BANK FOR INTERNATIONAL SETTLEMENTS

Basel Committee on Banking Supervision
Consultative Document: Strengthening the resilience of the banking sector
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Paragraph 95. Minority interest

Minority interest Minority interest will not be eligible for inclusion in the Common Equity component of Tier 1.
95. The proposal addresses the concern that while minority interest can support the risks in the subsidiary to which it relates, it is not available to support risks in the group as a whole and in some circumstances may represent an interest in a subsidiary with little or no risk.

While we understand the committee's concern in terms of preventing entities from setting up subsidiaries with minority interests and practically no risk, we do not feel that the appropriate measure would be to penalise minority interests as a whole, excluding them from the Core Capital, since minority interests *per se*, at the subsidiary, fulfil the requirements to be considered as Core Capital (Item 87. Criteria for inclusion in Tier 1 Core Capital).

We therefore feel that one reasonable solution would be to tie the computability of minority interests at the group level (in other words, the capacity of loss absorption corresponding to such minority interests) to the risk assumed at the subsidiary (risk-based requirements generated by the subsidiary). In fact, this type of limit already exists in the current regulation in certain jurisdictions, such as in Spain, with limits placed on the computability of capital located at the subsidiary up to a certain level, e.g. or a certain percentage is exceeded with regard to the risk-based requirements located at the subsidiary.

This solution in no way challenges the intrinsic nature of minority interests as capital of the utmost quality, or core capital.

Anyway, if minority interests are not considered as Core Capital, then the risk-weighted assets associated with the minority interests of the subsidiary should likewise be excluded from the Core Capital ratio denominator.

Paragraph 98. Deferred tax assets

Deferred tax assets Deferred tax assets which rely on future profitability of the bank to be realised should be deducted from the Common Equity component of Tier 1. The amount of such assets net of deferred tax liabilities should be deducted. Deferred tax assets which do not rely on the future profitability of the bank to be realised (eg prepayments to tax authorities) should be assigned the relevant sovereign risk weighting.
98. Some deferred tax assets do not rely on the future profitability of the bank; local tax law varies considerably but an example could include prepayments to or carry-back of tax deductions from the local tax authority, which in effect are receivables from the local taxing authority. Such assets should simply be assigned the relevant sovereign risk weighting.

The classification considers two large groups of tax assets:

1. Deferred tax assets that do not rely on the future profitability of the financial entity to be realised: prepayments to tax authorities and carry-back of tax deductions, as long as it can be affirmed that they are going to be effectively recovered from the tax authority.

2. Deferred tax assets that do rely on the future profitability of the financial entity to be realised.

GROUP 1

The following account balances with the tax authorities are receivables that do not depend on the future profitability of the financial entity:

⇒ Prepayments of the Corporation Tax.
⇒ Withholdings of the Corporation Tax.
⇒ Amounts from VAT self-assessment to be refunded.
⇒ Other agreed or simply requested tax refunds.
⇒ As an illustration of “carry-back of tax deductions” we would cite the input VAT amounts for the acquisition of goods and services, which can be deducted according to the applicable pro rata rule, but either they have not yet been transferred to the declaration form (concerning the input VAT of the current month) or the refund of the negative balance of the settlement has simply not been requested due to having opted for deferred compensation.

GROUP 2

The following account balances with the tax authority can be recovered if there are positive tax bases in the future, meaning the *future profitability of the financial entity*.

- ⇒ Tax credit for negative tax bases in the Corporation Tax.
- ⇒ Tax credit for accredited deductions and deductions pending application: deductions for double internal taxation, deductions for reinvestment, for activities, etc.
- ⇒ Income taxes satisfied abroad for which the deduction for double international taxation is pending (some entities record these balances as withholdings made at foreign tax administrations, but they should not be confused with the concept of withholdings previously included in Group 1).

SPECIAL CASE

As a special case, we have balances for “Prepaid Tax” recorded as an asset as a result of temporary differences in the tax base of the Corporation Tax.

For example, a posted provision whose allocation was not deductible, thereby giving rise to a positive adjustment to the tax base: the reversion of this provision to income will give rise to a negative adjustment to the tax base, so the balance for “Prepaid Tax” will be cancelled and will give rise to a lower amount to be paid for the Corporation Tax. However, in order for this to be so, it is necessary for a positive tax base to occur when making the accounting reversal, because otherwise the “Prepaid Tax” balance is simply cancelled, and assets are charged with a “Tax credit for negative tax bases in the Corporation Tax” (clearly included in Group 2).

Now, the fact that the financial entity has some manoeuvring room to decide in which financial year the provision is reversed advocates considering it to be effectively recoverable (and not subject to future profitability). Therefore, as long as said provision is kept on the balance sheet, the period for calculating the expiration thereof will not have started, while conversely, for all other tax assets classified in Group 2, said expiration period has started and the effective recoverability of the asset depends directly, before said period ends, on the fact that the financial entity has generated a certain amount of profit. It is therefore reasonable to consider that the capacity to effectively recover these assets is no longer directly and hopelessly linked to generating profit, but linked to something else that the financial entity could manage, and they should not represent an impairment of its capital. Therefore, these assets should not be deducted from capital.

When it is posed that there isn’t full confidence in the fact that these assets may provide protection in the event of insolvency, it gives the impression that an equity criterion is being applied, where the value of the asset is equated with the “liquidation value”, when in our opinion it should be based on “current value” criteria, which are clearly associated with the continuity of the business. Based on the capacity of the assets of the Special Case to remain current over time, without an expiration

date, and to keep their value unaltered until the time when the entity decides to materialise them as a lower amount of the Corporation Tax to be paid, it is reasonable to assume full confidence in their capacity to absorb future losses of the financial entity.

Nonetheless, even for tax assets in Group 2, although they depend on the capacity of the financial entity to generate profits in the future, we feel that in jurisdictions with strict accounting regulations in terms of the registering of tax credits and entities with a favourable opinion from the auditors regarding the future viability of the entity in the short and medium terms, these assets should not be deducted from the Core Capital, as confidence exists that positive tax bases will arise in the future, meaning that the tax asset will be recoverable.

Paragraph 202-205. Leverage ratio

Leverage ratio

202. One of the underlying features of the crisis was the build up of excessive on- and off-balance sheet leverage in the banking system. In many cases, banks built up excessive leverage while still showing strong risk based capital ratios. During the most severe part of the crisis, the banking sector was forced by the market to reduce its leverage in a manner that amplified downward pressure on asset prices, further exacerbating the positive feedback loop between losses, declines in bank capital, and contraction in credit availability.

203. The Committee announced in 2009 its intention to introduce a leverage ratio as a supplemental measure to the risk-based ratio of Basel II. This decision was endorsed on 7 September 2009 by the Group of Central Bank Governors and Heads of Supervision, the Committee's governing body, and supported by the G20 leaders at the September 2009 Pittsburgh Summit.

204. The leverage ratio is intended to achieve the following objectives:

1. constrain the build-up of leverage in the banking sector, helping avoid destabilising deleveraging processes which can damage the broader financial system and the economy; and
2. reinforce the risk-based requirements with a simple, non-risk-based "backstop" measure based on gross exposure.

205. The Committee has designed a leverage ratio as a supplementary measure to the Basel II risk-based framework with a view to migrating to a Pillar 1 treatment based on appropriate review and calibration. To ensure comparability across jurisdictions, the leverage ratio will be harmonised internationally, fully adjusting for material differences in accounting and will appropriately integrate off-balance sheet items that have also been a major source of leverage in the last crisis.

We agree with the desirability of establishing a financial leverage measure to serve as a useful and simple tool for comparison and evaluation of the financial sector, for supervisory bodies, ratings agencies, investors and others. In this regard, the calibration of a leverage ratio within the context of Pillar II and Pillar III, provided that international harmonisation should be guaranteed, would be welcome.

We do nonetheless feel that the inclusion of a leverage ratio in Pillar I is inappropriate, since this ratio, as it is defined, and unlike the BIS II capital ratios, does not take into consideration the risk level of assets nor their expected/potential losses, since the denominator includes total exposure applying the following criteria:

1. All exposure on the balance sheet is included (except cash and liquid assets) with a weighting of 100%, with no regard for its credit quality.
2. In principle off-balance-sheet exposure is included with a conversion factor of 100% (although the possibility of using the CCFs as the standard BIS II method has been discussed, an approach which in our opinion would not be appropriate).
3. No consideration is given to credit risk mitigating factors or netting agreements (although the use of BIS II netting for repos is being considered).

Inclusion of this ratio in Pillar I would thus serve as a huge penalty on entities focusing on the retail banking business, with a greater proportion on their balance sheet of low-risk assets, such as retail mortgage loans or loans to corporations with a high rating.

Meanwhile, the proposal that the calculation of the numerator or capital measurement should be not the total computable equity but the Core Capital (Tier I) could have the contradictory effect of encouraging the holding of high-risk assets at entities with a low relative level of Core Capital or Tier I. This would furthermore penalise the capacity for growth of financial entities such as Savings Banks, with structurally less equity than banks themselves, without taking into consideration (as they do capital ratios based on risk-weighted assets), the fact that in general they have a lower risk profile in their business model and assets.

In fact, the modifications being examined for calibration of the leverage ratio are intended to reflect in some way the BIS II risk weighting criteria and to alleviate the limitations of this leverage ratio (e.g. using BIS II CCFs, using BIS II netting for repurchase agreements, excluding liquid assets, etc.). In other words, this would ultimately serve to define a ratio which would contribute nothing in addition to those existing ratios, but it would be even less precise as a measurement of risk, by failing to take into account the calculation complexity involved in BIS II capital requirements. In short, we do not believe that inclusion of a leverage ratio in Pillar I would be appropriate.

Paragraph 243. Forward-looking provisioning

> **Forward looking provisioning**
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> 243. The Committee is promoting stronger provisioning practices through three related initiatives. First, it is advocating a change in the accounting standards towards an expected loss approach. Second, it is updating its supervisory guidance to be consistent with the move to such an expected loss approach. Third, it is addressing disincentives to provisioning in the regulatory capital framework. And finally, it is promoting stronger disclosures of banks' provisioning practices..

These measures are being examined in the context of reducing the cyclical nature of capital. We feel that the introduction of anti-cyclical components in the provisioning criteria is an appropriate approach.

As for the methodology, we feel that for entities which use the standard method to calculate their credit risk capital requirements, as no models are available or they have not been validated by the Supervisor, appropriate information is not available on the PD or LGD parameters. For this reason we propose a coefficient-based approach for each risk category (similar to the general provisions existing in the Spanish Accounting Standards, Annex IX CBdE 4/2004).

Nonetheless, for IRB entities, the natural aproach would be, for forward-looking provisions calculated (with counter-cyclical PDs), adjusted or limited in terms of total credit risk exposure by means of a calibration process applied to such provisions, obtained in the same method as stated for standard-method entities, in order to guarantee a stable, non-discriminatory framework.

Paragraph 247-259. Capital buffers

Building buffers through capital conservation
247. This section outlines a proposal to ensure that banks build up capital buffers outside periods of stress which can be drawn down as losses are incurred. The proposal is based on simple capital conservation rules designed to ensure that banks follow common sense best practice procedures to avoid breaching their minimum capital requirements.

These measures are being examined in the context of reducing the cyclical nature of capital. We believe that such capital buffers are not useful since the financial entity can itself adapt the pay-out and increase/reduce its capital surpluses in accordance with the economic cycle. Meanwhile, buffers restrict the capacity to manage core capital, and even the ability to raise this type of highest-quality capital, since they limit the capacity of entities to establish their policy on returns for shareholders (or holders of participatory stakes in the case of Savings Banks). We therefore do not feel that such capital conservation rules should be established.