Nederlandse Vereniging van Banken

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Basel Committee on Banking Supervision
Via email baselcommittee@bis.org

Date April 16, 2010
Reference BR1120

Subject: NVB Reaction to BCBS 164 – Strengthening the resilience of the banking sector

Dear Sir / Madam,

On behalf of the Dutch Banking Association[1] (NVB), I would like to thank you for giving us the opportunity to provide you with our feedback on consultation paper 164, '*Strengthening the resilience of the banking sector'.*

This paper, in conjunction with consultation paper 165, '*International framework for liquidity risk measurement, standards and monitoring',* represents a major step in enhancing the resilience of the banking sector. These two papers address a number of very significant areas where improvements to the Basel II Capital Accord are required. Given the events that took place over the last couple of years, we endorse the Basel Committee's mission to increase the resilience of the financial sector. Although we agree with the general objective of both the consultation papers, there are a number of proposals that concern us. In our response, which you will find attached to this letter, we will address these concerns as well as a number of alternative approaches to the proposals.

The key areas we would like to draw your attention to are listed in paragraph 1.3 of the Management Summary. The most important concern we have relates to the economic impact of the proposed measures and the consequences for banks' clients. Given this concern, we welcome the quantitative impact study that will yield the required insight into the individual effects of the proposed measures as well as the cumulative impact they will have. In addition, the transitional requirements for phasing in the new requirements and phasing out those currently in force are extremely important.

Our feedback on consultation paper 165 will be sent to you in a separate letter, with reference BR1122.

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1 The Nederlandse Vereniging van Banken (NVB) is the representative voice of the Dutch banking community with over 90 member firms, large and small, domestic and international, carrying out business in the Dutch market and overseas. The NVB strives towards a strong, healthy and internationally competitive banking industry in the Netherlands, whilst working towards wider single market aims in Europe.

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Should you have any questions relating to our feedback, please feel free to contact me at your convenience.

Kind regards,

Wim Mijs
Managing Director

Onno Steins
Advisor Risk Management

Enclosure: NVB Reaction to *'Strengthening the resilience of the banking sector'*

NVB Reaction to *'Strengthening the resilience of the banking sector'*

Nederlandse Vereniging van Banken

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1 Management summary; main points.

We appreciate the proactive approach that was adopted by the Basel Committee on Banking Supervision in the wake of the crisis. A lot of proposals have been put forward to make the banking sector more resilient, for instance:

- BCBS 147: Principles for sound stress testing practices and supervision.
- BCBS 148: Revisions to the Basel II market risk framework.
- BCBS 149: Guidelines for computing capital for incremental risk in the trading book.
- BCBS 150: Proposed enhancements to the Basel II framework.

And, in Europe, the CRD revisions:

- CRD2, containing changes to the requirements for own funds, large exposures, supervisory arrangements, crisis management, securitisations and OTC derivatives.
- CRD3, containing changes that relate to remuneration, market risk, (re-) securitisations, the extension of the Basel I floor as well as the alignment of the trading and banking book.

We endorse the objective of the Committee and we are pleased that shortcomings in the capital requirements that have surfaced during the crisis are now being addressed. Although the end goal of the reassessment of the capital requirements is to strengthen the financial industry, the approach of this consultation paper appears to be quite fragmented. This is clearly reflected in the different levels of detail that are put forward in this consultation paper. Some areas are affected in two or three different ways, because the new measures approach the same problems form different angles. Also, as the array of proposals covers a very large part of the banking business, there is a risk that the total additional capital requirements are too high, hindering the economic recovery and future economic growth.

We would also like to direct your attention to the reaction from the European Banking Federation, which has our full support.

Our feedback to consultation paper 165 '*International framework for liquidity risk measurement, standards and monitoring'* will be sent to you in a separate letter, with reference BR1122.

1.1 How to read this document

This document has been structured in such a way that it can be read as a whole, but the various subjects can also be read in isolation. All relevant arguments are included in each section; the overarching chapter puts the proposals into a broader perspective.

1.2 Developments in the banking industry

Although this document is a reaction to the proposals made by the Basel Committee, there is a broader movement that is seeking additional regulation of financial institutions. In the end, it will be the cumulative effect of all the rules and regulations that will dictate how banks will be able to fulfil their role in the economy. For instance, there are currently discussions around remuneration, financial responsibility tax, setting limits on banks that are too big or too complex to fail and discussions around deposit guarantee schemes.
It is clear that banking as we knew it over the last decades will undergo significant changes. After the sector has reinvented itself in the wake of the crisis, banks should still be able to fulfil their purpose in society; supporting sustainable economic development by acting as an intermediary on the financial markets, providing credit- and payment services to clients as well as contributing to the

important challenges that lie ahead for society, such as the transition away from a carbon economy, combating global economic imbalances, etc.

1.3 Key Concerns

We note that the introduction of Basel II has created an enormous momentum in the development of risk management. This is especially true for the availability of management information. If it weren't for the changes made to become Basel II-compliant, banks would have a hard time gathering the data for the QIS. In this respect, we observe a clear improvement.
Looking at the proposals that are put forward in 'Strengthening the resilience of the banking sector', we have a number of concerns and recommendations regarding various areas of the consultation document. For our reaction to 'International framework for liquidity risk measurement, standards and monitoring' we refer to BR1122, which we published separately.
The original purpose of the Basel II framework was to create an incentive for more sophisticated risk management, but the current proposals only appear to focus on increasing the capital requirements, especially for the more advanced approaches. In addition to this point, we note that alongside the requirements, the effectiveness of the Basel II framework results from the enforcement of these requirements in the form of effective supervision. This plays an important role in ensuring a level playing field and maintaining financial stability. Our overarching concerns relating to 'Strengthening the resilience' are:

Impact on the real economy
The proposals put forward by the Basel Committee represent the largest overhaul of the Basel II framework since its inception. It is even sometimes referred to as Basel III. Given the experience that was gained during the financial crisis, we agree that a number of fundamental shortcomings surfaced, which need to be fixed. We applaud the proactive approach adopted by the Basel Committee in issuing the consultation papers '*Strengthening the resilience of the banking sector*' and '*International framework for liquidity risk measurement, standards and monitoring*'. Both the number and the severity of the proposals are significant. In addition, there is also a large degree of interconnectedness among the various proposals. This could result in an amplifying effect. It is therefore important to take a holistic view of the proposals, both in terms of the added capital requirements and the costs organisations will incur as a result of their implementation. However, at this point in time it is not certain what the total effect of the proposals will be, as most are principle-based. The calibration of the measures is of the essence in achieving the objective of making the financial sector more resilient.

Making the sector more resilient will impact the way banks operate. Strengthening the sector's resilience will increase the capital and liquidity buffers and thus also the costs of banking. These increased costs can result in a change of business models and product offerings. It can lead to a reduced availability of credit and may have an increasing effect on product pricing. This directly impacts consumers and companies; credit will become more expensive and financing will be harder to procure.

There is clearly a trade-off to be made between making the sector more resilient and the role banks play in supporting the real economy. It is crucial to ensure that banks will be able support sustainable levels of economic growth after the new regulations have been calibrated and phased in. The proper assessment of the submissions of the quantitative impact study is of the essence, as this is the only way to get this calibration right.

International level playing field
We have several concerns related to the level playing field. It is particularly important that the timing of the introduction of the proposals be aligned internationally. Given the extent of the proposals, jurisdictions that delay the introduction will create a competitive advantage for their financial industry. Although we are aware that the Basel Committee does not have the jurisdiction to set the timelines for introduction, alignment of the proposals is a key element in achieving a global applicability of the new proposals and the enhanced resilience that it creates.
The comparability of results across jurisdictions is also a concern to us. Efforts should be made to enhance this comparability, thereby minimising the potential for level playing issues.
With regard to the leverage ratio, we note the accounting differences that pose a serious problem when calibrating the ratio to be non-discriminatory. Some regions may have specific mechanisms in place that allow banks to manage their leverage ratio more effectively.

The need for a holistic evaluation
Since its inception, a lot of changes have been proposed for the Basel II framework. Going forward, the Basel framework will consist of the original Basel II framework, the changes made as a result of BCBS 164 and BCBS 165, as well as the changes that were made during the period prior to these two consultations. The result may be that the new Basel framework becomes a stacking of proposals.

As the proposals made in BCBS 164 and BCBS 165 cover a large part of the Basel framework and are largely principle-based, we request:

- The set-up of a second consultation round that looks at the proposals made in BCBS 164 and BCBS 165 on an integrated level. This consultation should take place after the proposals have been calibrated and made more concrete. This consultation should also allow banks to incorporate the results of the QIS in its response, as this information is extremely relevant in gaining insight into what the updated framework (i.e. the original Basel II framework and all the changes that were subsequently applied, including BCBS 164 and BCBS 165) will require on an aggregated basis.
- The creation of a short-term planning, showing what changes are scheduled to take place until the end of 2010.
- The creation of a long-term planning, stating how the phasing in and grandfathering will be arranged.

Complexity of the proposals
In certain areas, the proposals are quite complex. Although we recognise that in some instances the added complexity of the regulations is required, we also note that there is a growing gap between risk managers and other stakeholders. As the regulations become ever more complex, the call for less sophisticated measures increases. Examples of this are the suggestions to introduce taxation on banks and to split banks into savings and investment banks. Where possible, we request that the Basel Committee re-evaluate the proposals based on the complexity of the suggestions and the desired goal of the proposal. A good example are the proposals that were made for counterparty credit risk, where recalibrating the alpha factor could generate the same result.

Level playing field towards non-bank lenders
As a result of the proposals that were made, business may be forced away from regulated institutions to non-bank lenders if banks have to restrict their lending as a result of the leverage ratio.

Disproportionate effects on certain products and business models
Certain safer products are impacted disproportionately by the proposals. Given the lower returns that are associated with the credit characteristics, banks will face the limits of the leverage ratio

sooner if they have safer business models. This applies to both the assets and the liabilities side of the balance sheet.

Transitional requirements and impact on financial markets
Proper arrangements need to be set up that facilitate a gradual transition, particularly for the proposals relating to liquidity risk, the leverage ratio and own funds. The transitional period should be sufficiently long, so that the phasing in of the proposals, in combination with grandfathering of existing instruments will:
-not hinder the economic recovery;
-not create disproportionate effects on asset prices and;
-not limit the ability of banks to support the future sustainable growth of the economy.
On the other hand, the transition period should be short enough so that it does not reward banks that are slow adopters. Further guidance in this area would be very beneficial.

Future Added Value of more advanced approaches
Most of the proposals that are put forward by the Basel Committee focus on more advanced approaches. Next to the higher degree of sophistication and professionalism, more advanced approaches are more expensive for banks to implement. The management decision to upgrade to a more advanced approach depends on the added value that is generated by more sophisticated risk management as well as the monetary consequences of upgrading (i.e. the added costs of implementing and maintaining the more sophisticated approach versus the benefits in terms of enhanced understanding of the risk characteristics of the portfolios and possible capital relief). In our view, there should always be an incentive for banks to implement more sophisticated methods of risk management.

Double Counting
There are a number of examples in the proposals where double counting of risks occurs. For instance, this is observed in counterparty credit risk for the capitalisation of credit valuation adjustments (CVA) as well as the estimation of the CVA.

Impact of Risk Mitigants
Risk mitigants are not taken into account in the leverage ratio. This goes for both accounting netting as well as netting and collateral. As the objective of these techniques is to limit the amount of risk in the system, the consequence of setting up a risk insensitive leverage ratio will be that these techniques will become less powerful.

Systemic Risk associated with the increased use of central counterparties
The incentives that are created to use central counterparties address systemic risks that were seen during the crisis. However, the elevated use of central counterparties increases the systemic risks that are associated with these CCPs. Therefore, central counterparties should be well-capitalised and should be subject to top-notch supervision.

1.4 Key Suggestions

Based on our analysis of this consultation paper, we have made a number of key suggestions for improvement. There suggestions have been consolidated in this paragraph. Our most important suggestions are:

- **Organise a second consultation**
  Referring to the concerns highlighted in paragraph 1.3 around the assessment of the total impact, we suggest setting up a second consultation after the proposals have been made more concrete and the results of the QIS have been fed back to the participating banks. We are aware of the ambitious timelines that the Basel Committee is facing. Therefore, this second consultation should

not result in a delay of the finalisation of the proposals; it should be used to make sure the calibration is done thoroughly, ensuring the proposals are well-balanced.

- **Leverage Ratio**
  Although we do not support the introduction of the leverage ratio, we would like to put forward an alternative model. This approach requires that an institution calculate its leverage ratio as a first step. This is followed by a periodic evaluation of the change in the leverage ratio; the delta approach. The observed changes are subsequently discussed with the regulator.
- **Grandfathering**
  There is a lack of clarity regarding the regulatory treatment of newly issued hybrid capital instruments as a result of the explicit exclusion of the grandfathering of these instruments. This lack of clarity should be minimised. We therefore suggest 'fast tracking' the development of the requirements regarding hybrids, reducing the timeframe as much as possible.
- **Feedback**
  We are aware that the Basel Committee will receive a lot of responses to the consultation. In order to make the process of providing feedback to the industry as effective as possible, we suggest using the same approach that is used by CEBS. CEBS publishes individual feedback on its website, provides an overview of the feedback that was received and how this feedback has been incorporated during the finalisation of the proposals. We have very positive experiences with this model and would like to pass on these observations to the Basel Committee.
- **Alternative approach for Counterparty Credit Risk**
  The proposals for counterparty credit risk are quite complex. As a simple alternative, we suggest recalibrating the alpha factor in such a way that it creates the additional capital requirement that is being sought.

1.5 Interactions between the proposals

As was mentioned before, there are several interactions between the proposals that can have amplifying and dampening effects on one another. Therefore, the proposals cannot be seen in isolation. As we understand from the speech that was given by Mr. Wellink at the Dutch Embassy in London on February 19th, 2010 the Basel Committee is aware of these interactions. The quantitative impact study will be used to calibrate the measures in an even and balanced way. When this feedback document was written, the results of the QIS were not available, as the deadline for submission of the data by individual banks had not yet passed. Therefore, we would like to point out the main areas where we feel interaction will occur.

Own funds definition and liquidity

As both the definition of the tier structure on the liabilities side of the balance sheet and the requirements for liquidity risk on the asset side are going to be changed, the interaction of these two elements should be taken on board when setting up the final calibration of the proposals.

Liquidity Risk and Leverage Ratio

As the suggested setup of the leverage ratio is risk-insensitive, the leverage ratio will be partly drawn by the requirement to hold additional unencumbered, marketable and highly liquid assets. These added – typically safe – assets will increase the leverage ratio, keeping all other items constant.

There are three key issues in this area:

- Cash-rich, highly liquid institutions are punished by the leverage ratio. This is contrary to the incentive one would expect from a regulatory standard setter.
- Making the regulations regarding liquidity risk more strict automatically increases your leverage ratio. This is a consequence of including the safe assets that are part of the liquidity buffer in the leverage ratio.
- There may be an impact on the real economy if banks have to change their business model in order to comply with the leverage ratio (potential impact on pricing of loans, negative impact on macro-economic growth, etc.).

Counterparty Credit Risk and Liquidity

Dependency on Capital Markets
The Basel Committee requires banks to manage their liquidity risk via the capital markets. Under normal conditions, this means that banks will be trading with parties on the financial markets to either acquire or sell cash depending on the liquidity position. These deals generate counterparty credit risk. As Basel also proposes additional capital requirements for this type of risk, the management of liquidity will become more expensive as a result.

Margining as a result of the incentive to settle via CCPs.
In addition to the dependency on the repo markets, an incentive is created to clear via central counterparties. The increased use of central counterparties will result in a concentration of trades among a small number of central counterparties. This creates a systemic risk. It is therefore key that these CCPs are well-capitalised and are subject to top-notch supervision. The requirement to post margins will increase the amount of capital that is tied up in the system as a result of banks managing their liquidity risk.

2 Raising the quality, consistency and transparency of the capital base

The Basel Committee has put forward a number of suggestions that will simplify the capital base and make it more transparent. In this respect, we note the suggested simplification of the tier structure and the clear distinction between going and gone concern capital. As these two concepts are to be introduced for the first time, it would be very beneficial if the Basel Committee provided an additional specification of these concepts, leaving no room for different interpretations.
In addition to the simplification and the enhanced transparency, the buffer capital will have to be of a higher quality as well. As such, the proposed measures will contribute to a higher degree of stability in the sector. We welcome the efforts of the Basel Committee in this area for the abovementioned reasons, but we also have a number of items we would like to highlight. Alongside our reaction, we would also like to direct your attention to the reaction that has been submitted by the European Banking Federation, which has our support.

2.1 Main Concerns

Looking at this section of the consultation paper, we would like to raise the following points:

Grandfathering and other transitional arrangements
The point that concerns us most is the impact the proposals will have on the real economy. We therefore appreciate the remarks regarding transitional arrangements included on page 13: '*Appropriate grandfathering and transitional arrangements will be established which will ensure that this process is completed without aggravating near term stress.*' We advocate setting up sufficiently long transition periods. The transition period should give banks enough time to adjust to the new requirements, without causing stress in the market. As the effects of the proposals on the real economy can be substantial, we welcome the remarks of the Basel Committee stating that: "*The fully calibrated set of standards will be developed by the end of 2010 to be phased in as financial conditions improve and the economic recovery is assured, with the aim of implementation by end-2012.*"

Alignment to the accounting standards
Some topics under consideration by the Basel Committee (e.g. consolidation, loan loss provisioning, asset qualification and hedging) are also being reviewed by the accounting standard setters. We believe it is crucial that the concepts and principles ultimately used by the Basel Committee be similar to the accounting standards in order to avoid the requirement to maintain two reporting standards.

Difference between going and gone concern capital
The Basel Committee clearly distinguishes between going and gone concern capital. We welcome the introduction of this clear distinction, but feel that the treatment of the balance sheet items should match this approach as well.

Limits on the Tier Structure components
At this point in the consultation process, the final limits and minima for the various elements of capital have not yet been set. It goes without saying that the final calibration of these limits and minima will have a large impact on banks. If the requirements are too strict, the advantage to society of the added safety (that is created by requiring banks to hold more capital) is offset by the dampening effect on the economy of banks' reduced ability to grant loans to the real economy.

Given the sector's importance to the economy, we are confident that the Basel Committee will consider this trade-off very seriously.

Position of banks on the capital markets
The suggested changes to the capital structure are intended to increase the level of capital that banks are required to hold. This makes banking safer, but also puts a strain on the expected return for investors. As banks need to compete for investment on the capital markets, the yield that banks can offer should be comparable to that of other industries. If banks cannot match the projected yields of other sectors, it will be very hard to find investors who are willing to invest in banking equity. Should this happen, it could mean that banks have to reduce their activities or increase the margins on their products.

Importance of the QIS
The proposals that have been put forward are quite descriptive. In order to make sure the proposals meet their objective, the quantitative impact study is very important, as the results will be used for the final calibration of the proposed measures (which dictates how much additional capital banks will need) as well as for providing feedback to individual banks. In this respect, the timing of the phasing in and the interaction with the other proposals is very important.

2.2 Detailed Remarks

Aligning the treatment of assets and liabilities
As a general point relating to capital deductions we feel that the deductions on the liabilities side should also be reflected on the asset side of the balance sheet. If the liabilities are deducted, the associated RWAs should be treated similarly in order to avoid a double negative impact, i.e. deducted from the assets side of the balance sheet when assessing capital adequacy.

Minority Interest
The current capital rules relating to minority interest do not always accurately reflect the true economic position. Therefore, the current proposal to remove minority interest as common equity tier 1 is a step in the right direction. A potential issue is that the capital of an acquired banking subsidiary can't be included in regulatory capital, which will limit banks. Furthermore, we believe that that there should be symmetry between equity and assets 'owned' by minority shareholders. The proposal should also allow for pro rata relief of the RWAs with respect to minority interest, if the liabilities are to be deducted.

Buy Backs
A lot of restrictions are placed on buy backs. This will impact the banks' ability to perform market-making activities. The requirements that relate to buy backs should, in our view, be linked to the amount that was offered to the market and the turnover of the instrument, such as 3 to 5% of the initial amount.

Hybrid Capital Instruments
As a result of the explicit absence of any grandfathering for hybrids issued after the release date, the consultation paper has created uncertainty for both banks and institutions that invest in hybrid capital instruments. For banks, this means that hybrids that are introduced before the finalisation of the consultation paper may not comply with the updated requirements. Investors face a higher degree of uncertainty because of the risk of early redemption by banks in the event an instrument turns out not to meet the new criteria for hybrids. Clarity around grandfathering should therefore be created as soon as possible.

Incorporation of grandfathering in future consultations
Given the uncertainty relating to the grandfathering that was addressed in the previous paragraph, we urge the Basel Committee to either:
-make the proposals detailed enough to allow banks to assess their instruments against new rules, or:
-to allow grandfathering until the regulations are finalised for future consultations.
This will ensure that the uncertainty created as a result of this consultation will not occur again in future consultations.

Deferred tax assets
How deferred tax assets will be treated is not clear at this stage of the consultation. In our opinion, deferred tax assets – as they originate from business-as-usual activities – should be included as a part of additional going concern capital. We also note that the accounting restrictions on deferred tax assets are very strict and could form a solid basis for the prudential capital adequacy treatment.

Contingent capital
We welcome the Basel Committee's efforts regarding contingent capital. As the actual setup has not yet been proposed, we are looking forward to the more detailed information that will follow during the course of 2010.

Safeguards on the use of call options
When looking at adding safeguards – such as lock-in mechanisms – there is a dilemma between predictability for investors and prudential considerations. It is very important for banks to have continued, reliable access to the capital markets by acting in a predictable and proper way with investors. If banks become less reliable for investors, these parties will take this into account in price setting, effectively increasing funding costs. On the other hand, having additional safeguards that help protect capitalisation levels will assist banks in times of stress. It is therefore quite difficult to come up with a clear-cut answer to this question, given the absence of detailed suggestions.

Investments in the capital of other banks, other financial institutions and insurance entities
Referring to '*Banks should apply a "corresponding deduction approach" to investments in the capital of other banks, other financial institutions and insurance entities where these fall outside of the regulatory scope of consolidation,*' we would like to point out that these restrictions should also apply to other financial institutions and insurance entities in order to maintain the level playing field. For insurance companies in the EU, this can be done via the Solvency II accord. In order to maintain the global level playing field, this issue should also be addressed outside the EU.
Looking at the requirements relating to cash flow hedge reserves, we note that the IASB is currently developing updated accounting standards for this. We urge the Basel Committee to align its approach to the accounting treatment, in order to avoid potential mismatches.
Defined benefit pension fund assets and liabilities
The approach of the Basel Committee regarding defined benefit pension fund assets and liabilities should, in our view, be aligned with the accounting standards. The accounting standards already set very strict conditions for this and could be used for risk purposes as well.

Revaluation reserve
The unrealised gains / losses that are recognised under IFRS should not be included in capital. The rationale for this is the fact that the available-for-sale assets are held in a long-term business model. The unrealised gains / losses will automatically revert over time and are therefore not relevant to the capital position. Real losses will impact capital as and when they occur, as actual impairments are not subject to a filter. Recognising unrealised gains and losses in regulatory capital will significantly increase volatility and procyclicality.

Furthermore, we do not see the rationale of amending the capital definitions based on IAS 39 principles. The new classification and measurement standard (IFRS 9) does not facilitate for the AFS category and is expected to be effective around the same time as the new Basel requirements. The accounting treatment under IFRS 9 will make the current prudential filter irrelevant.

3 Enhancing Risk Coverage

The proposals in this section focus on counterpart credit risk and the dependency on external rating agencies.

3.1 Main Concerns

Incentive to use less sophisticated approaches
The proposals that are put forward by the Basel Committee largely focus on the internal model method (IMM), whilst the changes to the other approaches are limited. We are not clear if it is the Basel Committee's intention that these proposals also should have an effect on non-IMM banks. In this respect, we would also like to point out that in our view there should always be an incentive for banks to implement more sophisticated methods of risk management. In other words, the possibility of achieving additional insight into the risk characteristics of banks' portfolios and possibility for lower capital requirements when using more advanced methods should remain, although actual benefits will depend on the characteristics of the institution.

Double counting CVA
The capitalisation of credit valuation adjustments (CVA) is at least partly covered by the Maturity Adjustment factor as used for the banking book capital calculations. Where the CVA capital represents the banks' vulnerability to (major) spread changes, the Maturity Adjustment capitalises for major spread changes as a result of rating migrations.
Further, double counting occurs as a result of using both the recent year as well as a stressed year for estimating the CVA. Performing the CVA calculation in two places will lead to double counting of the risk. From an economic perspective it is almost as if these proposals mean the same risks will be included in the calculation three times.

Therefore, the NVB proposes the following:

- Use the spread changes of a *generic index* for a particular rating class in order to measure the spread changes within that rating class. If single name spreads were used, a lot of the changes in the spread would imply a rating migration. However, this is already covered by the Maturity Adjustment.
- Apply diversification benefits of the rest of the market risk portfolio, e.g. if you measure the spread changes of a bond, there will be diversification benefits with the other market risk factors like FX and interest. This follows from fundamental economic theory.
- We propose to only apply a *stressed* period for estimating the EADs as an input to the CVA calculation. The application of a stressed period will yield conservative results and, therefore, the additional estimation based on the VaR period is not required. Also, the results will be through-the-cycle. This is contrary to the use of a rolling window, as it is used for VaR calculations, which result in point-in-time results.

It should be noted that initial calculations for C-QIS will result in capital figures that may exceed the EAD of the portfolio. Therefore, we would like to request that the Basel Committee very closely consider the current CVA regulation. Multiplying stressed VaR shocks by 3*5 will lead to very high results. For instance, if the 10-day historical credit shock is 2% and duration equals 5, the capital will be 150% of EAD (2% * 5 * 3 * 5).

Use of central counterparties
The incentives that are created for institutions to use central counterparties will result in additional liquidity consumption. This is a result of the added margins a bank needs to post with the central counterparty. The increased use of central counterparties can create a systemic risk as well. Given

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the added importance central counterparties will have in the financial system and the associated systemic risk, it is extremely important that these central counterparties be well-capitalised and subject to top-notch supervision. In addition, we are unsure how central counterparties will be able to capture exotic deals.

Severity of new regulation
The NVB understands that the Counterparty Credit Risk regulation is under review as a result of the crisis. Still, the additional capital requirement can be disproportionate due to a variety of interactions between the individual requirements and proposals. Some examples of such interactions:

- Under certain criteria, Basel proposes to increase the margining period. As a result, the EAD will increase. Alongside this, the maximum EAD has to be determined on the basis of a period with normal market circumstances and a period marked by stressed market circumstances. Therefore, the horizon is increased and a stress scenario is applied during this longer period. As a consequence, the EAD will be increased twice, leading to a disproportionate rise in the capital requirement.
- Further, the capital percentage will increase as a result of the asset correlation multiplication by 1.25. Multiplying the increased EAD (please refer to the first bullet point) by the increased capital percentage means the total capital requirement can reach over inflated levels.
- The increased EAD is also used in the CVA calculation. This, too, will lead to additional capital requirements.

The NVB requests that the Basel Committee take these concerns on board when it is studying the results of the QIS. In particular, the aggregated impact of the combined proposals – including double counting – should receive appropriate attention.

Complexity of new regulation
There are a lot of additional regulatory requirements that will put severe pressure on the banks' capacity in terms of staff and IT systems, and may result in a framework that is less transparent. Rather than introducing all the individual items that are aimed at increasing the capital requirements, we propose a simpler approach.
Our suggestion involves adjusting the alpha factor, as this has the same effect if it is carefully calibrated and will be far less complex.

Reducing the dependency on external ratings
We endorse the objective of the Basel Committee to reduce banks' dependency on external ratings for securitisations, although we do not fully recognize the conclusions that are made in paragraph 180. We agree that banks should conduct an internal risk assessment for securitisations, but we do not perceive that the availability of external ratings creates an incentive not to apply internal risk management practices as well.

3.2 Detailed Remarks

Netting sets
The proposals regarding netting sets contain a number of suggestions that we feel are too harsh.
For instance:
-the extension of the margin period for large netting sets (5000+ trades); and
-netting sets that contain illiquid collateral; or
-netting sets that contain hard-to-replace derivatives.
These proposals will result in high capital requirements for collateralised portfolios against financial counterparties. Furthermore, these requirements are difficult to comply with as they require banks to continuously monitor all the trades in their portfolios and netting sets.

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The implementation of these proposals will also have serious consequences for the IT infrastructure, as the required calculations will be massive.

Additionally, we see little connection between the proposals around netting sets and the actual associated risks. For instance, a portfolio of 5001 plain vanilla interest rate swaps would be labelled high risk. Furthermore, the assumption of hedging the exposure in a netting set of plain vanilla products should be allowed on an aggregated level, as there is no added value of hedging on a more granular level.
In another example, a portfolio of 5000 trades where one trade has an underlying illiquid equity instrument would, according to the proposed rules, make the entire set 'hard to unwind'. This clearly requires a more balanced approach.

The consultation document lacks empirical evidence to back up the assumptions that are made regarding the netting set size, underlying asset criteria, etc. We request that the Basel Committee share the empirical data that was used in preparing the consultation document with the industry. Feedback on why the proposal was thus formulated is essential to understanding the reasons behind it. This is especially true given that our practical experience does not back up the observations made by the Committee.

Wrong-way risk
With regard to wrong-way risk, the paper states in paragraph 119: '*The significant general wrong-way risk that was evidenced during the recent market crisis calls for a strengthening of the point-in-time estimate of average future exposure, such as Effective EPE as the basis for determining EAD for trading counterparties. While this metric has a number of shortcomings, the Committee, after consideration of several alternatives, is proposing to retain Effective EPE as the metric used for EAD, but to ensure that parameters, such as volatilities and correlations, are calibrated based on the more conservative of a historic period that includes stress or the most recent period of experience. The Committee notes that the calibration of the Alpha add-on factor already includes an adjustment for wrong-way risk.*'
We feel that adjusting the exposure is not the right way to approach this problem. Some types of wrong-way risk are difficult to capture in models, as these depend on the specifics of the deal. Deals with marginal wrong-way risk will also be targeted via the proposal to stress market risk parameters. At deal origination, one could flag trades with specific wrong-way risk and use this indicator to allocate an additional capital charge to the particular trade. If a more general approach is desired, the alpha factor is probably the best place for implementation, because both the exposure and credit quality are taken into account.

Asset Correlations
The Basel Committee is clear that it wants to limit the interconnectedness among financial institutions. However, the transactions that are conducted between banks form part of the mechanism that allows for an efficient transfer of risk, liquidity, etc. to other parties. The suggested threshold for increasing the asset correlation factor of USD 25 bln appears to be quite low and no evidence is provided as to why this threshold would be appropriate.
Although an increase of the correlation between banks may have been observed in recent times, we would like to note that an increase in the asset correlation will lead to an additional increase in the capital requirements, on top of the substantial increases resulting from the other proposals. Therefore, we request that the Basel Committee take a holistic view of the amplifying and stacking effect of all the individual proposals, based on the C-QIS results.

Eligible hedges
On page 34 of the 'resilience document', it is stated that: '*This capital charge should be calculated in a standalone manner on the portfolio composed of the set of bond-equivalents described above and their eligible hedges. No offset against other instruments on the firm's balance sheet should be reflected.*' We would like to make the following comments:

- We do not understand why positions that are an effective hedge, but sit elsewhere on the balance sheet, are not recognised.
- In addition, the document is not clear about the recognition of short positions on bonds as hedges.
- Only single name hedges are presumed to be eligible hedges. Portfolio hedges, however, should also be allowed.

CVA
When calculating credit valuation adjustments (CVA), interest shocks should not be used for the purpose of measuring the credit risk of the counterparty, as this will already be included in the market risk calculation.

- The proposed capital charge for CVA would be determined on a simplified, stand-alone basis with limited possibility to incorporate hedges and using a mixture of banking and trading book models. A more consistent approach would be preferable, where CVA risks and hedges are treated as an integral part of the trading book (i.e. included in VaR and stressed VaR).
- In the VaR model, the different sensitivities of CVA to interest rate and credit spread curves would be a better alternative than a bond-equivalent approach.
- The Basel proposal only allows for single name CDS hedges. In practice, CVA exposure is often hedged using index or proxy hedges. In practice, CVA exposure can also relate to corporate counterparties. For these counterparties, there are no CDS hedges available. Although index and proxy hedges do not create a perfect hedge, not including them at all would be too conservative. It would also result in less effective risk management, as hedging CVA exposure will not result in a capital reduction using these instruments.

Calculation of CVA
Banks calculate CVA for financial reporting purposes. Banks can use two approaches for this purpose:

1. A market-implied measure, based on CDS prices.
2. A through-the-cycle (TTC) approach, using historical PDs and LGDs.

The CVA proposal does not differentiate between the two accounting treatments that individual banks can use. As the historical PD and LGD approach is less volatile (as it is not based on market prices), an add-on that takes price volatilities into account is not required. We suggest requiring the add-on only for banks that use a market-based approach.

The CVA losses that were observed during the crisis were not a consequence of actual losses based on the underlying credit risk, but were created by the use of the market implied accounting treatment.

We also note that the measurement of the CVA depends on the longest tenor in the netting set. This is a very prudent approach that does not reflect the underlying risk. Therefore, we propose using the exposure-weighted average tenor within the netting set.

Margin call disputes
Paragraph 152 states: '*In addition, the Committee is proposing that banks which have a history of margin call disputes on a netting set that exceed the margin period of risk would be required to double the applicable margin period of risk for the affected netting set. In particular, if a bank*

experiences more than two disputes regarding a particular netting set over the past two quarters that last longer than that netting set's margin period of risk (e.g. 5 business days), then the margin period of risk for that netting set would double (e.g. 10 business days) for the next two quarters. Implementing such a requirement would capture the additional risk of long disputes and provide incentives for banks to limit such events.' We note, however, that the Committee does not provide a definition of a margin call dispute. We request that the Committee provide a definition of this concept, as there is a significant difference between an operational hiccup and a full-blown disagreement. In this respect, we would also like to note that the dynamic nature of margining will cause slight differences in the calculation of the margin requirements on an ongoing basis. The safeties that are built into the system via the threshold- and minimum transfer amounts already address this issue.
In addition, we feel that margin call disputes should be part of the operational risk framework and should not lead to an increased margin period.

Securities Financing Transactions
Regarding the suggested added paragraph to the Basel Accord: '*61(ii). If the internal model includes the effect of collateral on changes in the market value of the netting set, the bank must model collateral other than cash of the same currency as the EAD jointly with the exposure in its EAD calculations for securities-financing transactions.*' It is not clear why a specific reference is made to security financing transactions as there may be no securities financing transactions in the portfolio.

Knowledge of counterparty's assets
We would like clarification regarding the addition that is proposed to paragraph 285: '*… PD estimates for counterparties that are highly leveraged or for counterparties whose assets are predominantly traded assets should reflect the performance of the counterparty's assets based on periods of stressed volatilities.*' Acknowledging that market volatility may disproportionately increase risk for some counterparties is a valid point, but it may not be possible to clearly demonstrate that there is a link to the current positions, as the exact positions are not known. In addition, the characteristics of a counterparty will already be incorporated into the banks' PD model. As these requirements refer to a trading environment, the chosen policy implementation should take into account the dynamics of the business, where it is of the essence to be able to respond quickly to customers' requests.

Central Counterparties: in more detail
We acknowledge that the Basel Committee wants to create an incentive for banks to transact using CCPs. The objective is to reduce the interconnectedness among financial institutions. However, this stimulation could result in the introduction of large concentration risks at these CCPs, as well as systemic risk. What will happen if a CCP is in trouble? There are also other operational questions. For instance, what would happen if a bank was late in providing margin to the CCP? Would the CCP be able to automatically cut off the bank from its network? We request that the Committee reconsider its severe position in encouraging the use of CCPs.

In addition to these points, we have a number of questions / remarks about a number of other items:
1) Are CCPs indeed the most suitable way of clearing non-standardised OTC derivatives?
2) In the end, CCPs are for-profit organisations that are primarily involved in securities and short-term standardised derivatives transactions. Increasing the scope of CCPs to include <u>long-term complex positions</u> could introduce more systemic risk.
3) Although CCPs currently carry a zero solvency weighting, the use of CCPs will increase the financial burden on banks and drain liquidity (e.g. cash and collateral will probably not be recognised as available liquidity for the Liquidity Coverage Ratio). The set-up should be handled such that these effects are mitigated as much as possible.
4) The acknowledgment of the importance of the central counterparties in the financial sector should be reflected in high-quality supervision and capital requirements that are in line with the task of a central counterparty.

Back testing and stress testing
With regard to the proposals for stress and back testing, we note that – although we agree that both types of tests should be carried out – the proposed approaches pose serious issues when it comes to implementation, both from a modelling and an IT perspective. We will give further information on this item in the detailed section.

Back testing: further detail
The requirements put forward on page 43, article 46(i) state that banks should use horizons of at least one year. Such back testing will result in only a handful of independent observations. Given this limited set of results, we are unsure of the added value and the envisaged purpose of this kind of back testing. Particularly as it will be next to impossible to draw any statistically significant conclusions based on the actual results. We request that the Basel Committee clarify the requirements for back testing, in particular as regards the parameter setting. Whilst acknowledging the necessity of back testing in general, the NVB would recommend removing the requirement to back test using the time horizons out to at least one year, and limiting back testing to a 30-day time horizon.

Stress testing: further detail
As regards the requirements for stress testing, we note that the involvement of senior management is not very pragmatic. Senior management should be responsible for the stress testing programs, but they should also have the discretion to delegate the responsibility of setting up and analysing the results to lower level risk managers. We are of the opinion that the requirements as they are currently formulated will not improve risk management and will put additional pressure on the capacity of risk management.
We therefore suggest allowing banks to shape their stress testing program according to their individual requirements, which follow from the organisation and the business model.

Reducing the dependency on external ratings
We agree with the Basel Committee that the proposals made in paragraphs 184 and 185 are not particularly desirable in limiting the reliance on external ratings. In order to limit this reliance for securitisations, the Basel Committee alternatively suggests supplementing the regulatory requirements (based on external ratings) with:
-Banks' own credit ratings
-Banks' own capital estimates
-A proper due diligence of the underlying exposures.

However, the proposal does not specify whether the capital requirement itself depends on the outcome of the analysis to be performed by the bank. And yet, if the analysis is deemed insufficient, exposure must be deducted from capital.

Unfortunately, the proposal does not expand on how detailed these analyses should be. We therefore request that the Basel Committee provide additional guidance on this subject.

Fundamental review of the securitisation framework (188)
The committee is undertaking a more fundamental review of the securitisation framework. However, no timelines are specified with regard to when this review will be finished and when the proposals based on this review will be communicated. We request that the Basel Committee provide more insight into the specific points of attention the committee is considering as well as an indication when the more detailed proposals will become available.

Incentive to avoid getting exposures rated.
Although we agree that there should not be an incentive to avoid the rating of exposures, we feel the suggested approach in paragraph 194, which contains the revision of paragraph 733 of the Accord, will be very hard to work with in practice. For instance, we question how the following should be handled in practice: '*assess exposures, regardless of whether they are rated or unrated, and determine whether the risk weights applied to such exposures, under the Standardised Approach, are appropriate for their inherent risk.*' The word 'appropriate', in particular, leaves room for multiple interpretations.

Unsolicited Ratings and recognition of ECAIs
We are unsure why the proposed change to paragraph 94 of the Accord is being put forward in paragraph 201 of BCBS 164, as there are already rules in place that provide guidance as to which rating should be used if there are multiple ratings available.

4 Leverage Ratio

This section discusses the proposed risk-insensitive leverage ratio, which is designed to constrain the build-up of leverage in the banking sector and will reinforce the risk-based requirements with a non-risk-based 'backstop' measure based on gross exposure.

4.1 Main Concerns

The NVB regards the introduction of a leverage ratio as a step back in time given the crude measure that is proposed. The fact that no specific elements of different business models are taken into account by developing only a single indicator, is a major weakness in the concept. At the end of our comments we will suggest an alternative approach.

As Dutch banks have spent the last decade making their risk management systems more advanced and risk sensitive, we do not endorse the introduction of the non-risk-sensitive leverage ratio. This is contrary to all the work that has been done in the past, aiming to professionalise the various areas of expertise of risk management.

Impact on the real economy
The leverage ratio discriminates against safer assets and liabilities. Some of the most important examples being:
-Mortgages
-Credit provision to small and medium-sized enterprises
-Savings

The proposals will also impact the real economy, as banks will need to compensate the cap on the leverage they are allowed to have. This can happen via two mechanisms:
1. A decrease in the amount of 'safer credit', i.e. banks will not be able to sustain the current amount of lending.
2. An increase in the price of 'safer' credit products.

These two scenarios are linked to the cap on the total amount of risk, which creates an incentive to shift product offerings to riskier products. However, the result of both scenarios is the same; less provision of credit to the real economy, effectively decreasing the level of economic growth.

The netting of overdrafts is no longer allowed. The same applies to corporate clients that have several accounts where some are overdrawn and others have sufficient funds to compensate this. Not being allowed to net these positions creates additional work and will make things more complex. We urge the Basel Committee to take a constructive approach to this issue, as this proposal would change the product offerings to corporate clients, making banking more difficult for these companies.

European banks are hit harder than banks in other jurisdictions
European banks have been managing their balance sheets based on risk. As a consequence, the assets of European banks are generally less risky compared to their US counterparts. The European Banks have a higher leverage ratio to compensate for the lower revenue that is a consequence of having safer assets on the balance sheet.

Leverage ratio discriminates against safer assets and safer business models
The idea of including a leverage ratio in the Basel II framework originated in the Unites States of America, a country that currently does not use the Basel II framework. As a result, the capital requirements that apply to US banks cannot be compared to those applicable to European banks. In

Europe, banks typically hold less risky assets on their balance sheets[2] and are required to hold less capital as a result of the risk sensitive Basel II framework. If the leverage ratio is introduced, European banks would be put at a disadvantage compared to their American counterparts. This is because European banks would need to strengthen their own funds in order to meet the requirements of the leverage ratio, even though there is no link to the amount of risk carried by these banks. In the United States, the FDIC[3] uses the leverage ratio as a supervision tool for 'savings and loans'. Considering the number of banks supervised by the FDIC that failed, there is clearly no direct link between financial stability and the use of a leverage ratio.

The leverage ratio is insensitive to risk taking; less risky assets – which usually also have lower returns – will become less attractive. Clear examples of assets of this type are mortgages and trade financing. Banks that are facing the limits of the leverage ratio will have an incentive to take on riskier assets that provide higher returns, effectively increasing the risk appetite of the institution as a result of balance sheet constraints that need to be taken into account alongside the risk management considerations. As European banks optimise their balance sheet in terms of risk, the leverage ratio may create an incentive to invest in riskier assets.

Changes required for implementation
The introduction of the leverage ratio will involve substantial efforts from banks' IT departments. Although the leverage ratio is simple from a conceptual perspective, it is not simple from a change management point of view. Existing systems would need to be changed in order to facilitate the calculations for the leverage ratio, especially given that the definitions in the leverage ratio do not allow for accounting netting.

Importance of the QIS
The leverage ratio will impact the business model of the bank on an integral basis. As the other proposals of the Basel Committee pertain to an array of different areas, the overlaps with the leverage ratio will be numerous. In our opinion, the only way to properly assess the impact of the leverage ratio is to see it in an integrated way with all the other proposals, including the paper on the framework for liquidity risk. We therefore wish to underline the importance of the QIS in this respect.

Implementation of the ratio
Although we strongly oppose the introduction of the leverage ratio, we are keen to make sure that if it is implemented, it will not disproportionately affect the real economy. We therefore advocate the use of the leverage ratio as a supplementary supervisory tool under pillar II, accompanied by a gradual introduction. As the leverage ratio will vary according to the each bank's business model, some banks that exceed the leverage ratio cap would need to restructure their balance sheet. As this pertains to the core of a bank, due time and care needs to be taken to make sure there are no unintended side effects. We suggest using a phased approach under pillar II, where the regulator and the individual institution work towards a healthy leverage ratio over a number of years, gradually transitioning to a less leveraged balance sheet. The phasing in of the leverage ratio should be done on the same timescale around the world to ensure that the level playing field is maintained. This is especially relevant for the Asia-Pacific region, Europe and North America.

[2] Citigroup Global Markets '*Re-plumbing the financial system*', September 10th 2009.
[3] Federal Deposit Insurance Corporation (FDIC) is a United States government corporation created by the Glass-Steagall Act of 1933. It provides deposit insurance, which guarantees the safety of deposits in member banks, currently up to $250,000 per depositor per bank.

Issues resulting from differences in accounting treatments
There are substantial differences in accounting treatments among jurisdictions. As a result, the leverage ratio will need to be calibrated very thoroughly in order to avoid the level playing field issues that could easily occur. As the Basel Committee only mentions this issue in one line of text, we would like to request additional guidance as to how the differences in accounting treatments will be incorporated into the actual use of the leverage ratio.

Position of banks relative to non-bank lenders
If banks are faced with a leverage ratio, competition from non-bank lenders may cause a shift in business to these types of institutions. Should this concern materialise, it would be a level playing field issue.

Connections to the proposals put forward in BCBS165

The proposals regarding the leverage ratio will be impacted by the proposals set forth in consultation paper BCBS165 on liquidity risk management.
Three key issues are involved:

- Cash-rich, highly liquid institutions are punished by the leverage ratio. This is contrary to the incentive one would expect from a regulatory standard setter.
- Making the regulations regarding liquidity risk more strict automatically increases your leverage ratio. This is a consequence of including the safe assets that are part of the liquidity buffer in the leverage ratio.
- There may be an impact on the real economy if banks have to change their business model in order to comply with the leverage ratio (potential impact on pricing of loans, negative impact on macro-economic growth, etc.).

A way to mitigate the impact of the leverage ratio would be to eliminate certain safe assets from the leverage ratio. We strongly suggest the Basel Committee develop a simple, principle-based approach that will compensate for the consequences of including all assets in the leverage ratio.

4.2 Detailed Remarks

In addition to the general comments we provided in the previous section, we would like to share a number of specific remarks:

Paragraph 202: '*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.*'
We doubt that there is historic evidence that shows a clear link between the value of the leverage ratio and a bank becoming insolvent. The shift in the leverage ratio is a far more valuable tool than a firm, universal cap. We would like additional guidance from the Basel Committee as to how the introduction of the leverage ratio should take place, in the event it is introduced. In our view, a gradual phasing in is required in order to minimise pressures in the market. If institutions are over-leveraged according to the definition, how will they be asked to comply with the regulation? For instance, will the leverage of every bank be measured at the introduction of the leverage ratio? Should banks decrease the leverage annually if they are over-leveraged or will the leverage ratio be introduced at a low level accompanied by an annual increase? In addition to the phasing in, the purpose of the ratio should also be specified in more detail. How will the backstop function be

achieved? Will it be a fixed – one-size-fits-all – measure or can it be adjusted according to the business model?

Paragraph 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.*'
Regarding this paragraph, we note that it is quite a challenge to calibrate the leverage ratio so as to truly achieve the objective of international harmonisation. Against this background, we would like to point out several level playing field issues:

- Exposures are calculated differently across jurisdictions
- Accounting treatments vary across regions
- Individual business models can result in different leverage ratios, which do not necessarily give a good impression of the riskiness of the institution.

Paragraph 206: '*The design of a leverage ratio requires a definition of capital (the capital measure) and a definition of total exposure (the total exposure or assets measure). The key elements of the Committee's proposal are listed below and summarised in the table in the Annex to this section…..'*
We welcome the fact that provisions are taken into account in the leverage ratio.
According to the proposal, accounting netting may not be taken into account. This actually makes the measure more complex. As there are very strict accounting rules set up around the subject of netting, we suggest including the accounting netting benefit in the leverage ratio.

Paragraph 212: '*The generally preferred measure of exposure for the leverage ratio follows the accounting measure of exposure. The advantages of this approach are that accounting data are readily available to the market and transparent, provide an independent measure of exposure to regulatory exposure; and are generally not risk-based. To be measured consistently with financial accounts, it follows that:*
• total exposure should be net of provisions and valuation adjustments (e.g. credit valuation adjustments); and
• physical or financial collateral is not allowed to reduce exposure. This approach is also consistent with developing a non-risk based measure, and addresses concerns around uncertainty in the valuation and time to recovery of physical collateral.'
In our opinion, these requirements penalise IRB banks. Basel dictates a gross value adjustment for regulatory capital purposes and net values for the leverage ratio. Benefits that are created by using IMM are not taken into account. Multiple runs of systems will also be required to facilitate the new proposals.

Paragraph 215: '*Consistent with taking a non-risk based approach and international comparability, the proposed measure of exposure does not permit netting. This applies to netting of derivatives, repo style transactions, and the netting of loans against deposits.*'
Here the leverage ratio clearly discourages sound risk management. If a bank actively manages and mitigates its exposures to derivatives, the leverage ratio would not take any of these additional safeties into account. Having sound risk management processes is effectively penalised as there is no benefit in the leverage ratio.

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Paragraph 218 & 219: '*a. High quality liquid assets*
218. The proposal is to include all assets (including high quality liquid assets) in the measure of exposure. This approach is simple, non risk-based and avoids the problem of trying to decide where to draw the line on inclusions and exclusions from the exposure measure based on relative liquidity.
219. The Committee's proposed international liquidity standard includes a definition of high quality liquid assets. The Committee will assess the interaction of the leverage ratio and liquidity framework requirements. In particular, the Committee will assess the impact of excluding certain high quality liquid assets, based on the liquidity framework definition, from the measure of exposure.'
Given the interaction of the leverage ratio with the proposals on liquidity risk management, we note that the increased requirements coming from the liquidity risk management area will have a significant impact on the leverage ratio, as high-quality assets may not be excluded from the leverage ratio calculation. As a result, the leverage ratio is partly used by increasing requirements in another area of the proposals.
We advocate allowing for the exclusion of certain high-quality assets from the leverage ratio. This maintains the desired simple approach, but also takes the interplay between the two proposals into account.

With regard to securitisation, we note that the proposals around the leverage ratio will make synthetic securitisations less attractive given that the underlying portfolio must be included in the leverage ratio and the risk mitigation measures, purchases CDSs, for example will not mitigate the leverage ratio. This measure comes on top of the proposals that were already adopted to impose higher capital requirements on securitisations.

Paragraph 225: '*In order to take into consideration the complexity of risks associated with securitisation operations, including cases where the originator could feel obliged to take back assets on the balance sheet, the Committee intends to consider, as an alternative approach, the total of all underlying securitised portfolios for the bank's originated securitisations. Such an alternative approach is robust against differing accounting treatments across jurisdictions with regard to de-recognition.'*
This type of situation is out of scope for accounting purposes, but is taken into scope for the leverage ratio. This creates different treatments that depend on which view is being considered – accounting or risk – and is contrary to the desired simplicity of the measure.

Derivatives: hedging will be discouraged, as hedging will deteriorate the leverage ratio. Therefore, banks could keep concentrations on their balance sheet. This could be the basis for the next crisis. We feel that there should always be an incentive to hedge.

Paragraph 227: '*The Committee will evaluate two distinct approaches without netting and also intends to understand the effect of those approaches with regulatory netting. The two options are:*
(i) follow the accounting approach but with no netting; and
(ii) use the current exposure method to measure potential exposure but with no netting. The Committee also proposes to assess both options with regulatory netting.'
This proposal will result in a disconnect between the accounting and the risk treatment. In our opinion, risk and finance treatments should be aligned as far as possible.

With regard to credit derivatives, we note that bought credit protection will not be netted off in the leverage ratio. This is another example where institutions that actively manage their risks are punished by the leverage ratio. In our view, the incentives involved in moving to a less proactive risk management as a result of the leverage ratio should be properly appreciated and taken into account by the Basel Committee.

Off-balance sheet items that are not derivatives are assigned a 100% credit conversion factor in the proposal. This factor is very high, but we appreciate the consistency.

With regard to disclosure, Basel advocates ‘rigorous Pillar III disclosures’. Given the arguments against the leverage ratio that we’ve raised in this paper, we are not in favour of disclosing the leverage ratio results, as this will not have added value. The measure cannot be compared between institutions, as it depends on the business model and does not provide a reliable estimation of the riskiness of the institution. If the Basel Committee insists on maintaining disclosure requirements, we are in favour of making this a high-level statement that tells the interested reader that the company discussed its leverage ratio with its regulator and that both parties are satisfied that the degree of leverage of the institution is within acceptable boundaries.

In paragraph 238, Basel states: ‘*The design of the leverage ratio relies on internationally consistent accounting rules where feasible*.’ We agree with this statement, but expect a lot of deviations in practice.

4.3 Alternative Model: the delta approach

Although we do not support the introduction of the leverage ratio, we would like to put forward an alternative model. This approach will act as a backstop measure, but will also incorporate the differences that arise from the very diverse business models banks can use. We have labelled this model the delta approach.
The first step in the delta approach is for an institution to calculate its leverage ratio – according to the final definition that is still to be agreed upon – and to discuss the result with the regulator. During this discussion, the value of the leverage ratio is analysed by taking into account the specific consequences of the business model on the leverage ratio. If the ratio is in line with what is to be expected given the business model, the bank is fine. By this we mean that the bank should not decrease its leverage, nor should it increase its capitalisation. If this is not the case, a plan of action must be agreed with the regulator. This would be the phasing in period.
Once the bank has achieved its target leverage ratio, there will be periodic supervision of the ratio, i.e. a pillar two approach. As the leverage ratio will depend on the business model, it is the relative change – or delta – that will be an important indicator of how the bank is doing. If the ratio increases too much, this will trigger a discussion with the regulator. The ratio therefore acts as a backstop, but more importantly as a regulatory tool that can have added value.

5 Procyclicality

This section discusses the proposals that the Basel Committee put forward to make banks more resilient to procyclical dynamics. The objective of these measures is to ensure that the banking sector serves as a shock absorber, instead of a transmitter of risk to the financial system and broader economy.

5.1 Main Concerns

In our view, the concept of limiting procyclicality can be very beneficial. Although we are afraid that the devil will be in the detail when it comes to the specification of the proposals.

The need for a second consultation round
Based on the current high-level information, it is difficult for us to assess the impact and consequences of the proposals. As more work is clearly needed, we request that the Basel Committee organise a second consultation round. This will allow us to provide feedback on the detailed proposals as well. This second round should occur after the results of the QIS have been communicated, so that this information can be included in our response. We encourage the Basel Committee to continue the development of this part of the consultation paper and we are looking forward to remaining involved in this process.

Impact on the real economy; making the trade-off
We agree that adding a certain limitation to the procyclicality of the financial system can be beneficial. That being said, we are worried that the approach that will finally be adopted will be too conservative, and will limit banks' ability to support the real economy.
The objective of this proposal should therefore be to properly limit the procyclicality and to define the trade-off between the costs and benefits of reducing the procyclicality of financial institutions, i.e. the additional costs to clients versus the added safety that is created. This underlines the importance of the calibration of the proposals. It also appears that the buffering function will be partly migrated from the ICAAP process to pillar one, allowing less room to take company-specific features into account.

5.2 Detailed Remarks

We will now give our feedback on each of the subsections of procyclicality.

Cyclicality of the minimum requirement
As a result of the suggested introduction of a downturn PD, the Basel II framework will be made less risk sensitive in relation to the point in time of the economic cycle. The downturn PD would be used in addition to the already existing downturn LGD that is part of the regulatory capital requirements. Having both a downturn PD and LGD will strongly reduce the dynamic elements in the RWA calculation. The result will be that the Basel framework becomes far less risk sensitive over the economic cycle. It will, however, remain risk sensitive with regard to the credit quality of the banks' portfolios. The same effect is achieved by requiring banks to use the highest PD in an exposure class instead of the mean PD. Although we note that the goal of the Basel paper is to decrease the procyclicality of Basel II, we feel the suggested approach is a bridge too far. We also note that a lot of terms are used in the section on procyclicality that can be open to multiple interpretations. We therefore request that the Basel Committee provide guidance on how to interpret the definitions of the terms that are used in this section.

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We have a number of questions with regard to using long-term average or downturn PDs to derive the scaling factor that would be used to adjust the PDs used in the RWA calculation:

- Depending on the modelling methodology used by the banks, different banks may (in similar conditions) determine the through-the-cycle (TTC) or downturn PDs to be different, and thus have different denominator values for the scaling factor. It is not yet clear how the differences in modelling methodologies would be taken into account when calculating the "target" TTC and downturn PDs.
- As the scaling factor would probably need to be reviewed periodically, it may create an additional burden for the institutions to maintain models in parallel, estimating additional types of PD values.
- One of the principles of the current Basel II framework is that the effect of stressed conditions varies on different points of the PD scale (stronger asset correlations are assumed for low-PD exposures, and weaker asset correlations assumed for high-PD exposures). However, the proposed scaling coefficient dismisses that assumption. The same value of the scaling coefficient would be applied to the PD of different rating grades within a portfolio.

Although BIS is still considering different methods to reduce the cyclicality (e.g. even the placement of the discussed PD adjustments - Pillar 1 or Pillar 2 requirements - is not certain), we generally expect these new adjustments to increase banks' capital requirement.

Referring to the QIS data that banks are asked to provide, we note that for the estimations of the long-term average PD, banks are likely to have data on a relatively short period of time. This may not result in a representative figure, i.e. the average PD will be overestimated as a result of the financial crisis. Should this fear be realised, the Basel Committee should estimate the average PD using a thorough process to ensure that proper long-term average PDs are derived.

If under IRB the internally calculated PDs need to be scaled to reflect a downturn PD, while the Standardised Approach continues to use external ratings that represent different principles, concerns emerge regarding the level playing field. Depending on the calibration, the current proposals could result in lower capital requirements under the standardised approach compared to the IRB approaches. We feel there should always be an incentive for banks to move to more sophisticated approaches of risk management and therefore ask the Basel Committee to advise on how it will make sure that an incentive to move to IRB-based approaches will continue to exist.

Forward Looking Provisioning
The Committee states that it is a supporter of stronger provisioning practices. We also advocate the enhancement of provisioning practices. However, we believe that the proposed "expected cash flow" model of the IASB has a number of significant and important drawbacks, including:

- Conceptual issues: as proposed in the exposure draft (ED), for example, the initial expected loss estimate is recognised over the life of the related assets, whereas the present value of (positive and negative) changes in the expected loss estimate must be recognised immediately. This results in significant <u>additional volatility and procyclicality.</u>
- Practical issues: the extreme complexity of the proposals in the ED mean they are not easily
  - understood by users, e.g. due to the proposed combination of credit losses and interest margins;
  - implemented by preparers. This is due, for example, to the need to design narrow portfolios in order to apply the EIR methodology proposed in accordance with the application guidance of the ED as well as maintaining the model. Moreover, the calculation of the EIR needs to precisely define the timing of the expected credit losses but no one can predict when the loss will occur as it depends primarily on the economic cycle; and
  - made reliable and relevant enough in practice given insufficient modelling capabilities.

For these reasons, the industry and the Basel Committee itself have been working to identify a number of sources of complexity as well as the conceptual issues. To address these shortcomings, the European Banking Federation has developed an alternative application of the concept of expected loss for impairment that it believes is conceptually superior, in line with the general objective of financial statements and consistent with the lending activity and credit risk management of financial institutions. This model captures actual losses more transparently and is also less procyclical than the current "incurred loss" approach. The model proposed by the industry is the *"Expected Loss over the Life of the Portfolio" ("ELLP")* model and is built around the following key principles:

1) The new impairment model should not change the current definition of amortised cost or the EIR calculation;
2) Expected losses in the context of the new impairment model should be determined on a portfolio level;
3) The methodology is based on the "expected loss over the life of each portfolio";
4) Impairment allowances are built up to be used, and are therefore not just buffers;
5) Impaired loans are treated as they are in the current IAS 39;
6) Impairment Allowances must be properly considered in the capital framework.

The Basel Committee has also identified a number of features which are in line with the industry proposal. The Committee is now working together with the industry to go over both proposals and determine whether one model can be created for expected loss. The NVB strongly supports these efforts and feels that creation of a single model is possible given the very few differences that exist.

Building buffers through capital conservation
We are also in favour of considering this concept and we understand the reasoning behind the introduction of dynamic buffering; banks should conserve their capital if their capital position falls below a certain level. This being said, we are afraid that the tricky part will be the operationalisation of these proposals into a framework that will work in practice.
As capital conservation is currently part of the banks' ICAAP process, the proposals will migrate part of these activities to pillar one. In that sense, there is a methodological mix-up of the two concepts. Given this contagion, we wonder why the proposals have been put forward. If a bank has a functioning capital planning and ICAAP process, which is complemented by a thorough SREP process, there should be no need to require dynamic buffering. After all, these buffers are already taken into account in the reservations that result from the ICAAP process. The proposed table of retention levels given a certain level of capitalisation is too much a 'one-size-fits-all' approach. Risk profiles and volatilities of capital requirements will differ according to the business model and local economics. This makes the current proposal too simplistic in our view, and we do not see who will benefit from it. We are positive about the statement in the consultation paper that states that the table is only an indication. We request that the Basel Committee add some discretion to the percentages, but are pleased that the concept of proportionality is recognised. Early intervention by regulators has our support, but the very conceptual nature of the text leaves too much room for interpretation. Regarding the conservation of capital, we assert that this mechanism needs to be set up in such a way that the regulator will not perform tasks that are the responsibility of the company's management, as long as the institution is financially healthy.

The proposal effectively establishes an add-on to the minimum required levels of capital established by the minimum capital ratios and it is not clear how the market will view these requirements. The capital conservation buffer should really become *buffer*, meaning that it can be drawn down on if necessary. The proposed additional standards restrict the capital management capability of the bank (e.g. dividend payments) even while the bank's capital exceeds that required by the minimum capital

ratios. Although BIS focuses on losses as the reason for the decreasing capital levels of a bank, the growth of the loan portfolio could also cause a decline in capital ratios, which would trigger the capital conservation-related restrictions. As the growth in loan portfolios supporting the investments in the economy are a prerequisite for economic recovery, the penalising effect of the capital conservation proposal may be undesirable. This may not only hold true for the banks, but also for the economy as a whole.

Excessive credit growth
With regard to this proposal, the consultation papers '*Strengthening the resilience of the banking sector*' and '*International framework for liquidity risk measurement, standards and monitoring*' put forward an array of new proposals that will raise the capital requirements substantially. This will already limit banks' ability to lend to the real economy and will dampen credit growth. Therefore, we feel that the goal of limiting credit growth may already be achieved by the other proposals, without addressing the issue specifically.