NATIONAL BANK OF POLAND

Position of the National Bank of Poland on the Commission Services Staff Working Document *Possible further changes to Capital Requirements Directive*

Consultations conducted by the European Commission are public, therefore the questions contained in the EC document are directed to all financial market participants, that is to various addressees. The following document presents answers and comments provided by the National Bank of Poland (NBP) to the questions that address macroprudential issues or may also bear some implications for banking sector stability.

General comments:

The changes proposed by the European Commission in the selected areas regulated by the provisions of Directive 2006/48/EC result from the experience of the present crisis, which has been pointed out in a number of cases by the authors of the Commission document.

However, due to the scale and depth of the proposed changes, and the need to assess the internal coherence of the proposed solutions, it would be appropriate for the European Commission to include in its proposal – when further work is underway – a general section that would specifically indicate:

- the weaknesses in the functioning of the banking and financial systems, identified during the present crisis,
- identified market failures that warrant regulatory intervention,
- the goals of specific regulatory tools as expressed in reference to the identified market failures, as well as the manner in which they are to achieve an impact.

The European Commission proposals that correspond with the proposals of the Basel Committee are designed to eliminate major irregularities that have been identified in the course of the present crisis, and, therefore, should be promptly implemented, in particular because under present circumstances it seems easier to reach political consensus.

Given the depth of the proposed changes, it is important in this context to properly take account of the scale of activity and complexity of the entities to be regulated, applying the proportionality principle where appropriate. Moreover, irrespective of the fast pace of the work and expected implementation in 2012-2013, significant emphasis should be placed on the application of adequate *vacatio legis*, where necessary or favourable to the safety of activity being conducted.

Section I – Liquidity

General comment:

Given lack of both international and EU liquidity standards, and the resulting great variety of solutions at national level, it will take time before some banks adjust to the new liquidity regulations. Therefore, in the case of liquidity solutions it would be desirable to carry out the legislative process in a timely manner, combined with a suitably long vacatio legis of three to five years, which will allow these banks to reduce adjustment costs.

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.*

The proposed regulation regarding banks' short-term liquidity has its equivalent in Polish regulatory solutions. This regulation, adopted by the Polish financial supervisory authority in 2007, introduced a short-term liquidity ratio which requires that all funds regarded by a bank as unstable to be covered by a core liquidity reserve and a supplementary liquidity reserve.

It can therefore be stated that the very concept of applying top-down short-term liquidity standards had already been implemented in the Polish banking system. Banks have been required to comply with the standard since July 2008, i.e. before the market crisis following the failure of Lehman Brothers. The basic difference between the Polish standards and the proposed Liquidity Coverage Requirement (LCR) lies in the assumptions concerning the value of funds that have to be covered with short-term liquid assets. Polish standards stipulate that the liquidity reserve is to cover liabilities regarded by a bank as unstable (based on analyses performed according to methodology approved by the supervisor, primarily in regard to determining the stable part of deposits, the so-called core deposits), whereas the LCR directly introduces parameters determining the liquidity outflows under a regulatory stress scenario. From the point of view of comparability and transparency, such a design of the LCR seems to be favourable. However, by introducing uniform levels of the outflow of funds, the LCR may be a worse gauge of individual liquidity risk in comparison with indicators that are largely based on calculations performed by individual institutions that take into account the specific character of both their liquidity profile and the market on which they operate. The financial systems of the countries to be subject to the proposed arrangements vary substantially, in terms of the development and penetration of the banking system, level of economic education of the public and confidence in financial institutions. All these factors may have a strong impact on the scale of a potential crisis and on the rate at which households' funds outflow from bank accounts. In this context, as the proposed LCR takes no account of the above factors, it may insufficiently fulfil its aim, i.e. to increase the resilience of financial institutions to liquidity risk. In the view of the NBP, a model taking into account the requirements of local supervisory authorities, arising out of their knowledge of the specificities of their markets, is a more favourable solution.

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?*

Instruments accepted by the central bank should form the primary group of instruments eligible for the buffer. Experience gained during the crisis indicates that in the period of serious disturbances obtaining liquidity even on markets that have normally exhibited a very high degree of liquidity is either made difficult or impossible, and that the central bank is the main source of liquidity.

The option to make other instruments that are not accepted by the central bank eligible for the buffer should solely rest with national supervisory authorities.

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.*

Similarly as in the case of the Liquidity Coverage Requirement, the Net Stable Funding Requirement (NFSR) already has its equivalent in Polish supervision solutions. The 2007 regulation introduced the obligation to maintain the ratio of coverage of illiquid assets and assets of limited liquidity with regulatory capital and stable external funds at a level exceeding 100%. Furthermore, as in the case of short-term standards, the difference between the Polish and European Commission proposals relates to the manner in which individual items of assets and liabilities are classified. The essential differences between the two are as follows:

- Polish standards stipulate that all assets not included in the liquidity reserve and not resulting from banking activities outside the wholesale financial market have to be covered by stable funds and regulatory capital; however, the proposed NFSR focuses on the maturity of assets, at the same time attributing various parameters of coverage by stable funds to different categories of these assets;
- Polish standards stipulate that a bank uses its own internal (approved by the supervision authority) models for calculating the amount of stable funds; whereas the proposed NFSR focuses on the maturity of liabilities, at the same time attributing uniform parameters of core deposits to various categories of liabilities with maturity of up to 1 year.

It can therefore be stated that the Polish standards are – to a greater degree – structural, and require banks to maintain stable funding sources, without directly specifying the need to balance assets and liabilities maturing in a period over 1 year.

It can be argued that in the case of the Polish banking sector and of other countries with poorly developed securitisation and bank debt instruments' markets, the solutions set out in the Polish long-term liquidity standard are more appropriate. A funding model consisting primarily in accumulating and rolling over (mainly current and short-term) deposits, with a marginal role of long-term liabilities, presently does not allow to balance assets and liabilities maturing in a period over 1 year. While acknowledging the need to introduce an arrangement that will contribute to enhancing the stability of liabilities of financial institutions, it should be emphasized that the present state of markets and models of banking activity in a number of countries (including Poland) does not allow them to rapidly meet the NFSR. Preliminary simulations conducted by the NBP show that the majority of Polish commercial banks would fail to comply with the NFSR as of the end of 2009. Moreover, in the sector of commercial banks as a whole, stable funding sources (calculated according to the methodology attached in Annex II) account for approximately from 76% to 85% (depending on the requirement for coverage of Polish government bonds) of assets that require funding. This implies that the whole banking sector would have to undergo structural changes for the banks to meet the criterion in question. In view of the above, the need to comply with the NFSR in the present shape would involve very high costs that may negatively impact the financial position of a considerable group of domestic financial institutions. Compliance with the requirement would also require taking actions aimed at stimulating the development of the market of non-treasury bonds, which requires more time.

This standard should be designed with great caution, taking into account all relevant factors. According to Annex II to this document, treasury securities with ratings below AA could not be included into the category of assets with a coverage ratio of 5%. Moreover, in line with the Annex, these securities would not be included into the category with a coverage ratio of 100% (there is no other category than 0% and 5% coverage that would include treasury securities). The category of assets with a coverage ratio of 5% should also include treasury securities with ratings lower than AA, which are among the most liquid instruments. However, their rating is constrained by the sovereign rating of the issuer country. It is worth pointing out that under the Liquidity Coverage Requirement, securities issued by a country in its national currency exhibit the highest weight of "quality" (liquidity).

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?*

It can be assumed that especially in the case of an institution facing problems in complying with the minimum Net Stable Funding Requirement indicator, originating long-term loans may indeed be constrained at the expense of short-term loans or securities. This may have a negative impact on the real economy due to constrained opportunities of funding private investments, inter alia, through being superseded by the funding of public debt. Moreover, it can be assumed that in order to comply with the NFSR, banks would seek to convert their long-term loans into short-term ones, which would reduce the stability of funding of entities from the real economy, with potential negative effects for economic growth.

We wish to express our doubts concerning the idea to divide the loan portfolio for non-financial entities within the NFSR according to original maturities, and to assign to them various parameters of required coverage with stable funding sources. It seems that the mismatch between the maturity of banks' assets and liabilities should be primarily reduced on the liabilities side of their balance sheets. Banks might be compelled by the proposed standards to limit their long-term loan portfolio. At the same time, it should be kept in mind that maturity transformation is the essence of banking activity, which supports economic growth. Therefore, the proposed arrangements should primarily affect retention of most stable funding sources, without excessively reducing loan supply.

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?*

In the view of the NBP, specific liquidity parameters should be set at country level. Setting various parameters for specific sub-categories of deposits is not sufficient to take into account the specificities of individual institutions and financial markets (see answers to Questions 1 and 4, respectively).

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 the view of the NBP, liquidity standards should be applied both to parent entities on a consolidated level and individual institutions (including subsidiaries) on a stand-alone level. National supervisory authorities must have the right to enforce standards on a stand-alone level irrespective of the terms referred to in point 17, including the right to impose local liquidity standards on branches (the Polish arrangement also applies to cross-border branches).

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 intragroup 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 treatment of intra-group transactions should primarily depend on the desired effect of solutions being implemented on the funding structure of subsidiaries. If the intention underlying the proposed measure was to decrease funds received by subsidiaries from foreign parent entities in their funding structure, then it would be reasonable to introduce the solutions proposed in point 24.

However, if the proposed solutions are to accurately reflect the present process of liquidity management, the proposal referred to in point 23 seems a better solution, which assumes that banks can obtain liquidity by, inter alia, using credit lines granted by other affiliated/parent entities. It should be emphasized that a large number of subsidiary banks in Poland are primarily funded via loans provided by their parent entities. Introducing the standards consistent with the assumptions of point 24 would require these banks to revise their business model and to build, practically from scratch, their deposit base or extend the maturity of liabilities obtained within the group, which might push up the funding cost of all banks. This, in turn, could translate into the increase in credit costs or into compromising banks’ capacity to generate capital internally.

During the crisis liquidity support provided by parent/affiliated entities has varied across countries. In the case of Poland, following the failure of Lehman Brothers, funds obtained from foreign parent banks were the main source of liquidity for domestic banks. However, the negative experience of some countries indicates that it cannot be assumed that intra-group liquidity support would have been provided under any circumstances.

Moreover, irrespective of the approach to liquidity support from parent or affiliated entities, it is important to introduce the requirement of the diversification of sources of emergency liquidity.

Therefore, it is our opinion that the regulation should be based on a prudential variant whereby funds obtained from affiliated entities cannot be treated as an accessible source of contingent liquidity.

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?*

Liquidity supervision serves a twofold purpose. The first is supervisory and is intended to verify a bank's liquidity security. Thus, it is of microprudential importance. However, on the other hand, banks are part of the financial system, and the latter is in turn subject to assessment for macro-prudential purposes. If a bank and a branch are in the same country, the same supervisory authority performs both functions. However, if a branch is in another country, security on a micro- and macro-level is split between the home and host supervisory authorities.

In this situation, the home supervisor is responsible for liquidity supervision over a bank as a whole, including a cross-border branch, and there is no reason to relieve him/her of this responsibility. However, on the other hand, the host supervisor, on account the stability of national financial system, must have the guaranteed right to perform liquidity supervision over a cross-border branch because it is necessary for ensuring financial stability in the host country. This principle does not preclude the possibility that supervisors share tasks and prerogatives. It is a matter of agreement between them, and such arrangements should not be interfered with.

Section II – Definition of capital

General remark:
It appears from the tentative analysis carried out in the National Bank of Poland that the proposed changes to the definition of capital will not have a significant impact on the level of own funds of the Polish banking sector owing to the strong capital position of Polish banks and the fact that some of the proposed changes had already been implemented in the legal system.

However, what has to be considered is the date of entering into force of the changes to the definition of capital. The present date (end of 2012) seems too early given the counter-cyclical measures proposed at the same time by the European Commission that will additionally increase the need for capital.

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

The changes proposed are appropriate. The distinction between Tier 1 (*going concern capital*) and Tier 2 (*gone concern capital*) clearly distinguishes between capital that may be used to absorb current losses and capital that may be used in case of a bank's insolvency. The crisis has demonstrated that Tier 3 capital is useless.

The proposal foresees that Tier 3 capital should be eliminated. Therefore, it should be specified more precisely whether "Net trading book profits" that are now comprised in *Tier 3* will not be treated as a component of capital any more or whether they will be included in *Tier2*.

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?*

To ensure the security of depositors' funds, it seems important that Tier 1 capital should comprise the highest quality capital and that the share of Tier 1 in capitals should be considerable. Therefore, the NBP approves of the criteria to include capitals in Tier 1 proposed by the Commission and the proposed list of prudential filters and potential deductions.

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?*

To preserve an appropriate proportion between Core Tier 1 and non-Core Tier 1, it should be proposed that if losses are absorbed by Core Tier 1, a corresponding portion of non-Core Tier 1 is converted into Core Tier 1 capital. In addition, if a supervisor demands the bank should increase Core Tier 1 and the bank does not meet this obligation and does not issue additional equity capital, the supervisor should be entitled to demand conversion of a relevant portion of non-Core Tier 1 instrument into Core Tier 1.

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

Most banks' capitals meet the requirements of Core Tier 1 in the Polish banking sector. The applicable list of prudential filters performs well in practice. This is why, from Poland's point of view implementing additional criteria does not seem necessary.

Question 20: *Are the proposed requirements in respect of calls for non-Core Tier 1 and Tier 2 sufficiently robust? Would it 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?*

In the opinion of the NBP, the proposed requirements in respect of buy-backs of hybrid instruments comprised in non-Core Tier 1 and the possibility of using the call option are appropriate.

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

In the opinion of the NBP, unrealized gains on balance-sheet positions should also be eliminated from Tier 1. This would strengthen the capital structure and would prevent "excessive" increase in capitals, the use of which, in principle, could not be possible to absorb losses if a recession or a crisis occurred.

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% of own funds) and the large exposures limits (25% own funds)?*

In the opinion of the NBP, a change to the basis of identification of large exposures from own funds to Tier 1 is justified. This should however, be followed by a recalculation of the amount of limits currently applicable.

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

The purpose of contingent capital should be quick and effective recapitalization of a distressed bank. It would be a long-term debt instrument, issued by a bank in times of financial market stability. In certain cases a mechanism would be triggered leading to an automatic conversion of the debt instrument into equity, thus in effect the burden of the recapitalization would be borne by the bank's creditors rather than taxpayers of a given country, as was the case during the current financial crisis. Freed from the need to repay debts, banks will be able to obtain more private capital to finance their operations. Moreover, the prospect of debt to equity conversion is likely to improve the assessment of a bank's future situation by creditors and other counterparties, as in the case of "traditional" convertible bonds.

Contingent capital should be used as an instrument of supervisory proceedings during the stage of early intervention, that is, e.g. when the bank's net worth is still positive but investors are not ready to participate in its recapitalization. Debt instruments would be converted to equity in two cases: (i) a major deterioration in the bank's financial condition, determined by reaching a specified minimum level of a selected solvency ratio, or (ii) an announcement made by the regulator that the financial system has been affected by a systemic crisis. The terms and triggers of conversion would be regulated by law and the supervisor's intervention would be possible in specific circumstances.

One of the above-mentioned ratios could be, for example, the ratio of a certain minimum (positive) level of Tier 1 capital to risk-weighted assets. In addition, it would be necessary to specify the rate at which debt converts to equity.

Question 24: *How should the grandfathering requirements under CDR II interact with those for 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?*

In the opinion of the NBP, grandfathering arrangements in respect of hybrid instruments counted as capitals that do not meet CRD II requirements should not be changed. With regard to hybrid instruments that do not meet CRD IV requirements the dates of grandfathering them should be correlated with the dates proposed for hybrid instruments that do not meet CRD II requirements (among others, the final date by which these instruments may be included in capitals should be compliant with the date as provided for in CRD II).

Section III – Leverage ratio

The European Commission has not determined which off-balance sheet assets should be included in the leverage ratio. The inclusion of off-balance sheet assets in the calculation of the leverage ratio should be driven by efforts to ensure international comparability of the ratio definition, particularly with respect to the American market.

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

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?*

The role of the leverage ratio should be to indicate the vulnerability of a financial institution in terms of solvency to changes in the prices of assets. The leverage ratio may perform a complementary role with respect to the solvency ratio and function as a buffer for supervisory authorities, taking into account the ‘model risk’ present in the design of the solvency ratio (i.e. the risk of error in the selection of risk weights used in calculating this ratio). As the example of the current financial crisis shows, faulty risk models caused banks that seemingly had a sufficient level of capital to quickly become undercapitalized.

In order to be useful in practice, the leverage ratio should have its minimal value set at a sufficiently high level for the supervisory authorities to take adequate action.

A supplementary role of the leverage ratio may be to show stockholders and other stakeholders the extent to which the financial results of the given bank are due to the profitability of its operations and to what extent are a consequence of leverage. For this reason (question 26) an adequate measure of capital would be the Core Tier 1 capital, corresponding to the funds put forward by stockholders.

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?*

The stance on the inclusion of non-credit derivatives in the leverage ratio depends on how we understand the role of the leverage ratio. The European Commission does not determine its role in the document. If it is understood as the indication of vulnerability of a financial institution in terms of solvency to changes in the prices of assets due to the credit risk of its counterparties and the risk of securities in its portfolio, then the adequate approach would be based on the gross fair value of the portfolio (i.e. without offsetting transactions). This value determines the ongoing value of bank‘s receivables from its counterparties.

On the other hand, if the role of the leverage ratio is the indication of vulnerability of a financial institution in terms of solvency to changes in the prices of assets due to risk of any kind, the possibility should be considered of derivative portfolio being measured by its delta equivalent, taking into account the vulnerability of derivative transaction pricing to changes in the value of the basis instrument.

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

The proposed approach is correct. Granting credit protection from the point of view of exposure to credit risk is economically equivalent to holding a basis instrument with value equal to the nominal credit derivative transaction in the portfolio.

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

Such a possibility would be obtained by setting a longer time limit for the return to the required level of leverage ratio in the case when the violation of the limit is due to losses incurred by the bank than in the case when it is the result of too rapid exposure growth.

Section V – Countercyclical measures

General remarks

The aim of the solutions proposed by the Commission is to limit the pro-cyclicality of bank behaviour, in particular to reduce banks' pro-cyclical behaviour in terms of credit supply. The resulting reduction in the amplitude of the credit cycle may be conducive to lowering the probability of imbalances arising in the financial sphere of the economy and thus it may contribute to a more stable long-term economic growth. This aim should be deemed legitimate.

From the economic point of view, the meeting of every regulatory requirement (at least in the short term) generates costs for the regulated institution. Therefore, it is only natural that regulated institutions react to the introduction of a regulation by looking for ways to minimise its costs. In the case of regulations aimed at reducing the amplitude of the credit cycle – which in the proposed form involves an increase in "regulatory costs" imposed on banks in the phase of fast economic growth (and their symmetrical reduction in the slowdown phase) – one has to reckon with a likely intensification, during the boom phase, of the processes of credit risk transfer from banks to other financial institutions whose regulatory burdens connected with bearing credit risk may prove lower (the so-called cross-sectoral arbitrage). The currently observed low activity of the global securitisation market may increase as the economic growth accelerates, so the emergence of such phenomenon cannot be ruled out in the future.

The above mentioned cross-sectoral arbitrage may reinforce banking sector stability, on the one hand, but on the other hand weaken the stability of the financial system as a whole, as credit risk would be held in the portfolios of institutions whose experience in bearing such risk is weaker than that of banks. In this perspective, it seems that regulations proposed by the European Commission may prove effective on the assumption that credit risk transfer from banks to other financial institutions will not be significant.

Another general problem should be emphasised in this context. If the regulation limiting pro-cyclical behaviour of banks is to mitigate imbalances arsing in the financial sphere of the economy (primarily in the form of credit booms), then restricting those measures to the banking sector only may prove insufficient.

If the regulations make the holding of loans on bank balance sheets costly and, consequently, they are sold to other financial institutions (with lower regulatory burdens), then the credit boom problem will remain unresolved. In an extreme situation, banks may only act as intermediaries that grant loans and then sell them off to other financial institutions (which was precisely the business model of lending companies in the United States prior to the current crisis).

The above reasoning indicates that it would be desirable that works on regulations concerning credit risk lead to the harmonisation of regulatory requirements imposed on all the financial institutions which are subject to regulations concerning capital requirements. Moreover, it should be considered whether the assessment of imbalances in the economy should involve the use of variables which are not limited to banking sector exposure to risk but encompass the entirety of the economic situation, including the prices of assets and financial market tendencies.

Part 1 – Through-the-cycle provisioning for expected credit losses

Question 38: *The Commission services invite stakeholders to perform a comparative assessment of the three different methods (ie 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.*

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.*

The envisaged goal of the through-the-cycle provisioning for expected losses is to reduce the volatility of earnings of financial institutions across the business cycle. This is not an uncontroversial solution. An argument raised in public discussion was that earnings are to represent the current value of assets and liabilities of the financial institution as precisely as possible. This reasoning underlined the approach that only accounts for asset impairment losses identified at the reporting date (incurred loss model) – as it is currently followed in IAS 39.

However, it has to be firmly stated that the current way of accounting for asset impairment losses is conducive to reinforcing the pro-cyclical behaviour of banks. Irrespective of the regulatory initiatives aimed at making a closer connection between incentive systems in place at banks and their long-term results, the current financial results of banks affect and will continue to affect their direction of operations. In such a situation, the accounting for costs of asset impairment losses only at the moment when problems with debt servicing arise leads to excessive growth in the supply of credit in periods of good economic climate and its excessive tightening in periods of economic downturn. These processes have been visible in the past five years and have contributed to the current global crisis.

As mentioned in the document of the European Commission, works on provisioning for asset impairment losses are also carried out by the IASB. The proposals presented by the IASB in the consultation paper of November 2009 postulate provisioning for impairment losses for financial instruments by determining, at each reporting date, the discounted value of expected cash flows from the financial instrument over its maturity and recognising impairment losses in case this value decreases as a result of heightened credit risk of the given exposure (expected cash flow model).

This way of determining impairment losses for financial instruments can potentially ensure a more precise representation of the value of financial instruments at the moment of their first inclusion in the balance sheet and, therefore, contribute to a more precise determination of yields earned by the financial institution on a given instrument.

However, the IASB-proposed way of provisioning for impairment losses still displays pro-cyclical characteristics. In the phase of a high rate of economic growth the expectations of institutions concerning the likelihood of not receiving financial flows from an instrument may prove overly optimistic. In case of a deterioration in economic climate, the assessed probability of not receiving cash flows would surge, which – similarly as the arrangements currently in force – would lead to a strong rise in provisions against impairment losses at the time of economic slowdown. For this reason, the IASB-proposed change of principles will not be conducive to reducing the pro-cyclicality of bank behaviour and so additional solutions should be proposed.

The European Commission postulates that banks, apart from provisions for asset impairment losses, also create general provisions for credit risk. The proposed mechanism is as follows. Banks would determine the expected value of loan losses in their held portfolio in one-year horizon. For banks calculating their capital requirements following the Internal Ratings-Based (IRB) approach, this value would be determined using the probability of default (PD) and loss given default (LGD) values estimated by banks. In line with the current wording of Directive 2006/48/EC, banks should derive PDs as long run averages of one-year realised default rates, which is to reflect credit risk of an exposure in through-the-cycle terms. For the banks following the standardised approach, the percentage of expected losses would be determined by regulations depending on the risk weights assigned to the given exposure.

In one year's time the expected value of losses would be comparable with the actually created provisions for impairment losses (calculated according to the incurred loss model in the proposal of the European Commission). If the estimated expected value of impairment losses proves higher than the actually incurred impairment losses, then the bank will be obliged to increase the value of general provisions against credit risk by this difference. In opposite situation, the bank will be entitled to release the respective part of general provisions. In line with the proposal of the Commission, creating and releasing general provisions against credit risk will influence the profit and loss account of the bank in the same way as creating and releasing impairment provisions. It should be added here that the solution in the form of a general provision for the whole portfolio and, additionally, for the retail loan portfolio has been established in Poland for a long time.

The overall direction of the proposed changes should be assessed positively. Reduction of the volatility of banks' earnings across the business cycle may contribute to an improvement in the stability of their operations and stabilisation of credit supply. In our opinion, however, the details of the proposed solutions require further elaboration. In particular:

- With the assumption that new solutions proposed by the IASB enter into force (and so, from the perspective of financial reporting standards, impairment losses for financial instruments will be calculated using the expected cash flow model), the proposal of the Commission to use the incurred loss model to determine provisions created in a given year will reduce the transparency of the proposed solution and cause additional obstacles for financial institutions. As suggested by the above presented analysis, <u>shifts</u> in the values of the financial instrument calculated with the incurred loss model and the expected cash flow model may be similar, due to market participants' propensity to extrapolate current trends into their forecasts. In this respect, the utilisation in the Commission-proposed mechanism of the provisions created in a given year based on the expected cash flow model – in line with accounting regulations – will simplify the proposed solution and enhance its transparency.
- Crucial for the solution proposed by the Commission is the assumption that the values of PD and LGD parameters derived by the IRB method accurately reflect the average values of these parameters across the business cycle. This gives rise to two problems:
    - Current qualification requirements for the application of the IRB method only indicate that PDs should be calculated as a long run average. Thus formulated requirement does not ensure that the data used for calculations will include data from the period of economic slowdown. Therefore, qualification requirements for the application of the

IRB method should be supplemented with such a requirement, the compliance with which should be strictly verified by supervisory authorities.

- As noted by the Commission, the current wording of the provisions of Directive 2006/48/EC indicates that, for purposes of determining capital requirement with the IRB method, LGDs should be estimated as LGDs corresponding to the period of economic slowdown. The most theoretically coherent value of LGD for the mechanism of calculating through-the-cycle provisions should be the average LGD value across the business cycle. The calculation of two LGD values may be an additional obstacle for banks. The decision whether to adopt the average LGD value across the economic cycle both for calculating capital requirements and through-the-cycle provisions should be made based on quantitative research carried out under the aegis of the CEBS, which would help assess the impact of possible options on the capital requirement level of banks.

- The calibration of the proposed mechanism for the banks following the standardised approach should be consistent with the requirements imposed on the banks following the Internal Ratings-Based approach.

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 counter-cyclical 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.*

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 European Commission postulates to change the capital requirements for banks by introducing an additional capital buffer (conservation buffer), i.e. the capital surplus above the minimum requirement which banks would be obliged to build up by accumulating profits. If a bank’s capital falls below the buffer limit, then the bank will be obliged to earmark part of its profits to raise the capital. The supervisory authorities may require the bank to reach a capital level that would ensure the compliance with the buffer requirement by a fixed deadline.

Additionally, the European Commission proposes to introduce the possibility of increasing the capital buffer (by means of a supplementary counter-cyclical buffer) depending on the path of a predetermined macroeconomic variable/group of variables revealing excessive credit growth in the economy, taking into consideration the level of development of financial sectors in particular countries. The target for such buffer would not be fixed as a deterministic function of the value of any selected variable. The Directive would only provide the “reference” value, based on which the supervisory authorities and the central bank of the given country would decide the level of the counter-cyclical buffer, taking into consideration all available information.

In the first place, it has to be observed that in case those solutions are adopted, the option proposed by the Commission to apply requirements at an individual level (i.e. at the level of subsidiaries of other banks) should necessarily be included in the final version of the regulations. Such a solution is necessary to ensure the operational stability of subsidiaries of international banks.

The introduction of the conservation buffer only would be equivalent to raising the minimum solvency ratio level and setting the minimum requirement for recovery plans of banks that do not comply with the capital requirements. Such a solution may enhance banks' resilience to economic downturn, but it will not decrease the pro-cyclicality of bank behaviour, especially in the period of good economic climate.

The introduction of the counter-cyclical buffer may contribute to reducing the pro-cyclicality of banks' behaviour in good times. However, the level of capital is not the only factor encouraging banks to tighten their credit policies in the period of economic downturn. The findings of studies on the situation in the loan market (Senior Loan Officer Opinion Survey) conducted by the NBP indicate that during the current economic downturn an equally important factor contributing to credit policy tightening by banks was the uncertainty as to the future economic tendencies, namely the rising credit risk and reduced risk-adjusted returns on new lending. However, at the current stage, the proposal of the European Commission is too general to be analysed in detail and to express opinion on its possible impact on the supply of credit across the business cycle. The comments below are therefore general in nature.

As rightly noted by the European Commission, the fundamental problem in designing this type of regulations is to select the suitable variable or group of variables that may be used to signal an excessive growth rate of loans in the economy. This means that for the proper accounting for the specificity of national conditions, this selection should be made by national institutions responsible for ensuring financial stability in their respective jurisdiction. The only proposed variable presented in the Commission's document is the deviation of credit-to-GDP ratio from its long-term trend. It seems that it would be desirable to consider the behaviour of credit in division, at least, into loans to enterprises, housing loans and consumer loans. Presentation of more detailed proposals by the European Commission should be supported with research findings identifying the variables that may point to the existence of a credit boom and justifying the selection of the threshold values whose breaching should trigger an increase in the counter-cyclical buffer.

The proposed regulation does not specify how often national authorities would be entitled to adjust the level of the counter-cyclical buffer. As the data necessary for its calculation will probably be available with delay, it is advisable that national authorities have the possibility to react flexibly to the changing economic conditions.

The introduction and then adjustment of the level of the counter-cyclical buffer will have an impact on the mechanism of monetary policy transmission into the real economy. In this respect, it is indispensible that the decisions changing the counter-cyclical buffer are taken in close cooperation between the financial supervisory authority and the central bank.

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

The list of items proposed by the European Commission seems accurate. What could be considered here is whether restrictions should also apply to instruments with the characteristics of shares privileged in terms of dividends. Another thing that might be considered is providing the supervisory authorities with the right to identify additional financial instruments subject to restrictions.

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?*

The experiences of financial crises indicate that effective prevention of crisis situations both on the systemic level and at an individual institution requires remedial measures to be taken at an earliest possible date. For this reason restrictions on profit distribution should enter into force as soon as possible once the need to supplement the buffer has been indentified.

As regards the time limit for achieving the capital buffer, it seems desirable that the CEBS elaborates technical standards that would act as guidance for supervisory authorities in setting the time limits for banks, which would help ensure a level playing field.

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

The two solutions should be deemed complementary. The merit of the through-the-cycle provisioning is the possibility of a more objective determination of its values and lesser need of discretionary intervention of the supervisory authorities into the operation of particular banks. However, these provisions only constitute a buffer for absorbing higher losses related to credit risk and they cannot serve to absorb the costs of other kinds of risk materialising.

In turn, the advantage of the counter-cyclical buffer is the enhanced resilience of banks to all kinds of risk that may be accumulated in a credit boom period. A large discretionary component in the structure of the counter-cyclical buffer provides, on the one hand, the possibility of responding flexibly to the macroeconomic developments but, on the other, creates the risk of inadequate response. The introduction of the counter-cyclical buffer will change the conditions for pursuing monetary policy and its transmission mechanism. For some time the pursuit of monetary policy may be hindered, but if the counter-cyclical buffer proves effective in reducing the amplitude of the credit cycle, then a greater economic stability may facilitate the achievement of price stability in the longer term.

Question 45: *Do you consider that it would be too early to fully assess the cyclicality of the minimum capital requirements.*

The minimum capital requirements are cyclical in nature. At the current stage, however, it is not possible to assess this phenomenon precisely. In order to perform such an assessment, it would be necessary to collect data covering the whole economic cycle in a stable regulatory environment. The CRD, however, which by its very nature is characterised by higher cyclicality than the previous regulatory solutions, has only been in place for two years. This picture is obscured by subsequent regulatory changes. Nevertheless, what has to be taken into consideration in the first place is the crisis situation, which has had an incomparably greater impact on bank behaviour than all recently introduced regulatory amendments.

Section VI – Systemically important financial institutions

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

Adequate methods of measuring systemic importance of a financial institution consist in analyzing the impact of potential shocks experienced by these institutions on the functioning of the whole financial system and real economy. For each institution adequate probable crisis scenarios should be developed, in which shocks would influence the functioning of separate elements of the financial system. Effects of these potential shocks should then be analyzed. In the analysis of a possible impact of shocks on other elements of the financial system and the economy as a whole, the main focus should be directed towards:

1) importance of functions performed by financial institutions affected by a shock,
2) the scale of involvement of particular institutions in the performance of important functions within the financial system and the economy,
3) the possibility to substitute the elements of the financial system affected by crisis in the performance of important functions and in the provision of important financial services,
4) the probability and potential scope of financial contagion effect among institutions,
5) potential costs incurred by economies and limited access to financial services during systemic crises.

The assessment methodology of systemic importance of financial institutions, banks in particular, was adopted by the ESCB General Council (it is used by the National Bank of Poland) and is based on the description presented above.

It is extremely difficult to measure all aspects of the systemic importance of a financial institution using quantitative methods and models, therefore qualitative assessments are very important as a complementary element of the overall systemic importance assessment framework.

Adequate policy addressing systemically important institutions consists in strengthening the scope and quality of analyses concerning the stability of the most important elements of the financial system. Special requirements and regulations for systemically important financial institutions, markets and financial infrastructure may be introduced in order to maintain the stability of the whole financial sector .

The SIFIs problem should be addressed in a twofold manner (which is also a viewpoint shared by the European Central Bank). First, the probability of a failure of a systemically important institution should be minimized. Therefore, it is particularly important to identify correctly institutions that are systemically important and then to introduce more intensive supervisory treatment of these institutions, including tighter capital requirements. Also a broad early intervention framework should be developed with respect to these institutions, related to actions aimed at crisis prevention. In order to reduce the risk of moral hazard, the early intervention framework should comprise, among others, more restrictive and intensive prudential supervision over systemically important financial institutions, as well as the possibility of using contingent capital. Second, regulations should be prepared to enable a timely and orderly restructuring or winding up of an institution in the case of a crisis. Yet, the key issue seems to be the introduction of the requirement of simplifying banks' organisational structures so that separate kinds of banking (financial) activity are conducted through entities having separate legal forms. To this end, the concept of the so-called non-operational holding company (NOHC) could be applied. Financial groups could carry out various activities (credit, investment, asset management, open pension funds, investment funds, leasing activities, etc.) as separate legal entities, whose stocks would be held by a holding company that would not perform any other activity. Such organizational structure would allow for bankruptcy of each entity in the holding which does not take deposits. In the case of a deposit taking institution , the risk of bankruptcy should be reduced by applying special law on bank restructuring and wind-up while ensuring deposit availability to depositors.

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

It seems that an important role in the coordination and provision of coherent treatment of systemically important financial institutions should be played by the European Supervisory Authorities (ESA) and the European Systemic Risk Board (ESRB).

Moreover, on the international stage, the Commission, by means of its participation in the FSB, should strive towards harmonization of global standards among the banking, insurance and capital market sectors in order to reduce the cross-sectoral and international regulatory arbitrage.

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?*

This question, taking up the issue of more stringent standards, should be regarded as the most important in the whole document under consultation, since it refers to the potential freedom of national regulators willing to introduce measures more restrictive than those envisaged in the CRD.

The risk related to the particular banking product depends not only on the characteristic of the given product and bank professionalism but is also to a great extent dependent on the legal and economic environment in which the bank operates. There is no full harmonization in this area, which means that risk related to the given banking product may depend strongly on the conditions in the given country – legal, business and other. Prudential regulations and supervisory procedures should take into account such differences.

However, the CRD based on the principle of maximum harmonization, requires strict transposition of almost all its provisions to national law, with the exception of a few provisions explicitly named in the directive. Such a solution strengthens the process of building a common market for financial services and facilitates management of cross-border banking groups. Nevertheless, it may lead to situations in which the adopted measure is too liberal for some countries and too restrictive for others.

It cannot be forgotten that – so far – the financial stability has a national dimension. As long as this remains true, it is the national supervisor who must have a possibility of adequate reaction. When the supervisor finds that certain EU provisions do not provide sufficient safeguard against elevated risk factors he must be able to put the financial stability of his country before the maximum harmonization of the CRD.

The use of Pillar 2, suggested by the authors as a substitute for introducing stricter supervisory standards, justified by the specific conditions of the given country is an interesting concept but at the same time unfeasible, for two reasons:

- First, all regulations, by nature apply to the whole banking system or certain, well defined, banking groups. This means that they have a systemic character. They are complemented by provisions of Pillar 2, which by definition deals with individual entities. Therefore, the capital requirement for a particular bank is tailored to its specific risk profile. The introduction of systemic solutions through this channel, as a substitute for regulations (e.g. raising the risk weight for a particular exposure class) does not fall within the concept of Pillar 2 and as such could be effectively overruled by banks on the legal basis.
- Second, the present proposal of changes to the CRD, envisaged by the Omnibus directive, allows for a situation where the amount of additional capital charge on a bank which is a subsidiary of a bank from another Member State could be established at a level lower than required by the host supervisor. Such a dependency of Pillar 2 scope of applicability on the bank ownership structure constitutes an additional argument against using it as a substitute to prudential regulations.

A compromise solution would be granting the national supervisor a right to use more restrictive solutions than those provided for in the CRD, under the condition that it presents the EBA with an adequate, convincing explanation, using the *comply or explain* principle. It is worth mentioning that the report of de Larosière Group, in paragraphs 107 and 108, as well as recommendation X, states that at the local level, the application of measures more stringent than provisions of the directive may be justified or even recommended as long as it does not breach the principles of the common market and complies with minimum conditions contained in the EU law.

It is difficult to anticipate all areas in which the application of stricter national solutions should be allowed. It will always depend on the specific conditions in a given country. One can still point to some of them.

- First of all, it would be the case with real estate lending. The supervisor must have the right to introduce higher risk weights, particularly for loans granted in a currency different to that in which the borrower's income is denominated, or to establish the maximum allowable LtV. It stems from the fact that real estate markets in particular Member States vary significantly and the risk level of such loans is strongly dependent on the country. It should be noted that in the case of economies outside the euro area in particular, granting loans in a currency other than the national currency constitutes a credit risk for banks, a property risk for citizens and a demand risk for the economy. What is more, it negatively affects the freedom of determining the monetary policy, and favours speculation on the capital market and real estate market. If a significant part of the loan portfolio is of such nature, and adequate regulations tailored to the specific conditions of the given market, aiming at reducing the related risk in the case of sizeable depreciation are missing, such a situation affects the results of financial institutions and in the case of considerable losses may lead to the moral hazard (by attempting to obtain state help on part of these institutions). This is particularly dangerous if there are differences in terms of duration and currency exposure between assets and liabilities. On the other hand, such stimulated appreciation trends may be unfavourable since they erase jobs in the economy based on exports in favour of cyclicality in the construction sector, and the property effect impact on clients is conducive to over-indebtedness of households. A temporary economic boom entails trouble during the currency bust coupled with a sudden drop in demand and threats to the banking system, which has been made plain during the recent crisis.

- Another area concerns liquidity regulations. This area has not been regulated at the EU level so far. There are also no widespread international standards in use. The practice of particular Member States has not been homogeneous - in some states there was no regulation at all, in others - standards at the national level were introduced. Presently there are plans to introduce provisions regulating liquidity issues to the CRD. Considering the diversity of experience of particular Member States as well as the diversity of applied solutions, there is a serious danger that liquidity regulations introduced to the CRD will require further changes. It should be borne in mind that ill-adjustment of the liquidity regulation to the given market may in special circumstances pose a threat to the stability of a single financial institution or even the whole country. Therefore, supervisors must have the right at their disposal to set higher requirements than those envisaged by the directive. Similarly, in the case of group models being applied, the regulatory solutions should in the particular case guarantee to the national supervisor the right to impose stricter liquidity norms than those anticipated in the model.
- The decision concerning approval of using advanced risk measurement models by bank groups needs to be reconsidered (art. 129(2) of the CRD). According to the presently applicable provisions, if, after joint assessment, unanimous decision cannot be reached, it may be taken by the consolidating supervisor. In special cases he can decide the model under dispute should be applied by a subsidiary bank against the opinion of the host supervisor responsible for its safety. At present, in such a case, the host supervisor may – after assessing increased risk related to the application of the given model - impose an additional capital requirement on the bank under Pillar 2. The amendment to the CRD directive (Omnibus Directive) subject to the work of the European Parliament, introduces changes which may impede the host supervisor to resort to Pillar 2. This would be equivalent to the transfer of decision rights concerning the application of advanced risk assessment models to the group level, while at the same time, leaving responsibility for the safety of this bank on the national level. It is therefore worth considering introducing an unequivocal distinction between decision levels: the national (i.e. individual) level and the group level. In absence of joint decision, the consolidating supervisor would have the casting vote in matters concerning the approval of group models and matters in respect of the consent for their application at the group level. The national supervisor, on the other hand, would have the casting vote in his jurisdiction in respect of matters related to the application of the model by a bank. This would be consistent with the scope of responsibility of each of the supervisors.
- The national supervisor should retain the right to decide whether the management processes may be outsourced, in particular to entities of the same banking group. Stable and safe bank management requires, among others, an adequate management structure. Therefore, the national supervisor must have the right to assess the level of risk related to the possible outsourcing of management processes. The abundance of possible solutions is such that the introduction of a single provision based on the maximum harmonisation principle is impossible in this case.

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?*

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?*

Due to the differences referred to above, between the markets for mortgage loans in particular Member States and markets' functioning, it is impossible to introduce for the community market as a whole, uniform conditions the meeting of which would allow for the application of preferential risk weights for exposures secured by mortgages and, at the same time, maintain the risk at an acceptable level.

Each supervisor should have the right to set conditions independently. Meeting such conditions would make it possible to apply a preferential risk weight. When setting such conditions, the supervisor should take into account at least the following: the LtV ratio, funding stability, legal conditions (national rules for the protection of tenants, priority of entry in the Land Register), and average time of satisfying claims by the bank from mortgage collateral.

Conditions that would enable the application of preferential risk weights will vary across countries depending on whether the bank can easily evict an unreliable debtor or if this is difficult; they will be different depending on whether the average time of satisfying claims by a bank from mortgage collateral is one month or one year; or different again if the bank has stable long-term funding sources rather than uses short-term liabilities for funding purposes.

In this context, it is worth emphasizing that if a loan is secured by a mortgage collateral, it is the national provisions that impose restrictions on enforcement activities that are important from the creditor's point of view.

It seems that there is an adequate relationship between preferential risk weight for exposures secured by mortgages on commercial real estate and exposures secured by mortgages on residential property and that it does not require changing, provided, however, that the legal solutions applicable and the practice used in a given country do not reduce the quality of the mortgage collateral on residential property (e.g. when it is easier for the bank to satisfy claims from mortgage collateral on commercial real estate rather than on residential property).

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?*

Assigning a risk weight to exposures secured by mortgages on residential property that is lower than the risk weight on exposures secured by mortgages on commercial real estate is a correct approach. The quality of residential loans is usually higher as the borrower attempts to protect his standard of living and own flat always takes precedence. Practice indicates that the borrower, who has problems, provided the deterioration in his financial situation is temporary, tends to take more expensive short-term cash loans in other banks to be able to regularly pay back the mortgage loan. The motivation of corporate entities is not as strong, which justifies a higher preferential risk weight than in the case of an exposure secured by mortgages on residential property inhabited by the borrower.

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?*

Real estate lending is usually long-term, which means loans are taken for a period exceeding one economic cycle. In particular, loans taken when the economic situation is good may, when there is an economic slowdown, carry a higher risk. Therefore, they should be treated differently than short-term loans.

Among the three approaches to treating such exposures, the second one seems advantageous. The third would be conducive to using systemic solutions through Pillar 2. The first approach is, in principle, embedded in the second one and for this reason the second approach should be preferred.

This approach is based on the mortgage lending value applied by banks to assess the real value of the collateral for prudential purposes in a changing economic situation with better accuracy than when applying market valuation.

In the context of Question 52, it should be emphasized that the mortgage lending value should reflect the level of risk related to the real estate as loan collateral, i.e. the risk related to the long-term possibility of the property sale, lease, alternative usage or using it to obtain a relatively stable income during the loan contract term. The mortgage lending value of the real estate set at the moment of concluding the loan agreement should, in all probability (regardless of temporary fluctuations triggered by trends on the real estate market which impact the market value), remain the same for the whole period of the loan term. Unlike the market value, which is set as at a given date due to the fact that it is to be the value as at the moment of setting it and has a relatively short validity time, the mortgage lending value should be adequate in the long period of the loan agreement validity. Therefore, when setting it all risks related to the real estate should be assessed.

The value of mortgage bonds issued by mortgage banks has not been markedly impaired during the crisis, which contributed to the fact that they could be used as the basis for repo operations conducted by the ECB and some central banks. This was due to a more conservative assessment applied by mortgage banks as well as adopting more conservative levels of LtV ratios. In their simulations, banks should also account for borrowers' financial capability and the fact that during a slowdown borrowers' income may decrease.

There is an ongoing discussion about the scale of real estate lending by universal banks. The common opinion is that from banks' point of view loans secured on real estate are safer. However, it should be borne in mind that they are extended for a much longer period, which, on the one hand, leads to the increase in liquidity risk, and on the other hand, is conducive to the fact that during the loan term the borrower's situation may significantly deteriorate which cannot be foreseen when the loan request is being assessed. In addition, universal banks, unlike mortgage banks, do not apply a more credible mortgage lending assessment but use a less accurate expert assessment based on a direct reference to current market prices. Moreover, universal banks tend to use more liberal LtV ratios in times of a good market situation. It should be noted in this context that mortgage banks finance their activities by issuing mortgage bonds while the source of funding in universal banks are client deposits. Therefore, the latter should not be exposed to additional risk arising from excessive concentration of the bank's exposure in the segment of mortgage loans. Various manners of mitigating this risk are possible. A relatively liberal one would be to introduce an acceptable level of concentration ratio for mortgage loans in universal banks. A more restrictive solution, which is used in some countries, would be to introduce the obligation to apply the mortgage lending assessment coupled with the requirement to finance the portfolio with mortgage bonds in whole or in part provided the percentage of partial funding with mortgage bonds is high (at least 90%). However, the effectiveness of such an approach requires a consistent application of this solution.