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Secretariat of the Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002 Basel
Switzerland

Dear Basel Committee Secretariat:

We are pleased to submit our response to the Basel Committee's Consultative Documents on *"Strengthening the Resilience of the Banking Sector"* and *"International Framework for Liquidity Risk Measurement, Standards and Monitoring."* We have reviewed the proposals in the respective Consultative Documents, considering the nature and level of activities being conducted by financial institutions in our jurisdiction as well as the potential impact of the proposed reforms on the resilience and stability of global financial sector. We have provided general commentary to the proposals in this covering letter and a more detailed list of concerns, following the order of the documents, in an Appendix. We hope you find our comments useful.

We believe that the rationale underlying the proposals is well founded and consistent with the objectives set out by the G20 leaders and the Financial Stability Board ("FSB") to promote a robust, global financial regulatory framework. We are generally in support of implementing the key elements of the proposed reforms package. We fully support the increased emphasis on Tier I, loss-absorbing, capital components in the capital calculation and the addition of a leverage ratio. **We have more concerns regarding the implementation of standardized liquidity measurement proposals. We look forward to the results of the impact studies related to the liquidity proposals to have a more robust set of data regarding the ultimate effects of this proposal from which supervisors and the banking industry may form their opinions.**

We believe that the calibrations in both of these proposals need to be flexible and adaptable for different jurisdictions and different types of activity. The calibration of liquidity ratio limits, in particular, needs to consider the nature and complexity of banking activities in the jurisdiction(s) and markets in which they operate. The proposals note that the stressed funding scenarios will be set by supervisors, yet also require adherence to an acute stress test scenario. We are particularly concerned with the acute stress scenario defined in the Liquidity Coverage Ratio (LCR) standard. We believe that the defined stress scenario, along with the definition of high quality liquid assets for the LCR standard, might be detrimental to many

institutions. Under some circumstances, the LCR standard could turn out to be an onerous burden on banks with a material negative impact on their ability to deliver a traditional banking service. The proposals should not over react to the most highly prominent failures by forcing banks to manage their daily operations under acute stress scenarios.

In addition to reaching out to supervisors and the banking industry with these consultative documents, we wish to emphasise the need for the Basel Committee to discuss these proposals with a complete range of standard setters affecting the financial services industry. It is clear that from the proposals, and from the global financial crisis, that the financial service sectors are more heavily inter-connected than ever before. This trend is likely to continue. **The Basel Committee needs to ensure that standards set for the banking sector do not create regulatory arbitrage opportunity with other sectors.** This can only be accomplished through active discussion with other standard setters and the FSB. If banking activity is overly restricted, an eventual tipping point might occur, pushing commercial banking customers toward other financial service providers not covered by the same oversight that might be able to offer the same or similar services for less cost. This would potentially leave commercial banks as performing a constricted utility function in the economy, contrary to their important role of risk intermediation.

We note that many of the global institutions needing significant government funding during the crisis period were using, or preparing to use, internal models allowed by the advanced measurement approach of Basel II. **While we support the risk sensitivity objective of Basel II, we also fully support a shift toward simplicity to address minimum levels of capital, model risk and the over-reliance on credit ratings in risk management.**

Basel II has created a tremendous administrative burden on assessors to understand and verify highly sophisticated and complex internal models. These proposals seem to add to that burden. We believe that many financial institutions were simply "gaming" the capital requirements in the lead up to the crisis, and might continue to do so after markets return to normality. **Supervisors, risk managers, accountants and auditors need to remain vigilant of new or expanded products and services that are designed or promoted for the purpose of avoiding capital charges, rather than servicing their communities and stakeholders.** We recommend an annual external auditor sign-off of the systems and controls surrounding internal models as a requirement for acceptance of the model for capital calculation.

We applaud the Basel Committee's efforts to expand its dialogue and engagement with the accounting industry, and wish for continuance of the same. Allowing pools of assets or special purpose entities to be removed from an institution's balance sheet – while the financial institution retains significant exposure to credit risk of the pools or offers implicit or explicit liquidity support lines to the pool – was a significant cause of the problems with securitization leading up to the financial crisis.

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Related to the issues surrounding the accounting industry, the Basel Committee should also liaise closely with the securities industry, and indirectly with national taxation bodies, to fully implement the recommendations for loss-given-default (LGD) and probability of default (PD) assumptions, and the concept of "forward looking provisions." Securities regulators have been historically reluctant to allow banks to set aside additional provisions during benign credit conditions that would avoid cyclicality later in an economic cycle. Likewise, national tax authorities have been reluctant to recognize these additional provisions as deductible items. These impediments to avoiding pro-cyclicality should not be underestimated.

The proposed reforms are likely to result in a near-term reduction of the return on equity of banks, as a result of lower leverage and higher liquidity requirements. Given the need for banks to raise their equity positions, particularly through common share issuance, these proposals will make capital raising more difficult. In order to raise the return on equity to the level of market expectations, banks will need to increase their operating margins. This is likely to result in higher spreads (cost of intermediation) and higher cost of banking services to bolster the return on assets. Consumers will likely bear the brunt of these costs through higher fees on services and higher interest rates on credits. It is of paramount importance that the proposals are implemented over a reasonable period of time, with an approach which ensures that all the stakeholders in the global banking sector receive a fair treatment in terms of risk-return trade-off. This requires a high level of focus on appropriate calibration of the key variables and metrics before implementation of the proposals.

Please do not hesitate to contact us for any clarification on the issues raised.

Sincerely,

Paul K Koster
Chief Executive

Appendix

Strengthening the Resilience of the Banking Sector

As stated earlier in this paper, we strongly support the efforts to raise the quality consistency and transparency of a bank's capital base. The increased emphasis on Tier I, loss-absorbing, forms of capital for calculations is a positive development in this regard. We also fully support the elimination of Tier III capital. While other forms of Tier II funding might have a long-term and stable nature, their inclusion in an entity's capital calculations should be discouraged, or at least minimised.

Paragraph 68 & 74 – The specific needs of non-joint stock companies. The proposal mentions that the proposals need to be cognisant of the specific needs of mutuals and cooperatives, which are unable to issue common stock. We recommend that you include Islamic finance companies in this list as well, as they are similar to mutuals and cooperatives and have grown into a mainstream participant in the global financial market

Paragraph 92 – The use of call options. The criteria for inclusion of capital instruments in Tier 1 additional going concern capital includes provisions on call options which are very conservative. These provisions place responsibility on the banks to refrain from creating any market expectations on top of the need to obtain explicit supervisory approval. We appreciate the strength of the criteria regarding preclusion of credit sensitive dividend feature, principal loss absorption capability through contingent conversion and controls on investment by related parties or SPEs in the group, though the metrics involved need to be calibrated appropriately.

Our views are that the requirement to obtain prior explicit supervisory approval for exercising call options would be adequate to preclude market expectations of the option being called at the bank's sole discretion. However, the issue of potential negative market reaction to the failure to exercise a call option is not solved as the information content in a regulator's decision to prohibit exercise of a call option would mean the same as the bank not exercising the option, particularly in times of market stress. Provisions in (c) of the preceding list of criteria for inclusion in Tier 1 additional going concern capital requiring a bank to replace the instrument being called with capital of the same or better quality would be helpful from addressing the impact on capital levels. To address this, the Basel Committee may wish to provide additional text relating to the decision of a supervisor not to grant approval to the calling of an option

Paragraph 93 – Treatment of stock surplus: This provision seems to be unduly restrictive. Stock surplus cannot be prohibited outright from being counted as common equity component of Tier 1. In cases where the stock surplus has the characteristics similar to that prescribed for common equity component (for example,

no redemption requirement), there would be no case to deny its inclusion in that component

Paragraphs 104 & 105 – Cash flow hedge reserves and gains/losses due to change in credit risk on fair valued financial liabilities. These proposals are favoured as they would limit undue volatility and preclude artificial or synthetic gains being included in equity or Tier 1. There is a sound case for non-inclusion of cumulative gains in fair valued liabilities due to changes in own credit risk in any component of capital.

Paragraph 108 – Disclosure requirements regarding a bank's capital position We encourage any efforts to improve transparency Banks – indeed all financial institutions – should disclose their capital positions in a manner that is readily understood, comparable and transparent to the general public, as well as the financial community.

Paragraph 122 – Use of stressed VaR for credit assets. This proposal is highly appreciated considering its consistency with the recent revisions in the market risk framework for use of stressed inputs. However, there is a possibility that a one-year stressed period for credit assets will unduly increase the capital requirements if the stress was due to non-credit factors and more due to interest rate and currency risks. The Basel Committee and all financial institutions should also consider a de minimus scenario for VaR models, where the most recent economic downturn is beyond the data set of the model being used. We believe the elongated period of economic stability allowed many VaR models to significantly underestimate the loss potential in many bank's balance sheets and welcome the provision wherein "The model must also employ data from a three-year period that includes the one-year stressed period that is used for the market risk Stressed VaR calculation for credit assets .

Paragraph 201 – Use of unsolicited ratings from ECAIs. This proposal aptly tightens the current Basel II provision of not allowing banks to cherry-pick ratings by explicitly prohibiting arbitrary changes in the use of ECAIs and their ratings. We are strongly in favour of the requirement for a bank to analyse the credit risk of all obligors, regardless of the rating of the obligor. The lack of credit analysis and over-reliance on credit rating agencies was an unintended effect of the initial Basel II proposal.

Paragraph 202 – The introduction of a non-risk-based leverage ratio to complement risk-based capital requirements The critical aspect of this key element of the reforms is the proper calibration of the limit for the proposed leverage ratio – limit for the ratio in terms of Tier 1 and in terms of Total capital. We are of the view that such calibration needs to be proportionate and provide options to address the risk and operational characteristics of different types of firms as well as the unique features of different countries and their banking systems. The definition of ratio and its components need to be standardized and harmonised globally. However, the nature of a commercial bank might necessitate a different level of acceptable leverage compared to that, say, for a residential mortgage lender.

Paragraph 206 – Definition of leverage ratio The proposal disallows reduction of on-balance sheet exposures by eligible financial collateral, ostensibly due to issues revolving uncertainty in their valuation. However, precluding cash and near-cash collateral like Treasury bonds denominated in the currency of the balance sheet would be unfair to the banks, as such collateral would be readily available to support the exposures involved.

Liquidity Risk Measurement, Standards and Monitoring

We strongly agree with the guidance for sound principles for liquidity risk management and support liquidity risk as part of a Pillar 2 exercise. Liquidity is much harder to gage than capital, and varies much more on the nature, size and complexity of an institution and its local, regional and global market for funding, in addition to national or jurisdictional safety nets Estimating cash flows of non-maturity balance sheet and off-balance sheet items is also highly subjective. However, we question whether all banks should manage their liquidity positions based on a replication of the current global financial crisis (acute stress scenario). Additionally, we do not object to certain, internationally accepted measures of liquidity, but we question the wisdom setting risk management targets for all financial institutions based on standard ratios. Incorporating industry feedback for this proposal and viewing the impact studies will be critical to its implementation.

Paragraph 22 – Definition of acute stress scenario. The proposed definition includes a combination of idiosyncratic and system-wide shocks likely to affect a bank at the same time. The defined stress scenario incorporates many of the shocks experienced at various points in time by different institutions in distinct markets into one acute stress scenario to be applied globally. This kind of combination is prudent to reflect the worst possible case scenario and address the different kinds of shocks which can affect a bank However, the combination of all the shocks leaves the stress scenario very acute, particularly for a large diversified bank which is likely to be stressed in the defined scenario in different dimensions under different business lines. We recommend that acute stress test scenarios be included in liquidity management principles.

Paragraph 29 – High quality liquid assets. The definition of high quality liquid assets in combination with the definition of acute stress scenario is likely to make the standard more infeasible for implementation. The proposal requires high quality liquid assets to have low credit and market risks and make some suggestions, which does not include assets or securities issued by central bank or government (as in the definition of liquid assets in paragraph 34) and denominated in the local currency of the bank. These need to be included along with the convertible currency securities in the current proposal. The proposal requires that LCR be met for each currency separately. So, it is appropriate to give the right consideration to a low risk asset as a highly liquid asset in the market where it faces little or no credit and market risks.

Paragraph 41 – Definition of cash outflows. We are of the opinion that banks could be allowed to use run-off factor estimates derived from behavioral analysis of funding providers. This is particularly effective in the case of retail and SME customer segments

Paragraph 89 – Table 2, Definition of required stable funding (RSF) factor. We are intrigued by the high level of stable funding requirement imposed for gold at 50% of asset value, while cash and money market instruments are given a 0% RSF factor. Similarly, the unencumbered equities listed on a major stock exchange are also given a 50% RSF factor. These RSF factors appear conservative and not necessarily consistent with the item's asset liquidity characteristics. Since the attempt is to focus purely on asset liquidity on a structural basis and not on the profitability impact of any resultant changes in a stressed scenario, we feel that these RSF factors need to be critically reviewed.