European Financial Services
Round Table

Paris, 16th April 2010

Mr Christian Noyer
Chairman of the Basel Committee
Centralbahnplatz 2
4002 Basel
Switzerland

Dear Mr Chairman,

You will find herewith the response of the banking members of the European Financial Services Round Table (EFR) to the December 2009 consultative documents of the Basel Committee on Banking Supervision concerning the revision of the Basel II framework.

We agree that the regulatory weaknesses revealed by the crisis need to be addressed and we strongly support the general aim of developing an internationally harmonised framework for capital and liquidity requirements. However, a balance is needed between, on the one hand, the stability of financial institutions and the financial system as a whole which the proposed measures aim to achieve and, on the other hand, their impact on the economy.

Preliminary analysis of the proposed measures reveals that their cumulative impact will threaten economic recovery and future growth, as either the supply of credit to the economy will be reduced, or the cost of credit will have to be raised. The impact on the real economy is a particular concern for the EU, where the intermediation role of the banking industry is far more important than in the US. Therefore, we strongly support EU efforts to undertake its own impact assessment in complement to the Basel Committee's general exercise, and call upon the Basel Committee and the EU to take sufficient time for high quality assessments, delaying the envisaged year-end 2010 deadline for calibration if necessary. In this

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context, we urge regulators to use the results of the ongoing full impact analysis of the capital and liquidity proposals not just for the purpose of calibration and transition, but for a more fundamental reconsideration of which measures are needed and how they are presented.

When appropriate measures will have been agreed and adequately calibrated, it is vital that they are phased in gradually, as financial conditions improve and economic recovery is assured. Sufficiently long transition periods should be foreseen, and in any case, the new rules should not come into force before the end of 2012.

We stress the need for the Basel II framework, as revised, to be implemented consistently across the world to ensure a global level playing field. Furthermore, prudential rules should be consistent with accounting and reporting rules to avoid duplication or contradiction.

Last, the EFR is convinced that good supervision and risk management is key and that regulation should both stimulate and recognise good supervisory and risk management practices.

We stand ready to further discuss any of those issues.

Yours sincerely,

M. Pébereau

Michel Pébereau
Chairman of the EFR

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Response of the EFR

to the Basel Committee on Banking Supervision

Consultative documents 'Strengthening the resilience of the banking sector' and 'International framework for liquidity risk measurement, standards and monitoring' (December 2009)

16 April 2010

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General messages:

- This is a response by the banking members of the EFR. References to the EFR should be read as references to the banking members of the EFR.
- The **EFR welcomes the efforts of the Basel Committee** to address the regulatory weaknesses revealed by the financial crisis and the opportunity to respond the consultation. We support the general aim of developing an internationally harmonised framework for capital requirements and liquidity management.
- However, the EFR is very concerned that consequences of the Basel Committee's capital and liquidity proposals for the economy will be severe, **threatening economic recovery and future growth**, as the banking industry's capacity to finance the economy would be strongly hampered by the proposed measures. Indeed, preliminary analysis of the proposals by individual banks and banking associations reveals a huge impact on the banking industry. The proposals, which go beyond tackling weaknesses observed during the financial crisis, could entail a de facto limitation of the cross-border universal banking business model, doing away with the proven value of that model for facilitating a globalised real economy and for diversifying risk. Therefore, EFR Members urge regulators to use the full impact analysis of the capital and liquidity proposals not just for the purpose of calibration and transition, but for a more **fundamental reconsideration of which measures are needed** and how they are presented.
- **The effect on credit to the real economy is a particular concern for the EU**, as the European economy, in contrast to the US, is primarily financed by credit rather than through capital markets. Economic growth prospects will likely suffer significantly as the cost of capital to non-financial companies and households will usually be above that of the financial sector. As for the financial sector, the proposed restrictions on the structure of capital will be more problematic for EU financial institutions, as the nature of capital markets in the EU makes it more difficult for them to raise common equity than for US financial institutions. Therefore, the EFR would strongly support EU efforts to undertake its own impact assessment, in addition to the Basel Committee's general exercise.
- Given the broad array of mostly complex measures to be assessed, as well as the expected consequences for the real economy, the EFR calls upon the Basel Committee and the EU to **take sufficient time for high quality assessments**, delaying the envisaged year-end 2010 deadline for calibration if necessary. These exercises should involve appropriate consultation of stakeholders, including the financial services industry.
- When appropriate measures will have been agreed and adequately calibrated, they should be phased in **gradually**, as financial conditions improve and economic recovery is assured. It should be made clear who would be authorised to decide whether conditions have improved and recovery is assured, and on which criteria such a decision would be based. The criteria should include consideration of the capacity of markets to adapt to the new rules. As a general rule, sufficiently **long transition periods** must be foreseen and appropriate grandfathering arrangements should be put in place. **In any case, the new rules should not come into force before the end of 2012.**
- Once adopted, the new rules should be **implemented consistently** across the world. We recall and stress the vital importance of the resolve of the leaders of the G20 to adopt the existing Basel II capital framework and to make significant

progress towards a single set of high quality global accounting standards. The EFR believes that it is **essential that prudential regulation is applied in a consistent manner with accounting and reporting rules**, to avoid duplicative requirements, recognising that differences may be necessary to reflect the different objectives of prudential regulation and financial reporting. The international consistence of rules is crucial to achieve a global level playing field. To the extent that the existing divergence of e.g. accounting and tax frameworks would prove too difficult to harmonise in a sufficiently short timeframe to implement the new rules in a fully consistent way, regulators should at least have a common view on how to realise the goals of the new rules.
- The EFR is convinced that **good supervision and risk management are key** and that regulation should both stimulate and recognise good supervisory and risk management practices. The proposed rules are mostly detailed and prescriptive, leaving little room for supervisory judgment, failing to incentivise qualitative risk management by financial institutions and potentially creating further procyclicality.

<u>On the definition of capital:</u>

Regarding the measures foreseen to improve the quality of capital, the EFR welcomes the development, at the international level, of a homogeneous understanding of capital. This, we believe, is particularly important for hybrid capital instruments where definitions still diverge significantly across countries and across financial sectors. Such harmonisation would contribute to achieving several key objectives, including achieving a common understanding of capital among economic agents, guaranteeing competitive neutrality, and creating more transparency for market participants.

As a principle, the diversity in eligible forms of capital should be encouraged as it allows financial institutions to respond to the specific needs of a broad range of investor groups and thereby broaden the range of investors which is good for financial stability.

Furthermore, in their efforts to harmonise the definition of capital, international and European regulatory bodies should refrain from adopting an over-restrictive definition and recognise the key role that non-common equity instruments - especially hybrids - play in the financing of the economy and in allowing flexible capital management solutions. In this context, regulators should consider the following aspects:
- Newly issued hybrid instruments should be allowed as Tier 1 capital to the extent that they meet the three main Basel Committee quality requirements, i.e. permanence, flexibility in payment and loss absorption. Concerning the criterion of permanence, careful consideration should be given to market investors' appetite for the instruments concerned. If such appetite holds for a sufficiently long period of time (to be defined), such capital instruments should be recognised as permanent.
- For existing hybrid instruments, clear and realistic guidelines on grandfathering should be provided as soon as possible, based on currently existing prudential rules (CRD in the EU). We are concerned to see that the Basel Committee's proposal (i) is vague on whether grandfathering of hybrids should be granted at all, and that it (ii) generally only considers grandfathering of hybrids issued before

the consultative document was issued in December 2009, although the proposals are neither finally agreed, nor complete as some key requirements are not exhaustively defined. It is important to also consider for grandfathering all hybrid instruments issued between December 2009 and the date on which the requirements are finalised.
- Tier 2 capital instruments should be properly valued and their loss-absorption capacity fully recognised. We do not believe that the systematic association of Tier 2 capital with the concept of "gone-concern" capital is an appropriate one. Subject to market acceptance, Tier 2 capital should be an integral part of the capital base of a financial institution, also as regards regulatory adjustments.
- EFR Members call on regulators to carefully review the proposals concerning regulatory adjustments to capital (i.a. relating to minority interests, minority participation, deferred tax assets…) on a case by case basis, taking into account relevant national legal, fiscal and accounting rules.
- Consideration should also be given to contingent capital arrangements, which may provide a useful element of prudent and sound capital management for banks in periods of market tensions.

<u>On counterparty risk:</u>

The EFR agrees that capital levels should be appropriate to cover real risks to ensure prudentially sound financial institutions and the wider financial stability necessary to protect the economy. The Basel paper proposes a completely new and untested approach to counterparty risk. This raises many technical questions, whilst creating capital requirements for risk positions which are already covered or which do not exist and introducing significant pro-cyclicality as it incites financial institutions to over-hedge corporate exposures, widening funding (CDS) spreads and thereby further increasing borrowing costs for the commercial sector. Applying the Credit Valuation Adjustment (CVA) under this new approach is likely to result in a punitive capital charge that is unjustified with respect to the underlying risk. The charge also does not take into account the variety of accounting regimes that materially affect the CVA volatility. In addition, the CVA approach is not comparable to the nature of other variables involved in a capital model (PD, LGD, asset correlation) which adopt a much more stable and through-the-cycle view.

The EFR accepts that that there is a risk of losses due to volatility in the CVA and that regulatory capital needs to be sufficient to cover this risk. However, the EFR does not consider the suggested charge an appropriate measure to accomplish this objective, given e.g. the overly conservative netting and maturity exposures.

Impact on use of CDS:
- Over-hedging: due to the penal nature of the proposed CVA capital charge, the proposed method is likely to lead to an overstatement of risks. Many banks will buy protection as it will be cost-effective for them to do so, even at high spreads. The proposal will thus encourage banks to over-hedge their credit risk exposure.
- Increased systemic stress: with all banks buying protection, it is unclear who the sellers will be. Possible sellers of such protection could include insurance companies, but also less regulated sectors such as hedge funds. Systemic risk

could increase if protection sellers struggle to meet their obligations during the next crisis.

- Unfair treatment of SMEs: the CVA capital charge can be hedged only for counterparties where liquid CDS markets exist – in other words only for large companies. The proposal thus unfairly discriminates against small companies for whom no CDS exists. Since in such cases banks would not be able to mitigate their capital costs, these would most likely be passed on, making it more expensive for smaller companies to mitigate their risk.
- Pro-cyclicality: in stressed market conditions, the CVA would be more volatile, and the suggested capital charge will likely increase in addition to this. Moreover an increase in CDS spreads – a likely consequence of increased demand to hedge – could also feed through to the real economy, making it more difficult for corporates, including larger ones, to obtain finance.

Impact on the OTC derivatives market:

- The proposals will make it significantly more difficult and expensive for corporates to hedge against their risks. The proposals are intended to encourage migration away from bilateral OTC derivatives arrangements towards central clearing. Bespoke OTC derivatives are currently used by the commercial sector to mitigate their financial risks. The use of central counterparties requires marking to market and collateral posting, but most commercial enterprises do not have the cash management systems to do so. As a result, a large part of the derivative positions cannot be cleared centrally, even though banks have an incentive to do so. In addition, hedge accounting treatment would be incomplete and there would be increased cost to corporates.
- The likely unintended consequences would be either that corporates, including larger ones, will choose on cost grounds not to mitigate their market-related risk, threatening the commercial sector and in some cases price stability, or that the increased cost of mitigation would itself impede economic recovery and growth. Cross-border flows may also be impeded, posing difficulties for firms operating across different jurisdictions.
- In addition, the EFR does not see the need for punitive capital charges for contracts that are not CCP-cleared. The probable zero risk weighting of CCP-cleared contracts already offers a sufficiently strong incentive to move to CCPs, recognising that CCP clearing has the important benefit of mitigating credit and operational risks.

<u>On a leverage ratio:</u>

The EFR recognizes that excessive asset growth can be a cause for risk both at the level of individual institutions and at the level of the system as a whole. It is therefore advisable to monitor the development of leverage at both levels. Importantly, this must include the monitoring of off-balance sheet exposures that have been a source of leverage in the last crisis. Such monitoring can help constrain the build-up of leverage in the financial system and help avoid subsequent, disorderly deleveraging processes which may damage the financial system and the economy.

Nonetheless, the EFR maintains and reiterates its fundamental view that, at the level of an individual institution, a binding leverage ratio is an overly simplistic, non risk-

sensitive regulatory tool that does not fit well within the existing (and future) capital requirements framework. The coexistence of binding risk-weighted asset and liquidity ratios together with leverage constraints under Pillar 1 would provide misaligned incentives and would be very complex to manage. Furthermore, low-risk banks would be hurt disproportionately. Therefore, we continue to believe that the introduction of a binding leverage ratio is not appropriate as it would constitute a huge step backwards.

We are therefore concerned to see that, in spite of these concerns, many in the supervisory community (as expressed, inter alia, in the Basel Committee's consultative document issued in December 2009) are strongly willing to introduce a leverage ratio for banks, initially as a Pillar 2 instrument, but "with a view to migrating to a Pillar 1 treatment". EFR strongly urges regulators to retain the leverage ratio within the Pillar 2 framework. A well designed leverage indicator would be an integral tool of the supervisory review and evaluation under Pillar 2, which would complement the Pillar 1 risk-based framework. As such, a newly defined leverage indicator could trigger supervisory review discussions and appropriate remedial steps, reflecting on an individual bank's business model and risk management practice.

The EFR welcomes that the Basel Committee's proposals are cognisant of the urgent need to ensure comparability of a potential leverage ratio across jurisdictions and the ensuing need for a full international harmonisation of any measure taken. This must mean consistent national implementation, and more or less simultaneous implementation not just in the EU but across all G20 members. Specifically, differences in accounting standards would have to be accounted for fully, so that assets and equity are defined in an equivalent way, irrespective of the accounting framework.

In the eyes of the EFR, Tier 1 capital is the natural choice as a reference point for the calculation of equity, as there is a broad international consensus on the definition of Tier 1 and as banks already manage their Tier 1 ratios actively. We are therefore concerned that the Basel Committee's proposal includes, as one option, to base the leverage ratio on the narrower concept of core Tier 1 capital, as this may result in an overly restrictive approach in the calculation of the leverage ratio.

A leverage indicator should be applied at the consolidated level and include relevant off-balance sheet items (e.g. undrawn lending commitments). It should not make a distinction between domestic and foreign assets.

We note the additional options for the Basel Committee impact assessment on the leverage ratio and suggest that the Basel Committee remains open to industry suggestions on determining the precise scope of additional options for the impact assessment. Moreover, a leverage indicator, even as a Pillar 2 instrument, should not be introduced until financial market conditions have fully normalised, as otherwise it would add to deleveraging pressures.

<u>On procyclicality:</u>

The EFR acknowledges the proposed series of measures that will contribute to making the banking system more stable, which will help dampen, instead of amplify, economic and financial shocks. However, it should be noted that procyclicality is inherent to the financial system: it follows not only from capital requirements, but also from other factors such as accounting rules and macro-economic factors, and not all of these factors are easy to capture in regulation. Furthermore, some of the proposals of the Basel Committee actually risk leading to more procyclicality, e.g. the proposed credit valuation adjustment and the herd behaviour induced by the liquidity metrics. Such additional procyclicality should of course be avoided.

The Basel Committee first addresses the cyclicality of the minimum capital requirement. Although safeguards already exist (long term data horizons, downturn loss-given-default estimates, calibration of the risk functions, etc.), history show us that the main factor generating crises is the inherent proclivity in financial markets to operate procyclically. Therefore, a more careful through the cycle calibration of banking internal models should be guaranteed, and the parameters of standard models should be adapted accordingly. However, a certain cyclicality of the minimum capital requirement can be argued for, in order to keep it sensitive to the risk in the portfolio.

Concerning the proposed introduction of forward-looking provisioning and an additional capital buffer, the EFR signals that both measures have a similar economic effect. Accordingly, only one of them should be introduced, to avoid a duplicative impact. Whichever measure is chosen, its goals and design should be clearly defined and carefully calibrated and its practical functioning should allow meeting the stated goals.

Regarding forward-looking provisioning, the EFR acknowledges the Basel Committee's support for IASB proposals to move from an incurred loss approach to an expected loss approach in accounting. For such an approach to be effective in meetings its goals of limiting excessive credit growth and strengthening financial institutions, it is essential that accounting and prudential standards are applied in a way that avoids duplicative requirements, recognising that prudential regulation and financial reporting have different objectives. It would be for the FSB to coordinate appropriately between the IASB and the Basel Committee. The rules must be set at the global level and be applicable to all entities to ensure a level playing field.

The EFR has strong reservations about the introduction of additional capital buffers, as there is a very real risk of them constituting discretionary reserves effectively coming down to an increased minimum capital requirement. If countercyclical buffers were introduced, the following guiding principles should be taken into account:

- It should be possible to draw down the buffers when needed. The EFR is sceptical about whether this condition can be met in practice, as regulators and the market are unlikely to allow drawing the buffers down in times of stress. As a result, rather than tempering procyclicality, the buffers could lead to the opposite result. As long as this issue is not solved, the EFR cannot support the introduction of capital buffers.
- Capital buffers should be based on a firm-specific situation and form an intrinsic part of the dialogue between a firm and its college of supervisors under Pillar 2

and, accordingly, they should not come in addition to Pillar 2. Capital buffers should in no way be construed as a de facto increase of minimum requirements.
- The authority in charge of defining the structure of any capital buffer should be clarified, as well as the conditions under which the buffer would be built up and drawn down. Clear macro-prudential triggers would be needed.
- As capital buffers should always be based on the location of the assets, global supervisory coordination is required.

Finally, regarding the measures foreseen to provide supervisory tools to promote capital conservation (i.e. to avoid/limit payouts in terms of dividends, share buybacks and bonuses, etc.), the EFR considers that it could be useful, as long as it does not endanger the raising of new capital, by reducing the attractiveness of bank equity as an investment. In any case, gradual and homogeneous implementation should be ensured, in order not to damage the level playing field.

<u>On liquidity risk:</u>

Liquidity risk played a major role in the recent financial crisis. Before the crisis, relatively little attention was paid to how liquidity crises can be avoided or at least mitigated in the future. Therefore, the EFR welcomes the Basel Committee's consultative document on an 'International framework for liquidity risk, measurement, standards and monitoring' as a useful basis for discussion.

The EFR strongly supports the efforts of the Basel Committee to develop an internationally harmonised framework for liquidity management. These efforts should discourage national regulators from further pursuing individual approaches, which will affect the level playing field and reduce the attractiveness of a cross-border business model.

Experience from the crisis shows that the extreme deflationary asset price spiral had its origins in liquidity. Consequently, any rules that could reduce market liquidity and make financial institutions more susceptible to exogenous shocks and contagion should be carefully assessed before implementation. In particular, there should be close cooperation between central banks and supervisors in assessing the market implications of new liquidity rules.

Generally speaking, the proposed general framework – a short-term and a longer-term ratio and a number of monitoring tools – meets market expectations and practices. However, the detailed prescriptions of the proposed framework are too restrictive.

The EFR welcomes the option that the proposed standards and monitoring tools be applied to all banks on a consolidated basis.

Concretely, the EFR warns against the following elements included in the consultative document:
- The underlying assumptions of the regulatory standards are very conservative, and go beyond what was observed during the recent crisis. For instance, the longer-term net stable funding ratio is based on an assumption of a protracted

liquidity stress period, like the short-term liquidity coverage ratio, whereas the EFR would promote a longer-term business-as-usual approach. Moreover, the net stable funding ratio is presented as a dynamic metric which requires long-term funding of not-yet-originated short-term business, thus increasing long-term funding to above what is necessary and accordingly increasing the cost of short-term borrowing. For sure, the proposed standards would eliminate most liquidity risk, but a certain risk appetite should be allowed, in line with the Basel Committee's September 2008 Principles for Sound Liquidity Risk Management and Supervision, as managing risk is not the same as avoiding risk. It should furthermore be kept in mind that the severity of the requirements will have a strong negative impact on the availability and price of lending to the real economy.

- The regulatory standards are very detailed and prescriptive. The EFR believes more room should be left for internal processes for identifying, measuring, monitoring and controlling liquidity risk, similar to what is foreseen in the abovementioned Principles for Sound Liquidity Risk Management and Supervision. In other words, the approach suggested by the Basel Committee could serve as the standard approach, which could be replaced by an advanced approach with the approval of the supervisors.
- Despite the aim of harmonisation, several national discretions are introduced (e.g. the increased liquidity needs related to market valuation changes on derivative transactions or the required stable funding factor to be applied to certain off-balance sheet categories) and, more generally, "national authorities are free to adopt arrangements that set higher levels of minimum liquidity." As mentioned above, national approaches risk distorting the level playing field and limit the attractiveness of a cross-border business model. Accordingly, the EFR calls for a harmonised cross-border liquidity risk regime, at least within the EU.
- In the context of the short-term stress test, it is proposed that there must be an active and sizable private market, also under stressed circumstances, for assets to be considered high quality liquid assets. This means that instruments which are central bank eligible still may be excluded. The EFR believes that central bank eligibility should be an important factor in determining the liquidity of an asset. In this context, we recall that the range of eligible instruments should be harmonised across central banks.
- The definition of certain key terms, such as stable/unstable deposits, is arbitrary and will require extensive IT investments to implement which are wholly disproportionate to the expected benefits. Furthermore, it can be doubted whether such categorisation will lead to better results than historical analysis.
- Attention is only paid to the intrinsic qualities of assets. However, the concrete liquidity of an asset may also depend on market infrastructures. For instance, during the crisis, markets in certain assets which would not necessarily meet the current requirements nevertheless remained liquid thanks to infrastructures which ensured trading anonymity and had established links with central banks, e.g. the repo trades on Eurex. Any proposals should take the positive effect on liquidity of such infrastructures into account.
- It is proposed that the capacity should exist to calculate and report the metrics on a weekly or even daily basis. Regulators should be aware that if such frequency were imposed, reporting for liquidity could no longer be done on the basis of the accounting model, which does not allow such short-term consolidation.

- The public disclosure of information on the metrics, particularly on the standards, risks becoming self-fulfilling and deepening potential weaknesses. Careful attention should therefore be paid to the question whether and, if so, which quantitative data can be disclosed publicly.

For further information or questions please contact EFR Secretary General Sebastian A. Fairhurst, secretariat@efr.be, or telephone +32 2 256 75 23.

Members of the **European Financial Services Round Table (EFR)** are Chairmen or Chief Executives of leading European banks and insurance companies. The EFR believes in the creation of open and competitive markets for financial services both within Europe and in a global context. We want to ensure that Europe is a highly attractive environment for financial services companies to base themselves.

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