European Association of Co-operative Banks
Groupement Européen des Banques Coopératives
Europäische Vereinigung der Genossenschaftsbanken

European Commission
DG Internal Market and Services
Banking and Financial Conglomerates Unit

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Commission services staff working document: Possible further changes to the Capital Requirement Directive

Dear Sir/Madam,

The European Association of Co-operative Banks (EACB) welcomes the opportunity to comment on the Public consultation regarding Possible further changes to the Capital Requirement Directive ("CRD").

Please find our general and specific remarks to the questions on the following pages.

We remain at your disposal for any further questions or requests for information.

Yours sincerely,

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GENERAL REMARKS

1. Introduction

The members of the EACB support the Commission's overall goal of improving the banking sector's ability to absorb shocks arising from financial and economic stress, while at the same time promoting sound credit and financial intermediation activity. Improving risk capture and the quality of the capital base, controlling excessive leverage in the financial system, addressing procyclicality in capital requirements and managing systemic risk are all goals that we endorse.

As said, we support the dual objective of improving the resilience of the global financial system and ensuring a level playing field sought by the reform package, but at the same time we think modifications will be needed to manage the tradeoffs between layers of protection on the one hand and prudent credit provision for economic growth on the other.

2. Economic impact

The regulatory reform package that was decided in Pittsburgh by the G20 to reduce systemic risks and which is the rationale for this consultation is currently a key topic in the international and national debates. The main issues concern the number and the impact of these measures on the overall economy. Some members of the EACB voiced that the required strengthening of own funds and liquidity standards will most probably have a very negative effect on the national and European economy and for the evolution of the banking industry. It is considered that the only effect of the solvency requirements is that it would cause a considerable restriction of the distribution of credit. Analysts of one of our Member banks estimated that there could be a reduction of the provision of credit by 20% in the EU with a negative impact on the real GDP of approximately 1.5% on the short term and 6% in the mid to long term. The reduction in credit provision could particularly affect clients in more peril situations like SMEs.

The EACB therefore considers that it is highly important to conduct an additional impact assessment to analyse the effect of the proposed reform package on the real economy on the short, medium to long term and also its impact on the international level playing field. The key message of the all policymakers worldwide and at European level to 'get it right' could not possibly mean that there should only be a strong and strengthened supervisory regime and not also a favourable banking environment. In order 'to get it right' the implications of the proposed measures must be subject to a comprehensive scrutiny to avoid a further slow down of the European economy and end up in the 'second league' behind the USA and Asia as stated by Dominique Strauss-Kahn in Bucharest on 30 March. While the members of the EACB acknowledge that it is necessary to act swiftly and in a coordinated manner, it is highly recommended to assess the impacts on the real economy in order not to assign ourselves a place at the sidelines. We therefore urge the Commission to initiates proportionate capital and liquidity measures and urge the legislators to take the possible consequences for the overall economy, for SMEs and the banks and their international level playing field carefully into consideration.

3. Cumulative impact

In the second place, the current proposals for further and additional changes to the capital requirements directive the so-called CRD IV and the sets of revisions of CRD III could as the Commission rightly recognises have a cumulative effect that might be substantial and could have implications for the amounts of funds that institutions have

available to lend to businesses. We therefore welcome the initiative of the Commission to invite CEBS to carry out a European Quantitative Impact Study (QIS) to aid the assessment of the aggregate affect of the two proposed revisions.
However, we can rely on the assumption that the impact assessment exercises currently being conducted for CRD IV and III will demonstrate that the proposals, if implemented as initially proposed, will create severe economic consequences both for the financial industry and the global economy at large.

Therefore, we consider that it is necessary and essential given the considerable economic impacts of the reform package to have next to the revisions of the proposals, also a revision of their calibration, an analysis of the interdependence between the proposed measures of different CRDs, a full assessment of their overall cumulative impact on the economy, the determination of priorities, and a realistic implementation calendar before a final set of standards is issued for implementation by the financial industry.

4. Further consultation

Given the fundamental nature of the proposals and the significant components that still remain to be defined, we consider that the present round of consultation should only be considered as a first step. We appreciate the G20 time plan but we would foremost like to underline that achieving the objectives and striking the right balance is the most important issue.

We would therefore like to request the Commission to conduct extensive further consultation as it revises the proposals around the summer of 2010. In that respect, we would also ask the Commission to incorporate in the assessment the impact of the introduction of the already approved CRD II (to be applied from 31 December 2010) onwards and CRD III presently under discussion in the EP and applied from 1 January 2011 onwards. We would appreciate to have next to an additional formal consultation paper on the revised proposals, also an additional QIS exercise, an additional impact assessment of the proposed measures and its effects on the real economy and a final impact assessment of all CRD proposals to be brought into circulation in parallel.

We think it is fundamental to assess all relevant changes cumulative, with full consideration of their interdependencies and their impact on the real economy in the short and long run. Moreover, it is necessary to fine tune the proposals by designing adequate grandfathering and phasing-in and phasing-out measures and time the transition to minimize the disruption of markets as to the pricing as well as the ability to meet extra demands of capital. In our opinion, this is essential for the Commission to meet its goal to “ensure that the sum of these measures does not result in banks holding excessive buffers beyond what is necessary to maintain a resilient banking sector.”

5. Implementation related issues

The whole proposal package is very complex and stricter rules are envisaged for capital adequacy measurement both from the side of the calculation of capital and the assessment of risks. It is very difficult to estimate the impact of the proposed changes on the activities of the credit institutions together with the modifications to the capital adequacy framework already in course. The introduction of the CRD4 package at one point in future time may have a credit squeeze effect and may contribute to another crisis. Therefore, we suggest that it would be better if the potential measures were introduced gradually, preceded by a strict monitoring phase, and not only by a quantitative impact study. A harmonised reporting and monitoring could help to minimise the negative impacts by introducing the necessary modifications yet before gradual implementation.

Timing is therefore essential. We would like the Commission to develop shortly a clearer strategy as to the way the reforms will be implemented. A detailed implementation plan, including phasing-in and -out and further explanation of possible degrees of flexibility, will need to be developed once the proposals acquire a more definitive shape. This is all necessary under the precondition that the recovery of the financial sector and the economy as a whole are not hampered. In this regard, our present assessment is that full implementation by the end of 2012 seems excessively ambitious.

On the implementation, we would like to refer also to the so called "announcement risk" of the proposals. This is the likely immediate impact the announcement of the Commission regarding its final decisions would have on market participants and rating agencies as to their expectations of the amounts of capital that banks should hold. While market dynamics are by definition autonomous, the Commission should carefully consider this issue as it finalizes its plans for implementation.

As an example we can mention the expectations of markets and rating agencies if the Commission decides to introduce higher minimum standards for the Tier 1 ratio. The markets and rating agencies will tend to evaluate these new standards right away, while official introduction is delayed for some time or fine tuned by phasing-in rules.

Implementation of the new CRD revisions and liquidity standards should be simultaneous, symmetrical, and comparable across all major financial markets, inside and outside the EU. Proper coordination with the US is required for which using the G20 seems a good opportunity. Especially, considering the fact that banks in the EU are more dependent on bank loans (approximately 80%) in comparison to banks in the US (less than 25%), it has to be taken into account that the macro-economic impact of new capital and liquidity requirements will have a smaller impact in the US in comparison to the EU.

Moreover, a global asymmetric situation could arise if Basel III is in the first place not implemented and secondly not applied to financial institutions in the United States. This would create an uncompetitive level playing field at the global level which will most likely curb the economic growth in the European Union.

A final remark is that we prefer continuing to support further convergence of accounting standards as final CRD rules will undoubtedly be affected by accounting. This however, does not conflict with our more fundamental position that we expect regulatory rules to be as much as possible to be independent from the actual accounting regime; or for that matter a taxation regime. We regard the independent standard setting of regulatory rules as the superior way of rule making; any dependency on changing accounting and/or taxation rules weakens the overall concept.

6. Conclusion

The members of the EACB would like the Commission to take carefully into account the economic and cumulative impact of their proposals to reform the capital framework and framework for liquidity risk standards, measurement and monitoring. The EACB would suggest to the Commission to conduct additional impact assessments which include the provisions of CRD II and III and their interdependence with CRD IV; and which focus on the effect of the measure on the real economy of the European Union. As one of members mentioned 'the impact of the planned changes of regulation will have a crucial impact on banks and on the whole economy'. We need adequate regulations that are right in the short and long term, which will also lead to equivalent treatment of co-operatives and their central institutions to continue their business according to the co-operative business model that has proven to be resilient throughout the crisis.

SPECIFIC REMARKS

Section I: Liquidity Standards

General Comments

In implementing these standards the Commission will have to achieve a balance between tighter liquidity requirements, as they interact with the new capital requirements, changing accounting standards, other new regulatory and market rules (e.g. for securitization and mutual funds), and the ability of credit institutions to employ resources productively in providing credit to society and sustain liquid markets.

With regard to our serious concern regarding the new liquidity standards, we think that it will be highly inappropriate to implement these concepts without an extensive analysis of their impact. Especially, as regards these standards, a single impact assessment, based on first concepts and by consequence on data of limited informative value, will not be sufficient. Supervisors should rather continue the dialogue with the industry when concepts are revised and have another impact assessment.

In addition, it has to be recalled that this is the first time that the liquidity-related standards are introduced at a global level. Due to their severe impact at least a one year-pilot period should be provided prior to their official introduction to enable all parties concerned to improve their understanding on trends, assessments and other metrics relating to the liquidity information.

Intra-Group Deposits in Co-operative Banks

Co-operative groups in Europe are two or three-tiered organizations.

- There are non-consolidating groups that are made up of autonomous, local cooperative banks and their central institutions.
- Other European Cooperative Groups are more integrated groups: they usually consolidate under a central body that exercise important control functions and have the right to give instructions to local/regional banks.

Nevertheless, other features remain the same. In most cases groups use common brand names and logos. As a general rule, local banks are the major, if not the exclusive shareholders of “their” central bank. There are robust division-of-labour arrangements in place: broadly speaking, in many ways the central bank is a wholesale service provider for the local retail banks, which normally do not have access to capital markets.

Due to those arrangements with their central banks (and other jointly owned central service providers) even smaller legally independent banks are able to offer customers a complete range of banking products and services.

Those central institutions provide payment and security services, but also cash clearing liquidity transfer within “their” co-operative group, called “liquidity schemes”[1]. Typically,

[1] In many countries’ decentralized banking network banks have established cash-clearing/liquidity systems, around their sectoral central bank. While in most cases these liquidity systems are based on agreements, there are also cases where those systems are established by law. In this context it has to be considered that decentralized banking sectors contribute substantially to the stability of

within these decentralized structures, there will be liquidity flows from the deposit-taking entities to the central institution, which will then either transfer it to other local banks or invest on the capital market.

There are strong incentives for both sides that this process is functioning well. In some jurisdictions (consolidating/and non-consolidating) local banks are even obliged to respect minimum levels of deposit to be held at the central bank.

While to some extent we share the opinion that generally inter-bank deposits can be volatile and inter-bank funding may not be regarded as stable, the present crisis has also shown that the deposits from the member institutions of a co-operative group behave in a different manner. In fact, the deposits held by and with other members of the same co-operative group have proven to be highly stable, with low run-offs (if at all).

Furthermore, we think that the current crisis has provided evidence that pooling liquidity with the central bank/body has made co-operative groups more resilient.

Both the requirements for the LCR and NSFR seem to put these existing structures into question, while exactly these structures have helped co-operative banks to master the crisis. Destroying solid structures of proven value could certainly not be the aim of the Basel Committee nor the European Commission.

It has to be recalled that Article 80 (7) as well as Article 80 (8) of the CRD have already taken the specific character of intra-group exposures into consideration, both for consolidating and for non-consolidating groups. Most recently, in 2009, the European legislative bodies have acknowledged the specific role of liquidity schemes within co-operative groups by granting special treatment for those systems, even in non-consolidating groups, under the large exposures regime (Article 113 (4)(d) CRD). The scope of supervision should be limited accordingly.

We therefore think that it would be highly appropriate to find appropriate solutions. Depending on the risk characteristics of the specific co-operative groups, these institutions and their supervisors should have a choice when calculating the liquidity ratios:

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the financial markets, as recognized by rating agencies and even the IMF Working Paper 2007: “Cooperative Banks and Financial Stability“.

The risk management of the bank is in many organizations complemented by liquidity/cash clearing arrangements with the network’s central bank. Such arrangements imply that the local bank should/is obliged to hold their liquid assets entirely or mainly with the central institution in the form of inter-bank deposits or to hold a certain amount of its deposits with the central bank. The liquidity management of the sectoral central bank has to respect high standards.

- The agreements and credit lines are especially designed to be served in times of crisis (e.g. short-term liquidity squeeze, etc.). Thus, especially in times of a liquidity crisis, local banks and central bank are obliged to stick to their arrangements. The more liquidity is concentrated within this system, the better the settlement within the system works.
- The stabilizing structures, which protect effectively against external crises, are only possible by the way of equity holdings within the consolidating group or decentralized banking groups. Equity “builds” the stabilizing structure. It has to be pointed out that these agreements are in place for decades and have proven their merits, not only in the current crisis.

- To appropriately consider deposits within co-operative groups in the relevant context of both LCR and NSFR as stable or as “original deposit as taken at regional/local bank level and/or
- To grant a possibility for a treatment similar to consolidating entities, if certain criteria, as mentioned above, are met or,
- To allow that the liquidity ratio for the central institution is calculated on a case-by-case basis.

As regards undrawn credit lines granted by central banks to local retail banks, we suggest applying a specific treatment so that local banks that have received those credit lines could assume they are always able to draw upon them and the central banks having granted them would assume liquidity outflows, to be calculated by an appropriate weighting factor (e.g. 25%) in order to take into account the benefits of a well diversified network of local banks.

Preferably, the possibility of such treatment should be explicitly stated in the framework.

Question 1: Comments are sought on the concept of the Liquidity Coverage Requirement and its likely impact on institutions' resilience to liquidity risk. Quantitative and qualitative evidence is also sought on the types and severity of liquidity stress experienced by institutions during the financial crisis and – in the light of that evidence – on the appropriateness of the tentative calibration in Annex I. In particular, we would be interested in learning how the pricing of banking products would be affected by this measure.

We have difficulties to understand the philosophy of an LCR as it is presented. If banks have to hold a fixed stock of highly liquid assets at any time, how can it fulfil any buffer function in times of stress? Institutions would be forced to hold a position of highly liquid assets that is reasonably higher than the minimum level in order to ensure that they can meet the criteria even when they are under stress, and when the value of such assets might decrease. This would make the requirement even more burdensome. In our opinion, a reduced size of the LCR in stress situation should therefore be treated explicitly in the document.

In a deep stress situation it may happen that a specific institution cannot comply with the LCR requirement. Possible supervisory sanctions should be addressed transparently in the proposal.

The definition of the 30-day stress scenario needs to be reconsidered. While it is likely that all institutions will face both institution-specific and systemic shocks during acute liquidity stress, it is not evident that all of the suggested shocks materialize for all institutions in a similar manner. If one or more stress assumptions are realised, it is not realistic to assume another stress with the same size. The consideration of the decrease of the stress over time is not reflected in the proposal either.

During the financial crisis some of the co-operative institutions saw an increase in retail deposits, rather than a run-off, while a run-off materialized for other banks. Systemic shocks are the ones most likely to hit all institutions. However, institution-specific shocks should be seen much more with regard to factors such as reputation, rating and customer proximity of banks. This would also create some positive incentives for banks.

Other key elements are the characteristics of highly liquid assets, the assumptions for defining an acute stress scenario and the haircuts applied for the various classes of eligible securities. The haircuts do not seem to be based on comprehensive research,

behavioural studies or other evidence and therefore seem to be rather arbitrary. We would expect that through impact studies and ongoing gathering of data, the respective parameters will be reviewed and adjusted in order to be based on solid evidence.

In particular, we have serious doubts about the exclusiveness granted to sovereign securities for the stock of highly liquid assets. This preference seems to ignore that also sovereign securities could be affected by systemic shocks. Especially in times of stress there can be significant spreads regarding sovereigns in one currency zone. Especially, when big institutions are trying to liquidate the same asset class, problems could arise.

The criterion induces a parallel behaviour that in itself could be the source of future problems when imposed on the whole industry. If all institutions including the big ones will be focusing on the same kind of government securities as assumed liquid assets, b this will lead to a new concentration risk in the banks' balance sheets and asset classes could become illiquid during a market wide crisis.

The requirement to dispose of a stock of highly liquid sovereign assets will most probably have an impact on prices of banking products in the longer run, since banks will have to compensate lower yields. Due to current prudential standards, liquidity is priced and its cost allocated to business units. Especially the latest guidelines on liquidity benefit cost allocation from CEBS published on March states that the cost of contingent liquidity risk should be priced and added to internal funds transfer price. This means that actually all of the additional costs should be borne by debtor. This implies that too narrow definitions and inadequate calibration will immediately affect loan takers.

In conclusion, it goes without saying that the pricing of banking products must rise due to the additional costs incurred via the lower yielding liquidity buffer assets and the longer funding requirements for customer assets.

Question 2: In particular, views would be welcome on whether certain corporate and covered bonds should also be eligible for the buffer (see Annex I) and whether central bank eligibility should be mandatory for the buffer assets?

Generally, we think that banks should be allowed to hold a liquidity reserve that is much more diversified:

- In many jurisdictions state guaranteed bank securities play an important role and are held by banks in large numbers. They are fully equivalent to sovereign securities in terms of liquidity and should be fully eligible as highly liquid assets.
- Especially covered bonds should be fully included in the stock of highly liquid assets. In Europe the market for covered bonds has been resilient throughout the crisis. However, we would like to point out that while the inclusion of corporate and covered bonds that are traded on *"large and active" markets* is understandable from system perspective, it is at the same time discriminating (favouring countries with big graded companies).
- We also think that the liquidity clearing on the basis of collateralized stable repo-markets with high turnovers can provide a strong contribution to reducing liquidity risk.
- However, we doubt that the differentiation between securities from financial institutions and non-financial corporates is justified. Especially, we fear that such privileges could lead to highly undesirable practices.

- Inter-bank deposits, which are held within the framework of legal or contractual systems of cash-clearing within decentralized co-operative banking groups, have to be acknowledged as highly liquid assets.
- Finally, the approach does not sufficiently consider all assets, which would enable a bank to generate liquidity by the way of central banks in order to overcome acute liquidity shortfalls. Since Credit Claims constitute a significant liquidity potential, we think that they should be taken into consideration as well. Co-operative banks as retails banks dispose of a large amount of high quality retail assets. Such assets, especially those with a maturity of less than one year, can be monetized rather easily.

We think that it is disproportionate that banks have to fulfil the LCR requirements in all significant currencies. At the composition of the liquidity buffer the swap market should have also be taken into account.

Question 3: Views are also sought on the possible implications of including various financial instruments in the buffer and of their tentative factors (see Annex I) for the primary and secondary markets in which these products are traded and their participants.

As mentioned above, a too narrow definition of the liquidity buffer may lead to dangerous market dynamics since it might induce parallel behaviour of banks that in itself could become a danger. In the event of a systemic crisis, it would imply that all banks might need to liquidate the same range of assets at the same time, which would drive prices down, potentially leading to a liquidity gridlock. This could lead to an exacerbation of a developing crisis, especially if the crisis had its origin in macroeconomic issues such as budgetary problems of large governments. Similarly, there would be the danger of parallel actions by many institutions, if an asset was downgraded or its liquidity characteristics were otherwise influenced. Thus, being too restrictive in establishing the acceptable composition of liquidity buffers would risk undermining the very purposes of any buffer requirement.

Bonds are usually traded in OTC-markets. Price history can often be rather sporadic. These suggested rules would favour the traditional issuers that tend to be big countries. It would put smaller or "peripheral" issuers at a disadvantage that have only recent history in bond issuance. For such reasons, it may be advisable that the necessary assessment of the relevant market is made by the national central bank.

The inclusion in stock of high quality liquid assets of AA- or higher rated corporate and covered bonds that are traded in only “large and active” markets is understandable from a system perspective, but is at the same time discriminating (favouring countries with big graded companies) and will probably lead to higher prices of banking products in the longer run in not-so-large-and-active markets where companies may be financially sound but not graded.

Large international companies issuing well-rated corporate bonds could benefit from LCR and an expected additional demand for corporate bonds coming from banks. Simultaneously, small and medium sized companies that rely on bank loans could be facing comparative disadvantage against large companies, since banks will be allocating all of the additional liquidity costs rising from LCR and NSFR to borrowers. In smaller Member States, there are often not many companies that are able to access the capital markets by issuing corporate bonds.

Question 4: Comments are sought on the concept of the Net Stable Funding Requirement and its likely impact on institutions' resilience to liquidity risk. Quantitative and qualitative evidence is also sought on the types and severity of liquidity stress experienced by institutions during the financial crisis and – in the light of that evidence – on the appropriateness of the tentative calibration in Annex II. In particular, we would be interested in learning how the pricing of banking products would be affected by this measure.

The objective of the NSFR is to discourage excessive reliance on short-term funding and to move institutions toward more medium and term funding. In setting their risk appetites, firms must balance an appropriate level of prudence against a desired level of maturity transformation. This process must be subject to appropriate prudential supervision. Instead, banks will be obliged to match the maturities of their lending and refinancing activities.

However, there is a risk in taking a simple metric and making it the basis of a mandatory and restrictive ratio. The proposed rules make the ratio highly prescriptive and even more important, not detailed enough to be applied smoothly. We fear that the application of worst-case assumptions, disregarding many nuances and subsets, would raise funding costs substantially, without adding adequate value from a risk-management and prudential perspective to those internal structural funding measures that banks already apply by now and which are often much more granular.

We fear that the Net Stable Funding Ratio, as suggested by the Committee would seriously hamper the central economic task of banks, especially of co-operative banks, which is maturity transformation.

This will especially be the case if banks will be prohibited to take up the required amounts by the way of long-term securities, which, however, are not eligible as highly liquid assets for other banks.

Thus the suggested calibration of the NSFR would probably lead to a tightened competition for (stable) deposits finally to higher prices for deposits than witnessed today (which will put significant pressure on banks' profitability). Institutions would pursue loyal customers.

However, already by now, the access of banks to the savings market may be affected, even restricted due to a number of external factors. This may be the case when other competitors, such as pension funds and insurance companies have certain direct or indirect tax advantages. This puts banks at a disadvantage compared to its peers already today. As a result of this structural imbalance, banks in such jurisdictions would need a comparatively higher amount of longer term and more expensive wholesale funding to comply with NSFR requirements.

In all jurisdictions, an increased competition for deposits will lead to higher deposit prices. Those higher deposit prices will be rolled out to loan pricing. In general, the proposal will increase incentives for savings (depositors) and decrease incentives for borrowing (debtors). This can be seen as an income transfer from borrowers to depositors and lead to reducing the dynamics in the economy. Most probably, however, unregulated parts of the economy may step in and fill the gap. Especially large corporates with retail customer relations, such as telephone or utility companies could seek to incentivize their customer accounts (e.g. prepaid accounts), while drawing advantage of a higher appreciation of their securities (lower coupons).

Furthermore, the NSFR seems to be inconsistent in so far as it does not apply the same kind of assumptions to the asset side as to the liability side. If for retail lending with a maturity of less than one year it is assumed that 85% will be rolled, and at the same time 'stable' retail deposits are for 85% included as available stable funding, the percentages are the same, but the actual amounts involved are completely different. Only a small part of the retail lending will be with a maturity of less than one year, and a large part of the stable retail deposits will be withdrawable at short notice. This creates a substantial gap. Transforming retail deposits into retail lending is the classical transformation function of co-operative banks. Also a perfectly matched position of a < one year private loan funded by a < one year bond creates a substantial gap, as the corporate loan requires 85% stable funding, whereas the one year issued bond has no value at all as available stable funding.

Moreover, the NSFR scenario does not seem to take into account any management intervention, as retail and corporate lending will largely be continued as before. If a bank will not receive any wholesale funding for a period of one year, it is quite unrealistic to assume that management will not intervene.

The current proposal implies that irrespective of the current credit rating, the impact of the stress scenario will be the same for every bank. This is not true. Also for the short term wholesale funding markets, a high credit rating and/or good reputation has a beneficial impact for a bank's access to funding. We therefore think that even for a bank with an external public rating of at least AA, 20%-30% of the outstanding amount per wholesale funding source (including central bank and fiduciary deposits, and funds from asset managers and pension funds) should be recognised as available funding in the calculation of the NSFR.

In general, financial institutions should be given the opportunity to demonstrate the stability of their deposits for their national authorities instead of applying fixed multipliers for all institutions.

Question 5: Comments are in particular sought on the merits of allowing less than 100% stable funding for commercial lending that has a contractual maturity of less than one year. Is it realistic to assume that lending is reduced under liquidity stress at the expense of risking established client relationships? Does such a differentiation between lending with more and with less than one year maturity set undesirable incentives that could discourage for instance long term funding of non-financial enterprises or encourage investment in marketable securities rather than loans?

When banks are forced to match funds, there will be some room for showing more advantageous rates for loans with maturities of less than one year. This in fact could give wrong incentives for the borrowers to increase their liquidity risk. The problem of liquidity risk would only be shifted from regulated areas to non regulated areas in economy.

Furthermore, it is plausible or even likely that commercial lending is reduced under liquidity stress. Maturing commercial lending can be reduced either by a change of the business strategy or as a result of specific circumstances regarding the stress situation. In an idiosyncratic stress, it is very likely that the affected bank will face a drop in market share and increased pricings may drive customers away to other banks. In such situation it may happen that certain types of banks are affected differently, especially have a more favourable liquidity position. They may therefore draw advantage from this situation to increase their market share. This is also the experience from the recent credit crisis of 2007. Therefore, such high requirements for maintaining the level of commercial lending may lead to unintended effects regarding market dynamics and competition.

Question 6: Views are sought on possible implications of inclusion and tentative "availability factors" (see Annex II) pertaining to various sources of stable funding for respective markets and funding suppliers. Would there be any implications of the tentative required degree of coverage for various asset categories for respective bank clients?

High availability of stable deposits would lead to severe deposit rate competition which could in turn make initially stable deposits less stable in the end. Deposit rate competition will rather lead to shopping around and cause volatility.

We have doubts regarding the appropriateness of the distinction between stable and less stable deposits. We think that in practice such differentiation will be highly burdensome if not impossible. Financial institutions should be given the opportunity to show the stability of their deposits for their national authorities instead of applying fixed multipliers for all institutions.

Furthermore, we think that the rates for available stable funding under the NSFR and the run-offs under the LCR should be convergent (especially for deposits).

Above, we have addressed the problem that even perfectly matched transactions may trigger additional coverage. In addition, we suggest introducing presumptions of new business and prolongation when calculating the NSFR or to limit any buffer requirements solely to committed lines. In fact, a perfectly matched corporate loan of three years refinanced with a 3 year bond issue, may require, after 2 years + 1 day additional stable funding, although nothing has changed.

Furthermore, we suggest granting 0% coverage to the following assets:

- assets collateralised by liquid assets, to the extent of the collateralised part, as far as the collateral would be eligible for the liquidity buffer and the contract to the counter-party provides the right to the credit institution to use the collaterals for rep transactions;
- assets re-financed by other banks and which are connected with special development goals.

Finally, the text related to the NSFR seems to contradict to Annex II as far as contingent commitments are concerned. While in point 12 stable funding is required for any contingent contractual and non-contractual obligations, in Annex II only assets are mentioned. The Basel Committee document on International Framework for Liquidity Measurement, Standards and Monitoring leaves the issue of stable funding for contingent commitments to national discretion.

Question 7: Do you agree that all parameters should be transparently set at European level possibly in the form of Technical Standards by the EBA where parameters need to reflect specific sub categories of retail deposits?

We doubt that detailed definitions of the relevant parameters will be the appropriate solution, since it will most probably not be possible to capture qualitative aspects (e.g. stability of customer relations). Therefore, only some of the parameters could be set at European level (those reflecting systemic shocks) while others (those reflecting institution-specific shocks) should be considered to be left to national authorities that are more familiar to local conditions.

We therefore rather suggest a system based on:

- Individual stress testing of various types of stress scenarios (regarding Annex I + II).
- Next to such standardised approaches, banks should be allowed to use a more advanced approach based on internal models, complemented by a constructive supervisory dialogue regarding results, implications and management action, etc.

The recent CEBS guidance on liquidity buffers for a more effective way to create the necessary stress scenario and the CEBS "ID Card" should be taken into consideration. In its standards, CEBS requires that banks define the scenario in concert with their colleges of supervisors, so that the scenarios reflects the specific business lines the firm is engaged in and the previous experience the firm has operating in its different jurisdictions.

There are doubts that the publication of standardised ratios or results to the public would be in public interest. These questions should be handled with great care.

Question 8: In your view what are the categories of deposits that require a different treatment from that in Annexes I and II and why? Please provide evidence relating to the behaviour of such deposits under stress.

As mentioned above, all factors should rather be based on evidence than presumptions and the suggested calibration of the NSFR and LCR should be adjusted.

Again, we would like to point out that the inappropriateness of the distinction between stable and less stable deposits. We think that in practice such differentiation will be highly burdensome if not impossible. Instead, more simple and conclusive criteria should be applied. We therefore suggest that deposits from clients, with whom the banks have a long-standing relationship of at least three years, should receive an 90% ASF-factor.

Furthermore, in situations as described under (created in accordance with art. 80(8) CRD) the total amount of deposits should be considered stable if covered by the scheme.

Above, we have addressed the situation in co-operative groups. As we pointed out, a large amount of retail deposits in local banks are usually transferred, within the context of a liquidity/cash-clearing scheme to the central bank, or even from the central bank to other local banks. There is evidence that such deposits are a stable funding base. We therefore suggest treating such deposits not different than "original retail deposits".

Question 9: Comments are sought on the scope of application as set out above and in particular on the criteria referred to in point 17 for both domestic entities and entities located in another Member State.

In consolidating groups, the fulfilment of the two requirements under para 16 should be limited to the parent institution, provided that there are enforceable arrangements as specified under para 17 allowing banks in times of stress to shift liquidity according to the requirements within the group.

Such arrangements are usually in place within consolidating and non-consolidating co-operative groups (see above), where such arrangements have turned out to be effective in the past.

Therefore, we think that the scope of para 17 should go beyond consolidating groups if non-consolidating cooperative groups provide adequate liquidity-arrangements. As mentioned above, the liquidity/cash-clearing systems of non-consolidating groups have

proven their efficiency as well. As regards intra-group exposures, article 80 (8) CRD describes a situation that is equivalent to consolidation. In a similar way, article 113 (4) (d) of the CRD sets out conditions for equal treatment of consolidating groups and cash-clearing systems under the large exposures regime. Such criteria should apply as well in this context when considering the requirements under which non-consolidating decentralized sectors are allowed to fulfil the liquidity-ratios, only on consolidated basis.

Question 10: Should entities other than credit institutions and 730K investment firms be subject to stand alone liquidity standards? Should other entities be included in the scope of consolidated liquidity requirements of a banking group even if not subject to stand alone liquidity standards (i.e. financial institutions or 50K or 125K investment firms)?

Maturity transformation and liquidity risk in the economy should be monitored as broadly as possible. It is not sufficient to assume that only by monitoring banks the problem is solved. Probably banks have the longest tradition in managing liquidity risk, however not a monopoly. Therefore, all companies capable of significant maturity transformation should be regulated. Finally, some of the recent troubles started outside the regulated areas.

Question 11: Should the standard apply in a modified form to investment firms? Should all 730K investment firms be included in the scope or are there some that should be exempted?

We strongly favour that any kind of liquidity regulation would be applied to the whole financial system, i.e. hedge funds, private equity, insurance and investment firms and not only to banks as regulated entities. Otherwise their might be a shift of activity out of the regulated into the unregulated parts of the system.

Question 12: Comments are sought on the different options and in particular for how they would operate for the treatment of intra group loans and deposits and for intra group commitments respectively, Comments are also sought as to whether there should be a difference made between the liquidity coverage and the net stable funding ratio

The option laid out in point 23 (asset transferability, central pooling of liquidity and even binding commitment) seems to come quite close to the situation in most consolidating co-operative groups and the role that individual banks have in it. We therefore think that it would be appropriate to grant a full waiver.

However, central pooling is also a key element in non-consolidating co-operative groups and their liquidity systems. There are rather detailed arrangements for cash clearing and liquidity management. In order to qualify for 0% weighting of intra-group exposures or “group treatment” under the large exposures regime, numerous criteria have to be fulfilled that could become relevant in this context as well. We therefore ask the Commission to integrate these groups in their considerations.

Question 13: Do stakeholders agree with the conclusion that for credit institutions with significant branches or cross border services in another Member State liquidity supervision should be the responsibility of the home Member State in close collaboration with the host member States? Do you agree that separate liquidity standards at the level of branches could be lifted based on a harmonised standard and uniform reorganisation and winding up procedures?

Yes, liquidity supervision should be the responsibility of the home Member State (but in close collaboration with the host Member State)

Question 14: Comments are sought on the merit of using harmonised Monitoring Tools either in the context of Supervisory Review or as mandatory elements of a supervisory reporting framework for liquidity risk. Comments are also sought on the individual tools listed in Annex III, their quality and possible alternatives or complements.

A set of harmonized monitoring tools proposed in Annex III should not be mandatory element of the reporting framework. They would be very costly to implement and heavy to maintain on a frequent basis. Instead we recommend, as stated above, to base further reflections on the CEBS guidance on liquidity buffers and the CEBS "ID Card". We think that contractual maturity mismatch data are not comparable between banks and are therefore of limited value in understanding the liquidity risk position of a bank. In addition, any type of market related monitoring tools must be calibrated to the individual risk position in order not to create blind spots in the monitoring of a potentially changing liquidity risk profile.

Question 15: What could be considered a meaningful approach for monitoring intraday liquidity risk?

Section II: Definition of capital

Question 16: What are your views on the prudential appropriateness of eliminating the distinction between upper and lower Tier 2, and of eliminating Tier 3 capital?

In principle we welcome the elimination of the distinction between upper and lower Tier 2 as well as the elimination of Tier 3 capital. Nevertheless, a simplification of the system is not automatically an improvement. If capital instruments that contain elements of loss absorption in going concern are eliminated from upper Tier 2 or if Tier 3 is no more counted as capital, the immediate consequence will be a reduced capital ratio. This will create an obligation to take up new capital in the first place.

The elimination of Tier 3 capital should lead to a full recognition of Tier 2, since currently any excess Tier 2 may be used as Tier 3. In addition, we would like to remind one that the minimum capital requirements for trading book risks that were included in Tier 3 in the past, have been significantly increased (up to the triple of the current level). This should also be taken into consideration when reshaping Tier 1 and Tier 2 and the respective percentages.

Question 17: Are the criteria proposed for Core Tier 1, non-Core Tier 1 and Tier 2 sufficiently robust and how might they be improved?

I. GENERAL ASPECTS

As regards the newly introduced issues of 'going-concern' and 'gone-concern' there is a broad understanding of both concepts. However, for the interpretation of the new rules and making sure that no misunderstanding occurs, a proper definition would be advisable. This could form the basis for developing any new instruments (including the later to be mentioned contingent capital issue) as well as discussions with supervisors.

The European Commission has recently harmonised the rules of capital definition for all EC banks. This includes limits on hybrids, with predominant core capital of a minimum of 50% and a possibility of having hybrids up to 35% of total capital before any deduction of banks holdings. We do support these limits and not see why the percentage of predominant capital should not diverge from these reference levels.

II. CORE TIER 1 CAPITAL

A. Member Shares in Co-operative Banks

The members of the EACB appreciate, that the Commission supports the principle based approach for the definition of capital elements, especially common equity, of the Basel Committee. However, the Basel Committee takes the shares of a joint stock company as a benchmark for assessing the features of instruments to be included as the common equity component of Tier 1 capital. Thus, the 14 criteria established by the Commission reproduce the picture of a share of a joint stock company.

Due to their specific business model and governance, which are different from those of joint stock companies, the instruments of co-operative and mutual banks would be automatically excluded from common equity. However, the members of the EACB are convinced that co-operative shares, which count for an amount of about 35 billion € are, from a prudential perspective, not of lesser quality than shares of joint-stock companies. Even throughout the most severe moments of the recent crisis, the capital bases of co-operative banks remained stable.

The Basel Committee, in its consultation paper, also stipulates that its suggested criteria should be applied also to "*instruments of equivalent quality which non joint stock companies, such as mutuals and cooperatives, can include in the predominant form of Tier 1 capital, while taking into account their specific constitution and legal structure.*" In so far the Basel Committee follows the approach of the CRD 2, where recital 4 underlines that original own funds should include instruments taking into account the specific constitution of co-operative societies, and which are deemed equivalent to ordinary shares in terms of their capital qualities, in particular as regards loss.

The members of the EACB therefore welcome that paragraphs 43 and 44 of the consultation paper confirm the approach of the Basel committee and of the CRD 2, and suggest amending recital 4 (para 44) to take into account the specific constitution and legal structure of co-operatives. We strongly encourage the Commission to maintain in the direction taken as is set out in para 44 and further develop provisions to recognize co-operative shares as Tier 1 capital when publishes its proposal. CEBS CP 33 has delivered important orientations in this respect.

In fact, when looking closely at the 14 criteria it becomes evident that it is impossible for co-operative banks to fulfil some of them, although from a prudential perspective such shares are not of lesser quality.

- **Access to net assets/Loss absorption**

The criteria 2, 6 (regarding the cap), 7 (second sentence), 8 (first sentence), are based on the presumption that the holder has a claim to a share of the assets of the entity and that he is entitled to a percentage of the assets of the entity that remain after all higher priority claims have been satisfied. Thus in a joint stock company only those instruments qualify, which bear the ultimate risk and which are entitled to the ultimate rewards inherent in the entity and its activities. Admittedly, without such instruments and their holders the entity could not exist. This excludes other claimants to the entity's assets, even if they bear risks and are entitled to rewards. However, the latter may be considered to be at least partially protected from risk by common equity instruments, and their share of the rewards is limited. Especially from the perspective of criterion 2, which takes the perspective of shareholders, any claim that is senior to common equity is potentially dilutive of the residual that would otherwise be attributable to common equity.

Thus, the intention of criterion 2 is not to ensure loss-absorption[2], but rather to make the definition of capital as narrow as possible in order to exclude, ***in a joint stock company***, any other instrument from common equity, especially sophisticated hybrid instruments.

However, such criteria lead to inappropriate results when the business purpose and governance of an undertaking are different to those of a joint stock company. Also a co-operative bank could not exist without its shareholders, whose economic interest it has to promote. However, "the ultimate reward" inherent in a co-operative is not maximum profit, but rather the provision of a maximum of usefulness to its members, while ensuring the existence of the undertaking beyond the participation of individual members. While co-operative capital and reserves are paid in and are available to cover losses, reserves (retained earnings) in a co-operative are normally fully (sometimes only in part) indivisible: at least as long as the co-operative is going concern, if not also in liquidation, members do not have access to reserves. Members/shareholders have renounced their access to net assets in order to ensure the proper functioning of the co-

[2] Where available, it is always the reserves that take the first losses, not the instrument. According to 57 b) reserves is a separate element of common equity anyway.

operative beyond their capital involvement. Nevertheless, retained earnings are fully available for the business of the co-operative. They even form a kind of capital, exclusively dedicated to the purpose of the business. Since neither members nor anybody else has access to net assets (retained earnings), those funds are ultimately dedicated to the common business purpose until liquidation.

Other claimants to the entity's assets are protected from risk by co-operative shares and capital as much as in a joint stock company: from a legal perspective, there is absolutely no difference between the impact of losses on capital and retained earnings in a co-operative and a joint stock company[3].

This makes it evident that the Commission takes a "shareholder (or ownership) perspective[4]" rather than a "creditor perspective" when it comes to self-absorption. From a creditor perspective, the decisive question regarding capital is whether it can fulfil the function as risk capital "*providing a buffer, a cushion for the entity in terms of variances in its performance*"[5]. In a similar way, from a prudential perspective, the key aspect of loss absorbency on a going concern basis should mean "*that an institution is able to incur a loss but remain solvent and viable, even if distributable reserves have already been depleted*"[6].

- **Flexibility of payments**

We equally doubt that the prohibition of any caps related to the payment on the instruments, as stipulated under criterion 5 is appropriate for co-operative banks.

There is no evidence that any such cap is viewed by the market as an obligation to pay such capped amount. The evidence available on caps regarding dividends on co-operative shares in some Member States rather proves the opposite: during the last ten years, the dividend payments of co-operative banks in relevant jurisdictions where always significantly below the relevant cap, which differs from jurisdiction to jurisdiction. In addition, there is no correlation between the development of that cap and the dividends paid.

Besides, we do not see the prudential rationale of the prohibition of caps. To the contrary, we believe that such a cap can even have very positive effects, since earnings are retained and the capital base can be strengthened.

- **Permanence and "Redeemability" of Co-operative Shares**

The permanence criteria 3 and 4 are equally based on the situation of joint stock companies, while ignoring realities regarding co-operative banks. They create problems, both for co-operative shares of the IFRIC 2–type and for the classic. In fact, the redeemabilty of shares is a specific co-operative element, linked to the specific governance and business model of a co-operative.

Due to the principle of "open membership", normally any citizen may decide to become a member, use the services of a co-operative, but also leave the co-operative at any time.

[3] This shows that criterion 8 rather intends to ensure the allocation of reserves to the shareholder.
[4] See also FASB, Preliminary Views - Financial Instruments with Characteristics of Equity November 30, 2007, p. 5, http://www.fasb.org/pv_liab_and_equity.pdf
[5] EFRAG et al: Pro-active Accounting Activities in Europe; Discussion Paper: Distinguishing between Liabilities and Equity, January 2008, page 46.
[6] See CEBS Implementation Guidelines for Hybrid Instruments, para. 96.

In Europe, redemptions of member shares in any year average about 1% of outstanding shares. At the same time, the overall amount of subscribed capital remained stable or is even increasing.

However, there are many mechanisms in different Member States to ensure that the capital basis remains stable and thus a permanence of capital is ensured.

In fact, the bank's obligation to make payments is subject to numerous regulatory restrictions. All in all two models can be distinguished.

In those co-operative banks that are subject to IFRS, the co-operative or its board have the unconditional right to decline requests for redemption. Following the adoption of IFRIC 2, many jurisdictions have implemented changes to their co-operative laws and thus provide for:

- Possibilities for an unconditional refusal of the redemption of shares (IFRIC 2 option 1)
- Or for introducing a level below which capital must not fall due to redemption (IFRIC 2 option 2)

In some jurisdictions combinations of both elements exist.

In other co-operative banks, especially those that are not subject to IFRS, there are normally many elements that make redemption are very heavy process:

- The request for redemption has to be presented within a delay. Payments will only take place at the end of the business year after the approval of accounts and the distribution of profits by the general assembly.
- National law or the bank's statute may require postponing the payments even for a longer period.
- Members remain liable for losses for several years after their reimbursement.
- In case of resignation members maximally receive the face value of their member shares and leaving members may lose their right to do business with the cooperative. Therefore there are barely any inducements for members of cooperatives to resign.
- Very often the above restrictions are supplemented with supervisor's powers to limit or exclude the redemption due to capital or solvency requirements.

Thus, there are sufficient mechanisms to ensure a stable capital base.

- **Other Elements**

In addition, member shares do not possess any features which could cause the condition of the institution to be weakened as a going concern during periods of market stress.

B. The Possibility to have additional common equity instruments.

The EACB believes that the possibility should remain for all banks to issue, apart from their "prime Tier 1 instruments", other financial instruments as common equity. In many jurisdictions company law allows entities to issue more than one type of "capital instruments" and that such concepts have worked well in the past. The existence of

different categories of instruments should not be prohibited, especially when the prudential rationale of such a prohibition is not evident.

There shall be an additional marketable equity instrument for non-joint stock companies to ensure the appropriate and flexible management of core tier 1 capital. However, for the past it should be ensured that capital instruments fulfilling the highest capital level when issued continues to be eligible as core tier 1 capital for an adequate grandfathering period. Furthermore, we recommend to carefully examine whether the exclusion of "preferential rights" as referred to under para 45 and as stipulated in the 14 criteria (only) refers to the rank of payments or also to the amount.

In particular, banks should have the option to issue non-voting stock without problems. With regard to principle 5 we do not see a reason why fixed coupons, at least of indicative character should exclude the common equity quality, as long as full discretion of the company on payments is ensured.

C. UK Co-operatives

Special consideration has to be given to the fact that in some countries, like the UK, it is not possible for a co-operative (or certain other types of mutual) to operate a banking business other than through a joint stock company subsidiary (i.e. a non-mutual company), with the group as a whole run along mutual principles. Such banks should be able to issue instruments with limited voting-rights as core Tier 1 capital to external investors in order to preserve mutual/co-operative credentials.

In this context, the national supervisors in applying Annex IV criteria should have explicit discretion to recognise the fact that shares held by the mutual/co-operative group in the bank fulfil a different function (including control rights) compared to external investments with limited voting rights.

D. Share Premium Accounts

One remark on the definition of 'Common equity' in footnote 18 concerns the fact that the 'related share premium accounts' are included. This is interpreted as share premium received at the issuance of common shares, the main part of Core Tier 1.

However, in our opinion all share premium accounts are eligible for Core Tier 1 as they qualify according to the requirements. It is 'cash in the bank' and only after approval of the supervisor they can be distributed. They are fully available to cover any losses. An extension of the definition is therefore required.

III. ADDITIONAL GOING CONCERN CAPITAL

As regards the additional going concern capital, the proposal is to fully phase out "innovative" hybrids altogether, but the scope of what is to be excluded is not clear.

There are several open technical questions on the proposals as to hybrids as well. To give one example, the proposal singles out step-up clauses as an example of an incentive to redeem for hybrid capital instruments, and states that instruments with such incentives cannot be included in Additional Going Concern Capital. A proportion of instruments with step-up features should, however, be acceptable, subject to specific analysis of the likely effects of a particular transaction. One of the benefits of allowing such instruments where appropriate could be by providing useful diversification of financing instruments. The extensive work of CEBS over the past three years shows it would be possible to achieve common definitions, appropriate buckets, and sensible economic limits for a somewhat

broader range of hybrids than seems to be contemplated at this moment. We would suggest therefore to further study this subject.

In recent discussions some of the main advantages of hybrids have not been taken into account to a sufficient degree: flexibility, access to various investors etc. furthermore, we would like to emphasize another positive aspect of hybrids: they allow to issue capital in foreign currencies which will be necessary to prevent volatility in solvency core tier one ratios due to foreign exchange fluctuations.

If banks are too strictly limited to a narrow set of instruments for their different capital baskets, it will be challenging for the market to absorb new offerings at a normal pricing level, especially if a great deal must be done over a short period of time. The ability of a capital-dependent industry to have access to deep, broad and varied sources of funding in markets that vary over time is fundamental. The present proposals therefore need to take a more market-sensitive approach to the definition of allowable instruments.

The proposals restricting indirect issuance via special-purpose vehicles are too far-reaching and need to be modulated to address the tax and corporate needs of issuers in certain countries, which could be done without compromising the prudential goals of the proposals. In our opinion an indirect structure could fully meet all fundamental objectives of a capital instrument (loss absorbency, permanence).

IV. TIER 2 CAPITAL

A. General Aspects

The maturity and amortization guidelines for Tier 2 capital outlined in the document are needlessly restrictive. The five-year minimum-maturity in respect of calls (Annex VII, item 5c.) needs re-examination given the purpose of Tier 2 capital as “gone concern capital”.

As all calls as well as exchange initiatives of the issuer are conditionally to supervisory approval, a minimum term is of limited use. Only in sound conditions and if the supervisor agrees to the call it is effected. Therefore, the ability of the issuer to call or exchange an instrument under the proper conditions should be allowed any time.

B. Commitments of co-operative bank members

It cannot be denied that the uncalled capital and commitments of certain credit institutions as co-operative societies are not paid in capital as the Commission services points out under para 60. This should, however, not lead to the conclusion that it does not meet the qualities of Tier 2 capital. According to the suggested capital concept, Tier 2 capital is „gone concern capital“, ensuring loss-absorption only in case of insolvency. In fact, commitments of members of co-operative banks can fulfil this function very well. These obligations become due just in case of insolvency. Like in the case of contingent Tier 1 capital, it lies in the nature of this capital element that it is generated when the relevant triggering event occurs. The fact that it is only generated when insolvency occurs does not hamper its availability for creditors. Legal obligations in relevant national company laws make this capital available to creditors when it is needed and even exclude that it is consumed at an earlier stage.

In addition, these guarantees rather ensure a specific discipline regarding the market behaviour of the cooperative banks in question. Different to the situation in limited liability companies, the commitments rather create an incentive for members not to encourage management to enter into risky transactions in order to seek a turnaround,

when it is in a difficult situation. Since additional capital charges might have to be borne, members may rather have a preference for risk-averseness. Thus, there are good reasons to exempt these instruments from the relevant criterion in Annex VII.

Question 18: In order to ensure the effective loss absorbency of non Core Tier 1 capital would it be appropriate under certain circumstances to require the write down of the principal amount of an instrument or its conversion to a Core Tier 1 instrument? To what extent should the trigger for write down/conversion be determined objectively or at the discretion of an institution or its supervisor?

The requirement for Tier 1 Additional Going Concern Capital in the form of liabilities to include either conversion into common shares or a write-down is not essential, given the other requirements. Should the requirement be retained, it is important to make clear that write-down features do not preclude a future write-up when the firm returns to appropriate conditions. Permanent write-down would not only be unacceptable to many investors but would effectively subordinate Additional Going Concern Capital to Common Equity, normally to be the most subordinated form of capital under the proposed scheme. An 'upward potential' mechanism in such cases for a Tier 1 Additional Going Concern Capital instrument should be 'part of the game'.

Instruments that can be converted into common equity should be eligible to additional going concern capital at a higher ratio than instruments without such terms. Conversion should be at the discretion of an institution.

Question 19: Which of the prudential adjustments proposed have the greatest impact? What alternative robust treatments might be considered and what is their prudential rationale?

We broadly support the harmonization of the regulatory adjustments ("prudential filters and deductions"). However, it has to be kept in mind that regulatory adjustments – especially by the way of deductions or exclusions – will make a great deal of difference to the financial and economic impact of the new requirements. The reasons to increase transparency and consistency of adjustments are understood, but we are concerned that some of the proposals would seriously harm both the recovery from the crisis and credit capacity for the future.

One of the most concerning aspects of the guidelines as currently proposed is that deductions are generally made from Core Tier 1 Equity. Such dogmatic approach fails to recognize that several of the items proposed for deduction have value in both "going-" and "gone-concern" situations and are of sufficient quality to be included in Core Tier 1 Equity.

1. Minority interest

General

A deduction of minority interest from the common equity component of Tier 1 capital will have a very negative impact on the composition and capitalization of central institutions within a cooperative banking network since it represents an important change with respect to the current regulation. The overall effect of minority deductions should be properly assessed in the impact assessment as well as possible alternative approaches to this measure.

From our point of view there are several arguments against the deduction of minority interest:

- The minority interest has the same quality and loss absorbency capacity as majority interest. As capital from the minority interest is controlled by the majority that means that it absorbs losses on a going concern basis.
- It represents an inefficient and simplistic answer to prevent abusive constructions of capital.
- The argument that minority interest can be shifted from one group to another is not enough. Capital cannot be shifted between subsidiaries but the consolidation of minority interest might allow the central institution to liberate capital that can be made available for another subsidiary in case it is needed.
- The deduction is not in line with the accounting perspective where minority interest is regarded as common equity if they fulfil the conditions to be considered as such.
- It would lead to disequilibrium between the consolidation approach and the solo approach.
- We do not think it is fair to remove minority interest from the common equity and requiring at the same time to still have to support 100% of the RWA of the subsidiary. We do not support the mismatch between the capital consolidation on the one hand and the risk consolidation on the other hand.

The allocation of minority interest as additional going concern capital is not enough because the market takes as a general parameter the common equity element of Tier 1 capital to assess the solvency of an institution. Most importantly it will be essential to permit the corresponding deduction of an appropriate amount of the subsidiary's risk weighted assets from those of the (consolidated) parent company in order to achieve symmetry. Full deduction may in many cases ignore real resources available to the group and could hinder the creation of coherent resolution plans. The current language would likewise penalize important forms of participation in emerging markets and transition economies, as banks often either choose, or are obliged by regulation, to enter foreign markets in this fashion.

In order to achieve a more balanced treatment the following options should be considered:

- To exclude RWA supported by minority interests from the denominator of the group Core Tier One ratio. For each subsidiary with minority interests, the consolidated RWA of the subsidiary would contribute to the total group's RWA only up to the percentage held by the parent company when calculating the Core Tier One ratio of the Group. The Group core tier one ratio would then reflect in a symmetrical way both the capital held by the Group (i.e. excluding minority interests) and the risks associated with the subsidiary (i.e. excluding the portion of RWA assumed by minority shareholders
- Another approach could also consist in the inclusion of Minority Interest up to a limit in the numerator of group core tier one ratio. There can be instances where the local subsidiary is capitalised well in excess of the Core Tier One ratio of the group measured on a consolidated basis. In this case, one could argue that the Group unduly benefits from this overcapitalisation through the inclusion of minority interests in the Group's regulatory capital.

The situation of decentralized co-operative Groups

Moreover, there are constellations within co-operative groups that should be looked at from a different angle when it comes to the deduction of minority interest.

The central institutions of cooperative networks hold majority parts in subsidiaries (e.g. leasing companies, factoring companies or companies providing ancillary services) where the minority shareholders are the members of the cooperative network. It would be harmful for under these situations, if the minority shareholders interests were deducted. It should be kept in mind that for cooperative banks the minority shareholders are no external persons, but the members of the network, therefore their treatment should be different.

The EACB is aware of the Commission's objective to avoid abuses of minority interest and thus to create unsound capital structures. A possibility could be, in the context of pillar 2, that the Supervisory Authority in its duty to monitor institutions could determine an abusive use of minority interest and requires the institution to deduct it based on objective criteria.

Possible criteria to prevent abuses could be to consider:

- The relationship of the minority interest with the RWA level
- Economic background and or purpose of the subsidiary
- Economic interest of the holders of the investment
- Relationship between the external funds and liabilities

The negative effect of the proposal to simply deduct minority interest in all cases could be massive. If such adjustments are to be applied, sufficiently long transition periods must be foreseen to ensure a smooth and stable transition to the new requirements.

Unrealized gains and losses on debt instruments, loans and receivables and equities

The proposal on unrealized gains and losses as put forward by the Commission Services in Annex V is in our view appropriate and encouraging.

As a general matter, there should be symmetry in the treatment of unrealized gains and unrealized losses and this principle should be maintained as pending accounting changes are factored in.

As regards any future work on this matter (see para 47), we would recommend waiting until US GAAP and IFRS amendments on financial instruments as well as transition provisions are fully finalised. Otherwise new rules on unrealised gains and losses could lead to unintended swings in the capital base due to changes in accounting standards. In order to reduce the need for prudential filters, it is crucial that accounting standards allow for a proper consideration of the actual business model of financial institutions and do not introduce artificial volatility in equity.

With regard to the possible deductions from Tier 1 and current projects on IFRS 9 and prudential filters we would like to point out the following aspects:

- Unrealised gains are often linked to strategic equity investments. From a prudential perspective, it seems fully appropriate to reflect the growth of the value of such

strategic investments, which are often held over long periods when calculating the own funds of the bank[7]. Supervisors may consider applying a haircut[8] to the value of the investment and/or accepting the unrealised gains as gone-concern capital only, but to fully filter unrealised gains whereas on the other side capital losses are deducted at 100% from tier one, clearly does not make sense.

- According the exposure draft of IFRS 9 banks *"will have to make an irrevocable election to present in other comprehensive income subsequent changes in the fair value of an investment in an equity instrument"*. This means that if the investment is sold, the profit would no longer be recognised in net income but in equity. There will be no rationale for developing short term or medium term activities with unrealised gains recognised in equity. Thus, "strategic investments will no longer go through P+L. For the reasons mentioned above, such unrealised gains should not be fully filtered out.

2. Intangibles

Whereas deduction of goodwill seems appropriate, the deduction of other items treated as intangibles from Core Tier 1 Equity need to be examined item-by-item. Intangibles such as mortgage servicing rights, purchased credit card receivables, and software do not exhibit the mentioned "high degree of uncertainty" and have a positive realizable value, especially in a going concern situation. These are very substantial items for some banks and the current approach imposes a false simplicity that ignores the economic realities of many items classed as "intangibles".

3. Deduction of own shares

The EACB disagrees with "look through" requirement for holdings of index securities to deduct exposures to own shares. Thus, investments in own shares and holdings of index securities are different activities. The identification, measurement and separation of the own share component in the index is artificial.

Provision should be made for a separate market-making exception to the proposed deduction in own shares.

The requirement that gross long positions may be deducted net of short positions only if the short positions involve "no" counterparty risk is unrealistic and probably impossible to attain on a meaningful basis. Collateral and other standard risk mitigation techniques should be recognized within otherwise-applicable CRD c.q. Basel rules.

4. Investment in the capital of certain banking, financial and insurance entities

General

While the concern about "double counting of capital" makes some sense with respect to investments in other banks, the members of the EACB take the view that the proposals seriously overshoot their prudential goals:

- First, a market-making exception is required, among other things to be sure that markets can be made in the securities of smaller banks.

[7] Example: If a bank buying a stock of 100 and this investment has after holding it for 20 years a value of 300, it does not seem realistic to base the value of the investment on the original value of the investment for its capital base (numerator).
[8] E.g. haircuts in Belgium are 20 % and in France 55 %.

- The principle of deduction should not be applicable for participations where certain regulations determine a consolidation of own funds. This is already the case in consolidating groups (Art.60 CRD) and – under certain circumstances – in decentralized groups (i.e. according to Art.80 (8) CRD). Participations in such non-consolidating groups should not have to be deducted because "double gearing" is avoided by the consolidation of own funds on group level.
- These cases are different from the minority interest issue (where the deductions have to be made in the consolidating entity), since normally every single bank has to deduct its participation in the common central institution when calculating solvency requirements on a solo basis.
- Moreover it seems to be adequate if the deduction is applied to the entire tier 1 capital as opposed to core tier 1 capital because concerning loss absorbency there is no difference between tier 1 and core tier 1 capital.
- More generally, it seems not appropriate to extend the same treatment of deduction of Core Tier 1 Equity to other financial institutions. The risk-based justification for the proposal is not obvious. Where there are offsetting short or derivative positions for positions in other financial institutions, the normal trading-book and counterparty-risk capital requirements would apply.
- Only direct participation should be taken into consideration.

Investments in Insurance Entities

With respect to the deduction of the participations in financial institutions, we urge to restrict the scope of this deduction to discard insurance companies. The full deduction is not the right answer to participations in insurance companies.

We strongly ask for the maintenance of the current EC regime of the conglomerates Directive

- we call on regulators to focus in priority on the implementation of Solvency 2 (and its equivalents outside of the EU) and now on the forthcoming Basel 3 framework before any review of the regulation in the conglomerate field.
- we request that no redundancy or interference to the current treatment should be made until the calculation of capital adequacy rules on a conglomerate basis is reviewed and updated globally within the appropriate bodies, i.e. the Joint Forum.
- More specifically, we recommend that the Basel Committee harmonises the international prudential practices by adopting the procedures of conglomerates which already exist in European groups, in line with the recommendations of the Joint forum.

First of all, it should be mentioned that substantial holdings in insurance companies allow banking groups to significantly enlarge the range of products they are offering to their customers, at a competitive price, through a common distribution channel.

However, risks borne by insurance companies are of different nature compared to the banking risks. In the insurance sector, the main risks are composed of

(i) underwriting risks (insurers predict the likelihood that a claim will be made against their policies and they price their products accordingly) and

(ii) asset management risks (companies have to ensure that the premiums and life insurance deposits they receive are invested in an appropriate way).

The requirements on investments are also different, in particular since the insurance investment period is typically very long-term. Banks and insurance companies are therefore regulated by specific regulatory requirements: in Europe, banks must comply with the Basel 2 prudential requirements, known as the Capital Requirements Directive (CRD) in the EU, while insurance companies are subject to the Solvency 1 and tomorrow the Solvency 2 directives.

The issue of potential double counting effects of own funds between banks and insurance companies, has been identified in the late '90s by the Joint Forum (a working group of the BSBC, IOSCO and the IAIS) and has proposed *"measurement techniques and principles to facilitate the assessment of capital adequacy on a group-wide basis".* In the EU, these recommendations were translated into the Financial Conglomerate Directive (EC 2002/87) in 2002. This global framework has now been operational for several years in all EU countries and has strongly proved its efficiency during the recent crisis.

The absence of double counting is analysed on the one hand at a global level (conglomerate ratio) and on the other hand at the banking and insurance level respectively.

Indeed, the way the conglomerate directive may be applied following the methods proposed by the Joint Forum correctly takes into consideration this consolidated approach as follows:

- a global control of the solvency of the conglomerate through the calculation of an "observation ratio". The latter is produced by adding up the requirements of the banking activities and those of the insurance group and by comparing this amount to the consolidated total capital of the group (intra-group transactions being eliminated) to ensure that the requirements are fully covered;
- for the bank solvency calculation, including:
    - deductions from the core tier one for the goodwill relating to insurance purchases ;
    - deductions from tier one for the part which relates to the double counting in the tier one (i.e. neutralisation of the insurance reserves and elimination of the potential capital gains and losses booked in the insurance companies as they would otherwise also appear as banking capital due to the prudential consolidation methodology which is used); equity participation risk weighting for any remaining holdings.

It should also be mentioned that this prudential assessment is integrated in an additional stringent European EC framework for all financial groups which have been designated as conglomerates, with more constraints than Basel 2 framework on larges exposures, sectorial analyses (equity investments, real estate), internal control issues and a review and elimination of the reciprocal transactions between the banking entity and the insurance one.

This double geared system includes therefore a full monitoring of all the risks taken by financial conglomerates and the careful control of their capital coverage.

Index securities

The EACB opposes the "look through" requirement for holdings of index securities to deduct exposures to financial institutions which exceed the threshold limit. Investments in financial institutions and holdings of index securities have no common grounds. Not only is the identification of financial institutions and the assessment of the holding value through the index a complex operating process extremely difficult operationally, but also it will reduce liquidity and impair risk management by impeding trading or market-making of index securities. Active trading firms typically have balanced long and short positions, while it appears that the long but not the short would be recognized.

We suggest focussing on direct participations only. If however work on such a rule is continued then the following aspects should be considered:

- balanced positions should be distinguished from outright long positions;
- a proportionality rule should be introduced to rule out unjustified administrative burden.

6. Deferred tax assets

The consultative document states that deferred tax assets ("DTAs") that rely on future profitability to be realised should be deducted from Predominant Core Tier 1. We recognise that a certain degree of prudence may be required for allowing DTAs in regulatory capital as their value can be affected in periods of economic stress. However, we see little justification for such a draconian deduction, which in our view fails to take into proper consideration the various categories of DTAs and the real value of DTAs on a going concern basis.

According to most accounting standards (e.g. IFRS, US GAAP, UK GAAP etc.), the objective of accounting for income taxes in the Profit & Loss statement is to recognise not only the amount of taxes payable or refundable for the current period but also deferred tax reflecting the future tax consequences of events recorded in the financial statements during that period.

6.1 Dependence upon future profitability

DTAs dependent upon future profitability arise both from tax loss carried forward and timing differences between the recognition of gains and losses in financial statement and their recognition for tax computation. Such timing differences commonly derive from the numerous discrepancies between tax and accounting rules, which vary greatly depending on tax laws and jurisdictions.

In reporting net DTAs companies are required by accounting standards to make an assessment of recoverability based on assumptions and estimate of future taxable profits. Importantly, this assessment is subject to scrutiny from external auditors. DTAs will not to be recognised (or will be written off in whole or in part if they have been previously recognised) in case there is not enough certainty that taxable profits will be available to support the utilisation of DTAs in future years. Such write down will decrease net profit reported for the period.

- We are not opposed to setting clear and transparent rules internationally to avoid undue reliance on DTAs in regulatory capital but consider that the proposed blanket rule deduction is unwarranted and will entail undesired effects.

The introduction of an internationally accepted rule DTAs allowance in regulatory capital could be useful to prevent extreme situation from happening again (for example; the Japanese cases). However, we strongly urge the Commission to revisit the blanket rule deduction envisaged which is not only unwarranted but could also have undesirable effects.

One could also debate as to whether a maximum time horizon should be set for DTAs recognition in regulatory capital as in theory DTAs could be utilised for a period extending beyond a foreseeable horizon. While the argument has its merits conceptually, we do not think it is practicable. If a set time horizon was used, this would necessarily involve the presentation of tax business plans on a regular basis to the regulators (as it is done with external auditors). This information would have to be provided on a significant number of entities (i.e. for each tax entity within the Group) as information on a consolidated level is irrelevant when assessing recoverability of DTAs. Complex explanations on the local tax regulations that impact the business plan would also be required. That is why we are of the opinion that the concern in respect of undue reliance on DTAs would be better addressed by a more straightforward limit expressed as a percentage of capital rather than based on a set time horizon.

6.2 Inconsistence with the going concern approach

The logic underlying the proposed deduction, i.e. that DTAs dependent on future profitability should hold no value at all whatever the circumstances, does not appear coherent with the "going concern" approach adopted by the Commission for Tier 1 capital. As explained earlier, DTAs are already subject to an economic value test conducted by external auditors to confirm their recoverability. The time limit set by tax authorities to utilise DTAs is usually very long or unlimited and therefore DTAs may retain value over the long term as long as the bank is in operation even if they have been temporarily written down. DTAs on tax losses carried forward also contribute substantially to the value of the business or the subsidiary in case it is sold or transferred.

6.3 Increase of pro-cyclicality

We consider the proposed deduction increases the pro-cyclicality of the capital regime. DTAs resulting from tax losses, loan loss reserves (not always tax deductible) and unrealised investment losses will increase during downturns and be reversed when results improve. As a consequence, the proposed deduction will further deplete capital in periods of economic stress.

6.4 Discourage "conservative" accounting

The forward-looking provisioning scheme advocated by the Commission will translate into non tax-deductible provisions thereby increasing substantially the amount of DTAs. Deducting such DTAs from Tier 1 Capital would in part annihilate the benefit of this countercyclical measure and may even discourage conservative accounting.

6.5 No level playing field

The proposed deduction is in part contradictory with the stated objective to maintain a level playing field. The proportion of DTAs resulting from temporary differences varies widely between countries depending upon local tax laws. Deducting such DTAs penalise banks operating in tax jurisdiction where certain asset value adjustments (e.g. loan loss reserves, impairment, write down) are not tax deductible and this will translate into

undesirable distortions based on the localisation of a bank's activities.

6.6 Recommendation to devising a partial deduction rule

We urge to consider a more balanced approach for DTAs such as the partial deduction rule already applied in some countries.

Some banking regulators already deduct DTAs only for the portion exceeding a specified maximum proportion of capital and this could be generalised for instance by deducting net DTAs from Predominant Core Tier One only above a threshold equivalent to 10% of Tier One Capital.

However, we consider that full allowance in Predominant Tier One Consideration should be maintained for DTAs resulting from discretionary forward looking provisions.

Question 20: Are the proposed requirements in respect of calls for non Core Tier 1 and Tier 2 sufficiently robust? Would it be appropriate to apply in the CRD the same requirements to buy backs as would apply to the call of such instruments? What restrictions on buy backs should apply in respect of Core Tier 1 instruments?

There should be no other restrictions than the institutions sufficient capital position after call or buy-back. In addition to this non-Core Tier1 capital and Tier 2 capital instruments may be called or bought back at the initiative of the issuer only after minimum of five years. Supervisor is to be informed of calls and buy-backs.

Question 21: What are your views on the need for further review of the treatment of unrealised gains? What would be the most appropriate treatment of such gains?

Unrealized gains and losses on debt instruments, loans and receivables and equities

The proposal on unrealized gains and losses as put forward by the Commission Services in Annex V is in our view appropriate and encouraging.

As a general matter, there should be symmetry in the treatment of unrealized gains and unrealized losses and this principle should be maintained as pending accounting changes are factored in.

As regards any future work on this matter (see para 47), we would recommend waiting until US GAAP and IFRS amendments on financial instruments as well as transition provisions are fully finalised. Otherwise new rules on unrealised gains and losses could lead to unintended swings in the capital base due to changes in accounting standards. In order to reduce the need for prudential filters, it is crucial that accounting standards allow for a proper consideration of the actual business model of financial institutions and do not introduce artificial volatility in equity.

With regard to the possible deductions from Tier 1 and current projects on IFRS 9 and prudential filters we would like to point out the following aspects:

- Unrealised gains are often linked to strategic equity investments. From a prudential perspective, it seems fully appropriate to reflect the growth of the value of such strategic investments, which are often held over long periods when calculating the

own funds of the bank[9]. Supervisors may consider applying a haircut[10] to the value of the investment and/or accepting the unrealised gains as gone-concern capital only, but to fully filter unrealised gains whereas on the other side capital losses are deducted at 100% from tier one, clearly does not make sense.

- According the exposure draft of IFRS 9 banks *"will have to make an irrevocable election to present in other comprehensive income subsequent changes in the fair value of an investment in an equity instrument"*. This means that if the investment is sold, the profit would no longer be recognised in net income but in equity. There will be no rationale for developing short term or medium term activities with unrealised gains recognised in equity. Thus, "strategic investments will no longer go through P+L. For the reasons mentioned above, such unrealised gains should not be fully filtered out.

Question 22: We would welcome comments on the appropriateness of reviewing the use of going concern Tier 1 capital for large exposures purposes. In this context would it be necessary to review the basis of identification of large exposures (10% own funds) and the large exposures limit (25% own funds)?

The large exposure regime has been just reformed by CRD2. A possible new change is justified only by the adjustment to the going concern principle. In our view the impacts of the CRD2 (e.g. inter-bank exposures, connected clients) are not yet clear.

Identifying large exposures only on the basis of going-concern Tier 1 would certainly have a highly restrictive impact on many parts of the banking industry. In particular, it would have a strong effect on smaller banks, where the large exposures generally have a greater share. We do not see that past events have shown that just this part of the industry deserves particular attention

Moreover, we would like to recall that the large exposures regime is based on the presumption of „traumatic losses" which implies a worst case scenario. Under these circumstances it seems to be appropriate to consider all capital elements.

However, if authorities intend to define the large exposures on a stricter basis, in relation to the original own funds, or equity Tier 1, the limits (10% and 25%) need to be reviewed, re-calculated and increased. In this case, proportionality remains a principal consideration: the EUR 150 million exemptions for inter-bank exposures and the even harder to obtain "case by case" agreement to exposures beyond 100% of own funds should not be removed. If the large exposure basis will be the original own funds, the limits should be multiplied at least by the minimum capital adequacy ratio divided by the minimum own funds ratio.

Since there is no specific evidence that changes of the limits of large exposures are required, we strongly recommend not entering into a review of the large exposure limits and calculation base.

Question 23: What is your view of the purpose of contingent capital? What forms and triggers would be most appropriate?

Contingent capital could possibly create attractive value for both issuers and investors, while giving supervisors assurances as to the delivery of additional common equity in

[9] Example: If a bank buying a stock of 100 and this investment has after holding it for 20 years a value of 300, it does not seem realistic to base the value of the investment on the original value of the investment for its capital base (numerator).
[10] E.g. haircuts in Belgium are 20 % and in France 55 %.

time of need. However, there are a number of issues in our view that must be resolved before the Commission could be confident that these instruments will work as intended.

Contingent-capital issuance should not be mandatory; banks should be able within their own discretion to issue contingent capital only if that makes sense in terms of their overall capital structure and contributes to their capital efficiency. In this respect issuance of contingent capital should be one of the elements to take into account in the ICAAP/SREP process.

Most important issue refers to the characteristics of Contingent Capital Triggers.
To appeal to investors, especially traditionally debt-focused investors, triggers must be simple, completely transparent, objective, and non-discretionary, so as to make the risk of exercise as readily analyzed as possible. These investors would also require a trigger *set low* enough that breach should only occur at a level that appears remote upon issuance.

On the other hand, the contribution of contingent capital elements to the robustness of 'going-concern' capital is of more value of the triggers are set as *high* as possible. Only then it is from a supervisor's perspective obvious enough that in a down ward scenario the value of these contingent capital elements is solid.

The challenge now is to strike a balance between both positions and define a minimum level for recognition. In our view this level can never be absolute at a certain fixed ratio. It should be determined in each banks case by its supervisor, under application of general guidelines.

More qualitatively, we would add that only triggers related to the idiosyncratic conditions of a particular institution are likely to be attractive to the market; triggers tied to systemic issues would dilute the market discipline that a well-designed contingent instrument should create. Triggers based on systemic issues would hamper investors' diversification of risks across issuers. The same reasoning applies also for supervisors as they are only interested in assuring that an individual banking institution is kept 'going-concern'.

The contingency could be provided by conversion (into equity) or by write-down (other reserves). However, it should be made clear that, where write-down is the means of improving the firm's capital situation, write-up should principally also be allowed when the firm recovers its stability. With supervisory approval of the details and form of instrument, there is no reason why write-up as the firm returns to health should always be precluded – especially as such a feature will attract a wider range of investors.

Question 24: How should the grandfathering requirements under CRD II interact with those for the new requirements? To what extent should the grandfathering provisions of CRD II be amended to bring them into line with those of the new capital requirements under CRD IV?

We suggest maintaining the grandfathering and transition clauses as defined under CRD 2. Any existing capital components that were issued so far should be subject to long grandfathering and transition periods. Different to the solution under article 154 CRD instruments should remain allocated to their original capital categories and not in a lesser category.

Missing or inappropriate grandfathering and transition rules could lead to an abrupt shortfall of eligible instruments and cause a shortage of capital, motivated by regulatory

intervention (only). By consequence, this is one of the most sensitive issues of the whole package.

Capital instruments should be treated in a particular way, while state aid rules should be carefully monitored. No additional support should be granted.

Section III – Leverage ratio

Question 25: What should be the objective of a leverage ratio?

The regulatory practice of the 60s and the 70s has demonstrated that a non-risk sensitive ratio is not adequate to regulate an industry where risk taking is a basic feature of the business activity. We wonder why the idea to introduce a ratio, which is less risk sensitive than the Basel I capital ratio has gained ground.

The introduction of leverage ratios is contradicting the existing solvency scheme under Basel II, which establishes a relation between the economic probabilities of loss and capital. Leverage ratios are not based on the risk level of the credit institution, but rather on the balance sheet total and off-balance sheet business. There is not only a striking lack of risk-sensitivity. There are also no incentives for banks to reduce risks inherent in their business model.

By no means should the relevance and reliability of a leverage ratio be overestimated. A leverage ratio does not consider aspects such as granularity of the portfolio and diversification aspects. Furthermore, a leverage ratio treats all exposures as equal and negates the risk-weights and parameters which are based on varying grades of risk inherent in individual exposures. While it is argued that for all these reasons a leverage ratio may deliver a necessary complement, its total risk-averseness is striking. Therefore, the weight of such a ratio in the prudential framework should be limited.

The leverage ratio is to be assessed not in an isolated way, but as an additional requirement with possible rigid effects: Either the ratio will not have any effects at all or it will offset the risk-based capital standards of Basel II. If it is supposed to have any effects, they will rather be of a temporary nature, since banks are obliged to increase own funds.

In particular, credit institutions that engage in comparably low risk business activities (consumer business, SME-financing, public financing) could be significantly affected. Problems would arise if the leverage ratio were calibrated as more strict than the Basel requirements: under such circumstances lending capacities would be reduced.

Especially the engagements in low risk business activities would be affected by such a rigid prudential requirement. Most probably, compliance with increased capital requirements would be sought by higher profits from business activities with increased risk. Thus, leverage ratio would have adverse effects.

In addition we point out that on an international level – from a technical perspective – the basis for the calculation is regarded so differently (US-GAAP, IFRS, local accounting standards) that there is no equal competitive environment. The aforesaid, however, would be prerequisite for the introduction of a leverage ratio that is internationally comparable and does not distort competition. In the case of Deutsche Bank, for example, the balance sheet total under US-GAAP is only 50% of the one under IFRS.

For all these reasons, we strongly advocate the leverage ratio should remain an observation factor under pillar II (ICAAP), triggering a dialogue with supervisors when passing limits and possibly leading to measures along the individual business model, when limits are reached.

Question 26: Which element of going concern capital do you consider would be a more appropriate basis for the leverage ratio? What is you rationale for this view?

In our view only the total amount before the deductions should be the basis because the entire core capital as a “going concern’ capital is available and the leverage ratio is also objectively focused to limit the leverage.

Setting an internationally uniform minimum capital ratio could result in significant distortions of competition. Those could only be avoided by an alignment of IFRS and U.S. GAAP, but also of national accounting standards reach. Such a successful alignment is currently not certain. However, it appears to be an essential prerequisite for the introduction of a global leverage ratio.

Question 27: What is your view on the proposed options for capturing the overall extent of an institution's derivatives business in the denominator of the leverage ratio?

We suggest drawing a clear line between derivatives that are used for hedging purposes and those that are used for other business purposes. Derivatives for hedging purposes should not be considered for a leverage ratio.

The gross positive fair value gives the best estimate of derivatives exposure at any given time. Especially, if LR would be in Pillar I, derivatives should be captured after taking into account legally binding netting agreements.

The method for the calculation of the ratio assumes that all institutions can calculate the gross fair value of the derivative contracts or the replacement cost of the derivative contracts using the marked-to-market method of Annex III in the CRD. However, it has to be considered that unlike the Basel Capital Accord, the CRD has not abolished the possibility to calculate the CCR of the derivative contracts by the original exposure method. Several small institutions, which use derivative contracts only for hedging purposes still apply the original exposure method for assessing the EAD of the derivatives.

Question 28: What is your view of the proposed approach to capturing leverage arising from credit derivatives?

Question 29: How could the design of the leverage ratio ensure that it would act as an effective constraint only in benign economic conditions?

Leverage ratio could be introduced as Pillar II principle. Multiple capital requirements would only confuse the users of Pillar III information.

Question 30: What would be the appropriate calibration of a leverage ratio?

As pointed out under paragraph 79 and 80, leverage ratio is intended to be a "backstop" measure. It is not very clear why such a regime would be necessary for the well-capitalised banks, which capital ratio is high even taking into account the Pillar 2 capital needs and the proposed capital buffer. Therefore, we think that, if it is introduced, it is crucial to calibrate the leverage ratio with great caution and it seems to be important to include some risk sensitivity, otherwise the new measure may be a relevant burden for the entire sector.

If the introduction of a leverage ratio is indispensable to restrict leverage effects, it will have to be calibrated in such as way that a (retail-) lending orientated bank is not

required to take up additional capital. For cooperative banks that engage in local retail and SME-lending business, it shall amount to 2.5% at maximum. In detail, this depends on the design of leverage ratio and calibration should be made on the basis of QIS-analysis. As the leverage ratio is non-risk based ratio, there are at least few aspects to consider regarding calibration: level playing field, appropriate level of the ratio and incentive to take more risk.

The level of the ratio has to be high enough to ensure the effectiveness of the ratio. High requirement puts low-risk retail institutions into difficult position, as they either have to raise capital levels or shift towards riskier assets (or both). In its present form the leverage ratio gives high risk corporate financers an unfair advantage over low risk retail financers and in our opinion it does not ensure a level playing field for all institutions. The aspects above give some idea of the contradiction in leverage ratio itself and its calibration.

Furthermore, we are not convinced that a leverage ratio should fully ignore risk weights. If a ratio were calibrated too tight, it would generate incentives to do less business, but possibly more risky business, which could be counterproductive. In particular, there is a danger that banks that have focused on low-risk exposures (e.g. loans to municipalities, residential mortgage) might be obliged to reduce their portfolios and be obliged to engage in more risky business. The business model of institutions that are specialized in the aforementioned low-risk exposures (e.g. municipal loans) and which are doing well by now, is undermined.

According to article 80(7) CRD (consolidating groups) and 80(8) (non-consolidating groups) a 0% risk-weight can be attributed, provided that certain “hard” criteria are fulfilled. We think that these conditions should apply under a leverage ratio as well. The two provision are based on the assumption that groups of banks create a “single economic entity” when the required conditions are fulfilled. Due to these close economic ties it would not make sense to establish leverage ratios for every single bank of such group. Any diverging approach would rather discourage the creation of banking groups.

Moreover, As regards the definition of total exposures, we would like to point out that the EACB believes that the inclusion of highly liquid assets, the exclusion of close-out netting agreements and a CCF of 100 per cent for all undrawn facilities and off-balance sheet items are not justified. We wonder whether it is possible to find a calibration to the ratio which would show anything at all.

Thus, we suggest that

- liquid assets should be left out from the calculation of the ratio;
- the inclusion of the off-balance sheet items listed in Annex II of the CRD should be calculated by applying the standardised regulatory CCF for capital adequacy purposes
- intra-group exposures in consolidating and non-consolidating co-operative groups should be excluded and loans and deposits from the co-operative network should be netted.

Section IV – Counterparty Credit Risk

Question 31: Views are sought on the suggested approach regarding the improved measurement or revised metric to better address counterparty credit risk. With respect to suggestion to incorporate - as an interim measure - a simple capital add on by means of calculating the loan equivalent CVA charge views are sought on the implications of using VaR models for these purposes instead.

Many banks still use add-ons for determining the limit of portfolios. One outcome of the crisis was that add-ons were systematically underestimated because there were no clear rules to calculate them and the regulatory add-ons were even lower and have absolutely no connection with the market environments.

Improved measurement

The proposed measures hardly differentiate between the degrees of progressiveness inserted in the internal risk models. We are very critical of such a development towards regulatory standard approaches to the detriment of internal models. Instead, particularly against the background of the experience of the financial crisis supervisory incentives for the ongoing development and application of internal risk models should be strengthened - even in the best sense of a risk model infrastructure, efficiency and even-diversity. This aspect is more significant, if that reinforces a majority of the proposals that increased risk-weighted assets (RWA) of those banks, which currently make use of the internal models. In particular, the incentives on the prudential use of IMM in relation to market valuation ("current exposure method", CEM) will be maintained.

In addition, a parallel must be safeguarded between the bank's internal modelling and calculation of regulatory capital requirements, particularly in the context of meeting the use test requirements.

Calculating the loan-equivalent CVA charge

The proposed measures based on loan-equivalent CVA charge appear to be very general and are consequently a best approximation of the risk of CVA change.

Therefore, the banks, that are subject to an internal model to CVA calculation over which there is decreased supervision, be allowed to use this model for the purpose of CVA-rate risk calculation. As a result, in comparison to the loan-equivalent approach advanced calculation approaches are used. We therefore suggest for an option to use their own internal models, provided that the risk adequacy can be demonstrated on a CVA-Value-at-Risk back testing.

Regarding the design of the CVA method still other concrete needs exist. The scope of the legislation opens up uncertainty. We ask for clarification, which institutions would be affected. We understand that the requirements do not concern institutions that apply both to the credit risk standardized approach and internal models for purposes of the trading book.

We also assess the maturity of the synthetic bond as the longest effective maturity of a counterparty netting agreements to be extremely conservative. If we hypothetically consider that with a counterparty netting two agreements are concluded: (1) a netting agreement, with few long-running transactions, and (2) an offset agreement with many short running transactions. In such a case, the current proposal would overestimate the risk of CVA change significantly.

Furthermore, it is unclear to us, on which grounds a holding period of one year is used. The one year period requirement is compared to other market price risks disproportionately conservative, because with this requirement it is not about comprehensive CVA risk in the classical sense, but it is about risk from changes in market parameters. Due to the supervisory requirements for general market risk, to evaluate the regulatory capital as the sum of VaR and stress-VaR and to neglect diversification with other market risk, the CVA-rate risk is already sufficiently covered. We therefore request to extend the holding period of one year.

It would be good if next to plain vanilla single name CDS also CDS indices in the Value at Risk-bill could be considered, since a large part of the counterparty risk portfolios is secured by CDS indices.

Capital add-on for CVA losses

The credit valuation adjustment in relation with the OTC derivatives is used in the IFRS accounts, but they do not exist everywhere in the national accounting standards. In some countries the OTC derivatives are off-balance sheet items, and the value adjustments are related to the market value and not to the counterparty credit risk. As many small institution in the EU do not prepare their accounts according to the IFRS and the annual accounts according to the IFRS are available sometimes only on a consolidated level, we think it would be important to describe the proposal also with the terms of the Directive 1986/635/EEC on the annual accounts of the banks.

It is not very clear, whether the banks using the standardised approach for credit risk should also calculate the capital requirement for the credit valuation adjustment.

It is not explained either how in case of credit institutions where neither the CDS spread nor the bond spread is available, the credit valuation adjustment should be calculated.

Question 32: Stakeholders are invited to express views on whether the use of own estimates of Alpha should continue to be permitted subject to supervisory approval and indicate any evidence in support of those views.

We welcome the current positioning. The alpha-factor can continue to be the bank's internal estimate. Also during the financial crisis there was no evidence pointing to a risk underestimation because of the alpha-factor. In any case, the alpha-factor estimate is restricted by a floor of 1.2. An increase of the floor is not necessary. This also applies to the regulatory factor of 1.4. In particular, the alpha-factor has also been an adjustment for the "wrong-way risk".

Question 33: Views are sought on the suggested approach regarding the multiplier for the asset value correlation for large financial institutions and in particular on the appropriate level of the proposed multiplier and the respective asset size threshold. In addition, comments are sought on the appropriate definitions for regulated and unregulated financial intermediaries.

The proposed changes reduce the incentives to use IRB models instead of the Standardized method in form of a shock (one-time) intervention. In the current crisis, even without the proposed changes, risk costs and capital costs of financial institution exposures for IRB banks are dramatically increasing due to the high number of defaults. The proposed changes increase these costs with a further 25-36% RWA increase. While the increase in risk costs due to larger PDs is an inherent portfolio-specific increase and so in line with improved risk management tasks, the proposed changes have no portfolio specific character and are conceptually against IRB principles. In addition, the proposal of

simple correlation-multiplier affects good quality FI counterparties much sharper than worse quality counterparties; the increase for RWAs in the best rating grades can be as high as 36%, while for lower bands 25%. This disproportional increase has a controversial effect on the inter bank market, typically done with good quality counterparties.

Multiplier for the asset value correlation

We reject the planned increase in capital requirements by about 30% for counterparty risk positions with banks and insurance companies with total assets greater than U.S. $ 25 billion by modifying the IRBA - underlying function for this sector,. The planned increase in asset correlation by a factor of 1.25 is currently not comprehensible. Because the principal function was derived from a single-factor model, the asset correlation is the only parameter whose change may be used in this function to an increase in capital requirements. Without adequate analysis of the correlation between "financial firms" that would justify the use of the plus-factor of 1.25, we can not accept the proposed adjustment of the capital function.

Therefore, we propose to recalibrate consequently, the asset correlations of the other asset classes by a general back-testing. There is strong evidence that the contribution of traditional credit risk to the system risk is much less pronounced than previously thought (and calibrated in the Basel framework). The crisis as a stress scenario has shown that the granular and mid-cap retail business in general - and Europe's financial structures in particular – have proven to be high stable against systemic risks. The recent empirical studies on the height of the asset correlations show explicitly for corporates and the retail exposure classes an overestimation of the asset correlation of 50% compared to the actual regulatory requirements. This is in general recognized, Basel II, however, had set the objective to keep the capital ratio in the system constant. This was achieved by a disproportionately conservative calibration of asset correlations. This reasoning is to be dispensed with the extended risk coverage and the increased demands on the quality of capital. In addition, there seems little understanding that the asset correlations for inter-bank claims on the basis of experience from the financial crisis will be adapted, without conducting an appropriate recalibration, also for the other asset classes.

We propose to calibrate anew the asset correlation factors through the oversight of the evaluation of the QIS across all asset classes.

Definitions for regulated and unregulated financial intermediaries

The EACB suggest the following definition of unregulated financial market players: '*unregulated Financial Market players are companies that, irrelevant of its legal, commercial music instruments and dispose of and subject to any special state supervision*'.

Question 34: Views are sought on the suggested approach regarding collateralized counterparties and margin period of risk. Views are particularly sought on the appropriate level of the new haircuts to be applied to repo-style transactions of (eligible) securitisations. In this context, what types of securitisation positions can in your view be treated as eligible collateral for purposes of the calculation of the regulatory requirements? Any qualitative and/or quantitative evidence supporting your arguments would be greatly appreciated.

We have a very critical view on the proposals in this section, as the modelling of the underlying assumptions is made based on cumulative worst-case considerations. As such it is neglected, that for general model uncertainty several successful factors are

considered in the internal model method (e.g. application of the alpha-factor and of the effective EPE as a non-decreasing exposure function). In this respect, the above aspects should be added as a requirement in a stress test approach, and not be capital effective in column I.

In particular, we can not understand why the risk imputed to the horizon (margin period of risk) should depend on the number of transactions in a credit contract. A business with a large volume can be more risky than 5,000 small individual businesses. The assumption that it is more common in large portfolios to have controversy with the contractors is also doubtful. Situations in which controversies occur should be less derived from the number rather than due to the nature of the business. A clear limit on the business number and frequency of incidents regarding controversies fall under the issues of operational risk, but not the counterparty risk. We also see the danger that a seemingly arbitrary limit set at 5,000 business institutions, gives an incentive for businesses to act under a collateral agreement, that the increased risk horizons will not be put into operation. Repeated exceeding and underceeding this barrier would also lead to undesirable jumps in exposure and RWA calculations. We reject the extended risk horizon for these reasons and ask for the retention of the existing risk horizons.

Question 35: Views are sought on the suggested approach regarding central counterparties and on the appropriate level of the risk weights to be applied to collateral and mark to market exposures to CCPs (on the assumptions that the CCP is run to defined strict standards) and to exposures arising from guarantee fund contributions.

We support the retention of the risk weight of 0% for the determination of capital requirements for counterparty risk from derivatives transactions, which are cleared through a central counterparty (CCP). We would like to point out again, however, that all derivatives are not suitable for a CCP clearing.

However, we do not understand why the intention of exposure from default and/or Guarantee Funds for CCPs from the zero weighting is excluded. The motivation for such a differentiation according to types of exposure is unclear and should be revised or clarified. Such was "Clearing Funds" are as rear stage of "Layers of Defense made" at clearing houses (e.g., the sixth stage in the Eurex Clearing) are only very rarely used in the history of clearing. To our knowledge, the Clearing Funds of the major European clearing house, Eurex Clearing, LCH, ECC, ICE Clear was never accessed, not even in the context of the bankruptcy of Lehman Brothers.

The announcement to have stricter regulations for CCP will reduce the likelihood to continue with the use of clearing funds. In so far, the proposed parallel measure is working in an irritating manner, as the case maybe to charge future contributions to clearing funds. In addition, it acts contrary to the stated objective, that more derivatives business should be administered via central counterparty.

Question 36: Views are sought on the risk management elements that should be addressed in the strong standards for CCPs to be used for regulatory capital purposes discussed above. Furthermore, stakeholders are invited to express their views whether the respective strong standards for CCPs to be used for regulatory capital purposes should be the same as the enhanced CPSS-IOSCO standards

To avoid distortions of competition, the requirements for CCPs that may be subject to a zero credit, should be uniformly set internationally. We therefore welcome the initiative of the Committee on Payment and Settlement Systems (CPSS) and the International Organization of Securities Commissions (IOSCO), to establish high quality requirements for CCPs. As a precaution, we point out, however, that it can not be for the banking

industry to examine whether and which issues should comply with the standards of CCPs. Here, supervisors should provide for a list.

At the same time there are concerns that strict requirements could lead to CCPs too high "occupancy costs" - such as higher margin requirements. The additional costs incurred by this relationship require a closer look. The "price of security" should not exceed the potential savings from the use of CCPs.

Question 37: Views are sought on the suggested approach regarding enhanced counterparty credit risk management requirements. Do the above proposed changes to the counterparty credit risk framework (in general, i.e. not only related to stress testing and backtesting) address fully the observed weaknesses in the area of risk measurement and management of the counterparty credit risk exposures (both bilateral and exposures to CCPs)?

The implementation of the proposed rule will require changes to the availability of long data histories, and would generate huge implementation efforts. In a stress testing environment, particularly reverse stress testing, the number of different scenarios and at the same time stressing of exposure and creditworthiness of the counterparty are emphasized.

The significance of back-testing with a longer than one year forecast horizon would be very low if it is considered to be less than once per year. In such a case no valuable sample can be obtained. It requires a certain minimum number of samples in order to draw robust statistical conclusions in order to avoid erratic back-testing results. We therefore propose to limit the back-testing to a maximum one-year forecast horizon.

For the validation of predictive distributions, it is sufficient in our opinion, to limit the EPE model on the most meaningful quantile (1%, 5%, 95%, 99%) and the 50% percentile. Back-testing of market data as input for the EPE model would cover the other hand, the entire forecast distribution**.**

Section V: Countercyclical measures

Through-the-cycle provisioning for expected losses in banks using the standardised approach for credit risk

Question 38: The Commission services invite stakeholders to perform a comparative assessment of the three different methods (i.e. ECF, incurred loss and IRB expected loss if it could be used for financial reporting) for credit loss provisioning from 2002 onwards based on their own data.

For banks using the standardised approach the proposal envisages the embedded PD-s in the risk weights. In our view the proposal is not justified for the following reasons:

- the standardised approach is not based on expected and unexpected losses concept,
- the CRD (Basel II) risk weights in the standardised approach were intentionally simplified in order to be not too complicated and to be similar in many respects to the Basel I capital adequacy framework, therefore risk weights reflect very little, if at all, the expected losses;
- the risk-weights based do not differentiate between the real risks of the market participants, which should be reflected in the EL in the case of
    - the risk weighs based on the sovereign applied for institutions and regional/local governments;
    - the risk weights for the corporate sector;
    - the risk weights of the retail sector;
- the PDs of the same rating grade are not equivalent for the sovereigns, institutions and corporates, and the methodology for the embedded PDs is not transparent;
- nobody has ever demonstrated that the proposed embedded PDs would be the characteristic in any of the Member States. Moreover, we have serious doubts, that in a country, which is in the Credit Quality Step 3 bucket, the 'realistic' EL for institutions would be the same as the EL for corporates. While all exposures to institutions with a maturity over three months bear the same 100 per cent risk weights than corporates.

It has to be mentioned that neither the quantitative impact study by CEBS measures the impacts of such a change for the banks using the standardised approach.

We would also raise the attention that in all Member States the credit institutions using the standardised approach have an important role in SME finance. To establish a provision on the 'embedded' PDs in the risk weights would increase the financing costs to the SME sector.

We think if general provisions will be clearly treated in the accounting systems, on the one hand the management of the banks using the standardised approach should have a possibility to set aside general provisions if they think it necessary due to specificities of the portfolio. On the other hand, the supervisors have already the power to require more capital under the SREP from the banks using the standardised approach, demonstrating that the standardised approach underestimates the real risks. In our view more steps in the case of the standardised banks are not necessary.

Tax treatment of through-the-cycle provisions

Through-the-cycle provisions, if introduced, should be introduced before tax in all Member States, since this is an ex-ante provision for specific losses. The tax treatment should be the same in all Member States. For tax differences the proposed treatment of deferred tax assets could only be a partial solution, since this item on the solo level does not exists.

Question 39: Views are sought on the suggested IRB based approach with respect to the through-the-cycle provisioning for expected losses as outlined above.

First of all, we should very carefully consider whether the proposed dynamic provisioning will a) affect income statement and as a result Tier 1 capital, b) only capital (Tier1 or 2) with no income statement entries, or c) should the dynamic provisioning be treated as one of the risk scenarios in Pillar II.

Secondly, we should have only one convergent method of calculating the provision regardless of the way of utilizing the provision (a, b or c before). The method should be transparent and decrease the volatility in the income statement and solvency.

Part 2 - Capital buffers and cyclicality of the minimum requirement

Question 40: Do you agree with the proposed dual structure of the capital buffers? In particular, we would welcome your views on the effectiveness of the conservation buffer and the countercyclical buffer, separately and taken together in terms of enhancing the resilience of banking sector going into economic downturn and ensuring the flow of bank credit to the "real economy" throughout economic cycle.

We strictly oppose the simultaneous creation of additional “reserves” and distribution restrictions.

The additional statutory buffers could, in theory, improve the solvency of the banking sector. In practice, however, the result could be quite opposite. The restrictions of dividends would make the banking sector less attractive to investors compared to other sectors, and as a result the capital injections would be much more difficult. This would lead to lower volumes in lending which in turn, would strengthen the cyclicality. Any unpredictable mathematical formulas for calculating the potential for dividends would lead lesser interest amongst investors.

The proposal would mean in practise that in order to operate normally, banks should have at least the double capital compared to minimum.

The answer to question about the right level of applying the framework is fairly clear. It should only be applied at the highest consolidation level and not at solo level. This is the only way to maintain a level playing field regardless of the legal structure of the banking group.

With regard to capital buffer, it is not exactly clear how the capital conservation buffer would work.

- In our understanding the capital conservation standards are bank specific, and they are built on the minimum capital requirement, which is disclosed. However it is not exactly clear, what is the relationship between the capital requirement taking into account the SREP and the level of the capital conservation standard. It should be clearly defined.

- The capital conservation standard would be applied on a consolidated level. However, it is not clear how the dividend payment on a solo level could be reconciled with the standard on a consolidation level. Also because in the subsidiaries the general meeting is usually earlier than in the parent company. Therefore it would be very difficult to calculate exactly how much dividend should be retained at the subsidiaries.
- The counter-cyclicality of the buffer would be expressed by an add-on, which means in our view the increase or decrease of the capital conservation standard. Even if clear rules are defined when and to what extent the capital conservation level is to be increased or decreased, capital planning would be very difficult because the uncertainty of the capital conservation level in the medium term.
- From an accounting point of view the undistributed profit should be a part of the other reserves, because it is a legal reserve which could be used only for covering losses. However, since it is a reserve, it is an element of own funds, too, and if so, it can generate more business. The counter-cyclical effect of the buffer for this reason is not clear.
- According to the proposal, capital should be increased after the first signs to a coming downturn, which may strengthen pro-cyclicality.

As far as the time limit for reaching the capital target level in case of non-compliance, we think that harmonisation across EU would help to encourage fair and equivalent conditions in all Member States.

However, capital buffers that shall be provided for in economic up-turns are questionable, since they limit the possibilities of credit financing and in consequence the economic development. If outrageous growth (in case it exists at all) shall be limited, measures on economical-political grounds seem more appropriate. Furthermore there are doubts, whether the contemplated goals can actually be attained.

a) Through the cycle provisioning and counter-cyclical capital buffers limit credit financing only, as opposed to the capital markets. At least large companies will seek for alternative access to capital on the capital markets (e.g. corporate bonds). Businesses that do not dispose of this possibility will be limited in their access to financing. Thus, there is a competitive disadvantage for the credit financed EU economy as opposed to the capital markets orientated US-economy.

It is questionable who shall be responsible for the determination of the actual market cycle of the economy, when managing credit growth. Are these national, European or global institutions? Depending thereon, different perspectives will be the outcome. In no event it is sufficient to undertake such determination merely on the basis of figures (see also Question 52).

As regard through-the-cycle-provision, we would like to point out that the focus is set on expected losses. However, this criterion is only used by IRB banks. Banks applying the standard approach would be pressed to IRB, since there expected losses are not provided for in the standard approach. This must be opposed against the backdrop of equality (which is regularly being confirmed by supervisors) of standard and IRB approach.

b) Concerning Capital Conservation Buffers (=distribution restrictions) there are relevant doubts, whether banks would be able to provide for the required capital at all. An investor's interest to acquire a share in a bank will be low, because an unrestricted distribution shall only be allowed, if the minimum capital is exceeded by 100%.

In that context banks will suffer a massive competitive disadvantage compared to non-banks, because investors will preferably invest in the latter business (which are not

subject to distribution restrictions). A run for capital with significant disadvantages for banks will be the result.

Prior to implementing any measures in the context at hand, a macro-economic QIS shall be performed (see also question 45).

Question 41: Which elements should be subject to distribution restrictions for both elements of the proposed capital buffers and why?

Items which have considered being subject to restrictions are ordinary dividends and share buybacks, discretionary payments on other Tier 1 capital instruments (cooperative capital?) and discretionary bonus payments to staff. Only bonus payments to staff should be included, question and answer 40.

Question 42: What is the appropriate timing – following the breach of capital buffer targets – for the restriction to capital distributions to start? Should the time limits for reaching capital buffer targets be determined by supervisors on a case-by-case basis or harmonised across EU?

It should be determined on a case-by-case basis. In particular, it should be determined taking into account the legal peculiarities of cooperative banks and their structural limitations to put outstanding transactions to increase capital (most of them are non listed companies and do not have access to capital markets). Otherwise, banks operating within the buffer limits, in order to reconstitute the latter in the timeframe specified by the supervisor, could put in place quick actions to reduce lending/RWA, thus strengthening pro-cyclicality. Furthermore, it should also be taken into account that in some jurisdictions the law already provides a “system of capital conservation” for co-operative banks. For instance, the Italian Banche di Credito Cooperativo must allocate 70 per cent of yearly net profits to legal reserve (in order to increase and reinforce the capital).

Question 43: What is the most suitable macro variable (or group of variables) that may be used in the counter-cyclical buffer to measure the dynamics of macro-level risks pertinent to the banking sector activities?

The difference between the aggregate credit-to-GDP ratio and its long term trend has been considered.

For banks with purely domestic lending and especially for the local banks, such as cooperative banks, the excessive credit grow should take into account the economic conditions of limited geographical areas in which they operate.

Question 44: What are the relative merits and drawbacks of capital buffers versus through-the-cycle provisioning for expected losses with respect to minimizing pro-cyclical effects of current EU banking regulation?

Merits: evaluating the cyclicality of the minimum requirement
Drawbacks: Through-the-cycle provision is principle based, EC model v. IFRS changes v. EBF alternative model, EC model with capital distribution restrictions.

Question 45: Do you consider that it would be too early to fully assess the cyclicality of

the minimum capital requirement?

Yes, taking into account the market cycle for capital provision, it would absolutely be too early at this stage. The plans at hand are immature. A macroeconomic QIS is indispensable, since the impact on the economy will be massive. If at all, such measures shall only be considered under pillar 2. In addition, we (again) point out that the pro-cyclical effect of Basel II is a result of the disproportional increase of the PD-curve. Therefore, the adjustment of the PD-curve would be the appropriate tool as opposed to the contemplated alternatives at hand.

Section VI: Systemically important financial institutions

Question 46: What is your view of the most appropriate means of measuring and addressing systemic importance?

In No. 169 of the consultation paper the Commission expressed that the size of a company is a key driver for systemic importance. Although this is acceptable to a certain extent, there are of course other factors that must be considered. The size must not be confused with size in terms of competition in this context. A single bank may be large enough to generate systemic risk and can at the same time not be large enough not to abuse its market position. Therefore, there no reference should be made to the EU competition law in order to define systemic relevance of financial institutions. The relevant size of an institution should be more determined by answering the following question: would the collapse of the financial institution have a material impact on other institutions or lead to endanger the stability of the entire financial system?

Systemic relevance is thus not a matter of size only. In addition the central position on a local and/or product related market are relevant. If only the size of an institution would matter, institutions like Northern Rock are HRE would not have been comprised. Of equal importance is the interconnectedness with other player on the financial market (see Hypo Alpe Adria) und the risk basis of the business. In that context it shall be taken into account that other banks will not be in the position to easily absorb high risk business of banks in distress (as contemplated in the “living will” concept).The outcome shall not be that only big states may host big banks (e.g. based on the GDP). The argument being occasionally made that only big states are able to recapitalize big banks does not fit with an integrated European economic area and an envisaged improved cross border crisis management. It seems, however, more important to handle the systemic risks that emanate from unregulated shadow-banking.

Question 47: How could the Commission services ensure a consistent prudential treatment of systemic importance across financial sectors and markets?

First, we share the observation that systemic crises are not only caused by banks but also by other institutions and these should therefore also be included in the analysis. As mentioned in Question 46, in future systemic risk should be an important inherent issue in the considerations and actions of banking supervision. In order to reduce the likelihood and implications of systemic crises, there is a need to improve for micro-and macro-prudential supervision, closer integration and cooperation of the international supervisors. It is therefore necessary to have structures that allow for the identification and quantification of systemic risk and the development of appropriate measures. Tasks of macro-prudential supervision institutions could include: assessing imbalances in markets and common sources of risk, and creating a network for market participants to recognize each other and exchange best practices to reduce risks. The plans of the European Commission to establish a European Systemic Risk Board (ESRB) with a European System of Financial Supervisors (ESFS) goes in the right direction. This macro-micro prudential supervision system should ensure that concerted actions can be performed both in banking, insurance and securities markets. To effectively prevent crises, the involvement of central banks, governments and the policy makers is essential in many ways.

Furthermore, an important point of consideration is to have a system in place to monitor and to react adequately to systemic risks in the future in order to prevent future crisis. However, provisions that allow for general prohibitions (e.g. as regard sizes of institutions) or breaking-up of existing structures are opposed.

Section VII – Single rule book

Question 48: In which areas are more stringent *general* requirements needed given national or other circumstances? Is Pillar 2 a sufficient tool to address *specific* negative circumstances at credit institutions and if not, how could it be strengthened?

We support the Commissions suggestion to prevent Member States from 'gold-plating' and have more general requirements in 'fully harmonised areas'. The members of the EACB welcome the proposal to reduce and remove the multiple possibilities for national discretion proportionally. However, some national discretion should remain based on existing local market conditions.

We consider that Pillar 2 is a sufficient tool to address specific negative circumstances. It should be taken into account that a harmonisation of Pillar 2 is not necessary.

Question 49: What is your view of the suggested prudential treatment for exposures secured by mortgages on residential property outlined above? What indicators and their respective values do you consider appropriate as possible preconditions for the application of the preferential treatment of exposures secured by mortgages on residential property?

The members of the EACB think it is not necessary to introduce and additional 'hard test' on losses when waiving the independence criterion for the preferential treatment of exposures secured by mortgages on residential property. The loss rates within mortgage credit market of some Member States are far below the set loss rate limits of the European Commission. The considerable expenditure that could exist due to the rise in the losses will only lead to an insignificant profit that is not worth to be subject to prudential requirements. In addition, considering that the repayment of the mortgage credit depends on other sources of income of the borrower and not on the property underlying it, a 'hard test; with its base on the national residential mortgage market is not efficient.

Furthermore, there should be no introduction of preconditions for the application of preferential treatment of exposures secured by mortgages on residential property such as a limit to LTI and LTV. Scenario such as in the Unites States where the provision of credit was based on insufficient credit worthiness checks, were not prevalent at EU level, only in certain MS. The indicators will not indicate whether the mortgage markets are stable. Moreover, these indicators should rather play a role in the context of conduct of business rules such as responsible lending than in the prudential requirements context.

Question 50: What is your view of the suggested prudential treatment for exposures secured by mortgages on commercial real estate outlined above? What indicators and their respective values do you consider appropriate as possible preconditions for the application of the preferential treatment of exposures secured by mortgages on commercial real estate? In particular, are additional preconditions needed to ensure the soundness of this treatment? Do you believe that the existing preferential risk weight applied to exposures secured by mortgages on commercial real estate should be increased? For both questions, any qualitative and/or quantitative evidence supporting your arguments would be greatly appreciated.

We consider that the introduction of a 'hard test' that will apply more generally as a condition for the preferential treatment of in Member States, rather than only as a condition for the waiver of the requirement that the risk of the borrower does not materially depend upon the credit quality of the borrower is neither based on value

adjustments of the national mortgage markets nor on the risk-based approach justified. The idea to have a sine qua non hard test for the losses of exposures secured by mortgages on commercial real estate leaves no option but to have a 100% risk weight assigned to the exposures. The risk weight of 100% will totally ignore the risk reduction effect of mortgages and as such undermine the risk sensitive determination of the risk weight. It will increase the price of commercial real estate mortgages. Furthermore, it will especially harm and affect SMEs whose credit is mostly secured by and dependent on the underlying commercial real estate. The credit conditions for SMEs could as a result of the introduction of a hard test deteriorate.

Furthermore, the erratic increase of the capital charge as a result of the introduction of a 'hard test' could unfold unwanted procyclical effects.

In addition, we consider it not necessary to have a LTV indicator as a precondition for the application of preferential treatment of exposures secured by mortgages on commercial real estate or any other indicators.

Finally, the existing preferential risk weight applied should not be increased and should be maintain to be subject to the developments of the national mortgage markets.

Question 51: Should the prudential treatment for exposures secured by mortgages on residential property be different from the prudential treatment for exposures secured by mortgages on commercial real estate? If so, in which areas and why?

In most EU countries, the losses of exposures secured by mortgages both on residential and commercial real estate have only given rise to limited loss rates. The current different prudential treatment regime for exposures secured by mortgages on residential and commercial property at EU level should be maintained.

Question 52: What is your view of the merits of introducing measures that would help to address real lending throughout the economic cycle? Which measures could be used for such purposes? What is your view about the effectiveness of the possible measures outlined above?

It is questionable who shall be responsible for the determination of the actual market cycle of the economy, when managing credit growth. Are these national, European or global institutions? Depending thereon, different perspectives will be the outcome. A suggestion would be to base the determination of collateral value over a long time period in order for it to be independent of market developments and to take into account possible risk and chances in the future.

We would like to draw your attention to the immense responsibility related to the determining the actual market cycle of the economy. In this regard, it can be mentioned that there were problems in the past, e.g. both subprime as well as the Spanish real estate bubble were evident, and however supervisors or politicians did not act. In any event, vigilant supervisors and an ESRB vested with relevant competences are needed.