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Basel Committee on Banking Supervision

Consultation document: *Strengthening the resilience of the banking sector*

Euroclear response

The Euroclear group is the world's leading provider of domestic and cross-border settlement and related services for bond, equity, fund and derivative transactions. User owned and user governed, the Euroclear group includes the International Central Securities Depositary (ICSD) Euroclear Bank, based in Brussels, as well as the national Central Securities Depositaries (CSDs) Euroclear Belgium, Euroclear Finland, Euroclear France, Euroclear Nederland, Euroclear Sweden and Euroclear UK & Ireland.

We are pleased to be given the opportunity to provide our view on the consultation issued by the Basel Committee on Banking Supervision, *Strengthening the resilience of the banking sector.* The views expressed in the responses to this consultation are similar to those communicated to the European Commission on *Possible further changes to the Capital Requirements Directive*.

Note that we have only included comments for which we believe our views can be helpful to the Committee.

General comments

We support the Committee's work aimed at enhancing capital requirements, and in particular efforts undertaken to improve the quality of institutions' capital, taking into account lessons learned during the financial crisis. In that respect, we understand that there is a need to take bold and swift remedial measures, as there is intense pressure on regulatory bodies, and as acceptance of necessary but radical initiatives may weaken when the dust fully settles. However, there is a general concern among industry participants that the cumulative effects of the proposed measures still need to be appropriately assessed; this concerns both the impact on institutions' capital adequacy and business models as well as the indirect consequences for lending practices and economic growth.

In that respect, the timelines proposed for the finalisation (including calibration) and for the implementation of the proposals seem excessively tight. Concerning implementation, as the proposals will require extensive IT developments, we would favour some flexibility regarding implementation deadlines. Implementation by end-2012 would oblige institutions to set aside a substantial budget for that purpose during one single budget-setting period.

We wish to draw you attention to the fact that a number of the proposals outlined in the Committee document may have unintended consequences for market infrastructures providing clearing and/or settlement services for clients, and therefore for the smooth processing of transactions in the post-trade environment. This concerns in particular proposals to take uncommitted credit lines into account in the leverage ratio, though a number of other elements may have a bearing on post-trade infrastructures that need to comply with the CRD. Arguments in favour of revising the Committee's preliminary intentions can be found in our comments below.

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Raising the quality, consistency and transparency of the capital base

Any grandfathering period should be sufficiently long to include outstanding instruments issued in the past, before supervisory intentions to revise the eligibility rules were known. Euroclear has issued a hybrid Tier 1 instrument with a step-up of 100 bps, with an in-built call option, which can be redeemed as from 2015. If it were disqualified as Tier 1 under CRD IV, the disqualifiaction event would automatically trigger the call option. We believe that this is not desirable and would go against the long term profile of this type of capital.

Regulatory adjustments applied to regulatory capital

We believe that the proposal to fully deduct certain Deferred Tax Assets (DTAs) (p.24) from Core Tier 1 is excessively prudent. The resulting level of Core Tier 1 would not adequately reflect the capital available to the institution on a going concern basis. DTAs should be allowed to be included if there is a high degree of certainty that the institution will be able to recover them in a reasonable timeframe (e.g. 5 years). We further believe that the treatment of DTAs is adequately covered by the accounting standards, which allow their recognition only under specific conditions. We would also like to note that deducting DTAs from Tier 1 in years in which institutions incur losses may detrimentally affect their capital and thereby have a procyclical effect on institutions' balance sheets.

Furthermore, the example of deferred tax assets which do not rely on the profitability of the bank does not seem appropriate to us, in particular the prepayments to tax authorities, which in our view relate to current taxes and not to deferred taxes. Finally, the distinction between deferred tax assets which rely or do not rely on future profitability appears a bit artificial to us, as in last instance the recognition/reversal of deferred tax assets will always depend on the profitability of the institution. Indeed, an institution that never makes profit will never be able to recover its deferred tax assets (in fact, it should not recognise them in the first place), whatever their source.

We also believe that the treatment of minority interest (p.23) (not eligible as regulatory capital) is not appropriate: the general rule should be that minority interests are included in regulatory capital. If certain exclusions have to be foreseen for prudential purposes, such exclusions should target limited and well-defined cases only.

Counterparty credit risk

Bond-equivalent of the counterparty exposure to capture CVA losses (p.32-34): We believe that this proposal should be applied in accordance with the proportionality principle. Euroclear Bank, for example, is only marginally involved in market activities, and only incurs market risk as a by-product of its settlement services. It is only engaged in derivatives transactions with a clear hedging purpose. Counterparty credit risk at Euroclear Bank is therefore very low. Building an infrastructure to calculate a bond equivalent to capture CVA losses would not be justified by the size of the exposures that Euroclear Bank is running. A quick estimate of the impact on Euroclear Bank's exposure calculation of introducing this method yielded an insignificant add-on. If exempting small or single-purpose institutions that do not run large derivative books is not deemed desirable, the Committee may consider a simple solution, requiring such institutions to include some pre-defined supervisory add-ons to their calculations.

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Asset value correlation (ACV) (p.36-38). As the proposal concerns the general treatment of interbank exposures under Pillar 1, it may be advisable to be very explicit about this upfront, and to include this point elsewhere in the proposals than under 'counterparty credit risk'.

The paper notes that AVCs for financial firms have tended to be higher than those of other firms by 25% or more. If such higher correlations are found in the overall population of financial firms, it is unclear why the proposal focuses on the largest firms only. Are there any indications that large financial firms would exhibit relatively large correlations compared to smaller institutions? If that is not the case, the higher correlation level should be applied to all exposures to financial institutions, independently of size. This would be methodologically consistent, and maintain a level-playing field among credit institutions. We do not believe that tampering asset value correlations is the right tool to achieve internalisation of externalities related to the systemic importance of large firms. Using one single correlation measure for financial firms presents the additional advantage of simplicity and can be easily implemented without unnecessary IT developments (as current systems do not allow for a selection based on institution size).

Such a methodological change should be accompanied by sufficient safeguards (in the calibration) to ensure that this does not prove unnecessarily detrimental for credit institutions, compared to the Committee's proposal.

Central counterparties (p.46-48)

We fully support the Committee's intention to reduce counterparty risk in derivatives markets. While we recognise the benefits that can be brought by standardisation of contracts and more generalised use of CCPs, we believe that CCPs should be only one of the building blocks contributing to managing counterparty credit risk appropriately in derivatives markets. We believe that upcoming regulations should not stifle financial innovation, which may be translated temporarily in the emergence of new non-standardised contacts, per se, nor should they prevent the market from developing alternative solutions to CCP clearing for managing the counterparty risks related to derivatives transactions.

Industry experience and market reality in OTC derivatives and other financial instruments demonstrate that a significant part of the OTC derivatives is likely to remain less standardised or less suitable for CCP clearing (e.g. total return swaps). The main reason for this is their specific risk profile or because the market for some of these instruments may be too small (making it difficult to price these instruments correctly). In addition, notwithstanding progressing standardisation of existing OTC derivatives contracts, new/innovative contracts will continue to emerge. Therefore, we are convinced that, while the importance of CCP-cleared contracts will steadily increase, it remains important for supervisors to recognise that other solutions exist in the market that fulfil clear market needs, which are complementary to CCP clearing (e.g. DerivManager, triResolve, Markit PortRec). When appropriately linked to collateral management solutions, these solutions allow participants also to effectively manage their exposure and/or collateral for the non-CCP cleared part of the portfolio. They can also offer a high degree of transparency to allow relevant regulators to assess the underlying risks.

Since capital requirements should be based on an objective risk assessment of the relevant instrument and counterparty, we are not convinced, prima facie, that non-CCP cleared derivatives should necessarily face higher capital requirements where they are subject to highly effective bilateral exposure mitigation techniques.

Euroclear believes that existing market infrastructure (reconciliation and collateral management) solutions supporting bilateral clearing, such as Euroclear Bank's integrated DerivManager exposure / tri-party collateral management solution can achieve very similar risk mitigation effects in OTC derivatives markets as CCP clearing. They provide for a solution for aligning positions and exposures bilaterally and agreeing on margin calls, and integrate this with an efficient same-day collateral

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process to cover the full exposure (with a possibility to move to intraday collateral management if required). We believe that regulators should take a balanced approach to risk mitigation, ensuring that existing bilateral risk mitigation techniques are actually recognised by regulators and are used by the market.

We kindly ask the Committee to clarify in the text how CCP-cleared trades and bilaterally cleared transactions that would be fully collateralised with eligible collateral would be treated. Would the treatment be different from CCP cleared trades? Would there be any residual exposure? If yes, how would the exposure value be calculated?

Leverage ratio

As a general comment, we would like to note that current proposals are too high-level to provide a clear indication of supervisors' intentions. The mix of accounting and risk-based measures proposed is particularly confusing. To our understanding, a leverage ratio should be a very simple and consistent metric, which should preferably rest on accounting treatment only. In that respect, the complete exclusion of netting, as proposed, would not be in line with such a treatment. The leverage ratio should be designed in such a way that it does not act as a hard constraint, in comparison with the risk-based capital ratios; it should be under Pillar 2. Indeed, if it were to act as a brake on the non-risk weighted exposures that an institution is taking, it may create an incentive for institutions to take additional risk at the margin, so as to align the constraint imposed by the risk-weighted measure on that imposed by the leverage ratio.

<u>Collateral and netting</u>

If the Committee decides to introduce some risk-based elements in the determination of the leverage ratio, we believe that these should include risk mitigation techniques such as collateral, provided collateral agreements are valid and enforceable. Treatment unsecured exposures and secured exposures in the same way may create undesirable incentives. It may also disproportionally penalise institutions that incur very short-term secured exposures that do not result from a desire to benefit from leverage, but from client activity related to the settlement of their securities transactions. This is the case, for example, of Euroclear Bank, which, as a single-purpose institution, provides only settlement-related services to clients. Euroclear Bank extends short-term credit to its clients to facilitate the settlement of their securities transactions. Such credit is generally secured with securities collateral held within the Euroclear system. While most of the credit is intraday and is repaid before the end of the day, it may occur that a client incurs a delay in funding its overdraft position and, as a result, that Euroclear Bank faces a secured exposure on that client overnight. Euroclear Bank also aims at using, as much as possible, secured transactions when placing the funds in the market that participants with a credit position overnight leave at its cash correspondents.

We would also like to note that the second argument for excluding collateral ("concerns around uncertainty in the valuation and time to recovery of physical collateral") does not apply to financial collateral, and certainly not to cash collateral.

<u>Off-balance sheet items</u> (p.64-65).

We believe that off-balance sheet items that are unconditionally cancellable should not be taken into account in a leverage ratio, and in particular low risk items as included in Annex II of the CRD (mainly unconditionally cancellable credit lines). There are several reasons for which such an inclusion would not provide a meaningful contribution to the leverage ratio:

- Such elements are unlikely to lead to a material increase in the de facto leverage ratio, as the institution is entitled to revoke them unilaterally, unconditionally, and immediately. For example, reputational considerations

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would not prevent Euroclear Bank from reducing or eliminating outstanding credit lines if they were believed to increase the risk to the ICSD beyond its risk appetite.

- Such credit lines are unlikely to be used simultaneously. Including all these lines in the leverage ratio assumes simultaneous usage of the lines.

In addition, including unconditionally revocable credit lines is likely to substantially affect institutions providing payment, clearing and settlement services for clients. Intraday credit provided by such institutions contributes to the well-functioning of financial markets. Including it in a regulatory ratio bears the risk of hampering the smooth settlement of financial market transactions, thereby increasing risks in the market.

As explained in Euroclear's Pillar 3 report (p.34, to be found on www.euroclear.com), Euroclear Bank extends short-term credit to its participants to facilitate the settlement of securities transactions. When the buyer does not have sufficient cash on its account to settle a transaction, temporary credit is extended, allowing settlement to take place efficiently. Such credit extensions occur when participants do not hold their cash reserves in Euroclear Bank and/or there are structural time lags in the flow of funds as a result of time-zone differences and differences in operating hours of the various intermediaries involved in payments.

Generally, the duration of exposures is less than 24 hours (ie intraday). The duration varies with the sources of exposure and funding. Participants for which cash flows are mainly driven by purchase and sales within the Euroclear system in a back-to-back mode, may need credit only for a few milliseconds, to allow the chain of transactions to settle. Exposure that needs to be funded by either cross-border deliveries or credits on Participant accounts from external intermediaries tends to last longer, up to several hours. Only in unforeseen circumstances (primarily as the result of settlement failures or delayed credits), part of the exposure can become an end-of-day overdraft retained in the books of Euroclear Bank until the next day.

This credit is unilaterally, unconditionally and immediately cancellable, and we believe Euroclear Bank will not hesitate to decrease or cancel such lines when the financial health of a client would deteriorate. Therefore, we believe that such credit lines should not be considered as leading to leverage build up.

Finally, we wish to highlight that (intraday) credit provided by Euroclear Bank is collateralised in the vast majority of cases (on average, more than 98% of the value of such credit is collateralised), with some uncollateralised credit facilities offered to central banks that cannot enter into secured transactions for various legal reasons. We have argued on the previous page why not taking collateral into account may not be appropriate. As mentioned above, we believe that collateralisation should be taken into account in the calculation of the leverage ratio, if some risk-based elements are included in the ratio.

As an aside, note that we do not find the terms "unconditionally cancellable commitments" to be very clear and would suggest aligning the terminology with that used in the paper on *Liquidity standards* ("unconditionally revocable facilities") or the other way round, if the same is meant. If such is not the case, we would kindly ask the Committee to provide a definition of the terms.

Procyclicality

Proposals regarding forward-looking provisioning and capital conservation are sensible. But we believe that measures to prevent excessive credit growth need more detailed consideration before being enacted.

We also wish to highlight the fact that capital conservation buffers should be designed to be applied on top of regulatory capital requirements (Pillar 1), and not

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on top of institutions' own assessment of capital needs (Pillar 2). Although this seems to be the Commitee's intention (§ 248 and further refer to "regulatory minimum"), we believe that it should be clearly stated in the text. When assessing how much capital it needs under its ICAAP process, Euroclear applies a number of capital buffers designed, among other things, to ensure capital stability. The resulting economic capital requirement is higher than the regulatory Pillar 1 capital requirement.

Finally, it seems to us that any measures aimed at addressing pro-cyclicality would need to be taken in conjunction with central banks. Given the fact that monetary policy also aims at limiting excessive credit growth, insofar as it could fuel inflation. This is done mainly by directly manipulating short-term interest rates. The introduction of supervisory measured intended to constrain credit growth in boom years may lead to unforeseen interactions with monetary policy measures. The potential impact of any such supervisory measures on transmission mechanisms is as yet untested. Such measures, if they share the intentions of monetary policy decisions, could reinforce the effect of such decisions beyond what may be desirable to adequately rein in inflation. In contrast, disagreements between supervisors and central bankers may lead to opposite moves, potentially preventing either measure to effectively achieve its goal. With that in mind, developing appropriate supervisory tools to address excessive credit provision and, in particular, asset price inflation, at times at which the central bank maintains interest rated low, will be challenging. This difficulty extends to the choice of criteria, as such criteria may be endogenously determined. For example, the credit growth-to-GDP ratio is unlikely to remain stable over the credit cycle, as credit drives economic growth, and economic growth increases incentives for credit growth.

Presentation

Please find hereunder some suggestions regarding the presentation and drafting of the chapters of the BCBS' paper, with a view to improving clarity and consistency:

- use the same terminology and present criteria for classification as common shares (p.18), inclusion in Tier 1 additional going concern (p.20) and criteria for inclusion in Tier 2 capital (p.21), in similar order;
- note that the text p. 18-27 seems to relate to "(e) criteria governing inclusion in the common equity component of tier 1" only – while it contains all elements announced in § 86;
- clarify which regulatory adjustments applied to regulatory capital are deducted from Tier 1 common equity and as a consequence deducted in full from capital, and which can be included elsewhere;
- clarify, regarding the proposals for counterparty credit risk, to which banks they apply.

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