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Basel Committee on Banking Supervision
Bank for International Settlements
Centralbahnplatz 2
CH – 4002 Basel
Switzerland

16th April 2010

Consultative Document on Strengthening the Resilience of the Banking Sector

Dear Sirs,

The European Investment Fund (EIF) welcomes the opportunity to comment on the consultative document dated December 2009 entitled 'Strengthening the resilience of the banking sector'. The EIF, with its status as MDB, is part of the EIB Group and the European Union's specialist provider for SME risk financing across Europe. We deliver a full spectrum of financing solutions through financial intermediaries (i.e. equity instruments, guarantee and credit enhancement instruments).

We fully support the Committee's desire to strengthen the capital adequacy regime and in particular the banking sector. In light of the renewed emphasis on the amount and quality of Tier 1 capital, however, we would like to highlight what may be the unintended consequences of what we perceive to be an inconsistency in the proposed methodology with regard to the treatment of certain securitisation exposures.

We stand ready to discuss, or expand on, any element of our comments.

Yours sincerely,

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Response to the Consultative Document on Strengthening the Resilience of the Banking Sector

This paper presents a proposal from the Risk Management and Monitoring Division of the European Investment Fund (EIF), in respect of the consultative document on Strengthening the Resilience of the banking Sector published, in December 2009, by the Basel Committee on Banking Supervision.

The aims of the committee, to raise the quality transparency and consistency of the capital to strengthen the resilience of the banking sector, are whole-heartedly supported by the EIF. We would, however, raise issue with one point in the consultative document that seems to be at odds with both this statement and with the use of a conservative approach to risk management.

Remaining 50:50 Deductions

We refer to paragraph 108 where the committee sets out its proposals for amending the treatment of regulatory adjustments for certain exposures that are currently deducted 50% from Tier 1 Capital and 50% from Tier 2 Capital.

The consultative document states that:

> "The 50:50 deductions complicate the definition of capital, particularly in the application of the limits and so the proposal is that they will receive a 1250% risk weight."

This paragraph seems at odds with the stated aims of the document. It would be more conservative and transparent to allow for a full deduction of the exposure from the level of common equity, consistent with paragraphs 69 and 102 that regulate the application of provisions to cover expected losses. The use of the 1250% risk weight alone will not improve the transparency of the Tier 2 capital and this issue is addressed separately within the document.

The current proposal penalizes institutions that exceed minimum capital requirements. This is as a result of the 1250% risk weight causing a greater decline in the Tier 1 capital ratio than a straight deduction does for institutions that target a Tier 1 ratio over 8%. As an illustrative example consider an institution with € 1000 of common equity[1] and € 3000 of risk weighted assets:

Tier 1 Capital Ratio = € 1000 / € 3000 = 33.3%

Under the current proposal if a B-rated securitisation exposure of € 100 was added to the portfolio and risk weighted at 1250%, the new capital ratio would be:

Consultation Doc. Tier 1 Capital Ratio = € 1000 / (€ 3000 + € 1250) = 23.5%

Whereas under a <u>more conservative</u> approach where the exposure is fully deducted from equity the ratio becomes:

Tier 1 Capital Ratio after Deduction = (€ 1000 - € 100) / € 3000 = 30.0%

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[1] The example holds also if one were to include Tier 2 capital in the calculation and consider the total capital ratio.

Full deduction is by definition a more conservative approach, as it gives results that are equivalent to full provisioning and write-off of the exposure. Thus, the more conservative capital ratio should be the one obtained under full deduction. In fact, the example shows that for highly capitalised banks the proposed application of the RW of 1250% instead of a 'deduction' results in much lower capital ratios – and understatement of the capital situation. Conversely, the result for banks with a ratio in the area below the 8% level is an overstatement of their capital adequacy. In the area around 8% the two methods give similar results.

Finally, we see the deduction method as an intuitive separation of a securitisation portfolio into a 'performing' part (rated BB- or above) and the 'high risk' part (rated lower than BB-). The capital adequacy under the deduction approach compares the 'healthy'/'available' capital to the risk profile of the 'performing' portfolio and separates the 'high risk' part by the conservative deduction treatment.

In conclusion, the application of a RW of 1250% instead of a 'deduction' in the relevant cases would lead to a situation, where the capital adequacy ratio would be severely understated, distort the relationship of capital and portfolio risks, dilute the distinction of 'performing' and 'high risk' portfolio segments, and rather be only a relative measure of capital and portfolio risk versus other banks.

Proposal:

In light of the above, we propose to retain the 'deduction' treatment for certain securitisation exposures as we strongly believe that a direct relationship between the 'healthy' capital of the financial intermediary and the 'performing part' of the portfolio risk profile should be expressed in the capital adequacy measure.

Nonetheless, to address the goal of reaching a higher level of transparency in the capital ratios of financial intermediaries and to follow a conservative treatment at the same time, the deduction proportions from Tier 1 and Tier 2 could be modified in the direction of a full deduction from Tier 1.