European Banking Federation
Secretary General

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

Brussels, 16 April 2010

Subject: ***EBF Positioning on the Basel Committee's Consultative Document entitled "Strengthening the resilience of the banking sector"***

Dear Mr Walter,

You will find attached the EBF comments on the Consultative Document entitled "Strengthening the resilience of the banking sector".

Yours faithfully,

Guido RAVOET

Enclosure: 1 – D0515J-2010

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RESPONSE TO THE BASEL COMMITTEE CONSULTATIVE PAPER ON STRENGTHENING THE RESILIENCE OF THE BANKING SECTOR

Index

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1. EXECUTIVE SUMMARY

The European Banking Federation[1] (EBF) welcomes the willingness of the Basel Committee to set a framework of rules geared to improve the resilience of the banking sector.

Nevertheless, as regards the ongoing discussions reconsidering the overall level of capital and liquidity in the financial sector, the EBF acknowledges the need for improved supervision which, together with better regulation, constitutes the bedrock of stability in the financial system.

The enhancement of the capital requirements should only be implemented once recovery is assured and be proportionate to the risks involved. The latter is a point of major concern among our member associations. We are committed to help policy-makers in the identification and correct evaluation of risks that might have been underestimated, but there are grounds for thinking that the new set of proposals points to an overall overstatement of the capital requirements far beyond the risks involved.

Despite the industry has dedicated huge resources to the analysis of the new proposals during the last months, the newness and complexity of the measures makes us think that further assessment is needed. We understand that the BCBS has left a number of key points undefined in waiting for the subsequent calibration process. In the same vein, we request the BCBS to conduct a second consultation when the results of the calibration are known and to invite the industry to revisit this first analysis. Further to the quantitative impact study, more clarity would contribute enormously to the management of the expectations of market participants, rating agencies and the industry.

It is also important to note that, in addition to the particular analysis of each individual measure, it will be of the utmost relevance to pay heed to the following dimensions:

- The interplays between different measures and the expected results of their combined effects. The EBF response includes a specific section about this issue.
- The overall impact of the proposed regulatory overhaul on the real economy. In this regard, the EBF is developing its own assessment in collaboration with the Institute of International Finance.

EBF strongly believes that substantial revisions will need to be performed to the proposals before they are able to achieve their objectives. EBF would also like clarification and

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[1] Set up in 1960, the European Banking Federation is the voice of the European banking sector (European Union & European Free Trade Association countries). The EBF represents the interests of some 5000 European banks: large and small, wholesale and retail, local and cross-border financial institutions. The EBF is committed to supporting EU policies to promote the single market in financial services in general and in banking activities in particular. It advocates free and fair competition in the EU and world markets and supports the banks' efforts to increase their efficiency and competitiveness.

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transparency on what capital increase that the BCBS aims for on an overall level and how it has arrived at this ambition.

The placement of grandfathering clauses and the recognition of a sufficiently long transition period will be key to succeed in the adoption of this overhaul of the prudential regulatory framework.

In a broad sense, we think that too much strain has been put in stressing the Pillar 1 of the Basel II framework. The changes to the capital definition geared to raise the quality of the capital base would be, themselves, more than enough to ensure resilience of banks up to a very high confidence level. It is important to maintain the meaningfulness and consistency of pillar 1 including the use test. All new extraordinarily cautious measures should be placed under the scope of pillar 2.

As regards the individual proposals:

- Raising the quality, consistency and transparency of the capital base:
  - It is essential that a consultation process be organised on arrangements that the Committee will propose, particularly (i) on the time-frame within which banks will need to apply the new framework as well as (ii) on transitional arrangements.
  - A transition period spanning some years would be required to allow banks to build up their capital base and, furthermore, make sure that most of the instruments that no longer meet the new definition have matured and can be substituted by qualifying instruments, without disturbing relevant markets and while maintaining adequate pricing levels.
  - Grandfathering arrangements need to be put in place which should apply in a digressive manner (similarly to the arrangements taken in the EU Capital Requirements Directive in respect of hybrids).
  - Concerning minority interest, we do not support the Committee proposal to ignore the capital of the subsidiary at group level totally whilst the risks exposures of the subsidiary would be fully recognized in the consolidated accounts. The requirement should be that, if excess capital within the subsidiary would be so significant that it would influence the capital ratio of the consolidated group in a substantial way, the excess should be deducted from the capital of the consolidated group. Bank Holding Companies whose main banking exposures consist of partly owned subsidiaries should be exempted the minority interest deduction rule.
  - We oppose the proposal that deferred tax assets (DTAs) which rely on future profitability of the bank to be realised should be deducted in full from the Common Equity component of Tier 1. DTAs do have value for firms and

are verified by auditors (on the basis of strict criteria assessing a firm´s future profitability), there is no need to deduct them from regulatory capital.

- We do not agree that defined pension fund assets should be deducted from the common Equity component, but do agree that the two questions of the quantum of the adjustment and level of any deduction in respect of such liabilities should be addressed. Regulators should introduce pro-cyclicality and volatility dampening mechanisms for capital requirements related to pension funds, aligning the regulatory treatment with the long term nature of pension fund liabilities. The mechanisms should be customized to the specifics of each country's pension model."

- Risk coverage:
  - The counterparty risk involved in derivative transactions should be reassessed without removing their contribution to the effectiveness of the financial markets.
  - The proposals around counterparty risk as presently formulated contain within them strong overlapping elements and will surely over-regulate this part of banks' business.
  - The respect for the right incentives to risk management should be observed. This involves the recognition of the diverse methodologies used in different institutions. Their functioning should only be challenged in the supervisory review process.
  - The counterparty valuation adjustment and other related proposals should be performed within the scope of pillar 2.
  - The important role of OTC derivatives in offering efficient financial hedging to commercial transactions would be put at risk with all the newly proposed measures. We advocate placing incentives to the use of CCPs without penalizing OTC derivatives notably those linked to international commerce.
  - We believe the BCBS shall not take a step backwards in the improvement of risk assessment by removing the use of external ratings in the standardised approach for credit risk, what would only put smaller banks at a disadvantage. There are different ways to overcome the specific problems of the ECAs mainly in the areas of governance and control. Moreover, the potential non-eligibility of ECAs ratings of emerging countries would reduce investment thus hinder the integration process of Eastern European countries.

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- Leverage ratio:
  - We oppose introducing a leverage ratio as it is a crude measure which contradicts the spirit and the purpose of the Basel II rules which take into account the riskiness of investments.
  - A leverage ratio should in any event not be construed as a Pillar I measure i.e. an absolute level that would be binding on a stand-alone basis on all financial institutions in every circumstance. Instead, it should merely serve as an indicator which would, in combination with a range of other key risk indicators, help supervisors assess the institution's capital strength within the Pillar 2 framework.

- Procyclicality:
  - The EBF understands that more clarity on the subject of procyclicality, Expected Loss provisioning and capital buffers will be provided in a document to be published later this year. In that respect, the EBF especially draws attention to the lack of clarity surrounding buffers on top of the pillar 1 minimum requirements and how all these different proposals relate to each other.
  - The EBF supports the provisioning based on EL model and is putting forward a proposal for a provisioning model based on the EL concept, which is capturing the economic reality of the lending activities of financial institutions in line with the BIS six principles to achieve sound EL provisioning approach. We believe that the forward-looking element of the provisioning system will contribute to mitigate procyclicality in consequence.
  - We think that a downturn probability of default should never be implemented in pillar 1 for a number of reasons, inter alia it would mislead the interpretation of the pillar 1 expected loss, the use test would be doomed to fail and institutions would be compelled to run a double process. Instead, we urge the BCBS to consider this measure in the pillar 2 within the scope of the stress testing process and its supervisory review.
  - The restrictions to dividend pay-outs would put the banking industry at a disadvantage vis-à-vis other economic sectors.
  - We share the concern of BCBS about the excessive credit growth during the upside of the economic cycle and we look forward to participating in the outlining of measures geared to enhance stability.

- The interplay between different measures:
  - The EBF has identified certain areas that would deserve special attention because they could pose undesirable effects due to the combination of proposals.
  - An outstanding one is the combination of the new liquidity ratios, the proposed capital buffers and the more stringent definition of capital. Will the market underwrite the new required capital while profitability is expected to decline and dividend pay-outs are pronounced to be curtailed by legislation?
  - This is an area that deserves further investigation when the results of the calibration are known. We are willing to participate in the process and contribute to outline a transition period that ensures the assimilation of both the banking industry and the wider market.

2. INTRODUCTION

In the context of the financial and economic crisis, prudential regulations have come under closer scrutiny. As envisaged in the outcome of the G20 statement on strengthening the financial system, the Basel Committee should review the levels of capital and should develop "internationally agreed rules" over the course of 2010 to improve both the quantity and quality.

The EBF welcomes the willingness of the Basel Committee to set a framework of rules geared to improve the resilience of the banking sector. Nevertheless, as regards the ongoing discussions reconsidering the overall level of capital and liquidity in the financial sector, the European Banking Federation (EBF) acknowledges the need for better regulation and improved supervision, which constitute the bedrock of stability in the financial system. The enhancement of the capital requirements should be implemented once recovery is assured and be proportionate to the risks involved.

Notwithstanding the above, in striving to understand the effects of a major overhaul of the prudential standards, the EBF also warns that there are potential adverse consequences of significantly higher and undiscriminating capital and liquidity requirements. There is no doubt that stability is a primary objective, but it is also true that the weakened post-crisis economy needs banks lending. And there are grounds for thinking that there is a trade-off between solvency and lending capacity.

The price that a general increase of the capital requirements would mean for European banks and the EU economy, notably for households and businesses, is not sufficiently clear so far. Therefore, there is need for an overall assessment from different angles, including all the stakeholders and ultimately the real economy. For this reason, the EBF is willing to contribute to the debate from the perspective of the European banking industry.

2.1. Background

In the wake of the financial and economic crisis there has been a general loss of counterparty creditworthiness. Credit rating downgrades, liquidity problems, the pro-cyclicality of accounting standards and the assets valuation difficulties when applying fair value rules, have also occurred.

It is broadly acknowledged that the capital base of banks shall be reinforced to address practices that have proved riskier than expected. In this line, the EBF has acknowledged the need for capital increase in some areas of the banking business. It has however expressed its long-standing concern over the multiple areas where capital increases are presently being considered indiscriminately. The EBF has repeatedly warned against the extent to which a capital increase and stricter liquidity limits, beyond a certain level of stability, could damage the lending capacity of banks and have perverse effects on the real economy in the longer term.

Indeed, there is need for a balance to be struck between banks' solvency, as an indicator of financial stability, and banks' lending, as a foundation for economic recovery.

In this regard, it must be ensured that the cumulative impact of all the new prudential measures be proportionate to the risks involved and, moreover, that their aggregate impact and effect on the global economy be carefully assessed and fully understood. For this purpose, the EBF is committed to actively participate, together with other stakeholders, in the calibration and assessment of the new framework.

EBF is convinced that good risk management is a key both for individual institutions and for the stability of the financial system, and that regulation should both stimulate and recognise good risk management practices. Many of the proposed regulations are detailed and prescriptive, failing to incentivise qualitative risk management by financial institutions. This creates incentives for banks to use more simple and standardised methods for measuring risk and regulatory capital, rather than encourage the use of more advanced internal models.

2.2. EBF interest and approach

Against this background, the EBF has decided to conduct an analysis of the consequences on the wider economy that a tightening of the prudential standards may have on the banking system. For this purpose, the following phased approach has been considered:

i. Firstly, to perform a preliminary estimation of the expected increase of the overall capital requirements for the European banking industry if all the regulatory proposals were put into force. The outcome of such an exercise is to seek a rough

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estimate of the range of new capital that would be needed to preserve the current levels over the regulatory minimum requirements[2].

ii. Subsequently, to assess the impact that such cumulative changes would have on the real economy.

The EBF wishes to gain more accurate understanding of the effects of this major overhaul of the prudential standards. The pros and cons of the new framework should be carefully analysed. Before taking further steps, all stakeholders should broadly understand how the financial system will be able to carry on playing its important role in the economy without major distortions or severe unintended consequences.

It is also important to observe the remedial actions already taken by the European industry and its supervisors in the aftermath of the crisis:

i. Recapitalization of the industry.

ii. Design of new, reinforced supervisory authorities in the European Union.

iii. Revision of supervisory approaches in a number of jurisdictions.

iv. Stress testing exercises.

v. Deleveraging process of the sector – to the average level of the last economic cycle

vi. Improvements of risk management practices.

vii. Closer control and tangible improvements in internal governance under a tighter supervisory environment.

We believe these remedial actions to be of the highest effectiveness and to have definitively shaped a new banking sector that operates under sufficient public control in all extents. In this scenario, the Basel Committee proposals of capital and liquidity constraints should at all times be considered from a wider perspective and refrain from unnecessarily squeezing the banking sector.

2.3. EBF position and principles

The EBF general position regarding the regulatory reform underway is driven by 4 principles, namely:

[2] The capital that would be needed to meet the enhanced requirements, irrespective of the current level of capitalisation.

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a) Preservation of banks' lending capacity especially in the EU.

There is need for careful analysis of the changes in capital and liquidity ratios and their significant consequences for the banking sector's propensity to lend and therefore for the financing of the real economy.

There will be a certain degree of transfer of tighter prudential standards to the rates and volumes of bank lending to businesses and households. All stakeholders should carefully assess this issue especially in the calibration of the new proposals.

In the European Union, whose economy is significantly more dependent on bank lending, there is a general concern about the shrinkage in the lending capacity of the banks and the effects it may produce on the road to economic recovery. This is especially important in the EU economy, whose private sector is particularly dependent on bank lending. Bank intermediation finances two-thirds of the European economy, whereas in comparison, this share is only one-third in the US, where capital markets are more developed.

b) Consistency in the regulation.

As a matter of principle a single rulebook should be pursued in the EU, so that the banking industry is better able to support its customers and contribute to prosperity and employment.

c) International level playing field.

Global coordination and convergence should be placed at the top of the political agenda and regulatory arbitrage discouraged. With regard to other jurisdictions, the level playing field should not be put at risk. The newly proposed measures might have quite diverse effects on different countries and regions depending on how they interplay with the rest of the regulation. True convergence of the accounting rules is a prerequisite for the consistent application of any new capital rules.

d) Maintenance of the banking sector competitiveness.

The loss of the banking industry's competitive edge compared to other economic sectors would result in tougher conditions when it comes to attracting the additional capital and liquidity required. If all banks needed to raise a significant amount of capital and liquidity at the same time as a result of the new requirements, private investors might not be willing to subscribe if the industry's return on investment capacity has been undermined.

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3. EBF VIEWS ON THE PROPOSALS

3.1. Raison the quality, consistency and transparency of the capital

3.1.1. Due process requirements

- We welcome the consultation process on a revised Own Funds definition which the Committee is proposing.

  We note, however, that the Committee has not delivered a finished product as the Consultation Paper reveals that there are still many uncertainties and incomplete proposals. This implies that our comments below - even though directionally correct - cannot be based on a comprehensive assessment of all proposals taken together. Moreover, the QIS exercise which is taking place in parallel has created confusion as to how the BC intends to implement the proposals as the QIS Questionnaire which was circulated amongst banks seems to suggest that many different options are being investigated. Whilst we deem it a positive sign that the Committee is open to analyse different possible solutions, we urge the Committee to organise a second consultative round together with another round of QIS if necessary, once the proposals will have taken a more concrete and comprehensive shape.

  We would also like to invite the Committee to provide clarity in the meantime about the way in which it intends to organise its further work and, particularly, about the timelines which it proposes.

  Furthermore, we would like to encourage the Committee to exercise its influence to insist on an even and simultaneous implementation of the ultimate proposals in all parts of the world. More particularly, the Basel II Framework needs to be implemented worldwide for the determination of RWA and for the consolidation of risks (RWA) and capital before the new Own Funds definition can take effect. If not, there will be an unlevel playing field across the financial market places worldwide.

- The Press Release accompanying the publication specifies that the Committee will put in place appropriate phase-in measures and grandfathering arrangements for a sufficiently long period to ensure a smooth transition to the new standards. The Consultative Paper indicates that the Committee intends, more particularly, to introduce the changes in a manner that does not prove disruptive for the capital instruments that are currently outstanding (Paragraph 16) and does not aggravate near term stress (Paragraph 64 of the Proposals). The Consultative Paper furthermore advocates allowing the grandfathering of instruments which have already been issued by banks

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prior to the publication of the Consultative Paper as well as an appropriate phase in period for the new capital standards (Paragraph 84).

- It is essential that a consultation process be organised on arrangements that the Committee will propose, particularly (i) on the time-frame within which banks will need to apply the new framework as well as (ii) on transitional arrangements.

- A transition period spanning some years would be required to allow banks to build up their capital base and, furthermore, make sure that most of the instruments that no longer meet the new definition have matured and can be substituted by qualifying instruments, without disturbing relevant markets and while maintaining adequate pricing levels.

- Grandfathering arrangements need to be put in place, which should apply in a digressive manner (similarly to the arrangements taken in the EU Capital Requirements Directive in respect of hybrids) and take into account of the decision taken at the level of the G-20 in the area of state-aid programmes.

• We note that the Committee has set 16 December 2009 as benchmark for the transitional arrangement which it proposes: instruments issued after that date will not benefit from grandfathering. This is worrying as it will take time for investors to switch over to markets of qualifying instruments – meaning that issuers of non-core-tier 1-instruments may face difficulties in the meantime.

  Because of the proposed end-date of December 16th 2009 and the uncertainty about the final rules until end of 2010, the Press Release has made issuers reluctant to issue non-core Tier 1 instruments. This is a cause of concern taking into account that huge amounts of capital are needed to meet the proposed new rules of the Committee whilst the investor base for common shares is shrinking as the returns on equity for financial institutions will decrease as a result of the turmoil and the new prudential rules.

  In these circumstances, we invite the Committee to make an official statement as soon as possible clarifying that the close-out date for instruments to benefit from grandfathering rules will be the date at which the final rules will become applicable or at the very least the date at which they will have been published.

• We note that the Commission has not calibrated yet the level of the Core Tier one, Tier 1 and the Total ratios. Moreover, it has not yet defined what portion of Tier 1 needs to be core Tier 1 predominant.

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When setting limits to the capital components, it needs to be borne in mind that institutions need to keep a sufficient level of non-predominant Tier one for two main reasons:

- the quality of non-core instruments will increase significantly compared to today's instruments, which were already eligible according to the 1998 Sydney Press Release of the Basel Committee;
- institutions will need to increase their global own funds level to comply with the new rules.

Therefore the non-core Tier 1 instruments have many merits, in particular a large investor base and the very useful currency diversification. This is why we ask the committee to set Core Tier 1 at a reasonable level, meaning near to 51%.

3.1.2. Main merits of the proposals

- The regulatory definition of Capital is inevitably embedded in company law which varies from country to country.

The Consultation Paper now proposes a range of criteria which are meant to filter out (the features or impact of) some national company law provisions which the Committee wishes to exclude from a regulatory Own Funds definition. We welcome the proposals for having adopted such a principles-based approach on the definition of capital. This is a substantial improvement in comparison to the 1988 Basel Accord which merely listed the instruments that were eligible as capital.

- We furthermore welcome the simplification which the proposals would introduce, i.e. (i) simplification of the structure of the different layers of capital – which is likely to contribute to a better understanding that outsiders will have of the capital situation of banks – as well as (ii) simplification of the limits to the different layers of capital as this will reduce the cliff effects resulting from interdependencies of the layers of capital.

3.1.3. General comments

- One of the main merits of the proposals is to demonstrate that the Basel Committee has a clear objective to foster convergence and, therefore, reduce competitive distortions across the globe.

We support in particular that regulatory adjustments ("prudential filters") will be harmonised.

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- We are concerned about the execessive reference which the proposals make to accounting conventions (see paragraph 87, numbers 9, 10 and 14).

  Obviously, in each country the regulatory definition of Capital is not only embedded in company law but also in applicable accounting conventions. Hence, it is inevitable that components of regulatory capital need to be defined by means of concepts used in banks' financial statements.

  We also agree that there is a need to filter out undue features and/or consequences of accounting conventions on the regulatory definition of Capital by means of prudential filters

  However, we do not share the view which is being taken in the Consultation Paper that it would be helpful for the regulatory definition of Capital to be made subject to accounting filters.

  - It would be useful if the Basel Committee would explain the thinking behind this requirement and, in particular, demonstrate how it would contribute to enhancing both transparency and comparability.

  - Today, significant differences still exist between IFRS and US GAAP. Moreover, in many European jurisdictions two sets of accounting standards – i.e. IFRS and national GAAP – need to be applied in parallel (depending on whether the financial statements need to be prepared at consolidated level or at entity level). This is one reason explaining why a mere reference to accounting conventions cannot possibly achieve the objective of transparency today – even to the contrary.

  - Making the definition of regulatory capital more dependent on accounting conventions implies automatically that the regulatory definition may need to be examined again whenever accounting standards have been amended.

- As will be explained below, we support, in general, the criteria which the Consultation Paper proposes to improve and strengthen the definition of capital of banks.

  We believe that those criteria need to be applied to all banks, irrespective of how they are incorporated. Differentiating the rules according to the way in which a bank is incorporated on the basis of national corporate law would result in an unlevel playing field. Achieving a level playing field is possible only if principles are set which need to be met by all banks. The proposals made by the Committee in this respect are sound. They should be applied to all types of companies. At the same time, this means that instruments must not be restricted for certain incorporations to one type of instruments, i. e. common shares for joint stock companies.

What basically matters is that specific characteristics of instruments of which those entities make use are acceptable to ensure the going concern status of a bank, irrespective of how it is incorporated ("substance over form").

- The concept of differentiating between going concern capital and gone concern capital is new and welcomed. Our understanding is that, as an overarching objective, Tier 1 capital must help a bank to remain a going concern and that non-common equity elements to be included in Tier 1 capital must be able to absorb losses while the bank remains a going concern. Gone concern capital is meant to safeguard depositors.

  The Paper remains silent on the implications of the proposed distinction and the way calibrations will be decided upon for the two distinct parts of capital. Our understanding is that the distinction is particularly relevant within the framework of deductions that need to be made.

  - The Paper takes the view that common equity should serve as a basis for all deductions that need to be made.

  - We believe, in contrast, that it would be more appropriate to differentiate depending on the kind of capital and its designation (supporting a bank in a going concern situation or to protect depositors in case of gone concern) to decide if the deduction in question needs to be made from core Tier 1, Tier 1 or Tier 2.

  Undue reliance on the Common Equity part of capital may lead to banks being unable to tap the investor base in a stressed event (as there may be a run for capital) and unable to diversify their funding sources. It especially creates issues for banks of which the RWAs are predominantly in foreign currency and which are required to issue shares in their home currency. Deducting all items from Common Equity aggravates this potential systemic and translation risk because of national company law. Therefore, after assessing which items need to be deducted from going concern capital and from gone concern capital, the Committee should consider imposing the going concern deductions from Tier I instead of from Common Equity.

3.1.4. Transparency

- We agree that there is a need to enhance the transparency of banks' disclosures on the composition of regulatory capital as disclosures provided by banks about their regulatory capital bases have frequently been deficient in the past.

  However, as explained above, we do not believe that it would be appropriate or helpful to require each component/used instrument of Tier 1 to be reconciled with accounting

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data as this would imply that the regulatory capital definition would be made subject to accounting filters (see our comments above, at page 14).

It should suffice that every position of capital on the balance sheet be reconciled with corresponding layers of regulatory capital.

- The treatment of mandatory convertible notes illustrates how irrelevant an instrument's accounting treatment may be. Mandatory convertible notes into shares with embedded optionalities for the investor have been used to obtain capital during the last financial crisis.

The accounting treatment of such a mandatory convertible note - which can be converted in equity - depends on whether a variable number of shares need to be delivered for settlement by the issuer. If so, such an instrument needs to be classified as a compound financial instrument consisting of a debt host and an embedded equity component. The equivalent instrument with a settlement in a fixed number of shares would be treated as an equity instrument.

Irrespective of the accounting treatment, however, the instrument will be recognised as core Tier 1 regulatory capital when the instrument is converted at maturity at the latest.

- It needs to be highlighted, furthermore, that requiring a full reconciliation with accounting data would be highly inappropriate.

Firstly, reconciling the components of regulatory capital with accounting data would be costly and difficult (if not impossible) to achieve.

Moreover, and probably more importantly, a reconciliation between both would be likely to achieve unintended consequences as, due to its complexity, market participants may be induced into misjudgements which may be damaging.
In addition, with the adoption of IFRS 9, such a reconciliation would be even more difficult to achieve because of the increasing differences between the prudential and accounting trading books (many Available-for-Sale Instruments will need to be reclassified in the accounting trading book but would remain in the prudential trading book).

We, therefore, invite the Committee to take into account the well established principles of Pillar 3 disclosures and particularly the concept of "materiality".

- The Paper proposes that banks would be required to make available the full terms and conditions of all instruments included in regulatory capital on their website.

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Such a requirement may be superfluous as (i) the Statutes will state what common shares are and (ii) the requirement would overlap with disclosure requirements which financial market supervisors have imposed on issuers.

Anyway, there are two main concerns:
(i) The mere posting of offering material on a bank's website is regarded as a public offer in many jurisdictions and may, therefore, have far reaching legal consequences.
(ii) It should not be overlooked that a confidentiality element is present where 'private placements' are involved. Specific details of such transactions would and should not be available to third parties.

Posting the key terms and conditions should be sufficient.

3.1.5. Common equity component of Tier 1

- In general, we welcome the clarity that the 14 criteria which are being proposed in the Paper will introduce.

- We welcome the Committee having recognised that banks may need to issue non-voting common shares as part of the predominant form of Tier 1. Features that differentiate common shares from regular voting common shares are useful indeed and, are moreover, needed to compensate investors for missing voting rights or to convince new investors to recapitalise a bank during stressed situations. Such features are laid down in nearly all national corporate laws and need to remain in place.

  What is more, such capital is needed to diversify the capital base while not diluting the grounding principles for core Tier 1 capital, meaning loss absorbency, flexibility of payments and permanence. For this reason we welcome the Committee's intention to restrain from referring to voting rights as a criterion as these are only relevant for corporate governance reasons which must not be taken into account for defining supervisory capital.

Criterion 3

- In respect of the "perpetual" concept, we propose that the Committee integrate the additional principle of "maturity equal to the life of the issuer". Introducing such a formal characteristic would not impinge on the quality of the instrument from a supervisory point of view.

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Criterion 4

- Our understanding is that Criterion # 4 does not oppose banks being market makers in their own shares.

Criterion 5

- Criterion 5 makes reference to "distributions". However, the very same concept is used in the Consultation Paper to include bonuses (see Paragraph 249).

  We, therefore, suggest substituting the term "distributions" by "dividends/coupons", in line with Paragraph 89, criterion 7.

- The circumstance that dividends are capped or tied to amounts paid in should not be an obstacle to recognising them as Common Equity. We, therefore, suggest deleting the second sentence of Criterion 5.

Criterion 6

- If a general shareholders' meeting has approved a dividend distribution proposal, the payment of such distribution becomes obligatory. Our understanding is that Criterion 6 is not intended to cover such dividend distributions.

- Mandatory convertible notes represent fully loss absorbing capital with a quality akin to share capital. Yet such instruments have coupons which are obligations of the issuing entity.

  Due to the high quality and loss absorbing nature of the capital injected through mandatory convertible notes, it should be allowed to include them in Common Equity, net of coupons payable until conversion into share capital.

Criterion 7

- The status which preferential distributions have under the proposal is unclear.

  Obviously, some preferential distributions – i.e. those that are tied to a dividend or to amounts paid in at issuance - do not meet the 14 "entry criteria" set forward in the paper to qualify as common shares as criterion 7 explicitly excludes preferential distributions. However, the Paper also contains a definition of ordinary shares which specifies that some class of eligible common stock may have certain debt-like features such as preferential dividends (footnote 15). Therefore it needs to be clarified in criterion 7, that there may be preferential distributions regarding the amount of

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distributions, but not the order of distribution in respect of core Tier 1 instruments. Furthermore, this is in line with the European core Tier 1 definition.

To conclude, our understanding is that, under the newly proposed definition, the form (i.e. the label "preference share") is not relevant as such and, therefore, that the 14 criteria constitute the only test that needs to be met. Therefore, nothing prevents shares which have a preferential right for dividend payment to be eligible as core Tier I as far as they meet the14 criteria.

Criterion 11

- It is unclear to us why only capital that is directly issued by the bank would be eligible. It would be useful if the Basel Committee would explain the thinking behind this requirement

3.1.6. Tier 1 additional going concern capital

- The Consultation Paper defines "Tier 1 Additional Going Concern Capital" in a precise way by means of a set of criteria: it is composed of instruments which are subordinated and, more particularly, are senior to ordinary shares.

  We believe the various eligibility criteria to be too strict and are particularly concerned that, as a result, banks will be deprived of a large and flexible source of diversified capital.

Criterion 4

- The concept of "perpetual" should imply that instruments with a maturity equal to the life of the issuer would qualify.

Criterion 5

- We object to the requirement that the instrument be callable at the initiative of the issuer only after a minimum of five years.

- We oppose the proposal that the bank would need to demonstrate that its capital position is "well above" the minimum capital requirement after the call option is exercised. Such language is not sufficiently precise.

We wonder, furthermore, if there would be a real need for imposing such a requirement as the Pillar 2 Framework provides supervisors with sufficient safeguards.

Criterion 6

- Our understanding is that limited activities for market making or market smoothening purposes would be allowed.

Criterion 7a

- We oppose the "full discretion"-requirement (see our comment made above, at page 18, under criterion 6).

- Our understanding is that dividend pushers would be allowed to preserve the ranking of the holders of additional going concern capital as such instruments allow the bank to have an efficient and diversified capital investor base. The seniority of holders of instruments included in Tier-1 Additional Going Concern above the holders of most subordinated instruments included in Common Equity must be respected. In this regard, we strongly support the application of Paragraph 83 from the CEBS implementation guidelines for hybrid capital instruments dated Dec, 10th 2009.

Criterion 11

- It is not clear why the proposed criterion - which requires instruments classified as liabilities to have principal loss absorption - applies to liabilities only with the exclusion of other types of going concern capital (such as preference shares). We refer to our comments made above concerning the reference which the paper makes to accounting conventions (see above, at page 14).

  It should be clarified that a write up is possible to preserve the ranking of the instrument if the situation of the bank improves; if not, investors in this kind of capital would be worse off than shareholders as they participate in the recovery of a bank when retained earnings are built up again.

- The Paper states that, "*as part of the impact assessment, the Committee will consider the appropriate treatment in the non-predominant element of Tier 1 capital of instruments which have tax deductible coupons*." (Paragraph 76)

  We wonder, however, if it would indeed be reasonable to take into consideration the tax treatment of an instrument for recognising it as regulatory capital. Tax treatment depends on national legislation and is not relevant to assess the loss absorbing capacity of an instrument. Moreover, taking into account the tax treatment would mean that the supervisory definition of capital would change with every change of national tax laws. Therefore, we believe that the tax treatment of capital elements should not be part of the criteria for eligibility of Additional Tier 1 instruments.

Criterion 12

- It would be useful to clarify that this criterion does not concern market making or repurchases of non-core Tier 1 instruments which have met with the prior approval from supervisory authorities.

3.1.7. Criteria for inclusion in Tier 2

Criterion 4

- It is proposed that an instrument would not qualify to be included in Tier 2 capital if there would be incentives to redeem.

  We propose maintaining a moderate incentive to early redemption as such an approach can provide benefits in terms of balance between capital stability (the incentive would be moderate and, in any case, early redemption would be subject to the authorization of the Supervisory Authority) and investor's risk.

Criterion 8

- It should be clarified that this criterion does not concern market making or repurchases of non-core Tier 1 instruments which have met with the prior approval from supervisory authorities.

Contingent Capital

- As the market for contingent capital instruments is not yet sufficiently developed, the Committee should restrain from imposing strict requirements which would limit demand for them.

Lock-in Mechanisms

- The Committee invites respondents to give their views on whether additional safeguards such as a lock-in mechanism are necessary to ensure that Tier 2 capital does not need to be repaid during a period of stress.

  We deem such mechanisms to be superfluous. They should not be introduced.

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3.1.8. Regulatory adjustments applied to regulatory capital

Stock surplus

- Stock surplus (i.e. share premium) will only be permitted to be included in the Common Equity component of Tier 1 if the shares giving rise to the stock surplus are also permitted to be included in the Common Equity component of Tier 1 (see Paragraph 94)

  Stock surplus necessarily results in 'cash in the bank' - irrespective of how the originating shares are classified in the Tier structure. Those cash proceeds are fully available to cover any losses or claims from depositors as they are accounted for as part of Own Funds. Furthermore, distributions on these items are fully discretionary and supervisors may prevent them if they seem too high from a prudential point of view. On this ground, we do not see any reason to discriminate between stock surplus depending on the classification of the relating shares. Additionally, any buy-back programme on any kind of shares needs prior supervisory approval which constitutes a safeguard for supervisors to avoid the amount of stock surplus to be unduly decreased.

  The Committee may envisage requiring additional supervisory approval for any stock surplus originating from shares with a surplus over a certain limit of the nominal value of the issuance, to prevent any possible misuse.

Minority interest

- Minority interest will not be eligible for inclusion in the Common Equity component of Tier 1. We note, however, that the list of criteria for inclusion in Tier 1 Additional Going Concern Capital explicitly confirms that minority interest may belong to this category. We also note that the Committee does not propose a treatment that would provide symmetry between the numerator and the denominator of the ratio and, more particularly, does not propose that the capital requirements of the quota corresponding to the minority interest on the entity level be deducted from total RWAs.

  We do not support the Committee proposal to ignore the capital of the subsidiary (owned by a third party or Minority Interest) at group level totally whilst the risks exposures of the subsidiary would be fully recognized in the consolidated accounts. Such an approach ignores that the capital of the subsidiary – including Minority Interest - is available to cover at least the risks to which the subsidiary is exposed.

  Still, we do understand the Committee’s desire to prevent misuse of minority interest as excess capital at the level of the subsidiary owned by a third party is not necessarily available to the group as a whole. However, we are not convinced that specific rules would be needed to address the concern as the competent supervisors are in a position

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to identify situations in which banking groups would draw capital from subsidiaries in an unreasonable way and to require them to deduct those at group level.

The capital ratio of the consolidated banking group as it stands before the accounts of the subsidiary have been consolidated should not be significantly worse than the ratio after consolidation of the relevant subsidiary. The requirement should be that, if excess capital within the subsidiary would be so significant that it would influence the capital ratio of the consolidated group in a substantial way, the excess of capital of the subsidiary owned by a third party should be deducted from the capital of the consolidated group. The underlying principle justifying the treatment that we propose would be that capital which is not needed to cover risks to which the subsidiary is exposed on a legal entity basis would be deducted at a group level.

We suggest that, to determine the amount of excess capital, the capital ratio of the consolidated group (including only wholly owned subsidiaries) – and, therefore, not merely the regulatory minimum requirements – be taken into account

We would like to observe, furthermore, that deductions of minority interest should not overlap with deductions that may need to be made concerning credit deferred taxes to avoid double counting. Therefore, we believe that it would be inappropriate to include into the deductions that need to be made deferred taxes corresponding to the minority interest.

- Due care should be taken to the particular situation of <u>non-operational Bank Holding Companies</u> of which the assets mainly consist of stakes they have in subsidiaries. If the level of minority interests constitutes a material proportion of their capital base, the consequence of the proposal may be that they would be deemed to be undercapitalised - and would, therefore, need to attract additional capital that is not matched by additional risks.

  For Bank Holding Companies of which the main banking exposures consist of partly owned subsidiaries, the proposed approach may fail to reflect the desired capital level of the Group, and, instead may set the 'target' capital level from a set of non-representative wholly owned subsidiaries. In an extreme case, if a regulated non-operational holding company owns only minority participations in subsidiary banks, it will not be possible to calculate the ‘target’ capital ratio on the basis of wholly owned subsidiaries.

  Groups having such structures should be granted an <u>exemption</u> from the proposed minority interest deduction rule at the discretion of the relevant supervisory authority.

<u>Unrealised gains and losses on debt instruments, loans and receivables, equities, own use properties and investment properties</u>

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- In some countries, a prudential filter is being used today to avoid unrealised losses to be deducted from Equity. The Paper states that this will no longer be possible in the future.

  We do not support the proposal as the consequence of the removal of the prudential filter on unrealised gains and losses would be that components of "Other Comprehensive Income" would need to be deducted from regulatory own funds even if they have no relationship whatsoever with changes in credit risk exposures.

  We strongly suggest that the Committee would put on hold its review of the prudential filter which applies to unrealized gains and losses until the IASB has finalized its work on the replacement of IAS 39 by a more appropriate standard.

<u>Deferred tax assets</u>

- The Consultation Paper proposes that deferred tax assets (DTAs) which rely on the future profitability of the bank to be realised, be deducted in full from the Common Equity component of Tier 1. This would imply that more or less all DTAs of EU based banks would need to be deducted.

  It could be argued in favour of such an approach that, when the bank's financial situation deteriorates materially, there may be no - or only a limited - ability to transform the DTA into cash to support the going concern position of the bank. However, we believe that such reasoning confuses between liquidity issues (which the Committee addresses in a separate Paper) and quality of capital.

  We believe that, as DTAs do have value for firms and are verified by the firm's auditors (on the basis of strict realisability tests assessing a firm´s future profitability), there is no need to deduct them from regulatory capital.

- If the Committee would nevertheless take the view that DTAs need to be deducted, we would like to suggest that the following 3 distinct situations be taken into account when considering the treatment of DTAs:

  a. A <u>timing difference</u> between accounting and tax systems arising <u>from income</u> (such as prepaid interest) being recognised for tax purposes before it is recognised for accounting purposes. This can arise from external or intra group transactions. The DTA is in effect a prepayment to the tax authorities of a tax expense that will be recognized for accounting purposes at a later stage.

     We do not see any valid reason explaining why such DTAs would need to be deducted from Equity Tier 1 capital. It would be useful if the Committee would confirm this.

b. A timing difference between accounting and tax systems arising from expenses (such as fair market value losses) being recognised for accounting purposes before they are recognised for tax purposes. Such a position will automatically reverse through the passage of time. For example, in the case of fair market value losses, the position will reverse either upon the market value recovering or when the losses will have been crystallised for tax purposes.

   As the timing of this effect is solely driven by the different allocation of taxable income and financial income to the various financial years, there is no underlying economic driver other than computation rules. Accordingly, DTAs on deductible temporary differences should not be deducted.

c. A claim against tax authorities to reduce the tax on future profits due to net operating losses (NOL) or tax credits carried forward.

   Tax credits carried forward represent tax benefits for future periods legally granted by tax authorities. The legal claim is materialised once there are future taxable profits. The tax liability on those is offset by existing tax attributes. The economic value of DTAs on tax attributes at any point in time is determined by creditworthiness of the obligor and availability of future taxable profits. Creditworthiness of the legal claim corresponds with the creditworthiness of the taxing authority (government) of a jurisdiction. Therefore, in practice, no impairment should be expected from that angle.

   As to the availability of future taxable profits the requirements of IFRS are stringent as IAS 12.35 requires compelling evidence that sufficient taxable profit will be available. Therefore, many DTAs on tax loss carry-forwards were not recognised during the recent crisis. If DTAs had been recognised the amount of DTAs and the nature of the evidence supporting its recognition would have needed to be disclosed [IAS 12.82].

   Against this backdrop, we think that for Tier 1 capital purposes conservative rules of projecting future taxable income and the avoidance of a pro-cyclical effect of an overly conservative approach should be considered. The current Tier 1 capital treatment for DTAs reduces the volatility of Tier 1 capital over the economic cycle. Capital consumption from losses is reduced by DTA recognition, capital contribution from profits is reduced by DTA releases. As a result, the recognition of DTAs dampens the pro-cyclicality of Tier 1 capital.

- The Committee should in any event accept that deduction for DTAs, if any, and limited to tax losses carried forward (see category c above), would need to be made from Tier 2 instead of from Tier 1 as the Paper explicitly recognises that DTAs need to be deducted because "*undue reliance on these assets is not appropriate for prudential*

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purposes, as they may provide no protection to depositors or governmental deposit insurance funds in insolvency and can be suddenly written off in a period of stress."

There is no justification for assuming that in a going-concern situation – i.e. when the institution is expecting to continue its operations and return to profit - all DTAs will be written off. As Tier 2 capital is dedicated to shield creditors in case of insolvency, we propose a deduction from Tier 2 capital.

- Should the Committee - notwithstanding the arguments mentioned above - nevertheless consider, that a deduction of tax losses carried forward (see category c above) is needed, we would suggest considering deducting only the portion exceeding a certain threshold of Tier 1 capital.

- Moreover, the Committee should consider that forward-looking provisioning will generate DTAs which should be excluded from deductions. Furthermore, DTAs deducted need to be adjusted for minority interest holdings if the proposal to deduct minority interest from core Tier 1 prevails.

Investments in own common shares

- According to the Paper, all of a bank's investments in own common shares need to be deducted from the Common Equity component of Tier 1 (unless already derecognised under the relevant accounting standards). In addition banks are required to look through holdings of index securities to deduct exposures to own shares.

  - We take the view that the proposed requirement disallowing deduction of short positions if they involve counterparty risk, should be deleted because it would not be appropriate to mix up considerations on wrong way risk (captured through capital for counterparty risk) with the calculation of the net positions. If not, ~~the~~ resulting capital requirements would be totally disproportionate and unrelated to the actual risk. Moreover there is no justification for totally disregarding such short positions when looking at the net delta exposure of the trading book: some short exposures involving counterparty risk are not entered into with banks (e.g. reverse repo's with mutual funds…) and, hence, are not subject to the wrong way risk which this clause aims to capture.

  - Where short exposures are provided by banking counterparties, a specific or general wrong way risk does arise. However, such risks are addressed elsewhere in the Basel II Framework and in the Resilience Paper. Those measures do not need to be supplemented nor double counted by such a specific measure. To summarise: the proposed deduction requirement would result in multiple layers of double counting of exposures and thus in a potentially significant and redundant capital requirements.

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- Concerning the proposal to look through holdings of index securities, we would like to suggest that a minimum threshold be established to take materiality into account.

- Finally, market-making should in any event be exempted to some extent.

Investments in financial sector entities which are outside the regulatory scope of consolidation

- The proposal is that investments in financial sector entities which are outside the regulatory scope of consolidation need to be deducted under certain conditions.

  a) The Joint Forum (consisting of the BCBS, the International Association of Insurance Supervisors and the International Organization of Securities Commissions) published a Report entitled "*Review of Differentiated Nature and Scope of Financial regulation – Key Issues and Recommendations*" in January 2010. This report is highly relevant as it recommends developing comparable high-quality cross-sectoral standards with the goal of reducing opportunities for regulatory arbitrage by ensuring that similar activities are subject to similar rules and standards, unless differences would be warranted due to specific attributes of each financial sector.

     The deduction which the Committee is proposing concerning investments in financial sector entities is not in line with the recommendations made in the Report as they clearly discriminate against banks.

     We, therefore, believe the proper way forward to be for the Committee to put this specific proposal on hold pending the outcome of the dialogue that it should have with IAIS and IOSCO to determine common rules in this regard.

  b) We agree that double counting of capital in the banking sector needs to be avoided. We do not agree, however, that it would be appropriate to achieve this objective by imposing a deduction from capital of holdings - including short term positions of the Trading Book and underlying positions of holdings in index funds.

     Appropriate assessment and intervention mechanisms by supervisors are envisaged in the near future, as macro-prudential oversight is reinforced. This will allow supervisors to handle double counting of capital in a discretionary way. Against this background we believe that a deduction approach should be handled with caution and be used only as a mechanism of last resort, i.e. when other alternative tools fail to address the systemic risk linked to an excessive intra-sector capital holdings and its feared contagion effect.

Concerning holdings in insurance companies, we believe that those would need to be treated along the lines of the recommendations made by the Joint Forum in its document entitled "Compendium of documents produced by the Joint Forum" (July 2001). Those recommendations have been translated in Europe in the "Financial Conglomerates Directive" which has been operational in the EU for several years and has strongly proved its efficiency during the crisis. As a result, the Financial Conglomerates Directive deals with the double gearing concern in an appropriate way. We, therefore suggest that:

i) participation in insurance companies be excluded from deduction if they represent less than 20% of this banks' insurance capital, and

ii) no capital deduction be required for banking groups which are subject to the additional supervision as a Financial Conglomerate, namely a quasi consolidation which is designed to avoid the double gearing of regulatory (bank and insurance) capital.

c) Further clarification would be welcome on the criteria to identify reciprocal cross holding agreements.

Given the expected reinforcement of macro-prudential oversight and supervisory scrutiny, we would like to suggest that reciprocal cross holdings of Financial Institutions that are listed on regulated equity markets and operate in different business areas ~~should~~ be exempted from the proposed capital deduction.

At least, permanent grandfathering should be granted for agreements in place at the time of the publication of the BCBS proposal. The 10% limit on the aggregated level of participations in financial institutions at each banking group level is sufficient to prevent systemic risk.

d) Concerning the proposal to look though holdings of index securities, we would like to suggest that a minimum threshold be established to take materiality into account.

e) Regarding the requirement to restrict netting to positions where no counterparty risk exists, we consider that it should be deleted (see in this regard the comments we made above regarding holdings in own stock under 46).

f) If deductions to regulatory capital arising from these participations are made, they should be analyzed together with the treatment of unrealized gains on those participations, avoiding the unintended consequence that an increase in the market value of participation leads to a reduction of the regulatory capital of the participating bank.

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g) Finally, we ask the committee to exempt market-making in any event as it is of utmost importance for banks active in financial markets to have the possibility to serve issuances which have been accompanied.

Shortfall of the stock of provisions to expected losses

- The Paper proposes that the deduction from capital in respect of a shortfall of the stock of provisions to expected losses under the IRB approach should be made 100% from the Common Equity component of Tier 1 capital.

  We note, however, that the Paper does not propose a symmetric treatment as excess of stock provisions is not included in Tier 1. This is not logical and amounts to discouraging banks from provisioning in excess of Basel II's expected loss.

Defined pension fund assets and liabilities

- We do not agree that defined pension fund assets should be deducted from the common Equity component but do agree that the two questions of the *quantum* and *level* of any deduction in respect of such liabilities should be addressed.

  However in answering these two questions it should be borne in mind that different countries and banks have different approaches to pension provision for their citizens and staff. In some countries the predominant form of pension provision is via a state provided pay-as-you-go unfunded scheme. In other countries employer-provided defined contribution or defined benefit pension plans are more common. The impact of the BCBS proposals will vary from country to country and from bank to bank, depending on the pension model adopted.

  Quantum of Adjustment

  There are a number of different methodologies that could be employed to assess the quantum of any deficit, including:
  - Accounting approach based on IAS19
  - Trustee's valuation
  - Pension Fund Regulator's valuation
  - Buy-out valuation
  - Any deficit recovery agreement (DRA) that has been agreed with the trustees

  Whilst we would normally support regulatory capital quantification based on accounting approaches, we believe that an accounting approach is not appropriate for pension valuation from a regulatory capital perspective as it potentially creates unwelcome volatility based as it is on point in time assessments of market prices. A

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full deduction of pension fund deficits will necessarily increase the pro-cyclicality and volatility of capital requirements. The figure below illustrates this point by simulating the impact on core Tier 1 ratio of a full deduction of the pension fund deficit. It is clear to see the level of volatility that would be added to the capital requirements. The comparison with the behaviour of capital markets throughout the period also shows how pro-cyclical banks' level of capital would become under this proposal. Furthermore changes in the accounting approach in the future – for instance in relation to the risk-free rate used and the expected removal of the "corridor approach" under IAS 39 – could impact regulatory capital arbitrarily.

We therefore ask the Committee to develop a mechanism to reduce impact on pro-cyclicality and volatility of capital requirements. Due to its nature, pension funds liabilities should be looked on a very long term perspective.

- For those institutions that are established in countries that can use this mechanism, the DRA derived from a statutory Recovery Plan that has been agreed by the bank sponsor with the pension fund trustees is the best assessment of quantum that should be used to adjust regulatory capital. Currently the DRA is the sum of five years additional funding under the Recovery Plan, and were the DRA to be extended, to cover say, ten years additional funding, then we would suggest that this be based on the net present value of the additional payments.

- For countries that have different pension fund systems, it should be the discretion of the national regulator to introduce pro-cyclicality and volatility dampening mechanisms for capital requirements related to pension fund assets. An example of this mechanism for fully funded pension fund systems could be a regulatory corridor method similar to the current version of the IAS 19. For the sake of transparency and because of level playing field considerations, the national regulators should be encouraged to publicly disclose the national capital requirement regime related to pension funds.

Level of Deduction

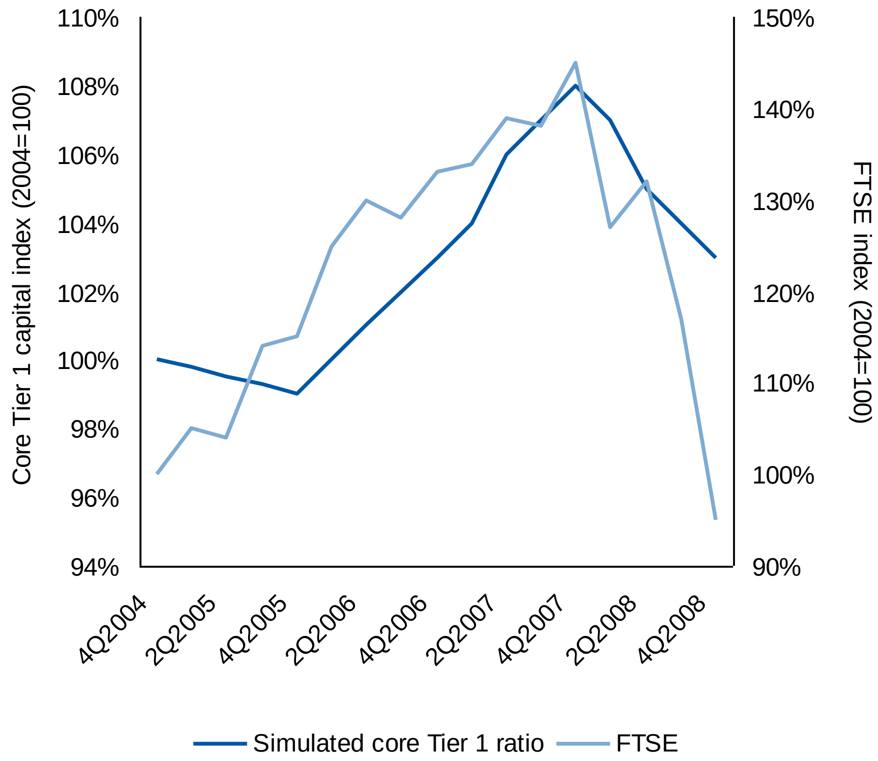
We do not believe that the deduction of the NPV of the deficit reduction amount should be made from common equity and reserves.

As the pension fund trustees have a claim alongside other creditors in insolvency and this is the point at which any under-funding would crystallise we believe that the default treatment should be deduction from gone concern capital, not going concern capital and recommend that the BCBS adopts this approach.

Disclosure

We acknowledge that the treatment by banks of pension funds for reporting purposes can be opaque and would be pleased to consider ways in which the reporting of the details of a banks' pension fund could be improved in Pillar 3, providing the NPV based DRA is adopted and deducted from gone concern capital.

Figure 1 - Index of UK banks simulated historical Core Tier 1 capital assuming a full deduction of actual historical pension fund deficits



Source: Annual Reports from Barclays, RBS, HSBC, Standard Chartered & Lloyds; BankScope; RWA & Core Tier 1 capital as of 2008; historical pension fund deficits from 2004 to 2008

3.2. Risk Coverage

<u>*3.2.1. Counterparty risk*</u>

<u>General remarks:</u>

The EBF acknowledges the need to review the treatment of counterparty credit risk given the difficulties recorded at the height of the financial turmoil. However, any change should be put in the context of the general overhaul of the prudential requirements, considering also the interplay with the rest of the measures notably those geared to stress the requirements of the market risk.

In this vein, it should be noted that derivative instruments have been created as risk management tools. As such, they represent an indispensable tool for investors to pursue their investment strategies and for companies to correctly manage business risk. The revised framework should distinguish between proprietary trading and the activities which support customer business.

We are of the view that the Committee's revised proposal should maintain the incentives to the use of Internal Model Methods (IMM) compared to the use of less sophisticated approaches.when considering the recalibration process which is likely to follow the Quantitative Impact Assessment. Financial institutions adopting IMM to compute their capital requirements, have to meet a set of qualitative and quantitative requirements, which go under a validation process carried out by national supervisory authorities and need to be maintained and verified on a regular basis by internal control systems in order to be eligible for regulatory purposes.

It is worth highlighting that the adoption of internal measurement systems encourages institutions to use better risk governance and management practices extending from the integration of the internal systems in the daily risk and limit management (use test) to a more effective risk reporting and a broader use of credit mitigation techniques.

We strongly believe that some shortcomings which the Committee has identified in the use of internal models, could be better addressed revising the validation process requirements, reviewing the activities of the independent risk control unit, strengthening the back-testing of internal assessments of CCR exposure and reinforcing the importance of stress analysis and stress testing programs rather than setting additional requirements.

BCBS 164 refers to results conducted by the Committee on the sensitivity of the financial firms to systemic risk, and concludes that asset value correlation for financial firms was some 25% higher than for non-financial firms. The EBF would wish to know more about the information the quoted results is based on.

The EBF understands the idea of extending a capital charge on credit valuation adjustment (CVA) risk. However EBF does not support the proposed method. The BCBS should observe carefully the following facts for the final proposal:

(i) The increase in procyclicality entailed.

(ii) The CVA is already taken into account to some degree in the current framework and double counting should be avoided at all times.

(iii)The excessive burdens imposed on OTC derivatives.

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We agree with the idea of setting incentives to the use of derivatives settled by CCPs like the zero risk weighting, but we do not support the proposal to introduce further burdens for contracts settled bilaterally.

The vast majority of OTC instruments are engrained in the international commercial transactions of the counterparties. In general, corporates and small-medium-size businesses use OTC derivatives specifically tailored for their needs. A shift to standardisation via CCPs would compel corporates to be somewhat exposed to financial risks if the range of derivatives offered does not suit their needs. Each commercial transaction has its own conditions of maturity, currencies, etc. The vast majority will not find perfect hedge in the standard derivatives offered by a CCP.

Disincentives for banks to enter into OTC derivatives would force corporate customers to find other techniques to manage their risks. These alternatives are not as efficient as derivatives and could lead to large unintended financial risks. This could have serious consequences for the customers and the real economy.

Moreover, it is our view that the rules and the measures the Committee has intention to set out, should move towards the direction of limiting the discretion of national supervisory authorities so as to ensure a level playing field among institutions and countries.

The EBF believes that further work is needed to develop the Basel Committee's proposals on counterparty credit risk to make them workable and appropriate for the risk that they are aiming to mitigate. At present, the proposals could damage the conduct of international business and result in an increase in systemic risk in the financial industry.

For all the above reasons, the EBF suggests placing the treatment of counterparty credit risk under the Pillar 2 of the Basel II framework.

<u>Specific EBF comments and suggestions:</u>

> *On the expected potential exposure (EPE) the BCBS proposal is to require that the Effective EPE metric be calculated on data that includes a period of stress.*

The Basel Committee's proposal to use stressed EAD values (as well as stressed PD and LGD) will overstate the risk in a stressed situation. It is quite conservative to stress all variables used to calculate the minimum capital requirements for counterparty credit risk. The three risk parameters – probability of default (PD), loss given default (LGD) and exposure at default (EAD) – are not fully correlated. It is not certain, or even probable, that the EAD reaches its peak at the same point in time as the LGD and PD reaches their peaks.

Stressing the parameters under the proposed method leads also to an unwanted situation where probabilistic interpretation of capital is lost. Hence, the Basel Committee should consider alternative methods to account for future economic downturns. Banks could for instance determine a capital buffer in pillar 2 that is based on a stress test designed to explicitly stress exposure values for OTC derivatives.

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On the credit valuation adjustment (CVA) the BCBS proposal is to incorporate a simple capital add-on to better capture CVA risk that recognises a clearly defined set of hedges.

The EBF accepts that not hedged, unexpected volatility of the CVA should be provided against, but go unnoticed when calculating market value. Therefore, CVA is an accounting definition. Banks use a variety of methodologies to take into account the changes in the creditworthiness of the counterparty, reflecting different accounting rules in different jurisdictions, as well as different market characteristics and the bank's own preferences. This is an area where no single approach is appropriate for all market participants. Banks should be allowed to continue to use approaches that reflect their operating environment; many will need to use a variety of approaches in different jurisdictions.

Some counterparties are traded on the CDS market. In this case the counterparty risk is a tradable risk and for these counterparties the publicly available CDS spread in the market can be used in the assessment of the CVA. For counterparties that are not traded on the CDS market, the assessment of CVA is more cumbersome. Either a market-based CDS index-spread (based on the a combination of rating, industry, country and other factors) is used as proxy for the credit quality, or the banks internally estimated probability of default (PD) and loss given default (LGD) is used.

The suggested bond loan-equivalent approach for calculating CVA risk proposed in BCBS 164 is not appropriate for all market participants. If a bank uses a through-the-cycle reserve approach in its CVA, using historical PDs, it is not subject to short term spread volatility. The use of proxies in the absence of spreads (non-traded counterparties) may result in excessive capital charges in relation to the risk, exacerbating an already conservative counterparty capital charge (if the bank has not adopted the IMM approach).

We believe that further analysis should be conducted to make sure that the revised regulatory framework reflects the proposed bond-equivalent approach should be subjected to careful analytical review in order to make sure that it gives a somewhat reasonable reflection of the true risks related to counterparty defaults prior to settlement of derivatives transactions. There are several reasons for this view:

(i) The bond-equivalent method increases the pro-cyclicality of the capital requirements.

(ii) Too conservative netting and maturity assumptions are proposed.

The Basel Committee proposes that only single name CDS protection can be netted with CVA risk with the same counterparty. This means that on one hand, the principle of CDS index proxy is valid in the proposal when it comes to calculation of the risk driving the CVA. But on the other hand when it comes to hedging the same risk, the principle is no longer seen as valid.

The effect is that not only are banks forced to hold capital for risks factors they do not view as be risk factors themselves, also they are not able to reduce capital by entering offsetting positions in these risk factors. The consequence is that the capital requirement for non traded counterparties will be much higher than for counterparties that are traded on the CDS market. This asymmetry will eventually result in higher margins for the companies outside the CDS market.

The utilisation of CDS as the reference for risk premium for discounting cash flow purposes might be somewhat optimistic given the current situation of still few deep and liquid markets for single names.

The proposed use of the longest dated netting set as the maturity of the respective bond is a too conservative ad hoc methodology that does not reflect the true CVA risk. We take the view that:

(i) For banks adopting IMM, notional should be better determined by the best estimate of expected exposures, such as duration based bond notional amounts, within a bank's CVA methodology Notional should be determined by the best estimate of expected exposures.

(ii) Independently from the used methodology used, EAD should take into account the contribution to risk mitigation provided by the collateral agreements, to the extent it is allowed by the current regulatory framework.

(iii) Banks should be allowed to set maturity on the basis of the margining period when collateral agreements are in place for a specific counterparty derivative exposure; in absence of collateral arrangements, the maturity of a derivative should be no longer than the break clause term, if stated in the contract, and the maturity of the overall derivative exposure toward a counterparty should be computed as the weighted average maturity of the contracts included in the exposure. For those institutions adopting IMM maturity should be determined by the expected exposure curve.

(iv) Time horizon should be consistent with other market risk factors or periods relating to liquidity constraints (as given by margin periods).

The Basel Committee proposes that the VaR of the bond-equivalent position shall be calculated on a standalone basis. This is very conservative since the bank might have an offsetting market risk position in the trading book. We suggest that diversification effects with other market risk positions in the trading book should be recognised.

EBF proposes to allow banks to use their internal risk measures for embedded CVA risk and allow aggregating the embedded CVA market risk with similar market risks in the bank and hereby giving incentives to managing the risk.

We are concerned that the Basel Committee's proposal might lead to that the capital charge for CVA risk is disproportionate to the risk involved. The CVA risk is already taken into

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account to some degree in the current capital requirements for counterparty credit risk. The exposure value according to the current exposure method (CEM) is a function of the market value of the instrument and an add-on for the potential future exposure. The CVA risk could already be accounted for up-front in the market value and in the add-on. A capital charge for expected CVA loss is only needed to correct the valuation error for derivatives when their mark-to-market values are calculated using Treasury curves (i.e. a risk free counterparty).

Furthermore, the unexpected CVA loss is to some extent reflected in the default risk charge, through the maturity adjustment in the IRB formula. The Basel Committee explains the rationale for the maturity adjustment in the following way:

"maturity adjustments can be interpreted as anticipations of additional capital requirements due to downgrades. Downgrades are more likely in case of long-term credits and hence the anticipated capital requirements will be higher than for short-term credits."[3]

On the implementation of an explicit Pillar 1 capital charge for specific wrong-way risk:

Under the internal risk management policies, the presence of specific adverse correlation can be readily minimised by a sound admission process that blocks the acceptance of certain types of collateral. Hence, for specific wrong-way risk we reckon that firms in possession of such policies should feel no significant impact from the Committee's new proposals.

We propose to use the financial statements consolidation perimeter as criteria to identify connections between counterparties for the purposes of wrong way risk.

On the Application of a multiplier of 1.25 to the asset value correlation of exposures to regulated financial firms (with assets of at least $25 billion) and to all exposures to unregulated financial firms (regardless of size):

The asset value correlation proposal affects all lending to financial counterparties, not just OTC derivatives and securities financing transactions. It will capture interbank lending, and could result in detrimental impact on liquidity placements, especially as the impact on better rated counterparties is disproportionately negative.

The proposed correlation factor discourages moves to IRB approaches, as it is only applied to the IRB approach, not the standardised approach. This is not consistent with the Basel Committee's stated target of providing incentives for banks to move towards more sophisticated approaches.

[3] Basel Committee on Banking Supervision; An Explanatory Note on the Basel II IRB Risk Weight Functions, July 2005.

It would be desirable to include as an alternative to the CVA multiplier of 1.25 the possibility of considering asset correlation as an internally model-measured parameter alongside PD and LGD.

The proposal is burdensome to implement due to that it does not rest on the current framework for asset classes and size adjustments. If the Basel Committee decides to go forward with this proposal, EBF ask the Committee to implement the increased correlation on the asset class Institutions and to use the same firm-size adjustment framework that is used for small and medium sized corporate entities in the IRB formula.

The increased correlation factor for financial institutions reduces the systemic risk in the financial sector. EBF can therefore conclude that there is no rationale for an additional capital requirement to address the interconnectedness of systemically important financial institutions, since such a capital charge would double count the correlation between institutions.

On the extension Extend the margin period of risk to 20 days for OTC derivatives and securities financing transactions (SFTs) netting sets that are large (ie over 5,000 trades), have illiquid collateral, or represent hard-to-replace derivatives. Application of a multiplier of 1.25 to the asset value correlation of exposures to regulated financial firms (with assets of at least $25 billion) and to all exposures to unregulated financial firms (regardless of size):

As regards paragraphs 150 to 153, we envisage a fundamental difficulty in the possibility of discriminating instruments such as OTC derivatives by "degree of liquidity" as the same are by definition not liquid. For this reason, parametering margin period to the different levels of liquidity could be difficult.

On the increase of the incentives to use CCPs for OTC derivatives and recognise that collateral and mark-to-market exposures to CCPs could have a zero percent risk weight if they comply with the stricter CPSS/IOSCO recommendations for CCPs:

In our view collateralisation of OTC derivatives contracts is important. Better collateralisation of the financial system is a key point to reducing contagion in crisis situations and consequently systemic risk. Hence, we support better collateral management processes in the industry and the collateralisation of all interdealer OTC derivatives trades.

It may help to underline that in the peak of the financial turmoil there was a broad tendency across the market players towards a revision of the terms of the collateral and CSA agreements in a tighter manner. It is worth mentioning the increased frequency of margining (from weekly to daily or from monthly to weekly, etc.), the lowering of the threshold amount and the setting of additional margining requirements tied to change in counterparty's credit rating.

The majority derivatives trading (particularly on interest rates and on credit risk) is settled bilaterally and not by a central counterparty or on a trading venue. The use of central counterparties inevitably requires a process of standardisation of the contractual characteristics of products, which, if excessive, would made these instruments less effective in fulfilling the risk management needs of investors and companies as well as making market operators less able to manage the risks assumed. The versatility in the use of OTC derivative contracts should be preserved or at least taken into consideration when making regulatory decisions.

We are in the opinion that the Committee's proposed incentives to move OTC derivatives from bilateral clearing to multilateral clearing through Central Counterparties could have the unintended consequence of increasing the costs for non financial corporations, which generally trade derivative contracts for hedging purposes and do not have the cash management systems necessary to engage in day to day margining. Having to comply with the margin requirements (initial margin and variation margins) set out by the CCPs, some entities will have to use part of their operational cash flow for reasons other than those implied by their typical business needs; in some cases they will even have to borrow it from the loan market, if short of liquidity. Therefore, for non financial corporations the result is likely to be an overall increase in the liquidity costs, or restrictions in the derivative contracts they will be able to stipulate. Thus, a large part of the derivative positions cannot be cleared centrally even though the bank has an incentive to do so.

We also believe that the move to clearing systems based on Central Counterparties will not necessarily imply a reduction in the overall credit risk exposure of the financial system. Some financial institutions are likely to make loans to non financial entities in order to support the margining requirements for their hedging activity through derivative contracts based on central clearing. From the one, hand this might lead to a reduction in counterparty risk arising from derivative exposures due to the use of multilateral clearing systems, on the other hand there might be an increase in credit risk exposure for the banking system owing to additional loans provided to derivative users. The impact of this two opposing effects is not clear and is far from being assessed.

All in all, disincentives for banks to enter into OTC derivatives ends up in higher cost of risk management.

The CCPs would become in turn counterparties "too big / too interconnected to fail". There should be proper regulation to ensure safe and sound risk governance of central counterparties.

As a conclusion, we agree with the idea of setting incentives to the use of derivatives settled by CCPs like the zero risk weighting, but we do not support the proposal to introduce further burdens for contracts settled bilaterally (in particular the envisaged stressed EPE and the CVA).

On the requirement that 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 (ref. 163-164).

EBF does not support the Basel Committee's proposal to introduce a separate PD requirement for counterparties that are highly leveraged and for counterparties whose assets are predominantly traded assets.

It is very common that bank's rating models already account~~s~~ for leverage. Thus, highly leveraged counterparties are already today assigned a higher PD and therefore also a higher capital requirement. However, the rating models do not necessarily reflect stressed asset values but rather the volatility of asset values in normal business conditions.

There are several implications if banks are forced to take the stressed volatilities into account when determining the PD used for regulatory capital purposes.

i. There will be a problem to validate the rating and PD models as they will represent periods of stressed conditions. During other time periods the models will show much higher estimates than what can be observed, which hampers the interpretation of validation results.

ii. The rating models that banks use for their business purposes (e.g. pricing or lending decisions) can not be used for capital adequacy purposes since the stressed conditions will render any economic capital models misleading.

iii. It would be inappropriate to use a PD based on a stressed scenario as an input to the IRB formula. The minimum capital requirement is already reflecting a stressed situation since the normal PD is converted into a conditional PD (i.e. a stressed PD) in the IRB formula. A customer with a high PD (e.g. due to high leverage) is stressed more in the IRB formula than a low PD customer (due to that the asset value correlation factor increases with PD).

Banks are already today required to perform stress tests as part of Pillar 2 and also to consider if the there is a need to hold an additional capital buffer due to the outcome of such stress tests. Thus, any stress test buffer for highly leveraged counterparties in pillar 2 could be reduced if this would be held within pillar 1 instead. The total (Pillar 1 plus Pillar 2) capital buffer for highly leveraged customers will be unaffected.

3.2.2. External ratings

The EBF understands the problems posed during the crisis which could have misled the interpretation of the external rating outcomes especially as regards certain instruments which probability of default proved to be highly correlated.

Nevertheless, the external ratings play an important role in the accurate assessment of risk. They show longstanding robustness as regards the discrimination and ranking of risks.

The improvement of in governance and controls of the external rating agencies as a result of their own commitment and the requirements of IOSCO reaffirm the general reliability of external ratings as a tool for adequate risk valuation.

The EBF supports the introduction of a set of transparent and stringent criteria for rating agencies which will enhance not only their overall quality but will help restore market confidence in their independent, non biased view on counterparties and structured credits. The EBF only notes that a balance must be found between high quality standards and the risk of creating a too high barrier to entry for new rating agencies.

The EBF very much welcomes the deletion of the minimum requirement for guarantors. Apart from possible cliff effects, we believe that a situation in which an exposure is guaranteed by a third party not related to the obligor under all circumstances presents a better risk profile, simply given that there are two repayment sources for the exposure in question.

The EBF would deem unwarranted the potential elimination or further restrictions in the use of external ratings in the Basel II framework. It would only mean a step backwards in risk valuation and management. Moreover, it would penalise the wide range of small and medium sized banks that make good use of the external ratings in their risk assessments.

In case the Basel Committee is specifically concerned with the performance of certain type of ratings, such as those assigned to re-securitisations, it would be advisable to address this problem separately.

Attention should be paid to the possible overlap between the Section on CVA risk and new calibrations and inferred rating treatments for securitisations (Paragraph 188). In view of the fact that a large part of securitisation related losses are known to have been accounting not real credit losses.

We note an inconsistency between Paragraph 192 creating an incentive to obtain external ratings and Paragraph 188 considering the possible deletion or change in the hierarchy structure for securitisations whereby the ratings based approach would be lower in the hierarchy. We believe that with the introduction of a stringent and clear set of rules and codes of conduct for rating agencies, external ratings will add value to the market players even though we acknowledge that these need to perform at all times their own due diligence. We believe that by taking away the –enhanced- scrutiny of the rating agencies, the securitisation market could be seriously jeopardized by less transparency and visibility.

Another point of concern stems from the potential loss of eligibility of ratings of emerging countries. We invite the BCBS to carefully study the implications it would have notably in the path to integration of Eastern European economies into the EU.

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A note of concern is raised in Paragraph 178 and subsequent paragraphs as to a blind use of external rating by banks. From these paragraphs it seems that the concern is primarily directed to the rating of securitisation products.

Prior to establishing a difference between external and internal ratings, we reckon that ‘rating models’ that are intended to measure the credit quality of a securitisation and the ones employed to rate genuine (non-securitisation) counterparties should be clearly distinguished. The former should be understood as credit portfolio models, able to incorporate the systematic risk of the underlying pools in the securitisation, and the latter are more specific to the counterparty i.e. financial ratios. Hence, we consider that a different category of ‘rating models’ (closer to a credit portfolio model or a valuation model) should be established when intending to assess the credit quality of securitisations.

As an example, an equally rated corporate bond and a securitisation product embed different amounts of systematic risk (a fact that is acknowledged in Paragraph 185, where the need for having a good estimation of asset correlation in the case of structured products is outlined). While a rating grade and its associated PD mainly contain information about the expected loss, it is also well known that the loss distributions of two assets with equal rating may differ qualitatively, mainly because of the different content of systematic risk. This observation should lead to a clear distinction of those rating models that are intended for counterparty credit quality assessment and those that are employed for assessing the credit quality of synthetic products that embed other sources of risk (ie. asset value correlation in the underlying pool). In this respect, paragraph 180 for instance, does not reflect this difference.

3.3. Leverage ratio

- The Consultative Paper recommends developing at a global level a non-risk based measure to contain leverage.

  Compared to the Basel ratio, the leverage ratio is a crude measure as it ignores the quality of assets and is, therefore, too simplistic. Re-introducing a leverage ratio would be in contradiction with the spirit and the purpose of the Basel II rules which take into account the riskiness of investments. As a result, a leverage ratio may require banks to hold more capital than justified from a risk-based point of view. In addition, it removes the incentives for institutions to improve their risk management practices. Therefore, introducing a leverage ratio would constitute a step backwards.

  Another basic flaw of a leverage ratio is that is not neutral as to the differing business models used by banks. Introducing a leverage ratio within the framework of Pillar 1 may have devastating effects on low risk banks (such as retail mortgage banks with sound lending procedures) as well as on the economy and financial markets of those countries in which low risks banks have an important market share as those may need

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to take actions to be able to meet the leverage ratio requirements. The most important victims of a leverage ratio will be banks that provide retail banking services and of which the lending portfolio mainly consists of well collateralised retail exposures carrying low risks – which creates a paradox as those types of banks have in general been faring rather well during the crisis.

- We agree that excessive leverage may amplify the effects of risk. However, the new regulatory framework which is under construction already contains a range of tools to address leverage.

  - As highlighted in the Resilience Paper, one of the objectives pursued by the leverage ratio is to help avoid destabilising deleveraging processes. However, this is precisely one of the issues which the proposed new liquidity risk management framework will help to address. One of the circumstances which, at the beginning of the crisis, prevented the unavoidable deleveraging process to develop in an orderly fashion was the flawed asset-liability structure of the balance sheets of financial institutions. As a result, many firms were not in a position to adjust their balance sheet size flexibly by reducing lending and not rolling over debt.
  - Accounting standards – which were also an obstacle to an orderly deleveraging process (revision of IAS 39 and Fair Value Measurement Guidance).
  - The increased capital requirements for trading book exposures will contribute as well to mitigating the potential effects of the leverage.
  - Avoiding bubbles and the associated excessive leveraging of the economy is, moreover, basically a macro-economic concern that needs to be addressed by measures which go far beyond the reach of the leverage ratio. Monetary and budget policies which are aimed at safeguarding the system as a whole are probably much more effective for that purpose. Macroprudential supervision which is in the process of being developed may, therefore, be a powerful and more appropriate tool to address and steer leverage within the financial system.

- If a leverage measure were to be introduced, it is crucial that it be imposed in a flexible way.

  The Basel Committee proposes that the leverage ratio ultimately be transformed into a Pillar I measure. However, we strongly oppose imposing a quantitative limit on the gross leverage of financial institutions which would take the shape of a hard number, i.e. an absolute level that would be binding on a stand-alone basis on all financial institutions in every circumstance.

  Instead, the leverage measure should merely serve as an indicator that would, in combination with a range of other key risk indicators, help supervisors assess the institution's capital strength within the Pillar 2 framework. Such an approach would

allow assessing the ratio's outcome by taking into account the bank's business model and, more importantly, to focus on how the leverage develops over time – which is likely to be a more relevant indicator than the (rather arbitrary) outcome of the ratio as such.

- The Consultation Paper makes some tentative proposals as to the design of the leverage ratio and, more particularly, on the composition of the ratio's numerator and denominator.

  We agree that, if a leverage ratio were to be introduced, it is essential for the definition of the numerator and the denominator to be harmonised on a global level to promote comparability and converging supervisory practices on a global level and, furthermore, to avoid creating competitive distortions.

  What is missing in the Consultation Paper, however, is a reasoned analysis of how each of the possible alternatives which are being considered would tie in with the various objectives which the leverage ratio is pursuing (i.e. to contain excessive growth; to avoid destabilizing processes; and to introduce a backstop measure against perceived shortcomings of the risk-weighted approach), including possible trade-offs that may need to be made in this respect.

  In the absence of such an analysis, it is impossible to argue in favour or against any of the tentative proposals made.

- The leverage measure should apply only at a consolidated level for banking groups.

- We note that the Committee is in the process of conducting impact studies to determine the calibration of the leverage measure. In addition, clarity should arise about the criteria determining the level.

- The Paper remains silent on the pro-cyclical dimension of the leverage measure, which we believed to be one of its basic features as the target value of the ratio is expected to vary through the economic cycle.

- If it would be introduced, the leverage measure should only be implemented at an appropriate time in the economic cycle, i.e. once economic recovery has been assured. Imposing it in the middle of the current crisis would put additional de-leveraging pressure on banks. In addition, institutions should be given sufficient time to adopt the new measure.

- As the Paper does not address a number of key features of the proposed leverage measure, it can merely be considered as an interim report. Many uncertainties still remain and we expect the consequences for the various types of banks and customers

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as well as for the real economy to be examined and explained in a new Consultation Paper.

3.4. Procyclicality

3.4.1. Cyclicality of the minimum requirement

The proposal made to dampen the cyclicality of the minimum requirement by stressing the risk parameters, although its definition is not clear so far, brings up a fundamental question about the trade-off between cyclicality and risk sensitivity.

We strongly oppose to the stress of the probability of default parameter in pillar 1 by means of a sort of PD downturn, for the following reasons:

(i) It does not seem to make sense to use stressed PDs in an already stressed capital formula, i.e. the 99.90% confidence interval already discounts for low probability events.

(ii) Having both a downturn PD and LGD will effectively remove the dynamic elements from the RWA calculation.

(iii) The adoption of a downturn PD, whatever its final definition, will turn the cost of capital less sensitive to risk or not sensitive at all.

(iv) It would distort the meaningfulness of the pillar 1 calculations. The expected loss calculated with a downturn PD in addition to a downturn LGD would not offer any practical use.

(v) Banks will be punished forever for large losses that have occurred in the past, even though the business model has been changed.

The use test of Basel II would be endangered. Banks would be compelled to run a double process: one for the imposed extra-conservative regulatory parameters and a different one for their own internal use. Yet one of Basel II's major objectives was to bring about an alignment of the procedures required by supervisors and those used internally.

A worst case scenario could be interesting to know as a point of reference but management needs more plausible information in their decision-making process.

We foresee that as a result, banks could tend to lend to higher risk profiles which offer higher profitability for the same cost of capital. Whatsoever, the consequences that this trend would entail, depending on its intensity, would not be desirable.

All in all, the obligation to use downturn PDs in IRB methods may distort the right incentives by making the more advanced methodologies more punitive in terms of capital charge than the standardised approach.

Moreover, the practical implementation of a downturn PD would broaden the problem of harmonisation of methodologies. The methods used by different banks under the approval of their respective national supervisors will make the bulk of the difference. The scaling factor will become essential to set the cost of capital.

Furthermore, using ultraconservative risk parameters may well results in jeopardizing the inbuilt incentive for banks using the standardised approach to move over time to the more risk sensitive IRB approaches. The obligation to use downturn PDs in IRB methods may on the contrary create an incentive for banks to remain in the standardised approach instead. Moreover the use of downturn PDs would increase capital requirements in good times without providing any relief in bad times. “Absolute” increases in capital requirements are not a suitable means of mitigating procyclicality.

3.4.2. Forward-looking provisioning

The EBF supports the provisioning based on EL model and is putting forward a proposal for a provisioning model based on the EL concept, which is capturing the economic reality of the lending activities of financial institutions in line with the BIS six principles to achieve sound EL provisioning approach. We believe that the forward-looking element of the provisioning system will contribute to mitigate procyclicality in consequence.

3.4.3. Capital buffers through capital conversation

The proposed additional standards restrict the capital management capability of the bank even while the bank still has capital above that required by the minimum capital ratios.

The competitive edge of the banking industry will be at risk. Reducing pay-out will directly turn banks common equity less attractive, while the stricter definition of capital will force banks to raise equity of this kind.

Too much conservation of capital can do more harm than good to the real economy. We fear that fixing mathematical limits to dividends, what is a measure never known before among industry sectors, could bring about unintended consequences. It is crucial that the Basel Committee assesses the impact on the real economy of increasing the capital requirements in the banking industry and takes it into consideration when calibrating the minimum requirements.

A point of concern is that disclosure obligations may lead investors to misinterpret the measures taken notably the dividends pay-out constraints, with the ensuing serious risk of reputational damage.

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3.4.4. Excessive credit growth

The EBF understands and appreciate the motivation of the Basel Committee to commence the outline of a possible regime which would come into action adjust the capital buffer range when there are signs that credit has grown to excessive levels in particular markets. However, rather than penalizing banks that have not shown such undesirable behaviour simply because they are active in the market or jurisdiction in question , i.e. did not show excessive credit growth, it should be considered to intervene solely in banks that show the trend to excess growth during the upside of the cycle (but how to distinguish “excessive” from “normal” credit growth and how to apply globally uniform criteria?). Also, it should be taken into account that controlled growth in so far under-banked markets should still be permitted.

Whatsoever, this proposal should be developed in connection with the macro prudential discussions underway.

We would like to highlight that credit growth is normally controlled first and foremost by macroeconomic variables (interest rates and minimum reserve requirements of central banks) and less by the banks themselves. Indeed, it would be an intervention in the credit market and the decision-making process of market participants. Moreover, the additional intervention by regulatory authorities could lead to a distortion of competition.

Notwithstanding the above, credit growth does not seem to be a problem in the next future. *Par contre*, the threat of credit shrinkage looks to be a matter for discussion these days.

3.5. The interplay between different measures

The EBF has long expressed its concern about the fact that the current overhaul of prudential regulations is being assessed from a piecemeal approach. Despite every measure could have a certain degree of rationale, the cumulative impact that they all would have on the banking sector – thus on the real economy - remains uncertain so far.

Specifically, there appears to be interplays between different proposals which have had very little regard insofar. The EBF is committed to understand not only every individual proposal but, far more importantly, the hidden effects behind the combination of different measures. It is in this area where the BCBS and all stakeholders should further investigate in a view to avoid overlaps and opposed measures.

The EBF has identified certain areas that would deserve special attention because they could pose undesirable effects due to the combination of proposals.

3.5.1. The Interplay between Capital definition, Liquidity ratios and Capital Buffers

The new liquidity proposals will undoubtedly affect negatively the return on equity of banks.

In turn, capital buffers through conservation of capital will limit the dividend pay-out.

In such a scenario, banks will be compelled to enhance substantially their capital base in terms of common shares, with a lower return on equity and the uncertainty caused by the new limits to pay-out.

Against this background, will the market be willing to subscribe the capital needed to meet the new enhanced core tier 1 requirements?

3.5.2. The Interplay between Regulatory Adjustments to Regulatory Capital and Cyclicality

The Resilience Paper seeks to strengthen the definition of capital focusing on its overall quality, consistency and transparency, amongst others, by means of the regulatory adjustments to regulatory capital which it proposes. However, some of those regulatory adjustments, in particular the proposed treatment of unrealized gains and losses, deferred taxes and of defined pension funds assets and liabilities, have the undesirable effect of excessively amplifying cyclicality and volatility of capital requirements.

3.5.3. The Interplay between Capital Definition and Cyclicality of the minimum requirement

The proposal to reduce the cyclicality of the minimum requirement lays in the use of a downturn probability of default (PD) in pillar 1, what will result in an increase of the expected loss (EL).

In turn, the capital definition section foresees the full deduction - from core tier 1 - of the difference between the EL and the loss reserves.

This would have a double effect: not only the EL would be increased, but also the deduction would be stricter – currently only 50% of the difference is deducted from tier 1 -.

It seems unwarranted to deduct from the first tranche of capital the gap between the loss reserves and a worst case scenario EL.

3.5.4. The Interplay between Cyclicality of the minimum requirement and Dynamic provisioning

The proposal to reduce the cyclicality of the minimum requirement is geared to produce a stressed expected loss.

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Given that the difference between the new stressed EL and the actual loss reserve will be fully deducted from core tier 1 capital, it could play as a permanent charge, in most cases irrespective of the result of the dynamic provisioning system.

We would suggest the BCBS merging both proposals for the sake of clarity and straightforwardness in the countercyclical measures.

3.5.5. The balance between Cyclicality and Risk sensitivity

Several measures are geared to reduce cyclicality.

We agree cyclicality should be put under control. But a bit of cyclicality would not be so bad, especially considering the need to preserve risk sensitivity.

Specifically the implementation of PD downturn, the dynamic provisioning system and the capital buffers are intended to remove cyclicality (at the expense of risk sensitivity and investor's profitability).

In turn, it appears that other measures could increase cyclicality, for instance: (i) grossing-up derivatives or (ii) certain measures included in the package of counterparty risk such as the credit valuation adjustments.

3.5.6. The Interplay between Counterparty risk, Leverage ratio and the former amendments to Market risk

It is broadly acknowledged that the risk of certain derivatives has been underestimated during the years previous to the recent crisis. It is for this reason that new regulations look very strict with this type of instruments. However, in general derivatives are quite useful in the financial market. Among other benefits they provide credit protection and hedging of the financial risk in commercial transactions and allow entities for diversifying their risk portfolios.

The review of market risk that the BCBS performed during Summer 2009 and the new stressed VaR methodologies introduced in the text of the CRD III – which will be put in place by the end of 2010 – already increased considerably the risk estimate of derivatives.

In turn, the proposal for a leverage ratio envisages grossing-up derivatives, adding higher costs to the use of derivatives.

As a result, we consider the important role of OTC derivatives is in danger and the shift to CCPs standardised contracts – which entails certain benefits – will not replace the function of OTC derivatives.

We urge the BCBS to perform an instrument-wise analysis considering all the changes the OTC derivatives would be subject to, including the previous amendments to market risk,

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the currently proposed measures for counterparty risk and other such as the gross value computation in the leverage ratio.

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