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Santander Views on Basel's *"Liquidity Framework"*

Presentation

Santander welcomes the effort made by the Basel Committee to safeguard financial market stability and to preserve the system from a renewed liquidity shortage. As a consequence, SANTANDER has been actively involved and engaged in discussions on the Basel Committee proposals under the umbrella of the main industry associations IIF and EBF, as well as the Spanish Banking Association. We deem these papers directionally correct and thus lend our full support to these papers but we wish to highlight certain points we deem crucial.

Executive summary

Above all, we consider that the goals of this proposal and the solution to the recent crisis would be better achieved by enhancing supervision and corporate governance. Tighter requirements, without the previous and by themselves will always be insufficient or inadequate for future unanticipated events and could create a false sense of security.

Nevertheless, Santander considers the proposal conceptually well defined focusing on liquidity coverage during a survival period and structural stability of liquidity sources.

However, we find that some relevant aspects of the current proposal still worth further consideration. In particular:

1. The envisaged scenario is not just unlikely but implausible, especially for the Net Stable Funding Ratio (NSFR), as it compounds on a combination of idiosyncratic and systemic shocks, both severe, while at the same time denying any possibility for the institution to react.
2. The proposal unfairly penalises retail commercial banks (e.g.: differential treatment of retail credits versus wholesale clients in the NSFR through more penalizing required factors). This is totally unjustified as traditional business models have proven to be more resilient in the current crisis than others. This would furthermore have dramatic consequences for retail real sectors.
3. The definition of liquid assets in the Liquidity Coverage Ratio (LCR) and NSFR is too restrictive and will at the end induce "herd behaviour", limiting the room for liquidity risk management, and increase risk of concentration in few asset classes, thus contributing to financial instability.
4. The proposal as it is will seriously impair the banking maturity transformation function. The proposed NSFR as defined implies that some short term assets will have to be financed with long term liabilities, creating thus a positive liquidity gap.
5. In addition, disclosure requirements seem to us to be counterproductive as the volatility of these ratios could be easily misunderstood by the markets.
6. Finally, we think that the "one size fits all" approach proposed does not adequately capture the great variety of business models and thus a more flexible approach is needed in order to not unduly penalise certain business models.

Comments on the process

We understand that many definitions and benchmarks remain yet undefined and are subjected to a comprehensive impact and calibration study during the fist half of 2010.

We feel that an additional consultation process with the industry would be needed once the calibration is done and before the proposal is ultimately approved.

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In addition, we think that a "trial period" would be advisable to gather experience on the implications of the proposal for the industry, markets and real economy. The experience could help to adjust those aspects around which there is at present more uncertainty.

This should take into account the aggregate impact of both ´Basel III´ and any additional capital and liquidity requirements considered (e.g: future requirements on systemic institutions). Moreover, the interplay between both liquidity ratios should be also carefully assessed.

Santander would also advice strong coordination efforts of regulators *vis-á-vis* central bank in view of the interlink between banking liquidity regulation and monetary policy implementation.

It is also a crucial matter that the Basel Committee, the European Commission, the US authorities as well as the accounting standards setters align their proposals to the extent possible not only in content but also in timing. Changes should also only be put in place once consideration has been given to (a) cumulative impacts, possible double counts, chain reactions as well as unintended consequences; (b) economic recovery patterns which differ from one country to another.

General Comments on the proposal

Impact on the real economy and on systemic risk

The new set of standards, in combination with others included in the capital measures package, will have severe consequences upon the real economy in terms of potential real growth and financial stability in the long term, and could seriously threaten the incipient recovery in the short term.

The current proposal would jeopardize the potential real growth by reducing credit supply to the real economy, especially to those sectors/countries with more difficult access to the markets, and by skewing the supply of credit towards the public sector.

The assumptions made in the proposal imply funding short term assets with long term liabilities. This would dramatically distort the maturity transformation function of the banking system bringing a reduction of the banking intermediation that will unavoidably weight on growth. This will imply a reduction in quantities (it will impede on the provision of credit) and impact on prices (the incremental cost derived from a more long run - more expensive- funded credit will likely be passed-through to clients leading to more expensive credit).

There is also a risk of crowding out if the liquidity standards remain totally skewed toward Treasuries in order to comply with the eligibility criteria that, at the end, could curb real sector productivity and therefore potential real growth.

Contrary to what is aimed with this proposal, it will also foster systemic risk by giving more room to "shadow banking" players, that are not or lighter regulated, and by inducing "herd behaviour" within the banking system by requiring banks to move always in the same direction within a narrow range of asset classes.

In the short term, we deem it very important to consider the effect upon Monetary Policy that the measures may have. The increase of liquid assets to hold in the balance sheets could have similar effects to that of a tighter monetary policy when implemented.

Additionally the proposal could have a huge impact on the monetary policy transmission channel generating severe uncertainty around the monetary policy reaction function (e.g.: impact on the interbank market due to the penalizing treatment of the interbank financing). Moreover, if the ratios are not consistently implemented across countries this could lead to imbalances in capital flows.

Calibrating the Stress Scenario

Santander considers that the stress scenario is too conservative since it assumes severe idiosyncratic and systemic risks at the same time and during a long lasting period. It is also striking that the stress scenario considers a situation where there is no reaction in the banks behaviour regarding their business and where contingent funding lines fade off but not funding compromises. This is at the local level implausibly severe but possible; however Santander does not see how that line would fit into a systemic crisis scenario, since it is not possible that all the banks are at the same time rolling-over its credit lines and suffering a dry-up of its funding sources.

Moreover, we consider that the LCR, as it is designed, could not work as a buffer since the stress event-triggered factors (withdrawal of deposits, rating drop etc) are assumed to permanently remain along the survival horizon instead of phasing out. It is not envisaged in the proposal how the buffer could be released once the stress scenario materialises. On the other hand it is also a reason of concern that the stress scenarios fully disregard the starting conditions of each bank (for instance in the re-rating of their balance) as the impact will be very different depending on which is the starting point.

Therefore we consider that:

1) The stress scenario should be reviewed in order to be plausible, and to the extent possible adapted to the institution's own characteristics
2) Some margin for banking reaction and contingency plan execution once the scenario materialises should be recognised
3) Some clarification is needed on how the LCR should be applied as the scenario materialises partly or in full.

<u>Disclosure</u>

A full public disclosure of all information required at the consolidated level and at the frequency requested above will not add further transparency to the system and, on the contrary, could lead to misinterpretations due to the high volatility of these ratios, inducing spurious volatility in market assessment of the banks risk profile.

We acknowledge the need for transparency regarding the bank liquidity risk profile, but certainly the proposal as it is does not help markets to properly assess this point. We advocate a full transparency to supervisors, auditors and other authorities (with confidentiality when dealing with the information) and less but simpler information, lower frequency and less sensitive to the rest of the market.

<u>Incentivising arbitrage</u>

The NFSR as it is defined in the current proposal, creates a room for arbitrage both for products (formalising loans by commercial paper or other securities) and institutions (non-bank institutions intermediating between banks and clients ~ shadow banking). The more incentives for arbitrage are being introduced the more resources the market will devote to circumvent regulations, and hence more systemic risk will arise (see Annex for an example on this).

<u>Impact on the interbank market</u>

The proposal seems to discard the interbank market as funding provider. However, this market plays a crucial role in the liquidity distribution during normal times preventing idiosyncratic liquidity risk. Santander would encourage considering the role of the interbank market in the design of stressed scenarios. Moreover, improvements in the functioning of the interbank market should also be considered as a way to mitigate the malfunctioning of this market during the crisis. For example, the drying up of liquidity in the interbank market during the crisis can be partly explained by the great uncertainty regarding banks´ balance sheets. Enhanced transparency could mitigate this problem in the future. A well functioning interbank market is essential for a modern and stable financial system. Therefore the solution should be to repair whatever was wrong in this market, not to downplay the role of this market in the future.

Comments on the Liquidity Coverage Ratio

Aligning to the Central Banks eligibility criteria and preserving the role of lender of last resort of Central Banks

It seems crucial to align eligibility criteria with those of central banks. In addition, although we share the view that banks liquidity management should not excessively rely on central bank provision of liquidity, we think that the rule of disregarding extended borrowing from central bank facilities is too rigid. Some level of intervention in severe systemic stresses would be reasonable to expect (keeping in mind that this would not extend to lender-of-last resort assistance to a bank facing idiosyncratic, as opposed to, systemic situations).

A too restrictive definition of eligible assets

As mentioned above, we find the eligibility criteria for assets to qualify as liquidity buffer too restrictive and therefore entailing serious macroeconomic (mentioned above) and market implications.

Among the latter we find foremost worrying that the requirements will virtually leave aside almost all securitised instruments. This could create an ABS -overflow in the market that seriously would impair their market value replicating thus the situation surrounding ABS at the beginning of 2008, and eliminating this key funding source. Also, not accepting securitised instruments will weigh on the funding of several markets. For example, not including RMBS may have an impact on the financing of the housing market.

In addition, not considering liquid any security issued by financial institutions (except maybe third-party covered bonds) will result in serious difficulties for the banks when having to sell their additional issuances to the market. Putting in place a limit to concentration in single issuances might serve as an acceptable solution for regulators and supervisors which would furthermore avoid cross-issuances between banks.

Additionally it would increase concentration risk since limiting the range of eligible liquid assets. Moreover, as the eligibility depends upon the credit rating a sudden downgrade of an issuer (e.g. sovereign) could promptly reduce the LCR buffer (cliff effects).

Comments on the Long-Term Net Stable Funding Ratio

Too conservative assumptions that could seriously impair the banking maturity transformation function

The proposed ratio as defined, when complied at 100%, implies that some short term assets will have to be financed with long term liabilities, creating thus a positive liquidity gap. The latter will require an additional need for maturity transformation generated by the banking system itself, and supplementary to the needs in the real economy. As it could be seen in the example in the Annex this happens even for a most conservative bank.

An over prescriptive proposal

The current proposal is overly prescriptive and does not take properly into account firm/business model specificities. We strongly believe that a “Pillar 2” approach would better achieve the intended goal of sound medium term funding structures, without impairing the maturity transformation function of the system.

In our opinion any structural funding requirements should be designed to be monitored without a prescriptive threshold and take the form of a set of principles under which firms and supervisors could work out an appropriate approach for each firm. The firm should report the supervisor on its funding structure making appropriate assumptions and stress tests for its own situation, subject to rigorous supervision.

If, nevertheless, the current approach is kept, at least some flexibility should be provided in order for the percentages proposed to reflect the nature of the business (e.g: the proposal must acknowledge that retail banks are usually funded by a stable deposit base) and to take into account the entity’s ability to react over one year both in its planned growth strategy and funding policy (given the assumed stress scenario, which in fact includes both a idiosyncratic and a systemic crisis).

Penalise commercial banking

The NSFR clearly penalises banks with a significant commercial lending activity, especially retail loans, as the proposal establishes 85% of the retail loans to be renewed over the year, compared with 50% for corporate clients.

Annex. Examples of how the NSFR could seriously impair the maturity transformation function of a bank and/or incentive arbitrage

Table 1 shows the NSFR, according to current Basel's draft, for a conservative bank, with retail and corporate business mainly funded by customer deposits. The initial ratio is well below 100% (partly due to the required funding factors applied to retail and corporate loans). The way to improve the ratio up to 100% would be:

- By issuing debt with a maturity over 1 year for an amount of 20 bn. (table 2)
- By transforming part of the corporate loans into corporate bonds and replace part of the retail loan portfolio (with maturities up to 1 year) by ABS´s with equivalent maturities. (table 3)

Hence, the bank would be forced to use long term funding to finance short term assets seriously impairing the maturity transformation function of the bank, or transforming its short term loans into short term debt, which would increase the cost of financing without adding any real value.

Table 1.

ASSETS	AMOUNT	NSFR %	Funding >1year	LIABILITIES	AMOUNT	NSFR %	Funding >1year
RETAIL LOANS	**100**		**96**	**RETAIL DEPOSITS**	**90**		**72**
Maturity > 1year	70	100%	70.0	Insured in transactional based accounts	60	85%	51.0
Maturity < 1year	30	85%	25.5	Other retail	30	70%	21.0
CORPORATE LOANS	**25**		**18**	**CORPORATE DEPOSITS**	**10**	50%	**5**
Maturity > 1year	10	100%	10.0				
Maturity < 1year	15	50%	7.5				
PROPERTY AND EQUIPMENT	**5**	100%	**5**	**SHAREHOLDER'S EQUITY**	**10**	100%	**10**
OTHER ASSETS	**3**	100%	**3**	**OTHER LIABILITIES**	**3**	0%	**0**
				MEDIUM AND LONG TERM ISSUES	**25**		**16**
				Residual maturity > 1 year	16	100%	16.0
				Residual maturity < 1 year	9	0%	0.0
SECURITIES PORTFOLIO	**8**		**0.4**	**SHORT TERM ISSUES**	**3**	0%	**0**
Government secs. >1year	8	5%	0.4				
TOTAL ASSETS	**141**		**121**	**TOTAL LIABILITIES**	**141**		**103**
Commited retail facilities	**20**	10%	**2**				
TOTAL FUNDING REQUIRED			***123***	***TOTAL AVAILABLE FUNDING***			***103***

NSFR $= \frac{103}{123} =$ **83%**

FUNDING DEFICIT > 1 Year = 20 bn

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Table 2.

ASSETS	AMOUNT	NSFR %	Funding >1year	LIABILITIES	AMOUNT	NSFR %	Funding >1year
RETAIL LOANS	**100**		**96**	**RETAIL DEPOSITS**	**90**		**72**
Maturity > 1year	70	100%	70.0	Insured in transactional based accounts	60	85%	51.0
Maturity < 1year	30	85%	25.5	Other retail	30	70%	21.0
CORPORATE LOANS	**25**		**18**	**CORPORATE DEPOSITS**	**10**	50%	**5**
Maturity > 1year	10	100%	10.0				
Maturity < 1year	15	50%	7.5				
PROPERTY AND EQUIPMENT	**5**	100%	**5**	**SHAREHOLDER'S EQUITY**	**10**	100%	**10**
OTHER ASSETS	**3**	100%	**3**	**OTHER LIABILITIES**	**3**	0%	**0**
				MEDIUM AND LONG TERM ISSUES	**45**		**36**
				Residual maturity > 1 year	36	100%	36.4
SECURITIES PORTFOLIO	**28**		**0.4**	Residual maturity < 1 year	9	0%	0.0
Government secs. >1year	8	5%	0.4				
Fixed income secs. <1year	20	0%	0.0	**SHORT TERM ISSUES**	**3**	0%	**0**
TOTAL ASSETS	**161**		**121**	**TOTAL LIABILITIES**	**161**		**123**
Commited retail facilities	**20**	10%	**2**				
TOTAL FUNDING REQUIRED			***123***	***TOTAL AVAILABLE FUNDING***			***123***

NSFR = $\frac{123}{123}$ **= 100%**

ADITIONAL FUNDING > 1 Year : 20 bn

Table 3.

ASSETS	AMOUNT	NSFR %	Funding >1year	LIABILITIES	AMOUNT	NSFR %	Funding >1year
RETAIL LOANS	**100**		**83**	**RETAIL DEPOSITS**	**90**		**72**
Maturity > 1year	70	100%	70.0	Insured in transactional based accounts	60	85%	51.0
Maturity < 1year	15	85%	12.8	Other retail	30	70%	21.0
Securitisation bonds < 1year	15	0%	0.0				
CORPORATE LOANS	**25**		**10**	**CORPORATE DEPOSITS**	**10**	50%	**5**
Maturity > 1year	10	100%	10.0				
Corporate bonds < 1year	15	0%	0.0				
PROPERTY AND EQUIPMENT	**5**	100%	**5**	**SHAREHOLDER'S EQUITY**	**10**	100%	**10**
OTHER ASSETS	**3**	100%	**3**	**OTHER LIABILITIES**	**3**	0%	**0**
				MEDIUM AND LONG TERM ISSUES	**25**		**16**
				Residual maturity > 1 year	16	100%	16.0
SECURITIES PORTFOLIO	**8**		**0.4**	Residual maturity < 1 year	9	0%	0.0
Government secs. >1year	8	5%	0.4				
				SHORT TERM ISSUES	**3**	0%	**0**
TOTAL ASSETS	**141**		**101**	**TOTAL LIABILITIES**	**141**		**103**
Commited retail facilities	**20**	10%	**2**				
TOTAL FUNDING REQUIRED			***103***	***TOTAL AVAILABLE FUNDING***			***103***

NSFR = $\frac{103}{103}$ **= 100%**