Santander

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,

Banco Santander, S.A. - Domicilio Social: Paseo de Pereda, 9-12. 39004 SANTANDER - R.M. de Santander, Hoja 286, Folio 64, Libro 5º de Sociedades, Inscripción 1ª. C.I.F. A-39000013

Santander

⇒ 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.

Banco Santander, S.A. - Domicilio Social: Paseo de Pereda, 9-12. 39004 SANTANDER - R.M. de Santander, Hoja 286, Folio 64, Libro 5º de Sociedades, Inscripción 1ª. C.I.F. A-39000013

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.

Santander

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.

Banco Santander, S.A. - Domicilio Social: Paseo de Pereda, 9-12. 39004 SANTANDER - R.M. de Santander, Hoja 286, Folio 64, Libro 5º de Sociedades, Inscripción 1ª. C.I.F. A-39000013

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.
