POLISH BANK ASSOCIATION

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Basel Committee on Banking Supervision

<u>Subject:</u> *Consultation on CD "Strengthening the resilience of the banking sector (BCBS 164), International framework for liquidity risk measurement, standards and monitoring" (BCBS 165)*

Dear Sirs,

On behalf of the Polish Bank Association I would like to present the position of our Association on the Consultative Documents of the Basle Committee on Banking Supervision published in December:

I. "International framework for liquidity risk measurement, standards and monitoring",
II. "Strengthening the resilience of the banking sector".

I. CD: "Strengthening the resilience of the banking sector"

The Polish Bank Association (PBA) welcomes the willingness of the Basel Committee to set a framework of rules to improve the resilience of the banking sector. PBA acknowledges the need for better regulation.

The enhancement of the capital requirements should only be implemented when it is proportionate to the risks involved. It must be ensured that the cumulative impact of all the new prudential measures be proportionate to the risks involved and that their aggregate impact and effect on the global economy be carefully assessed. New capital requirements can not destabilize the situation on the financial market, contribute to changes in the architecture of financial market and the occurrence of new wave of merger and takeover in banking sector. New capital requirements cause the situation of the shareholders in banks. The return on equity will drop drastically, the dividend payment will have to be strictly limited. Many shareholders, particularly the institutional investors may decide to withdraw their financial involvement in bank. New capital requirements should be introduced step by step in order to avoid the negative consequences for financial market and rise the pressure for banks to building the higher capital buffers . The placement of grandfathering clauses

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and the recognition of a sufficiently long transition period will be key to succeed in the adoption of this overhaul of the prudential regulatory framework.

It is also important to note that concerning each individual measure, it will be of the utmost relevance to pay attention to the overall impact of the proposed regulatory overhaul on the real economy. There is no doubt that stability is a primary objective, but it is also true that the weakened post-crisis economy needs banks lending. And there are grounds for thinking that there is a trade-off between solvency and lending capacity. New capital requirements for banks can not cause the negative consequences for bank ability to deliver the financial resources to support the weak economic recovery of economy in the post-crisis era.

So far, the proposals presented only show the direction of the Committee's efforts to tighten the capital requirements. Hence, at the present stage, it is hard to estimate the potential impact that the proposed arrangements may have on risk-weighted assets and the capital requirement. The greatest potential changes arising from the Consultative Document will concern the quality, transparency and components of the capital base. It seems that some of the proposals for strengthening the capital base will have a limited impact on commercial banks in Poland, as the share of equity and retained earnings in total own funds is greater in Poland than in many banks operating internationally. Also the scale of Polish banks' transactions in the derivatives market is smaller, which will reduce the consequences of introducing higher capital requirements for this type of instruments. However, it is estimated that the proposed changes will have an adverse effect on the size of the capital base, and hence reduce the capital adequacy ratio.

1. **Unique nature of the cooperative bank sector**

   However, the proposed provisions should take into account the unique nature of cooperative banks in Poland, which operate, among other things, under the provisions of the cooperative law. Owing to legal and business restrictions, cooperative banks find it difficult to increase the "hard" capital level. The provisions of the Consultative Document do not specify explicitly whether the "share fund" (share capital of cooperative banks) can be included in Tier 1. It only suggests that the local supervisory authority can adopt its own arrangements in this respect, dedicated to specific local institutions. Please note that quick doubling of the capital requirements for cooperative banks means will expose them to the risk of bringing their growth to a halt or a wave of forced consolidations.

2. **Grandfathering period (Section 84)**

   IT seems that grandfathering is to apply only to HT1 hybrid capital instruments as well as UT2 and LT2 instruments issued before the publication of the above document by BIS, i.e. before 17 December 2009.

   The provisions of the document may suggest that issues of an HT1 instrument consistent with the resolution of the Polish banking supervisory authority (No 314/2009 of 14 October 2009) made in 2010, but inconsistent with the above BIS document will become "invalid" after the BIS arrangements are adopted by the European Commission (in the form of amendments to CRD) and in consequence of the adoption of CRD amendments in Polish law. This would mean that the law would operate retroactively if e.g. a bank issues an HT1 instrument with 30-year maturity (i.e. the maximum possible according to the Polish Financial Supervision

Authority's Resolution No 314/2009) in 2010, and then, e.g. in 2011, the PFSA adopts the BIS guidelines concerned, which provide that HT1 instruments must be "perpetual" only (i.e. without a defined redemption date).

In the PFSA's opinion, the grandfathering period should be extended until the local law is modified by adopting the BIS guidelines under consideration (obviously, subject to their adoption by the European Commission as part of CRD amendments).

3. **Conditions required for hybrid capital instruments (Section 89)**

   According to the guidelines, the instrument is to be provided with a write-down mechanism, i.e. if a bank incurs losses, the nominal value of an HT1 hybrid instrument is to be reduced.

   Therefore we suggest that a write-up mechanism should also be allowed, where the nominal value of the HT1 instrument under consideration would be increased (event to its original level) in successive periods. Such an arrangement will ensure symmericity of the instrument in the event losses are realised/profits are made, which will, in turn, reduce the cost of capital acquisition by banks.

4. **Counterparty credit risk (Sections 112-116)**

   With regard to credit risk, the new package seeks to strengthen the requirements for counterparty risk coverage in the case of derivative instruments, repos and securities financing transactions. At the same time, the Committee indicates that regulatory mechanisms will be established to promote moving OTC derivative exposures to central counterparties and exchanges. We endorse the proposed direction of changes.

   The Polish Bank Association is currently working on the establishment of a central counterparty institution for the Polish interbank OTC market. In our opinion, the general assumption should be adopted that different instruments can be introduced into such a system gradually, and the order of introduction or the choice of the instruments themselves should be hinged on he degree of development of the local market and the needs of its participants. In addition to enhancing the security and stability of the entire market, the purpose for which the central counterparty institution is established should also be to maintain the diversity and flexibility of the OTC market.

5. **Mark-to-market unexpected counterparty risk losses (Section 125)**

   The introduction of the new capital requirement in respect of mark-to-market unexpected counterparty risk losses (Section 125) means an additional specific risk charge for banks using the standard method of calculating the capital requirement combined with the mark-to-market method used to determine the balance-sheet equivalent of derivative transactions, in the amount comparable to the capital requirement amount in respect of counterparty credit risk.
   In addition, the use in calculating the general interest rate risk of the maturity method or the time-adjusted average payback period method rate combined with the EAD definition that sets to zero exposures smaller than zero results in an additional disproportionate increase in requirements (no matched positions in zones).

Proposal: calculation of the additional requirement only in respect of the specific risk of newly established virtual bonds or a change of the EAD definition (with negative values allowed).

6. **Bond-equivalent and credit valuation adjustment (CVA) (Sections 123-125)**

The concept presented in the document is not comprehensible, and as it has evoked many discussions in the bank sector, its precise definition and justification is necessary.
In particular, in order to estimate the impact of this change it is necessary to present specific guidelines for the method of calculation the additional capital requirement.

We would like to focus on the fact that the proposals seem inconsistent, as the additional capital requirement covering the CVA risk in the case of institutions calculating counterparty credit risk exposures by the Current Exposure Method (defined in the PFSA's resolution as the mark-to-market method and the primary exposure method, respectively), would be based on a method of calculation of the general interest rate risk requirement, while, on the other hand, it is to be connected with the calculation of the capital requirement in respect of specific debt instrument risk.

In addition, we have the impression that both approaches have their flaws. The use of a calculation method similar to that used in calculating specific risk is based on the debtor's present credit quality, and thus it does not cover the CVA risk arising mainly from a change in the probability of a counterparty's insolvency. On the other hand, the approach based on algorithms applied in calculating the general risk will probably better cover the CVA risk, yet there is no way to allocate the resulting amount to individual counterparties, which should not be acceptable in the case of the counterparty credit risk requirement.

7. **Asset value correlation – AVC (Section 135)**

The Committee points out that assets of financial firms are correlated 25% more than for non-financial firms. Therefore the Committee proposes that a multiplier of 1.25 to be applied to asset value correlation (AVC) in estimating the capital requirement using the IRB method. As the dependence of the capital requirement on AVC is not linear, it is estimated that the change will result in an increase of the requirement by about 35% with regard to the counterparty risk. The Committee also proposes that the multiplier should be adopted only for counterparties with assets of $25 bn and more. In the Polish market there are few such large counterparties, but the proposal will affect mutual relationships between Polish banks and their foreign strategic investors, which are usually the largest global financial institutions with assets significantly exceeding the 25 bn threshold.
We propose that the asset value threshold for the entities to which the adjustment of asset value correlation should apply should be increased. With a threshold of $25 bn most institutions that are market stakeholders will exceed the value, hence the adjustment will not diversify the approach to those entities, and apparently this is the assumption behind the introduction of the adjustment.

We suggest setting the asset threshold at a level of at least EUR 100 bn – such a value will allow the intended diversification to be achieved.

8. **Testing**

   In addition, the Committee enhances the role of stress tests for counterparty risk and the significance of backtesting and validation of models for counterparty credit risk exposures under the IRB method. The Committee suggests that the calculation of the impact of extreme conditions be limited to exposures an individual counterparty. This will make banks to deeply review the local approach both to rating models and to their methods of stress-testing. We propose that stress tests should not be limited to that level, as a wider view seems to be advisable here – an analysis product type, counterparty quality group, sector and other levels that make it possible to fully identify the counterparty credit risk and the wrong- way risk.

9. **"Highly leveraged institutions" (Section 136)**

   It is necessary to define the entities defined as "highly leverages institutions" and "unregulated financial intermediaries". In addition, for the avoidance of doubt, it is necessary to use those terms consistently throughout the document (apparently they are sometimes used interchangeably).

10. **Collaterals (Section 148)**

    The approach presented is too restrictive. Banks should monitor the use of collaterals, but only those with low liquidity. Additional requirements for monitoring and reporting cash collaterals received seems redundant, as the bank is already obligated to manage its liquidity risk.

11. **Netting sets (Section 152)**

    This arrangement is too strict. Disputes over netting sets usually are of a fortuitous nature and hence they do not testify to a lasting increase in the settlement risk for a given bank. What is more, standard CSA/Collateral Agreement mechanisms provide that in the case of disputes the indisputable part is transferred, and the dispute concerns the outstanding value only.

12. **Ratings (Section 184)**

    The Committee also notes that banks are excessively dependent on external ratings in credit risk assessment. Switching to the internal rating method for capital requirement estimation should make banks independent of external ratings, while in certain internal rating systems external ratings are treated as benchmarks.

13. Leverage ratio

The Consultative Paper recommends developing at a global level a non-risk based measure to contain leverage. Compared to the Basel ratio, the leverage ratio ignores the quality of assets and is, therefore, too simplistic. Introducing a leverage ratio would be in contradiction with the spirit and the purpose of the Basel II rules which take into account the riskiness of investments. As a result, a leverage ratio requires banks to hold more capital than justified from a risk-based point of view.

In addition, it removes the incentives for institutions to improve their risk management practices. Therefore, introducing a leverage ratio would constitute a step backwards.

The Basel Committee proposes that the leverage ratio would ultimately be transformed into a Pillar I measure. However, imposing a quantitative limit on the gross leverage of financial institutions which would take the shape of a hard number, i.e. an absolute level that would be binding on a stand-alone basis on all financial institutions in every circumstance, would not be appropriate as such an approach would not be neutral as to the differing business models used by banks.

The most important victims of a leverage ratio which would be conceived as a Pillar 1 measure will be banks that provide mortgage and retail banking services and of which the lending portfolio mainly consists of well collateralised retail exposures carrying low risks. Introducing a leverage ratio within the framework of Pillar 1 may have devastating effects on low risk banks.

There are reasons to extend the leverage measure to all financial intermediaries and, therefore, not just on banks, in order to avoid the need for a unlevel playing field and regulatory arbitrage.

14. **Procyclicality (Sections 239-242)**
The PBA understands that more clarity on the subject of procyclicality, Expected Loss provisioning and capital buffers will be provided in a document to be published later this year. In that respect, the Polish banking sector especially draws attention to the lack of clarity surrounding buffers on top of the pillar 1 minimum requirements and how all these different proposals relate to each other. We believe that the forward-looking element of the provisioning system will contribute to mitigate procyclicality.

What is also worth noting is the proposal that certain mechanisms Na should be introduced in the methodology to reduce procyclicality of risk model behaviour, and hence capital requirements. This concerns the achievement of better balanced risk sensitivity and stability of capital requirements. In this context, the Basle Committee is considering two proposals: one suggested by the Committee of European Banking Supervisors (CEBS) concerns the introduction of PD estimation adjustment in Tier II using the IRB for the effect of PD decline in economic prosperity periods. The other proposal comes from UK's FSA. It consists in introducing PD values not charged with procyclicality by applying a factor scaling the current PD to values corresponding to through-the-circle (TTC) PD estimates. Both approaches have good and bad sides, but it must be admitted that both measures are aimed in the right direction. Adapting the currently operating models to the new philosophy will require not only changes in algorithms, but also in procedures related to rating appeals owing to current customer risk.

15. **Forward Looking provisioning (Section 243-246)**

The document also seeks to review the current approach to the question of calculating IFRS forward looking provisioning instead of the incurred loss concept adopted in IAS 39. The Committee intends to use, in provisioning, the expected loss concept and wants provisions to also cover unexpected loss on default transactions. Those proposals from the Committee are considered justified. Their implementation will contribute not only to strengthening provisions for credit risk, but also to achieving synergy between the IFRS provisioning methodology and the calculation of capital requirements in accordance with the Basle IRB method.

16. **Creating a capital buffer in a period of excessive credit growth (Section 260-262)**
The presented idea to establish an additional capital buffer in a period of excessive credit only reveals rather imprecise assumptions not based on an substantive arguments, which would make it possible to conclude that the introduction of this regulation will promote banks' ability to absorb losses, without simultaneously accelerating the suppression of growth trends in the economy.
It seems that the principal objective, i.e. increasing the financial sector's capability to absorb losses will be achieved through a change in approach to provisioning and increasing the required capital base in the form of the idea of minimum and recommended capital conservation standards).

As rightly noticed in the Consultative Document, there is set of macroeconomic variables that would enable a local supervisor to objectively conclude that lending activity in a given market is already excessive. In practice, the introduction of this type of regulation may be used as a tool of macroeconomic policy, which, when used without coordination with other instruments of monetary policy, may lead to economic disturbances and effects contrary to the intended ones.

The proposed arrangement also gives rise to serious doubts as to how the requirement for the maintenance of additional capital will be communicated by supervisors. We expect that from the moment the supervisory authority announces the need to increase the capital base owing to excessive lending to the entry of the requirement into force banks will be allowed time (at least 12 months) to implement the requirements. In practice, the shift in time between the date at which the local supervisory authority declares that lending is excessive and the date at which the bank will be required to increase capital may be so long that capital buffers will not be increased before another economic slump.

It should be expected that the growth rate of lending activity in Poland will be considered to be high and hence it will be subjected to additional capital requirements. There is no specific proposal so far on how large this additional burden will be. However, the fact that the Polish banking sector has been least affected in Europe by the recent crisis is indicative of the need for a more in-depth review of the proposal.

17. **The interplay between different measures:**
The PBA has identified certain areas that could pose undesirable effects due to the combination of proposals. There is the couple of proposed solution to minimalize

negative effects of procyclicality. When the results of the calibration are known, it would be right to assess the impact of combined measures on the bank activity. There are a lot of proposed instruments to limit the procyclicality effect of banking activity. For Polish banking sector which is developing very rapidly recently, it is very important question if all measure will be introduce simultaneously and what impact they will have for banks and economy. The measure should be created in other way for rapidly growing economy, particularly the emerging economy.

II. Liquidity risk – Consultative Document (CD): "International framework for liquidity risk measurement, standards and monitoring"

The document provided shows the main directions in which regulations will be developing and discusses the considerations behind the Committee's guidelines. The regulations proposed apply to international banks at a consolidated level, and hence they will affect Polish banks operating as members of multinational groups. It should be noted that the document in its present form is highly general, which makes an in-depth analysis of impact on banks difficult.

1. Owing to major difficulties in implementing supervisory regulations with the use of the proposed classifications and, first of all, the required ratio levels (banks will probably have to considerably decrease the level of their liquid assets or reduce lending activity, which may trigger very keen competition in the deposit market, spread narrowing, and an adverse effect on their bottom line), its seems advisable to consider a sufficiently long *vacatio legis* period for the document or define a path of reaching the required parameters so that its adoption does not translate into halting the economic rebound once the crisis is overcome.

2. We would like to pay attention to significant proposals regarding the disclosure of minimum standard liquidity ratios. All information should be published at an appropriate level of generality (presentation of selected values only – as is the case with IFRS 7) so as to avoid an unfavourable impact on the competitiveness of the different banks. In this area, the role of the local regulator will be important, whose responsibility will be to specify in detail disclosure rules for banks that are members of international financial groups in the local market.

3. In the light of the local conditions, the proposal to use the LCR is limited in the context of diversification of liquid securities. Therefore the local definition of liquid assets is highly important and it should be adjusted to the market's capabilities. It is worth emphasising that the debt securities market in Poland is not comparable to that in developed international markets, and therefore it may prove difficult to maintain a portfolio of liquid securities meeting all the characteristics described in the Consultative Document. It would be necessary for the local regulator to provide detailed guidelines and instructions.

4. (Section 32) As part of operational requirements, the Committee suggests that the availability of liquid assets should be tested periodically through repo or outright sale, which the PFSA considers to be far-fetched prudence. In addition, it should be noted that such activity will burden the sector with additional liquidity costs, which will consequently affect the product offer for customers.

5. (Sections 36-37) The introduction of conditions for recognising corporate bonds and covered bonds as liquid assets rules out compliance with those conditions in practice, e.g. owing to a lack of sufficiently detailed historic data.

6. (Sections 41-42 and 85) The lack of explanation of the exact meaning of "have other established relationships with the same bank which make deposit withdrawal highly unlikely" makes this condition too discretionary. It may be interpreted differently by supervisors in different countries.

7. (Sections 55 and 85) It is worth reviewing the proposal for taking into account the potential run-off of deposits of public sector entities in the same manner as for financial institutions. Public sector entities are likely to behave more like corporate entities and this is how they should be taken into account in potential deposit run-off factors. Besides, their behaviour is different for banks related e.g. by equity to the public sector and for typical commercial banks – therefore it is not correct to apply the same ratios in both cases.

8. The obligatory reserve is a very important component of liquid assets. Currently banks in Poland may use it on a monthly basis under certain regime – this means some availability in day-to-day liquidity management. What will be important for banks is the extent to which banks will be able to use the central bank's reserves in a crisis situation.

   At the same time, the Polish central bank should be more strongly involved in the securities market, so that when a crisis arises banks could include relevant debt securities in the liquid asset portfolio defined in the Consultative Document as the "central bank eligible corporate and covered bonds". The Polish market is not a highly developed debt securities market, and therefore it will be very difficult to diversify the liquid securities portfolio. It should be noted that that in Poland the range of securities that may be used to secure operations with the NBP is significantly smaller than in other EU countries, especially with regard to securities accepted by the European Central Bank, which puts Polish banks in a considerably worse situation than banks belonging to the Euro Area. It must be stressed that preferring only those securities in liquid assets will lead to their higher prices and reduces availability for banks.

9. It is worth reviewing the definition of significant currency, especially in percentage terms. The requirement to maintain an appropriate relationship between liquid assets and a stable net position for such a small balance in a foreign currency is an excessive burden for a bank, especially where it is necessary to take into account off-balance-sheet (derivative) transactions, especially CIRS, in which banks convert one

currency into another to be able to provide financing in that currency, in determining the metrics proposed in the Consultative Document (Sections II.33 and III.2). We propose that the level of significant currency liabilities in a bank's total assets be increased from 1% to 5% or 10%.

10. In addition, the run-off values assumed seem to high for specific banks – there are banks in the different countries, which, owing to the policy they pursue, have a much higher stability of the deposit base than that determined on the basis of the basis of the proposed ratios, even in a market crisis situation, what is more, owing to their reputation they attract customers' funs in periods of crisis. A bank's reputation developed over years (e.g. in connection with a conservative approach to risk) must not be penalized, as is the case with arbitrarily set funds run-off ratios.

11. In addition, penalizing a bank for providing customers with access to fund over the Internet, even in the case of customers with who the bank maintains "other relationships" seems excessively conservative (banks are aiming to increasingly serve their customers via the Internet).

12. The definitions of stable and less stable liabilities presented in the document are based on potential customer behaviour in a normal or stressed situation. In order to unify and introduce a uniform measurement of liquidity risk, it is preferable to apply the proposed standards.

13. According to Polish regulations, at present banks may use internal models for the evaluation of stable and unstable assets. From our point of view, for the evaluation of stability of current and savings accounts (i.e. indefinite-maturity liabilities), banks use models replicating liquidity and interest risk characteristics, and this approach is used to measure the stability of deposits. The amount of guarantees from the Bank Guarantee Fund is not necessarily a decisive factor in withdrawing funds before maturity – one example is the last financial crisis in 2008/2009. What is worth emphasising is that bank awareness of retail customers is now greater than in the period in question.

14. Although the arrangements proposed in the document concern international banks, they will later be contained in EU directives and will be binding on all banks in Poland. Therefore we want to point out that the strict rules for the calculation and maintenance of supervisory liquidity metrics in force in Poland since mid-2008 seem to be more restrictive than may appear from the liquidity situation of the bank sector, especially the cooperative bank sector, which continues to represent a significant source of funds for commercial banks. The proposed changes which impose highly labour-consuming daily calculations do not improve the liquidity situation of cooperative banks, and have an adverse effect on their performance. The Polish banking supervisory authority should take advantage of the possibility of defining selected institutions, as contained in several sections of the Consultative Document ,–in particular cooperative banks – as strong groups in terms of capital and liquidity, mainly owing to joint measures taken within the framework of associations – to which the new restrictions will not apply. We also note the fact that it is

necessary to make it possible to include in the balance of liquid assets interbank deposits held by cooperative banks with the associating bank. Otherwise, not only will the balance-sheet structure of both types of financial institutions change, with an adverse impact on the profitability of cooperative banks, leading to their reduced competitiveness in local markets, but the very sense of existence of the association and the associating bank as an entity that guarantees liquidity of associated banks will be undermined .

15. It seems reasonable to introduce diversified assumptions regarding the scale of run-off in a stressed situation (customers' behaviour may differ both depending on the market/country and on the competitive position/reputation of each individual bank).

16. So far, banks have been using internal models to evaluate the stability of their deposit base (e.g. when calculating supervisory liquidity metrics). The proposals aim at unifying the rules of such evaluation, which may prove to be excessive simplification, given the existing differences between markets/individual customers (see above).

17. We confirm the need to examine the impact of the proposed changes on the bank sector and to adopt a transition period to enable banks to adjust to the proposed liquidity metrics and their limits. It will be possible to assess potential restrictions imposed by the new liquidity ratios on banks' policy will be possible when e.g. detailed rules are known, e.g. for the classification of assets (in particular, the conditions that allow them to be included in the liquidity buffer).

18. To sum up, the proposed changes are highly conservative and restrictive, which may significantly affect bank's results and the availability credit for individuals and for companies. It should also be noted that the implementation of the proposed liquidity measurement standards will increase the bank's IT expenditure (development of appropriate risk measurement applications).

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