"la Caixa"

Barcelona, 15th April 2010

Secretariat of the Basel Committee
On Banking Supervision
BANK FOR INTERNATIONAL SETTLEMENTS
CH-4002 BASEL
Switzerland

Dear Sirs,

Find herewith enclosed the "la Caixa" Group comments on the Consultative Documents "Strengthening the resilience of the banking sector" and "International framework for liquidity risk measurement, standards and monitoring".

Please do not hesitate to contact us should you require further clarification or amplification of any matter you consider appropriate.

Yours faithfully,

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”la Caixa” comments on the Basel Committee’s consultative documents entitled ‘Strengthening the resilience of the banking sector’ and ‘International framework for liquidity risk measurement, standards and monitoring’, issued on December 17th 2009

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1. General comments

On 17 December 2009 the Basel Committee on Banking Supervision (“the Committee”) published two consultative documents with a series of proposals to strengthen the resilience of the banking sector and manage liquidity risk (“the Proposals”) in response to the G20’s call to international supervisors to design a new regulatory framework to prevent the repeat of an international financial crisis.

The Committee has indicated in several communications that the crisis has highlighted the need to increase the quantity and quality of the capital of financial institutions and to raise liquidity requirements. So as not to hinder the economic recovery, the Committee has undertaken, on the one hand, to establish sufficiently long adaptation periods and, on the other, to introduce grandfathering clauses. The new regulatory framework is expected to come into force at the end of 2012.

The ”la Caixa” Group shares the Committee’s view that it is advisable to have in place a regulatory and supervisory framework at international level that ensures the robustness of the financial institutions and their survival in periods of stress. Also, it is necessary to provide the international financial system with sufficient mechanisms to stimulate the prudential management of the financial institutions and to discourage practices that might give rise to systemic risks.

In this connection, the ”la Caixa” Group considers that a profound reform of the regulation of the International Financial System (IFS) will be effective in so far as it encompasses four key elements:

- 1.Not only does the IFS need more regulation but also an **improved supervision**. In this regard, better regulation may be insufficient without the appropriate **strengthening of the supervisory process**, which constitutes a cornerstone of the IFS architecture.

- 2.The new regulatory framework should affect financial activity as a whole; however, at the same time, it should be sufficiently flexible to deal adequately with the **diversity of financial business models** and, therefore, the various **risk profiles** associated with these models. In this regard, the proposed treatment of minority interests (see section 3.1.2) and of investments in banking entities (see section 3.1.3) is seriously may endanger the gradual international expansion through minority investments or joint ventures. Moreover, the proposed liquidity ratios (see section 3.2) penalise the traditional banking business model with retail-customer-based funding.

- 3. The capital required should be proportional to the risk assumed. The treatment of minority interests (see section 3.1.2) and of investments in insurance entities (see section 3.1.4) would not seem to respect this principle. The Leverage Ratio is not aligned with the risk profile, either (see section 3.1.7).

- 4. In any case, a reform of the magnitude envisaged in the consultative documents should only be undertaken after a detailed assessment of its **potential impact** both on the IFS and on the economy as a whole (see section 4). Also, **sufficiently long adaptation periods** and the necessary grandfathering **clauses** should be provided for in order to avoid a drastic reduction in the supply of credit to the economy as a whole by the IFS in the current climate of economic uncertainty.

”la Caixa” wishes to emphasize that the Consultative Documents show many uncertainties. Moreover, the **QIS exercise** which is currently being worked out suggests that there may be **differing ways to implement the Proposals**.

”la Caixa” considers that the Proposals, in their current wording, could pose a threat to the sustainability of its retail banking business model, with high solvency and excellent liquidity, which for more than a century has shown its capacity to overcome the most difficult climates (see section 2 for a review of the ”la Caixa” Group highlights).

Clearly, due process needs to be observed and a new consultation round once the Proposals have been reshaped seems to be inevitable. ”la Caixa” wishes to encourage the Committee to clarify in the meantime the way it intends to organize its further work and, particularly, about the proposed timelines.

This document contains the improvements which ”la Caixa” considers should be incorporated in the Committee’s Proposals in order to achieve the necessary strengthening of the financial system without detriment to the operating capacity of banks such as ”la Caixa”, whose business model, capital adequacy and liquidity have never been questioned throughout its history.

2. The ”la Caixa” Group

The ”la Caixa” Group is the third-largest financial group in Spain and the largest savings bank in Europe as a result of its sustained growth and expansion strategy. ”la Caixa” is a benchmark bank in terms of household and business banking, with a customer base of 10.5 million managed through sound segmenting and a multi-channel strategy. The ”la Caixa” Group has the largest branch network in the Spanish financial system (5,236 branches) and 27,505 employees, and its market shares in the various products and services are around 10%. Also, ”la Caixa” stands out because of its leadership in multi-channel management, as illustrated by the largest ATM network in Spain and its leadership in on-line and mobile telephone banking and in payment systems.

In 2009 this strong positioning enabled the ”la Caixa” Group to achieve a business volume (loans granted plus managed customer funds) of EUR 415.8 billion and an attributable net profit of EUR 1.5 billion, and to consolidate its financial strengths in terms of capital adequacy (core capital EUR 13.7 billion, ratio 8.7%, according to the Basel II Framework) and liquidity (EUR 21.2 billion, i.e. 7.8% of total assets). The ”la Caixa” Group business model and financial strengths that have just been summarised **have awarded ratings within the AA range from the three rating agencies**.

The most significant ”la Caixa” Group data for 2009 and 2008 are as follows:

“la Caixa” Group highlights

Financial Information

Figures in millions of euros	2009	2008	Change Amount	Change %
Total assets	271,873	260,827	11,046	4.2
Total Banking Business volume	415,825	414,123	1,702	0.4
Loans and credits, gross	178,026	176,423	1,603	0.9
Total customer funds	237,799	237,700	99	0.0
Recurring profit attributable to the “la Caixa” Group	1,710	2,052	(342)	(16.7)
Net extraordinary profit	(200)	(250)	50	
Profit attributable to the “la Caixa” Group	1,510	1,802	(292)	(16.2)
Recurring efficiency ratio	42.9%	45.2%	(2.3)	
Return on Equity (Recurring attributable profit / Average own funds)	11.3%	14.8%	(3.5)	
NPL ratio	3.42%	2.48%	0.94	
NPL coverage ratio	62%	66%	(4)	
“la Caixa” liquidity	21,208	22,262	(1,054)	(4.7)
Core capital	8.7%	8.8%	(0.1)	
Capital ratio (BIS II ratio)	11.0%	11.0%	0.0	

In parallel to the expansion of the banking business, the ”la Caixa” Group has created a considerable portfolio of strategic holdings in financial and industrial companies with a significant presence in their respective markets. This portfolio enables the Group to diversify risk and income and generate value and recurring profitability, and it has boosted the growth, development and profitability of the investees. The market value of the listed holdings of the ”la Caixa” Group at 31 December 2009 totalled EUR 20.1 billion, giving rise to unrealised gains of EUR 3.9 billion.

The ”la Caixa” Group manages its holdings portfolio through Criteria CaixaCorp, S.A., an entity which is listed on the IBEX 35 and in which the Group held a 79.45% ownership

interest at 31 December 2009. This company is responsible for the implementation of the ”la Caixa” Group’s investment strategy and international banking expansion. Financial interests (in banking and insurance entities) account for approximately 33% of the market value of the portfolio managed through Criteria CaixaCorp, S.A.

As regards its international banking expansion strategy, the Group has opted for a model based on forging strategic alliances with local partners with which it shares a common vision and developing joint initiatives. The investment profile focuses on well-managed banks with strong competitive positions, and the investments are materialised through ownership interests with significant influence, a presence on governing bodies and the transfer of the ”la Caixa” Group’s expertise as and when appropriate. This investment strategy, in comparison with the acquisition of controlling interests, involves the obtainment of synergies in the long term; however, it involves lower risk and avoids the payment of control premiums. Also, the ”la Caixa” Group’s portfolio includes ownership interests in listed Spanish companies that are leaders in their respective markets, have a strong international presence and operate in non-cyclical sectors such as infrastructure, energy and services.

3. Comments on the consultative documents issued on 17 December 2009

This document includes the ”la Caixa” Group’s comments on the two series of Proposals published by the Committee on 17 December 2009, namely:

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

3.1. “Strengthening the resilience of the banking sector”

The comments made by ”la Caixa” in this document refer basically to chapter 1 “Raising the quality, consistency and transparency of the capital base”, given the potentially unfavourable impacts for the sector of the literal application of the proposed regulatory changes simultaneously.

The ”la Caixa” Group has identified six essential matters requiring in-depth analysis:

- Deferred tax assets
- Minority interests
- Minority investments in banking entities
- Investments of more than 10% in insurance entities
- Shortfalls of the stock of provisions for expected losses
- Weighting applicable to significant investments in commercial entities.

In each case, the basis supporting the Proposal per the Consultative Document is stated and then discussed, indicating possible weaknesses and areas for improvement.

Certain considerations relating to chapter 3 “Leverage Ratio” are also included.

3.1.1. Deduction of deferred tax assets (net of liabilities) (DTA)

3.1.1.1. Basis of the Proposal

The Committee distinguishes between two types of deferred tax assets:

- Tax prepayments arising from regulations established in national tax law. Such assets should simply be assigned the relevant sovereign risk weighting (paragraph 98).
- Deferred tax assets arising from losses incurred by the bank. In this case, it is proposed that the amount of these assets be deducted from the Common Equity component of Tier 1, net of any possible tax liabilities, as they may provide no protection to depositors in a period of stress (paragraph 99).

3.1.1.2. Comments

European banks are subject to application of International Financial Reporting Standards (IFRSs), which **establish strict criteria for the recognition of all assets** and lay down procedures for the periodic evaluation of the possible impairment thereof. In general, banks should not be required to deduct from their equity items recognised in assets under current accounting regulations. If circumstances were to arise that cast doubt on the valuation of such assets, the accounting standards envisage that they will be written down with a charge to the bank’s equity and, consequently, will be deducted from the Common Equity component of Tier 1.

In particular, special attention must be paid to tax assets recognised by Spanish banks arising from the **recognition of countercyclical provisions and provisions to pension funds for their employees**. Such provisions and funds, charged to profit and loss, are in fact an additional guarantee mechanism for depositors. Consequently, deducting from the Common Equity component of Tier 1 the tax assets relating to these provisions would in fact penalise banks managed in a prudent conservative manner compared to those using less strict accounting principles. In particular, the proposed measure would not provide an incentive to recognise countercyclical provisions but would, in this case, **be clearly procyclical**.

3.1.2. Ineligibility of minority interests for inclusion in the Common Equity component of Tier 1 capital

3.1.2.1. Basis of the Proposal

The Committee uses two main arguments as the basis of the proposal. On the one hand, it considers that there is uncertainty regarding minority interests’ effective ability to meet possible losses that the bank might incur. On the other hand, it indicates that the funds contributed by the minority interests of a certain group company are not available to cover losses at the parent or at any other group entity.

The Committee wishes to avoid regulatory arbitrage (the generation of capital by incorporating group entities with minority interests and limited risk exposure) to back the capital requirements of the parent or other group entities.

3.1.2.2. Comments

We agree with the Committee that the use of capital provided by minority interests of a subsidiary to cover risks assumed by the parent or another

group entity must be avoided. However, we also consider that **asymmetric treatment**, under which the group is required to cover the capital requirements of all the risks assumed by the affiliate without being able to include the funds contributed by the minority interests, **must also be avoided**.

In this regard, the proposal should establish that **the eligibility of the minority interests arising from and affiliate must be in sufficient proportion to the amount of capital required to risks such affiliate bears**. Specifically, minority interests exceeding a certain threshold over the affiliate’s minimum capital requirements should not be included in eligible capital, provided that the surplus is significant in relation to the total amount of the Common Equity component of Tier 1.

It must be stated that the aforementioned surplus should be calculated after deducting from the minority interests the amount of any deductions (goodwill, minority investments in banking/insurance entities, etc.) attributable thereto.

In Circular 3/2008, the Bank of Spain has in place a limit on the eligibility of minority interests, which could be included in international regulations. Firstly, only banking and special purpose subsidiaries, with minority interests representing a significant volume of the group’s assets (> 1%) are taken into account. Secondly, the proportion of the use of capital attributable to minority interests is calculated, and increased by 25%, since it is considered that, in general, banks operate with capital margins above the regulatory minimum. The calculation of the use of attributable capital also includes the regulatory deductions (goodwill, deductions for investments of more than 10% or 20% in banking/insurance entities, etc.). Lastly, the amount of the minority interests contributed by the affiliate is compared with the use of capital attributable to minority interests. The positive difference (surplus of minority interests over the use of capital) is deducted from Tier 1 only when it reaches an amount considered significant (the surplus is more than 10% of Tier 1).

Mention must also be made of the importance of minority interests as **suppliers of capital and management know-how**. The proposal will adversely affect holdings of less than 100% in affiliates, i.e. with minority interests that contribute capital and their experience of the markets in which the affiliate operates. Strict limitations on the eligibility of minority interests would encourage them to disappear and may eventually give rise to a reduction in the available capital in the banking sector as a whole. **They would also hamper international expansion** in countries that restrict foreign investment in their financial institutions.

3.1.3. Deduction of minority investments (> 10% and < 50%) in banks from the Common Equity component of Tier 1 capital

3.1.3.1. Basis of the Proposal

Since the first Basel Capital Accord (1988), regulators have wanted to avoid the fictitious creation of capital in the banking sector (double gearing) by establishing consolidated supervision of banks and deduction mechanisms when the consolidation of an investment is not possible. Accordingly, in addition to the goodwill attributable to the investment, the rest of the investment was deducted from the capital base of the investor bank. The Basel II Framework (2004) introduced an additional requirement, explicitly determining that the aforementioned deduction would be 50% from Tier 1 and 50% from Tier 2 capital. Now the Committee is proposing that the full amount of the deduction be made from the Common Equity component of Tier 1 capital, in order to avoid a loss incurred by the affiliate spreading immediately to the capital of the holding company. This would reduce procyclicality and systemic risk.

3.1.3.2. Comments

The elimination of double gearing is a reasonable objective that regulators have considered from the beginning. The mechanism currently in use – deduction of investments exceeding 10%, net of goodwill - has the advantage of simplicity and a reasonable cost, since it is applied on a 50:50 basis to Tier 1 and Tier 2 capital. However, the Proposal significantly increases the requirements in relation to the current framework, and in this case the procedure needs to be made more sophisticated to avoid undesirable effects. Thus, if the intention is to avoid losses spreading through the system, **the minimum capital requirement of the risk profile of the affiliate should be taken as the reference, rather than the total investment**. Not taking this approach is equivalent to penalising investments in well managed and capitalised banks with a low risk profile, since it puts them on the same level, with regard to the use of capital, as investments in companies with higher risk profiles that are probably more profitable in the short term. Similarly, investment in lowly capitalised banks or a reduction in shareholders’ equity at investees would be encouraged, thereby obtaining the opposite of the desired effect.

It must be stated that current regulations already have in place a powerful mechanism to avoid double gearing to a considerable extent, since it requires the goodwill associated with the acquisition of an investment to be deducted from the Common Equity component of Tier 1.

Also, the proposal provides an incentive for the acquisition of majority investments. If this is added to the elimination of the eligibility of minority interests, the proposal, as a whole, would encourage the acquisition of 100% investments. **This may, in fact, give rise to the elimination of capital from the system** and, consequently, also produce the opposite of the desired effect.

Thirdly, the higher cost, in capital terms, of the Proposal makes **gradual international expansion through purchases of minority interests more difficult**. In particular, it places considerable limits on international expansion strategies based on strategic alliances with local partners sharing a common vision, which act as a very effective channel for providing capital and management know-how to emerging markets that restrict foreign investment in their financial institutions.

Consequently, it seems reasonable to include certain variations in the proposal. Firstly, the nature of the **investee** should be determined and more favourable treatment given to business models based on strategic investments with **significant influence** and a long-term time horizon, under due Supervisory review process, than to those based on speculative financial investments.

Secondly, **the positive effects inherent to a diversified portfolio** of international minority investments should also be taken into account.

Thirdly, since the objective of the Proposal is to prevent losses spreading through the system, **the deduction should be calculated in accordance with the risk profile of the investee**. Since the investee’s capital requirements are covered by capital with various levels of quality, the deduction at the holding company should also be applied to the various capital tiers.

A possible alternative to this last treatment would be to establish a threshold above which the amount of minority investment is considered to be significant.

3.1.4. Deduction of investments of > 10% in insurance entities from the Common Equity component of Tier 1 capital

3.1.4.1. Basis of the Proposal

The application of the deduction for investments in insurance entities exceeding a certain threshold is relatively recent in international regulations. It was introduced by the Basel II Framework of 2004, since it

was considered to be the best possible approximation to the quantification of the risks arising from the insurance business (Basel II, paragraph 30). The Basel II Framework establishes that the amount of the deduction will be equally distributed between Tier 1 and Tier 2 capital.

Basel II also permits the portion of the investment exceeding the insurance entity’s minimum capital adequacy requirements not to be deducted.

The proposal toughens the treatment of these investments, since the deduction is applied in full to the Common Equity component of Tier 1 capital for an amount equal to the value of the investment. Thus minority interests in banking entities would be on an equal footing, in terms of the use of capital, with (minority or majority) interests in insurance entities, because in both cases double gearing must be eliminated and procyclicality and systemic risk reduced.

3.1.4.2. Comments

It does not seem reasonable to establish parallel treatment for use of capital for situations with highly different causes. While the deduction of minority investments in banks (>10%) is based on double gearing, the reasoning behind the deduction of insurance investments is the difficulty of correctly quantifying incurred risk. **Accordingly, the treatment applied to minority (> 10%) or controlling insurance investments seems disproportionate** and does not take into account the **diversification benefits** of the insurance business. In particular, it **jeopardises the ‘bancassurance’ business model**, i.e., the distribution through the banking network of insurance products issued by insurance subsidiaries (investments of >51% or 100%).

The Basel II Framework recognises the difficulties inherent to the valuation of certain risks assumed by banks, such as interest rate risk in the banking book and reputational risk. In these cases, the regulations do not identify an explicit capital charge in Pillar 1 but rather transfer the responsibility for valuing the risks to banks as part of the supervisory review process (Pillar 2). Accordingly, the treatment of insurance risk in Pillar 1, with respect to other risks, is a scarcely justified exception. From this standpoint, it would seem reasonable to exclude the risk inherent to the insurance business from Pillar 1 so that it can be assessed internally by banks in the context of Pillar 2.

However, if it is preferred to continue to treat these investments as a deduction, in general, the deduction should be limited to **the amount of the minimum capital requirement under insurance-specific legislation**. The

establishment of a higher requirement than this minimum would, in fact, represent a disavowal of insurance legislation. Conversely, limiting the deduction to the minimum capital amount required of insurance entities (solvency margin) would avoid giving an unwanted incentive to reduce the level of capitalisation of insurance affiliates or worsen the quality of their equity by encouraging them to meet their solvency requirements using hybrid instruments.

Also, it should be borne in mind that the minimum capital requirements for insurance companies can be covered with equity of varying quality. Consequently, the application of the deduction to the Common Equity component of Tier 1 should be confined to the minimum capital requirements that must, under insurance regulations, be covered with core capital. At present, this amount is known as the "guarantee fund" and is equal to one-third of the solvency requirement.

Thus, the **current treatment** established by the Basel II Framework whereby the capital adequacy ratio is deducted 50% from Tier 1 and 50% from Tier 2 capital **seems to be sufficiently conservative** and is in line with the capital adequacy regulations in force for the insurance industry.

Lastly, in the European Union, financial conglomerates enjoy specific capital adequacy regulations that probably render a specific capital charge for insurance risk in Pillar 1 unnecessary.

3.1.5. Deduction from the Common Equity component of Tier 1 capital of the shortfall of the stock of provisions to expected losses (EL) per IRB approaches

3.1.5.1. Basis of the Proposal

The IRB approaches for the calculation of minimum capital requirements were introduced by the Basel II Framework. Since then, the expected loss (EL) on the loan portfolio has been an essential aggregate in the management of financial institutions. Basel II also established a link between the stock of provisions recognised by a bank and the level of its expected loss. Accordingly, 50% of the shortfall of the stock of provisions to expected losses (EL) is deducted from Tier 1 capital and 50% from Tier 2.

The purpose of the Proposal is to avoid providing an incentive for regulatory arbitrage. On the one hand, banks would tend to recognise a lower stock of provisions to limit the recognition of losses, and, thus, present a higher level of Core Tier 1 capital than they actually had. On the other, 50% of the shortfall with respect to the expected loss would be

recognised in Tier 2 capital. Accordingly, banks would generate Core Tier 1 capital from Tier 2 capital.

Additionally, the proposal attempts to make progress in reducing the procyclicality of the current capital regulatory framework by providing an incentive for the recognition of provisions based on expected loss throughout the life of a portfolio.

3.1.5.2. Comments

The proposal seems to implicitly assume that banks can tie their stock of provisions to the expected losses on their portfolio. However, the accounting standards in force in the European Union associate the recognition of impairment with an incurred loss. Also, in certain jurisdictions, there are factors in tax regulations that also affect the recognition of provisions. Consequently, the divergences between the provisions recognised and the expected loss do not generally relate to regulatory arbitrage.

Paragraph 35 of the Proposal also points out that the Committee of Banking Supervisors supports the initiative of the International Accounting Standards Board (IASB) to move the accounting recognition of impairment to an EL approach. Thus it can be observed that **there is no appropriate accounting regulatory model** that links the recognition of impairment and the level of risk associated with a portfolio.

Furthermore, **there is still no commonly accepted methodology** for determining the expected loss throughout the life of a portfolio.

Progress must be made towards an integrated treatment of procyclicality that includes both accounting impairment recognition procedures based on expected loss and the definition of capital buffers. However, in the current situation, the Proposal seems premature and might exacerbate the high level of procyclicality of the legislation currently in force.

3.1.6. Application of a 1,250% risk weighting to remaining significant investments in commercial entities

3.1.6.1. Basis of the Proposal

In paragraph 108, the Committee argues that replacing the deduction of remaining significant investments in commercial entities with the application of a use of capital of 100% (1,250% risk weighting) simplifies the definition of capital and facilitates the application of limits to the various tiers of capital.

3.1.6.2. Comments

The proposed change to simplify the definition of capital has an indirect effect on banks’ capital adequacy ratios. The replacement of the deduction applied to date to Tier 2 capital with an asset with a risk weighting of 1250% increases the risk-weighted asset base. Consequently, banks’ Core Tier 1 capital ratio is reduced and, therefore, the proposal in fact **adds an additional charge to Core Tier 1 capital requirements**.

Thus, **certain equity investments** which, in general, have high levels of use of capital, **are unjustifiably penalised**.

Accordingly, it would seem reasonable to establish capital requirements for the significant investments that are in line with the risk associated therewith, measured using the VaR or PD/LGD models envisaged in current legislation.

3.1.7. Leverage ratio

3.1.7.1. Basis of the Proposal

The Committee has proposed the establishment of a leverage ratio, based on accounting exposures, to be an additional safeguard to the minimum capital ratio required by capital adequacy regulations.

The purpose of the leverage ratio would be to limit the level of borrowing assumed by financial institutions.

3.1.7.2. Comments

The introduction of a simple ratio that does not take into account banks’ risk profiles **is a backward step** in relation to the regulatory framework for

capital adequacy established by the Basel II Framework. Thus, a paradoxical situation may arise in which banks with similar risk profiles and, consequently, similar capital adequacy ratios, have disparate leverage ratios. Therefore, it does not seem reasonable to include the leverage ratio in the requirements envisaged by Pillar 1.

The relative simplicity of the calculation of the leverage ratio is also its greatest weakness. Thus, it does not seem advisable to publish the ratio since it could give rise to erroneous interpretations by the market of banks’ comparative positions.

Conversely, it would be reasonable to **include this measure** in the scope of Pillar 2, i.e. in **the supervisory review process**. In particular, banks should monitor changes in their borrowing levels over a given time horizon and check them with the Supervisor and, thus, the variable being monitored would not be the ratio itself but the changes therein.

In summary, it does not seem appropriate to establish a minimum ratio such as Tier 1 capital / total assets > x%, **since different business models give rise to different leverage ratios**. Conversely, it would be preferable to monitor the changes in the ratio at each individual bank.

3.2. International framework for liquidity risk measurement, standards and monitoring

General view

In our opinion, the new requirements are based on a given banking model and are not taking into consideration the characteristics of traditional banking, in particular retail banking. This business model is based on a strong relationship with customers through cross-selling, as evidenced by the significant stable retail funding base of these banks, which do not need to resort excessively to the capital/wholesale markets.

Furthermore, the proposed ratios show a lack of consistency between the definition of liquid assets and the severity of the stresses applied. For example, in the short-term liquidity coverage ratio (LCR), a combined systemic and reputational stress is being used, however the definition of liquid assets that enable banks to deal with this stress is very narrow and does not take into account the capacity of banks to monetise their balance sheets in such extreme circumstances. Also, the aim of the net stable funding ratio (NSFR) is to promote the medium and long-term funding of the assets and activities of financial institutions. We consider this objective as a desirable management policy that should be pursued. However, the way in which this ratio has been defined produces results that are inconsistent with its goal, due to the fact that it penalises traditional banks with a retail-customer funding base and ignores the role

they play in financial intermediation and in the transformation of maturities among the various players in the economy.

In short, these ratios have a negative impact on the traditional banking model. Its implementation could result in higher spreads for loans and in a lessening of the capacity of the economy as a whole to generate wealth.

3.2.1. Liquidity Coverage Ratio (LCR)

3.2.1.1. Description

The regulator establishes a short-term liquidity coverage ratio that is defined as the quotient of the balance of high-quality liquid assets and the net cash outflows over a 30-day time period in a crisis environment.

The aim of this ratio, which must be greater than 100%, is to ensure that banks maintain an adequate level of unencumbered high-quality assets that can be converted into cash to cover their liquidity needs for a 30-day time horizon, under an acute stress scenario that considers a combined financial-system and reputational crisis.

$$LCR = \frac{\textbf{Stock of high-quality liquid assets}}{\textbf{Net cash outflows over a 30-day time period}} \geq 100\%$$

3.2.1.2. General view

From a conceptual standpoint, there is a lack of consistency between the narrow definition of liquid assets and the severity of the stress scenario. In such an acute stress scenario, banks would use all the available instruments to convert them into cash.

3.2.1.3. Definition of the numerator: Stock of high-quality liquid assets

The proposal only includes the following assets as high-quality liquid assets: cash, central bank reserves and government debt issues. The Basel Committee is considering the inclusion of corporate bonds and covered bonds which meet a series of requirements confirming their high quality.

3.2.1.4. <u>**Comment on the narrow definition of high-quality liquid assets**</u>

With regard to the definition of liquid assets, we consider it appropriate to make the following remarks/proposals:

- Inclusion of the undrawn amounts of credit facilities at central banks. These represent a liquidity buffer for this kind of crisis. They are immediately available and they avoid the forced sales of assets. Although we agree that banks should not rely on these credit facilities on a daily basis management of their business, it is also true that their usefulness in times of crisis is beyond doubt. Provided the supervisor verifies that the entity is not relying on them on a daily basis management, it would be rather convenient to account ECB credit facilities as a high liquid asset.

  In any case, it must be avoided the use of the ECB credit facilities to finance the purchase of liquid assets ratio wich artificially improves the LCR.

- Inclusion of guaranteed debt issued by financial institutions, as well as covered bonds and corporate bonds. These instruments have demonstrated their liquidity during the crisis and their exclusion could trigger extremely adverse consequences for these important markets. Securitisations that meet the ECB requirements should also be included.

- Inclusion of listed equity securities. The stock market has demonstrated its liquidity in this crisis.

3.2.1.5. <u>**Definition of the denominator: Net cash outflows over a 30-day time period**</u>

The scenario proposed by the regulator combines a reputational crisis with a financial system-wide crisis, resulting in a series of high-severity shocks.

3.2.1.6. <u>**Comment on the severity of the proposed scenario**</u>

We would like to make the following remarks/proposals in relation to the stress scenarios:

<u>- SME/wholesale segmentation.</u>

<u>**The Proposal**</u> establishes run-off rates of 7.5-15% for SME customers (depending on whether or not they are covered by a deposit insurance scheme) and of 25-75% for non-financial wholesale entities (depending on whether or not the deposits are used for operational purposes).

Comment: Introduction of a more detailed segmentation to better reflect the various types of customers regarding to the stability of their deposits.

- Deposit run-off rates.

The Proposal establishes run-off rates of 7.5-15% (depending on whether or not the deposits are covered by a deposit insurance scheme).

Comment: The run-off rates are excessive. Balances of demand deposits are considered to have the same stability as those of time deposits. It must be recognized in some way the effect on depositor’s behaviour of their theoretic commitment to maintain their savings for a longer time although the penalty does not exceed the interest received.

In addition, the deposit insurance scheme should have greater importance as a stability factor, as has been observed in the crisis.

- Intra-group transactions

The Proposal does not establish a different run-off rate for intra-group transactions, and the rate to be applied to affiliates is based on the type of company concerned (for example, a rate of 100% for financial companies).

Comment: Run-off rates of 100% are considered without taking into account the control of the parent company. These funds should be considered to have greater stability, given that their behaviour in crisis is more stable for the entity, since it is not influenced by market rumours but merely by regulatory investment limits.

- Contingent liabilities.

The Proposal establishes outflows, in all undrawn credit and liquidity facilities, of 10% for retail customers, for credit facilities extended to non-financial entities, and 100% for all other customers, leaving the supervisor to decide upon the rate to be applied to guarantees, letters of credit and revocable credit and liquidity facilities.

Comment:
a. Guarantees. The amounts recognised for these contingent outflows in the off-balance-sheet accounts of banks very often do not adequately reflect the risk of potential cash outflows. Therefore, we propose that these balance positions be adapted to reflect the items representing a real risk of an outflow of funds.

b. Undrawn position of credit facilities. Despite their irrevocable nature, in certain cases these facilities are subject to the achievement of certain

milestones, which will determine the period within which the balances will be drawn down.

It should be possible to separate the drawable amounts associated with transactions related to certain milestones and whose impact does not depend on any scenario, from other drawable amounts whose impact could be associated with a specific scenario.

In addition, in times of crisis companies reduce its funding requirements due to the contraction of business. Therefore, it does not seem reasonable to consider outflows of funds for credit facilities or, in any case, they should not be of such magnitude.

3.2.2. Net Stable Funding Ratio (NSFR)

3.2.2.1. Description

The Proposal establishes a medium and long-term liquidity ratio, the NSFR. This ratio is defined as the quotient of available stable funding (ASF) and required stable funding (RSF) over a one-year horizon.

It is considered that if this ratio is greater than 100%, the medium and long-term funding of the financial activities of a bank is based on long-term funds. At the same time, the ratio aims to avoid (although it does not achieve this goal) the over-reliance of banks on funding from capital markets.

$$\text{NSFR} = \frac{\textbf{Available amount of stable funding}}{\textbf{Required amount of stable funding}} > \textbf{100\%}$$

3.2.2.2. General view

The aim of promoting medium and long-term funding of the assets and activities of financial institutions is a desirable management policy that should be pursued. However, the way in which this ratio has been defined produces results that are inconsistent with its goal, since it penalises traditional banks and ignores the role they play in financial intermediation among the various players in the economy.

In addition we have to bear in mind that financial institutions transform maturities between financing and investment flows in the economy. Traditionally, retail banking customers have preferred to have available

funds to be able to meet their payment obligations, and have held significant amounts in demand accounts or on short-term deposit. On the other hand, the economy in general, businesses and individuals require long-term financing to undertake their investment, home buying and consumer projects. As this ratio is instrumented, it seems arbitrary to define 1 year as being the relevant period for measuring the possible imbalance between funding and investment. The way this ratio has been defined, although appropriate from a conceptual standpoint, encourages the banking system to perform the function of a mere intermediary. In such a case the market would therefore take on the function of transforming maturities. However, it would seem reasonable for such an important role for society and the real economy to be performed preferably by entities subject to ongoing supervision and strict capital adequacy and liquidity requirements and also equipped with control mechanisms, such as liquidity ratios, and anti-crisis instruments such as the ECB credit facility.

In general terms, if the intermediation role played by banks is accepted, a certain mismatch inherent to the maturity transformation process is inevitable. As a result, it seems contradictory to establish a minimum level of 100% for the NSFR. What would be logical would be to establish a level under 100% adapted to the particular characteristics of each market.

3.2.2.3. Definition of the numerator: Available Amount of Stable Funding (ASF)

The regulator includes as stable funding sources 100% of wholesale balances maturing in more than one year (wholesale customers, interbank, issuances) and 85%-70% of retail balances without taking into account the contractual maturity (no distinction is made between current accounts and time deposits maturing in more than one year). All other balances with residual maturities of less than one year are not deemed to be stable and are assigned a 0% factor in calculating the numerator.

3.2.2.4. Comments on the restrictive definition of liabilities deemed to be stable

- Penalisation of retail funding vis-à-vis wholesale funding.

The Proposal assigns a weighting of 100% to wholesale funding sources maturing at more than one year, gives a weighting of 85%-70% to retail funding sources irrespective of their maturity and a weighting of 50% to wholesale funding at less than one year.

Comment: Retail funding is penalised in comparision to wholesale funding, because, in general, most wholesale funding has a maturity of

more than one year (according to data from Bloomberg, for Spanish banks, wholesale maturities of less than one year are only 12.5% of total maturities).

Retail banks are also affected due to the insufficient customer segmentation and the high run-off rates applied to retail accounts. As to retail funding, different standards should be considered based on the particular country or business model (based on the relationship with customers), and the own internal models should also be considered. Under the current definition it arises the contradiction that banks that rely heavily on the capital markets obtain a better ratio, because most of its funding has a maturity of more than one year. However, reality has shown the danger of relying only in this kind of funding.

- Penalisation of intra-group balances

The Proposal assigns a weighting of 0% to funding sources maturing in less than one year and does not contemplate a different treatment for intra-group transactions.

Comment: Intra-group balances are penalised under this ratio because they mostly mature at less than one year. However, these balances are very stable and we consider that higher stability factors should be applied to them. We propose a 50% stability factor for such balances in line with the weighting assigned to wholesale funding.

- Excessive penalisation of retail funding with respect to the LCR

The Proposal assigns a weighting of 85%-70% to retail funding sources. This means applying run-off rates to retail balances (15%-30%) that are twice those applied to run-off rates applied in the LCR denominator (currently 7.5% -15%).

Comment: It seems excessive to double the cash outflows in a structural ratio such as the NSFR compared to the outflows considered in a short-term ratio such as the LCR although the stress time horizons are annual and monthly, respectively. Experience has shown that in this type of crisis the impacts occur immediately or in the very short term.

3.2.2.5. Definition of the denominator: Required Amount of Stable Funding (RSF)

The Proposal considers as assets to be refinanced in the medium or long term 100% of retail and wholesale loans maturing at more than one year, **85% of retail loans maturing in less than one year, 50% of wholesale loans**

maturing in less than one year and 100% of financial assets maturing at more than one year. All the other financial assets maturing in less than one year are assigned an RSF factor of 0% and, therefore, it is considered that they do not need to be refinanced.

- Does not contemplate the monetisation capacity of mortgage loans.

The Proposal assigns a weighting of 100% to long-term loans.

Comment: Long-term loans, which basically comprise mortgage loans, should contemplate the possibility that banks have to monetise these assets through securitisations or portfolio sales, in particular considering a one-year time horizon. A minimum of 50% of such securitisable assets could be taken into consideration.

- Does not contemplate the ability of banks to modify their business plans/models.

Proposal: Under a one-year stress scenario, measures to modify the commercial strategy of banks focusing on their main activities are not taken into account.

Comment: Within a one-year time horizon banks can modify their loan renewal and business growth policies to adapt them to their capacity to generate liquidity. If it is necessary, a bank could decide not to refinance any loans maturing in less than one year and, therefore, the 85% and 50% factors applied could be much lower.

- Does not contemplate the monetisation capacity of high-quality assets.

Regulator: It assigns a weighting of 100% to financial assets maturing at more than one year (including securitisations contributed to the credit facility of the ECB) and considers that these assets must be refinanced.

Comment: Eligible securitisations for the ECB credit facility should be considered to be liquid assets since they can be converted into cash immediately. Consequently, we consider that the underlying loans of those securitisations should not be treated in the same way as the rest of the loan portfolio. The amount for which securitisations could be monetised under the ECB credit facility should be subtracted from those loans.

4. Potential effects of the Proposals on the financial sector and the real economy

In addition to the specific comments made on certain of the proposed regulatory changes, it is very important to bear in mind **the combined effect of the Proposals on the structure of the financial sector and the real economy**.

Of particular significance with regard to the **impact on the structure of the financial sector** is the combination of the reclassification of minority interests from the equity component of core capital to other Tier 1 capital and the deduction from core capital of minority investments in banking affiliates. Within this framework, joint investments with banking partners would be **too costly in terms of capital**, and in practice this would lead to a **substantial reduction in cooperation, diversification and international integration**. The same effect would be produced by the deduction from core capital of the total investment in insurance entities, including controlled affiliates (more than 51% owned), which would **discourage diversification** in related businesses. The result would be a much narrower, less diversified and less international financial system and, as a whole, a much lower level of capitalisation in terms of both quantity and quality.

Furthermore, the various proposals that are particularly detrimental to the traditional banking business (households banking) are of critical importance. The proposed regulatory framework does not introduce the necessary differentiation between banks with different business models; the parameters used to calculate the liquidity ratios, for example, do not allow a distinction to be made **between customer-focused retail banks** and other banks with a more transaction or product-based approach, the latter being more prone to deposit run-offs in times of crisis. Moreover, the introduction of a **leverage ratio** that is not weighted (neither by type of risk nor collateral) is more **detrimental** to banks **whose main business is to extend credit with substantial guarantees (mortgages)** than to those which grant financing without collateral (consumer credit, working capital financing, etc.). Paradoxically, it would seem that precisely those banks which emerged unscathed from the latest financial crisis are going to be the ones most adversely affected by the current Proposal for regulatory reform.

It is of paramount importance, in order to avoid any undesired consequences, that these effects on the structure of the financial sector be analysed and assessed in the greatest possible depth, with maximum rigour and using the required time frame.

Alongside these effects on the structure of the financial sector, a careful appraisal must be made of the global impact of the proposed measures on the real economy. Although the Committee has not yet revealed the new levels of capital requirements, it can already be ventured that the proposals regarding adjustments to the quality of capital will entail a significant need to recapitalise the system. If to this we add the introduction of liquidity

and leverage ratios, the adverse impact on the profitability of financial institutions will be considerable (lower ROE due to increased capital and more expensive funding). The outcome will be a **much more expensive and narrower banking channel**, in which SMEs and individuals (mortgages and consumer credit) will be the hardest hit customer groups, leading to a reduction in the capacity of the economy as a whole to generate wealth. This is **particularly significant in Europe**, where the importance of the banking channel in funding the real economy comparably high.

Additionally to avoiding these adverse effects in the medium to long term, the **implementation date and the short-term transition periods are fundamental**. The increase in capital requirements and stable funding is being proposed in a period of uncertainty regarding the macroeconomic landscape in which the sector has less capacity to generate recurring profits. There is a high risk of a shortage of capital and financing if the new requirements are introduced abruptly and prematurely. The resulting credit restrictions would have a major impact on the potential for economic growth.

As an example, **internal estimates for the Spanish financial system**[1] indicate that compliance with the new regulations will only be achieved through a certain degree of credit restriction after exhausting other adjustment mechanisms.

In the most favourable scenario, we assume that either the transition period will be sufficiently long or the debt and capital markets will be re-established in full upon implementation. We consider, that in this scenario Spanish credit institutions are able to comply with the new capital adequacy regulations through the issuance of equity instruments (with a volume of approximately EUR 36 billion). However, we estimate that **the debt markets would not be capable of absorbing the necessary volume of fixed-income issues, estimated at around EUR 158 billion** (24% of the current outstanding balance of the debt issued by Spanish banks). If only half could be issued (around EUR 79 billion), the necessary **credit restriction** to meet the stable funding requirements would be **around 5%.** This credit restriction would result in the **long term in a fall in GDP of 1.6%**.

In a more plausible scenario, however, we expected that the markets will only be able to be re-established in part or that the transition period will be relatively short. In this case, the credit restrictions would be greater, due to the difficulties credit institutions would experience in increasing their capital base. We estimate that credit institutions would only be able to issue EUR 18 billion in equity instruments. To cover the remaining lack of capital, another EUR 18 billion, **a credit contraction of 14%** would be required. In this case, the new liquidity ratios would be met automatically, as a result of this contraction. **The impact on GDP**, however, would be substantial, with a fall of **around 5%**.

[1] The methodology used and the details of our computations can be made available upon request

Lastly, the current Proposals should not weaken but rather reinforce the **central role of the national supervisor**. This latest crisis has highlighted the importance of close, effective supervision that is adapted to the domestic economic reality in order to build a robust financial system. In the implementation of the new regulations an effort must be made to grant a certain degree of freedom to the national supervisory body so that it can adapt the general regulations to **the idiosyncrasies of each system and business model**. The national supervisor is the very body that is ultimately most familiar with the distinguishing features of the respective systems and their financial institutions and of the local social and economic context. A rigid one-size-fits-all approach would entail the loss of the **benefits** stemming from such **diversity**.