15 April 2010

Our ref: ICAEW Rep 39/10

Your ref:

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

Dear Sir

Strengthening the resilience of the banking sector

We are responding to the proposals set out in the Basel Committee's December paper on 'Strengthening the Resilience of the Banking Sector'. We agree it is important to include in the impact study the Committee's earlier work on trading book exposures, re-securitisations and liquidity lines that were agreed in July 2009 to take effect at the end of 2010.

ICAEW operates under a Royal Charter, working in the public interest. Its regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the Financial Reporting Council. As a world leading professional accountancy body, we provide leadership and practical support to over 134,000 members in more than 160 countries, working with governments, regulators and industry in order to ensure the highest standards are maintained. We are a founding member of the Global Accounting Alliance with over 775,000 members worldwide.

Introduction

Our primary concern is over the sheer range of new regulation that is being introduced at the moment. While most items are individually sensible, when considered in aggregate they may have unintended consequences through the efforts required to implement them and the knock-on impact of increased capital requirements onto the general economy. As such it is desirable that the impact of all these changes is considered before any decision is taken on a blanket increase in capital ratios – and we welcome the Committee's intention in this regard.

We encourage the Committee to carry out its global quantitative impact study (QIS) in a comprehensive manner. We are concerned that the QIS proposals as we currently understand them would make it difficult to understand the macro-economic implications of the proposals and to identify potential impacts on, or changes to, firms' business models. We trust these factors will be taken into account in considering the over-arching calibration of the new proposals: to the extent that they have already been addressed we look forward to further details being published in order to allay these fears.

In looking at this issue, it is necessary for policymakers to consider the balance between financial stability and economic growth, both in the near-term and on a longer perspective. We would welcome further analysis of the trade-off, while accepting that this analysis is difficult to perform, with a need for numerous, potentially inaccurate, assumptions, and no single model well-suited to the task.

The Institute of Chartered Accountants in England and Wales
Chartered Accountants' Hall
Moorgate Place London EC2R 6EA UK
icaew.com

T +44 (0)20 7920 8100
F +44 (0)20 7920 0547
DX 877 London/City

Given the global nature of the international financial services industry, we very much hope that the Basel Committee will continue to drive forward consistency at the international level. However, we remain concerned that fragmentation of the regulatory reform process may take place given recent proposals from a number of countries such as the US that are not obviously in line with the international consensus being pursued by Basel. We would urge regulators around the world to seek consistency of approach. This will avoid incentives to structure transactions artificially so as to reduce capital costs, and will also reduce compliance costs; and aid competition.

Using financial statements for the purposes of prudential regulation is appropriate, but we strongly believe that financial statements should be considered only as a starting point for prudential regulation and that the primary purpose of financial statements must remain that of informing the investors. We expand on this in our sections on the proposed deductions and adjustments to capital and the leverage ratio, where we generally favour an approach which follows the accounting treatment more closely than is currently being considered. On the leverage ratio, we would like to highlight the fact that we disagree strongly with the proposals to ignore netting, and explain our reasoning for this later in the response.

Raising the quality, consistency and transparency of the capital base

The past two years have seen increasing emphasis in the market on the importance of 'core' Tier 1 – based on common equity. In part this is based on a desire for simplicity and transparency; in part on the need for a robust buffer from which to meet losses, losses which in today's markets crystallise more rapidly in bank accounts than in the past.

We agree that exactly what counts as 'capital' may well be more important than a detailed refining of risk weights to determine the level of capital requirements – and that this is not an area that has been at the forefront of regulatory attention for the past decade.

We therefore fully understand the Committee's wish to reconsider the quality of capital in a wide-ranging fashion that does not get bogged down in too much detail. The previous regime led to the development of highly complex structures and the ingenious interpretation of rules.

We nevertheless have concerns about how best to manage the scale of change proposed here – and how far it is possible to do so by reference solely to grandfathering and/or phased implementation.

Grandfathering is important to avoid unnecessary disruption in capital markets. However, it implies that regulators are prepared to commit that they, and their successors, will include certain instruments in capital for several years even though these do not fulfil the criteria now believed to be necessary to allow a firm to remain as a going concern. This logical inconsistency leads to doubts as to whether such a position is tenable for long. If the commitment or rationale for grandfathering is called into question, such instruments will be discounted in market-based calculations of capital.

Where implementation is phased, experience suggests that market pressures can lead to a firm's capital position being estimated on the 'new' basis almost immediately. This is particularly likely when – as here – this can be done relatively easily without firms first needing to build complex systems to calculate their new position. As a result, this may not mitigate the impact of the new rules to the extent implied in the paper, certainly if full implementation is to take place in the next 2-3 years.

Definition of core Tier 1/common equity

We welcome the proposal to set criteria so that the position of core Tier 1/common equity is defined consistently across jurisdictions and to formalise its central role in the new regulatory framework, which has come about in a rather piecemeal fashion.

Deductions to be made from core Tier 1, rather than elsewhere

In cases where the need for a deduction from capital base has been demonstrated we agree that this should typically be from 'core' Tier 1, especially for large international banks whose failure – which would trigger the protection offered by Tier 2 instruments – might create severe problems. By the same token the case for doing so for other organisations is much weaker. It would be extremely helpful if this point was flagged by the Committee, to reduce the risk that its regime would be copied across inappropriately to other types/sizes of firm.

With this proviso, we agree that it is helpful to harmonise these adjustments internationally.

Proposed deductions or 'adjustments'

These can be listed as follows, and our comments are attached to each:

- **Stock surplus**: The proposed treatment seems sensible.

- **Minority interests**: The proposed treatment is undoubtedly prudent but may create significant problems, particularly for groups entering countries where co-investment is heavily encouraged or even required. A more proportionate approach would be to exclude only that part that was not required to support the subsidiary: ie, 'excess' capital that could be withdrawn by the third party, and/or to consider if any part of the minority interest is available to meet a deficit on a 'gone' concern basis. Also, the proposed approach does not take into account the fact that different accounting approaches can be adopted or required in this area. US GAAP differs from IFRS in requiring recognition of full minority interests under a full fair value approach, whereas this full fair value approach is optional under IFRS. Those entities which do recognise the full amount of minority interest are penalised under the proposed treatment as the full minority interest amount is deducted from capital, yet there is no comparable adjustment to the related assets. We recommend that this part of the proposal be revised.

- **Unrealised gains/losses**: We support the proposed approach that no adjustments would be made to unrealised gains and losses for capital purposes. We agree that unrealised losses should not be filtered out. We also think that a consistent approach to unrealised gains and losses should be adopted, and the proposed approach achieves this. A clear definition of unrealised gains and losses is not given in the paper, but would need to be provided.

- **Goodwill/intangibles**: With the exception of our comment above relating to the treatment of minority interest, we agree with the proposed deduction of goodwill, but do not agree that all intangible assets should be deducted. The intangible assets category incorporates a wide range of assets, including some which are underpinned by legal rights which can be sold separately, for example patents and licences. For such intangible assets, their recoverability would not diminish in periods of stress or insolvency; but even when they are, under accounting requirements that would be written down in the financial statements to a recoverable value. Accordingly, we do not think that it is justified to deduct **all** intangibles from capital.

- **Deferred tax assets (DTA)**: Although one of the objectives of the changes to the treatment of deductions is to harmonise the treatment across countries, the proposed approach to DTAs would in practice create an unlevel playing field globally. This is in part because 'not reliant on future income' means different things in different countries even though the economic substance of the DTA (likelihood of realisation) might be the same. For example, in the US, in assessing whether DTAs are dependent on future income, DTAs and deferred tax liabilities are netted on a global basis even where there is no legal right of offset and there is a hypothetical global unlimited 2-year loss carry back. This includes losses made by US banks in countries such as Germany where in fact carry back is limited to one year. To create a level playing field (and

recognise that overall, even in crisis, DTAs have intrinsic value) we suggest that for all banks DTAs on unused tax losses and unused tax credits be allowed up to a flat limit of x% of Tier1 or total capital. A haircut could instead be applied to the DTAs allowed into capital instead of a limit.

An alternative view is that the proposed blanket rule for deduction of deferred tax assets without regard to their recoverability is unjustified. Under accounting requirements, deferred tax assets are recognised only where their recoverability is probable. In many cases, the recoverability of deferred tax assets is highly probable, and relatively low levels of judgement are involved in applying this accounting principle, for example where loss carry backs are available. In other cases greater judgement may be required, so it is very important that the recoverability of deferred tax assets is considered according to a consistent framework such as the one provided under IFRS, rather than arbitrary rules. Furthermore, the proposed blanket rule would have unjustified procyclical effects because deferred tax assets tend to be higher during downturns.

- **Investments in own shares**: This approach is intellectually rigorous, though we wonder if the proposal that firms look through holdings of index securities would be justifiable on cost/benefit grounds.

- **Investments in other financial institutions**: We agree it is important to avoid double-counting of capital. The regulatory burden in looking through holdings of index securities is ameliorated to some extent by the thresholds proposed. But the impact on some groups is considerable if holdings in affiliates not included within consolidation are considered, and it would be helpful if the Committee looked at other means of addressing the prudential concerns underlying this proposal. This might also be an area for which a much longer transitional period before implementation was appropriate; to allow firms to restructure in an orderly way that meets prudential concerns.

- **Shortfall of provisions to expected losses**: We support this proposal.

- **Cash flow hedge reserve**: Cash flow hedges may be either of expected cash flows which are not on the balance sheet (such as FX hedges of next year's overheads), or of the variability of cash flows on assets or liabilities which are on the balance sheet, such as floating rate assets and liabilities. We would want the regulatory treatment to be the same for both: to reverse the adjustment made to equity in each case. The current wording at paragraph 103 is ambiguous and could imply a distinction is intended between the two types of cash flow hedges, or it may simply mean that the floating rate cash flows are not themselves yet on the balance sheet, even though the assets and liabilities that give rise to them are. Assuming the latter is the intended meaning, we support this proposal, but think it could be more clearly expressed.

- **Cumulative gains/losses due to changes in own credit risk on fair valued liabilities**: We agree that gains and losses resulting on changes in the fair value of liabilities should be adjusted for, providing this proposal excludes liabilities in the trading book.

- **Defined benefit pension fund liabilities**: Our general preference is for financial reporting to be used as a starting point for regulatory capital, with adjustments being made as necessary. Where robust funding plans have not been developed, the accounting treatment is likely to be the best approach. Where funding plans are in place, and agreed between firm, trustees and actuaries, in some jurisdictions these are used for regulatory purposes instead of the defined pension fund liabilities in the financial statements. We believe that these alternative approaches need to be analysed carefully, both as part of the impact study and on analytical grounds, before final decisions are taken in this area.

Abolition of certain forms of capital

This is proposed for innovative hybrid Tier 1 and Tier 3 capital for the trading book.

So far as innovative Tier 1 instruments are concerned, the accounting for such instruments is not currently certain as the International Accounting Standards Board (IASB) and Financial Accounting Standards Board (FASB) have a project on financial instruments with the characteristics of equity. However, once it has been finalised, the accounting will provide a consistent starting point for the regulatory treatment of equity and debt, although regulatory adjustments may be needed as the objectives of financial statements and prudential regulation differ.

The test therefore needs to be whether such instruments do indeed absorb loss while not weakening the position of the bank as a going concern. To the extent they do not we agree that they should not be eligible as Tier 1.

For Tier 3 capital, the key issue is not its original maturity but whether it can be repaid on its due date without supervisory consent/breaching its capital requirement. If repayment is subject to such conditions (and if firms and their supervisors can accurately forecast the firm's capital position on a forward-looking basis) the greater flexibility and hence lower cost that short-dated capital offers does not necessarily increase risk to depositors.

Whatever decision is taken in this area, we agree it is anomalous to allow Tier 3 capital for market risk and not for other risks of equal predictability, or indeed to distinguish it from other forms of 'gone concern' capital.

Inclusion of new forms of capital

It is essential that the treatment of contingent and convertible capital is clarified as soon as possible. Until this is done the development of this market, which has received strong support from some policymakers, will face unnecessary uncertainty. We therefore hope that the July 2010 meeting of the Committee will result in specific proposals being published without delay.

Simplification of regime

The Committee proposes merging 'upper' and 'lower' Tier 2 capital – a simplification we welcome going forward.

We also welcome the tidying up of the limits regime – ie, setting minimum Tier 1 and total capital requirements rather than limiting Tier 2 to a multiple of Tier 1.

We strongly support the statement in paragraph 82 that the Committee proposes to set a minimum common equity/core Tier 1 ratio explicitly. Elsewhere it states that this should be the 'predominant form' of Tier 1, without explaining what 'predominant' is meant to represent, a stipulation that introduces unnecessary opacity and complexity, and which should be unnecessary if explicit core Tier 1 ratios are introduced.

Improved transparency

We note that it is proposed to disclose all elements of capital together with a detailed reconciliation to the reported accounts.

We support this proposal: it will help reduce uncertainty about a firm's position which is likely to be helpful to most, even if it may sometimes result in problems becoming apparent more rapidly, making covert contingency management more difficult.

Counterparty credit risk

Expected positive exposure (EPE)

The Basel Committee has left the core methodologies available for counterparty credit risk measurement unchanged which remains sensible. The use of a stressed period to calibrate the EPE measurements would introduce consistency with the market risk changes which is logical, and we support the impact this should have on reducing the cyclicality of capital requirements in this area.

There remains a danger that these approaches of ‘belt and braces’ layer too much conservatism over other layers of conservatism such as market risk stressed VaR, definition of capital, leverage ratios etc. We strongly encourage the Basel Committee to review the calibration on an aggregate basis.

Wrong way risk

The experience of the financial crisis has demonstrated that market and credit events are often positively correlated in an unhelpful manner – for instance swings in market prices that increase the amount payable by a counterparty may also weaken that counterparty’s ability to repay. Evidence for specific and general wrong way risk is widespread and firms need to be encouraged to review portfolio composition and modelling capability appropriately.

The Basel Committee’s increasing focus on wrong way risk is therefore useful and beneficial. As with other areas of reform, the introduction of an explicit charge for specific wrong way risk needs to fit within the overall calibration of the revised proposals to ensure the aggregate impact is appropriate.

Stress testing guidance

The original requirements on stress testing for counterparty credit risk were very limited and not very clear. We support the Basel Committee’s focus on introducing enhanced requirements or guidance to reduce the ambiguity for firms and to encourage greater consistency of robust effort and application across the industry.

Calibration of correlation for financial firms

It is hard to argue with the Committee’s assertion that the correlation between financial firms has been shown to be higher than for other firms during the financial crisis. There is therefore an inherent logic in increasing the correlation for exposures between financial firms which would have the effect of increasing the capital requirements between financial firms.

However, given the pressure on retail deposit funding sources and the desire to kick-start the wholesale markets, such changes to capital requirements will be another factor militating against the use of wholesale market funding.

Furthermore, as the Committee has identified there are considerable cliff effects or definitional issues regarding what is meant by a financial institution. At the moment, the full population has been left undefined and the Committee is seeking consultation responses in order to finalise its proposals.

The other important area of note here is the link between the asset value correlation (AVC) and the PD values i.e. good quality firms (low PD) incur a greater correlation and are therefore impacted even more by the proposed changes than poor quality firms (high PD). This increases the disincentives for inter-bank lending to good quality firms. We appreciate that the Committee has recognised that the link between AVC and PD needs further work.

PDs for highly leveraged counterparties

The proposed change for the way PDs are defined for highly leveraged companies seems out of place within the context of the overall proposals. Furthermore it seems highly difficult for the Committee to

define ‘highly leveraged’, as it has itself demonstrated by failing to include a definition in the current proposal.

Collateral management

We support the Basel Committee’s increased focus on enhanced collateral management. Many aspects of collateral management in a wide range of firms were shown to be inadequate during the financial crisis, and the greater clarity on treatments is to be supported. However, the overall burden of change increases and the quantitative measurements need to be incorporated into the overall calibration again.

Central clearing

Central Clearing Counterparties (CCPs) are seen by many policy-makers as the solution to one of the significant problems arising from the failure of Lehman Brothers, namely the systemic issues arising from derivative exposure, together with the lack of knowledge of the extent of possible exposures within the system. The current regulatory proposals introduce not just the carrot of a zero exposure value for exposures to CCPs but a stick for those unwilling or unable to use instruments that are not dealt with by CCPs.

However, there is increasing concern from a wide range of parties that this potentially creates a different, or simply new, area of focus and failure as the system is only as good as the weakest link, which could then move to be the CCPs. It certainly introduces another ‘single point of failure’ into the system.

In the US there is talk of having at least a 20% Risk Weight being applied to CCPs – while this recognises some of the residual risk in a CCP environment, given that the Basel approach is currently to provide a zero exposure (EAD) then this will lead to some awkward inconsistencies. It is also second-best compared with a solution that ensures that risk in these counterparties is reduced as far as possible through robust margining, capitalisation, risk management systems and clear loss-sharing arrangements. Any regulation in this area should provide incentives for CCPs to make continued progress in this area, rather than introduce a broad-brush regulatory capital treatment.

Back-testing proposals for counterparty credit risk

The additional guidance on counterparty back-testing that is promised would be a very welcome future introduction as it will resolve some of the uncertainties in regulatory expectations.

Reliance on external rating grades and cliff effects

Basel 2 is often criticised for its supposed reliance on external ratings, and whilst it is true that there is actually limited reliance, we support the efforts that the Basel Committee has made to investigate how to reduce the limited reliance. We support the limited changes that are proposed which try to eliminate or reduce cliff effects in certain areas, particularly in the area of credit risk mitigation.

In the case of the treatment of unrated exposures under the Standardised approach, then whilst this appears sensible, it arguably simply clarifies what should already have been done under the auspices of Pillar 2.

Leverage ratio

In the early 1970s, firms faced a simple leverage ratio, calculated by their supervisor and by market counterparties. Whilst some countries, for example Canada, continue to use a leverage ratio as a supplement to a risk-based measure, most jurisdictions moved away from a simple leverage ratio because it took no account of the relative riskiness of the positions to which firms are exposed. The development of Basel 1, crude as it was, and subsequent refinements to this approach attempted to take this point on board.

Whilst simple ratios such as leverage ratios have an attraction as back-stop mechanisms they are inherently flawed as they take no account of the relative riskiness of positions and thus do not compare like with like. Indeed experience from the US is said to suggest that rather than step up leverage to increase returns, firms instead simply shifted into higher-risk assets such as sub-prime. This question is fundamentally difficult to solve and is one of the key reasons why Basel 2 was more complicated than Basel 1 and why the new proposals may well be more complicated again – any attempt to define a leverage ratio approach must be relatively complex in order to prevent evasion.

There therefore needs to be a clear analysis of what purpose the introduction of a leverage ratio serves, and why it is right to penalise large ‘low risk’ positions as against smaller ‘high risk’ ones. We are disappointed at the superficial way in which the paper deals with this point. It would greatly benefit from being subject to a separate and rigorous cost/benefit study.

Among the possible reasons for a leverage ratio might be:

- a large balance-sheet is more difficult to fund than a smaller, high-risk, one;

- there are certain hedged positions that are said to be ‘zero risk’ but are not – and are subject to basis risk (this may be what the Committee means when it says that safeguards are needed against model risk); and

- models systematically underestimate the risk on unhedged ‘low risk’ assets: it is not at all clear why this should be, unless these relate to credit products that demonstrate low volatility in a bull market.

Each of these factors lends itself to a different regulatory approach, which is why it is important to be clear about the ‘problem’ which the leverage ratio is intended to address. For instance, for netted positions, where the netting is well-founded, it is difficult to argue that the second and third sets of risk are material – if not then the leverage ratio is in effect a measure designed to address a liquidity problem and should be labelled as such. We expand on this point later.

There is also a danger that in some circumstances, the leverage ratio could operate pro-cyclically: ie, given the marked impact of a reduction in capital base, it may encourage a cutback in overall lending as the economy turns down, and not just a shift to relatively less risky credits.

If the case for a leverage ratio can be established, its primary objective should be to act as a regulatory capital floor or back-stop and not to over-ride the risk-based approach with any regularity.

Once the rationale for a leverage ratio is clearly established, the definition and construction of the ratio is complicated, and calibration will be dependent on the asset (and off-balance-sheet) coverage, the definition of capital and the overall limit set. We support a further, integrated look at all three of these issues. The Committee’s paper sets out some of the criteria to be considered in determining the leverage ratio. The use of core tier 1 capital as the numerator of the leverage ratio brings simplicity, and is consistent with the greater emphasis elsewhere in the proposals: this is probably appropriate for a ‘simple’ measure of leverage.

However, we strongly disagree with the approach proposed for exposures – particularly for netting. The exclusion of all netting, even when enforceable netting arrangements are in place, will not result in more useful information for regulatory purposes. We recommend that you consider very carefully the results in this area from the ongoing QIS work, as we would expect that such an assets measure will make it extremely difficult, if not impossible, to assess an entity’s true leverage. We then urge you to revise your proposals so that netting is allowed where it is legally robust, for instance where there is a valid master netting agreement in place.

We believe that written credit derivatives should not be treated differently to any other derivative contract. The risk arising on these contracts should be evaluated consistently to any other derivative and onerous capital requirements applied only in those situations where such requirements are justified.

In determining how to deal with off-balance sheet exposures there are two possible options:

- Full possible exposure – this is an over-statement of the possible exposure but could be considered conservative and all-encompassing; or

- Credit Conversion Factor (CCF) version of exposure (for Standardised or Internal Ratings Based (IRB) firms).

For derivative exposures then again the exposure amount would need to be linked to the regulatory capital exposure amount – either through using the 'Mark to Market (MTM) + add-on' approach or the Standardised Measurement Method (SMM)/Internal Models Method (IMM) approach.

The accounting treatment of securitisations will not necessarily capture the risk arising from such transactions for prudential capital purposes and the accounting treatment is not necessarily yet consistent in this area. For this reason, we believe that adjustments may be required to the accounting for prudential capital purposes.

Whatever method is used for capturing the off-balance sheet exposures, the calibration of the actual ratio must be adjusted accordingly.

Capital buffers and other counter-cyclical measures

Cyclicality of the minimum requirement

We recognise that regulators wish to reduce cyclicality and support the Committee's decision to evaluate two approaches to adjust for probability of default. We note that the Basel Committee refers to the UK Financial Services Authority's (FSA's) proposals. We are concerned that the UK regulator is considering including a revised approach to provisions in the financial statements, rather than simply making a regulatory adjustment. We have explained our concerns to the FSA in ICAEW REP 70/09 on Discussion Paper 09/2*, A regulatory response to the global banking crisis*, (see paragraphs 12-17, 56-88). We consider the calculation of through-the-cycle provisions in our response to the European Commission's staff paper on the Capital Requirements Directive, ICAEW REP 92/09.

Forward looking provisioning

We are concerned that regulators are focussing too heavily on the development of accounting standards as a remedy for industry-specific problems, where they are ill-suited to provide the desired outcome when their primary purpose is, rightly, informing investors. We note that regulators have powers to request specific information directly from the bodies they regulate, and to adjust information provided in the financial statements for prudential purposes. We believe it is more appropriate for regulators to use these powers than seek to develop bank-specific accounting standards. Accounting standards are built on a coherent supporting framework which ensures that individual standards are developed and applied consistently. A fundamental principle is that similar transactions should be accounted for in similar ways, a principle that could be endangered if accounting standards are developed differently for banks. The role of the regulator is, and should continue to be, distinct from that of an independent financial reporting standard setter.

We are currently evaluating the IASB's proposals on impairment of financial assets and will be commenting on their exposure draft in June. We agree that the Committee should support the IASB's work into whether standards should allow for early identification and recognition of losses by incorporating a broader range of available credit information than is permitted under the incurred loss

model. Their work may not deliver an impairment model which is less pro-cyclical than the incurred loss model. While both capital and provisioning solutions should be considered in addressing the issue of pro-cyclicality, we believe that there is a limited amount that can be achieved on this issue by making changes to provisioning methodology in the financial statements. The largest contribution by far should come from a careful review of banking supervisory practice and regulatory capital methodology. The lack of data on pro-cyclicality makes it virtually impossible to come up with the right calibration of a solution to pro-cyclicality in the financial statements, and would raise serious concerns over the reliability and objectivity of financial statements, damaging market confidence.

Given the subjectivity involved in determining expected cash flows, we would welcome any guidance that can be set at a global level to minimise the possibility of local banking regulators seeking to fill a guidance vacuum and so creating local versions of the rules. The Committee should coordinate with the IASB's expert advisory panel in this process.

We note that while risk alters in response to the economic cycle, it does so by less than reflected in many models (such as point-in-time approaches) and the supervisory approach needs to reflect this fact. While the Committee has been acutely aware of this point in developing Basel 2, application of these safeguards has not always been of the highest standard in all countries.

We also have some observations about the proposal that banks should build buffers that can be used in times of stress, to guard against unexpected losses.

The first is that regulators should allow not just the 'build up' but also the 'use' to happen – at present this is a concept which is accepted in theory but not always implemented by supervisors on the ground. As a result buffers are not (yet) being used in a downturn.

The second is that this change is done in a way that does not create market instability. Markets often look to firms to bolster their capital at the start of a downturn, and may be concerned by an apparent worsening in the capital position. It is therefore important that the arrangements take such factors into account, and where possible are implemented in a way that mitigates overreaction by markets. This might be more easily done by adjusting risk weights, rather than the floor for the capital ratio: as such capital might decline in a downturn but measured capital ratios would remain the same.

While we understand the concerns that lead supervisors to wish to impose capital conservation measures on firms – by restricting dividend and/or bonus payments – we are concerned at the market signals that this may produce. The media reaction to such steps, which by their nature would be public events, might well be to assert that the firm was in serious trouble, thereby increasing the risk of a disorderly outcome. In our view such a possibility requires significantly more attention than it has been given in this paper. It is not good enough for the Committee to say that it is "not acceptable" for banks to try to signal their financial strength in this way unless they have thought through in much more detail than is apparent here what the market dynamics might be of implementing their own proposals on the financial stability of the system as a whole.

Of course, if the market is already aware of problems at the firm, it is possible that steps to retain capital will be positively received. The challenge is where this is not the case; as over the past three years it has often been the case that changes in the financial strength of firms has not been anticipated by the market.

Finally, we do not believe that the proposals to prevent banks with reduced capital from making inappropriate distributions are necessary, as the rules relating to minimum capital requirements should be sufficient. Either banks have enough capital and can do what they want with the excess, or they don't and must conserve. Providing the capital requirements are properly set, there should not be a need for these additional measures.

Systemically important institutions

We feel that the issue of systemically important firms can be addressed in a number of ways (ie, making firms less ‘systemic’ and/or less likely to come close to failure, and/or reducing the consequences if they do), and regard such distinctions as helpful. Attempting to tackle the issue in a piecemeal fashion is unlikely to be successful, as is the search for a ‘silver bullet’ solution.

In trying to determine what factors or criteria could be used to determine systemic firms, a range of elements need to be considered, as the Committee suggests:

- size should not necessarily be the main criterion: there are some big simple firms and some small complex firms. Nevertheless, it is a relevant factor, since a large complex firm has a bigger impact on others than a small firm;
- interconnectedness (which needs to be measured in a number of ways that go beyond direct credit exposures to other financial firms). This requires much more work in order to make the concept workable in operational terms, on a basis that can be implemented worldwide;
- substitutability (can customers easily get the same service elsewhere – if not that may be a reason to prevent failure);
- complexity of products and organisational/geographical entity structure; and
- geographical spread.

Clearly this is a complex issue, and the criteria need to be dynamic, since what is systemic in one case may not be systemic at another point in time. But we would not support a list of ‘systemic’ firms being published for the moral hazard that this introduces, and the risk of confusion as firms are ‘promoted’ or ‘relegated’ from a list that the media may describe as consisting of firms that are ‘too big to fail’.

As we have set out above, systemic risk needs to be defined in the round across a range of factors and in a way that does not lead to marked threshold/cliff effects at a particular size/boundary.

We note that the implication behind the introduction of capital surcharges for systemically important banks would be that such firms have a bigger impact on others if they fail, and that these externalities are not currently adequately captured by the supervisory regime, suggesting a move from ‘risk-based’ capital to ‘risk-and-impact based’ capital. This is a significant step. The hope is that this is equivalent to ‘risk-to-the-system based’ capital, but that will need to be demonstrated in considerably more detail than has currently been the case.

Please contact me should you wish to discuss any of the points raised in this response.

Yours sincerely

Shamim Diouman
Manager, Risk and Regulation

T +44 (0) 20 7920 8412
E shamim.diouman@icaew.com