

Basel Committee on Banking Supervision  
Bank for International Settlements  
CH-4002 Basel, Switzerland

Transmitted via e-mail: [baselcommittee@bis.org](mailto:baselcommittee@bis.org)

16 April 2010

## **EAPB comments on the Basel Committee's consultation on "Strengthening the resilience of the banking sector" and "International framework for liquidity risk measurement, standards and monitoring"**

The EAPB appreciates the opportunity to comment on the two consultation papers "Strengthening the resilience of the banking sector" (CP 164) and "International framework for liquidity risk measurement, standards and monitoring" (CP 165). We would like to provide our response in the following. Before we comment on the changes presented in the two papers in detail, we would like to start with a few basic comments.

### **A. Comments on the paper "Strengthening the resilience of the banking sector"**

#### **General remarks**

The financial crisis has revealed structural and contentual deficits in supervising markets, stakeholders and financial products. We fully support the final resolution of the G20 that all financial markets, stakeholders and financial products shall be subject to adequate supervision. It is decisive though to put regulation in place where the financial crisis has actually made deficits and risk concentration obvious.

The approach of the international committees to put rigid but targeted regulation for those risk position of financial institutions in place, which caused the crisis, finds our approval. A mandatory retention of re-securitisations, higher capital requirements for the trading book and further standardising of the derivative markets are useful measures to avoid a potential future crisis. It is evident that also the risk and liquidity management of the financial institutions need a reform.

Taking into account all efforts currently discussed to tighten financial regulation, it appears that all elements of banking supervision will undergo a dramatic aggravation. Such a "regulatory overkill" will not only harm credit institutions but also enterprises in need of

loans at a time of economic upswing, where these enterprises are especially depending on the credit availability.

The current proposal for supervisory regulation are targeting own funds as well as risk positions in assets. The cause of the financial crisis is not the lack of quality of regulatory capital. Each alternation of equity positions of a financial institutions will show up on fully on the assets side through the leverage effect and subsequently influences the banks' lending capacity. In times of economic recovery, the lending capacity should by no means be restricted.

Since the impacts on the real economy are not fully foreseeable, all proposal must be evaluated. Without carrying out proper impact assessments, including the impacts on real economic of the planned measures, the new regulatory framework would be a hazardous manoeuvre.

One member suggests to apply an evolving *cap* to capital as a consequence, like for the implementation of the Basel II ratio in 2006 (application of *floors*), in order to limit a possible “cliff effect”. This would be of utmost importance for some specific elements of the resilience paper, detailed here after.

## **I. Executive summary**

### **(e) Addressing systemic risk and interconnectedness (subsection 46 –49)**

We strictly reject supervisory requirements for systemically relevant banks. Higher capital and liquidity requirements do not contribute to reduce systemic risk. Diverging rules rather constitute a market distortion. In order to avoid a complete extinction of systemically relevant institutes from the market, any mark up must not supersede a certain acceptable limit. However, this measure would not solve the so called “too big too fail” issue. The supervisory rule of “same business – same risk – same rule” should not be disregarded in this context. Therefore, we urge for capital and liquidity requirements which are determined solely on the basis of the risk of a bank and not in relation to its size or market position.

## **II. Strengthening the global capital framework**

### **1. Raising the quality, consistency and transparency of the capital base**

#### **Limits of recognition**

The majority of the tier 1 capital base should in the future consist of common equity (subsection 82). In the G20 Summit side letter, the Financial Stability Board proposed a range

of 50 to 85 %. The qualitative requirements for common equity and additional going concern capital instruments are already being sufficiently increased. In our view, an additional tightening of the recognition limits is therefore not required. In this respect, we expressly request that the current limit of a maximum of 50 % remain the same for additional going concern capital instruments. Otherwise, non-listed banks with no access to the capital market would be significantly disadvantaged. For these banks in particular, hybrid tier 1 capital is often the only way to raise tier 1 capital on the capital market.

## **Common equity – general**

The principle-orientated approach to the recognition to equity instruments proposed by the Basel Committee is to be welcomed in general. However, we cannot identify any objective reason why this approach should not also be applied to the recognition of common capital instruments. We categorically reject the planned unequal treatment of different forms of organisation, which will result in a deterioration in the situation for joint stock companies in comparison with non-joint stock companies with regards to the recognition of common equity. All capital instruments that fulfil the 14 criteria defined by the Basel Committee should be suitable for recognition as common equity for all banks, regardless of the form of organisation. The quality of an instrument must be the determining factor for classification as common equity, rather than the issuing bank's form of organisation. A limitation of the common equity to common shares and retained earnings would also make reorganisation measures in the banking sector significantly more difficult. For instance, if a bank were to change its legal form to an joint stock company, forms of capital which previously fulfilled the updated requirements for common equity would no longer be recognised.

Furthermore, there are many banks which are joint stock companies but which are not listed on the stock market and therefore only have a limited group of shareholders. Access to the capital market and consequently also access to common equity is not available to these banks through shares. This would lead to a clear competitive disadvantage in comparison with listed banks. It must therefore at the very least be ensured that other forms of capital in addition to common equity can also be recognised for non-listed joint stock companies.

## **Criteria governing inclusion in the Common Equity component of Tier 1 (subsection 87)**

### *5th criterion (level of distributions)*

We categorically reject the proposal that no cap is to be permitted and that the level of distributions cannot be linked to the amount paid in. A fixed or maximum interest payment will not have an influence on the quality of the equity as long as the distributions are subject to the sole discretion of the issuer and the payments are made on a non-cumulative basis. The required flexibility of the payments is already sufficiently guaranteed in this way.

## *7th criterion (preferential distribution)*

The criterion requires that no preferential distribution can take place, even in connection with other common tier 1 equity instruments. We do not understand the prohibition of a preferential distribution within the common tier 1 capital. As long as the loss participation of the instrument is secured by the fulfilment of the other criteria, we consider the rule regarding a preferential distribution to be completely pointless. The Basel Committee correctly refrained from defining the criteria for entitlement to vote in its catalogue of requirements. In the case of instruments with reduced investor rights, as in the case of a lack of voting rights, there must, however, be compensatory features. Otherwise such an instrument could no longer be placed on the market.

## *10th criterion (balance sheet classification)*

The criterion requires that the amount paid pursuant to the respective accounting standards be classified as equity. We have a fundamentally critical view of the link constructed here between the balance sheet and supervisory treatment. First of all, there are substantial differences between the various currently applied accounting standards such as IFRS or US-GAAP. These differences can lead to considerable market distortions when calculating benchmarks. Due to the growing importance of IFRS as an accounting standard, ability to comply with the criteria – and consequently the identification of those capital elements that can be used for supervisory purposes – has been increasingly placed in the hands of external standard-setters. In order to avoid dependence upon frequently amended accounting standards, we propose that the definition of common capital should not be linked to accounting standards.

## *11th criterion (direct issue)*

This requirement demands that the instrument is directly issued and paid-up. The requirement for direct issue clearly intends that it will no longer be possible to consider instruments that are issued through an SPV to be common tier 1 capital in the future. As long as only fully paid-up instruments are recognised and the principle of effective raising of capital is sufficiently fulfilled, the channel of distribution is irrelevant from our point of view.

The requirement that only direct issues represent common tier 1 capital also limits European banks, as instruments held by little known European banks would barely have a chance on the international capital market. In our opinion, this requirement represents a clear competitive advantage for all well known banks in the international capital market. Against this background we are expressly in favour of indirectly issued instruments being recognised as well.

## *14th criterion (disclosure on balance sheet)*

The criteria requests that the instrument be clearly and separately disclosed on the balance sheet. In this respect we refer to our explanations regarding the 10th criteria and propose a deletion of the requirement with no replacement.

## **Criteria for inclusion in Tier 1 Additional Going Concern Capital (subsection 88)**

Subsection 76 states that the Basel Committee will separately assess the categorisation of instruments with tax-deductible coupons within the scope of the impact assessment. We would like to draw attention to the fact that the tax categorisation is not a decisive factor for the quality of an instrument. Tax aspects should therefore not be relevant in any way to the supervisory recognition of capital instruments.

## *4th criterion (perpetual)*

According to this criterion the instrument should be perpetual, i.e. there is neither a maturity date nor an incentive to redeem. These requirements are a clear tightening of the criteria for additional going concern capital instruments that were recently revised in the CRD. According to these, instruments with an original maturity of 30 years and innovative instruments can be recognised for up to 15 % of Tier 1. With regards to the provision of funds, obtaining fixed coupon investors is also of central importance to banks. However, a foreseeable maturity is particularly important for fixed coupon investors.

As the repayment of instruments according to the sixth requirement is subject to supervisory approval, we consider the agreement of incentives to redeem and a limited maturity to be innocuous. Instead, ensuring that the capital is effectively available, in particular for the purpose of covering possible losses, should be the decisive factor. We therefore request that this comply with the European regulations. In our opinion, the European provision, according to which these instruments can only be offset up to a limit of 15 %, is a good compromise between the needs of the investors for flexibility and the supervisory capital preservation interests.

## *7th criterion (definition of payments)*

According to this criterion, the payments should be developed in such a way that the bank has full discretion to cancel distributions at any time. We consider the requirement that coupon payments must be subject to such full discretion to be a step too far for additional going concern capital instruments and therefore request that this criterion be deleted. Instead, the usual profit test approach should be used. This entails that either a sufficient annual surplus or a sufficient balance sheet profit must be present for distributions to take

place. These requirements are to some extent combined with the requirement for a supervisory capital base. If banks had full discretion at all times regarding the distributions, the instruments would be more comparable in nature to shares and would no longer be purchased by fixed coupon investors or would only be acquired with a high surcharge.

## *9th criterion (credit-related features for payments)*

According to this criterion, instruments should not have any credit-related features for the payment of distributions, i.e. the payments must not depend on the creditworthiness of the bank. These requirements should not, however, apply to instruments where regular revision of the interest rate takes place after the fixed rate period has ended, with the rate being established on the basis of the current creditworthiness of the bank.

## *11th criterion (mechanisms for loss participation)*

The regulations for write-down mechanisms are unclear with regards to the appreciation of the capital. We have interpreted the proposal of the Basel Committee to mean that only a permanent write-down is intended for the nominal amount. However, this would place additional going concern capital investors in a disadvantaged position in comparison to shareholders. In times when the economic situation of the issuers has recovered, shareholders will be able to participate in the success of the company but the hybrid capital investors will not. There should therefore be an option to write-down temporarily, whereby it is possible to completely write up the capital.

## *12th Criterion (purchase of the instrument by the bank)*

The criterion requires that neither the bank nor a company associated with the bank is permitted to purchase the instrument. We assume that the intention of this requirement is to prevent such instruments from being allowable in the sense of the principle of effective raising of capital. The criteria should not, however, conflict with market making regulations. We therefore ask for clarification as to whether the intention of this criterion is merely to ensure that effective capital inflow from a third party can take place and that circumvention has been ruled out. It must be ensured that market making is permitted within certain limits if treasury stock is being deducted when determining capital (see subsection 100).

## **Criteria for inclusion in Tier 2 (gone concern capital) (subsection 90)**

We welcome the deletion of the cap limit for tier 2 capital.

In subsection 92, the Basel Committee requests feedback on whether additional safeguards, such as the specification of a lock-in mechanism, are necessary to ensure that the tier 2

capital does not need to be repaid in times of stress. Such an addition would result in a further tightening of the requirements for tier 2 capital. In particular with regards to the future function of tier 2 capital, we do not consider there to be any justification for the creation of further conditions.

#### *4th criterion (maturity, recognition, repayment incentives)*

Similar to our statements regarding additional going concern capital instruments, we also support the option of creating an incentive to repay in the case of tier 2 capital elements.

#### *5th criterion (exercising calls)*

According to this criterion, the instrument is not callable on the initiative of the issuer before a minimum of 5 years has elapsed. The call option must also receive prior supervisory authorisation. The bank are only permitted to make a call if (i) they replace the called instrument with capital of the same or better quality or (ii) the bank demonstrates that its capital position is well above the minimum capital requirements after the call option has been exercised. Supervisory approval and the fulfilment of specific conditions are no doubt necessary for Tier 1 capital. However, we consider this requirement to be clearly excessive for tier 2 capital. We therefore propose the deletion of the 5th criterion with no replacement.

### **Regulatory adjustments applied to regulatory capital (subsection 93)**

We would like to state that we cannot understand the proposal of the Basel Committee that the regulatory adjustments must generally be applied to core Tier 1 capital (subsection 69). In our opinion, regulatory adjustments should continue to be deducted in equal proportions from tier 1 and tier 2 capital or from the overall capital in the future.

### **Minority Interests (subsection 95)**

We categorically reject the proposal that minority interests should no longer be included in full consolidation. Full consolidation is traditionally a concept involving the summary of capital resources for banking supervision purposes, which is characterised by the fact that the group is allocated 100 % of the risks but also 100 % of the equity capital in the case of subordinated companies in which the group does not have full ownership. As a result of the new regulation, equity capital and risk positions would be handled asymmetrically in future. We cannot understand why the “risk consolidation and “capital consolidation” should be separated. As long as the group effectively has shared control over the minority shares on the basis of the majority holding, these minority shares are also freely available for the absorption of loss at the group level. Otherwise, it would logically follow that the weighted risk assets of the minority shares are only proportionally evaluated.

In any case, there must be an exemption when dealing with minority interests for operative companies that are part of a group. In the case of an “overcapitalisation”, consideration could also be given to whether or not to allocate minimum interests to the core tier 1 capital that are not required to cover the risk assets of the subordinated companies.

## **Unrealised gains and losses on debt instruments, loans and receivables, equities, own use properties and investment properties (subsection 96)**

When IFRS were put in place, regulators created a series of prudential filters that “managed” the impact of the accounting standards on the solvency ratio and limited the volatility of own funds. As a matter of fact, unrealized gains as well as losses are less stable components of accounting own funds and should not be included in the regulatory common equity. In any case we advocate the same treatment for unrealised gains and losses. If unrealised losses will be fully deducted from core Tier 1 capital in the future, also unrealised gains should be fully accountable for the core Tier 1 capital. It is not acceptable that there is a filter only on the gain side (as outlined in footnote 17).

In this context, banks should be allowed to benefit from a transition period of 5 years, during which no prudential filter would be abolished. This would also avoid any possible arbitrage with regards to the date of implementation of IFRS 9 by banks (some may want to consider to adopt IFRS 9 as soon as possible to eliminate all unrealized losses from their balance sheet, other may want to do the opposite when accounting for unrealized gains). As such, it would smooth the shocks created by the successive implementation of Basel III and IFRS 9 in bank’s ratio, as well as improving comparability across banks during this transition period.

## **Deferred tax assets (subsection 98f.)**

We categorically reject the deduction of active deferred taxes for the following reasons.

- The reduction of deferred taxes for the regulatory equity capital is not necessary, as their recoverability is proven before they are activated.
- Active deferred taxes perhaps do not provide any cash flow – but they reduce the funds paid for actual taxes. Furthermore, accumulated deficits and active deferred taxes can be completely realised on this basis if a suitable fiscal strategy is used.
- A reduction of active deferred taxes can only be considered to the extent that they exceed the passive deferred taxes (if applicable, taking “maturity” into consideration). In the sense of equal treatment with American banks, the balancing should be “decoupled” from the requirements of the IAS 12 – i.e. balancing should be possible across the entire company irrespective of the tax jurisdictions (Single Jurisdiction Presumption).

- If active deferred tax assets remain unconsidered in the case of unrealised losses, the regulatory capital resources will be reduced at the full level of the loss. In the case of unrealised profits, passive deferred taxes are created which will, however, result in a reduction of the capital. This will intensify possible crises.
- The level of the deferred taxes is codetermined by national fiscal law. A reduction of deferred taxes could result in a reaction from national fiscal law, e.g. the development of special regulations for tax carryover at banks (in particular if the US regulation of hypothetical tax carryovers were to be adopted).
- We remind that these assets are, under IFRS, subject to strict rules in order to be recognized on the balance sheet and under the control of the company's auditors. Hence, in our view, it is legitimate to consider these as own funds. If not, a deduction of these DTA would decrease the own funds more at the moment of a downturn cycle of the economy and would as such increase the pro-cyclicality of the measures. In line with our above proposed treatment for the unrealized gains and losses, we propose not to deduct the DTA booked in relation to these unrealized gains and losses from own funds either. Again, if it would not be the case, it would imply a higher volatility in own funds.

## **Investments in the capital of certain banking, financial and insurance entities which are outside the regulatory scope of consolidation (subsection 101)**

The Basel Committee proposes that, when dealing with non-consolidated investments within the financial sector, a corresponding deduction should be made from the respective equity category for which the capital would be qualified if it was issued by the bank. However, it should be noted that the formulation used in subsection 10 – “holdings of common stock” does not cover additional going-concern capital and tier 2 capital investments. A clarification is needed here as to how investments in the form of additional going-concern capital and tier 2 capital are to be handled.

In particular in the case of holdings within the financial sector with an amount of holding of up to 10 %, the fundamental grounds for assessment to be applied are unclear with regards to the equity category of the bank that should be used. We propose that the entire equity of the bank be used as the basis for assessing the upper limit (10 % of the bank's equity). Furthermore, as with the current regulation, the gross assessment basis, i.e. the capital before deduction of all deduction positions, should be used.

We also reject the planned review of index securities to determine the nonconsolidated investments within the financial sector. This would lead to increased implementation costs for banks.

The proposed regulation of the Basel Committee does not clearly state whether this mandatory deduction is applicable only for direct or indirect interests. If this is only applicable to indirect interests, it must be made clear until which level (subsidiary, etc.) the

credit institutions have to look through. If such a regime needs to be applied also to very minor interests it would cause substantial additional efforts without yielding prudential gains. We therefore advocate an application of this proposed regulation only on direct interests.

## **Remaining 50:50 deductions (subsection 108)**

The banks' existing right to choose between a capital deduction and a setting-off with a risk weighting of 1250 % for securitisations should be maintained at the very least for the remaining half of the deduction positions.

## **Transparency requirements (subsection 80, 81 and 109)**

In general we feel that an extension of the transparency requirements will contribute to an improved information basis. We also would like to point out that too much information could lead to an overload on the addressee's side. Furthermore, also competition aspects has to be taken into account when improving the information basis. Hence, the disclosure requirements as laid out in subsection 80 and 81 shall be restricted to essential information only.

Subsection 80, 1 paragraph: Since regulatory and accounting equity generally differ and since there are differences in equity according to the respective accounting standards, we do not consider a complete reconciliation of the regulatory equity to the accounting equity as useful. Also, this entails a considerable amount of effort for the financial institution whereas the value added of this measure cannot be clearly seen.

Subsection 80, 2 paragraph: For information efficiency reason only substantial regulatory adjustments shall be indicated. A disclosure of all adjustments would quickly develop into an information overflow and blur the view for the actually important changes. Paragraph 80 prescribes required disclosures to improve transparency, e.g. a full reconciliation of regulatory capital elements back to the audited financial statements. If market stakeholders do feel the need for this information, it will be proactively requested. A full reconciliation of accounts is extremely difficult to apply in practice because the consolidation scopes are different in accounting and regulatory frameworks (some companies – insurance companies for instance – are equity accounted). This reconciliation would be very costly and very difficult (if not impossible) to put in place. And, due to its complexity, it could lead to undesired side-effects, like misjudgements by the market participants with potential collateral damage.

Subsection 81: The disclosure of all conditions and requirements of own funds will lead to an information overflow, which would rather blur the view than improve transparency. Furthermore, in many cases some information is competitively sensitive and its disclosure could be misunderstood as an offer under the prospectus-law. There could emerge a number of questions in relation to the prospectus law in this regard, which implications we cannot assess yet. Above all, there is a danger that disclosure of conditions and requirements might collide with private law contracts. This might result in legal questions we would like to avoid. Therefore, we strictly reject the disclosure of conditions and requirements of all equity components.

## **Grandfathering clauses and transitional provisions**

When introducing new equity capital regulations, there must be a sufficient number of grandfather clauses and transitional deadlines to avoid putting the capital base of the banks at risk and to therefore prevent delays in the provision of credit. The transitional regulations should span a minimum of 30 years in total and must on no account annul existing national and European grandfather regulations. It is particularly important that it is not mandatory to exercise the option of terminating instruments when their regulatory approval has changed (regulatory call). A termination and the associated reduction of equity must be feasible for the bank.

Furthermore, the transitional regulations must in no way relate to those capital instruments which were issued before the release of the consultation paper (subsection 84) and should only apply to those instruments that were issued before the new regulations came into force.

## **Leverage Ratio (subsection 202 f.)**

We reject the concept of a leverage ratio because we do not think that this additional requirement is consistent with the risk-sensitive approach under Basel II. The capital requirements under Basel II require rightly to compare a parameter of potential economic loss (sum of risk weighted positions) calculated according to supervisory standards with a parameter suitable to cover for loss (own funds). Orienting towards a capital adequacy ratio in relation to nominal asset side will lead to a preference for higher risk activities in case the leverage ratio has a limiting effect. It cannot be the intention of the regulators though that inherent risk of certain businesses are neglected.

If the limit for the leverage ratio will be set tighter than that of the own funds, it would curtail the lending ability much more than the proposed capital requirements. In our view, the leverage ratio should be at the utmost a Pillar 2 benchmark as part of the supervisory review process.

Banks with special business models (promotional banks, funding agencies, private bankers, guarantee banks compared with other deposit banks) have different refinancing structures. For example, if deposits are defined as a major business segment, this will lead to a higher leverage ratio. Also, different types of access to external equity funding normally leads to varied capital resources. Certain business models would be harmed by the introduction of a leverage ratio. In particular institutions which are active mainly in providing financing to the public sector. The rationale behind government funding agencies and other institutions providing finance for the public sector is typically to utilize the accumulated funding needs of the sector to achieve a stable, diversified and cost efficient funding base. The size of the combined funding needs will allow institutions to enter markets that are not within reach for any single client, and through access to a broader funding base be better enabled to efficiently fund essential services to the end public sector client through the economic cycles.

Promotional banks would be affected in a similar way. Their business is competitively neutral and low-risk and their business model has stood the test especially during the financial crisis. Thanks to their product offer they help absorbing the economic downturn and stimulating the upturn. The introduction of a leverage ratio would heavily hinder promotional banks in their role. Loans granted by promotional banks are funded partly by programmes of public investment and partly their own resources. Clients who currently meet the conditions for receiving such loans would no longer be able to benefit from these, after the introduction of a leverage ratio. Thus the economic development instrument of promotional banks would be heavily restrained.

As borrowers, the European public sectors are associated with very few, if any, defaults. This has enabled the local government funding agencies to operate under the Basle I and II regimes with an equity base tailored to suit its low default counterparties, a feature that has ensured that the public sector could reap the benefits of their ability to consistently make timely payments directly through lower financing cost through their access to efficiently capitalized specialized lenders.

The possible introduction of a leverage ratio will force many government funding agencies to significantly increase their equity capital, a measure that is bound to increase the funding cost for the public sector borrowers, as the government funding agencies will be facing a higher total cost of capital. Facing an increased cost of capital, institutions can typically either try to pass on the extra cost to their existing customers or shift their focus towards riskier assets classes that offers a higher return on capital. The latter choice will not be a viable option for government funding agencies, as they usually operate under clearly defined guidelines limiting their customer base to public sector customers within their domicile country, thus leaving them with no other option than increasing own funds, thereby increasing funding costs and finally leading to more expensive financing for the public sector.

The problem concerns not only special banks, but also universal banks with the same business portfolio. There would be an unverified disadvantage for banks within a network which take the function of a central bank. The function of liquidity equalisation in a network leads to a build-up of loans or liabilities towards associated companies (balance extension) and therefore, this will lead to a higher leverage ratio. Hence, even if the ratio is a Pillar 2 benchmark as part of the supervisory review process, the validity of the leverage ratio for national and international comparisons of banks would be very limited.

Apart from our general concerns, we take the view that a single leverage ratio should not be introduced for all banks and business models. A “one fits all” solution can never capture the differences of the various business models of banks and leads to more distortion of competition.

The extend of the leverage ratio also depends on the underlying accounting standard. It would vary extensively according to the respective standard that had been applied (e.g. US-GAAP, IFRS or National GAAP). A harmonisation of the rules for netting would eliminate only one source of differences. Distortion of competition can be only eliminated if the various accounting standards converge (especially IFRS and US-GAAP). We consider this to be difficult to achieve, however it is an inevitable precondition also for the disclosure of the leverage ratio in the international context. Therefore, we clearly reject a disclosure of this indicator in Pillar 3.

We would like to point out the interdependency with the Basel consultation “International Framework for Liquidity, Risk Measurement, Standards and Monitoring” and the respective liquidity requirements. The proposed definition of “high quality liquid assets” for government bonds will lead to the fact that the leverage ratio will be taken up to a large extend already by fulfilling this requirement instead of providing loans. We therefore urge for an exemption of the liquidity reserve that is held to fulfil the requirement of “high quality liquid assets” from the leverage ratio.

The Basel Committee intends to eliminate the pitfalls revealed by the financial crisis through a various reviews and aggravation of the risk-based Basel II standards in the area of market risk models or securitisations. We support this approach. The review of Basel II in the above mentioned area will lead to better internal models for risk evaluation.

Subsection 208:

In our view, the total sum of Tier 1 capital before adjustments shall be used as the assessment basis since the total Tier 1 capital is “going concern” capital and the leverage ratio aims at limiting the debt capital ratio.

Subsection 218, 219:

So called „cash-like“ instruments will fully considered in the baseline proposal whereas the alternative option allows for “zero weighting”. Since there are interdependencies with the liquidity standards we opt for “zero weighting” of the instruments.

We plead for a uniform definition of cash-like instruments in the case of the leverage ratio as well as in the case of high quality liquid assets when determining the liquidity standards.

Subsection 233:

We do not support the inclusion of off-balance sheet elements in the exposure measure of the ratio at a 100% conversion factor. Here it is assumed that all off-balance-sheet liabilities are utilized to the conceded extent. Hence, the fully addition of off-balance-sheet liabilities does not differ from the actually utilized credit, which is not understandable from a risk based point of view. Off-balance sheet elements should be included by using their conversion factor. In any case, we strongly advocate for the non inclusion of interest rate derivatives and “European portfolio hedge” derivatives since they are never exchanged at the notional amount. The notional amount does not represent a true and fair view of the leverage exposure of the bank on these elements.

Since the leverage ratio is intended to complement the risk-weighted indicators in Pillar 1, we plead for conversion factors, which are the same for capital requirements and the leverage ratio.

## **2. Risk coverage**

### **Counterparty credit risk**

We deem the proposal of calculating the capital charge for counterparty credit risks in general as too conservative. As a consequence of the parallel tightening of several calculatory components (e. g. CVA, Margin period of risk), institutions which use an internal model must apply regulatory parameters that could considerably conflict with their economic risk management. Model results could not be proper interpreted anymore.

We are afraid that this would result in a clear divergence arising between the internal exposure calculation and the regulatory capital calculation. The processes used for the regulatory calculation of equity would ultimately be used as a “model shell”, but would no longer concur within the internal calculation of risk control. We are highly critical of this development.

This is also essential in relation to compliance with the use test-requirements. Institutions should be allowed to use others than the regulatory parameters for internal risk management purposes to meet the regulatory requirements as well as those of the economic management.

## Subsection 118 – 122

The calculation of the stress-EPE means a significant effort for modelling and calibration. We are critical of this additional effort which is only based on a regulatory motivation while the institutions do not benefit from it in their economic exposure calculation – which is particularly relevant for the daily surveillance of the limits.

Furthermore, the concept of the stress-EPE-calculation raises further questions concerning the implementation. It remains unanswered, for example, how drift- or mean-reversion-parameters should be taken into account using such an approach.

The simulation via EPE-models is also typically based on using the forward-curve. The consultation paper does not comment whether the current forward-curve or historical data should be used. A clarification is needed in this respect.

It should also be taken into account that the required calculation with stressed parameters is associated with considerable costs. In addition to the economic exposure calculation, which is also used to monitor limits on a daily basis, a second EPE calculation needs to be made with regulatory parameters. Now a third stress EPE calculation would also be required.

## Subsection 123 – 125

The scope of these provisions is unclear and it needs to be clarified which institutions will be affected. We understand that the proposed requirements do not apply for institutions which use the standardized approach for credit risk and waive using internal models for purposes of the trading book.

We assume that CVA is an accounting definition (depending on the rating of the counterparty, the spread used, and other parameters which vary over time) used to adjust the market value of a derivative instruments to reflect the counterparty creditworthiness. Indeed, CVA is computed as an economic expected loss for the credit risk. Industry practices are still very different thus we advocate that supervisory authorities should take into account the CVA framework and its management (banking or trading) in place for each bank. Especially advanced institutes should be allowed to alternatively use an eligible internal model.

The regulatory capital charge should depend on management intent of the CVA position. Especially, in the case of banking book management intent we are of the opinion that counterparty credit risk is already entirely covered by the internal models of the bank which reflect the management view on this risk type. In this way, the proposed capital add on (in the supervisors' view) would imply a double impact, indeed the amount of CVA is not recognized as a deduction in the calculation of the counterparty risk capital charge.

If a default occurs the CVA is available to cover the loss partly or at large. For the part of the loss covered by CVA provision it is unnecessary to provide a capital charge.

The bonds equivalent approach does not properly represent the CVAs sensitivities to market risk factors. Some assumptions of this method are too conservatives:

- Maturity: The maturity has been chosen conservatively as the longest effective maturity of all master netting agreements of a counterparty. Institutions often only have a few master netting agreements with a long maturity (several decades) which are not representative for the average maturity. The CVA-risk of change would be significantly overestimated. It is not clear to us why a holding period of one year is required. It should also be taken into account that the risks to be considered do not involve non-payment risks in the classical sense, but risks resulting from the change of market parameters
- One year horizon: The requirement that equivalent market risk capital must be calculated from the total of VaR and stress VaR, and that diversification with other market risk provisions should be ignored has already resulted in a conservative calculation method. The additional requirement of scaling with factor 5 is disproportionally conservative and conceptually unfounded in comparison with other market price risks.

With this approach the impact is totally disproportionate with the risk involved, and leads, as mentioned above, to double counting with already existing methodologies to identify counterparty risk.

We support that further analysis should be conducted in order to ensure that the approach gives a reasonable reflection of the true risks related to counterparty defaults.

Subsection 126 – 131

The proposed process for the management of special correlation risks provides a first approach for risk identification and initial risk monitoring. However, we consider them to be too far reaching and undifferentiated to form the basis for the calculation the regulatory capital charge. At this time it would be more appropriate to take it into account within Pillar 2.

## Subsection 135 – 140

We oppose the intended increase of the capital requirements of app. 30 % for the counterparty credit risk positions for banks and insurances with a balance sheet total larger than 25 Billion USD. Since the capital function is derived from an one-factor-model, the asset value correlation is the only parameter whose variation can be used within this function to determine an increase of the capital set aside to cover losses arising from credit risk. We cannot agree to the suggested adaption of the capital function without a thorough analyses of the correlation between „financial firms“ that would justify the application of a multiplicative factor of 1,25.

In subsection 140 of the consultation paper the Basel Committee furthermore asks for comments on the general asset value correlation level. In this context we suggest to consequently recalibrate the asset value correlations of the other asset classes through a general backtesting. There is evidence that the contribution of the classical credit business to the systemic risk is much lower than so far assumed (and calibrated in the Basel framework). We suggest a recalibration of the asset value correlation factors in all asset classes through the supervision within the scope of the evaluation of the QIS.

## Subsection 140

We suggest the following definition for unregulated financial institutions: „Unregulated financial institutions are institutions which, independent of their legal form, commercially buy and sell financial instruments and are not subject of a specific financial supervision.“ (definition according to § 1 Abs. 11 KWG; note from the author)

## Subsection 141 – 149

We are very critical of the proposals in this section. We consider it to be excessive that conservative assumptions have been made for all aspects of the modelling. We in particular consider it to be excessive that the capital requirements are to be determined on the basis of these cumulative worst case considerations. It should be taken into consideration that several factors have already been implemented for general modelling uncertainties (e.g. the application of the alpha factor and effective EPE as a non-decreasing exposure function). In this respect, the stated aspects should be included as a requirement in a stress test concept but should not have a direct effect on the capital.

## Subsection 150 – 153

The motivation for the suggestions is understandable but several questions remain unanswered. It is unclear why the number of transactions should be crucial for the

calculation of the risk horizon. A transaction with a high volume can carry more risk than 5,000 small transactions. Taking the number of transactions as the basis of regulatory requirements rather leaves the impression that the operational risk should be calculated. Moreover, the randomised limitation could incentivise to only trade as many transactions under a specific collateral contract that the increased risk horizons do not apply. Repeated exceedings or shortfalls of this limitation would cause unwelcomed leaps in the exposure- and RWA-calculations. It is also doubtful that large portfolios would more often lead to controversies with the contract partners. Disagreements are more likely based on the content of the transactions rather than on their number.

## Central counterparties

We support a credit exposure of zero when calculating the capital requirements for counterparty credit risks of derivatives, which have been concluded via a central counterparty.

We welcome the initiative of the Committee on Payment and Settlement Systems (CPSS) and the International Organization of Securities Commissions (IOSCO) to develop high quality requirements for CCPs. In this context we would like to mention that it cannot be the task of the credit industry to ensure the compliance of CCPs. The supervisory authority should publish a respective list.

At the same time we would like to stress that more stringent requirements for CCPs will incur higher “cost of usage”, such as e.g. higher margins. The resulting additional costs need to be analyzed in more detail. The “price of safety” shall not exceed the potential savings from actually using CCPs.

We also would like to stress that not all derivatives are suitable for CCP clearing.

## Subsection 171 – 176

The implementation of the suggested regulatory amendments necessitates the availability of extremely comprehensive data histories and would generate an enormous implementation cost. With respect to stress testing, specifically the reverse stress testing, the multitude of different scenarios as well as the parallel stressing of the counterparty’s exposure and the credit rating need to be pointed out.

## Procyclicality

## Subsection 243 – 244

First of all, we need to indicate that we have difficulties to fully comprehend (i) the way the different measures proposed (risk and accounting) will interact with each other and, (ii) whether and how this package of measures will have truly countercyclical effects.

We would strongly advocate that the conclusions on the forward looking provisioning could take into account the following principles:

- a) There should be **no double charges built in own funds and accounting**;
- b) **The accounting and risk framework should be fully complementary** and kept as straightforward as possible.

## Expected cash flow model IASB

We are not in favour of the expected cash flow model as proposed by the IASB. While we agree with the principle of an expected loss approach instead of an incurred loss approach, the proposed model is in our view too complex. Furthermore, we strongly believe that institutions should have the possibility to align the features of the accounting model as closely as possible with the Basel II requirements. In other words, we defend a maximum reconciliation with Basel II requirements. This is based upon two principles: (i) on capital level: no double charges in own funds and accounting and (ii) on operational level: being able to use to a maximum extent the portfolio management followed for risk purposes in order to reduce implementation costs.

We advocate also that any excess in provisioning could be included in the regulatory capital.

## Subsection 247 – 262

The Basel II framework has already introduced a number of safeguards in order to limit procyclicality, the main safeguards here are the PD through the cycle and the downturn LGD. We note that the procyclicality of the Basel II is not proved in current data.

We support the provisioning based on an EL model based on Basel II parameters, but fail to understand how the provisioning model interacts with the EL model as developed by the IASB.

**Irrespective of this, we advocate that the counter-cyclical capital buffer should be included in Pillar 2 and not in Pillar 1.** Therefore, we want to underline the following points:

- a) We advocate strongly that the downturn PD should never be implemented in Pillar 1 since this PD will not meet the use test requirement and will require to run a double process. In addition, PDs are already stressed in the IRBA formula, i.e. the 99.9% confidence interval. This measure might be considered in the stress test process in the scope of Pillar 2.

- b) A capital buffer through capital conservation will disadvantage the banking sector and can be considered as an additional capital requirement above the minimum capital requirement.

## **B. Comments on the paper “International framework for liquidity risk measurement, standards and monitoring”**

In principle, we welcome the intention of the Basel Committee to modernise and internationally standardise the regulatory treatment of liquidity. The suggested indicators “Liquidity Coverage Ratio” (LCR) and “Net Stable Funding Ratio” (NSFR) represent a concept which is in principle suitable for this purpose. However, with regards to the details of these indicators, we think there is still enormous need for change.

We would first of all suggest that, to assess their liquidity risk, banks should also be able to use internal procedures for the measurement and management of liquidity risk as an alternative to the indicators suggested by the Basel Committee. In recent decades, the use of internal procedures has justifiably played an increasingly important role in banking supervision, in particular with regards to market and credit risk. By using internal procedures, special features of banks’ business models and the resulting individual risks could be captured in a more effective way than by a standardised approach. Suitable minimum qualitative and quantitative requirements should be developed together with banks for the supervisory application of such procedures. This would further improve the quality of liquidity risk management.

We are particularly critical of the clear preference for government-issued securities in the formation of the liquidity buffer for the **liquidity coverage ratio**. Relying solely on top-quality government securities would worsen the funding conditions of private companies in the capital market and weaken the profitability of the banks. This would in particular lead to an increase in the cost of corporate financing.

According to subsection 34 lit. (c), it should be possible to include marketable bonds issued by public bodies with excellent creditworthiness in the liquidity buffer. This appears to be appropriate in principle. However, the Committee’s reluctance to recognise other bonds results in a clear preference for government bonds, which will lead to considerable problems. First of all, it raises the question of whether there are sufficient quantities of such securities available in the market to cover the liquidity needs of all banks. Even if this were the case, relative prices in the capital market would change significantly to the disadvantage of the private sector. We regard this as a questionable signal in a market economy. Furthermore, the preference for government bonds would also have significant negative effects on the profitability of banks. They would namely be forced into relatively non-

lucrative investments on the assets side. At the same time, funding costs for banks would increase on the liabilities side. It must therefore be ensured that further assets can be included in the liquidity reserve in addition to government bonds, as long as it would be possible to generate sufficient liquidity from these assets in stress situations. Also, this narrow definition of liquid assets may also have an impact on the real economy in times of crisis since all demand will focus on this type of assets. We fear this will create a distortion in markets.

Also, the significant widening of credit spreads which has recently been observed in the case of Greek government bonds, for instance, indicates that even high-quality government bonds have a credit risk. We therefore believe that banks urgently need to be permitted a widely diversified liquidity reserve. For this purpose, it will be necessary to significantly expand the group of assets which can be included in the liquidity reserve.

According to subsection 34 lit. (c) (iii) only marketable securities issued by public bodies with a rating of at least AA- can be included in the liquidity buffer. Since the Basel Committee is contemplating the inclusion of covered bonds and corporate bonds with a rating of at least A- bonds issued by public bodies with a corresponding rating should be included in the liquidity buffer as well. We suggest a haircut of 20 % for these securities.

The main features of high quality liquid assets are listed in subsection 29. The requirement in the third bullet point states that the assets should have a low correlation with the general market risk (wrong-way risk). In this regard it is assumed that bank bonds are highly likely to become illiquid during a crisis in the banking sector. Presumably this is the reason why, according to subsection 34 lit (c) (iii), bank bonds cannot even be included in the liquidity reserve if they are guaranteed by a government body. This discrimination against state-guaranteed bank bonds compared to other bonds with a state guarantee is incomprehensible in our view. Government-guaranteed bank bonds have a risk profile which is comparable with government securities and high liquidity. This is also indicated by the fact that, after the issuance of bank bonds almost came to a halt in the financial crisis, government guaranteed bonds issued within the scope of national rescue packages represented the first bank issues, even before covered bonds. It should therefore be possible to include these bonds in the liquidity reserve with no limits, as long as the conditions in lit. (c) (i) and (iii) are fulfilled.

On the basis of their limited scope of business and a comprehensive guarantee (guarantor's liability) a Federal state, we believe that bonds issued by government development banks in particular should be permitted for inclusion in the liquidity reserve. These banks are acting on behalf of the government and are not aiming to maximise profits. Receivables in these banks therefore represent a risk comparable to that of their sponsors. This is clear from both the low risk premiums of these papers and their treatment in the field of prudential regulation. Here, the risk weighting of sponsors can be applied to receivables of

development banks in the standard approach to credit risk. Development banks have not had any refinancing difficulties even during the financial crisis.

Following the same reasoning unsecured debt from public sector banks with full government ownership but without a comprehensive guarantee should be included in the liquidity reserve. These unsecured issuances have performed in the financial crisis in line with bonds issued by government development banks with a comprehensive guarantee and bank bonds with a state guarantee.

The Basel Committee is currently assessing whether and to what extent company bonds and covered bonds can be included in the liquidity reserve. We definitely support the inclusion of these securities. The application of high-quality government bonds alone would have general negative effects on refinancing conditions in the private sector as outlined above and in particular on the earnings situation of banks.

However, we consider the criteria suggested for the inclusion of these securities to be impractical with regards to the characteristics of the markets in which these bonds are traded (subsection 36 and 37, 4th and 5th bullet points). The requirement that the securities must to be traded in a large, deep and active market with a low level of "concentration" is not operational. The required 10-year data history for the bid-ask-yield spread is only likely to be available in isolated cases. This also applies to the required data history with regards to the negative market value fluctuations. It would be completely unreasonable for the papers to remain excluded from the liquidity reserve until the required data history had been obtained.

For the above reasons, the creditworthiness of the issuers and the central bank eligibility of the securities should be the decisive criteria for including these bonds in the liquidity buffer.

From our point of view it is not reasonable to exclude covered bonds issued by the bank itself from the liquidity buffer. These bonds are not of lesser liquidity value when held by the issuer than by any other bank.

We also consider it to be of great importance that the criteria for the inclusion of assets in the liquidity buffer only need to be fulfilled when they are acquired. If the criteria – in particular those relating to quality and market liquidity – were to be complied with at all times, this would result in the removal of certain bonds from the liquidity reserve in the event of a temporary loss of trust in this firm. This would consequently reduce the liquidity of the security, as banks would try to sell this security. Ultimately, the regulatory

requirements would aggravate the effects of a crisis, as established by the Bank for International Settlements in its Working Paper no. 293.<sup>1</sup>

However, the Basel Committee has suggested that these assets should make up no more than 50 percent of the liquidity. This limit appears to be arbitrary. As the liquidity reserve conversely needs to consist of at least 50 percent cash or government bonds, the limit could also prevent the banks from diversifying to the extent required. The 50 percent limit should therefore be removed.

Due to strict legal requirements, German or Austrian covered bonds (“Pfandbriefe”) are of excellent quality and therefore have good market liquidity. In our opinion, the suggested haircut of 20 percent does not seem reasonable. It should therefore be possible to include bonds with a rating of at least AA in the liquidity reserve without a haircut. In the case of these financial instruments, banks should also be permitted to hold their own issues in the liquidity reserve.

From our point of view, unsecured bank bonds have similar risk characteristics to those of unsecured corporate bonds outside of the financial sector. The financial crisis has shown that the bilateral repo market has worked for these securities. For this reason, they should be included in the liquidity reserve under the same conditions as corporate bonds. The complete exclusion of bank bonds from the liquidity reserve as envisioned by the Basel Committee would, in our opinion, prevent banks with short-term liquidity surpluses from transferring these to banks which are looking for long-term liquidity. This in turn would have a negative effect on the liquidity situation of banks in general.

The suggestion of the Basel Committee is apparently based on the belief that banks need to secure their liquidity, even in the case of stress, without central bank transactions. The implied assumption that central banks provide no liquidity at all in such circumstances is completely unfounded. Even in normal times, business banks can obtain liquidity from the central banks through various instruments. The current crisis has shown that central banks have in fact provided additional liquidity for the market during such stress periods. Naturally, banks should not assume in their planning that the central banks will provide additional facilities in a crisis. However, it can at least be presumed that they will not limit the refinancing options of banks in such a situation. Allowances should therefore be made for all assets recognised by the respective banks of issue, not just those assets recognised by the Basel Committee. Inclusion in the liquidity reserve should be permitted at the same level as liquidity can be generated by the central banks with these securities under normal circumstances. This should also include non-marketable assets such as high-quality loan

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<sup>1</sup> Borio, Claudio (2009): Ten propositions about liquidity crises, BIS Working Paper No 293, p. 9.

receivables. Especially loans to or guaranteed by sovereigns, central banks and non-central government PSE's should be included in the liquidity reserve. The loans have low credit risk, which is recognized under Basel II with a risk weighting of 0% under the Standardized Approach.

In principle, the outflow of liquidity which, according to the Basel Committee, banks should assume when determining the liquidity coverage ratio appears to be unrealistically high. Even against the background of experiences during the financial market crisis these assumptions seem to be exaggerated. We therefore encourage the Basel Committee to justify the suggested rates empirically. At the suggested level, the regulations would cause bank refinancing to be considerably more expensive, and these costs would need to be passed on to customers. Otherwise, the amount of credit provided needs to be reduced.

A differentiation must be made between "stable" and "less stable" deposits when it comes to deposits held by private individuals. In order to qualify as a "stable" deposit, the customer must have other established relationships with the bank which would make a withdrawal of the deposit highly unlikely, and the deposits have to be "transactional accounts". This distinction seems arbitrary to us and would lead to a very high additional technical and organisational burden due to the chosen differentiation criteria. Banks with large retail divisions would be forced to individually assess thousands of customer relationships for each supervisory report. Unless the Committee can provide empirical evidence that such a differentiation is necessary, this should be discarded and a standard run-off factor of 7.5 percent assumed. A run-off factor of 15 percent is not comprehensible, particularly in the case of saving deposits in view of our experiences during the financial crisis. The same applies to the differentiation between "stable" and "less stable" deposits held by smaller corporate customers.

In the case of amounts owed to non-financial companies, where important services are performed for the customers, it should be assumed that 25 per cent of the receivables will be claimed. However, if no important services are performed, the withdrawal rate should be increased to 75 percent. In this respect we would point out that the classification of the two groups described above is not justified from a risk point of view, as companies for which no important services are performed are significantly less sensitive to the effects of a financial crisis than banks, for instance. In addition to this, the differentiation between the two groups would result in a high technical and organisational burden. A standard withdrawal rate of 25 percent should therefore be assumed.

According to paragraph 55, the banks should assume that in stress cases, 100 percent of the funds provided by other banks will be withdrawn. This assumption seems completely unrealistic to us. The risk of withdrawal should, in our opinion, be differentiated on the basis of specific groups of financial companies. We suggest a withdrawal factor of 50 percent for

financial funds provided by internationally active banks. In the case of other companies in the financial sector (asset managers, insurance companies etc.) withdrawal rates have been significantly lower during the crisis. We suggest a withdrawal rate of 25 percent for these companies. Retail bank deposits have the lowest withdrawal rates, so the same withdrawal rate as for stable retail customer deposits (7.5 percent) should be applied.

The assumption of a total withdrawal seems particularly unrealistic to us in the case of accounts held by “central banks” for affiliated banks in the case of an institutional protection scheme. In the EU such receivables do not have to be backed with equity if the protection scheme fulfils certain criteria. In parallel with this privilege, a significantly lower withdrawal rate should be required for deposits within such institutional protection schemes. In such schemes affiliated banks are required by the articles or statute to hold surplus liquidity with their responsible “central bank”. This results in significantly lower withdrawal rates. In our opinion, the same approach should be taken here as in the case of stable retail deposits (7.5 percent).

Furthermore according to paragraph 55 banks would have to assume a complete withdrawal of deposits from public sector clients. This is completely unreasonable. The crisis has shown that deposits from public sector entities were quite stable. Public sector banks were even in a position to attract additional funds from this sources during the most acute phase of the liquidity crises. The stability of these deposits is positively influenced by the fact that the respective customers often are shareholders. We would therefore recommend to apply to public sector entities the same treatment as to small business customers.

Credit lines and liquidity facilities should only be included if they are contractually irrevocable. In this case, they should in principle be counted as 100 percent of the currently undrawn portion of these liquidity facilities. This in particular applies to facilities provided for other financial corporate customers. In our opinion, this factor is set significantly too high. In our experience, the drawdown is just under 20 percent. If a higher factor is applied, it would also be necessary to allow banks to account for credit lines provided by other banks as an inflow of liquidity. In this case it is currently assumed that the bank is in no way able to use contractually promised lines of credit.

Lines of credit for private individuals and non-financial companies are to be accounted for with only 10 percent. In our opinion, this rate should also be applicable to credit facilities to public bodies. Such lines have not been used in the financial markets crisis not more frequently than before (except in the case of US public finance business). Furthermore, if banks receive assets which are central bank eligible as a result of the drawdown of a credit facility, they should be able to take these into account as a discharge. The same factor should also be applied for conditional claims, e.g. against insurance companies, where an

externalisation is only possible once additional conditions (dependent on projects) have been fulfilled.

The suggested form of the **Net Stable Funding Ratio** would force banks to extensively refinance their long-term credit business to match maturities. Banks would consequently be less able to perform their important economic function of liquidity transformation. It is also highly doubtful whether the capital market would be able to absorb the volumes of long-term bank bonds required for this purpose. This is in particular the case if (as suggested) these securities could not be included in the liquidity reserves for the purposes of the LCR. This lower attractiveness of bank bonds could only be compensated for with significant price increases. There is therefore a risk of limitation or major rises in cost for long-term credit provision with a lack of refinancing options to match maturities. These effects may also result in increased liquidity transformation in unregulated parts of the economy.

In principle, the suggested required degrees of coverage by sources of stable funding (RSF Factors) seem to be excessively conservative, both for the available amount of stable funding (numerator) and also for the required amount stable funding (denominators). The Basel Committee should also provide empirical evidence of the applied assumptions.

On these grounds, more realistic assumptions should be made with regards to the prolongation assumptions for the funds provided to banks with a remaining maturity of less than one year, which are consistent with those assumed within the scope of the LCR. The factors for assets with a maturity of over a year should also be consistent with the assumptions of the LCR.

The Basel Committee wants to differentiate between “stable” and “less stable” deposits when it comes to deposits held by private or small corporate customers. In that respect the same criteria should be applied as those used for the Liquidity Coverage Ratio (paragraph 86). In connection with this, we would like to draw attention to the criticism we made in the subsection with regards to the additional technical and organisational costs associated with this limit. Furthermore, the NSFR factors should be consistent with the withdrawal rates applied within the scope of the LCR. As we requested that a standard withdrawal rate of 7.5 percent should be applied to the stated deposits for the LCR, it should be assumed that within the scope of the NSFR, 92.5 percent of the deposits held by private individuals and small corporate customers of the banks will also be available for a period of over a year as stable refinancing sources. A standard factor of 92.5 percent should therefore apply for all deposits of this type.

The suggested ASF factor for refinancing funding provided by non-financial companies (50 percent) also appears to be excessively conservative to us. In accordance with our requested

withdrawal rate of 25 percent for LCD, such liabilities should be allocated a factor of 75 percent.

Liabilities which cannot be expressly allocated a lower ASF factor cannot be included in the available stable refinancing sources. This predominately includes liabilities owed to other companies in the financial sector. This appears to be completely unreasonable. Comparable to the case with withdrawal rates in the area of LCR, a differentiation should also be made here between different groups of companies. In our opinion, it should be possible to allocate up to 50 percent for funds which are provided by internationally active banks. Retail bank deposits, on the other hand, should be treated in the same way as retail customers and small corporate customers and should accordingly be allocated a rate of 92.5 percent.

An ASF factor of 92.5 percent should in particular be used for amounts owed to banks which belong to the same institutional protection scheme. As justification we refer to the explanations made above in reference to the LCR and the stability of affiliated banks' deposits with their "central banks".

Funds which are provided by other companies in the financial sector (e.g. capital investment companies or insurance companies) should be accounted for with a ASF factor of 75 percent.

The factors for assets with a residual maturity of over a year should, in our opinion, be consistent with the assumptions made within the scope of the LCR with regards to the saleability of these assets. It can be assumed that it will be possible to sell an equally large percentage of these assets in the time frame of over a year considered within the scope of the NSTR, as within the acute stress phase of 30 days.

Unencumbered marketable securities with a residual maturity of one year or more which can be included in the liquidity reserve according to subsection 34 lit. c) are to be assigned a factor of 5 percent with long-term stable refinancing. This contradicts the assumption of the Basel Committee in relation to the purposes of the LCR that the abovementioned securities will be sellable at any time and with no loss of value. It should therefore not be a requirement to take the securities into account for the necessary stable refinancing.

"Pfandbriefe" with a residual maturity of one year or more and a rating of at least AA should, in our opinion, also not be subject to long-term stable refinancing, as these securities can also be sold at any time with no loss of value.

Those corporate bonds listed in subsections 36 and 37 which can be taken out with a reduction of 40 percent in the LCR will be assigned a factor of 50 percent. The factor here is again inconsistent with the assumed liquidity within the scope of the LCR. The named security should accordingly be assigned only 40 percent.

Loans with a residual maturity of under one year which were granted to companies outside of the financial sector are to be assigned a factor of 50 percent. The assumed prolongation rate seems substantially too high to us. A lower factor should be assigned in this case on the basis of empirical research.

The proposed full funding of claims for companies in the financial sector with a residual maturity of over a year with long-term stable funding appears substantially unfounded to us. In this regard, we suggest that securities issued by companies in the financial sector traded on regulated markets should only be assigned a factor of 70 percent. Credit for this type of company should only be assigned a factor of 85 percent with long-term refinancing.

Loans to or guaranteed by sovereigns, central banks and non-central government PSE's with a residual maturity of less than 1 year are not explicitly mentioned in Table 2. Therefore they have to be assigned a factor of 100%. The assumed prolongation rate is not according to our experience, because the loans have a hard maturity date and the experience is that there is no obligatory refinancing necessary in order to redeem the loan. The loans should have the same treatment as loans to financials with a remaining maturity of less than one year. For this reason a RSF factor of 0% seems appropriate.

Loans to or guaranteed by sovereigns, central banks and non-central government PSE's with a residual maturity of more than 1 year are to be assigned a factor of 100%. The loans have low credit risk, which is recognized under Basel II with a risk weighting of 0% under the Standardized Approach. The loans furthermore have a proven marketability, which is recognized by central bank eligibility. These loans should be compared to marketable securities awarded with a lower factor than 1, the proposal is to use the same factor of 50% as non-financial corporate unsecured debt with a rating AA- to A-.

For both, the LCR and in particular the suggested NSFR, there is at present no evidence of aggregated effects or effects on individual banks. These are currently being investigated within the scope of the Sixth Quantitative Impact Study of the Basel Committee (QIS 6). Before the final establishment of the factors, we recommend waiting for the results of the QIS 6.

We welcome complete transparency vis-à-vis the respective regulatory authorities. However, we do not consider the intended publication of the data within the scope of the banking supervisory **disclosure** to be advisable. For one thing, banks may be encouraged to over-comply with the minimum requirements in a kind of competition, although even the minimum relations guarantee coverage in a worst-case scenario. Investors could also withdraw deposits from those banks where the proportions are only slightly above the

minimum requirements. This could result in a self-fulfilling prophecy which would worsen the liquidity situation of the banks.

As a last point, it would be extremely desirable from the point of view of the banks that the different regulatory efforts to limit liquidity risk currently discussed by different bodies are harmonised and adapted. This would reduce both, the complexity of the liquidity control and the cost of the required reporting.

Should you have any questions, please do not hesitate to contact us.

Kind regards,

A handwritten signature in blue ink, reading 'Schoppmann'.

Henning Schoppmann  
EAPB

A handwritten signature in blue ink, reading 'Hafner'.

Sandra Hafner  
EAPB

*The European Association of Public Banks (EAPB) represents the interests of 34 public banks, funding agencies and associations of public banks throughout Europe, which together represent some 100 public financial institutions. The latter have a combined balance sheet total of about EUR 3,500 billion and represent about 190,000 employees, i.e. covering a European market share of approximately 15%.*