hold, if their long-term funding is not sufficient to engage in more long-term lending.

Furthermore, prices for long-term loans are likely to become much less risk-sensitive than they currently are, damaging mainly high quality borrowers.

ESBG remarks on the likely impact on institutions' resilience to liquidity risk

As regards the business models (i.e. some forms of investment banking, wholesale activities etc) which the NSF sets out to address, ESBG sees that more stability may well be achieved.

However, regulators will face a trade-off: They will reduce liquidity risk for some players and increase credit risk for others. This is a direct result of the predicament banks face when mid to long-term loans they give become more expensive (in funding terms) irrespectively of the quality of the loan and the risk taken by the bank.

Furthermore, if institutions have to publicly share information on how they fulfil the liquidity requirements, this can actually reduce their resilience to liquidity risk: In case the bank have a problem to issue new debt and start to use its liquidity reserve to pay back maturing debt and is, as required, transparent about this, the bank will send a signal that it has liquidity issues, which will then accelerate and turn into true liquidity problems.



Question 5: 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?

ESBG strongly favours a reduction of the stable funding requirement (currently at 100%) for commercial lending, and also urges for more fine-tuning of the treatment of this asset category.

ESBG also apprehends, that under liquidity stress lending even to established clients will be reduced, for the cost of the bank defaulting on the liquidity requirements is far greater than the cost of damaging an established client relationship.

ESBG foresees a significant effect on banks' asset portfolios due to the differentiation between lending with more and with less than one year maturity. The present regulation will effectively reduce incentives to provide long-term funding to non-financial enterprises and will lead to a greater preference for investments in marketable securities (as opposed to less liquid loans); these changes in incentives will also cumulate in higher interest rates on (the remaining) long-term loans. De facto, the regulation gives banks a strong motivation to transfer liquidity risk to their customers.

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?

ESBG would like to reiterate that the present availability factors for deposits are far too punitive.

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?

EBSG does not support the objective of setting *all* parameters at European level, given the importance of reflecting in the supervisory process institution, market and country specific liquidity risks.

Question 8: In your view, what are the categories of deposits that require a different treatment from that in Annexes I and II and why? Please provide evidence relating to the behaviour of such deposits under stress.

As EBSG has already indicated in its answers to Question 4, especially retail deposits should be recognized as much more stable and hence be attributed much higher availability factors.

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.



ESBG would support the possibility to waive requirement (a) in point 16 as outlined in point 17, as it will improve banking groups' ability to manage funding and liquidity efficiently. The outlined conditions for derogating from an application on an individual "stand-alone" basis are reasonable.

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)?

ESBG would like to remark that the proposed liquidity regulations create incentives for moving credits out of regulated banks' balance sheets. As a result of these new incentives the shadow banking system may grow. All institutions not regulated may take part in this shadow system, since they will have a competitive advantage in comparison to regulated entities.

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?

The regulation is likely to increase the cost of bank lending. This will increase the incentives for non banking entities to provide loans and the likelihood of a growing shadow banking system increases. All institutions exempt from the liquidity regulation are candidates for participation in the growth of lending outside liquidity regulated entities.

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.

ESBG appreciates that the Commission recognizes the problem of the asymmetric treatment of intra-group transactions when calculating the LCR and NSF measurements on individual legal entities. This asymmetric treatment would lead to an undesirable increase of the size of required liquidity buffers and long-term funding within banking groups (which of course also increases the associated costs).

We fully agree with the Commission that a symmetrical treatment of those transactions is preferable. Here, the Commission describes two alternative approaches for symmetrical treatment of intra-group transactions: one alternative that suits banks managing liquidity centrally and one that suits banks with a more decentralised liquidity management.

Since the choice between these set-ups depends on local market conditions and the business model applied by the banks ESBG finds that both alternatives should be possible choices in order not to unnecessarily limit banking groups' ability to organise their liquidity management effectively.

In addition, ESBG highlights that the treatment proposed for intra-group transactions should also apply to transactions between counterparties which are members of the same institutional protection scheme, as referred in Article 80(8) of the Capital Requirements Directive 2006/48/EC. In this context, it should be noted that even at the peak of the financial crisis, where liquidity risk reached levels never experienced before, almost no run-off at all was observed in relation to funding provided between such entities. The contrary is in fact true: those exposures proved to be very robust. Furthermore, even when difficulties occurred with some specific individual institutions, the funding



between these entities and others belonging to the same institutional protection scheme was not affected.

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?

ESBG agrees with both proposals.

Question 14: Comments are sought on the merit of using harmonised Monitoring Tools, either in the context of Supervisory Review or as mandatory elements of a supervisory reporting framework for liquidity risk. Comments are also sought on the individual tools listed in Annex III, their quality and possible alternatives or complements.

The presented proposals are yet unspecific, hence no particular comments.

Question 15: What could be considered a meaningful approach for monitoring intraday liquidity risk?

No particular comments.



Section II - Definition of capital

ESBG supports as a matter of principle the efforts undertaken by European and international banking regulators to improve the quality, consistency and transparency of banks' capital base. The financial crisis has clearly demonstrated that there were some flaws in the existing capital adequacy framework, which unquestionably need to be addressed. Yet, it is important to be aware that whereas the shortcomings in capital regulations are one of the important drawbacks that contributed to the crisis, the crisis could not have been prevented merely by requirements for higher capital of a better quality to all market participants, and other substantial aspects need to be given equal attention.

ESBG is generally supportive of the Commission's approach and would like to welcome as positive especially the proposals' very likely contribution to simplifying the structure of own funds, fostering convergence and thereby reducing competitive distortions. In light of such broad support for the proposals on capital and of our general reservations as regards the current consultation document expressed in the introductory remarks, ESBG would also like to underline some specific aspects that raise concerns.

1. Interplay between Commission's proposals and CEBS guidelines on hybrid capital instruments, as well as CEBS draft guidelines for Core Tier 1 capital instruments under Article 57a

The revision of the definition of own funds is one of the central topics of the ongoing regulatory efforts for repairing and strengthening the prudential framework in the EU and worldwide. In Europe, apart from the current Commission proposal, the definition of capital is the object of guidelines issued by CEBS (the December 2009 CEBS guidance on supervisory practices in respect of hybrid capital instruments) and of the CEBS CP 33 on draft implementation guidelines for Core Tier 1 capital instruments under article 57a. These CEBS documents – to which the Commission proposals make explicit references (p.15) – are restricted to guidance given in the framework drawn by the 2009 amendments to the CRD (CRD 2). The Commission's proposals here discussed go much beyond the proposals incorporated in the CRD 2 and are not yet fully developed – leaving many questions open for debate.

In this context we understand that the CEBS guidelines are a valuable input to these overall discussions on improving the quality of capital. At the same time we keep in mind that once the new rules will be adopted further revisions of the concept of own funds will need to be implemented, supposing further additional guidance from CEBS. It is therefore particularly important that CEBS guidelines do in no way anticipate or constrain developments at the Commission level. Conversely, for legal certainty considerations, the Commission's reliance on CEBS advice as given in these documents should be limited and duly account for their specific contexts and implementation timelines.

2. Principles-oriented approach for defining capital

ESBG is supportive of a principles-based approach to the definition of capital as a means to achieve European and international harmonisation (§ 42). We believe that a principles-based definition of capital is the right way forward and is reflected in the proposed approach consisting of a catalogue of criteria for the eligibility of capital instruments for regulatory purposes. The main focus in the



assessment process of an instrument should be on the fulfilment of the three principles of permanence, loss absorption and flexibility of payments. The very purpose of developing criteria governing inclusion in the capital base is meant to support such a principles-based approach, where emphasis is on the substance.

Yet, the wording used in the consultation paper may be interpreted as adding also a formal criterion in the case of joint stock companies, for which the Core Tier 1 capital must comprise common equity, which is defined in footnote 18 as “common shares, the related share premium accounts, reserves and profits and losses brought forward as a result of the final application of profit and loss”. ESBG considers that the legal form of an instrument does not have any relevance as long as the criteria are fulfilled in substance. Therefore, it needs to be avoided that a specific form (e.g. “common shares”) is required that would actually exclude - merely because of formal aspects - instruments that substantially comply with the required criteria. Hence, we argue that – also in the case of joint-stock companies – other instruments than common shares be eligible for the common equity component of Tier 1 Capital. We would invite the European Commission to accordingly change the definition of common equity. In support of this approach we would like to point also to the definition of common equity given in footnote 17 (§ 85) of the Basel Committee’s consultation document on strengthening the resilience of the banking sector (BCBS 164), where common equity is considered inclusive of not only common shares plus retained earnings, but also of “other comprehensive income net of the associated regulatory adjustments”.

3. Specificity of non-joint stock (NJS) companies and inappropriateness of designating common shares as the benchmark

ESBG wishes to firmly recall that a functional and balanced banking environment is characterised by pluralism and the participation of a variety of financial actors. Such variety of actors implies a variety of corporate structures that regulators need to properly consider when proposing new regulatory measures. This was explicitly recognised in recital 4 of CRD 2 that already required the specific constitution of mutuals, co-operative and similar institutions to be taken into account and defining the circumstances in which NJS companies’ capital instruments may be included in Core Tier 1 capital under Article 57a.

Therefore, ESBG welcomes the acknowledgement, for purposes of defining Core Tier 1 capital, in § 43 of the Commission’s proposal of the specificity of mutuals, cooperatives, or savings institutions and the need for prudential rules to take into account the specific constitution and legal structure of NJS companies. ESBG underlines that this is an important aspect of the proposals and that it should be dealt with in the main text of the Commission’s proposal.

However, ESBG fears that the Commission’s text may not offer sufficient guarantees that such specificities will be taken into account substantially. § 44 of the Commission’s proposal provides for some safeguards stating that the application of the criteria in Annex IV should take into account the specificities of NJS companies. Yet, the main problem is that the approach taken by the Commission implies the consideration of common shares as the benchmark for assessing the features of instruments issued by joint stock and non joint stock companies. Therefore, the criteria were devised exclusively upon the model of common shares of joint-stock companies and some of them are conceptually unfit to be simply adapted to the instruments issued by NJS companies. Henceforth, ESBG invites the Commission also to explicitly leave some leeway in the criteria for accommodating the specific features of certain capital instruments issued by NJS companies, which are considered capital in the strictest sense by national law.



In addition, the ESBG calls for the specificities of NJS companies to be duly taken into account also when determining Non-Core Tier 1 capital, as well as Tier 2 capital.

4. Minimum capital requirements and predominance (§ 73)

The Commission proposes to introduce explicit higher minimum requirements for the minimum levels of the ratios of Core Tier 1, Tier 1 and total capital (net of deductions) to risk weighted assets. Concrete figures have not been proposed yet and in their absence it is practically impossible to give a final assessment of the proposed new system of limits. Yet, at this stage, ESBG would like to underline that any increase of the existing limits and minima (4% Tier 1 Capital and 8% solvency ratio) would have an impact on both the earning and lending capacity of banks.

Furthermore, the Commission considers whether the level of predominance of Core Tier 1 capital should be raised above the current 50% level. At international level, in the accompanying letter to the G20, FSB mentioned a range between 50-85%. Yet, in the light of the new qualitative requirements for core capital and hybrid instruments, which ensure the equivalence of the two capital instruments in terms of regulatory quality, as well as their common purpose as “going concern capital”, a predominance of core Tier 1 capital beyond 50% would not be justified. This is moreover the case when considering that the Commission’s proposals are likely to make hybrid Tier 1 Capital more equity-like and homogeneous, with a higher likelihood of coupons on future hybrids being cancelled in periods of stress. Consequently, ESBG assumes that predominance will mean above, but strictly near 50%.

The Commission’s proposal does not specifically refer to the possible eligibility of excess Tier 1 capital as Tier 2 capital. However, ESBG assumes that – in line with previous regulatory practice – eligible higher-quality capital instruments will be taken into account in the next capital category if the ratio-based restriction does not permit eligibility in its original capital category. This is mainly due to the fact that going concern capital by definition is also available in gone concern situations. This issue is of utmost importance, particularly since under the current proposal, minority interest would no longer be eligible as core Tier 1 capital, but only as other Tier 1 capital. We therefore suggest that the Commission inserts a new provision whereby it explicitly provides for excess Tier 1 capital to be eligible as Tier 2 capital.

5. Different classes of shares

Corporate law has always permitted and supported the existence of different classes of shares. Different rights and privileges counterbalance certain specific features of particular shares (e.g. the privileged payment of dividends compensates for the lack of voting rights). Such rights and privileges do not interfere with the substance of the criteria for the definition of capital, and especially they do not impinge on the loss absorbency capacity of the instrument.

In this context, ESBG does not see why certain categories of shares, such as shares with non-cumulative preferential distributions, would be of less quality than common shares because of their preferential distribution right in respect of other stock holders. In light of the Commission’s proposals to strengthen the loss absorption capacity of Tier 1 Capital, in our opinion there is no difference in quality between common shares and shares with non-cumulative preferential distributions to absorb losses in a going concern. A preferential distribution right – exercised after decision and with full discretion of the general assembly – does not change the quality of the instrument as such. On the contrary our belief is that during the financial crisis such instruments have proven to absorb losses to



the same extent as ordinary shares. Consequently, given that shares with non-cumulative preferential distributions fully comply with the criteria for Common Equity they should be explicitly included in the Core Tier 1 capital.

To us it seems irrelevant if different classes of equity capital have different precedence in dividends and/or ranking in the event of liquidation. The important factor is that the shareholders collectively are subordinated to all other claim holders, and thus jointly represent the most subordinated class or “the last line of defence” both during going concern and in liquidation. It must be up to the shareholders to decide differences between the different types of classes of equities, which are done at a shareholders’ general meeting. Any such agreement amongst the shareholders leaves their joint relationship toward the rest of the claim holders unaffected, which should be the only concern of the regulators.

To be able to attract equity capital in the event of a financial turmoil it is of greatest importance that different ways to have access to the capital market are available. To offer investors shares with precedence in dividends and/or prior ranking to ordinary shares in liquidation might be one way to ease the supply of equity share capital in a crisis situation. If this type of equity capital is excluded from Core Tier 1 Capital it will affect banks access to capital markets, particularly in stressed situations which will be contrary to the aim to create financial stability.

Commission’s questions

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?

ESBG supports the Commission’s proposal to simplify the structure of the capital base. Therefore ESBG welcomes the proposed deletion of the distinction between upper and lower Tier 2 capital, as well as of eliminating Tier 3 capital.

ESBG is supportive of the proposal to introduce a new distinction, indicating Tier 1 Capital as “going concern capital”, and Tier 2 capital as “gone concern capital”. We welcome the explanation of the differentiation between the two categories in terms of the underlying rationale, namely that “going concern capital” helps keeping a bank running, whereas “gone concern capital” should be seen mainly as a capital cushion for safeguarding deposits and other liabilities. We would appreciate it also if it were made explicit that going concern capital should also serve in gone concern situations.

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?

As explained, there is a general concern that the criteria developed are structurally biased by the chosen benchmark, namely common shares of joint-stock companies. Especially some of these criteria have been conceived in a way that cannot be adjusted or simply transposed to NJS companies. Therefore, ESBG would like to stress that it is important that the focus is kept on the three principles underlying the criteria: permanence, loss absorbency and flexibility of payments. Also, it is crucial that supervisory authorities maintain a leeway in the application of these criteria that would allow them substantially, not only superficially and formally, to adapt the criteria to NJS companies.

In line with our previous remarks on the acceptability of different classes of shares, ESBG highlights that shares with a non-cumulative preference in dividend should henceforth be eligible for inclusion in



Core Tier 1 capital. Any dividend paid on such equity capital is decided on – and with full discretion – by the General Assembly. Such equity capital has thus the same loss absorbing capacity in a going concern situation as ordinary shares. We are also of the opinion that if different classes of equity capital have different ranking in liquidation this is not a valid reason for excluding them from being eligible for inclusion in Core Tier 1 capital, as the only relevant distinction in a liquidation situation is between claim holders in general on one hand and the shareholders collectively on the other. This distinction is inherent in the type of claim each of these categories represent. Hence, we urge the Commission to change appropriately the following concrete aspects of its proposal:

- Proposed § 45 and criterion 7 in Annex IV: ESBG does not see why shares with non-cumulative preferential distributions would be of less quality than common shares because of their preference in respect of other share holders.
- According to criterion 2 in Annex IV any instrument eligible for inclusion in Core Tier 1 capital must be entitled to a claim of the residual assets that is proportional with its share of issued capital, after all senior claims have been repaid in liquidation. In case there are different classes of equity capital with different ranking in liquidation it is not obvious if the current wording of criterion 2 would allow all equity classes irrespective of the ranking. We believe a more adequate wording would be: “Entitled to a claim on any residual amount only after all other claims are satisfied in liquidation. In case the institution has more than one category of capital instruments (i.e. ordinary shares and other capital instruments) with different ranking in liquidation, on a break-up basis the proceeds from the realisation of the credit institution’s assets are applied firstly to satisfy all prior claims (e.g. depositors, creditors, holders of subordinated instruments) and any residual amount is distributed between the ordinary shareholders and the holders of such other capital instruments in accordance with the articles of association, or equivalent, of the institution.”

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?

As explained in the ESBG response to CEBS draft implementation guidelines on hybrid capital (CP 27), we consider that writing down permanently the nominal amount of the principal at a trigger point would disadvantage hybrid holders as compared to equity holders. Whereas equity holders could benefit from the improvement of market conditions through the increase in the share price or the payment of dividends in case of profit, hybrid holders will not. This would discourage investments in hybrid instruments, as it would be difficult to explain why undated hybrids could not be written back up again to their nominal value. It would be very difficult and costly to place on the market hybrids endowed with this kind of mechanism.

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?

Because of the short period for providing feed-back we cannot present in detail the regulatory adjustments that we believe will have the greatest impact.



We have however concerns on the prudential rationale of some of the proposed adjustments. We will therefore present in details the regulatory adjustment in Annex V for which we recommend changes.

Preliminary Comment

ESBG believes that international harmonization of prudential adjustments applied to regulatory capital has the capacity to foster comparability of banks' capitalization, and is therefore a welcome endeavour. This being said, regulators should keep in mind when pursuing the objective of comparability that differences will inevitably remain, as a result of differences in national company, tax and insolvency law.

ESBG also considers that the sum of all the prudential adjustments appears far too extensive and is likely to lead to an unnecessarily stricter regulatory environment for the banking industry. In particular, the proposed deduction regime and regulatory adjustments represent a significant tightening of regulatory capital requirements. This tightening will not only arise from the extension of the deductions' catalogue (by adding deferred tax assets and minority interests) but also from the mandatory rule to apply these adjustments to the Core Tier 1.

1. Stock surplus

The Commission considers that Equity comprises common shares, the related share premium accounts, reserves and profits and losses brought forward as a result of the final application of profit and loss (§39, footnote 18). The criterion 6 governing the inclusion in the Core Tier 1 in Annex IV states that under no circumstances distributions should be obligatory.

As a matter of principle, the decision over the distribution of profits is left to be taken by shareholders after all legal and contractual obligations have been met and payments on more senior capital instruments have also been made.

Against this background, ESBG considers that the proposal is too strict. It is not adequate to deduct stock surplus from the Core Tier 1 capital if (1) these revenues are as retained earnings and (2) banks meet criteria 6 regarding distributions. In addition and as already explained above, ESBG believes that preference shares with non cumulative preferential rights in relation to other parts of common equity should be explicitly included in the Core Tier 1 capital. Therefore, stock surplus relating to such shares should be granted a similar treatment.

2. Minority interest

2.1 General comments on minority interests

The Commission's proposal on minority interests excludes minority interests from Core Tier 1 (although it is not explicit, we assume that minority interests will continue to be fully included in Tier 1).

The exclusion of minority interests may be reasonable to the extent that there are no doubts on the liability of minority interests on the risks of the entire consolidated group. But as drafted, the proposal is methodologically inconsistent, as it treats assets and liabilities of subsidiaries asymmetrically. This imbalance would reduce the Common Equity on the one hand (deductions of minority interests) while



the risks of the subsidiaries would have to be consolidated on the other hand (full inclusion of RWA which are included in the calculation of capital ratios).

In this context we understand that the goal is also to prevent the misuse of corporate structures to increase the group's capital base by consolidating special and not supervised Special Purpose Vehicles (SPVs) structures where the capital base is accompanied by little or no risk. However, we consider that supervisors should distinguish between abusive consolidation constructions and the consolidation of financial/banking subsidiaries, which are the subject of on-going supervision. As a consequence, minority interests of at least financial/banking supervised subsidiaries should continue to count as eligible Common Equity in the future.

Finally, we stress that we are uncomfortable with any difference between the proposals aiming at strengthening the Tier 1 capital base and the current consolidation rules of capital. In our understanding minority interests cover the losses related to their proportional share in the consolidated RWA.

Against this background, we do not support the current proposal as it ignores the capital of subsidiaries at group level while the risks exposures of the same subsidiaries would be fully recognized in the consolidated accounts.

2.2 ESBG's main proposals on minority interests

- Symmetry of liabilities and assets has to be restored by deducting from the consolidated capital the RWA covered by the minority interests.
- Minority interests of at least financial/banking supervised subsidiaries should continue to count as eligible Common Equity in the future.
- Alternatively, minority interests should be eligible for Tier 1 up to the necessary level to cover the assets of the subsidiary. If excess capital within the subsidiary is so significant that it would influence the capital ratio of the consolidated Group and lead of overcapitalization, the excess should be eligible for additional Tier 1 or Tier 2.

2.3 Joint liability schemes

ESBG highlights that the Commission has to take into account the specific issue of control agreements with joint liability schemes. Joint liability schemes generally increase recoverable assets on a going concern basis by making it mandatory for banks that are members of such a scheme to guarantee coverage in case of losses from any other member of the same scheme. The coverage is performed through payments and aim at avoiding insolvency or liquidity issues. Hence, the potential liability basis is as strong and potentially stronger compared to other group structures which do not possess this obligation to provide assistance.

As liability agreements call on the members of a scheme to take their share in the scheme; their capital would also be used to cover losses. As a consequence, it is secondary to wonder if schemes imply coverage through members' own shares or through minority interests in the controlled company.

ESBG is concerned that these structures, which have proven their resilience during the crisis, and are recognized in EU legislation, might be put at risk. The non-eligibility of minority interest could imply that the current joint liability schemes would no longer be allowed. Any regulation excluding minority



interests from the Common Equity capital base should take into account the specificity of joint liability schemes and therefore not be applied to any contractual groups based on them.

2.4 Minority interest: more specific comments

- *Coherence between prudential rules and accounting standards is needed*

ESBG considers that there is a need of consistency between prudential and accounting rules. In this particular context, we are uncomfortable with any difference between the proposal aiming at strengthening of the Tier 1 capital base and the current consolidation rules of capital. In our understanding, the mandatory consolidation rules set up that all companies are to be considered as one single company. The capital base of a company is by definition responsible to absorb the risks and losses with respect to the stated Risk Weighted Assets (RWA) of this firm. At the level of the subsidiary, the capital base of the individual subsidiaries stands for their own risk. At group level, the minority interests support their own risk and stand for their own portion of risk, i.e. take their proportional share in the consolidated RWA, while benefiting the whole group.

- *A distinction between abusive consolidation constructions and the consolidation of financial/banking subsidiaries is necessary*

We understand that the Commission also aims at preventing the abuse of Special Purpose Vehicles structures where the capital base is accompanied by little or no risk base. However, the Commission does not fully fulfil its goal as the exclusion rule is also applied to subsidiaries which are credit or financial institutions or securities firms. From our point of view, and in order to achieve their objective of introducing a reasonable capital framework for banks, another balance has to be found. Supervisors should distinguish between abusive consolidation constructions and the consolidation of financial/banking subsidiaries when talking about the exclusion of minority interests from Core Tier 1. Therefore, minority interests of at least financial/banking supervised subsidiaries should continue to count as eligible Common Equity in the future.

- *Some banking groups will be unintentionally penalized*

The complete exclusion of minority interests would penalize the business model of a number of banking organisations; especially for those groups with minority interests in listed subsidiaries. The asymmetry between full deduction of the minority interest and full inclusion of the RWA creates particularly disparate impacts and unnecessarily unfair results.

- *A disincentive to investment is to be expected*

The proposed deduction creates a disincentive to investment that would be detrimental both to the banks and to the markets in which they might wish to invest. It will penalize banks in their external growth strategy and/or will change their behaviour in relation to the capitalisation of their subsidiaries. We specifically highlight the case of developing countries where there are cases in which national entities have to have a participation in financial institutions made up by foreign banks.

- *An unintended weakening of crisis management can be foreseen*

The proposed deduction would also limit private sector solutions for rescuing ailing banks: if minority interests had not been considered by regulators as part of Core Tier 1, some operations would have probably never happened. This is contradictory with the objective to build a stronger framework of crisis management with a more balanced burden-sharing between private and public sectors.



3. Deferred tax assets

3.1 General comments on deferred tax assets

We support the Commission's goal to set clear and transparent rules at international level to avoid undue reliance on deferred tax assets in regulatory capital. We recognise that a certain degree of prudence may be required for allowing deferred tax assets in regulatory capital as their value can be affected in periods of economic stress. However, we see little justification for the proposal made in the document, i.e. that deferred tax assets that rely on future profitability to be realised should be deducted from Core Tier 1. In our view this fails to take into proper consideration the various categories of deferred tax assets and the real value of deferred tax assets on a going concern basis.

3.2 ESBG position on deferred tax assets

- ESBG considers that the full allowance in Core Tier 1 should be maintained for deferred tax assets for which there is no doubt about their future realization, i.e. for those assets resulting from discretionary forward looking provisions or from pension plans.
- In addition, ESBG recommends considering a more balanced approach for deferred tax assets such as the partial deduction rule already applied in some countries. Some banking regulators partially deduct deferred tax assets for the portion exceeding a specified maximum proportion of capital. In some jurisdictions, where banks have booked significant losses and taken some credit for tax recoverable on these, the deduction of deferred tax assets could have a very significant impact. As a consequence, we support partial deduction for deferred tax assets for which the realization is dependant on future profits.

3.3 Deferred tax assets: more specific comments

- *The necessity to take auditors into account*

According to most accounting standards (e.g. IFRS - IAS 12 for instance -, US GAAP, UK GAAP etc.), the objective of accounting for income taxes in the Profit & Loss statement is to recognise not only the amount of taxes payable or refundable for the current period but also deferred tax reflecting the future tax consequences of events recorded in the financial statements during that period.

Most deferred tax assets dependent upon future profitability arise both from tax loss carried forward and timing differences between the recognition of gains and losses in financial statement and their recognition for tax computation. Such timing differences commonly derive from the numerous discrepancies between tax and accounting rules, which vary greatly depending on tax laws and jurisdictions.

In reporting net deferred tax assets, companies are required by accounting standards to make an assessment of recoverability based on assumptions and estimates of future taxable profits. ESBG stresses that this assessment is subject to scrutiny from external auditors, an element which has to be taken into account. Deferred tax assets will not be recognised (or will be written off in whole or in part if they have been previously recognised) in case there is not enough certainty that taxable profits will be



available to support the utilisation of deferred tax assets in future years. Such write down will decrease the net profit reported for the period.

- *Inconsistency with the going concern approach*

The logic underlying the proposed deduction (which is that deferred tax assets are dependent on future profitability and should hold no value at all whatever the circumstances), does not appear coherent with the “going concern” approach adopted by the Commission for Tier 1 capital. As explained earlier, deferred tax assets are already subject to an economic value test conducted by external auditors to confirm their recoverability. The time limit set by tax authorities to utilise deferred tax assets is usually very long or unlimited and therefore deferred tax assets may retain value over the long term as long as the bank is in operation and even if they have been temporarily written down. Deferred tax assets on tax losses carried forward also contribute substantially to the value of the business or the subsidiary in case it is sold or transferred.

- *Increase of pro-cyclicality*

We consider that the deferred tax assets deduction can be a pro-cyclical measure which will further deplete capital during economic crises. A significant driver of deferred tax assets for banks is the fact that many tax systems only permit a deduction for loan loss provisions upon actual realization of those losses, whereas the deduction for accounting arises at the time the provision is made. Requiring deduction for deferred tax assets resulting from tax losses, loan loss reserves (not always tax deductible) and from unrealised investment losses will have pro-cyclical effects: the deduction will increase during downturns and will be reversed when results improve. As a consequence, the proposed deduction will further deplete capital in periods of economic stress.

- *Forward looking provisioning might increase the amount of deferred tax assets*

There is the risk that the forward-looking provisioning scheme will generate deferred tax assets that must be excluded from deductions altogether. This will substantially increase the amount of deferred tax assets. Deducting such artificially created deferred tax assets from the Core Tier 1 would in part annihilate the benefit of this countercyclical measure and may even discourage conservative accounting. Therefore, we support the Commission’ comment on paragraph 152 which states that “where the constitution of a dynamic provision gives rises to a deferred tax asset, these deferred tax assets should not be deducted from own funds”.

- *No level playing field*

The proposed deduction is in part contradictory with the stated objective to maintain a level playing field. The proportion of deferred tax assets resulting from temporary differences varies widely between countries depending upon local tax laws. Deducting such deferred tax assets penalise banks operating in tax jurisdiction where certain asset value adjustments (e.g. loan loss reserves, impairment, write down) are not tax deductible and this will translate into undesirable distortions based on the localisation of a bank’s activities.

4. Investments in own shares (treasury stock)

The Commission proposal implies that banks will have to perform a “look through” approach requiring to deduct the exposures of index securities to own shares. Banks usually hold inventory of index securities for market making purposes. Investments in own shares and holdings of index securities are different activities. The identification, measurement and separation of the own share



component in the index is in our opinion artificial. A capital deduction of indirect holding of own shares via index securities would put stock listed banks at a disadvantage to non-listed banks.

Banks already have an incentive to limit the size of inventory in order to limit the associated funding costs. Finally it is questionable whether the benefit for the banking industry from deducting indirectly held own shares will outweigh the costs. Consequently, instead of focusing on indirectly held own shares, ESBG urges the Commission to concentrate on the deduction of directly held own shares.

5. Investments in the capital of certain banking, financial and insurance entities which are outside the regulatory scope of consolidation

We have similar concerns as regards the “look through” requirement for holdings of index securities to deduct exposures to financial institutions which exceed the threshold limit. We stress again that investments in financial institutions and holdings of index securities have no common grounds. Not only is the identification of financial institutions and the assessment of the holding value through the index a complex operating process, but also the deduction of those items is totally artificial and unjustified as there is no double gearing through index. Banks usually hold inventory of index funds for market making purposes. Thus, a capital deduction of indirect investments held via index funds would increase the costs of market making. In line with the comments made above, it is highly questionable whether the benefits to the banking system resulting from deducting indirectly held investments will outweigh the costs.

In addition, we have difficulties to understand to what kind of capital the threshold that will trigger the deduction of holdings of common stock in (a) financial institution(s) will be applied. We propose that it should be applied to gross capital, i.e. to Tier 1, Tier 2 and before any deduction. Otherwise, the common stock of financial institutions will quickly be exhausted. The proposal could reduce the incentive for banks to diminish the risk of their investments by taking a mitigating short position. We propose to allow the netting of long and short positions.

6. Shortfall of the stock of provisions to expected losses

By principle, expected losses are covered by provisions under an IRB approach and unexpected losses are covered by capital. The Tier 1 capital base should be fully available to absorb losses on a going concern basis. In this proposal, the Commission aims at avoiding any incentive for banks to provision at low levels. It proposes to deduct a shortfall of the stock of provisions on capital.

ESBG does not fully agree with the Commission’s proposal. We believe that the deduction of a shortfall of the stock of provisions should impact not only Core capital but also the whole Tier one, including additional capital as it is part of the going-concern criteria.

7. Defined benefit pension fund assets and liabilities

From our point of view, the proposal appears very general. A deduction would provide an incentive for banks to minimize the over funding of pension funds but it could also encourage them to accept under funding, putting pensions at risk. It is important to know that in numerous cases prudential filters have already been defined to mitigate actuarial deviations. This results from the adoption of IFRS.

First of all, ESBG suggests that the Commission takes into account the most recent work of the IASB on this topic. Indeed, an “Exposure Draft” on employees benefits is expected to be issued (comprising



benefits associated with pensions funds) for the first quarter of 2010, which will enter into force in the first of half 2010, and foresees a review of the actuarial deviations.

We propose to waive the deduction until the IASB publishes its final standard. Should the Commission still feel the need of a deduction, we would propose deduction from Tier 2 capital because the pension surplus would only need to be realized in a gone-concern scenario.

8. Remaining 50:50 deductions

The planned change to replace the deductions of certain assets in the numerator of the ratio by weights of 1250% in the denominator is not neutral and produces very significant effect on the coefficient level without having technical grounds. We believe that the best way to picture our concerns is to use a numerical example.

Example:

A financial institution has a capital of € 1,200 and risk-weighted assets (RWA) of € 10,000. Its capital adequacy ratio would be: $1200/10000 = 12\%$. The same bank invests in an asset that involves deduction of own resources:

- a) With the current rules its capital adequacy ratio would be the same (12%)
- b) With the new rules, the coefficient will be as follows: $1200 + 400 / 10000 + (400 * 12.5) = 1600/15000 = 10.7\%$. The solvency ratio decreases.

A weighting of 1250% is intended to be equivalent to requiring coverage with capital of 100% of the assets concerned. However the proposal does not achieve this target. By including the new capital in the numerator and by including in the denominator the assets weighted at 1250%, the solvency ratio decreases. As a result The Commission obtains an unintended consequence: the ratio obtained is not equivalent to the current 50:50 proposal, it is more stringent.

In addition, it is important to see that the impact of the reduction is greater as the current solvency ratio level of the institution is larger. This results in punishing the more capitalized entities:

- a) If the previous rate is 15%, capital would be reduced to 12.7%
- b) If the previous rate is 20%, would drop to 16%

More examples can be constructed with different combinations and structures that give other results but in all cases the impact is significant.

- a) The impact is neutral only if the entity has prior solvency ratio of 8%
- b) If the bank was failing and had a solvency ratio below 8%, the new regulation would improve the new ratio. Example: From a previous rate of 6%, the result is:
 - Current Regulation: $600/10000 = 6\%$
 - Future regulation: $(600 + 400) / 15,000 = 6.7\%$

Therefore, the weighting of assets at 1250% produces a perverse effect on the solvency ratio. Overall it will render appropriate comparisons in the system more difficult, distort the perception that the market has of the actual creditworthiness, and might also affect the calculation of capital buffers.



Requirements for buy-backs

Question 20: Are the proposed requirements in respect of calls for non-Core Tier 1 and Tier 2 sufficiently robust? Would it be 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?

As underlined in the ESBG response to CEBS draft guidelines on hybrid capital, ESBG would not support proposals for buy-backs of hybrid capital instruments. Buy back is not a topic typical for hybrid capital instruments, but concerns a wider series of capital instruments, beyond the core capital and should therefore be discussed in detail in such a wider context. So far there are no rules on buy back, be it in European legislation, in recommendations of the Basel Committee or in the Sydney Press Release. Before considering whether the requirements for calls can be simply applied to buy-backs, the main question is whether there is at all any need for regulating buy-backs. In case a thorough analysis of the pros and cons for the introduction of buy-back requirements would ever lead to the conclusion that such regulation is needed, then there should first be an agreement at international level before any attempt is made to impose European rules.

Beyond this position of principle, ESBG regards the very idea of imposing supervisory approval for buy-back programs as inadequate. Two very different issues (redemption at par at the sole initiative of the issuer and buy backs at market prices with the agreement of the investor) are treated equally in CEBS guidelines although they are not comparable. Buy backs should obviously be less restrictive as compared to redemption and should not be subject to supervisory approval.

Consequently, ESBG urges the Commission to be cautious when considering CEBS recommendations.

Unrealised gains

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?

Introducing a waiver of filters is not useful as this would amplify pro-cyclicality. Filters on gains and losses should be maintained. In addition, and as far as IFRS are concerned, such a provision will no longer be needed as the relevant category “available for sale” will be eliminated in IAS 39 - this raises again the procyclicality problem. ESBG insists that on no account it seems appropriate to filter only gains because this would be one sided.

Implications for Large Exposures

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)?

The review of the large exposures regime in the CRD 2 was much influenced by the financial crisis and resulted in the elimination of the privileged treatment of interbank exposures and tougher criteria for identifying interconnectedness. Moreover, it should be highlighted that during the revision of the regime, there was no discussion of the necessity to amend the existent limits of 10% and 25%. The new regime, due to come into effect as of 31 December 2010, will overall considerably weigh down on institutions, especially where business cannot be substituted.



The main objective of the large exposures regime is to contain the maximum possible loss risk linked to banks' single clients or connected clients. The relevant amounts of exposures considered for the measurement of large exposures and for the limit to large exposures are however, as a rule, not risk-weighted, which means that the credit-worthiness of the debtor is not taken into account. This reflects a very conservative approach to large exposures, which is – as a matter of principle – appropriate for a back-stop regime. On the contrary, for the purpose of determining the adequacy of own funds, it is commensurate to consider the risk-weighted positions. It is thus obvious that the reference parameter (i.e. own funds) is used for the determination of different goals, and therefore, it is appropriate that different arrangements for such reference parameter be used.

The effect of using only core capital as an assessment base for the limits applicable in case of large exposures would be an increase in the number of large exposures and a frequent overstepping of the large exposures limits, which would need supervisory approval and would imply a capital deduction. Such non-observance of the large exposures limit would weigh even more in the light of the revision of the definition of capital.

In this context, ESBG takes the view that no changes should be undertaken to the large exposures regime as a consequence of the amendment of the definition of own funds. The CRD 2 provisions on large exposures are sufficiently strict and already assume a worst-case scenario. A further tightening through a change in the basis of calculation from own funds to Tier 1 capital would result in additional restraints to the banks' lending capacity.

In our view, it makes sense, because of the strong conservative character of the large exposures regime, to maintain Tier 2 capital in the reference base for determining the large exposures limits. Should the Commission nevertheless decide to have only Tier 1 capital as a basis for calculation for the large exposure limits, it is imperative that this will not materially affect institutions and that the large exposure limits are considerably increased, on the basis of an impact assessment. Only this could avoid disastrous effects on the lending capacity of credit institutions. In any case, such a change would necessitate extensive IT adjustments, which would impose a burden that is not proportionate by reference to the eventual benefits linked to such change.

Contingent capital

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

ESBG considers it useful to analyse the potential role of contingent capital in strengthening the capital base for certain banks. The purpose of contingent capital should be mainly to bolster a firm's capital position during a period of financial stress, primarily in emergency situations.

ESBG highlights however that the concept of contingent capital should also be considered in the light of the plurality of actors in the EU's financial markets and their specificities. Already at this stage, it appears to us as particularly important that contingent capital is merely an option to be considered by institutions, but should in no way amount to a mandatory requirement. A mandatory requirement in this sense would be particularly detrimental to savings banks, which would find it more difficult than big commercial banks to find investors willing to buy such instruments.



Grandfathering

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?

As already highlighted in our introductory remarks related to transitional and grandfathering arrangements, ESBG gives a crucial importance to the need for maintaining legal certainty. Implementation timelines and transitional and grandfathering clauses in the CRD II were a core issue at the time of the negotiations and have already created expectations and directed accordingly the actions and forward planning of activities by those affected. Legal certainty needs to be preserved, and no contradictory messages should be sent out to the industry. The CRD IV proposals should – as a minimum - preserve the grandfathering and transitional arrangements foreseen in the CRD II. Yet, given the substantial overall implications of regulatory capital reforms, it appears reasonable that even longer transition and grandfathering periods be taken into consideration.



Section III - Leverage ratio

ESBG strongly opposes the introduction of a mandatory leverage ratio, defined as a supplement to risk-based minimum capital requirements. Actually, as already mentioned in our general introduction, ESBG fundamentally questions the rationale of a leverage ratio at international or European level, notably because we regard it as an inappropriate response to the problems made apparent by the financial crisis. This comment applies irrespective of whether the ratio is introduced under Pillar 1 or under Pillar 2. The decision to use a leverage ratio under Pillar 2 as a non-binding indicator should be left to the national competent authorities, who should decide on the appropriateness of such an indicator and on its appropriate use depending on the structure of the banking market they are in charge of.

Along the same lines, ESBG does not share the view that a leverage ratio is a suitable way to perform ‘meaningful comparison across jurisdictions’, notably because of the important structural differences within the banking industry and because of existing differences in accounting treatments. We comment below in some more detail on these and other concerns of a general nature, before providing responses to the Commission’s questions.

Inadequacy of a one-size-fits-all approach

By taking a one-size-fits-all approach, a leverage ratio could lead to inappropriate comparisons of financial institutions with completely different features, in terms of risk profile, funding structures and systemic relevance. In addition, as a result of its non risk-based structure, a leverage ratio could put retail banks, conducting traditional intermediation activities, at a serious competitive disadvantage (given that their balance sheet generally consists of well collateralised retail exposures carrying low risk). Yet, these banks proved to be amongst the most resilient throughout the crisis, and were the ones who consistently provided credit to the real economy thus preventing an overall credit crunch.

A single leverage figure applied to all institutions irrespective of their business model could not possibly account for the specificities of these institutions, and independently of their risk situation would either privilege or disadvantage certain business models. This actually transforms the leverage ratio into a policy instrument that could determine the structure of the banking market. This is in ESBG’s view unacceptable, especially should it lead to discriminating against the least risky entities. Regulatory requirements have to remain neutral as regards the business model of the regulated entities.

Differences in accounting frameworks

ESBG considers that the major differences still existing between accounting frameworks used worldwide, and especially between IFRS and US GAAP, make it impossible to achieve international consistency of the leverage ratio, calculated on the basis of different accounting frameworks. As such, ESBG calls for the accounting issue to be seriously discussed and not to be minimised, especially if the intention is to use a leverage ratio for comparison purposes.

ESBG recalls that there are differences not only between IFRS and US-GAAP, but also between IFRS and national accounting standards, which are used by a number of small retail banks in the EU. The



same business activities would be valued differently according to each of these standards. Whereas the proposed netting adjustments address one of the important causes in accounting differences, there are further accounting differences that influence the amount of own funds and the measure of exposure for balance sheet and off-balance sheet items. Given that the amount of own funds actually constitutes a residual measure following from the valuation of items on the assets and liabilities side, accounting differences cannot be dealt away by providing netting adjustments for derivatives and REPOs.

The only way to address the competitive distortions stemming from accounting differences would be to achieve a far-reaching harmonisation of accounting standards, especially of IFRS and US-GAAP, but also of national accounting frameworks. Such harmonisation will not be achieved in the short run. Yet it is a condition sine-qua-non for ensuring a sufficient degree of comparability and for introducing at international level a leverage measure.

Difficulty to combine a leverage ratio with the existing risk-based approach

The Commission's intention is that the leverage ratio shall supplement the risk-based minimum capital requirements. In practice, however, it is difficult to find a convenient way to combine effectively a risk-based approach with a non risk-based one. In this context, it has to be kept in mind that the Basel II risk-based requirements are currently undergoing a substantial review in order for them to be strengthened; this means in particular that the requirements applicable to the most risky financial activities should be reinforced. The introduction of a non-risk based leverage ratio would not only question the very purpose and effectiveness of the ongoing prudential reforms, but ultimately could just override completely the risk-based capital requirements. Depending on its calibration, the leverage ratio could indicate the quantitative threshold to which the risk-based capital requirements would have to indirectly adjust; should the limit of the leverage ratio be set higher than the currently foreseen own fund requirements, notably in the case of retail banks, then the consequence would undoubtedly be a decrease in banks' lending capacity.

An additional, well-known concern is the fact that a poorly calibrated leverage ratio could have perverse effects, such as providing an incentive to the most risky activities (i.e. those that could potentially bring the highest returns).

As mentioned above, in our opinion a leverage ratio could possibly reinforce the risk-based prudential requirements only in as far as it would constitute a reference indicator under Pillar 2 to guide the supervisory review process. Within this process, supervisors could monitor the amount of leverage and its evolution and, in a situation where a bank would exceed the supervisory defined thresholds, the competent authority could initiate a dialogue with the supervised institution and eventually apply relevant sanctions. However, since the banking structures vary substantially from country to country within the EU, and as a consequence as the supervisory concerns also vary, ESBG believes that it should be left to the national supervisors to decide if a leverage ratio could usefully contribute to the supervisory review process and if so, under which conditions of use.

Excessive focus on leverage inadequate

ESBG agrees that excessive leverage can be a cause of excessive risk-taking and henceforth understands the interest of regulators in addressing this issue. However, ESBG calls for the Commission to acknowledge the complexity of addressing such difficulties and the importance of identifying those instances where leverage becomes problematic. Such instances are not necessarily linked to the degree of leverage as such (irrespective of how it is measured), but rather and foremost to



the quality and riskiness of assets held by institutions and in some instances to the hereto-linked maturity mismatches. Ignoring this would transform the proposal into box-ticking measure for supervisors, and a source of burden for banks, without any benefit.

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

For the above-mentioned reasons, ESBG fundamentally questions the idea of introducing a mandatory leverage ratio at EU or worldwide level. An eventual measure of leverage should serve exclusively as a non-mandatory indicator amongst other indicators to guide overall supervisory assessment of institutions under Pillar 2.

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

The total amount of Tier 1 capital should be taken into account as a basis for the capital measure of the leverage ratio used as a non-mandatory indicator, as all of the Tier 1 capital is available as “going concern” 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?

No particular comments.

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

No particular comments.

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

For the above-mentioned reasons, ESBG does not believe that a leverage ratio can fill in the objectives expected from it, such as acting as an effective constraint only in benign economic conditions.

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

No particular comments.



Section V - Countercyclical measures

From a conceptual perspective, ESBG agrees with the proposed framework of which the main idea consists in linking capital requirements with economic cycles. Capital buffers should cancel out the propensity banks have, when facing an economic crisis, to decrease their exposures and fire-sell their assets in order to maintain an adequate capital ratio. It should also diminish the incentive banks have to increase leverage in periods of economic growth. Given that the financial crisis has demonstrated the excesses in credit developments in the past, it is necessary to identify a new and sustainable equilibrium regarding prudential capital requirements.

ESBG main concern: the necessity to limit the number of ways to address procyclicality.

The main concern of ESBG is related to the idea of simultaneously handling a unique problem (excessive procyclicality) through various angles: by the introduction of countercyclical capital buffers, by the introduction of forward looking provisioning, by the introduction of a leverage ratio, by emphasizing a “through the cycle” as opposed to a “point in time” approach, by amending accounting standards. It is in our view necessary to limit the number of ways to address the issue of excessive procyclicality and to introduce only targeted changes, after a carefully conducted impact assessment. It is also of particular importance for the accounting and regulatory communities to work together in order to come to solutions which are appropriate from the two perspectives – notably as regards the definition/treatment of provisions.

Overall, ESBG lists four main reasons why the Commission should pay particular attention to the effects of all the proposed changes on banks’ capital requirements.

1. First of all, the Commission should ensure that the sum of all the measures will not increase too much the complexity of the framework applicable to banks. We stress that the proposed solutions should not be applied simultaneously as the combined effect of all the envisaged measures are at this stage extremely difficult to foresee (as many of the changes would add up and reinforce each others). The Commission should limit the number of proposals to address excessive procyclicality to one or two proposal(s) maximum after carefully assessing their impact.
2. Additionally, the Commission should also ensure that the sum of all the measures will not result in banks holding excessive capital buffers beyond what is necessary to maintain a resilient banking sector. ESBG warns that the devil is in the details. Conducting an in-depth calibration exercise is of utmost importance.
3. The specific business model of retail banks has also to be taken into account in order to avoid the risk of a credit crunch. The proposal could excessively increase the cost of funding of banks in normal times, which would incite banks to limit their credit allocation. History has proven that increasing capital requirements encourages banks to develop activities that demand less capital. Overall it is possible that increasing capital requirements will reduce banking intermediation in Europe. Paradoxically, the proposal could ultimately favour an originate-to-distribute model financial system (disintermediation and securitisation) rather than the classical originate-and-hold business model. It is therefore important to take into account the



specificities of the different business models of banks and accept that different models requirements may require different level of capital buffers.

4. Finally, ESBG highlights that the proposals could hamper retail banks with respect to all other financial companies. In order to avoid competition distortions, the Commission has to follow a more flexible approach, such as, for instance, when it comes to control the latitude banks can have to distribute their earnings.

Part 1 - Through-the-cycle provisioning for expected credit losses

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.

ESBG does not have any comment on the IRB expected loss approach due to the short consultation period. A more detailed response will also depend on the outcome of the IASB's second-step approach to review IAS 39.

During the financial crisis, criticisms were raised against the current IFRS incurred loss model on impairment. The issue with the incurred loss model is that impairment losses can only be recognized when there is evidence that they exist ("have been incurred"). Reporting entities are not allowed to consider the effects of expected losses. ESBG considers that it is likely that an earlier recognition of loan losses could have potentially reduced the cyclical moves in the recent financial crisis.

It is however too early for us to reach a definitive conclusion on the incurred loss model as ESBG is still in the process of assessing whether an expected cash flow method to provisioning could efficiently solve the procyclicality issue.

ESBG has in addition concerns on the IASB's proposals. For three reasons that we will develop hereunder, ESBG believes that forward looking provisioning is at a too early stage to be considered a possible solution.

1. First of all, while we think that the IASB's Exposure Draft (ED) *"Financial Instruments: Amortised Cost and Impairment"* moves towards the right direction as it is based on "expected losses" and is clearly principles based, it has some drawbacks. The most important of them is its complexity. It would also require significant developments in the systems of banks, presumably making it expensive to implement to attain little benefit. Additionally, given the methodology proposed by the ED, the definition of "amortised cost" could change, resulting in additional uncertainty.
2. In addition, while ESBG is in line with most of the BIS six points plan to achieve a sound "expected loss provisioning approach" established in the paper "Guiding Principles for Replacement of IAS 39"³ (published 27 August 2009) it wonders if the IASB will be able to

³ The six points consisted in:

1. addressing the deficiencies of the incurred loss approach without introducing an expansion of fair value accounting,
2. promoting adequate and more forward looking provisioning through early identification and recognition of credit losses in a consistent and robust manner,
3. addressing concerns about pro-cyclicality under the current incurred loss provisioning model,



address all these guidelines. Some of our concerns are best summarized in EFRAG's assessment of the IASB's proposal. EFRAG - which was set up in 2001 to assist the European Commission in the endorsement of IFRS by providing expert advice on the technical quality of IFRS - is cautiously supportive of the proposals from a conceptual perspective (regarding the general objective as well as with the decision not to proceed with the alternative impairment models - such as fair value and through-the-cycle approach) but has some significant concerns on their operational implications⁴. Some of these concerns are:

- Subjectivity: management judgment is central when calculating expected cash flows, including credit losses, therefore this subjectivity has to be sustained by comprehensible disclosures.
 - Uncertainty on the future content of the proposals: the content of the ED is likely to change significantly prior to the issuance of the final standard as a result of input from the Expert Advisory Panel and stakeholders on operational issues.
 - Necessity for further guidance: input from the Expert Advisory Panel is urgently needed to avoid a wide range of interpretations which would impair comparability.
3. Thirdly, and as a consequence of our second concern, ESBG members would like to avoid that the measures taken on both the accounting and the prudential/regulatory sides overlap. Any lack of coordination between accounting standard setters and prudential supervisors could mean that entities end up with an excess of requirements that are not desirable.

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.

Because of the short period for providing feed-back no comments on this question could be prepared.

Part 2 - Capital buffers and cyclicity of the minimum requirement

Question 40: 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.

Because of the short period for providing feed-back and the timing of the consultation it is too early to provide the Commission with a position on the proposed dual structure of capital buffers. For these reasons we will develop hereunder our main concerns in relation to capital buffers and the necessity to address excessive procyclicality.

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- 4. incorporating a broader range of credit information, both quantitative and qualitative,
 - 5. drawing from banks' risk management and capital adequacy systems and
 - 6. being transparent and subject to appropriate internal and external validation by auditors, supervisors and other constituents

⁴ <http://www.efrag.org/news/detail.asp?id=485>



ESBG's position on capital conservation buffers

ESBG has some concerns with the proposed framework. These buffers not only aim at protecting banks from bankruptcy but also at aligning the behaviour of the whole banking industry with the concerns of supervisory and prudential authorities. Our contribution will therefore focus on the efficiency of the proposal. Additionally, and as the Commission acknowledges, calibration will be a key aspect of the proposals. Against the background of these two issues, we have four main concerns:

1. Can capital conservation buffers offer an adequate protection against systemic risks (i.e. protecting financial stability)?

Systemic financial crisis are rare and capital is costly. The introduction of capital conservation buffers will impose significant capital constraints on an everyday basis for banks. An inappropriate level of regulatory requirements (via either too low or too high capital buffers) might prove to be either inefficient or excessively expensive.

We recall the recent experience in the latest crisis when market expectations (and also regulators' demands at that time) forbid banks to reduce their capital base. On the contrary, they had to boost it immediately. Based on this experience, we wonder if the fact that capital markets generally expect higher capital requirements in time of crisis renders the approach on capital buffers ineffective. We conclude that conducting an in-depth calibration exercise is of utmost importance as the right balance has to be found between the cost of capital and protecting financial stability.

2. Can they play a role in maintaining credit supply in case of a downturn of the economy?

Concerning the issue of credit availability, ESBG is concerned that the Commission's proposal might trigger some negative effects and even lead to a credit crunch if the business model of retail banks is not taken into account.

The proposal imposes economic constraints on the intermediation business model during normal periods in order to offset the risk of insolvency in the whole banking industry in periods of stress. One of our concerns is that in case of inadequate calibration the growth of the demand for credit could exceed the speed at which banks can rebuild their capital buffers. Time inconsistency could then be a major problem. Secondly, we consider that regulatory capital tends to overestimate economic capital when it comes to retail activity. Numerous empirical experiences show that the internal rating parameters used in assessing the risk of retail portfolios (and especially when taking into account the correlation between different assets) leads to lower economic capital than the regulatory requirements.

A particular concern relates to the availability of funding to SMEs. The crisis clearly made banks more risk adverse. Credit rates have a natural tendency to increase in periods of stress. We highlight that the Commission should take into account the business model of retail banks so as to avoid the risk of a credit crunch. Any extension of the difference between regulatory capital and economic capital could heighten the credit limitations that SMEs face when it comes to their short-term and treasury issues. Indeed, while credit allocation to SMEs is individually risky, diversification, along with an in-depth client relationship mitigate it to a great extent. This is the reason why retail banks' economic capital, when measured with internal models, is generally inferior to the capital measured by regulatory formulas. It is therefore essential to calibrate the proposed measures by taking into account the specificities of the business model of retail banks. Too strict capital buffers will affect the lending activity and dramatically increase the prices of the loans.



3. Is there a risk to introduce competitive distortions with other financial institutions or other competitive continents?

While we generally challenge the capacity of buffers to reduce procyclicality and improve the stress resilience of banks, the introduction of capital buffers on top of a minimum capital requirement and the corresponding reduction of dividend payments could from our point of view hamper the competitiveness of retail banks with all other financial companies. Our position will be more detailed in our answer to question 41.

4. Could capital conservation buffers be redundant with the business model of retail banks?

The business model of retail banks consists in building capital buffers. Capital conservation could ultimately appear redundant with such business model in case of inadequate calibration.

The retail banking activity requires holding a sound capital base to perform a lending activity. Retail banking therefore imposes naturally high capital buffers. This is indeed necessary as retail banks have to cover the internal risk correlation between illiquid portfolios for which there is little possibility to hedge the risks through either capital markets, securitisation or insurance coverage. It is therefore possible that countercyclical buffers ultimately appear redundant with the business model of retail banks if they do not take into account the specificity of their business models. This would appear counterproductive as retail banks' business models have proven to be extremely resilient during the crisis.

Against this background, ESBG stresses that it is of utmost importance to take into account the specificities of the different business models of banks and accept that different models requirements require different capital buffers. The calibration and impact assessment should at least make the difference between the different systemic risks that retail banks entail when compared to investment banks. It should not be forgotten that retail banks are liquidity providers to the economy and that they are not at the origin of the financial crisis.

Adopting an inadequate calibration would per se penalize retail banks and by extension an important part of the world economy. It would achieve the contrary to what is intended: it would not automatically address the insolvency issue while penalizing part of the industry which did not cause the financial crisis.

ESBG's position on counter-cyclical buffers

The idea of counter-cyclical buffers consists in adjusting the size of the buffer range established by the capital conservation buffers. The underlying idea is that it is necessary to protect the banking sector from excess credit growth.

ESBG urges the Commission to be very cautious with this very preliminary proposal. ESBG wonders if it is possible or even desirable to measure the dynamic of macro-level risks across banking sector activities. It is unlikely that any authority could know or have the right tools to assess the right level of growth for the - or some part of the financial sector. This raises numerous questions as the banking industry is a risk taking business by definition and as cyclicality is inherent to its activities. Therefore we wonder:

- What will be the signs of excessive credit growth? Which macro-economic tools are going to be used?



- What about the competitiveness of EU countries and companies against Asia or US?

For these reasons ESBG is sceptical on this proposal and suggests that the Commission does not implement a rules-based regime. Should this approach be given further, then the Commission should rather opt for general guidelines leaving sufficient room to national authorities.

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

Banks should be granted sufficient latitude to distribute their earnings in order to attract investors and avoid facing competition distortions. We have serious concerns with additional regulatory rules which restrict paying dividends to shareholders and investors. The introduction of capital buffers on top of a minimum capital requirement and the corresponding reduction of dividend payments could from our point of view hamper the competitiveness of retail banks with all other financial companies.

Capital buffers will intensify the pressure on banks because they have to attract investors to raise capital to comply with the increased capital requirements. The Commission should bear in mind that banks have to compete not only among the group of financial institutions but with all participants on the global capital markets in respect to raising fresh capital.

This worldwide competition to raise capital is also a reason why shares with preferential distributions rights should still be considered as equity and part of Core Tier 1. Features that differentiate common shares from regular voting common shares are needed to compensate investors for missing voting rights or for convincing new investors to recapitalize a bank during stressed situations. There is no difference in quality between common shares and preference shares when it comes to absorb losses (preference shares are subordinated to all debt instruments). On the contrary, preference shares will be needed, first of all, to maintain the competitiveness of banks vis-à-vis other financial institutions and, more importantly, to ensure that banks will be able to raise the necessary amount of capital when they will all face a systemic crisis.

Question 42: 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?

We do not yet have a specific position concerning the timing for reaching capital buffer targets. However, we wish to emphasize a specific concern related to this timing which needs to be handled very carefully in light of the fragility of the emerging economic recovery worldwide. Due to the cumulative effect of the tightening of the capital criteria, the increase of capital ratios and the extension of the deduction regime, many banks may have to increase their capital base at the same time; this might prove extremely costly for banks and investors may in fact not be able to provide the needed amount. As a consequence, we believe that the time limits for reaching capital buffer targets should be determined by supervisors on a case-by-case basis.

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?



Due to the short period for providing feed-back we do not have any comment on the most suitable macro variables that may be used in the counter-cyclical buffer.

In addition we would like to highlight that we are sceptical with this proposal. We consider that it is unlikely that any authority could know or have the right tools to assess the right level of growth for the - or some part of the financial sector. For these reasons ESBG stresses that the Commission should not implement a rules-based regime. Should this approach be given further, then the Commission should rather opt for general guidelines leaving sufficient room to national authorities.

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

At this stage, ESBG does not have any comment on through-the-cycle provisioning as it is still assessing its potential effectiveness.

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

Because of the short period for providing feed-back no comments on this question could be prepared.



Section VI – Systemically important financial institutions

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

ESBG understands and shares the general concerns regarding the risks associated with systemically important financial institutions (SIFIs), repeatedly expressed by the G20, the European Commission and national governments.

However, ESBG is highly sceptical of an approach consisting in strictly identifying SIFIs and singling them out for special measures or treatment, i.e. the approach focused on during the earlier stages in the discussion on systemic importance. While ESBG understands that as a first reaction such a direction may appear promising, closer contemplation highlights several substantial weaknesses.

As the Commission rightly points out, the reasons behind systemic importance are extremely complex. Furthermore the very effect of systemic importance on overall financial stability is different for each financial firm, with a different degree of systemic relevance in each case. To a large extent all possible impacts depend on institution and market specific characteristics, as well as on the degree and kind of interconnectedness of the SIFI with other market participants and the real economy.

Against this background ESBG does not believe in the suitability of any ‘binary’ approach, which would distinguish between SIFIs and ‘the rest’, and submit SIFIs to special treatment. Such an approach would even be unfeasible in the European environment, characterised by institutions of all types, namely different sizes, structures and business orientations.

Firstly, ESBG seriously doubts that this would be a satisfactory way to address the problems potentially arising from SIFIs. Even the first step, i.e. the identification of ‘SIFI’ is fraught with difficulties – in particular since there is not even clarity on the appropriate reference market (i.e. regional, national, EU-level, global) for systemic importance. Furthermore, the idea to publicly signal which financial institutions are considered systemic will only propagate moral hazard, and may result in sizable competitive disadvantages for other financial institutions on the one hand, and in significantly greater risks for the financial system as a whole on the other hand.

Secondly, ESBG apprehends that ‘identification and special treatment for SIFIs’ would de facto lead to a ‘two-tier’ regulatory or supervisory framework. Such a development is not advisable, also given the significant heterogeneity even among those institutions which would be singled out as SIFIs. In addition, also from the perspective of smaller and regionally focused institutions such a regulatory split-up would be a great set-back, as it would put an end to the current level-playing field for competition with larger, potentially systemically important competitors. This, however, puts into danger the quality and fairness of the European banking market and the progress in market integration already achieved.

However, this being said ESBG agrees that a judicious and adequate solution, or at least mitigation, of the ‘systemic risk problem’ would be a substantial improvement, which would considerably contribute to future financial stability. In this context we would also like to emphasize that systemic risk is not the same as the abuse of a dominant market position resulting from the size of a SIFI. This means that size in the context of systemic importance is not equivalent to size in the meaning of the Treaty provisions on competition law. Hence, a specific financial institution may be large enough to constitute a systemic risk for the financial market and the economy at large, although it does not have and abuse a dominant



market position. From this it follows that EU competition law criteria should not be drawn upon when looking at the size of a company to determine its systemic relevance

ESBG believes that the most promising direction for progress is to take a flexible, effective and outcome-oriented approach to systemic relevance. On this basis ESBG proposes that regulators should investigate the following course of action:

- Firstly, it should be recognised that systemic importance cannot be nailed down in terms of quantitative criteria. Systemic importance in itself is dynamic and undergoes a continuous evolution, depending on technology, market trends, competitive pressures etc. Any attempt to capture systemic importance of institutions (and also markets) therefore needs to be adjustable and to take into consideration the evolutions in the financial sector and the economic environment. ESBG believes that a principles-based, non-binary, indicator for systemic relevance would fulfil these criteria and could be a promising approach.
- Secondly, ESBG sees scope for more risk-based regulation, with greater weight given to the riskiness of banks' business models and business activities. This approach would effectively also reduce the wider risks associated with systemic relevance. The focus should be on identifying and tightening the prudential requirements for risky activities, which is the approach already taken in the CRD 2 and CRD 3 for the trading book activities, securitisations, etc.

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

ESBG would first like to stress the greatly increased sensitivity towards the risks associated with systemic importance. In addition the currently discussed reform package seeks to ensure greater financial stability.

As regards the consistency in the approach to systemic importance it is necessary to keep in mind that each firm of systemic relevance is systemically important in its own way, depending on its specific characteristics, balance sheet structures and the markets in which it is active. These idiosyncrasies need to be reflected in supervisors' approaches. Therefore even for financial institutions where the main reason for their systemic importance is their size, an adequate one-size-fits-all approach cannot be developed and should not be expected. Hence, ESBG does not believe in the appropriateness and the success of a prescriptive legislative approach in this area.

This being said, ESBG clearly sees a need for convergence in supervisory cultures as well as supervisory practices across Europe. Going forward, ESBG believe that CEBS (and later EBA) has an important role to play in achieving further convergence and hence EU wide consistency. This also applies to the issue of the treatment of systemically important institutions, where ESBG is convinced of the added value of a risk based approach under Pillar 2. Furthermore, ESBG is confident that the development of a more gradual indicator on systemic relevance (also see response to Question 46) could be of added value: it promises to promote consistency in and provide a shared basis for supervisors' assessment and approach to addressing systemic relevance.



Section VII – Single rule book

ESBG welcomes in principle the removal of national discretions as long as harmonisation among the Member States has been achieved. However, it needs to be considered that Member States' markets are not homogeneous and that there are areas of regulation where it is important to maintain differences and grant national discretion given the specificities of the local market. Henceforth, ESBG explicitly welcomes the Commission's explanation that "a single rule book does not mean uniform rules regardless of specific national circumstances. Rather it should encompass the necessary differentiation according to national or product circumstances." This reflects the so-called "gold plating" prohibition, which precludes Member States from introducing additional requirements in fully harmonised areas, and thereby contributes the maintenance of the level playing field.

Areas where more stringent requirements are necessary

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?

ESBG has not identified any concrete area, where a more stringent treatment would need to be generalised and incorporated in the single rule book. In our view, the instruments available under Pillar 2 to national supervisors for imposing more stringent requirements are sufficient to address national specificities in individual cases. ESBG takes the view that a European harmonisation of Pillar 2 requirements is not necessary.

Treatment of real estate lending

Against the background of the financial market crisis and the hereto related distortions in several national real estate markets, it is justified – as a matter of principle – to put to test the prudential regulatory framework for exposures secured by mortgages.

However, any envisaged amendment of the current rules should pay due account to the fact that the national real estate markets across the EU have developed very differently for a number of reasons, such as economic growth, demographics or historical realities. This was made clear during the financial crisis, when some real estate markets suffered substantial losses and witnessed important decreases in the value of real estate, whereas in other markets real estate prices and loss ratios remained stable. In order for such differences to be appropriately considered and in view of avoiding unjustified disadvantages to specific real estate markets, it is important that certain national discretions be maintained.

Residential real estate

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?

ESBG does not support the suggested tightening of the prudential treatment for exposures secured by mortgages on residential property.

No mandatory additional hard test needed at EU level:

For exposures secured by mortgages on residential property, the competent authorities may currently waive the independence criterion - which requires that the creditworthiness of the borrower does not materially depend on the performance of the underlying property – if there is evidence of a well-developed and long-established residential real-estate market in that territory (Annex VI Part 1 § 49 of the CRD). The Commission proposes that the national discretion be replaced with a hard test construed on the basis of certain limits to loss rates.

In light of the solidity of certain national real estate markets that have constantly shown solidity and loss rates below the limits requested by the Commission so far, it may be reasonably assumed that the product and market structure will not undergo significant changes in the future. For such market, the introduction of an additional hard test would be disproportionate and inappropriate. The additional burden resulting from introducing an additional hard test with changed loss rates would not be justified given the small additional findings to be gained by the supervisors pursuant to the conduct of such hard test.

Additionally, as regards residential property used by the borrower himself it should be anyways assumed that the creditworthiness of the borrower does not depend on the performance of the property, but on other revenue flows. A hard test would be redundant.

No mandatory additional indicators (such as a loan-to-income ratio) needed at EU level:

ESBG does not support the proposed introduction of a specific maximum harmonised Loan-to-Income (LTI) ratio and/or other indicators as an additional precondition for the application of the preferential treatment of exposures secured by residential real estate.

ESBG would like to highlight that the problems encountered in the US sub-prime market were not manifest in the European real estate markets. The fall in real estate prices in some EU markets were rather the result of real-estate bubbles built on speculation, and had no connection with the LTI ratio of borrowers. Such indicators should not be considered in the context of prudential requirements. They rather pertain to the ongoing discussions on “responsible lending”.

The privileged treatment of exposures secured by residential property depends mainly on the value of the real estate, with the focus being put on a sufficiently conservative evaluation of the value of the security, that would ensure that outstanding debt is repaid even in case of the failure of the borrower. On the contrary, a LTI ratio and other indicators are dependent on the individual borrower and therefore do not say anything about the solidity of the real estate market.

Furthermore, the introduction of a LTI ratio would be difficult to reconcile with the arrangements on credit conditions. The privileged treatment of an exposure is integrated in the price when the credit is granted. Should an indicator not be fulfilled anymore at a later point, it would be necessary to apply higher capital requirements to the specific exposure. This is hard to include in the credit margin, especially in the context of the long-term interest rate conditions applicable to mortgage lending. Therefore, the failure to meet such indicators would be taken into account already at the time of granting the credit, which would result in more expensive lending.



Commercial real estate

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?

For questions 49 and 50, any qualitative and/or quantitative evidence supporting your arguments would be greatly appreciated.

No hard test as a condition for the preferential treatment:

The Commission proposes introducing a hard test entailing a maximum loss rate. The sanction in case of exceeding the limits would amount to imposing a flat 100% risk weight. Such tightening of the conditions for the preferential treatment of exposures secured by mortgages on commercial real estate is not justified either from a risk perspective or from the need to adapt values on the individual commercial real estate markets in the EU. The imposition of a 100% flat rate would completely ignore the risk-reducing effects of mortgages and undermine all efforts to risk-sensitively determine risk weights. Higher capital requirements will definitely constrain lending, and will have an important impact on small and medium sized enterprises, which generally rely on commercial real estate to secure loans they take up.

Furthermore, it should be taken account of the distortions that will arise should the maximum loss rates not be observed after the preferential treatment was granted. Such privileged treatment would have to be abandoned as of the day when the limits are trespassed and a 100% risk-weight will have to apply. This will significantly raise regulatory capital requirements, which can have undesired procyclical effects.

For these reasons, ESBG does not support the proposed introduction of a hard test for the preferential treatment of exposures secured by mortgages on commercial real estate.

No need to amend existing levels of Loan-to-Value (LTV) and introduce other indicators:

In ESBG's view there is no reason or evidence justifying amendments to the existing levels of the LTV and/or mortgage lending value benchmarks. Nor is there any compelling evidence of the need to introduce any other indicators as additional preconditions for the application of the preferential treatment of exposures secured by mortgages on commercial real estate.

No need to increase the existing preferential risk weight:

ESBG believes that the existing privileged risk-weights on exposures secured by mortgages on commercial real estate are adequate and should therefore be maintained. There is to our knowledge no evidence to the contrary.

Question 51: 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?



ESBG takes the view that the current EU legislation for the prudential treatment of exposures secured by mortgages on residential property and the prudential treatment of exposures secured by mortgages on commercial real estate is adequate and therefore it should not be changed.

Treatment of real estate lending throughout the economic cycle

Question 52: 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?

ESBG is supportive of the idea to make a more extensive use of the mortgage lending value, which reflects the value of the respective property over a longer period of time. When determining the mortgage lending value only the sustainable characteristics of the real estate should be considered. Thus it would be possible to obtain a value over the whole mortgage period that would be independent of temporary or cyclical value oscillations in the respective market. In this way it would be possible to level out value fluctuations in both directions, especially in volatile markets.

ESBG opposes the introduction of additional provisions into the Pillar 2 framework dealing explicitly with exposures arising from mortgage lending and reflecting the different stages of the economic cycle in estimating the resulting regulatory capital levels. The European Commission proposes already measures to address pro-cyclicality related concerns. Such proposals refer to the whole bank portfolio, hence include also exposures secured by real estate. Introducing separate requirements in the area of real estate financing would amount to a double burden and is therefore considered as unacceptable.

Removal of options and national discretions

As already pointed out in the ESBG response to the Commission's consultation from July 2009, ESBG does not support the proposed reduction – from end 2017 to end 2012 – of the grandfathering clause in article 154(6) CRD allowing for the exemption from the IRB treatment of certain equity exposures. The agreement on these transitional arrangements was a core issue during the negotiations of the CRD. Furthermore, the European decision-makers decided on the preservation of the status quo for valid reasons during the subsequent discussion on CRD 2 and CRD 3. This created legitimate expectations and legal certainty. It cannot be simply departed from this situation without appropriate justification.



About ESBG (European Savings Banks Group)

ESBG (European Savings Banks Group) is an international banking association that represents one of the largest European retail banking networks, comprising about one third of the retail banking market in Europe, with total assets of € 5967 billion (1 January 2008). It represents the interest of its Members vis-à-vis the EU Institutions and generates, facilitates and manages high quality cross-border banking projects.

ESBG Members are typically savings and retail banks or associations thereof. They are often organized in decentralized networks and offer their services throughout their region. ESBG Member banks have reinvested responsibly in their region for many decades and are one distinct benchmark for corporate social responsibility activities throughout Europe and the world.



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