Madrid, 16 April 2010

THE SPANISH BANKING ASSOCIATION COMMENTS TO THE BASEL COMMITTEE ON BANKING SUPERVISION CONSULTATIVE DOCUMENT

Strengthening the resilience of the banking sector

The Spanish Banking Association (AEB)[1] wishes to thank the Basel Committee on Banking Supervision (BCBS) for the opportunity to comment on its consultation document *Strengthening the resilience of the banking sector*. AEB, in its capacity as member of the European Banking Federation (EBF), has played an active role in the drafting of the EBF's response to the aforementioned document, and it broadly supports the opinions contained therein. However, given the importance of the issues under consultation, AEB wishes to report to BCBS directly regarding its opinions on this matter, emphasising the issues that affect the Spanish banks most and, as a consequence of the above, the markets in which our organisations operate.

The response is divided into two parts: a general comments section, and a further section on specific issues, with the latter following the order of the consultation document itself.

General Comments:

- It is necessary to acknowledge the efforts made by the Basel Committee in developing this consultation document in such a short space of time, and the right direction of most of the proposals which the Committee has put forward, especially those aimed at better calibration of risk, as well as those which advocate the maximum possible harmonisation between jurisdictions and therefore level the playing field. We support in particular the objective to harmonise to the extent feasible regulatory adjustments ("prudential filters").
- However, there are a series of proposals, the strict application of which could have perverse consequences both regarding the objectives sought by the Committee as well as for suitable credit flow towards households and companies and for the smooth functioning of the financial markets. Among these proposals we are particularly concerned about the following ones (in order of appearance in the consultative document), as we argue in the body of the response:
  - We agree with the BCBS' general criteria that stress the relevance of Tier 1 capital to absorb losses in going concern situations. So a principle based definition is welcomed, but it shouldn't go further than what the preservation of the objectives pursued strictly requires. Otherwise, the investor's base for banks capital would be excessively reduced and concentrate in a sole type of investors. Needless to say that this could have a negative impact on financial stability, jeopardizing the possibility of banks finding the capital required to preserve their solvency
  - In the area of Minority interests (MI), we believe that it is necessary to achieve consistency in the definitions of the numerator and denominator components of the ratios. Failure to do so, would compromise the current and future development

[1] The Spanish Banking Association (AEB) is the voice of the Spanish banking sector representing and defending the collective interests of banks operating in Spain (94 member banks: 59 Spanish and 35 credit entities' branches of foreign banks operating in Spain), with total consolidated assets of € 2,110 billion as of December 2010 and 109,996 employees in Spain.

strategy of banking groups, which would be disadvantaged compared to organisations without subsidiaries and this could even hinder the resolution of banking crises.

  - In relation to the Deferred Tax Assets, applying the same deduction to the carry forward of unused tax losses and to the tax assets originated by temporary differences would penalise those entities which, having made profits, have also made provisions which may be used in the future, as opposed to those which have simply sustained losses in the past.

  - In relation to the deduction from capital of holdings in banks and similar financial entities which are not controlled by the group, it is clear that it supposes a break in the desirable principle of alignment of capital requirements to risks assumed.

  - Regarding the shortfall of the stock of provisions to expected losses, the position of Spanish banks is to support this proposal and, additionally, we consider it essential to eliminate disincentives to a prudent provisioning policy, and therefore the excess accounting provisions over the expected losses should be accounted without caps as Common Equity.

  - In relation to *Remaining 50:50 deductions*, we consider that the change consisting in replacing deductions of certain assets in the numerator of the coefficient by weights of 1250% in the denominator, is not neutral and results in highly significant effects on the level of the coefficient without being supported by any technical or prudential justification. Therefore, our position is that the entities should be able to choose which mechanisms produce less distortion to their real solvency (weighting or deduction).

  - In the area of procyclicality and capital buffers, in our view it is key to strive to a correct calibration of risk rather than changing the level of minimum capital required depending on the point in the cycle that we are currently in. It is important to take into account the double impact that would occur with the use of a downturn PD, in those jurisdictions where the effect of rating migration of models has not been adjusted.

  - In general terms, it does not seem reasonable to stipulate the deduction of assets without exploring the proper assessment of the risks that such assets involve. The technique of the deduction of certain assets was perhaps justified by the inadequacy of valuation methods existing in 1988, but it is inconsistent with advanced valuation methods currently used by banks, which are validated and accepted by the Supervisor.

  - The definition of capital included in the solvency rules should be self-comprehensive, meaning that irrespective of the accounting standard that is applied or the commercial law in force in each jurisdiction, the definition of the components of capital should not change from one country to another.

- The Committee announced that during the third quarter of 2010 it will analyse the possible need for additional capital requirements, liquidity, or others, to address the externalities created by systemically important institutions (SIFIs, paragraphs 8 and 46 to 49). The debate on this issue firstly focused, in our view wrongly, on size as the most important variable when characterising SIFIs (*too big to fail*). Subsequently, the attention has shifted to other more important parameters in terms of systemic risk, such as interconnection or complexity of the activities carried out by a given organisation. As a consequence, the best way to address the SIFI issue would be, in our opinion, the one suggested in paragraph 48: that is, inclusion in risk weights of genuinely systemic risks, so that the Basel framework itself may define, without specific treatment, higher capital requirements –and, when applicable, liquidity– that systemically important institutions should support.

- Notwithstanding our broad support to the EBF's response expressed above, we consider that the treatment of counterparty credit risk should be included by its own nature, and for the sake of comparability among entities, in Pillar 1 and not in Pillar 2 as the EBF suggests. Indeed, and even though we acknowledge the merits of the Pillar 2 approach,, we are aware of its drawbacks as the most common source of national discretions and a major hindrance for a level playing field. Therefore we strongly believe that, should any topic be included in the Pillar 2 approach, regulators and supervisors would necessarily have to globally agree on common guidelines and criteria in order to achieve a harmonized application of Pillar 2.

- Taking into account the relevance of the changes proposed by the Committee, we consider necessary to establish an appropriate grandfathering period for capital instruments and a reasonable and realistic phase-in period for the new capital standards. In the case of capital instruments , we consider that grandfathering arrangements need to be put in place in respect of Tier-1 Additional Going Concern Capital and Tier -2 Capital. However, with respect to instruments to be included in Common Equity, we do not believe that it would be legitimate to provide for grandfathering arrangements as it concerns a newly defined capital category. It does not seem conceivable to us that grandfathering arrangements can possibly be extended to concepts that did not existed beforehand. Allowing grandfathering for instruments to be included in Common Equity would be detrimental to the overarching objective that the Committee is pursuing,, i.e.to have consistent Common Equity instruments compliant with the eligibility criteria forming the predominant part of Tier-1 across the institutions and countries .

- We note, finally, that the Committee has not delivered a finished product as the Consultation paper reveals that there are still many uncertainties. Moreover, the QIS exercise which is taking place in parallel has created confusion as the Questionnaire which was circulated amongst banks seems to suggest that there may be many differing ways to implement the proposals.

  Clearly, due process needs to be observed. We conclude from this that the Committee will need to organize another consultation round and QIS once its proposals will have taken a more definite shape. We would like to invite the Committee to provide clarity in the meantime about the way in which it intends to organize its further work and, particularly, about the timelines which it proposes.

Specific comments to the different Sections:

Raising the quality, consistency and transparency of the capital base.

These proposals refer, among other issues, to the constituent elements of capital and to the elements that should be deducted from it, i.e., the numerator of the new BIS ratios.

The main comments, according to the order in which they appear in the document, are the following:

- Paragraph 72, bullet 5. We support any proposal aimed at increasing transparency, however, one should bear in mind that reconciliation with the accounts may lead to inappropriate interpretations by the market and rating agencies.

- The breakdown of *Common Equity* before deductions is not consistently defined throughout the document. For instance, in paragraph 73, it could be assumed that it comprises share capital and reserves, however, the footnote on page No. 17 defines it as capital, reserves and *Other Comprehensive Income.* Later, in paragraph 94, it states that; "*… the proposal ensures that there is no loop holes for including instruments other than common shares in the Common Equity component of Tier 1*".

- Paragraph 73. Having established coefficients x%, y% z%, there seems little point in using the concept that Tier 1 must <u>predominantly</u> be *Common Equity.*

- Paragraph 87 on the criteria that must be met by ***Common Equity***, raises the following comments:

  This paragraph establishes 14 criteria to be fulfilled, without dealing with the mandatory convertible instruments into equity in a specific way. The mandatory convertible instruments may hold a high degree of "going concern" loss absorption from the very moment of their issuance. This fact, together with their mandatory conversion into equity in the short term (up to 5 years), should allow these instruments to be classified as Core Capital from the very moment of their issuance without having to wait until their conversion as it is proposed by the Committee.

  The high degree of loss absorption could be justified by the fact that there is no obligation to pay interest in case distributable profits are not obtained or if the capital requirements according to solvency rules are not fulfilled. Moreover, the amount of capital paid in at the issuance of the instruments grants the ability to absorb losses, since that amount will be available for solvency purposes and the issuer has no possibility of amortizing the instrument in cash.

  The features to be taken into account in order to classify the convertible bonds as Core Capital should be totally independent from their treatment in accounting as Equity or Liability. The accounting classification neither affects the amount of capital that the entity has available for solvency purposes since the issuance of the bonds, nor affects the final Equity that will be issued as common shares and stock surplus.

  Moreover, the FSA has already debated this topic in their Discussion Paper issued in December 2007. In that paper they stated:
  "….

  i. *Conversion into equity capital is a mechanism that appears to increase the lossabsorbency of a hybrid instrument. If conversion were triggered at an early enough point then the instrument would be available to absorb losses to the same degree as equity when such loss absorbency is needed.*

  ii. *To provide enhanced loss absorbency for the issuer, the conversion should be into a more loss-absorbent instrument. If ordinary shares are the benchmark, in terms of the characteristics of going concern capital, it would follow that conversion should be into ordinary shares.21 On the other hand, preference shares only absorb losses after all the common equity has been used up so conversion into preference shares may not be any more loss absorbent than the original hybrid instrument.*

  iii. *The rate of conversion will determine whether a loss is suffered by the holders of the instrument at the point of conversion. If holders receive a variable amount of shares equal in value to the nominal value of the original hybrid instrument, they will not suffer a loss at the point of conversion. After conversion, hybrid investors would benefit from future earnings to the same extent as other shareholders.*

  iv. *If hybrid capital instruments included such a conversion feature then after conversion, investors would suffer losses (or benefit from gains) to the same extent as ordinary shareholders. Moreover recapitalisation would not be hindered as the instrument would be in the form of ordinary shares at the point when new capital would be injected. As no part of the new capital would be used to restore the claims of the hybrid investors, the full amount of the new capital would be available to absorb losses for the firm.*

v. *For the purposes of achieving going concern loss absorbency, it does not matter whether conversion is into a fixed number of shares or an unlimited number of shares. However, the latter may be difficult to achieve in practice and may raise corporate governance issues. For example, if the bank's share price has fallen markedly it may not have sufficient authorised share capital to issue or existing shareholders may not agree to the conversion. Unlimited conversion may also result in new shareholder controllers. "*

Additionally, the bail-outs provided by several governments to some financial institutions have some features that do not fulfill Core Capital criteria. However, it is more than likely that they will be included as Core Capital. In contrast with those instruments, mandatory convertible bonds have features closer to equity and the complete certainty of being converted into equity (and never being settled in cash).

Other comments about this paragraph are:

- As a general comment, the definition of capital (common shares) included in the solvency rules should be self-comprehensive, i.e. avoiding unnecessary referrals to accounting regulations (criterion 10) or insolvency laws (criterion 9), and this is because further changes in national or international accounting standards, or changes in insolvency laws of countries, may involve unanticipated changes in the accountability as capital of the affected components, without the economic function thereof varying at all. In addition, neither accounting rules nor insolvency regulations are harmonised on a global level, meaning that elements meeting the same requirements from a prudency point of view could, however, have differing qualifications in different jurisdictions depending on the accounting or insolvency regulations which are applicable in each case.

- Criterion No. 3, there would appear to be doubts on the treatment of redeemable shares, in this sense we would ask for this point being clarified by the Committee.

- Criterion No. 7. This criterion seems to imply the impossibility to consider non-voting shares as Common Equity, since when a right is given up it always has to be compensated with something else. Therefore, the Committee must carefully consider the negative impact that this criterion would have on this particular market.

  In this sense, we believe that a reasonable and balanced criterion is the one established by CEBS in its consultation paper CP 33, where in paragraphs 32 and 38, it allows non-voting shares the payment of a preferred dividend to offset the assignment of a right, without the loss of their status as an accountable instrument for the purposes of Article 57 (a) of EU CRD.

  Regarding criterion No. 11, it would be convenient for the Basel Committee to clarify what is meant by *paid-up*, that is, clarify if for issued capital to be accounted, it must be fully paid in and, if this is not the case, if the effectively paid-in portion could be accounted as *Common Equity*.

- Paragraph 89, on the criteria that must be met by ***Tier 1 Additional Going Concern Capital:***

Even if it is true that the financial crisis has shown that some capital instruments were not properly absorbing losses, it shouldn't be over-stressed their role in the financial crisis or make generalisations about their ability to absorb losses.

Special attention should be focused on the reasons for some instruments not to have worked properly, before excluding them from Tier 1 regulatory capital on a general basis. For instance, the diversity of legal and fiscal national frameworks could provoke that capital instruments apparently similar could have a different behaviour in relation to loss absorbency. We consider that, in some cases, bad managerial decisions about redemptions or calls, in conjunction with the lack of a procedure for supervisory intervention are more to blame, than the capacity of instruments to be loss absorbing.

The recommendations establish a new framework whereby hybrids will be subject to strict criteria concerning supervisory approval for calling or for redemption, in order to preserve their permanence. Besides, the capital conservation mechanism proposed envisages restrictions in distributions when buffers are below those established by regulators.

This reinforced supervision joined with a "reinforced management decision taking" should allow and make reasonable not to be unnecessarily restrictive in the definition of hybrid capital. We agree with the BCBS' general criteria that stress the relevance of Tier 1 capital to absorb losses in going concern situations. So a principle based definition is welcomed, but it shouldn't go further than what the preservation of the objectives pursued strictly requires.

Otherwise, the investor's base for banks capital would be excessively reduced and concentrate in a single type of investors. Needless to say that this could have a negative impact on financial stability and on a proper functioning of the financial markets,, jeopardizing the possibility of banks finding the capital required to preserve their solvency.

We consider that this is the case of the inclusion of some criteria to be fulfilled by non-core Tier 1 instruments that are spurious for the objective pursued, and that can make it difficult or overly expensive to issue instruments that comply with them.

This is the case, for instance of the criterion number 7a that establishes that banks must have full discretion at all times to cancel distributions/payments. We consider that this full discretion is excessive in order to meet the loss-absorbency objective, being enough to have discretion when need be. So, we propose to modify this full discretion by an obligation to cancel distribution and payments when not complying or being close to not complying with capital regulatory requirements.

Additionally, we would like to put forward other specific comments about this paragraph:

- Criterion No. 4. In our understanding this criterion leaves outside Tier 1 two instruments which the current EU Directive does allow, namely 30-year preferred shares and preferred shares with a moderate *step up* (the latter are also outside *Tier 2*).
- Criterion No. 6. A certain percentage, excluded from the prior supervisory approval requirement, should be allowed for market-making purposes. Banks or

Bank Holding Companies are at the same time issuers and lead managers / underwriters in a syndicate placing hybrid Tier 1 instruments in the capital markets. The lead manager of a transaction is expected to be able to make a market in instruments which are placed. Should the market making exception go away or be subject to burdensome operational requirements, investors would be subject to a potential substantial bid-ask spread volatility which would prevent the instrument from being priced in a reliable way.

So we take the view that limited buy-back activity for market making or for market smoothing purposes should be permitted provided that, at any time, repurchased instruments held by the financial institution do not exceed certain pre-determined thresholds.

- Criterion No. 7, section a). If *"full discretion"* is to be understood in its most literal and strict sense, all current preferred shares would not meet this requirement and, therefore, would be outside *Tier 1.*

  We consider that asking for full discretion at all times exceeds the needs for solvency purposes and could add an unnecessary difficulty, and related extra cost, in the placement of these instruments. We think that for solvency purposes it would be enough to require the cancelation of distributions/payments when it is necessary to preserve the solvency of the institution. So, it should be enough to refer to situations for cancellation contemplated in the solvency regulation (nor complying with capital requirements established by the regulation) and to situations when there are not enough distributable items, providing in this way for a loss-absorbency capacity coupled with a greater degree of certainty for investors.

  In this regard, we believe that the Basel Committee should make an effort to objectify or parameterize when an issuer must cancel the payment of the coupon or dividend with the ultimate goal of relaxing the criterion of "*full discretion*".

- Regarding Criterion 11, we consider that loss absorbency of hybrids works because in an stressed situation they don't suppose any drain in the resources of the entity: coupons can be waived in a non-cumulative basis and principal is not paid back. We think that these features introduce a beneficial loss absorbency capacity with a proporcionate cost to the issuer. We don't see the necessity of improving loss-absorbency through the additional requirements of conversion or write downs recommended, just because the instruments have been accounted for as a liability.

  If we want to maintain a principle based approach, the solvency rules shouldn't be so closely linked to accounting criteria, to avoid changes on capital definition based solely on changes in accounting criteria. Besides there could exist differing accounting criteria applied on an individual and a consolidated basis, with the additional risk of losing more consistency in the capital definition for solvency purposes.

  Besides, adding extra requirements with the sole objective of converting hybrids in more equity like instruments would push in the direction of reducing the diversity of the investment base with the possible negative side effects on the financial stability such as herd behaviour in systemic risk events. Write-down mechanisms could break the seniority of these instruments in relation to equity, so, in any case, write up mechanisms should be allowed.

- Criterion No. 12. In relation to the exclusion of instruments when the bank has funded, directly or indirectly, its purchase, we think that it is too conservative. We

consider that a risk related approach should be adopted in order to qualify for capital.

We understand the concern of supervisors when capital instruments are funded by the issuing bank in situations where there is a high correlation between the fall in the price of the instrument and the probability of those instruments coming back to the balance sheet of the issuer. In those cases, we agree with the recommendation to deduct those positions. This could happen, for instance, when loans have been granted based primarily on the guarantee of the shares acquired or given to related partners in financial terms that differ from market terms or that are not adequately secured in line with banking best practices.

But in the case that the funding given to purchase the instrument is being granted on market terms and when the solvency of the borrower has been primarily taken into account to assess the reimbursement of the loan, asking for additional guarantees if considered necessary (they are adequately secured in line with banking practices) then the risk assumed would depend on the repayment capacity of the borrower. So we think that they shouldn't be deducted from capital simply because risks posed by the high correlation mentioned earlier between the bad performance of the capital instrument and the probability of coming back to the balance sheet of the issuing entity are not assumed in such cases. It should be excessively restrictive to recommend in these cases to do a look-though of the funding given to customers to assume that the issuer bears the risk of what they have bought and we consider that a risk related approach should be adopted.

  - In relation to the Additional requirements, we would ask for some clarification about the proposal of deducting from Tier 1 (and Tier 2) capital holdings of non-common equity capital instruments in other financial institutions.

- Paragraph 90 on the criteria that must be met in ***Tier 2.***

  - Criterion No. 4, section c) As we mentioned above, preferred stocks with *step up* would not be included in *Tier 2,* proposal that we challenge provided the incentive is limited to a sensible extent

- As far as **deductions** are concerned, we can highlight the following:

  In general, we believe that the practice of deducting assets from capital is not the most appropriate procedure for the assessment of credit institutions' solvency.

  We believe that there are a number of arguments, which can be traced to the developments in banking since the publication of Basel I until today, and it would be desirable to take them into consideration in the new definition of regulatory capital.

  Deduction of assets is not a method consistent with the proper risk assessment advocated by Basel II. The main purpose of measures taken since the first Capital Accord was published in 1988 has been to achieve a more adequate assessment of the risks incurred by credit institutions. Thus, among other things, the scope of observation has been extended firstly to market risks and secondly to operational risks and, in addition to the improvements in the assessment of credit risk using the standard method, institutions have been allowed to use their own internal models (IRB).

  In this context, it does not seem reasonable to require the deduction of assets without exploring the proper assessment of the risks that such assets involve. The technique of the

deduction of certain assets was perhaps justified by the inadequacy of valuation methods existing in 1988, but it is inconsistent with advanced valuation methods currently used by banks, which are in addition validated and accepted by the Supervisor. To mention one example, various methods for assessing the credit risk of equity exposures are recognised as valid and, at the same time, the full deduction of goodwill is proposed when, strictly speaking, it is only a part of the value of the equity instrument.

It is perfectly understandable that the regulator finds that certain assets involve higher levels of risk and, consequently, higher minimum capital requirements are demanded. In fact, unlike Basel I, the current Framework already establishes weightings over 100% of certain exposures for credit risk. This system of raising the weights above the usual requirements allows modulation of capital requirements based on the risk of each type of asset and, in turn, gives the regulator a broad discretion to control (weights between 100% and 1250%), unlike the rigidity of the deduction, which amounts to a weighting of 1250%, without qualification, for all assets that are deducted, when it is clear that not all assets deducted have the same level of risk, nor is the level of risk involved in most cases twelve-and-a-half times above that of a regular asset.

The concerns of the prudential regulator would have been understandable in 1988 regarding the proper valuation of assets on the balance sheet, especially in the framework of a Global Accord for a variety of jurisdictions, at a time when a variety of different GAAP were in use. However, since then, progress in the banking accounting field has been remarkable, both with regard to the quality of financial reporting standards, and the levels of homogeneity achieved internationally and, today, although full consistency has not yet been achieved, the bulk of international banking activity is carried out under two sets of high-quality and converging accounting standards.

In this sense, some of the proposed deductions, which could have been justified in the past due to a lack of confidence in the suitable valuation of assets and proper accounting reflection, make no sense today. Current accounting standards in force already establish far more precise recognition and valuation criteria and require, in any event, the recognition of the potential impairment of assets. In this sense, it is hard to understand why the Document raises doubts on the value of some assets and not others. As an example, we can quote “the concern that undue reliance on these assets is not appropriate for prudential purposes” (paragraph 99) referring exclusively to assets for deferred taxes.

Sometimes these concerns, seeking to justify the reasonableness of the capital base deduction, refer to the liquidation value of assets (for instance, in paragraphs 63, 97, and 99) It seems unnecessary to recall that all balance sheet items (assets, liabilities and equity) are valued under the going concern principle and, in the case of valuing assets at liquidation value, this would most likely involve the recognition of losses regarding their book value. But this discussion is equally valid for almost all assets and not solely those stated in the Document, and this does not seem to provide sufficient grounds to require the deduction of the possible loss of value upon liquidation, because many other assets whose valuation is not questioned could also be in the same situation.

Furthermore, it does not seem consistent to distinguish capital items based on their ability to absorb losses on a going concern basis and, at the same time, to deny certain assets (only a few) the value that they have on a going concern basis. Under the going concern principle, assets are valued according to the criteria set out by accounting standards and it does not seem reasonable or appropriate for solvency rules to establish valuation criteria, for some of them, alternative to accounting criteria, on the basis of the value that these selected assets would reach in hypothetical situations, outside the going concern basis.

Additionally, we would like to point out other specific comments about these paragraphs:

- *Stock surplus:* In our view, the share premium must be included in the relevant capital category depending, as in the case of any other element, on the economic function which it responds to (loss absorption capacity, subordination, etc.) and its legal makeup, that is, bearing in mind whether it becomes part of the equity of the issuer or whether it could become a right of the holder.

  If the share premium, like any other element, meets the requirements to be deemed *common equity* it does not seem justified that it must necessarily be treated the same as the element which generated it, even in the cases where the features of both, the premium and the element giving rise to it are essentially different.

- *Minority interest:* We believe that it is necessary to achieve consistency in the definitions of the numerator and denominator of the coefficients

  Therefore, when the numerator of the coefficient excludes MI, it is important that the denominator also excludes the proportion of the risk assets of subsidiaries covered under said MI. This is particularly important when assets are financed totally and directly with minority interests in the subsidiaries. Failure to do so, would compromise the current and future development strategy of banking groups, which would be disadvantaged compared to organisations without subsidiaries and this could hinder the resolution of banking crises in which the bank takes control, but not total control, over troubled institutions. Besides comparisons of organisations in the system would not be homogeneous and this could, furthermore, involve rating implications.

  Therefore, this same argument would also be valid for calculating the leverage ratio and would also be perfectly consistent with the idea set out in paragraph 209[2].

  Groups in which, in addition, there are risk assets weighted at 1250% (see comment below), would be doubly penalised.

  Finally, and again to keep consistency in the various proposals in the document, the proportional share belonging to minority interests of the assets proposed as deductions should be taken into account, such as in the case of *Deferred tax assets*.

  Unrealised gains and losses on debt instruments, loans and receivables, equities, own use properties and investment properties: We believe that any proposal leading to greater harmonisation of regulations across jurisdictions is appropriate, considering that it has been an important source of lack of comparability among financial institutions from different countries.

  As a general matter, we consider that there should be symmetry in the treatment of unrealised gains and unrealised losses. So, if, as proposed, unrealised losses are not filtered-out, it should be considered including in capital unrealised gains as well.

[2] "Items that are deducted completely from capital do not contribute to leverage, and should therefore also be deducted from the measure of exposure. That is, the capital and exposure should be measured consistently and avoid double counting. This means that deductions from regulatory capital (as set out in Section II.1) should also be made from the total exposure measure."

- *Goodwill and other intangibles*:

  The treatment of the goodwill arising from business combinations has evolved over time and the appreciation of the same, as to the nature and economic function thereof, is now considerably different than it was at the time the Capital Accord of 1988 was published, as evidenced by successive amendments contained in international accounting standards regulating this goodwill. In this sense, assessment of risks has also changed significantly after the introduction of Basel II, so it seems appropriate to review the treatment of goodwill and other intangibles.

  As discussed in other sections of this note, it would not appear that, in general terms, there is sufficient justification for the deduction from capital of assets recognised in the balance sheet. Accounting regulations already provide for matters relating to the recognition and proper valuation of assets and, in the case of goodwill and other intangibles, these regulations are especially demanding in terms of immediate recognition of the possible impairment of the value thereof and it therefore seems inconsistent that, in the case of solvency standards, the value is questioned fully and under all circumstances. A different matter is that, as in the case of other assets, weighting could be different from the general response depending, in any case, on the risk level assigned, consistent with the general criteria for risk assessment introduced by Basel II.

  We cannot share the rationale expressed in the consultation paper (paragraphs 63 and 97), in the sense that, in our view, a controlling stake (subsidiaries) or one that gives a significant influence (associates) is an asset that may be sold in stressful situations, because the problems that the holder may have in those situations do not necessarily have to be shared by the subsidiary or associate. It must be at least recognised that, in periods of stress or insolvency of the holding company, the sale of an investee is not more difficult, nor is the uncertainty surrounding its value greater, than that of a business unit that does not have the form of an independent legal entity. The relevant issue therefore, should be proper valuation of assets, tangible or intangible, and not the uncertainty of their realization value under extreme conditions, an approach that would force us to rethink the deductibility of a large number of assets, and not only goodwill, according to their realization value.

  Neither does it seem quite correct to oppose goodwill against organic growth (paragraph 97), because, as is well known, in any business combination there is also a revaluation of tangible elements (*real assets and liabilities*) which, although not sourced to organic growth, are not, however, questioned as to their value nor is a deduction from capital imposed.

  Finally, the deduction from capital of goodwill arising from business combinations or valuation using the equity method is discriminatory regarding equity instruments recorded at fair value.

  The purchase price of a stake that does not grant control (or involve significant influence), provided that the relationship between price and book value (*price to book value*) is greater than one, includes, whether in whole or in part, compensation for goodwill, to the extent that not all of this premium is attributable to specific tangible assets. Proof of the above are the quotations on major stock markets in the past and recent developments, as this verifies that the market value price included goodwill in a large number of cases.

  That goodwill included in unconsolidated equity (or using the equity method), however, is not deducted from capital. Moreover, in shares accounted at fair value with changes in profit and loss, increases in fair value, even if found to be

entirely attributable to underlying goodwill, are recognised directly in the profit and loss account for the year.

That is, crossing the line of control (or significant influence) over the investee involves going from no deduction whatsoever to fully deducting goodwill when, strictly speaking, the holding is neither more nor less capitalised nor are risks significantly different and, conversely, the ability to reach decisions on the investee is greater. Obviously, not all goodwill that is to be deducted can be attributed to the control premium.

Basel II already provides different methods for assessing the risk of stakes in other investees (in the case of the CRD, with the IRB method, with three alternatives: simple method for risk weighting, the PD/ LGD method and internal models method) that would be equally valid for assessing the risk associated with goodwill and intangibles of investees and, at the same time, preventing the "cliff effect" that occurs when the line of significant influence or control is crossed.

- *Deferred tax assets*: Given the importance that this deduction has for Spanish banks, we attach an overview of our argumentation in this area as Annex No. 1.

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

In relation to the deduction from capital of holdings in banks and similar financial entities which are not controlled by the group, which has been strengthened in the proposal including short term positions of the Trading Book and underlying positions of holdings in index funds, it is clear that it supposes a breach in the principle of alignment of capital requirements to risks assumed.

This deduction approach imposes higher capital requirements to investments in other banks than to investments in other businesses, even if the latter were to have much worse credit rating, and, consequently, it contributes to distortions in the comparability of capital ratios and in the desirable playing field between financial entities. Other negative side-effects of this regulatory approach are the obstacles to strategic decisions as step by step buying of other banks or the investments in banks subject to government imposed constrains to the maximum investment amount by a foreign bank.

Taking into account these negative side-effects we understand that this deduction approach should be used with caution by supervisors and only as a last resort mechanism, when other alternative tools fail to address the systemic risk linked to an excessive intra-sector capital holdings and its feared contagion effect.

Appropriate assessment and intervention mechanisms by supervisors are envisaged in the near future, as macro-prudential oversight is reinforced, which should allow relaxing these distorting provisions instead of reinforcing them, as the Document proposes.

Therefore, we request to consider the possibility of substituting the deduction approach by a more risk sensitive approach or, if it is too premature for that, at least to consider maintaining the provision for deducting investments in banks in similar terms as the current one, instead of substituting it by a more restrictive one.

In relation to the proposals to include positions in the Trading Book and to look through holdings of index securities, they could be quite burdensome to compute, giving the changing nature of the operations included in the Trading Book so a

minimum threshold should be established to take materiality into account. We consider that, for not being unnecessarily restrictive, the possibility of netting long and short positions with the same counterparty should be allowed, at least when there are netting agreements in place considered valid for solvency purposes.

In relation to investments in insurance companies, we strongly oppose the proposal to apply to these investments the deduction approach because we disagree with the underlying assumption that systemic risk in the banking and insurance sectors are of similar nature and should be considered jointly. Even if it is true that there are links between entities of both sectors, as is the case of financial conglomerates, it should not be taken for granted that insurance entities pose the same systemic risk as banks.

The insurance sector deals mostly with risks that are of a different nature than risks of banks. They receive premiums that are invested long term and claim payments that are dependent on the probabilities of occurrence and severity of the risks covered. So they do not have the same liquidity risks as banks and are not subject to systemic risk of contagion in the form of "runs on insurers" in the sense of runs on banks, where depositors ask for their money back at short notice.

We think that it is difficult to question the different nature of the business of insurance companies compared to those of banks as well as the different behaviour along the economic and financial cycles, as has been demonstrated in the last crisis.

Consequently, we consider that there are no reasons for a consolidated vision and assessments of global capital that includes both the banking and the insurance sectors in order to monitor systemic risk of undercapitalisation of the system and contagion risks, which we understand are the prudential reasons for imposing the deduction approach in the case of the banking prudential sectorial rules.

In the particular case of Financial Conglomerates (financial groups which provide services and products both in the banking sector and in the insurance sector, being significant, or above certain thresholds, the activity in both sectors) there is an European Directive in order to establish additional requirements at the group level to supplement the sectorial regulatory rules applied to banks and insurance entities, focusing, among other aspects, on potential double gearing or multiple use of capital inside the financial conglomerate. So, if certain conditions are met, a quasi consolidation is allowed in order to compute the capital of the financial conglomerate.

So, we consider that the proposal to extent the deduction treatment for investments in banks to insurance companies is not justified in terms of systemic risk, and hence the consideration to align requirements to risks assumed by an entity should clearly prevail in this case. A risk weighting approach should be used instead of the penalizing deduction approach.

- *Shortfall of the stock of provisions to expected losses*. The position of Spanish banks is to support this proposal as well as the proposal suppressing any caps on accountability of surplus provisions over the expected losses

  In this sense, we consider it essential to eliminate disincentives to a prudent provisioning policy, as stated in paragraph 246[3] of the document, and therefore,

[3] "The Committee also is reviewing the treatment of provisions under the Basel II capital framework with a view to removing disincentives to sound provisioning practices. In this context, the Committee is proposing that any shortfall of the stock of provisions to expected loss be deducted fully from the common equity component of Tier 1 capital…"

excess accounting provisions over the expected loss should be accounted as Common Equity. The reasons are clear:

- This excess of provisions is, in practice, the first buffer applied to absorb losses on a going concern basis.
- Otherwise, it would be a disincentive to a prudent provisions policy which, at the same time, helps to reduce system cyclicality.
- When deducing the provision shortfall from Common Equity, the surplus should also be regarded as Common Equity in order to avoid any asymmetry.

Additionally, before drawing final conclusions we deem it important to await the results of Phase II of the review of the IAS 39 which IASB currently has open to consultation.

- *Defined benefit pension fund assets and liabilities.* We believe that a harmonisation of accounting with prudential filters for this item would reduce complexity and eliminate national discretions which, in some cases, are distorting competition.

- *Remaining 50:50 deductions*: The change consisting in replacing deductions of certain assets in the numerator of the coefficient by weights of 1250% in the denominator, is not neutral and results in highly significant effects on the level of the coefficient without this having any technical basis.

  Annex No. 2 provides very specific examples on this effect.

Reducing procyclicality and promoting countercyclical buffers.

Cyclicality of the minimum requirement

We believe that any proposal intending to achieve along the cycle a stable average of minimum capital required is appropriate; however, we do not believe this would have to involve greater capital requirements in Tier I.

Therefore, in our view it is key to strive to a correct calibration of risks rather than changing the level of minimum capital required depending on the point in the cycle that we are currently in (i.e., harmonising the estimation of the PD's among jurisdictions –long run or downturn PD's-, recalibrating models, increasing sensibility to macroeconomic environment changes, etc). It is important to take into account the double impact that would occur with the use of a downturn PD, in those jurisdictions where the effect of rating migration of models has not been adjusted.

Forward looking provisioning

In order to reduce complexity for banks and information users, we believe that the proposals regarding provisions that the Basel Committee makes should coincide with the criteria finally adopted by IASB.

In any case, it is essential to avoid any overlap between accounting standards and prudential standards and, therefore, as previously stated, excess accounting provisions over the expected loss should be taken into account for the purposes of Capital.

Building buffers through capital conservation

The idea that institutions have excess capital over minimum regulatory capital in order to cope with periods of stress and losses without danger of falling below the levels of the latter is very appropriate, and the best proof of this is that it has been a common and widespread practice for a long time. This may be a result of a bilateral or country wide supervisory requirement, the end result of the bank-supervisor dialogue in the context of Pillar 2, or because it is voluntarily decided by each bank within its capital planning; the fact is that most organisations choose to situate their ratios a few percentage points above the minimum requirement.

However, as posed in the document, it is difficult not to notice the buffer proposed as a new regulatory minimum that would add to the x%, y% z% proposed respectively for core capital, Tier 1 and Tier 2. This would bring rigidity to what has been common practice, a practice which has allowed banks to decide for themselves on the strategies to follow in terms of their capital planning. Furthermore, this would also make the concept of regulatory minimum itself confusing, as the perspective is lost on the appropriate level of capital to perform the activity without setbacks along the cycle.

With respect to the mechanism proposed for capital preservation, it is true that when recalled the reckless dividend policy that some of the rescued banks have developed during the crisis, the objectives to be attained by limiting the pay out are understandable.

However, for those banks that have needed no public aid, and even cooperated with private solutions to help troubled foreign banks, and which also belong to countries where supervisors are particularly stringent in the application of Pillar 2, the dividend restriction policy is a clear example of unfair over-regulation.

The dividend policy is an essential part of the strategy of an organisation and therefore, except for those countries where Pillar 2 is not being properly applied, it should not be regulated or limited, even less so with schemes that rest on automatisms on the basis of certain quantitative levels, which become overly-prescriptive as a result.

Additionally, a point of concern is that disclosure obligations may lead investors to misinterpret the measures taken, notably the dividend pay-out constraints, with the ensuing serious risk of reputational damage.

Excessive Credit growth

Any proposals intending to limit credit growth once certain levels of indebtedness are reached should be evaluated very carefully, for the following two reasons:

- It could be a disadvantage for economies with greater bank intermediation versus those that have more developed capital markets, which could continue to borrow as much or more without apparent growth of credit.
- It would discriminate against small and medium businesses versus corporations with an adequate size - generally quite large- to gain direct access to capital markets.

ANNEX No. 1 **– Deferred tax assets**

The document proposes that the deferred tax assets amount, net of deferred tax liabilities, be deducted from common equity, a concept which, with some fine distinctions, would be equivalent to what now is known as core capital (basically, common shares and retained earnings).

Irrespective of the response to the consultative document that, on behalf of its associate banks, the AEB will forward to the BCBS, a number of arguments are detailed below where we support our position against deducting deferred tax assets from common equity .

- In general, the deduction from capital of elements that are part of the balance sheet assets is not sufficiently justified.

  Accounting standards establish a clear distinction between assets and contingent assets[4], regulate the criteria for the recognition and valuation of assets on the balance sheet, and set rules for recognising the possible impairment of their value. In this regard, if the effectiveness of a given asset is questioned, it would be reasonable to adjust its book value, which would involve the recognition of a loss impairment, or even its reclassification to contingent assets, and which ultimately causes the desired effects in terms of solvency through its reflection in the profit and loss account.

  On the other hand, with the solvency rules, the whole of the assets are risk weighted (between 0 and 1.250%) in order to determine the level of the minimum required capital. Deducting an asset from common equity, or its equivalent weighting by 1.250% (for a minimum ratio of 8%), means putting those assets, in terms of risk level and required capital, on the same level as material losses of the current financial year, the first-loss tranche in securitisation, the unrealised losses in AFS instruments, the deficits in provisions for expected losses, or investment in own shares (treasury stock) i. e., either with elements that represent realised or very likely losses, or with elements that entail the ineffectiveness of own funds.

  In most cases, the assets that are to be deducted from common equity do not represent a level of risk equivalent in any way to those of the aforementioned elements, and for this reason at the most they might be subjected to a weighting percentage higher than 100%, if it is deemed that their risk is higher than that of the majority of the assets, but proportionate to the potential risk they introduce in the balance sheet and, of course, very far from 1.250%.

  In the case of deferred tax assets, this risk has so far been considered very low, to the point that Bank of Spain Circular 3/2008 (rule 13.3) grants them the following treatment:

  > *Insofar as they do not constitute exposures, the following items of reserved, individual and consolidated statements referred to by BSC 4/2004 are not subject to weighting:*
  >
  > …
  >
  > *d) Tax assets, provided that the foreseeable recovery period does not exceed 10 years.*

- Deferred tax assets reflected on the balance sheet are due to different items of different origin and nature. Recognition of deferred tax assets is not homogeneous in all European countries. Tax laws also vary from one country to another.

[4] See the Framework for the preparation and presentation of financial statements of the IASB and, among others, International Accounting Standards IAS 37 concerning contingent assets, IAS 38 relating to intangible assets and IAS 12 about Income taxes.

The consultative document itself recognises that one part corresponds to those deferred tax assets representing a tax credit strictly speaking and, consequently, should not be deducted from common equity, but instead weighted according to the level of risk that corresponds to the debtor public administration.

The other deferred tax assets can be classified, at least, into two large categories: those corresponding to the carry forward of unused tax losses and those generated by deductible temporary differences between the accounting and tax allocation of certain expenditure or income.

The first category, corresponding to the carry forward of unused tax losses, originate in losses incurred in the past. Thus, to enable their recognition as a deferred tax asset, accounting standards require, among other conditions, the likelihood of the entity obtaining in the future sufficient tax gains to offset them, and that the tax losses result from identified causes that are unlikely to recur.

The second group, temporary differences, originates in the different temporary allocation of certain expenses with both accounting and tax criteria, and is fed, especially, by provisioning against the profit and loss account, precisely because profits existed with which to make such provisioning.

Applying the same deduction or weighting to both groups of tax assets would penalise those entities which, having made profits, have also made provisions which may be used in the future, as opposed to those which have simply sustained losses in the past.

- For the aforementioned reasons, the existence of deferred tax assets has an obvious economic substance in those cases included in the first category: the existence of losses in previous years, whereas in the second category such simply does not exist, and its accounting reflection is due exclusively to a mere formal convention resulting from the criteria used by the tax authorities for temporary allocation/ non-deductibility of some expenses, when such criteria differ from the accounting standards. Therefore, the principle of prevalence of the economic substance[5] of the operations leads us to the conclusion that, they are not identical assets and, consequently, their regulatory treatment should also be different.

- It is hard to understand the justification claimed by the BCBS for deducting deferred tax assets from common equity: *they may provide no protection to depositors or governmental deposit insurance funds in insolvency and can be suddenly written off in a period of stress*.

  As for the first cause, we should reiterate that the accounting standards already provide sufficient cautions to ensure that, before arriving at a situation of insolvency, the tax assets have been written off, from the moment it is no longer likely that the entity will obtain in the future sufficient tax gains to offset them[6].

  It would seem more justified for the solution to this problem an appropriate application of the accounting standards, and not the indiscriminate deduction of tax assets for all the entities, irrespective of their situation and of the nature of the tax assets. Deduction without exception of all the tax deferred assets from the capital could alter the level playing field.

  In the case of tax assets originating in provisioning, we should add that it is precisely the existence of the provision funds that affords more protection to the depositors than their non-existence, which once again reveals the penalising nature of the deduction for entities with this type of tax assets compared with those which have not provisioned the funds.

[5] See IASB's*: Framework for the Preparation and Presentation of Financial Statements*. Paragraph 35.

[6] See IAS 12. Paragraphs 34 through 36.

As for the second point mentioned in the BCBS document, it has not been proved that a sudden disappearance of the tax assets occurs in periods of stress. This has definitely not been the case with Spanish banks.

At any rate, it seems that there are other types of assets whose loss in value has been much greater and swifter during the recent crisis, in relation to which, however, the deduction from common equity is not proposed.

- The consultative document of the BCBS proposes that the distinction between the constituent elements of Tiers 1 and 2 be made according to whether it is capital with the ability to absorb losses on a going concern basis, or when the company is a gone concern, respectively.

  According to this criterion, deferred tax assets are fully effective under the "going concern basis" principle, where the company's ability to continue generating profits in the future and, therefore, to materialise the tax assets is assumed[7].

  Only when the company is a gone concern, or it is highly likely that it will become a gone concern in the short term, might the effectiveness of the activated tax assets be questioned. In this regard, should deduction be preferred to standard accounting valuation, the proposed deduction of common equity should be done from the components of Tier 2, not of Tier 1. It would be logical to assume that, in the case of a gone concern, the entity, in order to absorb losses, has additional own funds (Tier 2), net of assets which, precisely because of being a gone concern, are no longer effective.

- Compared with other assets, deferred tax assets retain their value for a period of up to 20 years. In this context, it should be noted that even in gone concern situations, DTAs have proven to have a value to creditors or to third party buyers of assets of the bank in question. Even in a liquidation scenario, the company can be sold to a third party who can make good use of its tax credits, and even in some countries tax credits can be sold directly. In addition, there is no counterparty risk, and these assets are not sensitive to changes in market values.

- Deducting deferred tax assets from common equity generated by provisioning is contrary to countercyclical measures.

  In general, tax authorities are reluctant to consent the tax deductibility of provisioning above the mandatory minimum levels, for purposes not expressly considered by the regulation, for risks with some type of additional collateral, or as a precaution against future losses.

  In Spain, countercyclical provisioning is tax-deductible up to 1% of the annual increase in the credit without collateral. The exceeding is not tax-deductible.

  Entities that make contributions to countercyclical funds against profit and loss account, which are not tax-deductible in the year when they are provisioned, would be doubly affected if, in addition to reducing their accounting profits owing to the provisions made, they had to deduct from their common equity the tax assets generated by simple temporary differences.

  The measure would be clearly discouraging for the establishment of countercyclical provisions and, for this reason, the deduction of common equity is a procyclical measure: in the prosperous phase of the cycle the entities would not provision additional funds and would report better results and, with no deferred tax assets to be deducted for this reason, more common equity, whereas the opposite effect would be generated during the downward phase, where all the provisions would be concentrated and sharp drops in common equity would be generated.

[7] See IASB document *Framework for the Preparation and Presentation of Financial Statements*. Paragraph 23.

ANNEX No. 2 – Inconsistency and perverse effects on the capital ratios of the 1250% weighting of certain assets, versus the deduction method (chart of paragraph 107 of the document).

The planned change consisting of replacing deductions of certain assets in the numerator of the coefficient by weights of 1250% in the denominator, is not neutral and results in highly significant effects on the level of the coefficient without this having any technical basis.

Let's see a possible example: Suppose a bank with a capital of 1,200 m€ and weighted assets of 10,000 m€ Its coefficient would be the following:

1,200/10,000 = 12%

Suppose that the same bank also has additional capital of 400 m€ invested in assets to deduct from capital under the current regulation and weighted at 1250% under the future regulation. The coefficient according to the future regulation would result in:

1,200+400 / 10,000+(400x12,5) = 1,600 / 15,000 = 10.7%

That is, this change of system would make the coefficient more "expensive", for no reason whatsoever. A 1250% weighting is proposed as an equivalent to demanding coverage with capital of 100% of the relevant assets and, therefore, it is incoherent to raise the capital demand. However, by including the new capital in the numerator and the assets weighted at 1250% in the denominator, the coefficient of other assets in which there was previously an excess over the regulatory minimum of 50% (coefficient of 12%) is made more expensive, and is now only 33% (10.7% coefficient).

In addition, it can be seen that the impact of the reduction is larger when the current level of solvency of the bank is larger, and this punishes organisations with the highest degree of capitalisation: If the prior coefficient was 15%, it would be reduced to 12.7%; if the prior coefficient was 20%, it would be reduced to 16%, etc. Other examples can be provided with different structure combinations and with other results but, in all cases, the impact is significant.

The change would solely be neutral if the bank´s capital position was at a level which would equal an exact compliance with the required 8% minimum. Interestingly, if the coefficient was breached and the bank´s capital position would actually be under the regulatory minimum of 8%, the new regulation would apparently improve the situation of this bank.

Indeed, continuing with the example provided above and on the basis of a coefficient of 6%, we would have the following::

Current regulation: 600/10,000 = 6%

Future regulation: 600+400 / 15,000 = 6.7%

Therefore, a 1250% asset weighting provokes a perverse effect on the coefficient, and it would be logical to maintain with the regulatory deductions of those assets for which the regulator wishes to have a 100 % capital coverage. If this is not the case, the coefficient of the affected organisations would be more expensive, and this would prevent suitable comparisons in the system, distorting the perception of real solvency on the market, affecting the rating, and also involving effects on the calculation of Pillar 2 buffers.