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Secretariat of the Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002 Basel
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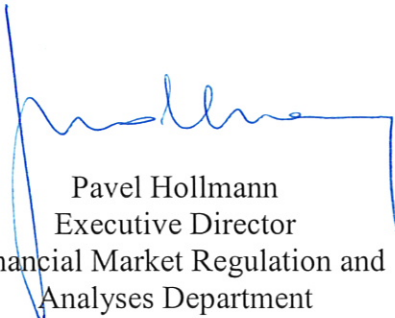
TO: baselcommittee@bis.org

Re

The Czech National Bank's comments on the proposed Basel II amendments

The Czech National Bank welcomes the opportunity to comment on the consultative documents issued by the Basel Committee on Banking Supervision in December 2009, namely "*Strengthening the resilience of the banking sector*" and "*International framework for liquidity risk measurement, standards and monitoring*".

Please find attached an enclosure containing our general opinion on the proposed changes and specific comments on the capital base, counterparty risk, external ratings, leverage ratio, procyclicality and strengthening liquidity.



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Enclosure

Opinion of the Czech National Bank on the consultative documents of the Basel Committee on Banking Supervision entitled "*Strengthening the resilience of the banking sector*" and "*International framework for liquidity risk measurement, standards and monitoring*"

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Opinion of the Czech National Bank on the consultative documents of the Basel Committee on Banking Supervision entitled “Strengthening the resilience of the banking sector” and “International framework for liquidity risk measurement, standards and monitoring”

The above-mentioned BCBS documents submit proposals for consultation concerning several areas of banking regulation.

These include:

- 1) raising the quality, transparency and consistency of the **capital base**,
- 2) **covering counterparty risk** stemming from derivatives, repos and securities transactions and using external ratings in regulation,
- 3) using **external ratings** in regulation with the aim to reduce it and strengthen internal analyses,
- 4) introducing the **leverage ratio in regulation** to reduce (the increase in) the use of external funds in the banking sector to finance exposures,
- 5) dealing with **procyclicality issues** in several ways, e.g. by supporting forward-looking provisioning according to an IASB¹ proposal and creating capital buffers above the minimum capital adequacy requirement, which would originate as a result of capital conservation,
- 6) **strengthening liquidity** – introducing two indicators for the calculation of a minimum liquidity buffer that banks should maintain on a continuous basis and several other instruments for monitoring and evaluating liquidity risk.

In general, the CNB stresses that the entire concept needs to be tested thoroughly, and repeatedly if possible, to prevent hasty introduction of regulation with consequences that are very hard to predict. We believe that testing and analysing the consequences should take precedence over speedy introduction, as these solutions are intended to prevent future crises, not deal with the current one.

Our opinions on the individual topics are given below.

The CNB’s opinion on the capital base

We regard the proposed adjustments in the capital area as a step in the right direction. We support strengthening the role of Tier 1 and introducing requirements for minimum core Tier 1 and total Tier 1. If these are set at sufficient levels, banks’ capital structure and capital situation could improve.

¹ International Accounting Standards Board.

The Czech National Bank has long applied a conservative approach in the capital area and it still does not allow inclusion of hybrid instruments in Tier 1.² We are also in favour of abolishing Tier 3 capital, as we regard subordinated debt with a maturity of two years, which is sufficient for Tier 3 capital, as very limited in terms of its ability to perform the function of capital.

We also support harmonisation of items deducted from capital and their application already in setting core Tier 1 or Tier 1.³ Last but not least, we also fully support the introduction of requirements for disclosure of detailed information on capital, which we consider very beneficial.

The CNB's opinion on counterparty risk

We doubt whether the goal of the Basel Committee in the area of counterparty risk, i.e. to increase the capital requirements relating to this risk, will be met in all cases. We understand that the proposals of the Basel Committee aim to reduce somewhat the freedom in setting capital requirements using EPE models. EPE models do not constitute a limitation in the calculation of capital requirements; in our opinion, the problem lies in the specification of expected positive exposure. We are not certain whether the proposed changes will resolve the problem; on the contrary, we fear that they will further increase the complexity of the issue. We believe the focus should be on fundamental problems related to the calculation of capital requirements and the question of whether capital requirements determined on the basis of EPE models can still perform the function of regulatory capital requirements.

The CNB's opinion on external ratings

In our opinion, the proposed changes are going in the right direction. We fully agree with most of them, e.g. the strengthening of own (internal) risk analyses. However, the question remains whether, for example, the proposed wording requiring that in Pillar 2 banks should only consider reflecting a higher degree of risk in capital adequacy, especially in the case of unrated exposures, is not too loose and vague in its essence. We believe the requirement to reflect higher risk in Pillar 2 should be phrased more specifically, e.g. the bank must be able to prove to the supervisory authority how it reflected the higher risk in the internally calculated capital.

Furthermore, the proposed removal of the requirement for a specific rating for eligible protection providers will of course eliminate the cliff effect, but it will considerably extend the set of eligible providers – in the case of the foundation IRB approach to virtually anyone who has an internal rating. In other words, for a provider to be eligible, it is sufficient to have an internal rating only one step better than the borrower. Therefore, we suggest that this rule be amended so that banks should have a reasonable definition of the set of eligible protection providers thus ensuring a sufficient difference in quality compared to the borrower and ineligibility of protection providers in lower speculative grades.

² Following the transposition of Capital Requirements Directive II into Decree No. 123/2007 Coll., it will be possible to include hybrid instruments in Tier 1 under certain conditions and subject to approval by the Czech National Bank, as the directive explicitly introduces hybrid instruments as part of Tier 1.

³ This is already an established practice in the Czech Republic.

The CNB's opinion on the leverage ratio

In our opinion, the leverage ratio is a suitable additional indicator for monitoring individual banks and also the banking sector as a whole. However, the variants of its construction must be tested thoroughly. Its calibration will probably be complicated as well; the Basel Committee has so far indicated no values or ranges within which the indicator should move.

We understand the efforts of the Basel Committee to include the leverage ratio in Pillar 1 to limit excessive increases in the balance sheet and off-balance sheet total and therefore also to reduce risk. However, we would regard it as more suitable to include this indicator as a supervisory review instrument under Pillar 2 to maintain a more flexible approach in this respect and preserve the priority of the risk-based capital adequacy indicator.

Moreover, the proposed capital buffers that should be created by banks may have a similar effect; therefore it would be appropriate to consider giving preference to only one of these limitations, or also making changes to the construction of risk-based exposures.

The CNB's opinion on procyclicality

We are of the opinion that the issue of procyclicality of capital requirements should be dealt with within the performance of supervision and with maximum use of the instruments available under the current regulations until the insufficiency of this concept is unequivocally established and the appropriateness of the proposed solutions is verified. Of the proposals of the Basel Committee regarding future amendments to Basel II, we support above all the solution to the issue of provisioning in accordance with the accounting standards.

Without deeper analysis it is difficult to give an opinion on the introduction of capital buffers beyond minimum capital adequacy. In particular, we regard the proposed introduction of the second component of the buffer, tied to macroeconomic developments, as especially strict and hard to determine. We are not completely against the obligation to create a buffer, but we would prefer a more flexible approach with regard to differences between the individual institutions and economies (e.g. introducing the right of the supervisory authority to require such a buffer to be created under Pillar 2, but not the same buffer for all).

The Basel Committee is also aware of these problematic issues and assumes that it will be at national supervisors' discretion to take into account the broader context prevailing at the given point in time when deciding on this component of the capital buffer. On the other hand, discretion of supervisory authorities may create an uneven playing field for banks in different jurisdictions, which could lead to geographical transfers of banking activities and therefore increased volatility and cyclicity. It would be appropriate to entrust an international body with unified monitoring of the national and regional developments and creating non-binding recommendations on how to select the macroeconomic variables and set the thresholds for the creation of the capital buffer for excess credit growth. At the European Union level this function could be performed by the newly established European Systemic Risk Board (ESRB).

The CNB's opinion on strengthening liquidity

We agree to the current proposal on liquidity indicators. The concept of liquid assets per se will always involve some uncertainty, as only cash can be considered a truly liquid instrument at times of severe crisis, as the experience of the Czech Republic has also shown. However, the proposals have yet to be verified in an impact analysis, which should result in more specific estimates of the effects of the regulation under preparation.

We also welcome the proposals for indicative measures for monitoring purposes.