ASSOCIATION FRANÇAISE DES SOCIÉTÉS FINANCIÈRES

Paris, le 22 avril 2010

Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002 Basel,
Switzerland

Basel Committee consultative documents on banking supervision :

- **Strengthening the resilience of the banking sector ;**
- **International framework for liquidity risk measurement, standards and monitoring.**

By email to baselcommittee@bis.org

Dear Madam, Dear Sir,

In addition to the responses you might have received from the large and international banks on your consultation paper dated on 17 December 2009, the ASF would like to draw your attention to analysis developed from a specialised institutions perspective.

The ASF (Association française des Sociétés Financières) is, according to the Banking Act of 24 January 1984, the representative body of all specialized financial institutions in France as factoring, equipment leasing (including vehicles), real estate leasing and credit, mutual guarantee institutions, consumer credit including cars financing and trading institutions.

The outstanding of financing in the hands of its 360 members amounted to approximately 290 billion Euros at the end of 2009 i.e. 20 % of the total amount of credits to the economy in France.

Due to the Banking Act, these companies are licensed as finance institutions (or, exceptionally, banks).

Therefore, our response –enclosed- to the Commission's consultation on possible further changes to the Capital Requirement inspired by your proposals, focus on issues that are of direct relevance for the specialised institutions represented by ASF.

Yours sincerely,

Françoise PALLE-GUILLABERT

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ASF's Position
on possible further changes to the Capital Requirements Directive ("CRD IV")

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Responses to the Commission services staff working document dated on 26th February 2010

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Please find hereinafter our preliminary observations:

In general, ASF understands the idea of updating the European legal framework for prudential supervision in order to achieve the dual objective of improving the resilience of the global financial system and ensuring a level playing field based on robust set of prudential capital requirements.

However, the scope of the Basel Committee is limited to large and international banks on consolidated basis. According to our analysis, implementing some of the Basel proposals at the European level on all credit institutions on an individual basis will raise a major issue as these rules have not been dedicated in the first place for small and specialised institutions which have no responsibility in the recent events.

American authorities have not implemented yet the Basel II rules. Even if they consent to implement the Basel III rules, it would be only for international banks.

Moreover, some European economies such as the French one are financed one-third from market activity and two-thirds from bank loans. The American model is strictly reversed. Then, the regulatory impact on the financing of the European economy will be much more important. Such a result, rather paradoxical, will be irrelevant in a context of economic and financial crisis.

Public authorities such as European Commission and the French government would put on French banking groups three main constraints: a significant increase of regulatory capital, a decrease of risk and an increase of amount of credit. Under those incompatible circumstances, these new rules would lead to either a credit crunch or an increase of credit cost.

The proposed measures such as building high quality capital, strengthening risk coverage, mitigating pro-cyclicality, discouraging leverage as well as strengthening liquidity risk requirements and forward-looking provisioning for credit losses will have crucial impacts on the financing of the economy for specialised institutions.

We do insist on the fact that as some activities represented by ASF (e.g. equipment and real estate leasing, mutual guarantee institutions, factoring...) are already under control of the French regulator which it is not the case for some of them in other members states, some aspects of these proposals need to be adapted, complemented or modified as set forth in the following paragraphs.

Section 1 Liquidity standards for credit institutions and investments firms

The French banking authority has already implemented a set of requirements related to liquidity risk management and the supervisory review of that risk management.

As a matter of fact, French bank liquidity is monitored on the basis of a liquidity ratio based on two different approaches. In order to measure their liquidity risk, credit institutions can opt for the standardised approach or the advanced approach.

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Actually, the French standards are dealing with the two European objectives which promote:

- Short term resilience of the liquidity risk profile of credit institutions by ensuring they have sufficient high quality liquid assets to survive an acute stress scenario lasting for one month. This standard approach would be equivalent to the Liquidity Coverage Requirement ;

- Resilience over the long term by imposing a Net Stable Funding Requirement and requiring credit institutions to fund their activities with more stable sources of funding on an ongoing structural basis.

<u>The standardised approach</u> requests from the credit institutions to be able to withstand the combination of an idiosyncratic crisis and a market crisis with parameters defined by regulations.
They must also have a set of minimum tool for measuring and managing liquidity risk.

<u>The advanced approach</u> (suitable for large banks including some of systemic importance) proposes a set of tools, some of which are sophisticated and some of which are very simple, that together help define a bank's risk profile and its liquidity management, both in ordinary times and times of crisis.
Credit institutions have to define global liquidity policies, procedures and limits and set up administration tools, It systems. They also have to define a proper governance of the liquidity risk management which covers short and long term horizon.

These two approaches seem to respond to the two liquidity risk standards with separate but complementary objectives that the European Commission proposes to introduce.

Therefore, ASF would consider important to maintain the French regulatory system.

Nevertheless, ASF would like to point out as additional comments the following observations:

<u>Liquidity Coverage Requirement (LCR)</u>

(Q1) If the purpose of the Commission is to define a unique ratio applicable to guarantees given different from the risk level of the Basel ratio then there is a risk that this ratio be exclusive with the business model of the credit institution and make it disappear at the end.

ASF thinks that covered bonds need to be taken into account for the following reasons:
- covered bonds have to participate to ready to sell assets;
- covered bonds shall not be controlled by a "bid/ask" range as covered bonds market showed their resistance during the crisis;
- the distinction between "egal covered bonds" and "others covered bonds " shall be taken into account throughout the narrow asset buffers and the additional assets or a risk weight (100% for "legal covered bonds" and 75% for the others)

As a general rule, we do consider that the « narrow buffer assets » shall include at least liquid assets or assets accepted to the BCE's refunding.

(Q2) covered bonds with good notation and monetary UCITS shall be taken into account in the narrow asset buffers.

<u>Net Stable Funding Requirement (NSFR)</u>

A dissymmetrical treatment of the calculation may raise a problem:
- a 50% risk weight is applicable for financing which duration is less than one year whereas a 85% risk weight is applicable for the exposures of a one year residual duration ;

- then, the overcharge generated is not justified particularly when these financing with a duration of less than a year correspond to the termination of initial operations with a longer maturity.

Consequently, such strict measures may conduct to harsh limitations of the asset liability management potential transformation of banks and financial institutions

(Q4) It should be noted as well that the issue of the mutual guarantee societies, which don't need funding should be treated specifically.

At the final day, for these two ratios described above, calculation shall be possible on a consolidated level and permitted under advanced approach.

Section 2 Definition of Capital

As mentioned in the past[1], the aggregate impact of the proposed revision to capital requirements would be financial and economic. It would represent a quantitative increase in regulatory capital for the credit institutions under standardised approach (especially in their real estate activity, housing loans).

The consequences would be:

- unfair conditions of competition between credit institutions under IRB approach and those under standardised approach;
- aggravation housing access conditions for first time buyers of credit institutions that are still under standardised approach.

From a mutual guarantee societies point of view (Q17), ASF would like to draw your attention to the fact that most of common forms of shares issued by cooperative or mutual societies are on one hand the shares issued by cooperative or mutual societies underwritten by the beneficiary companies themselves and on the other hand certain forms of mutual guarantee funds paid in by the same companies or shareholders.

These shares are directly linked to individual loan operations or a specific financial asset's risk and are subject to strict reimbursement rules regarding the loan covered, other assets, liquidity situation, and as they involve the withdrawal of the beneficiary from the guarantee society, ASF considers they should be treated as Tier 1 capital.

In annex IV on page 75 of the consultation paper, the Commission provides 14 detailed criteria which are too restrictive according to us.

Therefore, ASF invites the European Commission during the review of the CRD to be inspired by the interpretation of the application of Article 57 (a) to cooperative and mutual shares, as proposed by CEBS (CP 33 dated on 17 December 2009). Actually, the 10 criteria listed as guidelines for the interpretation of Article 57 (a), in particular as regards the conditions to be fulfilled by cooperative or mutual shares to be considered as own funds instruments are generally measured and adequate.

In addition and generally speaking, as the Commission does not mention the mutual guarantee funds, ASF would require to rather adopt an economic and operational definition as the one proposed by the Basel committee[2] based on the idea that the application of the criteria governing inclusion in Tier 1 "should preserve the quality of the instruments by requiring that they are deemed fully equivalent to common shares in terms of their quality as regards loss absorption [...]".

[1] See ASF's response to the Commission CRD4 consultation of 24 July 2009
[2] Strengthening the resilience of the banking sector document –17 december 2009- page 18 –foot page 19

(Q19 and 24) If the Commission would not maintain to include the mutual guarantee institutions (shares or funds) in core Tier one, that decision may challenge the guarantee model applicable to real estate finance which represents 50% of the home loans French market.

Section 3 Leverage ratio

Firstly, the introduction of this ratio is two steps backwards compared with the Basel II provisions. Secondly, this ratio was already implemented in different countries but did not prevent the recent events to happen. Finally it would treat equally high and low risk level activities. Therefore, ASF considers the introduction of the leverage ratio as irrelevant and hazardous for small and specialised institutions.

Moreover, due to a strong interaction with US GAAP or IASB accounting rules, ASF considers as a crucial issue the fact that different practices must be harmonized to prevent a huge distortion of competition.

Besides, the main activity of the institution shall be taken into consideration. Indeed, ratio will be much lower for long term credit activities (e.g for real estate) than for short term credit activities.

Using different types of funding such as covered bonds for most of the long term credit activity should be taken into account as well.

If necessary, a risk weight shall be taken into consideration especially for off balance risk such as guarantees given.

Leverage ratio should be an indicator which could help the local regulator to measure the risk management on a specific activity.

Section 4 Counterparty credit risk

A few institutions represented by ASF are concerned by the counterparty credit risk.

Section 5 Countercyclical measures

ASF welcomes the decision of the Commission which considers that the two counter-cyclical measures, through-the-cycle provisioning for expected losses and capital buffers may not be cumulative and as generally speaking, these measures shall be implemented gradually and during a favourable period activity.

Nevertheless, these countercyclical measures shall be settled if are considerated the QIS results and the capacity of the Industry especially for its specialised activities to resist to such a change without generating high impacts on the economy.

(Q38/39) However, it appears to us that the method comparing General provision for a given year with Expected losses could be an acceptable approach.

Besides, ASF considers as relevant to take into consideration mutual guarantee which constitutes a part of capital and covers credit risk much further than classic provisioning.

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As it makes sense that credit institutions have to fulfill their obligation related to capital requirement and through-the-cycle value adjustment, then ASF considers that it would be relevant as well to use regulatory capital and/or dynamic provisioning to face these requirements. This flexibility would stop any regulatory arbitration that may arise in that kind of situation. In fine, these two requirements take aim for ensuring provisions against credit risk.

Then, ASF's position is to avoid a double dynamic provisioning. If a credit institution is guarantor on a loan distributed by another credit institution, dynamic provisioning should not be required to both institutions.

Off balance sheet items may be included into calculation with particular risk weight as it is laid down in Basel II with the "CCF". Thus, the scope of this dynamic provisioning should correspond to through-the-cycle expected loss provisioning.
A fair competition between the different actors should also be required.

For example, regarding joint and several liability (credit secured by a guarantee) used by both bank and insurance activities, dynamic provisioning on sole credit institutions would create a distortion and give preferential treatment to the insurance companies that is irrelevant.

Calibration of the « capital buffers » level can not be the same for risk market activity than for real estate finance activity.

Section 6 systemically important financial institutions

We have no comment.

Section 7 Single rule book in banking

Once provisioning rules and countercyclical measures are defined in addition to Pilar I, then Pilar 2 has only justified for specific cases.

In a matter of residential finance, there is no interest to include in the Capital Requirement Directive the loan to income ratio (LTI) as this parameter is quite difficult to benchmark from a country to another due to different rules and tax policies. A « responsible lending » approach would be more convenient in that case.

Due to process in France, the concept of loan to value ratio (LTV) is irrelevant.

The use of lending value mortgage seems to be particularly hazardous in light of recent events.

Finally, we do not consider sustainable to ask for complementary provisions if dynamic provisioning has been set up.

Therefore, for these reasons, we do think extremely difficult to examine these proposals on an European level as the real estate cycle may differ from a country to another.

*Regarding residential real estate (Q49), which is a low risk, even under economic crisis circumstances, as it can be seen nowadays in France, current provisions of the Capital Requirement Directive n°2006/48/CE seem sufficient.

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ASF agrees with CEBS's conclusion[3] that does not incorporate the concern of procyclicality when assessing the prudence of the treatment of real-estate collateral.

*Regarding the provisions related to the commercial real estate (Q50), we do agree with the CEBS's observations[4] explaining that the CRE markets within the EU differ considerably and the institutions are required to monitor the values of the properties taken in as collateral and to adjust the value if the market is subject to a significant change in conditions.

Regarding the current situation in France, no significantly altered in a period of economic crisis, ASF proposes to keep the current drafting of the respective national discretions as national discretions allowing for differences in the local real estate markets, and to add a binding recognition clause.

Moreover, we should remind regarding the CRE lease that the ownership on whole property remains a very strong guarantee which continues to be totally efficient in France in case of bankruptcy proceedings.

(Q51)A harmonization of the two credit risk criteria which are loan to value ratio (LTV) and loan to income ratio (LTI) seems not to be relevant for French market (see above our comments on commercial real estate lease).

Besides, the preventive action of French institutions to control their default numbers will always be more acceptable than the solution which is to limit the expected losses thanks to a lower loan to value ratio or loan to income ratio (see on that point the survey of the Joint Forum's report dated December 2009 preferring the capacity of the borrower to reimburse).

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As a conclusion, ASF points out that these former observations are strictly submitted to the solution of current and future regulatory policy gap between the countries of the major economic area (and especially the USA).

Indeed, it could not be acceptable to create such rules in Europe if they would not be set up simultaneously in the USA.

Moreover, these measures must be implemented at a very reasonable pace regarding the huge impacts they could generate.

ASF- 16/04/10

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[3] Second Advice on Options and National Discretions dated on 10th June 2009

[4] Extract from CEBS's Second Advice: *"The provision to monitor the value of the property on a frequent basis should ensure a conservative valuation of real estate collateral. Therefore, even, in the event of a downturn of the real estate market in a given country, the requirement to monitor and revalue (if necessary) the property value ensures a prudential treatment of real estate collateral. It should be noted that proper revaluation of property values results in fulfilling the conditions for preferential treatment even under downturn conditions. Even where higher losses under downturn conditions, this does not necessarily increase the losses for the part of the exposure, which is recognised as fully and completely protected by real estate. If the value of a real estate property is adjusted for downturn conditions, the part considered as fully and completely secured by the real estate collateral will be appropriately reduced as well. Therefore, no increase of losses for this part of the exposure will occur. Higher losses for the unsecured part of the exposure under downturn conditions are assumed to be no concern with respect to credit risk mitigation by real estate collateral.*

In its assessment, the CEBS also discussed the issue of procyclicality as the value adjustment of real-estate property, which in downturn conditions leads to an increase in capital requirements- to the extend that the value of the collateral decreases, the part of the exposure that becomes uncovered and therefore receives a risk weight of 100% increases. The risk weight applied to the overall exposure therefore gets gradually closer to 100%.

The procyclical rise of capital requirements in a time when raising capital might be severely constrained is seen as negative effect of these discretions. However, fixing a risk weight of 100% (for all markets regardless of their development) doses not alleviate the situation in downturn and could be hampering factor in an economic upturn. The impact that deleting the discretions will have in "good" times should not be overlooked and assessed in particular with regard to real-estate collateral provided by small and medium sized companies".