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Juan A. Yanes
Chief Corporate Officer
Santander USA

April 27, 2010

Board of Governors of the
Federal Reserve System
Division of Banking
Supervision and Regulation
Washington, DC 20551

Attn.: Patrick M. Parkinson, Director

Re: SR 10-7

Dear Mr. Parkinson,

Enclosed please find Banco Santander's views on the Basel "Liquidity Framework" and "Strengthening the Resilience of the Banking Sector" in response to your letter dated March 25, 2010.

Should you have any further questions, do not hesitate to contact the undersigned.

Sincerely,

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Santander Views on Basel's *"Strengthening the Resilience of the Banking Sector"*

Presentation

SANTANDER shares the goal of the BCBS to strengthen the foundations of the financial sector, to enhance overall financial stability and to achieve a common definition of capital among jurisdictions. For that reason, SANTANDER has been actively involved and engaged in discussions on these proposals under the umbrella of the main industry associations to which it belongs (IIF, EBF and the Spanish Banking Association). SANTANDER deems the detailed position papers of the IIF, the EBF and the Spanish Banking Association directionally correct and thus lends its full support to those papers.

In addition to the points raised by the above mentioned industry groups, SANTANDER wishes to highlight certain points it deems crucial in the current private-public sector dialogue.

General statements

I – In many cases intrusive supervision proves to be more effective than additional layers of regulation. The application of uniform standards in an international environment with a wide range of industry practices renders effective supervision even more crucial to ensure an even implementation of the content and spirit of the law.

II – SANTANDER takes the view that weak corporate governance and lack of internal control has been one of the root causes of the crisis and therefore more regulatory and supervisory focus is needed on this dimension in forthcoming proposals. SANTANDER believes that capital requirements can not replace sound and robust corporate governance.

III - The aim should not just be to penalize and avoid *bad* practices, but equally to give full recognition to, and thus reward, *good* practices. The market clearly demands stronger differentiation between good and bad practices, and we believe such assessment to be necessarily fostered by clear and transparent rules.

IV - Size is not the key component of systemic risk: key are in our view the interconnectedness of a firm with other market players and the embedded complexity of a firm's operations as well as its role in the markets. In this context, SANTANDER strongly believes in the resilience of its own business model mainly focused on retail banking activities and with self supporting and fully autonomous subsidiaries in liquidity and capital terms.

V - A uniform notion of capital and a level playing field is not fully achievable as long as related or underlying local corporate, fiscal and other laws and regulations are not harmonized. As long as accounting differences exist, capital metrics will yield diverging results. A clear example of the former is the proposal to fully deduct DTAs from core capital while these are generated by the different accounting and fiscal regulations in the different jurisdictions.

VI - As was shown in Spain, dynamic provisioning has proven to be effective, does not drive investors away and should be enhanced by making full use of bank's own -internally and externally validated- models.

Key observations

I. Timing of Implementation

Given the enormous repercussions for the banking sector, the financial markets and knock-on effects for the real economy of the full regulatory package if adopted in the current form, SANTANDER deems it important that implementation is:

⇒ **simultaneous** in all parts of the world,

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- ⇒ only takes place when due consideration has been given to (a) **cumulative impacts**, interaction (and possible double counts) between regulatory proposals, chain reactions as well as unintended consequences; (b) economic recovery patterns which may differ from one country to another.
- ⇒ This should include an analysis of the joint impact for **systemically important** banks of both ´Basel III´ and any additional requirements dealing with systemic risk which will be published in the near future.

In addition, to avoid aggravation of systemic risk, we deem it important that the Basel Committee, the European Commission, the US authorities as well as the accounting standards setters **align their proposals** to the extent possible both in terms of content and timing.

We furthermore urge the Basel Committee to provide, as soon as reasonably possible, **full clarity and transparency** to the market on the application calendar so that both the industry and the markets can prepare for the necessary change in an orderly fashion and to avoid undue speculation.

We also consider it relevant to mention the need for an additional consultation process after the calibration exercises have been carried out.

We will focus below on specific parts in the BCBS proposal which are relevant to SANTANDER and which we deem relevant to bring to the attention of the BCBS.

II. Deductions from Common equity: Deferred Tax Assets – Intangibles

Deferred tax accounting arises when companies postpone or prepay taxes on profits pertaining to a particular period. It results from:

(a) Temporary differences between book value of assets & liabilities and their tax value;
(b) Timing differences between the recognition of gains and losses in financial statements and their recognition in a tax computation.
(c) In some jurisdictions it is allowed to realize deferred tax assets through carry backs to taxes paid on income earned in the past (e.g. US).

IFRS adopts the approach described under (a), while the UK GAAP adopts the approach described in (b) and US GAAP the one described under both (a) and (c).

In view of the above, even when not having incurred losses during the crisis, banks can still have substantial DTAs in their books.

The building up, and subsequent treatment, of DTAs is depending on applicable local tax and corporate laws as well as accounting regimes, and therefore differ from one bank to another and from one jurisdiction to another.

For instance, in Spain the existence of a countercyclical provisioning scheme and pre-retirement funds create significant amounts of DTAs, for this reason; the full harmonization of Common Equity is therefore distorted if all DTAs are to be deducted.

Under IFRS, deferred taxes may be activated when in compliance with a set of strict criteria: only if they can demonstrate that their future income will be enough to allow the company to set off the tax assets.

Even though the recovery period of DTAs differs per type (DTAs built up due to e.g. pensions displaying a higher time span), the likelihood of recuperating the DTAs is considerable. This applies both to going concern and gone concern situations, with actual evidence noted during the 2007-9 period: SANTANDER observed cases of financial firms in (near) liquidation whereby DTAs were transferred to the buyer of (parts of) the financial firm in distress, the buyer being able to demonstrate taxable profits. In certain jurisdictions, DTAs may be sold in a separate asset sale.

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Hence, DTAs:
-retain their value over a time period of up to 20 years,
-have retained their value in liquidation scenarios,
-are independent of an external party´s willingness or ability to pay,
-are not sensitive to changes in market value

SANTANDER proposes a three layer approach:
(1) Distinguishes between DTAs due to losses in previous years and DTAs due to other reasons
(2) Distinguishes between DTAs with an intended realization in the next 10 years[1] and those > 10 years
(3) Takes DTAs associated with Expected Losses (EL) provisioning out of the equation so as to avoid contradictory incentives.

In short, DTAs not associated with losses reported in previous years and with a < 10 yr realization period or related to EL provisions should not be deducted.

SANTANDER is furthermore appreciative of the fact that the BCBS has acknowledged that a deduction, if any, should be net of deferred tax liabilities.

SANTANDER is also of the opinion, and has supportive evidence, that **software rights** present a realizable market value both in M&A situations and in liquidation scenarios. SANTANDER depreciates the software rights activated on its balance sheet in 3 years time which can be deemed conservative. Hence, we also propose not to deduct these assets from Common Equity.

For further development on this issue we refer to Annex 1 of Spanish Banking Association's answer to this consultation, which we completely support.

III. Deductions from Common equity: Deduction of minority interests

The Basel Committee proposes to deduct from common equity minority interests and participations in financial entities outside the scope of consolidation. We remark that this effectively means that on a macro level no value is attributed to minority stakes of one bank in another whilst they still contribute positively, especially in emerging markets, to a more stable sector and more effective risk-spreading over the global economy.

In order to avoid an asymmetric treatment, deductions of minority interests from capital should automatically be equalised with equivalent deductions from RWA in the denominator of any Pillar 1 capital requirements.

Even though minority interests may not be available to support risks or risk events in other parts of the group, deduction from common equity would imply that they do not provide any value or loss absorbency for the group as a whole in an ongoing concern. Especially where minority interests are sizeable in important group entities, their loss absorption capacity for the subsidiary in question also implies that in crisis situations fewer funds from other parts of the group need to be transferred and allocated to this subsidiary.

IV. Predominant share of Tier 1

The Basel III proposal introduces a new ratio structure whereby the predominant share of Tier 1 must be common equity. Where banks have substantial minority interests, especially in emerging markets countries, and such minority interests are qualifying as Additional Going Concern Capital, this predominant share criteria could prove constraining in its own right[2]. SANTANDER advocates that due consideration is given to the effect on FDI in EM countries, and opposes such implementation. In the event that the latter it would prove unavoidable SANTANDER proposes at least a phased implementation of the predominant share percentage.

[1] A 10 years horizon bears very little uncertainty on the realization of these DTAs. It is Banco de España current treatment.

[2] Depending on whether Tier 1 or Tier 2 is chosen for the re-allocation of the minority interest.

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Furthermore, SANTANDER takes the view that the Basel Committee should find an optimal balance between high quality capital in the form of common shares and a bank's need for a diversified funding structure whereby various investor bases can be tapped at all times.

V. The inclusion / exclusion of preferred shares

SANTANDER questions whether the proposed change to Tier 1 (de facto dismissing any type of preference shares) is required to preserve capital quality. Additionally SANTANDER considers that further clarification on the conditions under which preferred shares can be included within AGC-Tier 1 (the full discretion of banks on dividend payments) is needed so that it does not impede the going concern loss absorption capacity of this asset class.

VI. Contingent capital

SANTANDER believes that a mandatory introduction of contingent capital, with an inbuilt trigger based on capital ratios may entail significant technical difficulties. Setting the right (automatic or regulatory) trigger levels for contingent capital may prove to be very complicated and if not properly designed could have far-reaching negative consequences for the bank. In any case, any initiative on alternative capital measures should be voluntary and take into account investors' potential interest in these instruments.

VII. Concentration risk

SANTANDER is concerned that the new capital standards, as it restricts the notion of capital to tap on, could increase concentration risk within the group. The emphasis put on a restricted category of common equity is not in line with internal policies and practices aimed at avoiding reliance on one single or limited type of capital.

VIII. Limitations of a harmonized leverage ratio

SANTANDER understands the desire of regulatory authorities to avoid excessive leverage and to introduce a universally applied backstop ratio.

However, in the view of SANTANDER, given the variety of business models and product scales, a leverage ratio as a fixed Pillar 1 requirement would not achieve the intended goals. We advocate the need of including this requirement within Pillar 2.

We would encourage the analysis of the behaviour of different types of on and off balance sheet items, commitments and other contingent liabilities, during systemic and idiosyncratic risk events before deciding on the appropriate treatment (gross or net, CCF) to be used in the leverage ratio.

Furthermore, the calibration of the leverage ratio should be such that the importance of the risk sensitive Basel II capital ratios, and the incentives for sound risk management they create at present, would not be at jeopardy.

The application at the subsidiary level of the leverage ratio may well lead to a situation in which banks must restructure their whole internal legal structure which often is based on product lines: e.g. low risk or low CCF activities structured in one particular legal entity may have to be moved to another legal entity with a wholly unrelated activity. SANTANDER believes this goes against sound corporate governance and control and as such is an undesirable side effect that should be avoided at all costs

Since we view the leverage ratio as a going concern issue, we think Tier 1 would be the most appropriate measure.

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Lastly, we believe that the incentive to create large buffers of highly liquid assets as propagated in the liquidity risk proposal is somewhat at odds with the leverage ratio aiming at keeping growth at controlled levels.

IX. Forward looking provisioning

Having experienced the positive, anticyclical effects of forward looking provisioning during the crisis, SANTANDER is in favour of introducing them integrally in the banking community. SANTANDER stresses the need for convergence between the Basel Committee and the IASB so as to avoid double, slightly dissimilar, standards which would defy the purpose of transparency in the market. SANTANDER firmly encourages regulatory and accounting bodies to continue efforts to converge standards and praises the enormous effort made so far.

Even though SANTANDER conceptually supports proposals currently on the table, it favours the proposal of the European Commission (as described in its CRD4 proposal) as in its simplicity it overcomes the technical impossibility to estimate and model expected losses or cash flows over the lifetime of the portfolio. SANTANDER fears any other proposal might lead to an uneven and non-transparent implementation across the industry. Therefore, SANTANDER advocates anticyclical provisions based on TTC (through the cycle) expected losses. SANTANDER further stresses the need to resolve procyclicality by way of provisions rather than through capital so as to avoid adding volatility to capital. Symmetrical with the stipulation to deduct an expected loss shortfall from common equity, SANTANDER advocates the need to include the excess from expected loss provisioning fully as common equity if agreement on implementing an EL provisioning scheme outside capital is not achieved

X. Capital buffers and capital conservation standards

In order to better preserve its countercyclical purpose capital buffers, if any, should remain in Pillar 2 and in no way be construed as a de facto increase of minimum standardised requirements .Capital buffers should have no obligation of disclosure to the market. If they were disclosed then markets would treat them as an additional capital requirement to Pillar 1 losing effectively its countercyclical effect

Furthermore, the proposal by the Basel Committee on capital conservation in the event of excessive growth as it stands now would imply that banks might be negatively impacted by the behaviour of other industry participants in the jurisdictions in which they are active. It is the view of SANTANDER that, rather than preventing banks that have behaved responsibly in a particular market from distributing dividends, it would be preferred if supervisory authorities, upon receiving such macro-economic warning signals, would intervene in the behaviour of the banks displaying such undesirable behaviour. Evidently, controlled growth in a thus far under-banked market should not erroneously be construed as excessive credit growth. An unintended consequence of this stipulation may well be that current investors in bank equity confronted with the risk of both *lower* and *uncertain* returns (because dependent on other banks´ behaviour in the jurisdictions in which the firm has operations) will shy away.

XI. Harmonization and the role of Pillar 2

In addition to the previous point SANTANDER urges the Basel Committee to give due consideration to the current uneven implementation in some jurisdictions of fixed add-ons in Pillar 2 for certain risk categories (e.g. concentration risk, pension risk etc.). A consistently applied capital standard should not generate or repeat such practices.

XII. Procyclical Adjustments - the Introduction of Downturn PDs

For reasons stated below SANTANDER does not support the proposal to introduce the highest average PD, or ´downturn´ PD:

- Depending on internal rating methodologies used it may not address the issue of procyclicality or have varying impacts across the banking industry.
- It is inconsistent with the current calibration of the capital formula (correlations).

- It may take away incentives for risk managers to take the appropriate actions when credit profiles deteriorate.
- It creates some implementation issues that may prove difficult to surmount.
- Additionally, we believe that If the methodologies applied for estimation of through-the-cycle PDs for IRB Banks is not consistent internationally (for instance implementation of non cyclical PDs methodologies that has been validated by the FSA in UK but not yet in other EU countries), it could result in an uneven playing field for banks in order to estimate downturn PDs and capital buffers.

Santander has developed extensive technical work on this issue and would be happy to hand the Basel Committee a technical explanatory annex on request.

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Santander Views on Basel's *"Liquidity Framework"*

Presentation

Santander welcomes the effort made by the Basel Committee to safeguard financial market stability and to preserve the system from a renewed liquidity shortage. As a consequence, SANTANDER has been actively involved and engaged in discussions on the Basel Committee proposals under the umbrella of the main industry associations IIF and EBF, as well as the Spanish Banking Association. We deem these papers directionally correct and thus lend our full support to these papers but we wish to highlight certain points we deem crucial.

Executive summary

Above all, we consider that the goals of this proposal and the solution to the recent crisis would be better achieved by enhancing supervision and corporate governance. Tighter requirements, without the previous and by themselves will always be insufficient or inadequate for future unanticipated events and could create a false sense of security.

Nevertheless, Santander considers the proposal conceptually well defined focusing on liquidity coverage during a survival period and structural stability of liquidity sources.

However, we find that some relevant aspects of the current proposal still worth further consideration. In particular:

1. The envisaged scenario is not just unlikely but implausible, especially for the Net Stable Funding Ratio (NSFR), as it compounds on a combination of idiosyncratic and systemic shocks, both severe, while at the same time denying any possibility for the institution to react.
2. The proposal unfairly penalises retail commercial banks (e.g.: differential treatment of retail credits versus wholesale clients in the NSFR through more penalizing required factors). This is totally unjustified as traditional business models have proven to be more resilient in the current crisis than others. This would furthermore have dramatic consequences for retail real sectors.
3. The definition of liquid assets in the Liquidity Coverage Ratio (LCR) and NSFR is too restrictive and will at the end induce "herd behaviour", limiting the room for liquidity risk management, and increase risk of concentration in few asset classes, thus contributing to financial instability.
4. The proposal as it is will seriously impair the banking maturity transformation function. The proposed NSFR as defined implies that some short term assets will have to be financed with long term liabilities, creating thus a positive liquidity gap.
5. In addition, disclosure requirements seem to us to be counterproductive as the volatility of these ratios could be easily misunderstood by the markets.
6. Finally, we think that the "one size fits all" approach proposed does not adequately capture the great variety of business models and thus a more flexible approach is needed in order to not unduly penalise certain business models.

Comments on the process

We understand that many definitions and benchmarks remain yet undefined and are subjected to a comprehensive impact and calibration study during the fist half of 2010.

We feel that an additional consultation process with the industry would be needed once the calibration is done and before the proposal is ultimately approved.

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In addition, we think that a "trial period" would be advisable to gather experience on the implications of the proposal for the industry, markets and real economy. The experience could help to adjust those aspects around which there is at present more uncertainty.

This should take into account the aggregate impact of both ´Basel III´ and any additional capital and liquidity requirements considered (e.g: future requirements on systemic institutions). Moreover, the interplay between both liquidity ratios should be also carefully assessed.

Santander would also advice strong coordination efforts of regulators *vis-á-vis* central bank in view of the interlink between banking liquidity regulation and monetary policy implementation.

It is also a crucial matter that the Basel Committee, the European Commission, the US authorities as well as the accounting standards setters align their proposals to the extent possible not only in content but also in timing. Changes should also only be put in place once consideration has been given to (a) cumulative impacts, possible double counts, chain reactions as well as unintended consequences; (b) economic recovery patterns which differ from one country to another.

General Comments on the proposal

Impact on the real economy and on systemic risk

The new set of standards, in combination with others included in the capital measures package, will have severe consequences upon the real economy in terms of potential real growth and financial stability in the long term, and could seriously threaten the incipient recovery in the short term.

The current proposal would jeopardize the potential real growth by reducing credit supply to the real economy, especially to those sectors/countries with more difficult access to the markets, and by skewing the supply of credit towards the public sector.

The assumptions made in the proposal imply funding short term assets with long term liabilities. This would dramatically distort the maturity transformation function of the banking system bringing a reduction of the banking intermediation that will unavoidably weight on growth. This will imply a reduction in quantities (it will impede on the provision of credit) and impact on prices (the incremental cost derived from a more long run - more expensive- funded credit will likely be passed-through to clients leading to more expensive credit).

There is also a risk of crowding out if the liquidity standards remain totally skewed toward Treasuries in order to comply with the eligibility criteria that, at the end, could curb real sector productivity and therefore potential real growth.

Contrary to what is aimed with this proposal, it will also foster systemic risk by giving more room to "shadow banking" players, that are not or lighter regulated, and by inducing "herd behaviour" within the banking system by requiring banks to move always in the same direction within a narrow range of asset classes.

In the short term, we deem it very important to consider the effect upon Monetary Policy that the measures may have. The increase of liquid assets to hold in the balance sheets could have similar effects to that of a tighter monetary policy when implemented.

Additionally the proposal could have a huge impact on the monetary policy transmission channel generating severe uncertainty around the monetary policy reaction function (e.g.: impact on the interbank market due to the penalizing treatment of the interbank financing). Moreover, if the ratios are not consistently implemented across countries this could lead to imbalances in capital flows.

Calibrating the Stress Scenario

Santander considers that the stress scenario is too conservative since it assumes severe idiosyncratic and systemic risks at the same time and during a long lasting period. It is also striking that the stress scenario

considers a situation where there is no reaction in the banks behaviour regarding their business and where contingent funding lines fade off but not funding compromises. This is at the local level implausibly severe but possible; however Santander does not see how that line would fit into a systemic crisis scenario, since it is not possible that all the banks are at the same time rolling-over its credit lines and suffering a dry-up of its funding sources.

Moreover, we consider that the LCR, as it is designed, could not work as a buffer since the stress event-triggered factors (withdrawal of deposits, rating drop etc) are assumed to permanently remain along the survival horizon instead of phasing out. It is not envisaged in the proposal how the buffer could be released once the stress scenario materialises. On the other hand it is also a reason of concern that the stress scenarios fully disregard the starting conditions of each bank (for instance in the re-rating of their balance) as the impact will be very different depending on which is the starting point.

Therefore we consider that:

1) The stress scenario should be reviewed in order to be plausible, and to the extent possible adapted to the institution's own characteristics
2) Some margin for banking reaction and contingency plan execution once the scenario materialises should be recognised
3) Some clarification is needed on how the LCR should be applied as the scenario materialises partly or in full.

Disclosure

A full public disclosure of all information required at the consolidated level and at the frequency requested above will not add further transparency to the system and, on the contrary, could lead to misinterpretations due to the high volatility of these ratios, inducing spurious volatility in market assessment of the banks risk profile.

We acknowledge the need for transparency regarding the bank liquidity risk profile, but certainly the proposal as it is does not help markets to properly assess this point. We advocate a full transparency to supervisors, auditors and other authorities (with confidentiality when dealing with the information) and less but simpler information, lower frequency and less sensitive to the rest of the market.

Incentivising arbitrage

The NFSR as it is defined in the current proposal, creates a room for arbitrage both for products (formalising loans by commercial paper or other securities) and institutions (non-bank institutions intermediating between banks and clients ~ shadow banking). The more incentives for arbitrage are being introduced the more resources the market will devote to circumvent regulations, and hence more systemic risk will arise (see Annex for an example on this).

Impact on the interbank market

The proposal seems to discard the interbank market as funding provider. However, this market plays a crucial role in the liquidity distribution during normal times preventing idiosyncratic liquidity risk. Santander would encourage considering the role of the interbank market in the design of stressed scenarios. Moreover, improvements in the functioning of the interbank market should also be considered as a way to mitigate the malfunctioning of this market during the crisis. For example, the drying up of liquidity in the interbank market during the crisis can be partly explained by the great uncertainty regarding banks´ balance sheets. Enhanced transparency could mitigate this problem in the future. A well functioning interbank market is essential for a modern and stable financial system. Therefore the solution should be to repair whatever was wrong in this market, not to downplay the role of this market in the future.

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Comments on the Liquidity Coverage Ratio

Aligning to the Central Banks eligibility criteria and preserving the role of lender of last resort of Central Banks

It seems crucial to align eligibility criteria with those of central banks. In addition, although we share the view that banks liquidity management should not excessively rely on central bank provision of liquidity, we think that the rule of disregarding extended borrowing from central bank facilities is too rigid. Some level of intervention in severe systemic stresses would be reasonable to expect (keeping in mind that this would not extend to lender-of-last resort assistance to a bank facing idiosyncratic, as opposed to, systemic situations).

A too restrictive definition of eligible assets

As mentioned above, we find the eligibility criteria for assets to qualify as liquidity buffer too restrictive and therefore entailing serious macroeconomic (mentioned above) and market implications.

Among the latter we find foremost worrying that the requirements will virtually leave aside almost all securitised instruments. This could create an ABS -overflow in the market that seriously would impair their market value replicating thus the situation surrounding ABS at the beginning of 2008, and eliminating this key funding source. Also, not accepting securitised instruments will weigh on the funding of several markets. For example, not including RMBS may have an impact on the financing of the housing market.

In addition, not considering liquid any security issued by financial institutions (except maybe third-party covered bonds) will result in serious difficulties for the banks when having to sell their additional issuances to the market. Putting in place a limit to concentration in single issuances might serve as an acceptable solution for regulators and supervisors which would furthermore avoid cross-issuances between banks.

Additionally it would increase concentration risk since limiting the range of eligible liquid assets. Moreover, as the eligibility depends upon the credit rating a sudden downgrade of an issuer (e.g. sovereign) could promptly reduce the LCR buffer (cliff effects).

Comments on the Long-Term Net Stable Funding Ratio

Too conservative assumptions that could seriously impair the banking maturity transformation function

The proposed ratio as defined, when complied at 100%, implies that some short term assets will have to be financed with long term liabilities, creating thus a positive liquidity gap. The latter will require an additional need for maturity transformation generated by the banking system itself, and supplementary to the needs in the real economy. As it could be seen in the example in the Annex this happens even for a most conservative bank.

An over prescriptive proposal

The current proposal is overly prescriptive and does not take properly into account firm/business model specificities. We strongly believe that a “Pillar 2” approach would better achieve the intended goal of sound medium term funding structures, without impairing the maturity transformation function of the system.

In our opinion any structural funding requirements should be designed to be monitored without a prescriptive threshold and take the form of a set of principles under which firms and supervisors could work out an appropriate approach for each firm. The firm should report the supervisor on its funding structure making appropriate assumptions and stress tests for its own situation, subject to rigorous supervision.

If, nevertheless, the current approach is kept, at least some flexibility should be provided in order for the percentages proposed to reflect the nature of the business (e.g: the proposal must acknowledge that retail banks are usually funded by a stable deposit base) and to take into account the entity’s ability to react over

one year both in its planned growth strategy and funding policy (given the assumed stress scenario, which in fact includes both a idiosyncratic and a systemic crisis).

<u>Penalise commercial banking</u>

The NSFR clearly penalises banks with a significant commercial lending activity, especially retail loans, as the proposal establishes 85% of the retail loans to be renewed over the year, compared with 50% for corporate clients.

Annex. Examples of how the NSFR could seriously impair the maturity transformation function of a bank and/or incentive arbitrage

Table 1 shows the NSFR, according to current Basel's draft, for a conservative bank, with retail and corporate business mainly funded by customer deposits. The initial ratio is well below 100% (partly due to the required funding factors applied to retail and corporate loans). The way to improve the ratio up to 100% would be:

- By issuing debt with a maturity over 1 year for an amount of 20 bn. (table 2)
- By transforming part of the corporate loans into corporate bonds and replace part of the retail loan portfolio (with maturities up to 1 year) by ABS´s with equivalent maturities. (table 3)

Hence, the bank would be forced to use long term funding to finance short term assets seriously impairing the maturity transformation function of the bank, or transforming its short term loans into short term debt, which would increase the cost of financing without adding any real value.

<u>Table 1.</u>

ASSETS	AMOUNT	NSFR %	Funding >1year	LIABILITIES	AMOUNT	NSFR %	Funding >1year
RETAIL LOANS	**100**		**96**	**RETAIL DEPOSITS**	**90**		**72**
Maturity > 1year	70	100%	70.0	Insured in transactional based accounts	60	85%	51.0
Maturity < 1year	30	85%	25.5	Other retail	30	70%	21.0
CORPORATE LOANS	**25**		**18**	**CORPORATE DEPOSITS**	**10**	50%	**5**
Maturity > 1year	10	100%	10.0				
Maturity < 1year	15	50%	7.5				
PROPERTY AND EQUIPMENT	**5**	100%	**5**	**SHAREHOLDER'S EQUITY**	**10**	100%	**10**
OTHER ASSETS	**3**	100%	**3**	**OTHER LIABILITIES**	**3**	0%	**0**
				MEDIUM AND LONG TERM ISSUES	**25**		**16**
				Residual maturity > 1 year	16	100%	16.0
				Residual maturity < 1 year	9	0%	0.0
SECURITIES PORTFOLIO	**8**		**0.4**	**SHORT TERM ISSUES**	**3**	0%	**0**
Government secs. >1year	8	5%	0.4				
TOTAL ASSETS	**141**		**121**	**TOTAL LIABILITIES**	**141**		**103**
Commited retail facilities	**20**	10%	**2**				
TOTAL FUNDING REQUIRED			***123***	***TOTAL AVAILABLE FUNDING***			***103***

NSFR = $\frac{103}{123}$ **= 83%**

FUNDING DEFICIT > 1 Year = 20 bn

Table 2.

ASSETS	AMOUNT	NSFR %	Funding >1year
RETAIL LOANS	**100**		**96**
Maturity > 1year	70	100%	70.0
Maturity < 1year	30	85%	25.5
CORPORATE LOANS	**25**		**18**
Maturity > 1year	10	100%	10.0
Maturity < 1year	15	50%	7.5
PROPERTY AND EQUIPMENT	**5**	100%	**5**
OTHER ASSETS	**3**	100%	**3**
SECURITIES PORTFOLIO	**28**		**0.4**
Government secs. >1year	8	5%	0.4
Fixed income secs. <1year	20	0%	0.0
TOTAL ASSETS	**161**		**121**
Commited retail facilities	**20**	10%	**2**
TOTAL FUNDING REQUIRED			***123***

LIABILITIES	AMOUNT	NSFR %	Funding >1year
RETAIL DEPOSITS	**90**		**72**
Insured in transactional based accounts	60	85%	51.0
Other retail	30	70%	21.0
CORPORATE DEPOSITS	**10**	50%	**5**
SHAREHOLDER'S EQUITY	**10**	100%	**10**
OTHER LIABILITIES	**3**	0%	**0**
MEDIUM AND LONG TERM ISSUES	**45**		**36**
Residual maturity > 1 year	36	100%	36.4
Residual maturity < 1 year	9	0%	0.0
SHORT TERM ISSUES	**3**	0%	**0**
TOTAL LIABILITIES	**161**		**123**
TOTAL AVAILABLE FUNDING			***123***

NSFR = $\frac{123}{123}$ = 100%

ADITIONAL FUNDING > 1 Year : 20 bn

Table 3.

ASSETS	AMOUNT	NSFR %	Funding >1year
RETAIL LOANS	**100**		**83**
Maturity > 1year	70	100%	70.0
Maturity < 1year	15	85%	12.8
Securitisation bonds < 1year	15	0%	0.0
CORPORATE LOANS	**25**		**10**
Maturity > 1year	10	100%	10.0
Corporate bonds < 1year	15	0%	0.0
PROPERTY AND EQUIPMENT	**5**	100%	**5**
OTHER ASSETS	**3**	100%	**3**
SECURITIES PORTFOLIO	**8**		**0.4**
Government secs. >1year	8	5%	0.4
TOTAL ASSETS	**141**		**101**
Commited retail facilities	**20**	10%	**2**
TOTAL FUNDING REQUIRED			***103***

LIABILITIES	AMOUNT	NSFR %	Funding >1year
RETAIL DEPOSITS	**90**		**72**
Insured in transactional based accounts	60	85%	51.0
Other retail	30	70%	21.0
CORPORATE DEPOSITS	**10**	50%	**5**
SHAREHOLDER'S EQUITY	**10**	100%	**10**
OTHER LIABILITIES	**3**	0%	**0**
MEDIUM AND LONG TERM ISSUES	**25**		**16**
Residual maturity > 1 year	16	100%	16.0
Residual maturity < 1 year	9	0%	0.0
SHORT TERM ISSUES	**3**	0%	**0**
TOTAL LIABILITIES	**141**		**103**
TOTAL AVAILABLE FUNDING			***103***

NSFR = $\frac{103}{103}$ = 100%

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