THE FINANCIAL SERVICES ROUNDTABLE

Impacting Policy. Impacting People.

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Via E-mail

April 16, 2010

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

Re: Consultative Document: *Strengthening the resilience of the banking sector*

Dear Sir or Madam:

The Financial Services Roundtable[1] is submitting this letter in response to your invitation to comment on the Consultative Document entitled "Strengthening the Resilience of the Banking Sector." We appreciate the Basel Committee's desire to conduct an open process with input from all interested parties, and we commend the Committee for recognizing the need to reconsider the Basel II framework. There would appear to be no question that the current capital standards need to be adjusted in light of the recent financial turmoil, and that banking organizations need to be better equipped to handle capital market disruptions in the future.

As a preliminary matter, we are very troubled that there does not appear to be a globally coordinated approach to capital and related prudential regulatory changes, despite the best efforts of the Committee. Rather, it appears that a number of regulatory changes are being proposed by various bodies, including national regulators, accounting standard setting bodies, and legislatures, without any appreciation by policy-makers or regulators of the full cumulative impact of all these proposed changes to economic activity and the ability of financial firms to meet all the legitimate needs of their customers. Unless coordinated and rationalized, these various regulatory and accounting changes will, in the aggregate, impose untenable burdens on financial services providers.

Moreover, these prudential and accounting changes will have at least two major counter-productive consequences: (1) decreasing the availability of credit and harming the fragile economic recovery; and (2) increasing the overall risk in the financial system by forcing more lending into the so-called "shadow banking system". In short, these proposals could have a significant and highly negative and decreasing the availability of credit and harming the

[1] The Financial Services Roundtable represents 100 of the largest integrated financial services companies providing banking, insurance, and investment products and services to the American consumer. Member companies participate through the Chief Executive Officer and other senior executives nominated by the CEO. Roundtable member companies provide fuel for America's economic engine, accounting directly for $74.7 trillion in managed assets, $1.1 trillion in revenue, and 2.3 million jobs.

economic recovery. In short, these proposals could have a significant and highly negative impact on the pricing and availability of capital for creditworthy businesses and consumers. Unless significantly modified, this proposal, coupled with the liquidity proposal and similar proposals made in other fora, will undermine current efforts to restore economic growth throughout the world.

1. Definition of Tier 1 Capital

The proposal would modify the definition of Tier 1 capital to place a higher emphasis on common shares and retained earnings. We agree that emphasis on common equity is appropriate, and that a more stringent definition of Tier 1 capital will strengthen the resiliency of the banking system. However, to the extent that the new capital framework will result in the need for banking institutions to raise additional levels of capital, it is important not to unnecessarily restrict the flexibility afforded by certain hybrid instruments (such as non-cumulative, perpetual trust preferred stock) that provide a tax efficient, lower cost method of raising capital that can effectively absorb losses. As the Committee notes, hybrid instruments that are deeply subordinated, are perpetual in duration, have fully discretionary dividends, and that do not provide any incentive for the bank to redeem, provide an effective cushion against loss. Other instruments, such as REIT preferred shares, that may be converted to common shares upon the direction of the bank's supervisor also provide economic protection against loss. We recommend that the Committee reconsider its proposed treatment of these instruments, including the percentage limit that may be used to satisfy Tier 1 requirements. If, nevertheless, the Committee decides to alter the status of hybrid instrument under the new framework, an appropriate grandfather clause for outstanding issuances should be included, as well as a lengthy phase-in period to allow sufficient time to adopt to the changes without harming the current economic progress.

The Roundtable is also concerned that the proposed deductions for mortgage servicing rights and deferred tax assets disregards the economic value of these assets. Mortgage servicing rights are a significant component of the assets created by the mortgage lending process, and experience has demonstrated that when conservatively valued and frequently marked-to-market, they maintain their value even in times of market disruption. In addition, they provide an effective interest-rate hedge because the value of these assets rises with increasing interest rates. Any concerns with this asset can be alleviated through valuation haircuts rather than a full deduction.

The full deduction of deferred tax assets also appears problematic. These assets, net of valuation allowances, have been shown to have economic value and their full deduction from Tier 1 capital appears excessive.

The Basel Committee recommends that unrealized losses on investment securities be deducted in full from Tier 1 capital. We do not support this approach since it fails to consider the nature of unrealized assets or the experience of the banking industry during the financial crisis. Specifically, the proposed framework does not reflect the fact that unrealized losses are largely temporary, and will recover as market conditions improve. Similarly, industry assessments consistently reveal that mark-to-market losses bear little resemblance to actual losses other than temporary impairment, even during periods of market-wide stress. We

therefore recommend that the proposed deduction of unrealized losses from Tier 1 capital be limited to established credit-related losses.

It would also be helpful for the Committee to clarify that assets held in a separate account, such as in a trust or fiduciary account, or in the separate accounts held by insurance companies, are not to be included in the computation of the leverage ratio.

Another problem with the proposal is its treatment of local currency sovereign (LCS) debt securities in investment portfolios. Many banks hold LCS securities as a tool for managing their interest rate risk or as a regulatory requirement to do business in a country. The liquidity risk Consultative Document, if implemented as written, will only increase banks' need to hold such securities. The value of these securities only depends on the local currency sovereign yield curve and is thus independent of spreads. The proposal would require banks to deduct from Tier 1 capital any market value losses of LCS debt securities caused by a rise of LCS interest rates, without accounting for the offsetting change in the market-value of the liabilities that are funding those assets.

2. <u>Capital Buffer</u>

The Consultative Document puts forth several proposals to reduce the pro-cyclicality of the Basel II framework. We are concerned in particular about the proposal to require banking organizations to hold a capital buffer in excess of minimum capital requirements. Banks that fall below the required buffer would not be "undercapitalized," but would be subject to restrictions on dividends, share buy-backs, and staff bonus payments. Regulators would adjust the size of the buffer upwards whenever regulators determine that there is "excessive" credit availability.

The Roundtable is convinced that the capital buffer would become the new minimum capital requirement because no financial institution would be willing to fall below the mandated buffer.[2] Further, to ensure that the buffer is not breached, banking organizations would, as a practical matter, hold an additional capital cushion on top of the regulatory imposed capital buffer.

Under this proposal, banking organizations would be required to hold capital that, by definition, would be in excess of the economically justified minimum capital levels necessary to protect the bank. While there may be advantages to holding excess amounts of capital, there are also significant disadvantages. Excessive capital requirements diminish lending and economic growth. Unnecessarily high capital requirements can also motivate financial institutions to increase their return on available equity by making riskier investments. Excessive capital requirements discourage private investment, and the future threat of higher-capital mandates will make it difficult for financial institutions to attract capital today. Finally, we note that capital is a lagging indicator of financial health. Additional reliance on sound underwriting, prudent management, and experienced regulatory oversight are more effective in assuring the safety and soundness of our financial system, and will not have the unintended consequences of demanding excessive regulatory capital.

[2] We do not believe that the fact that the restraints on dividends varies with the amount by which the bank's capital declines below the buffer level ameliorates this problem. The mere fact that the bank is subject to <u>any</u> Governmentally imposed dividend restriction will be of serious concern to the bank and to the markets.

3. Leverage Ratio

The proposal mandates the adoption of a leverage ratio that, unlike the current leverage ratio applicable in the United States, would include certain off-balance sheet items in the denominator. These off-balance sheet items would include liquidity facilities, cancelable commitments, and standby letters of credit. Further, in determining total assets, there would be no recognition of collateral, guarantees or netting. This proposal ignores the fact that the financial and economic risks contained in off-balance sheet assets are not equivalent to the risks in on-balance sheet assets. For example, a commitment that is fully cancelable by the bank is far less risky than a binding line of credit or an on-balance sheet loan. We believe that the Committee should carefully consider the wisdom of sweeping all of these off-balance sheet exposures into the leverage ratio without considering the diverse economic risks that they present.

We believe that it is critically important that the rules recognize the benefits of collateral and netting on a bank's true economic exposure. Public policy dictates that netting arrangements that are legally enforceable even in receivership or bankruptcy should be recognized under the capital rules. Bank regulatory policy should strongly encourage the use of enforceable netting agreements, and one of the best ways to encourage the use of these arrangements would be through capital recognition of their benefits.

Another concern is that the proposed leverage ratio would include the gross notional value of credit default swaps sold by banks, while ignoring the offsetting market-risk hedges provided by credit default swap purchases. This treatment does not make economic sense. For banks with large trading desks, the inclusion of the gross notional value of sold credit default swaps would materially distort the meaning and usefulness of the leverage ratio. The trading desks of virtually all internationally significant banks function as financial intermediaries between buyers and sellers of these instruments, and the leverage ratio should be designed to capture the true economic risk of this activity.

If the Committee still decides to sweep off-balance sheet exposures into the leverage ratio, the Committee should consider using the conversion weights applicable to off-balance sheet exposures in the Standardized Approach. This would much better reflect the risks involved.

Finally, we want to urge that any leverage ratio requirement should be appropriately calibrated so that it does not become the binding ratio for most financial institutions. If financial institutions are required to adjust their assets and activities to a binding, non-risk adjusted leverage ratio, the benefits of the risk-adjusted standard will be eliminated. Capital will no longer be a tool to control risk, but instead, under a binding leverage ratio, capital requirements will become an incentive to hold riskier assets. The leverage ratio should be viewed as a "backstop" and not applied so as to become the "managed-to" capital ratio for banking institutions.

4. Credit Exposures to and Investments in Financial Institutions

The Committee is proposing to increase the capital charge on inter-bank exposures and to require a capital deduction for equity investments in other financial institutions that exceed a 10 percent threshold.

The Roundtable agrees that the capital framework should restrict the double counting of equity in the regulated financial sector through reciprocal holding of equity interests. This problem should be addressed by referencing the size of the investment relative to the investing bank's aggregate assets and by adjusting the risk-weight of such assets.

In this regard, we are also concerned that the term "financial institution" will be broadly defined, and that as the proposal is currently drafted, prudent and legitimate investments, including investments held in a bank's trading book, might be captured in the definition. We suggest that the proposal be limited to the *reciprocal* holding of equity interests by financial companies.

If the Committee determines to proceed with an adjustment to the asset-value correlation factor for financially-related assets, the Committee should fully explain the basis and include supporting financial data for any proposed asset-value adjustment.

5. Derivatives

We also note that the Committee is proposing to use the capital rules to encourage the central clearing of derivative contracts. The debate over the efficacy of requiring clearing through clearinghouses is currently being debated by the U.S. Congress and the prudential regulators. For many end users, non-speculative derivative contracts are individually-tailored to match unique positions and are not suitable for processing through a clearinghouse. It is expected that under these legislative proposals the CFTC and the SEC will be overseeing a new framework for derivatives in the near future. We believe that any capital adjustments should not be undertaken until after the details of the new prudential framework for derivative transactions has been determined.

6. Capital Surcharges for Systemically Important Financial Institutions

The Basel Committee is considering a capital surcharge on systemically important banking organizations, as well as a liquidity surcharge and other supervisory requirements. The Roundtable notes that the U.S. Congress is considering a new supervisory approach for systemically important financial institutions that would subject these companies to significant oversight, new prudential rules, and additional discretion to require increased capital or liquidity on an institution specific basis. The imposition of an across-the-board capital surcharge on U.S. companies would not appear to be necessary if this approach is adopted in the United States or in other countries. In fact, this may be another example of why the Basel Committee's recommendations must take account of other developments both in the United States and elsewhere.

Conclusion

The Financial Services Roundtable recognizes the need to revise the current capital framework, and applauds the Basel Committee for its work and leadership. Developing and publishing the Consultative Document is a good starting point for further discussions on this topic. However, any new capital framework must take into consideration the cumulative impact of the entire range of regulatory, supervisory and accounting proposals currently being considered or that have been recently implemented. An internationally coordinated approach is critical to avoid the potential of excessive mandates that will decrease the safety and soundness of our financial system and impede economic growth and recovery.

The Consultative Document put forth a number of new and dramatic changes to the current capital framework. In our view, there is a high potential for serious and dramatic negative consequences. In fact, it is quite possible that the adoption of this proposal could trigger the growth of the unregulated or less regulated "shadow banking system," as companies not subject to these new rules will have more ability to provide necessary credit without the limitations and costs that will be imposed on regulated entities.

We strongly recommend that after evaluating the comments submitted during this review period, the Basel Committee publish a revised proposal, including proposed quantitative inputs developed during the QIS process, and then conduct a second round of consultation before reaching a final agreed upon approach.

Thank you for the opportunity to comment on your proposal. If you have any questions, please contact me at (202) 289-4322.

Sincerely,

Richard M. Whiting

Richard Whiting

Executive Director