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Mr. Arnout Wellink
Chairman
Basel Committee on Banking Supervision
Bank for International Settlements
Centralbahnplatz 2
CH 4002 Basel, Switzerland

Re: "Strengthening the Resilience of the Financial Sector" and "International Framework for Liquidity Risk, Measurement, Standards and Monitoring".

Dear Chairman Wellink:

The Institute of International Finance is pleased to present the attached comments on the Basel Committee's two Consultative Documents, which are essential elements of the global response to the crisis and the G20's challenging objectives. Comments were developed by the IIF Steering Committee on Regulatory Capital, on the basis of work by a number of expert working groups.

First, we would like to emphasize that the Institute and its members endorse the goals and objectives of the proposals in the Consultative Documents and in particular the use of improved capital and liquidity requirements, as well as internal risk management, to achieve both more robust banks and a more resilient system.

At the same time, and with equal emphasis, the IIF underscores the importance of conducting a comprehensive analysis of the cumulative impact of all regulatory proposals currently being considered on employment and the economies in the major markets. The Institute is aware of current work by the BCBS on this issue but it is nonetheless important to highlight how essential this is before any reforms are finalized. The IIF is currently concluding its own analysis and while only preliminary data exists it can be said that, as written, the proposals will likely have severe economic consequences both for the financial industry and the economy at large that ought to be avoided.

In its comment letter the Institute highlights serious concerns on various specific proposals which, when considered in aggregate, could run contrary the overall goals of the reform and would fail to support an effective and risk-sensitive regulatory framework as a fundamental element of a prudently managed and efficient financial system. Thus, with these points in mind we would encourage the committee to consider adopting modifications of many of the specifics of the proposals. This is essential for the current recovery phase, but even more so for a solid, sustainable level of future growth. As the BCBS has made clear it is aware, it is important through impact assessment and economic analysis to be sure that the final measures are balanced and do not result in the burden on the economy.

In addition to appropriate design and calibration of the specifics, the success of the revised capital requirements and the new liquidity regime will depend on appropriate timing. The BCBS is fully aware of the need not to disrupt a fragile recovery. This implies a sensitive analysis of the timing of final promulgation and adequate phasing-in of implementation of the new frameworks.

The BCBS has made significant advances with its capital and liquidity proposals. However, additional work on the side of both the industry and the regulatory community may well be needed in order to achieve revised capital and liquidity frameworks that respond adequately to the twin goals of system resilience and sound economic growth. The Institute hopes to contribute both by the substantial economic analysis of cumulative impacts already mentioned and by standing ready to engage in constructive dialogue with the BCBS to find workable and technically robust solutions to the problems that remain.

We hope you find these comments useful as you strive to achieve a robust global regulatory regime overseeing a resilient international financial system and growing global economy.

Very truly yours,

Dr. Josef Ackermann
Chairman of the Management Board
and the Group Executive Committee
Deutsche Bank AG

Mr. Stephen K. Green
Group Chairman
HSBC Holdings plc

Charles Dallara
Managing Director
Institute of International Finance

IIF Comments on BCBS Consultative Documents *Strengthening the Resilience of the Banking Sector* and *International Framework for Liquidity Risk Measurement, Standards and Monitoring*

Executive Summary

Introduction and Overarching Themes

1. Support for Objectives: The Institute of International Finance (IIF) and its members are supportive of the Basel Committee's (BCBS) overall goal of improving the banking sector's ability to absorb shocks arising from financial and economic stress while promoting sound credit and financial intermediation activity. Improving risk capture and the quality of the capital base, controlling excessive leverage in the financial system, addressing procyclicality in capital requirements and managing systemic risk are all goals that the Institute endorses. The fundamental reforms proposed in the two Consultative Documents represent a sweeping change of the global financial regulatory framework, even without considering other reform proposals not included in the package. They therefore require the close and thoughtful consideration of all concerned.

2. Achieving Objectives Requires Substantial Revisions: While the Institute and its members support the objectives sought by the reform package, substantial modifications will be needed if the proposals are to manage the tradeoffs between layers of protection and prudent credit provision for economic growth. The impact-assessment exercises currently being conducted by the public and private sectors (included that of the IIF) will demonstrate that the proposals, if implemented as initially proposed, risk creating severe economic consequences both for the financial industry and the global economy at large. Without needed modifications and appropriate calibration, the proposals as issued would hamper the ability of banks to continue serving in a prudent way the needs of their clients, who would likely end up feeling the effects in the quality and price of financial products. Many of the proposals imply profound changes in markets for financial instruments, the implications of which require further consideration. Revisions to the proposals, their judicious calibration, consideration of the interdependencies among the proposed measures, full assessment of their cumulative impact and the determination of priorities, and a realistic implementation calendar are all essential before a final set of standards is issued for implementation by the global financial industry.

3. Critical Issues for Consideration: in its extensive comments, the IIF highlights a number of issues that require serious consideration by the BCBS as it proceeds with the refinement of its proposals. All the comments presented are the results of very careful and judicious consideration throughout the past four months by a number of technical working groups and senior committees. Among the very serious considerations raised in this comment submission, the following are of very critical nature:

- Cumulative Impact Assessment: judicious design and calibration of the proposals, with full consideration of the interdependencies among the proposed measures, must be based on a full assessment of their cumulative impact and the determination of priorities.

- Timing of Implementation: implementation timing should be based on a careful assessment of the macroeconomic conditions and the state of resilience of the global financial industry at the proposed date. Implementation should be undertaken based on careful phasing-in of specific requirements, with grandfathering when necessary.
- Capital Composition: the new definition of capital framework and the specific requirements regarding the composition of predominant and Tier 1 capital should only be calibrated once a full assessment of interaction of the proposed exclusions, deductions and new requirements on capital composition; the current proposals are in many ways procyclical and would have counterproductive as well as disparate impacts. The excessively conservative regime of exclusions and deductions needs revision and needs to be reconceived to achieve a more economically realistic result.
- Leverage Ratio: a carefully designed leverage ratio should apply exclusively under Pillar 2. Its supplementary nature and the extensive requirement for supervisory judgment for its application to individual firms makes it incompatible with a Pillar 1 approach.
- Counter-cyclical Measures: a combination of risk management, provisioning and capital tools is needed to address procyclicality. Specifically, when defining a capital-buffer framework, such buffers must be determined, under flexible guidance, through a Pillar 2 approach, avoiding rigid triggers that are likely to be ineffective or counterproductive to a firm's recovery. The effective availability of capital buffers during times of stress needs to be ensured.
- New Liquidity Framework: the new liquidity framework needs to be adequately phased in given not only the step change in regulation that it would represent, but also the change in the role of banks in the economy; the Net Stable Funding Ratio should be put on a Pillar 2 basis, replacing the current rigid Pillar 1 proposal with something much more adapted to the situation and risks of each firm.

4. Cumulative Impact Assessment: As recognized by the BCBS, there is need for a thorough assessment of the cumulative impact of the proposals as a whole, along with other pending regulatory changes. Such analysis should determine whether the right balance among the objectives is likely to be achieved, *i.e.* to achieve greater resilience of individual banks and the banking sector in periods of stress while preserving sound credit and financial intermediation in support of a growing economy. Such combined objectives are complementary and should be preserved by the BCBS through the final definition and calibration of the proposals, as well as the timing for implementation. In this regard, certainty should exist that the shape and timing of the proposals will not undermine economic recovery or affect sustainable economic growth, which are recognized by the G20, the FSB and the BCBS as essential goals.

5. Industry's Work on Impact Assessment: Preliminary results of the ongoing work of an IIF Working Group tasked with modeling the potential impact of reforms currently under consideration for the US and Euro Area are quite sobering. Introduction of the regulatory measures as originally proposed by the Basel Committee would constrain the growth of credit flows and, in so doing, considerably affect GDP growth. Given the typical relationship between output and employment in the US, this would likely translate into a weaker path for employment. In the Euro Area, the results could be even more substantial, in part reflecting the greater relative importance of banks to the financing of the region's

economy. Japan, whose banks were not directly involved in the crisis, would also be materially affected by the proposed changes. In addition, it will be important to consider carefully the effects on emerging market economies and their banking systems. The Working Group's projections conclude that the current mix of specifically targeted reforms would combine – against the backdrop of an already fragile global expansion – to hinder medium-term credit growth. The final results of the full analysis will be made available to the BCBS in time for its own planned consideration of the cumulative impacts of its proposals, which we hope will assist the BCBS in ensuring that these impacts are taken into account in the finalization of the proposals and the eventual calibration of the required capital and other related measures. The Working Group is composed of chief economists and regulatory economists from IIF member firms and chaired by the Chief Economist of the Institute.

6. <u>Further Consultation</u>: Given the sweeping nature of the proposals, the many technical issues, and the significant components that still remain to be defined, the present round of consultations can only be considered the first step in the policy making. Therefore, the IIF urges the BCBS to make clear its intention to conduct extensive further consultation as it revises the proposals, to circulate an additional formal consultation paper on the final package of revised proposals planned for the end of 2010, when full technical details and the intended calibration can be understood and evaluated, and to conduct an additional QIS exercise and final impact assessment at that time. This is essential for the Committee to meet its goal to "ensure that the sum of these measures does not result in banks holding excessive buffers beyond what is necessary to maintain a resilient banking sector."

7. <u>Recognition of Progress Made</u>: Development of the proposals should include full consideration the very substantial remedial actions that the industry and the supervisory community have taken and continue to take in order to address many of the deficiencies evidenced by the crisis. The substantial recapitalization of the industry, the improvement of governance practices, the undertaking of severe stress testing, the deleveraging of the sector, the tangible improvements of risk management capabilities (including liquidity risk management) and the profound revision to supervisory approaches in a number of jurisdictions should all be taken into account in finalizing and calibrating specific measures. While much work remains to be done, the significance of the remedial actions already taken ought to be more fully recognized in the policy-making process.

8. <u>Level Playing Field</u>: Implementation of the new Basel II revisions, the trading book proposals announced last July, and liquidity standards should be simultaneous, symmetrical, and comparable across all major financial markets. Similarly, the BCBS should continue to be a strong voice for convergence of accounting standards as it develops final standards that will be affected by accounting. To that end, the G20 and the FSB need to ensure that the firm goal of a single global set of high-quality accounting standards is maintained.

9. <u>Retention of Basel II and its Incentive Structure</u>: The Institute fully supports the G20 mandate to retain Basel II as the core standard for global regulatory capital purposes. The

proposals should be crafted in such way that they do not undermine the primacy of the risk-based capital framework.

10. More Emphasis on Supervision: The proposals generally shift the balance between rules-based regulation and supervision in favor of the former, but, as discussed in detail, often in new areas where neither the state of development of new thinking nor the granularity of the proposals really allow for fully effective rules without substantially unbalanced effects or unknown consequences. At several points, the only conclusion can be to advocate a “Pillar 2” solution. This in turn suggests that the BCBS needs to do more to enhance globally consistent, demanding and effective supervision as a fundamental part of the solution.

Implementation Issues

11. Implementation Timing: It is essential that the BCBS develop a clearer strategy as to the way the reforms will be implemented. A detailed implementation plan, including phasing and explanation of its degree of flexibility, will need to be developed once the proposals acquire a more definitive shape. While reforms need to be implemented with diligence and consistency in order to achieve international harmonization, especially in the major markets, this needs to be done in such way that new requirements do not hamper the recovery of the financial sector and the economy as a whole, and do not unduly brake ongoing growth once recovery is achieved. The final implementation date will need to be reviewed carefully given the state of economic recovery, as the BCBS well recognizes, and tempered by appropriate grandfathering and phase-in provisions. A definitive decision as to the implementation date, which however should be consistent across major markets, should only be made after careful evaluation of the state of the global economy.

12. Announcement Risk: The BCBS should explicitly address the “announcement risk” of the proposals i.e. the likely immediate impact that the announcement by the BCBS regarding its final decisions, or even a perception that high-impact decisions have firmed up in the market’s estimation, would have on market participants and rating agencies as to their expectations of the amounts of capital that banks should hold. Market reactions could in turn have substantial effects on the real economy. Especially with respect to the new liquidity proposals, care is advisable because an overreaction by the market could hamper recovery or even create new systemic risk. While market dynamics are by definition autonomous, the BCBS should carefully consider this issue as it finalizes its plans for implementation and should use available options to address this “announcement risk”.

13. Phase-in and Grandfathering: The BCBS should consider the overall phase-in program for the new proposals (including the Trading Book proposals announced last July, which are largely outside the present proposals) once calibrated and finalized, to avoid unmanageable impacts on markets, and to be sure that banks and supervisors are prepared to implement each reform on a reasonably consistent basis across markets. Such phase-in program could foresee sequential implementation of different components of the final proposals, based on transparent assessment of priorities.

14. Emerging Markets: the implementation in emerging markets of the proposals should be guided the by the same overarching principles and objectives set at the international level. However, it is essential that implementation take into account the significant progress of regulation and supervision in emerging markets in recent years and contain the necessary degree of flexibility to adapt to local market circumstances. Moreover, banking plays a fundamental role in emerging markets supporting economic growth. Providing credit to consumers and companies, notably SMEs, financing infrastructure projects, while expanding access to formal financial services across their countries are essential banking functions. Higher growth rates and deeper social and economic developments in EMs also require higher rates of credit growth. Regulatory and supervisory regimes in EMs should therefore be sufficiently robust to ensure that their financial sector maintain this pivotal role while safeguarding their soundness and stability. These objectives will not be served if proposals go beyond what is strictly required by prudential objectives. Similarly, a number of secondary effects on emerging markets, including the effects of the proposals on investment by major-market banks in emerging markets, effects on trade credit, and effects on banks' willingness to extend credit to emerging-market borrowers (including financial institutions) need to be considered in the calibration and finalization of the proposals.

15. Clarification and Enhancement of the Role of Pillar 2: A number of areas dealt with in the proposals should be addressed through an effective and comprehensive Pillar 2 approach, which would allow the necessary flexibility to supervisors to tailor capital requirements to the specific risks within a bank. There is an urgent need to clarify the use of Pillar 2 within the revised Basel II framework. Equally urgent is the need to enhance globally consistent, demanding, and effective supervision as a fundamental part of the solution. The Committee's Standards Implementation Group and the new FSB focus on consistency of implementation of regulatory changes should provide the means to achieve this.

I. ***The following summarizes the Institute's comments on the Basel Committee's Consultative document, "Strengthening the Resilience of the Banking Sector".***

Definition of Capital

16. Need for Improvement of the Definition of Capital: The Institute agrees with the objective of a simpler and more harmonized, robust and transparent regime for the composition and quality of capital. Enhanced transparency of quality-of-capital requirements should be designed to prevent future misperceptions and inconsistencies both at the market and supervisory levels. However, there are concerns about the disparate impacts and likely procyclical effects of the specifics as proposed. This procyclicality would be amplified via the use of the new definition of capital for the leverage ratio, especially if put on a Pillar 1 basis.

17. Grandfathering and Transition: The BCBS has recognized that, especially as the industry is recovering from multiple challenges and will be making many demands on the market for equity, other capital instruments and debt financing, it will be important to grandfather existing instruments and requirements. This would include grandfathering the effects of deductions to mitigate disparate impacts or effects on markets; for example, minority stakes

in overseas financial institutions ought to be grandfathered to avoid disruption in local markets, if an exception for such investments is not made, as suggested below. The transition must be phased and timed to minimize disruption of broader economic recovery, of markets, and of the industry's ability to meet credit demand.

18. Legal Differences Across Jurisdictions: The difficulty of the trade-off between the goal of harmonization and the differences of legal regimes across jurisdictions should not lead the BCBS to accept rigid or arbitrary solutions. Rather, the Institute would urge the Committee to use colleges and the processes of the Standards Implementation Group (SIG) and FSB to assure international consistency with the necessary degree of elasticity.

19. Types of Capital: The IIF agrees with the renewed emphasis on Tier 1 and the importance of Common Equity and retained earnings as the core or predominant form of capital; however the roles allotted to the ratios of Common Equity, all Tier 1 and total (Tier 1 plus Tier 2) capital are extremely important to firms' ability to operate on a capital-efficient basis and to plan for future stresses and need further clarification. It will continue to be important for banks to be able to rely on additional Tier 1 and Tier 2 capital as part of their overall capital-management programs.

20. Predominance of Common Equity: One issue that will take serious consideration by the BCBS is what level of "predominance" it will mandate for the level of Common Equity required as the "predominant" part of Tier 1 capital. When setting the level of "predominance" of common equity and retained earnings based on the results of the QIS, the BCBS should consider the increased quality of capital that has resulted from the measures being taken by the Committee and national supervisors, as well as firms' responses to market pressure. Given all the other regulatory and accounting changes, a test for predominance that would not be excessively constraining would be appropriate. The effects of the "predominance" test will depend on the outcome of the debate on the treatment of deductions and the other definition-of-capital issues the proposals raises; hence, its final calibration must await resolution of those questions. To avoid "acceleration" effects, the definition of "predominance" should only apply to the capital that fulfills the new minimum regulatory level requirements, and not to the total capital a bank chooses to hold.

21. Emerging Markets: It is highly important that, for emerging markets that already have substantially higher minimum capital requirements, the new Basel minima be treated as minima, and not induce reflexive increases over current stated requirements. Similarly, the reform should take into account the special characteristics of local capital instruments (such as preferred stock) in a number of jurisdictions, which while diverse in form, comply with the general principles of loss-absorbency endorsed by the proposals.

22. Market Making: For a number of provisions there is no stated market-making exemption in the Consultative Document. Market making is a fundamental economic function of banks; clear exemptions need to be spelled out in certain cases.

Additional Going Concern Capital

23. Loss Absorbency: Additional going concern (non-core) capital can have real loss-absorbing capacity on a going concern basis, and this dimension of capitalization requirement requires more recognition to preserve banks' access to the broadest possible markets. While the general principles of loss absorbency of instruments in Tier 1 capital are appropriate, a more granular examination of the principles is required to avoid excluding instruments that would qualify economically.

24. Hybrids: The proposal is to phase out "innovative" hybrids altogether, but the scope of what is to be excluded is as sweeping as it is opaque. There are several technical comments on the proposals as to hybrids as well. To give one example, the proposal singles out step-up clauses as an example of an incentive to redeem for hybrid capital instruments, and states that instruments with such incentives cannot be included in Additional Going Concern Capital. A proportion of instruments with step-up features should, however, be acceptable, subject to analysis of the likely effects of a particular transaction - allowance of such instruments where appropriate could provide useful diversification of financing instruments. The extensive work of the Committee of European Banking Supervisors (CEBS) over the past three years shows it would be possible to achieve common definitions, appropriate buckets, and sensible economic limits for a somewhat broader range of hybrids than seems to be contemplated.

25. New Instruments: If banks are too strictly limited to a narrow set of instruments for their different capital baskets, it will be challenging for the market to absorb new offerings, especially if a great deal must be done over a short period of time. The ability of a capital-dependent industry to have access to deep, broad and varied sources of funding in markets that vary over time is fundamental. The proposals need to take a more market-sensitive approach to definition of allowable instruments.

26. Conversion/Write-Down Requirements: The requirement for Tier 1 Additional Going Concern Capital in the form of liabilities to include either conversion into common shares or a write-down is not essential, given the other requirements. If the requirement is retained, it is important to make clear that write-down features do not preclude a future write-up when the firm returns to appropriate conditions. Permanent write-down would not only be unacceptable to many investors but would effectively subordinate Additional Going Concern Capital to Common Equity, normally to be the most subordinated form of capital under the Basel scheme.

27. Indirect Issuance: The proposals restricting indirect issuance via special-purpose vehicles are overreaching and need to be modulated to address the tax and corporate needs of issuers in certain countries, which could be done without compromising the prudential goals of the proposals.

Tier 2 Capital

28. Restrictions on Tier 2 capital: The maturity and amortization guidelines for Tier 2 capital outlined in the Consultative Document are needlessly restrictive. The five-year minimum-maturity, minimum-call and amortization period for Tier 2 capital need reexamination given the purpose of Tier 2 capital as "gone concern capital". As Tier 2 capital is fully available as "gone concern capital" until the day it matures, there should be room for shorter-maturity instruments and short amortization periods or bullet maturities. Availability of Tier 2 capital from different classes of investors could be substantially enhanced by removing unnecessary constraints.

29. Lock-Ins: The Basel Committee states it is seeking views on whether lock-ins could help ensure that Tier 2 capital is not repaid during a crisis. The new guidelines should allow firms the leeway to design different structures with or without lock-in as long as they fulfill other requirements.

Contingent Capital

30. Role of Contingent Capital: Contingent-capital instruments may have the potential to create attractive value for both issuers and investors, while giving supervisors assurances as to the delivery of additional equity in time of need. The potential of contingent capital should continue to be explored with an eye to increasing the financing options and range of investors available to banks. However, there are a number of issues that must be resolved before the Committee could be confident that instruments within regulatory guidelines for contingent capital would actually find reasonably deep markets and work as intended from a prudential perspective.

31. Issuance of Contingent Capital: Contingent-capital issuance should not be mandatory; banks should be able to issue contingent capital only if that makes sense in terms of their overall capital structure and contributes to their capital efficiency. Such instruments could be one option for a bank to meet any capital buffer requirements elaborated in other parts of the Consultative Document.

32. Characteristics of Contingent Capital Triggers: To appeal to investors, especially traditionally debt-focused investors, triggers must be simple, completely transparent, objective, and non-discretionary, so as to make the risk of exercise as readily analyzed as possible. These investors would also require a trigger set low enough that breach should only occur at a level that appears remote upon issuance. Any regulatory guidelines should, however, also permit firms to negotiate with investors to create instruments with dual-trigger structures, so that management would have the option, but not the obligation, to convert at a somewhat higher trigger level in order to give the firm choices in the management of its capital before the trip-wire conversion level is reached.

33. Macroeconomic Triggers: Only triggers related to the idiosyncratic conditions of a particular institution are likely to be attractive to the market; triggers tied to systemic issues would dilute the market discipline that a well-designed contingent instrument should

create. Triggers based on systemic issues would hamper investors' diversification of risks across issuers.

34. Ability of Firms to Write Up: The contingency could be provided by conversion or by write-down; however, it should be made clear that, where write-down is the means of improving the firm's capital situation, write-up should be allowed when the firm recovers its stability. With supervisory approval of the form of instrument, there is no reason why write-up as the firm returns to health should be precluded – especially as such a feature will attract a wider range of investors.

Regulatory Adjustments

35. Regulatory adjustments: Adjustments– deductions or exclusions – will make a great deal of difference to the financial and economic impact of the new requirements. The reasons to increase transparency and consistency of adjustments are understood, but the industry is gravely concerned that the proposals would seriously burden both recovery from the crisis and credit capacity for the future, in ways that are ultimately unnecessary. Aspects of the proposals would contribute a substantial degree of procyclicality, undermining the BCBS's efforts to reduce procyclicality, consistently with the mandate of the G20, in other parts of its proposals.

36. Deductions from Common Equity: One of the most concerning aspects of the guidelines as currently proposed is deducting adjustment items from Common Equity. A dogmatic approach to making all regulatory adjustments to capital to the Common Equity component of Tier 1 risks failure to recognize that several of the items proposed for deduction have value in both "going-" and "gone-concern" situations and are of sufficient quality to be included in Common Equity.

37. Minority Interest: The deduction of all minority interests from Common Equity without exception raises a number of concerns. Most importantly, if this guideline is kept, it will be essential to permit the corresponding deduction of an appropriate amount of the subsidiary's risk weighted assets from those of the parent company. Full deduction may in many cases ignore real resources available to the group and could hinder the creation of coherent resolution plans. The current language would likewise penalize important forms of participation in emerging markets and transition economies, as banks often either choose, or are obliged by regulation, to enter foreign markets in this fashion. Alternatively, the BCBS could include minority interests in Common Equity up to a limit defined either by reference to the Tier 1 ratio of the parent group (excluding minority interests) or by reference to a normative Tier 1 ratio set by the regulators. Reconsideration to achieve a more risk-based result is in order.

38. Unrealized Gains and Losses: The proposal as put forward by the BCBS is appropriate and encouraging, though the specifics may need to be revisited once accounting changes now under discussion are finalized. As a general matter, there should be symmetry in the treatment of unrealized gains and unrealized losses, and this principle should be maintained as pending accounting changes are factored in.

39. Intangibles: Whereas deduction of goodwill is appropriate, the deduction of other items treated as intangibles from Common Equity needs to be examined item-by-item. Intangibles such as mortgage servicing rights, purchased credit card receivables, and software do not exhibit the mentioned "high degree of uncertainty" and have a positive realizable value. These are very substantial items for some banks and the current approach imposes a false simplicity that ignores the economic realities of many items classed as "intangibles."

40. Deferred Tax Assets (DTAs): A blanket rule for deduction of DTAs against core Tier 1 is unwarranted. The IIF supports making a distinction between DTA categories, namely between DTAs based on timing differences and DTAs based on tax losses carried forward. This would more accurately reflect the actual behavior of DTAs, and also avoid the issues of offsetting DTLs that may also arise from timing differences. Thus, any deduction should only be considered for tax losses carried forward, and such deduction should appropriately be taken from Tier 2, gone-concern capital.

41. Investments in Own Shares: Provision should be made for a market-making exception to the proposed deduction in own shares. The requirement that gross long positions may be deducted net of short positions only if the short positions involve "no" counterparty risk is unrealistic and probably impossible to attain on a meaningful basis. Collateral and other standard risk mitigation techniques should be recognized within otherwise-applicable Basel rules.

42. Investments in Other Financial Firms: The requirements regarding holdings of other financial firms pose a number of problems. While the concern about "double counting of capital" makes some sense in certain instances, the proposals seriously overshoot their prudential goals. A market-making exception is required, among other things to be sure that markets can be made in the securities of smaller banks. Where there are offsetting short or derivative positions for positions in other financial institutions, these positions should be netted against the long positions to make the capital impact risk base, with the normal trading-book and counterparty-risk capital requirements being applied. More generally, it is not appropriate to extend the same treatment of deduction from Common Equity to other financial institutions, especially insurance companies as to banks. Risks faced by such firms are on the whole not highly correlated with banking risks, and thus the risk-based justification for the proposal is not obvious. In addition, deductions should not create disincentives to beneficial overseas investment, especially in emerging markets. Finally, the Committee should carefully consider an appropriate treatment of investments in industrial leasing companies and whether true correlation with financial institutions exists.

43. Look-Through of Index Securities: The requirements to look through index securities will not only be extremely difficult operationally, but will also reduce liquidity and impair risk management by impeding trading or market-making of index securities. Active trading firms typically have balanced long and short positions, while it appears that the long but

not the short would be recognized. If it is deemed necessary to maintain some version of the rule, then balanced positions should be distinguished from outright long positions.

44. Provisioning Shortfalls: A full deduction regime may be antithetical to the goals of the new forward-looking provisioning, and the proposed buffer rules, and could compound the burdens on recovery. It is difficult to comment with confidence on the provision in regard to the shortfall of provisions to expected losses given the uncertainty about future provisioning rules under both IFRS and US GAAP. Certain outcomes of that debate could bring very substantial shortfalls, the effects of which would have to be reconsidered.

45. Pension Fund Assets and Liabilities: Treatment of pension assets and liabilities is likely to matter only in insolvency (gone concern); as such, the proposed deduction exclusively from Tier 1 capital may contribute excessively to volatility and procyclicality and fail to recognize the allocation of pension burdens between the going concern and possible gone-concern claims. The valuation of pensions also requires further guidance from the regulators and accounting standard-setters to work out appropriate treatment and measurement of pension issues without exacerbating procyclicality.

46. 50:50 Deductions: The BCBS has modified the prior approach to certain categories, of regulatory adjustments, such as securitizations, to eliminate the current deductions made 50% from Tier 1 capital and 50% from Tier 2 capital, and to substitute a 1250% risk weight. Aside from the additional burden this would place on the recovery of securitization, on top of the numerous other measure being implemented, the proposed rule would in many cases create a capital charge that would exceed the risk exposure itself, for example if a particular country required a higher minimum capital than the internationally agreed level of 8% (the level at which the 1250% risk weight was evidently calculated). A simple solution to this issue is to cap any deduction at 100% of the exposure equivalent.

Counterparty Credit Risk

47. Improvement of Counterparty Risk Management: The IIF believes that it is appropriate to review the treatment of counterparty risk, together with its measurement and management, in light of experience from 2007 on. It seems clear from this experience that a regime that encourages more accurate and realistic assessment of the level, variability and drivers of counterparty risk is desirable, including such crucial factors as wrong-way risk.

48. Credit Valuation Adjustments: The industry supports the goal of greater and better aggregation of exposures at the counterparty level. The industry would in fact go further and recommend integration of all credit-exposure information.Any regulatory requirements should follow the basic principle that firms that effectively hedge economic risk should hold less capital than those with unhedged economic risk. The Institute underscores, however, that the industry has significant reservations in regard to the proposed “Bond Equivalent” approach. In particular, this proposal departs substantially from good practice, would discourage sound hedging and active risk management, and would produce capital estimates of a magnitude that is not supported by prudential concerns. . The industry proposes instead recognizing in regulatory capital requirements the differences of trading

book and banking book treatments of credit counterparty risk (CCR). Regulatory approaches to CCR should provide incentives for prudent management of risk, including hedging.

49. Expected Positive Exposure (EPE): While the industry is supportive of the development of industry and regulatory approaches that better deal with wrong-way risk, the industry believes the proposed stressed EPE charge is not an adequate tool to deal with this type of risk. Concern exists that existing Pillar 2 stress testing charges already capture such risk and therefore, the additional EPE charge would result in unjustified, duplicative charges. Backtesting should therefore be used to corroborate the adequacy of stress testing rather than imposing a duplicative regulatory tool.

50. Asset Value Correlations: The industry supports further study in this area but believes that current available data does not justify the proposed measures. In particular, the proposal allows for no distinction between quality of financial counterparties and ignores the significant improvements of industry practices in regard to collateral and central clearing, which mitigate and reduce the 'interconnectedness' the charge is presumably targeting. The industry is also concerned that by increasing the value correlation the framework introduces a strong disincentive for financial firms to deal with each other, weakening the market unnecessarily, particularly when the liquidity regime already strengthens firms' resources.

51. Increased Incentives for CCPs for OTC Derivatives: The industry agrees that there should be a relative incentive to face a CCP (provided, of course, that the CCP adheres to reasonable international standards set by CPSS-IOSCO and, in particular, does not undertake the clearing of contracts that would be inherently unsuited to clear centrally). The industry, however, cautions against penalizing contracts that are not centrally cleared, since by definition this would include the very tailored contracts that are often most valued by end-users. As in other parts of the proposal, this risks overshooting safety concerns to the extent that risk-management value-added provided to the real economy becomes less feasible.

52. Proportionality: Application of paragraphs 112 through 177 to smaller firms with simpler business models (especially in emerging market countries) should respect the principle of proportionality. Additional guidance as to the appropriate implementation of these provisions as to such institutions should be included in the final package, with the recognition that as proposed, implementation of the standards would be extremely challenging for these firms. The SIG should include in its reviews how to maintain the principle of proportionality while also attaining the greatest comparability of outcomes.

Leverage Ratio

53. Need to Address Excessive Leverage: The IIF agrees on the need for financial firms to manage leverage prudently and believes that supervisory tools have a role in preventing unhealthy levels of leverage. However, a Pillar 1 ratio, with its one-size-fits-all nature would never be able to provide an effective, fair, and economically realistic view of leverage, and the present proposal's unwarranted disregard of risk mitigation and netting

would apply the leverage ratio to vastly overstated exposures (including the exaggerated treatment of off-balance sheet assets, undrawn commitments, and written derivatives), constraining the industry's capacity in a manner many times disproportionate to actual risk, however considered.

54. Importance of Pillar 2 Nature: These goals of a supervisory tool to control excessive leverage can best be achieved on an international level if the leverage ratio is exclusively a Pillar 2 measure. Under a Pillar 2 approach, a leverage ratio can be a useful tool for supervisors to assess leverage build-up in an institution, particularly from the perspective of how leverage evolves through time in such institution. Together with risk-based tools, the leverage ratio can assist management and supervisors to form a view on the soundness and resilience of the capital position of each individual firm. However, this is by definition a Pillar 2 firm-specific analysis, avoiding conclusory and mechanical application implied by a Pillar 1 approach that would penalize prudent practices yet could miss significant risks.

55. Supplementary Nature: As the BCBS proposal recognizes, the specific design of the supervisory tool ought to be such that it truly works as a supplementary measure to the risk-based framework. Care is needed so the leverage ratio does not become the binding capital constraint (which by definition under Basel II should be risk-based). However, a Pillar 1 leverage ratio (on any assumption about its final calibration), would indeed supersede the risk-based measure and undermine Basel II, potentially giving rise to a build up of risk in banks' balance sheets.

56. Additional Concerns: The design of a leverage ratio should be carefully considered so that such tool can adequately play its supplementary supervisory objective. In this regard, the IIF has the following additional concerns regarding the proposals:

- Capital Measure: Given the move to strengthen the definition of Tier 1 and its predominant components, Total Tier 1 (at the group level) would provide a sound basis for the calculation of a leverage ratio.

- Exposure Measure: IIF encourages the BCBS to recognize on a reasonable basis the forms of risk mitigation (including netting and collateral) that are already well-grounded in regulation (subject of course to appropriate haircuts).

- Netting: Given the unreasonable and uneconomic treatment of financial instruments such as derivatives, repos, securities financing and loans that would result from the elimination of netting, a common set of regulatory netting rules (as currently determined under Basel II) is essential if the leverage ratio is to provide any useful information on the economic risks taken by a firm.

- High-quality liquid assets: IIF encourages the BCBS to craft a framework that makes adjustments (including exemptions) for the types of assets that are required to be held by banks in accordance with the new liquidity regime.

- Securitization: Owing to stringent credit risk transfer criteria and provisions in the capital adequacy regulation, those assets would be considered transferred for legal purposes should be considered effectively transferred for all purposes (both from the legal and risk management perspectives) and should not be considered for leverage purposes.

- Derivatives: The IIF disagrees with a proposal to consider derivative contracts at gross notional value for leverage ratio purposes, and urges the BCBS to adopt the *current exposure approach* contained in Basel II. with due consideration to netting.

- Credit Derivatives: The proposed inclusion of notional value in the measure of exposure without netting against bought protection denies the very essence of derivatives trading, where notional amounts are generally meaningless given the management of derivatives books on an offsetting basis and extensive use of legally enforceable netting.

- Off-balance sheet items: The IIF encourages the BCBS to develop an approach that adequately recognizes the cash-flow characteristics of many types of off-balance sheet assets through mechanisms such as standardized credit conversion factors (thus avoiding penalizing low-risk assets).

57. Disclosure: The Institute supports the development of an adequate disclosure framework for leverage purposes. However, if wrongly designed, rigid sets of mandatory disclosures on leverage could be misinterpreted by the market as indicators of risk, which would be misleading for firms with large portfolios of low-risk. Finally, the BCBS should also consider the implications, from the disclosure perspective, of the Pillar 2 nature of the leverage ratio so that the right balance is achieved between the informational needs of the market and the necessary confidentiality of Pillar 2 data.

Procyclicality

58. Importance of Addressing Procyclicality: It is necessary to address the risk management and capital implications of the economic cycle. However, as recognized by the BCBS, data as to the level of procyclicality in the regulatory capital framework are scarce and inconclusive. It follows, necessarily, that until a better assessment of magnitude of procyclicality, it would be almost impossible to achieve the right calibration of any proposal.

59. Need for both Capital and Provisioning Solutions: The Institute shares also the view that both capital and provisions need to be designed with an eye to addressing procyclicality, carefully assessing unexpected and expected losses, respectively. However, the current proposals will likely result in double counting. As currently proposed, adjusted PDs, loan provisions and capital buffers (both micro and macro), together with current approaches to Pillar 2 capital add-ons, would in many cases address the same issues and vastly overstate capital requirements.

60. PD Adjustments: the IIF supports the need for increased and balanced use of through-the-cycle approaches to Probability of Default (PD) estimation. However, the Institute has grave doubts about the feasibility and the effects on cyclicality of both the "highest average PD" and the "average historic PD" approaches that are under consideration. The Institute believes strongly that PD inputs into the internal risk management process and the calculation of risk-based capital should not be manipulated by introducing what in effect are "downturn PDs". Adjustments to the inputs of models interfere with sound risk management, reduce their transparency and the comparability of capital requirements across firms, and ultimately would de facto create a new minimum capital standard.

    Given the unresolved technical issues, the most prudent procedure would be for the BCBS, in collaboration with the industry, to continue analyzing this issue without rushing into adopting any untested approach that could have severely negative consequences on the way banks manage their risks. In the meantime, Pillar 2 provides all the necessary tools for supervisors to address any deficiency in banks' estimation of risk parameters.

61. Forward-Looking Provisioning: The Institute has for a considerable time supported a more forward-looking approach to loan-loss provisioning. The Institute is convinced that divergence between the accounting standard-setters must be avoided at all costs, but that a converged accounting standard that will also meet the goals of the G20 and the BCBS should be entirely possible.

62. Basic Provisioning Principles: a resolution of the limitations of current provisioning for both accounting and regulatory purposes should recognize a few principles, which include:

    - Keeping provisioning consistent with the way banks manage their lending and securities businesses (which for most exposures is an open-portfolio basis).
    - Reflecting management's view of expected loss and ensuring that provisions include -- as a minimum-- information based on impairment in banks' portfolios reflecting reasonably determinable near-term changes in expected losses, plus actual non-performing loan charges as they emerge.
    - Provisions must be usable in fact; i.e. without penalizing accounting or prudential treatment.
    - Multiplication or duplication of systems and calculation requirements for accounting and regulatory purposes should be avoided if at all possible.

    The BCBS should continue to work with the standard-setters in to achieve a satisfactory, globally applicable, solution.

63. Fixed Capital Buffers: the Institute supports the work of the BCBS on management of the capital implications of procyclicality. However, the proposal for "fixed" capital buffers through capital conservation, as sketched out in the Consultative Document, needs to be revised in various aspects that could affect its effectiveness:

    a. While capital conservation measures are supported by the industry, such measures would be more effective under a flexible Pillar 2 approach, allowing for a firm-

focused discussion with the respective supervisor, and not reduced to rigid formulae.

b. The proposals fail to specify the methodology by which the target capital (or buffer range) would be set. The industry would appreciate additional details on the methodology under which this would be done, including the time horizon of the type of losses the buffer is expected to cover, the difference between the proposed buffers and the regular capital requirements.

c. Fundamentally, the industry is highly skeptical as to the potential effectiveness of the capital buffer concept with a stated buffer range and minimum capital conservation ratios as proposed. Most importantly, it is unclear whether firms would be able in practice to draw from the capital buffer during times of stress. While the BCBS is aware of this problem, there is no indication as to how the Committee could make buffers actually usable in hard times. If not usable, the effects of buffers would be pro-, not anti-, cyclical as the burden of carrying them will force banks to reduce assets and new lending, contributing to the downward spiral.

d. While supervisors have long had the power to restrict dividends when banks are in a truly precarious position, restriction of the ability of boards to pay dividends or conduct share buy-backs to the extent apparently envisioned would seriously narrow the business judgment of management and boards, hobble firms' ability to manage their capital and their relations with the market, and quite likely make redressing a firm's situation more rather than less difficult. If the expanded capital-conservation measures are applied at the subsidiary level, firms would lose the diversification benefit of having subsidiaries in multiple countries; any application of capital-conservation at the subsidiary level should be debated through the group's college.

64. <u>Reliance on Pillar 2</u>: The Institute believes that unless the very serious doubts as to the practical effectiveness of the proposed buffers are addressed, the BCBS should consider providing additional guidance, on the use of currently available Pillar 2 tools (and role of colleges) for the purposes of capital conservation at individual banks, in order to achieve results that are globally consistent but also sensible for the situation of each institution.

65. <u>Variable Capital Buffers for Macroprudential Purposes: Excessive Credit Growth</u>: While, conceptually, variable buffers could potentially be useful, the international debate on this subject shows that a great deal of further analysis is needed as to the intent, design, and effectiveness of such buffers (including issues such as the multiplicity of macro variables to be considered, the limitations of any single variable, the differences across economic cycles and the specificities of banks with different business models). Other issues include are the scope of the analysis (by country, region, globally), the criteria to be used for determining what is "excessive" growth, the need for coordination across jurisdictions, the situation of global, cross-border banks with exposures in multiple jurisdictions, etc. Macro scenarios are likely to be very difficult to design and apply and, of course, effects of applying macro

constraints at any point in time would require analysis of effects on SMEs, retail borrowers, emerging markets, and economic activity generally. These challenges to the official sector would be replicated at the firm level, if firms were expected to run related, mandated macro scenarios through their risk systems. At a time that the BCBS is focused on addressing issues of the magnitude of a revised definition of capital, the implementation of a global leverage ratio, and a completely new liquidity framework, rush should be avoided in developing actionable proposals on issues on which basic policy, methodological, and technical discussion is still essential.

<u>Systemically Relevant Banks: Capital Implications</u>

66. <u>Support for Risk-based Supervision:</u> Although the current Consultative Document does not include specific proposals on "systemically important banks", the BCBS is considering alternatives that include capital and liquidity "surcharges" for such firms. In this regard the Institute reiterates its support for a risk-based approach to supervision, with inclusion of systemic risk in the supervision of each individual firm. Also, the IIF reiterates support for a comprehensive approach addressing issues such as interconnectedness and the role of market discipline. Issues of interconnectedness can be managed through infrastructure improvements, such as the CCPs. Market discipline should be reinforced by creating conditions under which large firm could be allowed to fail, including adequate resolution regimes.

67. <u>Avoiding Size as a Single Criterion for Systemic Relevance:</u> While supervision of a firm will be more intensive where the failure of the firm would have a material impact on the system, the Institute does not believe that it would be appropriate to apply different regulations to firms purely based on the size or because they are determined to fall within a predetermined category of high systemic relevance. Rather, regulation should remain risk-based and assess the actual risks faced by a firm given its mix of business, diversification, geographic scope, and quality of risk management.

68. <u>Further Industry Work</u>: The Institute is developing industry thinking on the overall issues of systemic risk, including, critically, the problem of cross-border resolution, and has given comments to the Committee on its important paper on that topic. The Institute looks forward to engaging in dialogue on this important issue.

II. The following summarizes the Institute's comments on the Basel Committee's Consultative Document, "International Framework for Liquidity Risk Measurement, Standards, and Monitoring".

69. <u>Support for Improved Liquidity Risk Management and Regulation</u>: The Institute has been a constant advocate of continued improvement in liquidity regulation and liquidity-risk management as demonstrated in its 2007 Report *"Principles of Liquidity Risk Management"*. Much progress has in fact been made, but more is needed. The Institute supports introduction of a globally consistent quantitative regulatory liquidity approach that would be binding for a short survival period, with a consistent but firm-specific "pillar 2"

approach for the longer period, in both cases subject to revisions to achieve more risk-based assumptions and parameters.

70. Industry's Responsibility: Members accept full responsibility for strengthened liquidity-risk management and for building buffers against firm-specific crisis and a degree of systemic disturbance. The comments on the Committee's proposals are intended to reinforce that duty, by making the proposals more efficient and more likely to be effective.

71. Getting Trade-offs Right: As the Committee recognizes, there are trade-offs between liquidity resilience and economic growth, both during recovery and over the long term. While some banks and the system as a whole may have been "under-insured" before the crisis, the present proposals expect the industry to carry too much of the "insurance" against *systemic* crisis. This is a serious point as the proposals threaten to have a very substantial effect on reducing banks' ability to provide credit and absorb risks in the wider economy. Redress of the balance is critical to recovery and to future growth.

72. Potential Effects of the Proposed Scenarios: The scenarios hard-wired into the proposal would have serious, market-wide effects and dramatically restrict banks' ability to provide credit and liquidity to the global real economy.

- It is likely there will not be enough low run-off retail deposits and not enough wholesale term funding at reasonable cost to sustain levels of bank lending consistent with broad global growth if banks have to manage to the ratios proposed.
- The proposals would cause a system-wide deleveraging and repricing of credit products and of risk, and appear likely to put liquidity risk back to the corporate sector, creating a new complex of risks and incentives.
- Feedback effects need to be considered. For example, increased competition for retail deposits would make them a less "sticky" source of funding.

73. Need for Revision of Proposed Scenarios: Taken in the aggregate, the assumptions behind the scenarios are predicated on a level of severity and correlation of market disturbances that, even in light of the recent crisis, is implausible, and therefore excessively restrictive for determining policy. Assumptions that would build a new regime akin to Basel II on the capital side are too arbitrary, too binary, and far from sufficiently granular to achieve their goals, even if a highly prescriptive approach were appropriate. The scenarios for the shorter and longer horizons need to be more differentiated, with conservative but risk-based and objective liquidity assumptions, run-off rates, haircuts, and other parameters. Their combined effects need to be assessed. Given the systemic severity of both scenarios, a more realistic assessment of central bank roles in the system (but excluding lender-of-last resort support of specific firms) needs to be included. It is important to have symmetry between the assumed severity of the asset- and funding-market disruptions and the degree of central bank systemic support that is provided.

74. Need for Institution-specific Approaches: A better approach would be to refocus the proposal on requiring liquidity resources to be structured to allow a solvent institution to survive a substantial institution-specific shock, or an incipient or modest systemic shock,

without central-bank support of the firm or the market, using the LCR and the NSFR or equivalent as two among several metrics relevant to the assessment of each firm's liquidity situation..

75. Liquidity Coverage Ratio: The LCR is conceptually appropriate, providing a fixed-ratio test for a short-term survival period, but based on assumptions that are not risk based and too extreme. It includes a much-too-narrow definition of eligible liquid assets that will compound rather than resolve liquidity tensions in a future crisis.

- It is particularly important to widen the very narrow requirements for liquid assets; this can be done by a combination of accepting a wider range of assets as liquid, including more types of assets with appropriate haircuts, and allowing liquidity value to be ascribed to the next level of liquid assets in the denominator of the LCR.
- LCR assumptions should be made more clearly risk-based.
- While all assumptions need to be revisited and their empirical bases better explained, the assumptions with respect to deposit run-offs are unrepresentative of any major market and all the more unrealistic and damaging in markets where banks are still able to rely to a substantial degree on retail deposits.
- Without substantial improvement, the liquid-assets definition will distort markets and create fire-sale imperatives that all banks will have to respond to at the same time.

76. Net Stable Funding Ratio: The proposed NSFR would impose limitations on banks that would eliminate much of their ability prudently to perform their social function of maturity transformation by making credit available to the economy, on both a stand-by and a committed basis. It is also much too prescriptive in an area where there is no sound grounding for a highly prescriptive approach.

- A "Pillar 2" type of approach is the only one feasible at this stage.
- If maturity transformation cannot be achieved to the same extent by banks, driving up the cost of providing contingent facilities to businesses for example, then businesses will have to take on liquidity risk, which they will certainly be less able to manage efficiently than the banking sector (subject to much less supervision).
- The substantial bank deleveraging that the NSFR would require must be carefully evaluated for its effects on the economy as a whole.

77. Procyclicality: The narrow eligible-assets definition of the LCR and the rigidity of the NSFR would increase procyclicality because wholesale investors tend to reduce the term of their investments in an emerging systemic crisis, putting pressure on banks to compensate for deteriorating LCR and NSFR by reducing other illiquid assets, including loans. Banks would be induced to sell the same assets at the same time, and to adjust lending and portfolios in the same direction simultaneously, contributing further to cyclicality.

78. Avoiding Trapped Pools of Liquidity: Another difficult tradeoff is between national and global liquidity. Fragmentation of regulatory and supervisory approaches to liquidity should be avoided. The ability of cross-border firms to move liquidity to troubled markets was critical at pivotal points of the crisis, and the ability of firms to contribute to global

liquidity by managing their internal liquidity across markets should not be underestimated. There continue to be strong arguments in favor of avoiding "trapped pools of liquidity" in local market. In addition, it is important to avoid doubling up of buffers between groups and subsidiaries. Consistent liquidity regulation across major markets would not only be beneficial to the quality, effectiveness, and efficiency of firms' liquidity management, but it would also contribute substantially to the sustainability of liquidity across markets and to the quality of supervision.

79. Avoiding Prescriptiveness: As the Basel *Principles for Liquidity Risk Management and Supervision* and many other official statements recognize, liquidity risk is highly dependent on each firm's mix of business, counterparties, market standing, and risk appetite, as well as on the markets in which it participates and other specific factors. Especially over the longer horizon, a prescriptive approach cannot accurately capture, measure or efficiently manage the actual risks a firm faces, yet the proposal effectively mandates a uniform risk appetite for all firms, and would diminish the value of and focus on good internal risk management, just when substantial improvements are coming on stream.

Instead, firms will be focused on the same approved assets, the same funding strategies, the same behavioral assumptions, and the same pricing incentives for different kinds of businesses and market activities, increasing the dangers of highly correlated responses by firms and market distortions.

Therefore, strong supervision of banks' ongoing progress with liquidity-risk management in accordance with a modified, bank-specific NSFR based on the Basel *Principles* will be the best course, for both microprudential and macroprudential purposes. The balance between regulation and supervision needs to be redressed: untried, highly prescriptive (but insufficiently granular) regulations are likely to have unintended or unfair effects, or both; quality supervision with continued progress on liquidity-risk management is what is needed for a more credible, reliable, and workable new regime.

80. Effectiveness of the Buffers: Whatever their final contours, both LCR and NSFR resources must actually be usable by firms for buffer purposes.

81. Disclosure Issues: Disclosing current LCR and NSFR numbers would be more misleading than helpful to investors, and carry risk of damage to the stability of firms and markets. Disclosing liquidity-buffer fluctuations, however normal for a healthy firm, could trigger a run if misinterpreted, preventing the firm from using the buffer as a stepping stone to recovery. Such disclosures could easily precipitate a firm-specific or systemic crisis, or worsen a deteriorating situation, and thus would be highly procyclical. Liquidity disclosure is fundamentally different from other types of disclosure (as prudential regulators have long recognized). A high degree of disclosure to the supervisor goes without saying. Ex-post disclosures to the market should throw light on trends and experience, to allow judgment of the quality of management, but not add new triggers of instability. Moreover, disclosures of NSFR data in particular would be problematic because the many arbitrary assumptions in the ratio as drafted would give a distorted picture of the individual firm and would be difficult for market participants to interpret on a meaningful basis.

82. Cumulative Impact Assessment: As the Committee is aware it is important to assess the cumulative impact of the proposals, with pending capital, resolution, risk-management, and other regulatory changes, before finalizing these proposals. Indications from the market and the Institute's own developing work on cumulative impact, suggest that economy-wide effects could be dramatic if the proposals were to go ahead unchanged.

83. Phase-in: Careful consideration must be given to phasing in the new requirements, because of the magnitude of the profound changes of environment for firms, clients, and markets that will result, because of the need to avoid derailing recovery, and because of the need to assure that both firms and supervisors can proceed in an orderly way through developing the new systems, controls, and oversight required. Phasing in will require close attention to interactions with the capital framework (especially the leverage ratio), the mode and timing of central bank exit from extraordinary interventions, the reopening of securitization markets, and assessment of whether robust global GDP has been achieved.

84. Consistent, Simultaneous Implementation: Avoiding asymmetrical or non-simultaneous implementation of the new liquidity requirements will be essential, given their potentially dramatic effects on firms' business models, funding, risks, and credit capacity. This is not just a level playing field issue for firms. As the proposals will have significant effects on the markets for different assets and for credit, even if modified significantly, a failure by the G20 to achieve simultaneous, highly comparable implementation would be highly distortive.

85. National Adaptations: Some national adaptations of the requirements will be needed, given the very different behavioral patterns of different national markets. This unavoidable fact should not detract from the goal of risk-based, globally comparable implementation. The industry is concerned about consistent implementation and interpretation of the new regime. This can be addressed, at least in part, by a high degree of regulatory transparency, effective use of colleges, and strong, outcomes-focused oversight by the Committee's Standards Implementation Group and the FSB.

86. Further Consultation and Review: Given that much of the liquidity framework is completely new, it will be important for the proposals as modified in the final package to be recirculated for debate and evaluation before implementation. Further evaluation should be planned to check the actual performance of the new standards a reasonable time after implementation.

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Annex 1

IIF Comments on the Basel Committee Consultative Document *Strengthening the Resilience of the Banking Sector*

I. Introduction and Overarching Issues

1. The IIF and its members are fully supportive of the Basel Committee on Banking Supervision's (BCBS) overall goal of improving the banking sector's ability to absorb shocks arising from financial and economic stress while promoting sound credit and financial intermediation activity. In that regard, the IIF and its members support the work of the BCBS exploring ways to improve the risk capture of the Basel II framework and the quality of the capital base, to control excessive leverage in the financial system, to address the potential procyclicality of capital requirements, and to manage more effective systemic risk in the financial system.

2. In this response, the IIF will outline numerous specific observations on the different proposals contained in the package, but it is important to underscore its support for the overall approach of addressing capital and liquidity adequacy from a multifaceted perspective. The issues at the core of the proposals –capital quality, risk-sensitivity, excessive leverage, procyclicality, adequacy of reserves and systemic risk- need to be addressed in a comprehensive way, with full consideration of the interdependencies among the different proposed measures. However, as explained in detail in these comments, the Institute strongly believes that substantial modifications will be needed if the proposals are to manage the tradeoffs between layers of protection and prudent credit provision for economic growth. As written, the proposals would hamper the ability of banks to continue serving in a prudent way the needs of their clients and risk creating severe economic consequences both for the financial industry and the economy at large. This is not just a matter of concern for the current recovery phase, but for the level of future growth that will be sustainable. As the BCBS points out, the point of the exercise is to restore confidence and achieve greater long-term stability and long-term growth.

3. The magnitude and comprehensiveness of the reform effort and the profound impact that it will have on the industry require a realistic assessment as to whether the reforms can all be implemented at the same time. The Institute agrees with the BCBS that the timing of implementation must be adjusted carefully to avoid disrupting recovery. It is important to give due consideration to the methods and timing of introducing of new standards based on the awareness that economic recovery will not be uniform and that each country's economic circumstances differ. In addition, the Institute believes that a clear order of priorities needs to be developed in order to define the timing of implementation of the different reforms.

4. This set of comments on the proposals is intended to highlight the areas in which the Institute believes the most essential improvements need to be made. Given the sweeping nature of the proposals and the significant components that still remain to be defined,, the Institute believes it important for the BCBS to make clear its intention to conduct extensive

further consultation as it revises the proposals, to circulate as an additional formal consultation paper on the final package of revised proposals planned for the end of 2010, and to conduct an additional Quantitative Impact Study (QIS) exercise and final impact study at that time, in a similar way to that detailed in *paragraph 10*[1] of the Consultative Document. This is essential for the Committee to meet its goal to "ensure that the sum of these measures does not result in banks holding excessive buffers beyond what is necessary to maintain a resilient banking sector." Additional consultation in regard to the more specific and detailed proposals that emerge, as well as their revision and specific calibration, is essential to allow the industry to fully assess the implications and impact of the reform and to contribute effectively to the finalization of the revised framework.. Clarity on the BCBS's intention to conduct such extensive consultation and study will also contribute enormously to the management of the expectations of market participants, rating agencies and the industry as to the robustness and transparency of the policy-making process.

5. As the BCBS is fully aware, the need for a comprehensive approach to the reform of the regulatory capital and liquidity frameworks demands an exhaustive and thorough assessment of the cumulative impact of the proposals as a whole. Such analysis is not only needed to assess the final quantitative impact of the proposals and their calibration but also to determine whether right balance among the objectives is likely to be achieved. In this regard, the IIF is also supportive of the twin objectives set out for the overall calibration in *paragraph 67*, namely the greater resilience of individual banks and the banking sector in periods of stress while preserving sound credit and financial intermediation activity in support of a growing economy. Such combined objectives are complementary and should be preserved as the BCBS moves on with the necessary assessment of the cumulative impact of the proposals and the definition of the final calibration of the key variables outstanding (e.g. overall capital level, minimum Tier 1 ratio, percentage of Tier 1 to be composed of core common equity and retained earnings, a leverage ratio and the size of the additional capital buffers, and the interaction of the new capital and liquidity requirements, just to cite some examples). Equally important, while the industry needs greater resilience, this needs to be balanced with the financial ability of the industry to respond to the credit needs of the economy as well as global trade. Getting this balance right requires particular care in defining the final calibration of the proposals and the assessment of their full impact.

6. It follows, however, that there is also a need to have a clear understanding of what is specifically meant in the Consultative Document by "economic recovery" and "sustainable economic growth", including how the differences in the economic cycles of different jurisdictions will be taken into account for the purposes of the calibration of the proposals and the definition of the timing for implementation. It will be essential to continue the dialogue already begun with the industry as the BCBS moves forward in the coming weeks with its impact assessment, in particular in regard to the top-down exercise where such macroeconomic considerations will be taken into account for the final calibration of the proposals. To this end, it will be important for the BCBS to include in the "comprehensive

[1] Italicized references to paragraph numbers in this document refer to numbered paragraphs of the BCBS Consultative Document.

analysis" mentioned at *paragraph 10* all the significant regulatory changes that are planned or may be anticipated, including all aspects of the BCBS' capital and liquidity proposals, but also the effects of accounting changes and other major changes in the regulatory environment.

7. Similarly, it is essential for regulators to consider the second-order effects of the proposals and their potential unintended consequences. While the latter are unknown ex ante by definition, it is nonetheless very likely that some of the proposals will result in the shifting of core financial activity outside the banking sector and from well regulated to less well regulated (or even unregulated) sectors, or simply putting risks back to the corporate and household sectors. This would clearly fail to address the issue of excessive risk in the financial system, as the result would not be the elimination of risk but simply shifting it from one sector to another, with potential further negative consequences given the net reduction of the scope of regulation and supervision. From the policy perspective, many of the proposals would also result in practice in severe constrains to banking activity without a clear sense (both economic and prudential) of which sectors would be expected to fill the gap. Such outcome is undesirable, self defeating and to be avoided.

Box 1 IIF Net Cumulative Impact Assessment

In order to simulate plausible effects of the Basel Committee proposed reforms on the major economies, the IIF has established a Working Group in charge of performing a net cumulative impact assessment study. The Working Group has built a series of spreadsheet-based projection models, which attempt to capture an appropriate combination of detail, behavior and adding-up constraints. Although each country model has its own local flavor, they all have a similar structure, which is described below. The study does not include national measures that go beyond the Basel proposals although it should be noted that they would likely exacerbate the effects of the reforms.

The model is built from four basic blocks: (a) a banking sector balance sheet model; (b) a core capital supply model; (c) a banking sector profit and loss model; and (d) a macroeconomic block, which links the output from the balance sheet model to the broader economy.

Proposed regulatory reforms are imposed as a series of shocks to the banking sector's balance sheet, which – ex ante -- have the effect of squeezing banking sector profit margins. Faced with capital market disciplines, banks then pass on this squeeze to private-sector borrowers. This squeeze then reduces bank credit supply to the private sector, which weakens whole economy private sector credit growth, nominal GDP growth and, thus, real GDP growth and employment. Preliminary results for the US and Euro areas are quite sobering. The introduction of the regulatory measures as originally proposed by the BCBS would constrain the growth of credit flows and, in so doing, considerably affect GDP growth. Given the typical relationship between output and employment in the US, this would likely translate into a weaker path for employment. In the Euro Area, the results could be even more substantial, in part reflecting the greater relative importance of banks to the financing of the region's economy. Japan, whose banks were not directly involved in the crisis, would also be materially affected by the proposed changes. In

addition, it will be important to consider carefully the effects on emerging market economies and their banking systems.

The Working Group's projections conclude that the current mix of specifically targeted reforms would combine – against the backdrop of an already fragile global expansion – to hinder medium-term credit growth.

The final results of the full analysis will be made available to the BCBS in time for its own planned consideration of the cumulative impacts of its proposals, which we hope will assist the BCBS in ensuring that these impacts are taken into account in the finalization of the proposals and the eventual calibration of the required capital and other related measures. The Working Group is composed of chief economists and regulatory economists from IIF member firms and chaired by the Chief Economist of the Institute.

8. Equally importantly, the Institute believes that the BCBS should promote active dialogue on the QIS exercise and the analysis of its results before they are finalized. Given how extensive and comprehensive the QIS is and the limited time given to the industry to complete it, it is essential that both the regulatory community and the industry take sufficiently ample time to analyze and discuss the data. Full transparency on the methodologies to be used for the assessment of the QIS and the top-down assessment is needed if a meaningful dialogue is to take place. Similarly, a process for the discussion of the results, including their relationship to the top-down macroeconomic analysis, should therefore be in place before decisions are made about the calibration and shape of the revised set of reforms.

9. The IIF would like to underscore the high degree of importance that the industry attaches to a level playing field in the definition, implementation, and interpretation of regulatory capital and liquidity standards globally. Implementation of the new Basel II revisions, the Trading Book proposals announced last July and liquidity standards should be simultaneous, symmetrical, and comparable across all major financial markets. As the BCBS considers important modifications to the Basel II framework, the reality is that despite the G20 commitment, progress still needs to be made on implementation of the framework across all major jurisdictions (and all jurisdictions need to complete implementation of the trading book enhancements). The BCBS is of course aware of these issues, but it is important that it explicitly take leadership, perhaps through the Standards Implementation Group, on the issue of simultaneous and consistent implementation of changes. Similarly, the BCBS should continue to be a strong voice for convergence of accounting standards as it develops final standards that will be affected by accounting. To that end, the G20 and the FSB need to ensure that the firm goal of a single global set of high-quality accounting standards is maintained.

10. The Institute would also like to emphasize the importance of due consideration of the expected levels of cross-border coordination among supervisory authorities, as well as of the important roles that the Standards Implementation Group (SIG) and the Financial

Stability Board's (FSB) framework for adherence to international standards and cooperation. In particular it appears that the design of the proposed regulatory tools fails to take into account the necessary and expected greater degree of cooperation among supervisory authorities. In the IIF's view, the proposals should more explicitly recognize the greater degree of cooperation among supervisors that will be needed to successfully implement many of the new proposed tools.

11. The reforms should also take into consideration the very substantial remedial actions that the industry and the supervisory community have taken and continue to take in order to address many of the deficiencies evidenced by the crisis[2]. In this regard, the substantial recapitalization of the industry, the improvement of governance practices, the undertaking of severe stress testing, the deleveraging of the sector, the tangible improvements of risk management capabilities (including liquidity risk management) and the profound revision to supervisory approaches in major jurisdictions should all be taken into account in finalizing and calibrating specific measures. While much work remains to be done, the significance of the remedial actions that have already taken place ought to be more fully recognized in the policy-making process. Making such decisions without regard of what the sector and the supervisory community have already done risks producing a regulatory response that could be both unreasonable and unbalanced.

12. The Institute agrees with the perception that the quality of capital in the system overall was inconsistent and open to damaging market questioning during the crisis. It is entirely appropriate to seek a simpler, more harmonized, and more transparent regime for the composition and quality of capital. The lack of consistency that emerged from the Sydney definition of capital was unfortunate, and was compounded not only by lack of transparency but by differing perceptions of instruments among supervisors and across markets. It is thus important to include agreed provisions subject to well-understood norms of interpretation on the quality of capital in the revised framework. Enhanced transparency of quality-of-capital requirements should be designed to prevent future misperceptions and inconsistencies.

13. The BCBS has appropriately recognized that, especially as the industry is recovering from multiple challenges and will be making many demands on the market for equity and various forms of capital instruments and debt financing, it will be important to grandfather existing capital instruments and requirements. This will be discussed in detail below, but it is worth underscoring the importance of the point, as it relates to one of the industry's most fundamental concerns, *viz.* that the transition to new requirements be properly phased and timed to minimize disruption of broader economic recovery, of markets, and of the industry's ability to meet credit demand.

14. While the Institute thus agrees with the intent and thrust of Part II of the Consultative Document on the quality of capital, there is nonetheless concern that many of the details as proposed will be counterproductive to the BCBS's overall goals, or create unfair burdens

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[2] The IIF Report *Reform in the Financial Services Industry,* December 2009; addresses these steps across a wide range of bank business practices, based on the results of an Ernst and Young survey on implementation of the IIF's recommendations formulated in its July 2008 Report of the IIF Committee on Market Best Practices (www.iif.com)..

on firms from different countries, given the very substantial impact on capital matters of corporate law, securities law, and tax, as well as prudential requirements. In some cases, there will be difficult trade-offs between the laudable desire to obtain international harmonization and a level playing field on the one hand and, on the other, legal, tax, and market differences that appear intractable at least for the short run. But the difficulty of those trade-offs should not lead the BCBS to accept rigid or arbitrary solutions. Rather, the Institute would urge the BCBS to use colleges and the processes of the SIG and FSB to assure consistent interpretation to build the necessary confidence in the equity and uniformity of application of new provisions, pursuing the overall goal of harmonization but with the necessary degree of elasticity.

14. As discussed in detail with respect to the Counterparty Credit Risk portions of the Consultative Document and other sections such as the highly conceptual proposals for "additional measures" to balance risk sensitivity and the stability of capital at *paragraph 24*, there are important dimensions of the proposals where further methodological development is imperative before binding requirements can be put in place. The industry is very willing to work with the regulatory community on the technical challenges that these areas pose. While the Institute endorses the general directional impetus of the conceptual thinking that is reflected here, subject to the detailed discussion, it cannot endorse producing binding requirements until broader consensus is reached in the technological community, including regulators and academics as well as industry specialists.

II. Implementation Issues

15. The modality and timing of the actual implementation of the comprehensive set of reforms will be of equal importance with the content and final shape of the reforms themselves. While the priority should be to revise the substance of the proposals so that they truly achieve their intended objectives, it is also essential that the BCBS develop a clearer strategy as to the way the reforms will be implemented. Understandably, given the preliminary nature of the proposals, the Consultative Document does not include a clear description of the BCBS's thinking in regard to actual implementation aside from the general description of the objective of having *"the fully calibrated set of standards (…) developed by 2010 to be phased in as financial conditions improve and the economic recovery is assured, with the aim of implementation by end-2012"*, as stated in *paragraph 10* of the Consultative Document. However, it is clear that a more detailed implementation plan, including phasing and explanation of its degree of flexibility, will need to be developed once the proposals acquire a more definitive shape. In this regard, the IIF would like to offer the following considerations:

- The IIF, as indicated at the beginning of these comments, is supportive of the objectives of the reform process being undertaken by the BCBS. In particular, the IIF shares the fundamental conviction that the reforms need to be implemented with diligence and consistency in order to achieve international harmonization, especially in the major markets, but in such way that new capital and liquidity requirements do not hamper the recovery of the financial sector and the economy as a whole and do

not impede the ability of the financial sector to continue fueling economic growth. Given the significance of the reforms, it is obvious that implementation of the final reforms will have a profound impact on markets and the capital structure of the industry and that its timing is of crucial importance.

- While it could be reasonable to assume that economic recovery will be well established by 2012, neither the industry or the regulatory community can be certain of that, nor of the extent to which such recovery will be stable. Therefore, it would be more transparent to clarify that the 2012 implementation date is just an expectation and that a definitive decision as to the implementation date, which should be consistent across major markets, should only be made after careful evaluation of the state of the economy at that time.

- As explained in detail in the definition of capital section of this response, and in the response to the liquidity proposals, it is necessary to consider the implications of the reform package on the supply and demand for capital and liquidity resources in the financial sector. As currently drafted, the proposals would result in significant capital and liquidity requirements that a great number of firms would need to satisfy at the same time. Whether or not the market will be able to supply the necessary capital and liquidity resources in economically feasible terms remains to be determined.

- Timing of implementation also needs to take into account the recovery and restructuring plans that have been defined for a number of major banks in several jurisdictions as a result of the crisis. Such plans commonly include capital targets, state-aid repayment dates, profitability targets, etc. for the short and medium terms which are based in scenarios that do not include the extreme capital challenges that will result from the proposals. Consideration of how the proposals could affect such recovery plans is therefore essential.

- In addition, it is important for the BCBS to address explicitly the issue of "announcement risk" of the proposals i.e. the likely immediate impact that the announcement by the BCBS regarding its final decisions, or even a perception that high-impact decisions have firmed up in the market's estimation, would have on market participants and rating agencies for the amounts of capital that banks should hold. In this regard, it is extremely likely markets and rating agencies will automatically take into account the future levels of required capital and expect banks to comply with such levels immediately (regardless of any phase-in and grandfathering provisions, the necessity for which is recognized in the Consultative Document). Especially with respect to the new liquidity proposals, care is advisable because overreaction by the market could hamper recovery or even create systemic risk. While market dynamics are by definition autonomous, the BCBS should carefully consider this issue as if finalizes its plans for implementation.

- This response includes discussions of various specific phase-in and grandfathering issues; however, the BCBS would be well advised to reconsider the overall phase-in program for the new proposals once calibrated and finalized, to avoid unmanageable

impacts on markets, and to be sure that both banks and supervisors are prepared to implement each reform on a reasonably consistent basis across markets. Such phase-in program should perhaps foresee sequential implementation of the different components of the final proposals, based on a transparent assessment of priorities and the realization that simultaneous implementation of all the proposals could have grave consequences for the financial sector and the global economy.

16. The implementation in emerging markets of the proposals should be guided the by the same overarching principles and objectives set at the international level. However, implementation should also take into account the significant progress of regulation and supervision in emerging markets as a result of previous local crises as well as the necessary degree of elasticity to adapt to local market circumstances. While emerging-market banks need to continue the improvement of risk management and governance that Basel II can foster, and while they should apply the same standards as all international banks as to their participation in international markets, it may also be that additional phasing-in of the Basel program for many domestic markets would be appropriate. Moreover, it is important to take into account that banking plays a fundamental role in emerging markets, enhancing the resilience of their economies at the height of the crisis, and playing leading roles directly thereafter in supporting economic growth. Today, banking plays fundamental roles in all areas of emerging market economies, from providing credit to consumers and companies, notably SMEs, to financing infrastructure projects, while expanding access to formal financial services across their countries. Higher growth rates and deeper social and economic developments in EMs also require higher rates of credit growth. Regulatory and supervisory regimes in EMs should therefore be sufficiently robust to ensure that their financial sector maintain this pivotal role while safeguarding their soundness and stability. These objectives will not be served if proposals go beyond what is strictly required by prudential objectives. Similarly, a number of secondary effects on emerging markets, including the effects of the proposals on investment by major-market banks in emerging markets, effects on trade credit, and effects on banks' willingness to extend credit to emerging-market borrowers (including financial institutions) need to be considered in the calibration and finalization of the proposals.

17. A number of proposals in the Consultative Document allude to the different roles of Pillar 1 and 2. For example, reference is made to the (initial) Pillar 2 nature of the leverage ratio, or the adjustment to PD being considered in *paragraph 241*. The measures being proposed under the "capital buffers" heading (*paragraphs 247ff)* would also be considered Pillar 2, especially with respect to conservation of capital, where the proposals appear to be consistently with national regulations in some countries and expectations from Pillar 2 more broadly. The Institute believes that a number of areas dealt with in the proposals could effectively be addressed through an effective and comprehensive Pillar 2 approach, which would allow the necessary flexibility to supervisors to tailor capital requirements to the specific risks within a bank, or market conditions. Such flexibility would be lost if excessive emphasis is placed on Pillar 1 measures. All this points out to an urgent need for the BCBS to clarify the use of Pillar 2 within the revised Basel II framework, and increase the consistency of its implementation among supervisors and across jurisdictions, again perhaps under the supervision of the SIG. The significance and magnitude of the capital

charges to be defined under Pillar 2 merit careful consideration whether the current framework adequately sets out the necessary elements for a correct and comparable implementation of Pillar 2 across jurisdictions.

18. While the proposed reform package is clearly targeted to all types of financial institutions, including firms operating under the Standardized and IRB approaches, it is unclear how many specific aspects would be applied to standardized banks. In particular, the section on procyclicality makes constant reference to features only applicable to IRB banks (e.g. adjustments to PDs). However, it does not specify what kind of provisions would be applicable to Standardized banks.

19. Improvement of the Definition of Capital: The Institute agrees with the renewed emphasis placed on Tier 1 capital and the shift to a sharper focus, with greater international consistency, on common equity and retained earnings, (sometimes referred to as "core Tier 1"). Nonetheless, there is danger of losing sight of the continuing importance of additional Tier 1 instruments and of Tier 2 finance in the capital management of firms. This will be important to firms as they seek a large amount of new financing. Additional Going Concern Capital has substantial loss absorption capacity and adds an important degree of flexibility for capital strategies. Tier 2, as gone-concern capital, plays a vital role in providing assurances that when a firm falls into difficulties, its resources will largely cover its obligations.[3] This capital takes pressure off deposit-guarantee schemes and provides resources for the recovery and resolution process.

20. Regulatory Focus on Common Equity: While it is true that the market has focused on tangible common equity during the crisis, and the Committee is right to augment the role of core Tier 1 in the Basel scheme, it does not follow that the regulatory norms should lock in a tendency to view core Tier 1 as the only capital that counts, especially taking into account the cumulative effects of the final ensemble of capital and liquidity reforms that will be applied. As with the liquidity regime, the rules applicable to the composition of capital should be applied with appropriate differentiation between idiosyncratic, firm-specific events and systemic crises in mind: this implies recognizing a range of instruments with differing benefits in the event of a firm-specific crisis.

21. Effects on Capital Markets: The BCBS is well aware of this but the Institute cannot stress too much the importance of keeping in mind the effects on the market for capital these new measures will have. The more banks are limited to a narrow set of instruments for their different capital baskets, the more it will be challenging for the market to absorb these new offerings, in particular, but not only, if a great deal must be done over a short period of time. Especially with the new focus on common equity, there may be more demand for equity than investors can reasonably be expected to absorb if firms are given a limited time frame within which to act. This is especially true as the value proposition of bank equity would be affected by many of the proposals, such as the "capital conservation" buffer. With the established markets for now-obsolete forms of hybrid capital securities no longer

[3] The IIF also makes this point in Subsection 3.3 of the IIF Report Restoring Confidence, Creating Resilience (July 2009; www.iif.com)

available, firms will need to be given sufficient time to issue new securities to build up their capital to the desired level.

22. Role of Different Categories of Capital: It is not entirely clear from the present draft which capital ratio will in fact be the operative capital measure either for regulatory or for market purposes, yet the roles allotted to the ratios of common equity, all Tier 1 and Tier 1 plus Tier 2 capital are extremely important to firms' ability to operate on a capital-efficient basis. There is the danger that excessive focus on common equity will unduly inhibit efficient financing of firms, especially if the range of available instruments (and hence of investor bases to tap) is unduly constrained. Similarly, too much reliance on one instrument – especially common equity subject to an extensive range of deductions – is likely to augment procyclicality and reduce firms' flexibility in responding to changes in market conditions.

23. Predominance of Common Equity: The question of how much emphasis is to be put on the different ratios in turn influences the question of the appropriate interpretation of the concept that common equity and retained earnings form the "predominant" form of Tier 1, as indicated in *paragraph 73* and elsewhere. The degree of focus on the core or predominant type of capital for various purposes will need to be taken into account in defining "predominance", given the greater or lesser influence resulting from choices about which ratio to focus on. In particular, the link to the impact of the eventual leverage ratio needs special attention.

24. Implementation of the Predominance Concept: Definition of "predominant" is to be finalized through the calibration process, but it is fundamental. It is difficult to take a view on the present state of the proposal as to what predominant ought to mean. This will depend in part on the overall calibration, based in turn on the QIS and top-down impact studies, the final dispositions of regulatory adjustments to capital, the grandfathering and phase-in provisions, whether innovative hybrids are dropped altogether, the definition of "Additional Going Concern Capital", and generally the final disposition of provisions on the definition of capital. Regardless, it will be important to allow to firms the flexibility to tap a broader range of investors than just equity investors, thus diversifying their possible sources of finance on an ongoing basis, and to be able to adapt to changing market conditions. This is important to maintaining access to capital markets, as well as to keeping the cost of capital manageable. Also to be considered when setting the level of predominance is the increased quality of capital that has resulted from firms' responses to market pressure as well as from the measures taken by the BCBS. Given all the other regulatory and accounting changes, the final "predominance" test should not be excessively constraining. Finally, as a general matter, the Institute advocates a reasonable allowance – sufficiently flexible at the beginning, perhaps then tightening gradually toward the final target level.

    In any case, to increase the mandatory quality of bank capital, and then significantly to narrow the definition of predominance of common equity and retained earnings, risks a serious impact on the ability of banks to supply credit and raise sufficient capital. There will also need to be carefully considered phase-in of the new standard.

25. Predominance and Minimum Capital Levels: In addition, the BCBS should ensure that the definition of "predominance" will only apply to the capital that fulfills the new minimum regulatory level requirements, once determined. As with the removal of the ceiling on Tier 2 capital, the predominance test should not operate to set a limit on additional capital raising, and any capital that the bank retains above and beyond that minimum should not be constrained. This relates to the "acceleration" issue in the existing rules: where a bank was operating with a Tier-1 ratio of 6% and a Tier-2 ratio of 6% for a Total Capital ratio of 12%, if the Tier-1 ratio of such bank were to deteriorate by 1%, its Total Capital ratio would deteriorate by 2%, given the current 50/50 test. The same phenomenon would be applicable to the relation between Common Equity and Additional Going Concern Capital. In order not to replicate this acceleration problem, if most regulatory deductions are to be applied on Common Equity, Common Equity should be the predominant form of Tier-1 with respect to the regulatory minimum but not necessarily in the actual capital structure of a bank operating at a higher level of capital.

26. Eventual Contingent Capital Standards: Closely related to Additional Going Concern Capital is the future role of contingent capital. There is considerable interest in the official sector in such securities, but it is clear that the definition of a widely acceptable instrument depends on discussions among investment bankers and different types of investors on market perceptions and willingness to purchase these securities. Properly structured, such instruments could well create attractive value for both issuers and investors, while giving supervisors assurances as to the delivery of additional equity in time of need. The potential of contingent capital should continue to be explored with an eye to increasing the finance options and range of investors available to banks. However, there are a number of issues that must be resolved before the Committee could be confident that instruments within regulatory guidelines for contingent capital would actually find reasonably deep market sand work as intended from a prudential perspective. Above all, the Institute believes that these instruments should not be mandatory, but instead accepted as a possible option to raise high quality capital. As well, these instruments should be available to play a role in banks' meeting their Pillar 2 requirements or capital buffers, as their explicit purpose is to act as a capital cushion in times of stress. It should be noted, however, that while many banks are interested in the contingent capital concept, there is in fact a wide range of opinion from greater and lesser degrees of interest in the concept to those who think it is not likely to be practical, to those who believe such instruments would definitely not be desirable from the perspective of financial stability, because of the risk of negative effects of a conversion not only on the affected firm but on the sector as a whole.

27. Triggers: A crucial issue to the success or failure of contingent capital instruments in the market will be the requirements for triggers. As the fuller discussion of *paragraph 91* in Capital Appendix A suggests, triggers should be clear, transparent, and related to firm-specific, rather than systemic, conditions.

28. Deductions against Common Equity: The many questions about the proposed capital deductions and exclusions and their application only against the common equity and retained earnings core element of Tier 1 are discussed in detail in the discussions of

paragraphs 93-109. However, the Institute must emphasize that while deductions of goodwill from the core Common Equity component are understandable and consistent with the practices of analysts and rating agencies, full deduction against core Common Equity Tier 1 across the board is harsh and often inconsistent with the dual focus on going- and gone-concern capital. Among other things, taking deductions against common equity exceeds market and regulatory practice on most items and makes the problem of the differential impact of some deductions and exclusions all the more dramatic, unnecessarily so in some cases. A more measured approach based on a factual analysis of the specific economic characteristics and implications of each of the various items proposed for deduction would likely suggest both reducing the amount of the required deduction of each item on a risk-adjusted basis and allocating at least part of the deduction to Tier 2, as will often be appropriate to reflect the going concern/gone concern effects of the items. This will also help with the important balancing of the important goal of global harmonization with the need to take into account the effects of different tax regimes. To deduct all these assets from common equity will cause this measure to become more procyclical, going against the G20 focus on reducing procyclicality in the financial system. This procyclicality would be amplified via the use of the new definition of capital for the leverage ratio, especially if put on a Pillar 1 basis.

29. <u>Analysis of Effects on Emerging Markets</u>: The effects of quality-of-capital proposals on emerging-market banks and on industrial-country banks participating in emerging markets also need careful evaluation. This is most obvious with respect to the effects of the proposed deductions for minority interests, as discussed below; however, a broader point also needs to be made.

30. <u>Emerging Markets and Minimum Capital Levels</u>: It is highly important that, for emerging markets that already have substantially higher minimum capital requirements, the new Basel minima be treated as minima, and not induce reflexive increases over current stated requirements. While the new requirements for the determination of the numerator in many respects introduce a new rigor into the process that should appropriately be followed by emerging-markets members of the BCBS, it might also be appropriate in many cases for them to adjust their overall capital requirements – where they exceed the general Basel norm -- so that this new degree of rigor does not necessitate a substantial increase of capital by banks that are already well capitalized by comparison with international benchmarks. It is of course highly important for emerging market supervisors and banks to continue to progress toward more advanced risk management, capital management, and liquidity-risk management, especially as major emerging-market banks are expected to expand their cross-border activities substantially. Nevertheless, except where local-market conditions indicate otherwise, it would be damaging for the augmented Basel capital framework to be interpreted to call for additional gross capital requirements in those emerging markets where the new norms are already exceeded.

31. <u>Firms with Significant Foreign Currency Exposure</u>: A significant issue that is not addressed in the Consultative Document is the relationship between common equity and exposures denominated in foreign currency. Based on the stress on common equity, there seems to be an assumption that firms operate primarily in the home currency; but this is certainly not

always the case. The large Swiss banks provide a good example to illustrate a generally applicable point. They operate with very large RWA denominated in currencies other than the Swiss Franc. Because in Switzerland, as in most countries, it is not possible to issue foreign-currency denominated common equity directly, they have indirectly issued Tier 1 capital in foreign currencies in order to stabilize the relationship between foreign currency-denominated risk-weighted assets and foreign-currency denominated Tier 1 capital. A sufficient allowance of Additional Going Concern Capital is necessary to allow any bank with a substantial amount of cross-border activity to manage its cross-currency exposures effectively.

32. Consideration of Market Conditions and Effects of New Guidelines: The final and most important general comment on the proposed quality-of-capital requirements is that the cost and marketability of capital instruments to diverse investor bases are paramount considerations. These issues need to be addressed in greater depth in connection with analysis of the overall impact of the proposed capital and liquidity changes, but the ability of a capital-dependent industry to have access to deep, broad and varied sources of funding is fundamental. Thus, the design of the overall capital system, and of requirements for specific types of instruments, needs to take into careful consideration not only desired prudential goals but also the investor markets to which they will appeal and their eventual impact on the cost and availability of capital. Market conditions for various instruments vary over time (and to some extent from market to market) and an excessive focus on equity investors (especially in the context of possible dividend and share buy-back restrictions and requirements that will limit profitability) would limit the resilience of the sector. This is yet another difficult balancing that must be achieved for the future stability of the system, quite as much as the overall Basel formula must be appropriately calibrated.

B. Counterparty Risk Issues

In developing specific comments on the majority of issues covered in the Counterparty Risk section of the Consultative Document, the IIF collaborated with the International Swaps and Derivatives Association (ISDA) and the Association for Financial Markets in Europe (AFME). The full response on these issues (with the exception of our comments on Ratings Issues which are presented below) is attached as Capital Appendix B.

Ratings Issues

33. Ratings: In general, the discussion of ratings issues is positive and consistent with the Institute's statements on the subject going back to 2008. There are however a few paragraphs that call for comment.

34. Incentives to Avoid Getting Exposures Rated: There is an inconsistency between *paragraph 192* creating an incentive to obtain external ratings and *paragraph 188* considering the possible deletion or change in the hierarchy structure for securitizations whereby the ratings-based approach would end up lower in the hierarchy. With the introduction of a stringent and clear set of rules and codes of conduct for rating agencies, and mandatory regulation in the major markets, external ratings will add value to the

market players even though we acknowledge that these need to perform at all times their own due diligence. By taking away the post-crisis enhanced scrutiny of the rating agencies, the securitization market could be seriously jeopardized by less transparency and visibility.

35. Credit Risk Mitigation (CRM) – Cliff Effects Arising from Guarantees and Credit Derivatives (*paragraphs 198-99*): The Institute welcomes the deletion of the minimum requirement for guarantors. Apart from possible cliff effects, a situation in which an exposure is guaranteed by a third party not related to the obligor under all circumstances presents a better risk profile, simply given that there are two repayment sources for the exposure in question.

36. Recognition of External Credit Assessment Institutions (ECAIs): The IIF supports transparent and stringent criteria for rating agencies which will enhance not only their overall quality but will help restore market confidence in their independent, non biased view on counterparties and structured credits[4]. We only note that at all times a balance must be found between high quality standards on the one hand and the risk of creating a too high barrier to entry for new rating agencies. Recognition standards should be built upon and not duplicate the IOSCO Code and various regulations being imposed on the ratings process.

C. Leverage Ratio Issues

37. Need to Address Excessive Leverage: The IIF is supportive of the BCBS's assessment of the importance of addressing excessive leverage in the financial system. While significant progress has been achieved by the industry in controlling leverage, regulatory and supervisory tools have a role in preventing unhealthy levels of leverage in the system. However, the proposal as initially issued, with its one-size-fits-all nature and its unwarranted disregard of risk mitigation and netting, would apply the leverage ratio to vastly overstated exposures (including the exaggerated treatment of off-balance sheet assets, undrawn commitments, and written derivatives), constraining the industry's capacity in a manner many times disproportionate to actual risk however considered, severely damaging its ability to support real economic activity to the extent required for a growing world economy. It is very clear that, depending on the level of calibration, literal application of the proposal as issued would be economically devastating, primarily to essential, but low-risk banking activities, and thus it could only be applied with ample supervisory discretion. The Institute believes as a matter of principle that the leverage ratio, even if reproposed on a more realistic basis, should be a Pillar 2 instrument (as discussed further below),

38. Importance of Pillar 2 Basis: These goals of a supervisory tool to control excessive leverage can best be achieved on an international level if the leverage ratio is exclusively a Pillar 2 measure. Under a Pillar 2 approach, a leverage ratio can be a useful tool for supervisors, allowing them to assess leverage build-up in a particular institution, particularly from the perspective of how leverage evolves through time in such institution.

[4] The important role of the BCBS in setting out standards for ECAIs was highlighted in our March 31 2009 letter to the BCBS.

Together with risk-based tools, the leverage ratio can assist management and supervisors to form a view on the soundness and resilience of the capital position of each individual firm. However, this is by definition a Pillar 2 analysis, where firm-specific analysis, taking into account all the facts and circumstances, is essential. Along this line of thinking, the Institute believes it is important to drop the proposed "migration" to Pillar 1 of the leverage ratio. In particular, the effectiveness of the proposed tool as a backstop can only be ensured if it is applied with judgment and under a comprehensive supervisory dialogue between individual firms and their supervisors. Rather than operating as a one-size-fits-all, crude mandatory requirement, a supplemental Pillar 2 measure looking at leverage should be used as an indicator among several others. Such approach would ensure appropriately targeted supervisory intervention, including increased monitoring, targeted remedial measures o additional capital requirements.

39. Simplicity of the Leverage Ratio: While the desire for a "simple" measure is understood, the proposed elimination of all risk considerations in the design of the leverage ratio needs to be reconsidered. Contrary to the apparent "simplicity" of the tool, the straightforward and automatic application of the proposed leverage ratio without considering netting, collateral and certain risk adjustments will surely result, as the results of the QIS will demonstrate, in such extreme capital constraint for the financial sector that its lending activity would be crippled, and supply of liquidity to the market through repo-style and securities financing transactions would be severely curtailed. In particular, a rigid and binding leverage ratio could potentially penalize firms with conservative and low-risk business models. In addition, if not carefully designed, disclosure of gross leverage-ratio figures, disregarding economic and legal realities of banks' exposures, will likely result in ill-informed views from the market and public alarm without any merit from the risk perspective.

40. Supplementary Nature: As the BCBS proposal recognizes, it is fundamental that the specific design of the supervisory tool ought to be such that it truly works as a supplementary measure to the Basel II risk-based framework. In other words, care should be employed so that the leverage ratio does not become the binding capital constraint, which by definition under Basel II it should be risk-based. However, a Pillar 1 leverage ratio (on any assumption about its final calibration) would likely become the binding constraint, undermining the risk-sensitive nature of the Basel II Accord and potentially giving rise to a build up of risk in banks' balance sheets. In effect, if it becomes a binding constraint, the leverage ratio would give banks incentives to use capital capacity for higher risk assets (which under the leverage ratio are treated exactly the same as low risk assets), precisely the opposite effect to that the revised capital framework is intended to have. The low-risk, prudently managed, in many cases traditional and infrastructure-oriented, banking activities swept up in the current proposed definition are mature, modestly profitable business that would become harder to sustain financially given increased capital costs and the capacity constraints imposed by the leverage ratio as proposed (plus liquidity and other new requirements)[5].

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5 The Bank of Japan has recently published a working paper by Koichiro Kamada and Kentaro Nasu, "How Can Leverage Regulations Work for the Stabilization of Financial Systems?" (Bank of Japan, March 2010) which underscores that *"We should note, however, that the leverage ratio requirement has a number of side effects. First,*

41. Role of Basel II: The preservation of Basel II as the core determinant of regulatory capital is a goal to which the Institute attaches utmost importance. This is also an objective explicitly recognized by the G20 as one of the main elements of the regulatory reform process. It is therefore essential that as the BCBS moves forward with the specific design and calibration of the leverage ratio, this is done in such way that the measure operates as a true backstop to correct anomalies or outlier behavior in terms of leverage but not to supplant sound capital requirements, put a brake on well-managed risk taking, or create disincentives for business in low-risk assets.

42. Issues to consider when devising specific Leverage Ratio tools: While the Institute is supportive of the concept of addressing through Pillar 2 supervision the potential for excessive leverage in individual firms, the present proposals raise the following issues of detail:

43. Capital Measure (*paragraphs 208-211*): the IIF agrees with the principle that measures of leverage should not have as a reference low-quality capital elements. However, the calculation of the ration with reference exclusively to the predominant form of Tier 1 would be excessively narrow and would constrain banking activity beyond what prudential considerations would dictate. Given the move to strengthen the definition of Tier 1 and its predominant components, Total Tier 1 (at the group level) would provide a sound basis for the calculation of a leverage ratio. As the results of the QIS and the broader calibration exercise will show, using predominant Tier 1 would be not only excessively restrictive but would compound the overstating of risk relative to available relative to loss-absorption capacity intrinsic to the gross approach and so fail to provide fully useful information.

44. Exposure Measure (*paragraphs 212-213*): The proposals as currently drafted would not recognise any type of collateral (physical or financial), guarantees, or any sort of credit risk mitigation for the purposes of calculating the on-balance sheet exposure subject to the leverage ratio. This would result in an inflated measure of exposure that is not justified by economic reality or prudential concerns and would go against basic principles of prudent risk management. Furthermore, this measure would create a disincentive to further improvement of risk management, as well as grossly misrepresenting the actual exposures of firms. Existing leverage ratios take into account risk mitigation, and the goal should be to recognize the forms of risk mitigation that are already well-grounded in regulation and subject to supervision (subject of course to appropriate haircuts), having been demonstrated to have robust risk-reducing characteristics.

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while the leverage ratio requirement reduces bank leverage effectively, it deteriorates the quality of bank assets simultaneously. The reason is that banks will react to the leverage ratio requirement by shifting their asset portfolio from safer assets to riskier assets in order to maximize their expected utility. This risk-taking behavior will undermine the soundness of bank management eventually. The second side effect is that the leverage ratio requirement narrows the scope of banking business and introduces inefficiencies in asset portfolio management. The model implies that gearing ratios and asset quality indices may vary from country to country, depending on financial environment and business models. The leverage ratio requirement will be restrictive particularly to those banks characterized by low gearing ratios and high asset quality and have significant detrimental effects on the efficiency of their asset portfolio management."

45. Netting *(paragraphs 214-216):* The proposed treatment of netting (i.e. its complete non-recognition) is a radical approach that is inconsistent with the trend of progress in the industry in the last 20 years, leading to an excessively penalizing treatment of financial instruments such as derivatives, repos, securities financing and loans. In particular, the lack of recognition of legally enforceable netting and margin agreements, including those under ISDA standard agreements, goes against long and established industry practice (practice that has been deemed safe and of low risk, so much that netting and margining agreements are afforded lower regulatory capital requirements). Furthermore, supervisory recognition of netting already requires in-house and outside legal opinions and supervisory approval. Similarly, the BCBS should also be mindful of further complexity being introduced by the proposed gross exposure measure (which would be a third metric in addition to US GAAP or IFRS and current supervisory netting), which would add confusion without any other value added.

    Furthermore, good policy should not deny the recognition of netting simply because its application across jurisdictions raises technical questions. Rather, the BCBS should undertake the necessary analysis to implement and apply a common set of regulatory netting rules (as currently determined under Basel II), which would be applied to assets before they are subject to the proposed leverage ratio. An adjustment could be made for those netted exposures which meet supervisory standards for recognition in risk-based capital, such that banks whose accounting shows un-netted exposure could be on an even footing with those that publish netted exposure in their financials. The BCBS should of course continue to advocate adoption by the accounting standard-setters of consistent and appropriate netting rules, but the Committee should not allow the present inconsistency of standards on netting to drive the decision to completely disregarding netting.

46. Netting and Standardization: Finally, the BCBS should be aware that the non-recognition of netting would deny banks the risk-reducing benefits of standardised agreements which would in turn diminish incentives for sound risk management. The capital and profitability implications for markets in derivatives, repos and securities financing, where netting is of the essence, would be devastating and would likely push much of these activities to less regulated markets to the extent the leverage ratio is binding. Furthermore, given that netting is assumed in positions with a central clearing counterparty (CCP), such positions would be penalized, something that is in clear contradiction with current regulatory policy re. CCPs (as reflected in *paragraphs 165-67)*.

47. High Quality Liquid Assets (*paragraph 218*): the inclusion, without exceptions or adjustments, of high quality liquid assets in the leverage ratio is not only unjustified by any prudential consideration but highly problematic. In effect, the stated justification of the proposal (its "simplicity" and because it "avoids the problem" of having to define criteria for exclusion of assets based on relative liquidity) is frankly arbitrary, in particular because of the very negative effects that the implementation of the proposal would have. As proposed, the leverage ratio would conflict directly with the requirements contained in the liquidity proposals, which would require banks to retain substantial positions in that type of assets.

48. Combined Effect of Liquidity Proposals and the Leverage Ratio: The effect of the proposal is highly penalizing and lacks coherence with other regulatory goals. On the asset side, banks in a number of jurisdictions are encouraged to hold substantial positions in national government paper often on deposit in central banks. However, such sound practices would be undermined by an excessively rigid leverage ratio regime. This cannot be justified by the "simplicity" of the tool or the desire to avoid solving the problem of adequately addressing relative liquidity criteria. The IIF recommendation would be for the BCBS to craft a framework that exempts from the leverage ratio, or makes adjustments for, the types of assets that are required to be held by banks in accordance with the new liquidity regime. Similarly the liquidity proposals and current supervisory guidance encourage banks to move to more stable sources of funding such as retail deposits, but the proposal does nothing to recognize this. Retail banks with large amounts of deposits as funding and large residential mortgage loan books as assets are likely to be especially burdened, especially those in countries where, by regulation or custom or both, mortgage books tend to be very low risk.[6]

49. Securitization (*paragraphs 222-25*): The proposed inclusion of the total of all underlying securitized portfolios for the bank's originated securitizations seems to be justified in part by the existence of differing accounting treatments in regard to de-recognition. However, once again, such justification fails to recognize the unreasonable and penalizing effect that such an expedient would have, as well as the vast improvements achieved in the treatment of securitization exposures from the capital, accounting and internal practice perspectives (including the significant revamping of securitizations rules done by the BCBS in July of 2009). The capital impact of such proposal would be enormous and disproportionate and would not be justified on risk grounds. Furthermore, the proposal would go directly against the desired revitalization of securitization markets, a goal on which there is global consensus at the highest policy-making levels.

50. Assets Transferred for Legal Purposes: Owing to stringent credit risk transfer criteria and provisions in the capital adequacy regulation, those assets considered transferred for legal purposes should be considered effectively transferred for all purposes (both from the legal and risk management perspectives) and should not be considered for leverage purposes[7]. While the differences in accounting treatment are real and need to be addressed in the

[6]See Chapter 3 of the Joint Forum *Review of the Differentiated Nature and Scope of Financial Supervision*, January 2010.

[7] The proposal in *paragraph* 225 also seems to refer to "reputation risk" cases where "the originator could feel obliged to take back assets on the balance sheet". Here again, the alternative proposal should be rejected as a blunt means of assessing the risks associated with the securitization exposure. While there were of course notable cases where banks took assets back on balance-sheet for relationship rather than legal reasons, mandatory regulation with real economic effects should not be based on a selective reading of past experience. It should be recognized that that experience will drastically affect market expectations and legal documentation in the future, as will significantly changed accounting requirements. Market convention and documentation requirements are in the process of changing and these changes are anticipated to establish greater clarity regarding a firm's ongoing obligations. Given this, caution is in order against making the assumption that things will be the same in the future would be both unrealistic and distortive. In determining the appropriate capital treatment for the anticipated level of support, each firm would have to discuss with its supervisor its products and practices, as well as a review of the actual legal and marketing documentation.

regulatory framework, it is not an adequate solution to the problem of inconsistent accounting to adopt a draconian approach that would increase capital requirements beyond levels required to support the underlying risk. The Institute therefore encourages the BCBS to avoid imposing a blanket rule requiring the inclusion of all the securitized portfolios for leverage ratio purposes.

51. Derivatives (*paragraphs 226-31*): Within the same line of reasoning presented above, the BCBS should avoid adopting approaches to exposure measure that would inflate exposures without any risk or prudential grounds. The Institute believes that the proposal would introduce a massively volatile and uncontrollable element into the leverage ratio, which would also be hugely procyclical. During times of economic stress, large swings in the present value of long and short derivative positions will occur. However, to the extent that firms are trading under legally nettable agreements, with associated collateral movements, the underlying risk position of the firm would only be changing by a marginal fraction of the apparent gross exposure change. The proposal is completely at odds with both the economics and the risk management of the business, and hence introduces complexity and confusion, rather than simplicity or useful information, into the leverage-ratio calculation. This artificial leverage ratio volatility cannot possibly be covered, in a meaningful way, by capital requirements. In that sense, the Institute urges the Committee to adopt for leverage purposes the current exposure approach contained in Basel II, including due consideration to netting.

52. Credit Derivatives (*paragraphs 230-31*): The proposed 100% CCF for credit derivatives is another area where the industry must conclude the BCBS is adopting a punitive approach. The proposed requirement to include the notional value of written credit derivatives in the measure of exposure without netting off against bought protection denies the very essence of derivatives trading, where notional amounts are generally meaningless given the management of derivatives books on an offsetting basis and extensive use of legally enforceable netting. Importantly, the proposal does not provide any prudential grounds for a requirement to use a gross measure of exposure, other than an incorrect analogy to guarantees that ignores the actual nature and management of the derivatives business.

53. Off-Balance Sheet Items (*paragraphs 233-6*): while understanding that off-balance sheet leverage needs to be adequately addressed, the Institute remains extremely concerned about the proposed 100% CCF for commitments (including mortgage offers and credit card lines), acceptances, standby letters of credit, trade letters of credit[8], indemnified securities

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[8] Furthermore, and specifically in regard to trade finance (including letters of credit, some types of standby Letters of Credit and commercial bank guarantees such as bid bonds, advance payment bonds, performance bonds and non-credit replacing bank guarantees), the Institute notes that the proposed 100% CCF factor will be extremely penalizing and risks having a very severe impact on global trade. In particular, by including this type of exposure at a 100% CCF, the proposed regulation will overstate the volume and risk in this type of assets and create disincentives for banks to provide the type of financing that global trade in a recovering economy needs. Importantly, the proposal would go against very specific guidance issued by the G20, which has underscored the importance of supporting trade finance during economic recovery, even through regulatory measures. Indeed, the final conclusions of the April 2 2009 G20 Meeting in London explicitly indicate that G20 leaders "… will ensure availability of at least $250 billion over the next two years to support trade finance through our export credit and investment agencies and through the MDBs. We also ask our regulators to make use of available flexibility in capital

lending failed transactions, and unsettled securities In particular, the proposed treatment is not in line with actual data on drawn amounts from such facilities, which vary somewhat across banks and markets but are invariably much less than 100%, regardless of whether in stressed or normal times (in fact, lower than 10% for a number of assets). A particular concern arises with respect to unconditionally cancellable commitments. Here, in addition to the very substantial overstatement of any real expectation of exposure, there is a basic business problem: agreements that are unconditionally cancellable are designated as such for a reason. National culture and practice, as well as extra-contractual legal strictures and market expectations, vary, but "uncommitted" is indeed "uncommitted" in many circumstances. Further, there would be a difficult question as to what exactly constitutes an "uncommitted" facility: does it include every advised line or consumer credit-card account, or informal guidance given from time to time to a client? There is a danger that well documented cancellable lines would be disadvantaged to "handshake" oral discussions with businesses, which would be less satisfactory for both businesses and banks because of less well developed terms and conditions and less easily managed risk. Providing contingent credit lines to businesses is one of the most basic traditional functions of banks, and one that should not be penalized or discouraged without good reason, given the importance of such facilities to business.[9]

54. Cash-Flow of Off Balance Sheet Items: The Institute therefore encourages the BCBS to develop an approach that adequately recognizes the cash-flow characteristics of these types of assets and avoids penalizing low-risk assets, through mechanisms such as the standardized credit conversion factors contained in the Basel II framework.

55. Disclosure (*paragraphs 236-38*): The Institute has always supported the view that disclosure requirements should be a complement to the supervisory and regulatory tools to address excessive leverage. However, as proposed in the BCBS document, the Pillar 3 disclosures could have serious negative consequences. In particular, if wrongly designed, rigid sets of mandatory disclosures on leverage could be misinterpreted by the market as indicators of risk, which would be misleading for firms with large portfolios of low-risk assets such as government bonds. Conversely, low levels of leverage could be interpreted as low levels of risk, when in reality such disclosures do not have any information capacity about the particular risks embedded in banks' assets.

56. Volume and Quality of Disclosures: Similarly, the BCBS should be aware that implementation of the leverage ratio as proposed would likely result in very significant increases in the volume and complexity of banks' disclosures. The intended "simplicity" of the proposed ratio would necessarily be accompanied of extensive disclosures by banks aimed at clarifying the real degree of risk embedded in firms' balance sheets, which as already noted, would likely be misconstrued by markets given the proposed used of gross measures and disproportionate treatment of off-balance sheet assets.

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requirements for trade finance." The Institute therefore encourages the BCBS to develop a more adequate treatment of trade finance for leverage ratio purposes, relying on Basel II CCFs (20%).

[9] See of Douglas J. Elliott "A Further Exploration of Bank Capital Requirements: Effects of Competition from Other Financial Sectors and Effects of Size of Bank or Borrower and of Loan Type." Brookings Institution, 28 January 2010, part 1.

57. Disclosures and Pillar 2: Finally, the BCBS should also consider the implications, from the disclosure perspective, of the Pillar 2 nature of the leverage ratio. Given that some of the Pillar 2 information is not of public measure, any disclosure regime on the issue of leverage should be carefully designed so that the right balance is achieved between the informational needs of the market and the necessary confidentiality of Pillar 2 data.

D. Procyclicality Issues

58. Addressing Procyclicality: The Institute shares and supports the view that it is necessary to address the risk management and capital implications of the economic cycle. As stated in the 2009 IIF Report *Reform in the Financial Services Industry*, procyclical effects must be carefully understood, planned for and managed, both from a risk perspective as well as a capital perspective.

59. Procyclicality and Basel II: However, as *paragraph 240* recognizes, data as to the level of procyclicality in the regulatory capital framework are scarce and inconclusive. The results of the BCBS data collection exercise aimed at measuring the impact of Basel II over the credit cycle are not yet available and therefore additional analysis ought to be done before the BCBS proceeds with further policy making on this subject. It follows, necessarily, that until a better idea is available as to the magnitude of procyclicality, it would be almost impossible to achieve the right calibration of any proposals.

60. Measures to Reduce Procyclicality: The Institute shares also the view that both capital and provisions need to be designed with an eye to addressing procyclicality, carefully assessing unexpected and expected losses, respectively. However, the current discussion still lacks sufficient clarity to be given an adequate technical assessment, but appears likely result in double counting and inflated capital requirements. As currently proposed, adjusted PDs, loan provisions and capital buffers (both micro and macro), together with current approaches to Pillar 2 capital add-ons, would in many cases address the same issues and vastly overstate capital requirements. Furthermore, the proposals on "fixed" capital buffers (based on capital conservation) also lack the necessary specificity to evaluate their effects or effectiveness. As proposed, it is not clear how the capital buffers would act as countercyclical tools, both from the micro and macro prudential perspective. In addition, as *paragraph 241* indicates, currently available proposals for lessening cyclicality in IRB requirements are far from commonly accepted, still subject to extensive debate in both the official and private sectors, and very much still under development.

61. PD Adjustments (*paragraph 242*): the BCBS indicates that it is currently assessing two specific proposals for the adjustment of PDs under the IRB approach, but analysis of procyclical effects and methodological development are far from complete. Among other things, the policy-making process should be based on a clear assessment of whether PDs calculated under the Basel II IRB approach are excessively procyclical, but that work is incomplete should be continued in both official and private sectors until a conclusion that gives solid base to policy-making is reached.

62. Cyclicality and PD Approaches: While the document does not give sufficient information for conclusive analysis, industry experts have grave doubts about the feasibility and the effects on cyclicality of both the “highest average PD” and the “average historic PD” approaches that are under consideration. The Institute believes strongly that PD inputs into the internal risk management process and the calculation of risk-based capital should not be manipulated by introducing in effect are "downturn PDs". Concern exists that ambiguous criteria for the estimation of downturn PDs across portfolios and regions will reduce risk sensitivity, alter the intrinsic calibration of the Basel II framework, and interfere with sound internal risk management practices. They would affect the credibility of the resulting outputs to management, and hence affect the use test In addition, adjustments to the inputs of models reduce their transparency and the comparability of capital requirements across firms, and ultimately would de facto create a new minimum capital standard.

63. Stress Supplement to the PD Formula: The Basel II RWA formula already in essence situates determination of PDs in a downturn situation. In effect, the implied PD distribution in the ASRF model (which has a mean value equivalent to the through-the-cycle PD) determines that the resulting PD outputs would be observed only with a small probability (1 in 1,000 based on a 99.9% confidence level calculation). Adding further stress in the PD calculation would therefore fundamentally alter the base Basel II formula and its assumptions. In other words, stressing the PD would result in a "double-stressed" number which by definition would overstate capital numbers.

64. Effects on Internal Risk Management: Furthermore, the proposal could render meaningless banks’ internal risk parameters as banks would be forced permanently to use historic averages that might not necessarily be of relevance for the current risk profile of their exposures, turning PD measures excessively idiosyncratic. Under such conditions, banks would cease to have incentives to improve the quality of internal estimates. In addition, the use of either the highest average or the average historic PD would “lock” banks into such averages (i.e. forcing the mean of the PD distribution to equal the largest historic outlier), regardless of any subsequent actions that banks might take to improve their risk profiles. Such an outcome would not only be counterintuitive but, as already indicated, would be a disincentive to sound risk management.[10] Finally, if wrongly designed, the measures could end up creating imbalances in capital requirements (and hence distorting incentives) in areas that do not require especially increased capital. Given the unresolved technical issues, the most prudent procedure would be for the BCBS, in collaboration with the industry, to continue analyzing this issue without rushing into adopting any untested approach that could have severely negative consequences on the way banks manage their risks. In the meantime, Pillar 2 provides all the necessary tools for supervisors to address any deficiency in banks’ estimation of risk parameters.

65. Forward-Looking Provisioning (*paragraphs 243-46*): *Paragraphs 243-46.* The Institute has for a considerable time supported a more forward-looking approach to loan-loss

[10] The Institute further notes that the QIS methodology to measure the potential effects of this proposal is potentially flawed. In effect, by using a scaling factor to be applied grade by grade based on the exposure mix as of 2009, the QIS will likely show biased results that will not be relevant for banks with improved risk profiles.

provisioning. This interest in removing the rigidities from practice of the recent past in the interpretation of the "incurred loss" approach was expressed well before the beginning of the crisis in conversations with the IASB, FASB and the Basel Committee's Accounting Task Force, because of the concern that, especially if interpreted narrowly, the incurred-loss standard led to under-provisioning and therefore both more cyclicality and lower quality disclosures. Early in the crisis, representatives of the Institute met with representatives of the FSB to reiterate and expound thinking on ways to achieve more forward-looking provisioning. Some banks have taken the view that the desired forward-looking effect could be achieved through a broader interpretation of "incurred loss".

66. <u>Accounting Standards-Setters Work on Expected Loss</u>: In light of the G20 mandate to find ways to pursue more forward-looking provisioning, the Basel Committee and many industry groups have been working on variations of the "expected loss" approach described by the Committee in *paragraph 244* and its principles for the replacement of IAS 39, published in 2009. The IASB has made a proposal based on expected cash flows that many have welcomed as going in the right direction conceptually, but has been challenged very widely as posing difficult to insurmountable technical problems. The FASB is working on revision of it thinking, although as of this writing a formal proposal has not been made, but one which will go in the direction of expanding the information that can be taken into account in determining "incurred loss." Various private-sector groups are working on principles that could be implemented to attain the benefits the Committee seeks from an expected-loss approach._The Institute endorses the work being done to achieve a more forward-looking basis of provisioning. The technical challenges that the IASB's proposal poses can, on the basis of work currently under way, be avoided.

67. <u>Basic Provisioning Principles</u>: Similarly, the Institute is convinced that divergence between the accounting standard-setters must be avoided at all costs. A converged accounting standard that will meet the goals of the G20 and the Basel Committee should be entirely possible if minds are kept open and a few principles are observed. Those principles include:

- Keeping provisioning consistent with the way banks manage their lending and securities businesses; in particular, it is necessary to manage provisions for most exposures on an open-portfolio basis.
- Reflecting management's view of expected loss.
- Ensuring that provisions include – as a minimum- based on impairment in banks' portfolios reflecting reasonably determinable near-term changes in expected losses, plus actual non-performing loans charges as they emerge.
- Provisions should not be seen as a means to achieve anti-cyclical buffers without regard to or in excess of actually expected losses.
- Provisions must be usable in fact; i.e. it must be possible for banks to draw them down as non-performing loans are identified and written off, without penalizing accounting or prudential treatment where the provisioning requirements have been complied with.
- Multiplication or duplication of systems and calculation requirements for accounting and regulatory purposes should be avoided if at all possible.

On the basis of such principles, the goals of useful disclosure of the condition of banks' portfolios to the market via high-quality accounting standards as well as the requirement of assuring adequate and realistic provisions, plus the G20 and BCBS goal of reducing procyclicality, can be achieved.

68. Fixed Capital Buffers (*paragraphs 247-59*): As already stated, the Institute supports the work of the BCBS in regard to adequate management of the capital implications of procyclicality. In its 2009 *Reform in the Financial Services Industry* Report the IIF recognized that '*firms should have available a set of potential measures for adjusting their actual capital structures in line with cyclical developments in capital requirements"* and that the choice of tools *"should enable banks to balance the need to conserve capital with wider business and strategic objectives"*[11].

69. Drawbacks of the Fixed Buffer Approach: However, the proposal for "fixed" capital buffers through capital conservation, as sketched out in the Consultative Document, has a number of drawbacks that will likely affect its effectiveness.

    a. While capital conservation measures are supported by the industry, such measures would be more effective under a flexible Pillar 2 approach, allowing for a firm-focused discussion with the respective supervisor. Indeed, the approach at *paragraphs 247ff* is broadly consistent with what at least some regulators already do, requiring banks that are in weaker condition to restrict payouts. As to the buffer's eventual implementation, the Institute also notes that in some jurisdictions, the prescribed operation of the proposed buffer mechanism would overlap or even overrule existing Pillar 2 supervisory dialog addressing precisely the same procyclicality challenges.

    b. However, the proposals fail to specify the methodology under which the target capital (or buffer range) would be set, other than to specify that the buffer should be *"large enough to enable banks to remain above the minimum requirement in the face of losses (…) during a severe downturn"*. The industry would appreciate additional details on the methodology under which this would be done, including the time horizon of the type of losses the buffer is expected to cover, the difference between the proposed buffers and the regular capital requirements. Transparency on the process is necessary so that the firm may engage in a meaningful discussion with its supervisor as to the appropriateness of the proposed buffer as well as to provide sufficient information to market participants in regard to the buffer, its size and determining factors.

    c. There is also a basic, philosophical issue here. Although supervisors have long had the power to restrict dividends and stock buy-backs when a bank is in precarious state (or below prompt-corrective action thresholds), restriction of the ability of boards to pay dividends or conduct share buy-backs to the extent apparently envisioned would seriously narrow the business judgment of management and

[11] See New Recommendation D in Appendix V of the IIF Report *Reform in the Financial Services Industry*

boards, hobble firms' ability to manage their capital and their relations with the market, and quite likely make redressing a firm's situation more rather than less difficult. While the reasons for the proposed reduction of discretion are clearly stated at *paragraphs 253-255, they* overlook the fundamental role of management and boards in the strategic management of their relationship with the capital markets. Although capital conservation restrictions do make sense when the firm enters the prompt-corrective-action or similar zone, a calibration of the proposed fixed buffers much above that would quickly put the supervisors, rather than the board, in charge of some of the most basic corporate functions (among other things changing in unforeseeable ways the incentives for the basic management of the firm that, at least in principle, would remain with the board per *paragraph 256.*

d. Fundamentally, the industry is highly skeptical as to the potential effectiveness of the capital buffer concept with a stated buffer range and minimum capital conservation ratios as proposed. Most importantly, it is unclear whether firms would be able in practice to draw from the capital buffer during times of stress, and this is a source of great concern to the member firms of the Institute. Recent experience during the crisis has demonstrated that during times of economic stress market participants expect banks to hold *additional* capital as opposed to *less* capital. The current assessment is that markets, investors and rating agencies would prevent banks from using the buffers. The BCBS is aware of this problem, but there is no indication as to how the Committee could make buffers actually usable in hard times. Buffers that cannot be used would become another incremental capital requirement, in addition to all the liquidity, leverage, capital and risk-management requirements, all of which will contribute to a bottom-line constraint on credit in the global economy. This effect would be pro-, not anti-, cyclical: to the extent buffers cannot be used in harder times, the burden of carrying them will force banks to reduce assets and new lending, contributing to the downward spiral.[12]

e. Similarly, initial discussions with rating agencies indicate that some market participants could find it difficult to accept that banks draw down their capital buffers during time of economic stress. Currently, rating agencies assign a low investment grade to banks that operate close to the regulatory minimum and only assign high ratings to banks with sufficient and permanent capital buffers. A reduction from the buffer would under many circumstances be penalizing from the rating point of view, which would result in the practical impossibility of using the buffer as proposed by the BCBS. Whether this likely effect could be mitigated by transparency or supervisory guidance remains highly debatable.

f. Any potential measures to be developed in this area should clearly operate at the consolidated group level. Application at the subsidiary level would not only be impractical but also extremely difficult to apply, particularly in regard to

[12] As noted in Capital Appendix A during the discussion of *paragraph 92* on contingent capital, the role of contingent capital needs to be worked out, and may play an important part in the effectiveness of any proposed buffer"

subsidiaries in which the holding company does not exert majority of control. Finally, if the expanded capital-conservation measures are applied at the subsidiary level, firms would lose the diversification benefit of having subsidiaries in multiple countries; any application of capital-conservation at the subsidiary level should be debated through the group's college of supervisors

70. <u>Need for Additional Guidance</u>: In conclusion, the Institute believes that unless the very serious doubts as to the practical effectiveness of the proposed buffers are addressed, the BCBS should consider providing additional guidance, if necessary, on the use of currently available Pillar 2 tools for the purposes of capital conservation at individual banks. Similarly, for cross-border groups, the SIG should develop guidance so that colleges of supervisors introduce into their methodologies, the determination of capital buffers and specific criteria for the use of a wide range of supervisory tools to address any deficiencies in regard to building up sufficient capital resources.

71. <u>Variable Capital Buffers for Macroprudential Purposes: Excessive Credit Growth (*paragraph 260)*</u>: the Institute believes that further consideration is needed in order to determine the right approach to the macroeconomic use of capital buffers. While conceptually the idea of variable buffers has some attraction and could potentially be useful, the international debate on this subject shows mainly that a great deal of further analysis as to the intent, design, and effectiveness of macroprudential capital buffer tool is needed. The Institute would urge the BCBS not to feel compelled to issue proposals at its July 2010 meeting; rather, the extensive study and discussion of this topic by the Committee, the BIS, the FSB and others, and by private-sector groups such as the Institute's Market Monitoring Group and the academic community should continue and it would probably be more appropriate for the BCBS to issue a discussion paper to set out its thinking and channel the further discussion that will certainly be required.

72. <u>Challenges of the Buffers Proposal</u>: The BCBS has correctly identified the various complex issues involved in the definition of any potential use of buffers for macroeconomic purposes (including the multiplicity of macro variables to be considered, the limitations of any single variable, the differences across economic cycles and the specificities of banks with different business models). The proposal would face many practical challenges, including the definition of the scope of the analysis (by country, region, globally), the type of criteria to be used for determining what is "excessive" and what is normal growth, the need for coordination across jurisdictions, the situation of global, cross-border banks with exposures in multiple jurisdictions, etc. Macro scenarios are likely to be very difficult to design and apply and, of course, effects of applying macro constraints at any point in time would require analysis of the effects on SMEs, retail borrowers, emerging markets, and economic activity generally. These challenges to the official sector would be replicated at the firm level, if firms were expected to run related, mandated macro scenarios through their risk systems.

73. <u>Penalizing All Banks</u>: The Institute also notes that the BCBS, while studying this approach, should take into account the fact that a variable buffer, as described, could result in a situation where firms that have behaved prudently are affected negatively by the behavior

of others. Imprudent credit growth caused by a few firms in a given market may in practice restrict sound credit activity of other firms that have been more cautious or have better risk management. Such contradictory outcomes would produce perverse incentives and should be avoided.

74. Need for Careful Analysis and Implementation: At a time that the BCBS is focused on addressing issues of the magnitude of a revised definition of capital, the implementation of a global leverage ratio, and a completely new liquidity framework, rush should be avoided in developing actionable proposals on issues on which basic policy, methodological, and technical discussion is still essential.

E. Systemically relevant banks: capital implications

75. Addressing Systemically Important Firms: Although in the current Consultative Document the BCBS does not include specific proposals in regard to "systemically important banks", it is indicated at *paragraphs 46-49* that the BCBS is currently considering alternatives that include capital and liquidity "surcharges" for such firms. While the Institute will comment in detail on any proposal to be issued in this area, it is important to reiterate the analysis that the IIF conducted on this issue in its July 2009 Report *Restoring Confidence, Creating Resilience*. In this report, the Institute warned against creating formalized categories of systemically important firms and reiterated its support for a risk-based approach to supervision and for supervisors to focus on systemic risk in the determination of their approach to the supervision of each individual firm. It is important to avoid approaches that create or increase moral hazard or which reflect an overly narrow view of systemic risk. It also pointed out that much of the risk attributed to "systemically important" firms was in fact the risk of interconnectedness, which could be managed through infrastructure and other improvements, such as the CCPs discussed at *paragraphs 165-167.* The report also stressed the importance of reinforcing market discipline by creating conditions under which a large firm could be allowed to fail.

76. Exposures to Large Financial Institutions: In addition to foreseeing "surcharges" for "systemically important banks" in a very general way, the Consultative Document discusses at *paragraphs 48 and 135-40* the concept of increasing asset value correlations for exposures to large financial institutions relative to other corporate exposures. The industry is uncomfortable with the implications of this penalization through the Basel formula of large financial institutions for the international markets, and urges that the effects on market activity overall need to be included in the impact assessment of the proposals. Moreover, the industry is respectfully skeptical of the empirical basis for this penalization of exposures to large institutions and would welcome the opportunity for a discussion among technical experts.

77. Importance of Risk-Based Regulation: It should of course be expected that the supervision of a firm will be more intensive where the failure of the firm would have a material impact on the system. Similarly, while it may be appropriate to apply more intensive supervision to larger firms, the Institute does not believe that it would be appropriate to apply different regulations to firms purely based on the size or because they are determined to fall within a

predetermined category of high systemic relevance. Rather, regulation should remain risk-based and assess the actual risks faced by a firm given its mix of business, diversification, geographic scope, and quality of risk management.

78. Collaboration between the Basel Committee and the Industry: The Institute is developing industry thinking on the overall issues of systemic risk, including, critically, the problem of cross-border resolution, and has given comments to the BCBS on its consultative paper on that topic. The Institute looks forward to engaging in dialogue on this important issue.

Capital Appendix A

Specific Comments on Definition of Capital Issues

Below the Institute presents detailed comments on the specific recommendations in the area of definition of capital. These comments should be read in conjunction with the general comments on this issue in the main section of the letter. References are made to the *paragraphs* as presented in the BCBS Consultative Document.

- *Paragraph 69.* While the proposal notes the distinction between going-concern and gone-concern capital, it is striking that all deductions are made from common equity. A dogmatic approach on this point risks failure to recognize that several of the items proposed for deduction have value in both "going-" and "gone-concern" situations and are of sufficient quality to be included in Tier 1, and thus there should be adjustment appropriately to reflect that fact. For example, as discussed further below, Deferred Tax Assets (DTA) may have substantial value in both going and gone concern situations, indicating that their treatment needs to be rethought.

- *Paragraph 76.* While the criteria for loss absorption are generally appropriate, it will be necessary to examine specifically customary types of preferred and other instruments in each jurisdiction: firms and the markets will need to understand specifically what will and will not be allowed, in local-market terms. For example, some firms issue preferred shares with must-pay requirements pursuant to which, if certain balance-sheet tests are met, a bank must make distributions before any common dividends can be paid. These distributions may not be fully discretionary, but the instrument will still be loss-absorbent and will pay out only when the firm is profitable. Some allowance for such instruments, with prior regulatory approval, would be appropriate. (See also the comments on *paragraph 89, point 7 a.)*

  It is stated that the Committee will consider the treatment of capital instruments that have tax-deductible coupons in the "non-predominant" element of Tier 1. It is not clear why tax deductibility is relevant to the criteria of loss-absorption that are discussed. There is a potential level playing field issue with respect to tax deductibility, in that some national regimes may allow deductions that others would not, and this can have a significant competitive effect; however, that level playing field issue should be addressed on its own terms. So long as all the relevant loss-absorbency, permanence, and other requirements are met, there is no reason relevant to capital support why any additional restriction should be imposed.13

- *Paragraph 77.* The phase-out of "innovative" hybrids calls for a number of comments. First, the language is quite sweeping but opaque, leaving open to question exactly what features are to be phased out, other than step-ups. When the framework is finalized, it will be important not to include in the phase-out features that do not create the inappropriate incentives. For example, it should be clarified that ACSM (Alternative Coupon Settlement

[13] The European Commission's services recently noted that they "do not consider additional eligibility requirements in relation to the tax treatment of hybrid instruments to be required." Commission Services Staff Working Document, Possible Further Changes to the Capital Requirements Directive, 2010, paragraph 58.

Mechanism) instruments remain appropriate under many circumstances. Such instruments are non-cumulative from an economic point of view, and essentially perform the same function as contingent convertible capital instruments, diluting equity and thus acting as a means of market discipline. While it is appropriate for supervisors to insist that it is made clear that the ACSM feature will be used under clearly stated conditions, there is no reason to exclude such instruments, though they may sometimes be considered "innovative".

Second, For purposes of this paragraph, assessment of a bank's "economic interest" in exercising a call should be understood not only refer to contractual funding cost but should also take into account the quality and terms of potential refinancing instruments and applicable market conditions.

Third, and most basically, many members are of the view that *paragraph 77* as written is too broad-brush even as to step-ups. A proportion of instruments with such features may be acceptable, subject to analysis of the likely effects of a particular transaction, and allowance of such instruments within well-defined bounds could provide useful diversification of financing instruments, appealing to additional investors in the market. The extensive work of CEBS over the past three years shows that it would be possible to achieve common definitions, appropriate buckets, and sensible economic limits on innovative hybrids, without the expansive but vague prohibition in the current *paragraph 77***.** Allowing some degree of step-ups, properly drawn, would not erode the quality of Tier 1 capital. . Redemptions must generally be approved in advance by supervisors, regardless of whether securities have step-ups or not, which serves as a check on issuers in cases where redemption might be imprudent. The design of particular step-up features in the context of each firm's overall capital structure should be subject to evaluation; this would be more appropriate to helping firms cultivate the market than a flat ban of step-ups based on pre-crisis documentation and practice that is not likely to reappear.

- *Paragraph 81*. Disclosure of the "full" terms and conditions of an issuance may prove problematic if a bank has had the benefit of a private placement of Tier 1 capital. Private placements are especially important for smaller institutions and can contribute significantly to the recovery of firms that have either been sliding into trouble or are close to entering the resolution process. While full disclosure to the firm's supervisors of all terms of any such investment is of course essential, market disclosures should be limited to material, general, essential terms, and not to full details in order not to limit access to a potentially important source of capital. Even for public transactions, a level of disclosure equivalent to the summary of terms in a public-offering prospectus under the EU Prospectus Directive would be sufficient.

- *Paragraph 84*. As discussed in the introduction to these comments, appropriate grandfathering and phase-in provisions will be essential to managing the impact of the new requirements. Grandfathering should cover all relevant elements of the new rules, including the required proportion of Tier 1 and definition of its components, the "predominance" requirement, and deductions.

In designing the grandfathering and phase-in requirements, it is important that market perceptions and effects be taken into account; grandfathering and phase-in periods will need to be defined with care, to avoid diluting their purpose, as the markets may be induced to factor in higher costs of capital well in advance of the grandfathering or phase-in date, thus burdening the any capital raising by firms.

In addition, because of likely market effects, it will be advisable to "amortize" the grandfather period, rather than create a cliff effect by reference to a final deadline. In this connection, the pattern proposed by CEBS seems appropriate: it requires non-compliant hybrids to be phased out over 30 years, with additional going concern limited to 20% of total Tier 1 after 10 years, 10% after 20 years, and 0% after 30 years. [14] Whether this exact pattern is appropriate in each case depends on economic analysis of the facts and circumstances with respect to each grandfathering issue, with the goal of achieving an equitable but non-disruptive result overall; nonetheless, the approach suggested would be appropriate conceptually to many situations.

Finally, it is essential that all instruments of like type be treated equally for grandfathering purposes. The QIS template asks, "Was the instrument issued to the government or a government agency as part of a recapitalization plan?" It would be very harmful if, as some have concluded, this implies that preferential grandfathering treatment might be given to such instruments. There are no prudential grounds for discriminating among instruments on the basis of the source of the capital. Furthermore, any such distinctions would treat private recapitalizations, which have in some cases been done with government, unfairly. From the point of view of banks competing for scarce capital, such discrimination could inequitably burden firms that have been able to rely to a greater degree on private capital. Finally, there might be unknowable but significant effects on the confidence of the capital markets at a time when much finance needs to be raised.

- *Paragraph 85*. The predominance rule states that common equity should be at least a percentage to be determined of Tier 1 capital. A staged method and timing of introduction should be envisioned, may appropriately not be the same for all countries, as different countries have different financial situations and economic conditions. As discussed above, the "predominance" test should not be allowed to limit additional capital raising as long as the basic requirement is met as to the minimum regulatory requirement.

- *Paragraph 87, criterion 4*. Some banks assume the role of a market maker in their own shares or may publicly announce a share buy back program. This may create an expectation that the instruments will be bought back. It should be made clear that there is no intent to disallow market making or buy back activities.

- *Paragraph 87, criterion 5*. The term "distributions" should be replaced by "dividends", (in line with paragraph 89, criterion 8, as in the context of paragraph 249, "distributions" are defined more broadly, e.g. to also include staff bonus payments.

[14] See paragraph 9 of Directive 2009/111/EC of the European Parliament and of the Council, Article 154.

- *Paragraph 87, criteria 10 and 14.* Adding accounting filter to the regulatory Tier 1 criteria is not appropriate. For example, a note which is mandatorily convertible into a variable number of common shares will require bifurcation of the instrument under the accounting rules, such that a substantial amount of the cash received at issuance would not be classified as equity under the accounting standards. Yet, for regulatory purposes, the variability of the number of shares to be delivered at the conversion date will not reduce the loss-absorbing Tier 1 character of the instrument. Furthermore, FASB and IASB are working on a new standard that defines the characteristics of equity. The regulatory capital criteria therefore need to provide the stable source of reference. [15]

  More broadly, at least as a phase-in matter, banks that have previously issued preferred stock with mandatory conversion to common stock at a date certain should continue to be able to treat it as Common Equity even before conversion. Not making such provision would, especially with a tight predominance test, cause considerable capital inefficiency for the affected banks, with little or no gain in overall capital quality.

- *Paragraph 89.* In designing the criteria for Additional Going Concern Capital, it needs to be kept in mind that it is not only firms from G7 countries that make appropriate and constructive use of preferred and other forms of capital in their capital structures. Emerging market banks in some countries commonly use preferred and hybrid instruments. While of course they should be subject to the same loss-absorption principles, they also face additional complexities where they list their additional instruments in developed markets, especially when ownership restrictions or ownership reporting requirements in the home country restrict convertibility.

- *Paragraph 89, criterion 6***.** A certain percentage, excluded from the prior supervisory approval requirement, should be allowed for market-making purposes. This should extend to firms themselves, or related parties, such as holding companies. Limited buy-back activity for market-making purposes or related to underwriting should be permitted provided that, at any time, repurchased instruments do not exceed thresholds to be discussed with the relevant supervisor.

- *Paragraph 89, criterion 7(a).* As discussed above at *paragraph 76* the Committee should provide for some flexibility on using full discretion as to distributions as a requirement for additional going concern capital. Some securities require payment in situations where the bank is profitable – such types of securities are loss absorbent and should not be discouraged, with appropriate terms and supervisory review.

- *Paragraph 89, criterion 8.* The Committee's Accounting Task Force should review the concept of "distributable items" to be sure that there will be a clear understanding of the term under major accounting standards - as of now, "distributable items" are only briefly described in Paragraph 249.

[15] See:
(http://www.iasb.org/Current+Projects/IASB+Projects/Liabilities+and+Equity/Characteristics+of+Equity.htm.)

- *Paragraph 89, criterion 11*. The provision with respect to instruments classified as liabilities needs further study, both for substantive and for level playing-field effects. It is assumed that this section refers to legal and not accounting classification as liabilities. In addition, it is recommended that the Committee consult widely with different types of investors to understand their needs and demands before finalizing these (or other) requirements).

  The requirement for terms to include either a conversion into common shares or a write-down has no obvious grounding in the other concerns of this paragraph. As long as criterion 10 is satisfied[16], there is no regulatory benefit in requiring such mechanisms for instruments that are liabilities in legal form as compared to instruments that take other legal forms, such as preference shares. *Criterion 11* would create a competitive distortion in practice between financial instruments and institutions with different legal options.

  If the requirement is, contrary to the foregoing recommendation, retained, is especially important to make clear that write-down features do not preclude *write-up* when the firm returns to appropriate conditions. Without allowing write-up it is hard to see how any such debt instrument could be attractive to investors at other than equity-equivalent pricing to the issuing bank. Given that the ability of equity markets to absorb expected large issuances on behalf of banks, available alternative instruments should not be penalized. Permanent write-down would not only be unacceptable to many or most investors but would effectively subordinate Additional Going Concern Capital to Common Equity, normally to be the most subordinated form of capital under the Basel scheme. Furthermore, the requirement could needlessly burden management of a restructuring plan. Any such structures would of course need to be clearly detailed so that investors and regulators know when to expect write-downs and write-ups.

  Further, if an instrument is classified as a liability but also includes a loss-absorbing conversion to a preferred share or another form of Other Going Concern Capital under stress conditions, the requirement for further principal loss absorption (whether conversion or write-down) should not be required.

- *Paragraph 89, criterion 12*. It should be made clear that the requirement that the bank not "directly or indirectly have funded the purchase of the instrument" is subject to an intent test. Banks will often have numerous relationships with investors and counterparties (especially insurance companies and other banks) that should not be affected by this rule, yet a very strict construction of "indirectly" could lead to unnecessary, legalistic doubts unless reasonably limited to instances where there is an intent to provide finance indirectly. This provision should also include an exemption for marking-making purposes.[17]

[16] Conversion or temporary write-down might be required to comply with *criterion 10* in some jurisdictions, but for all other jurisdictions, it is hard to see the added value in terms of capital quality of the requirement.

[17] Example of such market-making exemption has been proposed by CEBS: "It is proposed that repurchased instruments held by the institution for market making purposes shall not at any time account for more than either 10% of the relevant issue or 3% of the total amount of all outstanding hybrid instruments issued by the institution, whichever of the two limits is the lowest. Supervisors may nevertheless apply stricter limits." Paragraph 73 of CEBS *Implementation Guidelines for Hybrid Capital Instruments*, 10 December 2009.

- *Paragraph 89, criterion 14*. In certain jurisdictions, hybrid capital instruments can be issued directly by the top company off its own balance sheet in a tax-deductible format (e.g. France, the Netherlands, Belgium, Scandinavia) and without the need for formal, instrument-related shareholder approval, which limits flexibility in market access; however, in others, (the UK, Germany) this is not so. The use of SPV structures therefore can be necessary to establish a level playing field with respect to tax cost and flexibility, without diluting the effectiveness of the capital instrument from the consolidated group perspective. Firms should therefore be allowed the flexibility to raise capital via SPVs and on-lend through a variety of structures through the group, so long and the legal and economic effect of the on-lending results in its being in the same position from a "going-concern" (deferral and principal treatment) and "gone-concern" (subordination) perspective as if it had issued the instruments directly. There is no need to restrict the form of the on-lending by requiring it to be identical to the Additional Going Concern instrument, so long as the combined structure of the on-lending achieves the required effect.

- *Paragraph 89, additional requirements, first bullet.* For the reasons given in the comments on *paragraph 87,* no accounting filter should be applied to the regulatory criteria.

- *Paragraph 89, additional comments, second bullet.* The intent and scope of this requirement need further explanation and clarification (it would be helpful to state that it refers to *paragraph 101* if that is the intent); however, the considerations raised in the discussion of *paragraph 101* below, need to be taken into account.

- *Paragraph 90, criteria 4, 5*. There is a degree of inconsistency between *paragraphs b* and *c* and *criterion 5* in that amortization and callability in themselves may, depending on market circumstances, constitute incentives to redeem. Thus, *paragraph c* should be clarified so that "incentives to redeem" refer clearly to other features such as penalizing step-ups that would be additional to the allowable structure as envisioned by *paragraph 90*. In addition, it is not clear why the criteria need to be as narrowly defined as proposed, given the requirement for supervisory approval to call.

  Tier 2 capital securities with step-ups should continue to be accepted, for the reasons discussed above at the discussion of *paragraph 77.* The debate on abolishing step-ups that stems from concerns relating to the probability of call options' being exercised should distinguish between Tier 1 capital required for loss absorption on a going concern basis and Tier 2 capital required for loss absorption on a gone concern basis. As recommended in the Consultative Document, instruments with maturities are also included in Tier 2 capital and a fundamental premise of such instruments is that they will be redeemed. With that in mind, instruments with call incentives in the form of step-ups should be considered as appropriate Tier 2 products, provided the other criteria for Tier 2 are met.

  The reasons for the five-year minimum-maturity, minimum-call and amortization period are not clear, and need reexamination given the purpose of Tier 2 capital as "gone concern capital". As a matter of principle, given that Tier 2 capital is fully available as "gone concern capital" until maturity, there should be room for shorter-maturity instruments and short

amortization periods or bullet maturities, and, indeed, it is not apparent why amortization terms that banks may negotiate with investors should be restricted. Ideally, given the role of Tier 2 capital and the usual need to obtain prior supervisory approval to exercise a call option, there should be no minimum period before a call option can be exercised.

Access to Tier 2 capital would be enhanced by removing any unnecessary constraints. Retail instruments exist in some markets with shorter initial maturities or call periods, and the rule should not deprive banks of a good source of diversification of finance.

Moreover, the amortization of the capital benefit before the allowable call would mean that firms would have to accept the cost of providing the call without the flexibility of capital management that calls are intended to provide. Again, supervisory approval of exercise of the call should be sufficient to prevent abuse, while not unduly raising the cost of funding.

- *Paragraph 90,* Additional requirements: For the reasons set out in discussion of paragraph 87, there is no need to apply an accounting filter to the regulatory criteria.

  The reasoning behind the netting of holdings of non-common equity in other financial instruments needs to be explained. It will be particularly important not to penalizing market-making. Double-counting with the Trading Book requirements should be avoided.

- *Paragraph 90, criterion 8*. Again, the Institute believes that there should be an exception included in this requirement to allow for firms' market making activities.

Contingent Capital

- *Paragraph 91*. The Basel Committee's "concrete proposals" for contingent capital will be one of the most important issues of its July meeting. The Institute would advise wide consultation with banks as issuers (CFOs and capital-management officers), investment bankers, rating agencies, and various categories of investors before taking any final decisions so that the potential market and ramifications are fully understood.

  Contingent capital instruments may have the potential to create attractive value for both issuers and investors, while giving supervisors assurances as to the delivery of additional equity in time of need. Contingent capital might be potentially useful, for example by establishing a market price for the contingency (thus contributing to market discipline), making available an additional type of capital buffer in times of stress, and, ideally, offering an alternative, cheaper capital source than equity for firms. The intensive exploration of the potential of the idea should seek to increase the financing options and range of investors available to banks. But there are many questions to be answered before it is clear that instruments within regulatory guidelines for contingent capital would actually find reasonably deep market and work as intended from a prudential perspective.

  Because the regulatory proposals on contingent capital are yet to be released, the Institute would like to emphasize the following pivotal points:

- Contingent-capital issuance should not be mandatory, as has sometimes been suggested - banks should be able to issue contingent capital only if that makes sense in terms of their overall capital structure and contributes to their capital efficiency. It is not likely that all banks would be able to issue contingent capital or that any banks would be able to issue on reasonable terms in some markets. While many banks are interested in the contingent capital concept, there is in fact a wide range of opinion from greater and lesser degrees of interest in the concept to those who think it is not likely to be practical, to those who believe such instruments would definitely not be desirable from the perspective of financial stability, because of the risk of negative effects of a conversion not only on the affected firm but on the sector as a whole.

- It should be clear that contingent capital instruments would be one option for a bank to meet any capital buffer requirements mentioned in *paragraphs 247ff*, but should not be on top of or in addition to such requirements

- To appeal to investors, especially traditionally debt-focused investors, triggers must be simple, transparent and predictable.

- Triggers for conversion or write-down should generally be objective and not discretionary.

- However, guidelines should permit firms to negotiate with investors to create instruments with dual-trigger structures, so that management would have the option, but not the obligation, to convert the instrument at a somewhat higher level than the base trigger level, in order to give the firm additional options for the management of its capital.

- Discussions with investors and market participants make clear that triggers that depend on regulatory decisions will not be acceptable, because of the loss of transparency and predictability that leaving the decision to regulators, as much as to management, would imply.

- The instruments will need to be similar enough to standard fixed income instruments so that funding will be available from insurance firms, pension funds, and other fixed income managers.

- To be appeal to the deep market of debt investors, triggers will need to be set low enough that breach should only occur at a level that appears remote upon issuance: normally this would be when the issuer is in a state where recovery plans might need to be activated without the capital infusion offered by the conversion or write-up of the security.

- Only triggers related to the idiosyncratic conditions of a particular institution are likely to be attractive to the market; triggers tied to systemic issues would dilute the market discipline that a well-designed contingent instrument should create.

- Conversion into Additional Going Concern capital should not be precluded.

- The contingency could be provided by conversion or by write-down; however, it should be made clear that, where write-down is the means of improving the firm's capital situation, write-up should not be precluded a priori. With supervisory approval of the form of instrument, there is no reason why write-up as the firm returns to health should be precluded. Write-downs are not available in all markets but the competitive implications of this fact should be addressed by flexibility in the types of conversions allowed and, in due course, by change of corporate laws to allow appropriate write-downs and write-ups where they do not exist.

- Assuming the proposed requirements of *paragraph 89 criterion 11* are, contrary to the IIF's recommendation, maintained for conversion or write-down of liability-type Additional Going Concern Capital, it is not clear what additional features or benefits Contingent Capital would have. To make meaningful the additional capital-raising capacity implied in the Contingent Capital idea, *criterion 11* needs to be reconsidered and eliminated or refocused.

- *Paragraph 92*. The market pressure that caused some (not all) firms to exercise call options at times when there might have been good arguments not to is not likely to recur in the same form, among other things because of other aspects of the Committee's proposals, and the likelihood that, for the foreseeable future at least, the market will clearly need to take into account those instances when call options were *not* exercised.

  In addition, it is not clear why a lock-in should be required. A lock-in might, in fact, needlessly both detract from the attractiveness of the instrument (because of the extension risk) and the firm's flexibility in managing its capital structure. The lock-in proposal needs to be analyzed not in light of the past crisis but in light of current market perceptions, the new capital regime, and the anticipated closer supervisory oversight. In some cases, a lock-in related to a regulatory event, such as requiring a deferral of interest payments upon a fall of regulatory capital below a given level, may have substantially the same effect as a write-down for regulatory purposes, but could remain acceptable to investors. Firms, with supervisors' approval, should have leeway to design different structures with or without lock-in that would assure that Tier 2 capital does not need to be repaid during times of stress. In short, an additional lock-in requirement is not required and may impede achievement of regulatory goals.

Regulatory adjustments

The regulatory adjustments to capital that are proposed would have a very substantial effect on the industry's overall capital position and needs to raise capital, albeit an effect very unevenly spread across countries and institutions, especially initially. The Committee's concern that a lack of transparency and consistency of deductions contributed to lack of resilience and, even more importantly, market perception of firms, as discussed at *paragraph 13*, is important and serious. Nonetheless, the present proposals go much too far in the opposite direction and would

seriously burden both recovery and credit capacity for the future, in ways that are ultimately unnecessary.

The principles to be applied to deductions and other regulatory adjustments should therefore be reconceptualized, and the specific requirements derived more directly. The revision of principles suggested would focus on "going concern"/"gone concern" analysis and this would, it is submitted, result in a focus on deductions from Tier 2 rather than Tier 1 as proposed.

- *Paragraph 93*. Given the extent of the concerns discussed below, it is gratifying to note that variants to certain of the proposed deductions will be assessed as part of the impact assessment. The Institute urges the Committee and national supervisors to consult widely and to consider carefully not only the overall impact of certain of the proposed deductions on firms, and on markets, but the differential impacts that would arise across countries given local tax, legal, and market conditions. Moreover, it is necessary to consider the high probability that these regulatory adjustments, taken individually and as a whole, will exacerbate procyclicality in times of economic downturns.

- <u>Stock Surplus - *Paragraph 94*</u>. Given that surplus or premium on all forms of shares, including preferred, is fully at the disposal of the firm, the proposed rule differentiating the source of surplus seems anomalous and unduly conservative. Distributions with respect to stock surplus would of course be subject to the usual corporate and regulatory procedures and approvals.

- <u>Minority Interests - *Paragraph 95*</u>. The exclusion of minority interests from common equity is, as proposed, problematic from a number of points of view.

  The penalization of minority interests, which can be quite severe depending on the circumstances, would create additional unpredictable and often unfortunate incentives. Among other things, it would penalize the "constellation" type of organization that some regulators have advocated, and some groups use to one degree or another, to no obvious policy purpose.[18]

  In addition, of course, although assets represented by minority interests may sometimes not be available to the entire group, they are available to the relevant parts of the group, and thus benefit the group as such. Thus, exclusion of minority interests from common-equity Tier 1 both ignores real resources available to the group and in some ways is contrary to the concept of "resolution plans", which would envision banks' planning for orderly downsizing when faced with deteriorating conditions (not of course that such divestments should be presumed, but only that they are often an option). The exclusion would, of course, also have a greater effect if the predominance test is defined tightly (assuming that the deduction would not affect Additional Going Concern Capital) and thus have an impact, significant for some groups, on the need to raise capital in the market or by reduction of lending.

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[18] Such other structures, like certain cooperative and savings banks, are among those who will be penalized by this exclusion; these structures are discussed in more detail in the section on *paragraph 101*

The complete exclusion of minority interests would penalize important forms of participation in emerging markets and transition economies. Banks may be required by host-country regulators to have some local participation via minority interests in subsidiaries, or banks may themselves prefer to enter a given market by such arrangements. The proposal creates a disincentive to ongoing presence in emerging markets and transition economies, which may be significant in important instances, especially as banks try to maintain diversified and forward-looking strategies while rebuilding capital. This disincentive to investment would be detrimental both to the banks and to the markets in which they might wish to invest.

In regard to cases of minority interests in a subsidiary with little or no risk, such cases may deserve special attention and there may be a good argument to apply the proposed rule thereto; however, the concern about certain SPV structures should not be allowed to dictate a harsh regime for all joint ventures and minority interests in operating companies; rather, if there is a need for a full-deduction regime, it should be applied only where well-defined concerns arise. As a general matter, the deduction should not be imposed where a subsidiary is a functional or operational part of the group.

While the text is silent on the point, practitioners would like to assume – but this is contrary to informal regulatory advice received-- that if the Committee maintains the proposal of full exclusion of minority interests, it will then make clear that there will be symmetrical treatment by permitting deduction of an appropriate portion of the affected subsidiaries' risk-weighted assets. *Paragraph 210*, referring to the leverage ratio proposal, suggests principles that should be applicable here as well: "where a bank has a subsidiary that is included in the accounting consolidation, but not in the regulatory consolidation, then the treatment is to deduct the holding in the subsidiary from capital and not to include the subsidiary's assets in the total exposure measure." This paragraph may appear in a different context, but the same principle of symmetry of treatment should apply to the RWAs of minority-interest subsidiaries. Otherwise, the obvious imbalance, in addition to being methodologically inconsistent, would impose disparate burdens on many groups, regardless of the quality of their risk management or their risk profiles.

Furthermore, there are special issues with firms in some countries where it is common for there to be minority interests in listed companies that operate in some respects as affiliates but in others as separate entities: here again, the asymmetry between full deduction of the minority interest and full inclusion of the RWA creates particularly disparate impacts and unnecessarily unfair results.

In addition, further adjustments would need to be made to take account of the treatment of goodwill under purchase accounting rules, which vary between accounting standards. In certain jurisdictions, accounting for acquisitions of less than 100% of a company requires that goodwill and other intangibles be recorded as if a 100% stake had been acquired. The accounting and current regulatory capital offset to this is recorded as non-controlling or minority interest (NCI). In eliminating NCI from the common equity component of Tier 1, the Basel Committee should consider excluding, for regulatory capital purposes, the portion of the goodwill and other intangibles (and RWAs) associated with the NCI. A company applying this accounting methodology (full fair value method) should not be penalized relatively to another company solely because of the accounting, given that the economic

exposures of the parent company are not affected by the accounting. The principle is thus the same as suggested for RWAs in the first bullet above.

Another way to treat minority interests that would partially capture their value would be to include them in Core Tier 1 capital but only up to limit, with such a limit being defined either by reference to the Tier 1 ratio of the parent group (excluding minority interests) or alternatively by reference to a normative Tier 1 ratio set by the regulators[19].

- Unrealized Gains and Losses - *Paragraph 96*. The filtering-out of unrealized gains and losses is generally appropriate in that temporary losses resulting from mark-to-market fluctuations would contribute to capital volatility, and conversely, counting unrealized gains could be seriously misleading; thus this is an important provision for reducing procyclicality as well as producing an accurate capital picture for each institution. Especially where a firm has a large AFS portfolio, the inclusion of either or both of unrealized gains and losses would likely result in substantially increased capital volatility, without reflecting fundamentals. The Institute is concerned that symmetry be maintained, as currently proposed. The Consultative Document states that other comprehensive income should be added to common equity, but says that treatment of unrealized gains is a matter for future consideration. As a general matter, there should be symmetry in the treatment of unrealized gains and unrealized losses

  The proposals of *paragraph 96* are based on present accounting standards; however, these are set to change and may make the proposal as written obsolete or counterproductive, as the Committee is well aware. Moreover, if the concepts of realized and unrealized are included in the capital standard, guidance will be needed, with reference to current accounting, as to how the concepts are to be used. Therefore, either a more principles-based approach should be described, or, preferably, this item should simply be left open for the Committee to assess in consultation with the industry when accounting changes are complete.

- Intangibles - *Paragraph 97*. The deduction of intangibles from Common Equity similarly needs to be examined more closely. Intangibles other than goodwill need to be examined case-by-case and may often factually generate value in both "going" and "gone" situations, without the "high degree of uncertainty" that is mentioned in the present text, because they would have a positive realizable value. The apparently undifferentiated extrapolation from goodwill to other items that may sometimes be classified as intangibles is in no way risk based. The following examples are important in themselves and illustrate the broader point:

  It should be noted that in certain cases, software may be classified as a fixed asset, whereas in several countries it is treated as an intangible. Regardless of accounting treatment, software is an asset that helps banks create future cash flows on a going concern basis, which is essential for a bank to operate, and which has a real, realizable value that would be taken into account in any transaction transferring a subsidiary or a business or the software itself. As well, in countries where software considered an intangible asset, it is depreciated over a relatively short period of time. Therefore, software should be specifically excluded from "other intangibles" for purposes of the capital deduction.

[19] This option takes into account the concept of overcapitalized subsidiaries mentioned on pages 16-17 of the BCBS' *Instructions for the comprehensive quantitative impact study* published on 17 February 2010.

Mortgage servicing rights (MSR) are especially important in the United States and, again, are more like tangible assets representing a source of capital than goodwill. Mortgage servicing rights have clear income streams attached to them, which are highly predicable on the basis of a good deal of experience, with prepayment risks fully hedged. Under most circumstances, MSRs could be sold by a bank as a going concern, or transferred in resolution. Because of the economics of the business, however, a 100% common equity burden would change the economics of the mortgage-servicing business (which would be detrimental to their understanding of the broader mortgage market, and deprive them of an appropriate income stream), as the cost of capital would have to be recovered through substantially increased pricing of mortgage services,, to the detriment of both mortgagors and mortgage investors.

Similarly, purchased credit card receivables are more like tangible assets than intangibles, regardless of accounting treatment, have easily ascertained income streams attached, and are readily saleable under most circumstance.

- Deferred Tax Assets (DTA) - *Paragraphs 98, 99*. DTAs are obviously highly influenced by tax policies and tax mechanisms (such as losses carried forward, losses carried back, and tax refunds) in relevant jurisdictions that require close analysis for any proposed deduction regime to achieve its goals and to operate fairly.

  In addition to the reasons discussed in these paragraphs, a substantial portion of DTAs arise for many banks because of the timing discrepancies between temporary differences between the book value of assets and liabilities and their tax value or because of timing differences between the recognition of gains and losses in financial statements and their recognition for tax purposes.

  An especially important timing discrepancy for many banks is between when provisions are taken for prudential purposes and when they are recognized for tax purposes: a draconian rule on deduction of DTA under such circumstances – which apply in many countries, both developed and emerging markets – will penalize and create disincentives to the expanded use of provisioning that both the Committee and the Institute would like to see.[20] Moreover, pensions in certain jurisdictions generate a fair amount of DTAs, deduction of which would result in a misleading depiction of a firm's capital position, as well as an unlevel playing field.

  Fundamentally, and in most or all tax regimes, the presumption of paragraph 98 that the value of DTAs relies in a direct and mechanical way on uncertain future profitability is incorrect.

  There is an important distinction between time-related DTAs and those arising from net operating losses that needs to be recognized in any analysis of the correct treatment of DTAs. DTAs related to these timing differences should not be deducted, while others require further analysis.

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[20] The European Commission has underscored the importance of this point; see Paragraph 152 of the Commission Staff Services *Working Document Public Consultation Regarding Further Changes to the CRD*, 26 Feb 2010.

Unlike certain other intangibles and indeed assets generally, use of DTAs is relatively objective and not dependent on performance by any other party; rather they depend on known rules applicable in each market. DTAs are not subject to the vagaries of market valuation and, depending on the country, retain value realizable over protracted periods (up to 20 years or indefinitely in the case of certain jurisdictions), making realization all the more likely, even where (as is not always the case) it is in fact dependent upon uncertain profitability.

In addition, the proposed treatment would contribute to the procyclicality of the Accord in that DTAs can be expected to rise in downturns as banks take more provisions and begin to make losses.

This contribution to procyclicality would be all the more unnecessary, given that DTAs very often have value even when a bank is falling into a loss-making situation, or even in event of failure. They contribute importantly to investors' analysis of potential future profitability and DTAs will often contribute substantially to the value of subsidiaries or businesses that might be sold in the event that a firm enters into recovery mode. Even in liquidation, in at least some countries, DTAs may be available to acquirers of parts of the business, or may be transferable to local investors. The transferable value of DTAs is often understated. They thus relate in part to gone-concern capital, as well as having considerable value to a going concern, even if it is not immediately profitable.

Clearly a blanket rule for deduction of DTAs (with the limited exception described in *paragraph 98*) against core Tier 1 is unwarranted. On the accounting side, there are strict and well-understood tests for recognition of DTAs, which introduce a high evidentiary hurdle before DTAs can be recognized, and which are policed by external auditors. A close analysis taking into account "going concern"/"gone concern" considerations as discussed above would suggest that at most a partial deduction against Tier 2 capital is appropriate.

The IIF supports making a distinction between DTA categories, namely between DTAs based on timing differences and DTAs based on tax losses carried forward. This would more accurately reflect the actual behavior of DTAs, and also avoid the issues of offsetting DTLs that may also arise from timing differences.

Thus, any deduction should only be considered for tax losses carried forward, and such deduction should appropriately be taken from Tier 2, gone-concern capital.

Should the Committee *not* accept the concept of making any deduction against Tier 2, as the Institute recommends, DTAs relating to tax losses carried forward could be deducted, presumably from the predominant form of capital, but only for the portion exceeding a threshold to be determined, with such a threshold being defined as a percentage of Tier 1 capital. Including such a threshold for deduction of DTAs related to tax losses carried forward would at least move the proposal in the direction of better reflecting actual economics, and would be congruent with current practice in some countries.

- Own-Share Positions - *Paragraph 100*. The proposed provision on treasury stock has been overly simplified and needs to be reconsidered to take into account a number of important considerations. The requirement that gross long positions may be deducted net of short positions only if the short positions involve "no" counterparty risk is unrealistic and probably impossible to attain on a meaningful basis, yet it reflects conservatism that would ultimately be destructive both of good internal risk management and of many policy goals. For example, a transaction settled against a CCP would have some degree of counterparty risk to the CCP, but surely this should be excluded. More broadly, collateral and other standard risk mitigation techniques should be recognized within otherwise-applicable Basel rules: the full deduction here, especially with stringent counterparty rules contemplated elsewhere in the revised Accord would result in additional, redundant conservatism.

  For example, where a short position is taken through a collateralized OTC transaction (which involves counterparty risk), the collateral is disregarded, shorts and longs are not netted, and the resulting very large net delta leads to wholly disproportionate capital requirements. The rationale appears to be an assumed correlation between the exposure of the bank to the counterparty with respect to the short exposure and the default of such counterparty. There is no strong argument for disregarding short positions when looking at the net delta exposure of the trading book. Some short exposure involving counterparty risk is not entered into with banks and hence not subject to the wrong-way risk that this appears intended to capture. Even where the short exposure is with a banking organization, specific or general wrong-way risks are already addressed in Basel II or proposed amendments, and so do not need duplicate coverage here[21] The proposal would result in multiple layers of double counting of exposures, and thus in significant, redundant capital requirements within the banking sector. This in turn would make trading positions on banking stocks unaffordable given the overlaying capital requirements, harming markets at a time when robust markets for bank securities will be needed, precisely to make it possible for banks to meet new capital requirements.

  The requirement to look through index securities poses a number of problems. It would discourage activity in index securities that are useful to the market for a number of purposes, and that tend to augment rather than detract from sound risk management. For the most part, firms active in trading or market-making of index securities will typically have balanced long and short positions, which facilitates market liquidity; here it appears that the long but not the short would be recognized, leading to an imbalance. If it is deemed necessary to maintain some version of the rule, then balanced positions should be distinguished from outright long positions. Moreover, care would need to be taken to avoid double-counting with other capital requirements in the system.

  Finally, the deduction of net short exposure with no counterparty risk could significantly burden the system, as discussed further with respect to *paragraph 101*.

- Other Financial Institutions - *Paragraph 101*. The proposals regarding deduction of investments in the capital of other financial institutions outside the regulatory scope of consolidation are of concern because they propose blanket rules that are not risk-based and

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21 This appears to duplicate the coverage of *paragraph 164* on specific and general wrong-way risk.

overshoot the legitimate concerns expressed. Of particular importance is the need to exempt market-maker activities from the scope of any such section. As it stands, the resulting diminution of market making could be a significant issue for the sector as whole, not least for small banks, which need markets to be made in their securities, and for investors such as mutual funds, for whom active and liquid markets are a major investment criterion (and whose appetite for bank paper would be correspondingly diminished if markets were less liquid). In addition to this fundamental point, the paragraph raises a number of questions of direction and purpose.

While the concern about “double counting of capital” makes some sense with respect to investments in other banks, it is not appropriate to extend the same treatment of deduction from Common Equity to insurance companies. Insurance-company risks are on the whole not correlated with banking risks – the nature and time horizon of insurance and banking risks greatly differ - and thus the risk-based justification for the proposal is not obvious.

There is no reason why the bancassurance business-structure option should be penalized, as proposed, through the capital rules. Bancassurance combination of insurance and banking activities continues to be attractive in some countries, permitting both competitive pricing for clients and significant diversification of financial groups. Even where risks in the two sectors could be considered similar, they seem mostly negatively correlated (for example, interest rate risk affects asset-liability mixes quite differently, given long liabilities in insurance companies and long assets in banks).

The proposal to deduct the full amount of equity investment in insurance companies also appears to indicate an assumption that the insurance or other business would have a zero value in a stressed going-concern situation. Yet any substantial insurance or other financial business would have a demonstrable value and there has historically been a market for such businesses, which indicates that this is not a reasonable assumption. While it might not be obvious to value such a business under stressed circumstances, nevertheless there will almost always be substantial value to be realized, in part because of the regulation under which insurance companies operate.

Moreover, where there may be concerns regarding double-counting, the issue is dealt with in other ways in many countries, through conglomerates regulation or otherwise. Joint Forum work on conglomerates regulation,[22] as translated into conglomerates supervision established in binding regulation, as in the Financial Conglomerates Directive of the EU, has proved effective to manage such risks.

The full deduction of insurance holdings is thus not appropriate and it would be preferable to use the well-established Joint Forum work as the basis of the international capital regime.

In addition, the Committee should carefully consider an appropriate treatment of investments in industrial leasing companies and whether true correlation with financial institutions exists. Only after careful assessment of this issue a final decision on deductions should be made

[22] See the compendium of documents published by the Joint Forum at www.bis.org/publ/joint02.htm.

A number of banks hold common stock of other financial institutions to hedge stock-based compensation programs and other business strategies. The intent of such holdings is risk management, not reciprocal or sister-company arrangement. It is difficult to see why such holdings undertaking for hedging purposes should be subject to these requirements.

Similarly, where there are offsetting short or derivative positions for positions in other financial institutions, these positions should be netted against the long positions to make the capital impact risk base, with the normal trading-book and counterparty-risk capital requirements being applied; the proposal here seems to create an unnecessary and punitive duplication.

Moreover, the proposed deduction unduly discourages investments in overseas markets including emerging markets where foreign banks are restricted to minority stakes. Investments in overseas financial institutions should be excluded from globally applied regulatory adjustments to maintain or create sound incentives for capital alliances and contribute to a stable and integrated global financial system. The present proposal would be for many banks an obstacle to strategic decisions with respect to alliances, acquisitions of other banks (especially weaker banks) in stages, or investments subject to constraints on maximum investments by foreign banks. In addition, if an appropriate adjustment is not made, existing investments should be fully grandfathered to avoid unnecessary disruption in the financial markets. As with the minority-interest deduction, this will only create disincentives to desirable investments, which in the Institute's view would outweigh the rather theoretical reasons advanced for the proposal. Reinforced supervision and Pillar 2 dialogue could be ways of balancing the goals of the proposal against the detriments of its overly broad application, to achieve a more risk-based result.

The Institute also believes the second bullet in the box above *paragraph 101,* "common equity in other financial institutions" should be clarified as follows: "Other financial institutions (excluding common stock in a financial institution which exceeds 10% of the common stock of the financial institution)". This seems to be the intent of the Basel Committee, but the point should be clarified. The stock excluded has already been fully deducted per the bullet directly beforehand.

Certain cooperative and savings banks or other special-company structures are substantially integrated by brand name and governance, but are structured through cross-holdings and guarantees of entities within an overall structure that is nevertheless substantially integrated economically. These banks have deep roots in their sectors and provide services on a well-established and well-understood business model. These banks will require adjustment of the rules on consolidation, but this can be done without compromise of the supervisory goal of preventing abuse of capital structures. Exemptions should be granted on a transparent basis, so that other regulators and investors understand them. Such adjustments would be analogous to the exceptions for non-joint-stock forms of ownership foreseen at various parts of the Consultative Document and, if done with care, should serve to put such institutions on a comparable basis with their commercial competitors, without disfavoring a form of organization that has long served their markets.

Finally, concerns stated with respect to *paragraph 100* regarding the look-through of index securities and non-netting of short positions are applicable to the last bullet in this paragraph as well.

- Shortfall of Provisions - *Paragraph 102*. It is difficult to comment on the provision in regard to the shortfall of provisions to expected losses given the uncertainty about future provisioning rules under both IFRS and US GAAP. Certain outcomes of that debate could bring very substantial shortfalls, the effects of which would have to be reconsidered. The effects of such shortfalls would thus have to be assessed as part of the overall assessment of the impact of other capital changes, buffers, and liquidity effects. A read-across to the proposals referring to average historic PDs or downturn PDs (discussed at *paragraphs 66-68*) would also be necessary.

  Full deduction under various combinations of circumstances possible under proposed prudential accounting rules could result in additional cyclicality and perhaps overshooting of prudential goals. Depending on how the accounting comes out, an excess of provisions over EL may not in fact indicate a needed correction of regulatory capital. A shortfall would occur in an economic recovery, when a forward-looking view of provisions would result in materially lower amounts than the EL calculation for capital purposes, based on stressed parameters and past history. The shortfall deduction would thus be duplicative of the capital (and possibly additional buffer) requirements, burden recovery and, moreover, would appear to override the accounting treatments in an unnecessary way.

  As part of sorting out the cross-currents of possible new regimes, it is important to keep in mind the judgment included in any provisioning regime, which (to be less procyclical) will need to be more forward looking. A full deduction regime may in fact be antithetical to the goals of the new provisioning and buffer rules, depending on how they turn out, and they could end up compounding the burdens on recovery and undermining buffer proposals. Depending on how the accounting debates turn out, the Committee may need to give additional consideration to level playing field issues.

- Inclusion of Provisions - *Paragraph 103*. The appropriate conclusion with respect to the current cap on inclusion of provisions in Tier 2 capital depends in large part on the outcome of current debates on accounting provisions and buffers. However, it appears likely that if accounting provisions are substantially higher, the full amount thereof, without caps, ought to be available for capital-buffer purposes; this is especially so if, as is possible, banks generally have substantial provisions in excess of EL (except perhaps in the recovery phase described in the discussion of *paragraph 102*). It is notable that much of the international discussion of buffer concepts has tended to conflate buffer and provisioning effects; even if kept analytically separate, buffers and any version of more forward-looking provisioning should generally be complementary, so the removal of caps seems logical.

  Furthermore, any adjustment that is retained should be net of tax effects.

- Own-Credit Risk - *Paragraph 105*. The proposal expansion of the filter to cover gains and losses owing to changes in own credit risk on all liabilities that are fair valued appears well

advised in principle; however, it will be necessary to take account of the significant changes being developed by the accounting standard-setters.

- Pensions - *Paragraphs 106-7*. As in other parts of this discussion, the treatment of pension assets and liabilities is highly influenced by national rules and requirements, as well as market custom. Moreover, the treatment of pension liabilities and assets will change substantially in coming years under IFRS. It is important to point out the proposed approach, with pending accounting changes, will create a great deal of added volatility, reflecting current-market fluctuations that are unlikely to be meaningfully reflective of what are intrinsically long-term obligations. Given the Basel Committee's desire to reduce procyclicality in the capital accord, it seems especially anomalous to introduce a new dimension of cyclicality, especially one that bears little relation to the underlying economics.

  The proposal to apply no filter to defined benefit pension fund net liabilities raises the question of whether the accounting treatment under IAS 19 is an appropriate method under which to consider the impact of defined benefit pension scheme obligations on regulatory capital adequacy. While there are two permitted treatments within the current IAS 19, the 'corridor approach' which serves to partially dampen the volatility of the accounting treatment of gains and losses is not universally adopted by IFRS reporters, and is proposed to be removed in future. Accordingly, this response considers the other approach, whereby actuarial gains and losses are recognized in full in the period they occur within Other Comprehensive Income. Under IAS 19 the measurements of plan assets and defined benefit obligations at each balance sheet date are highly volatile, being sensitive to point-in-time fair values of plan assets, and point-in-time corporate bond yields, respectively. These movements bear little relation to the actual funding requirements from the Bank, which are agreed to fund what are essentially long term liabilities, and which we believe have far greater relevance in the context of measuring capital adequacy. In considering the proposed deduction of any net defined benefit pension fund asset, we note that recognition of such an asset would require that the asset is recoverable by the company, although it is acknowledged that recovery may be over a long period of time depending on the scheme rules and circumstances, and that the measurement of the asset under IAS 19 is beset by the same issue of sensitivity to point-in-time fair values of plan assets and bond yields.

  The above accounting treatment would have procyclical results when used in the regulatory capital adequacy context, for example during the onset of a financial crisis when the fair values of plan assets fall, and interest rates in general would tend to fall, increasing the present value of the defined benefit obligations as reported under IAS 19. When economic conditions improve, large reported net liabilities can reduce substantially in a relatively short period of time.

  The volatility associated with the IFRS methodology and assumptions would argue for a more stable and scheme specific valuation methodology, which in many instances is in fact prescribed by local regulation or statute. Such assessments, undertaken every year or at the least every three years, deliver a liability value that is reflective of the expected return on the scheme's underlying assets and includes agreement on funding of any disclosed deficit. An alternative might be recognizing the quantum of agreed payments under such plans,

(currently limited to a five-year rolling period), as a deduction from Tier 1 capital. This might deliver a more stable deduction, capable of review and adjustment at successive assessments, and reflective of actual scheme experience; however, in designing any such approach, care would need to be taken to avoid double counting possible under some accounting treatments where the pension deficit is recognized in shareholders' equity, and hence in Tier 1 capital.

It is important to point out that treatment of pension assets and liabilities is likely to matter only in insolvency (gone concern), so that deduction exclusively from Tier 1 capital may contribute excessively to volatility and fail to recognize the allocation of pension burdens between the going concern and possible gone-concern claims. Further guidance from the regulators and accounting setters will be required to work out appropriate treatment and measurement of pension issues without exacerbating procyclicality. In particular, there are choices to be made between the measures of pension liabilities; the solvency approach, the going concern approach and the funding or accounting approach: these may yield rather different results.

The analysis should distinguish situations in which an employer is liable for the shortfall of a pension fund, which is not always the case, even in a "gone-concern" situation. In such cases, the volatility resulting from the capital treatment would distort the view of how much loss-absorbing capital is actually available. Where an employer is only liable for payment of contributions, the accounting effects should be ignored, except for contributions owed. Similarly, where the amount owed is based on actuarial, rather than accounting amounts, the actual economic liability should be used for capital purposes.

The proposed rule will have a disproportionate effect in certain countries, such as Japan. Insofar as pension assets represent merely a difference between actuarial claims and present value of related assets, supervisory permission to forego the deduction as envisioned in the proposal is appropriate, and should not be too narrowly construed, for fear of unanticipated consequences. Among other things, unduly burdening traditional pension plans may penalize countries and institutions that have continued to emphasize salary-based compensation complemented by pensions, as opposed to variable compensation, which would be a paradoxical result under present circumstances. [

- 50/50 Deductions - *Paragraph 108*. The proposed change from the current 50/50 Tier 1/Tier 2 deduction rule to a 1250% risk-weighted asset requirement will have perverse and no-doubt unanticipated consequences. The problems with this paragraph have a simple solution: cap any deduction at 100% of the exposure equivalent.

  The proposed rule could have the effect in many cases of creating a capital charge on an investment that would exceed the risk exposure itself, if a particular country required a higher minimum capital than the internationally agreed level. More basically, the deduction is not mathematically equivalent except at the 8% level; therefore, in what should be the usual case, where firms are well above that level, the charge will be excessive.

Given the other changes affecting securitization, and the widely acknowledged need to revive securitization markets, the penal treatment of securitization constitutes both double-counting and a wrong incentive.   This could be the last straw to needed securitization structures.

While the proposed treatment of non-DVP and non-PVP transactions may be understood as an inducement to move to DVP and PVP, which are appropriate goals in general, it should also be kept in mind that DVP and PVP are not always feasible or indeed necessary, and the proposed a priori approach is both too harsh and not risk based.   A more analytical approach, and possibly grandfathering to give markets the chance to adjust in an orderly fashion, is indicated.

With respect to equity and commercial investments, it may be again the case that investments in emerging markets will be hit disproportionately, and it is not at all clear why more than 100% deduction would be appropriate. This provision needs to be reconsidered in tandem with the deduction for minority interests.

- Disclosure - *Paragraph 109*. The issue of "full" disclosure of private-placement investments is discussed above.

Capital Appendix B

Counterparty Risk Issues

The associations (IIF, ISDA and AFME) believe that it is appropriate to review the treatment of counterparty risk, together with its measurement and management, in light of experiences in the period from 2007 on. It seems clear from these experiences that a regime that encourages more accurate and realistic assessments of the level, variability and drivers of counterparty risk is desirable, including such crucial factors as wrong-way risk. At the same time, the regime can usefully recognise where firms hedge counterparty exposures and their variability.

To put the issue of counterparty risk in perspective, we believe it is vital to bear in mind that:

- losses realised because of outright defaults were very effectively contained and mitigated by the operation of netting and collateralisation;
- Losses were also realised because of declines in the value of marketable securities, notably because liquidity dropped across the system as a whole, as a result of concerns about creditworthiness more generally – not counterparty risk exclusively.

We note the Basel Committee's desire to see greater and better aggregation of exposure at counterparty level and agree that this is a *sine qua non*.

A closer analysis of the 2007-09 experiences reveals some important aspects of how an improved regime could, in industry's view, best operate. This would not only set the overall level of capital appropriately, but also allocate that capital proportionately to the various components of risk, while avoiding:

1. double-counting (whether with existing measures or as between the current set of new proposals); and
2. arbitrary increases (i.e., ones that are not risk-sensitive and which therefore incentivise behaviour that is at odds with the stated aims of the CP).

CVA

We focus particularly on CVA, where we believe that the 'Bond Equivalent' approach violates both these principles in certain ways. As a general principle, we feel that there should be due recognition where firms hedge risk in a demonstrably prudent fashion; and that the proposed approach does not satisfactorily mesh, either with the factors that drive exposure (or, therefore, ways of hedging that exposure) or with credit-risk hedging practice. To formally state the key principle, therefore:

A firm that reduces its economic risk to the default of a counterparty should post less capital than another firm with the same economic exposure that chooses not to hedge. The reduction in capital should be commensurate with the reduction in risk; and there should never be a capital dis-incentive to reduce economic risk.

We also note in regard to this issue the consultation's observation (in Par 120) that "over time, CCR should…be treated in an integrated manner with market risk" – something that the Bond Equivalent approach does not achieve.

At the same time, it is clear that 1) different firms (or parts of firms) experience different degrees of balance-sheet impact from CVA changes and that (as we set out in some detail in our response) different approaches to a CVA charge could be adopted accordingly; 2) that the CVA charge will only work effectively to influence behaviour if analysed jointly with other elements of the capital regime, notably charges for jump-to-default and expected loss.

Put another way, important as it is to set the *overall* level of capital that banks hold, it is vital also to get the right *allocation* of that capital, relative to the nature and size of the underlying economic risks. This appears particularly relevant in the case of a CVA charge. If the capital rule is simplistic and risk-insensitive, it will distort relative prices and will create uneconomic incentives that will lead capital-optimizing banks to pursue strategies that are sub-optimal (and could ultimately result in large costs to society). It is better to have risk-sensitive models, whose results are scaled appropriately to reach the desired level of capital, than blunt rules that assess capital on an idiosyncratic basis to each activity and arbitrarily fix the relative amount of capital, irrespective of the actual underlying economic risks.

Firms' analysis clearly shows already that the impact of the CVA charge, as set out in the December 2009 proposal, will be non-trivial. While we recognise that the full, detailed QIS will be important in validating this, we believe it important to make it clear now that, on its own, the CVA charge will demand that significant new capital be raised, with even the most modest impact assessments representing a whole-number multiple of current counterparty-risk charges, *after* hedging. At the same time, quite clearly it is business with end-users that will attract the largest CVA charge (since portfolios with end-users are those most likely to entail significant open positions). Assisting corporate customers in managing risk is a basic banking function. The impact of the current proposals on the costs and availability of hedging services is likely to be economically significant. Moreover, these increased costs will affect firms whose main business does *not* consist of taking interest rate, foreign exchange or other financial market risks, and the effect will be proportionally larger for smaller end users. These are factors that should be considered when the Committee decides on revisions to its proposals.

We further note i) the double counting with the existing treatment of maturity in Basel II and ii) the ultra-conservative nature of the bond equivalent.

Industry firmly believes that the deficiencies of the bond equivalent approach run much deeper than questions as to how it is calibrated. Merely adjusting the scaling factors, for example, would not address its shortcomings, because it would remain misaligned with both risk and the hedges of that risk. It might, of course, be possible in theory to re-engineer the bond equivalent approach, taking due account of the ways in which it is deficient and addressing each of them in turn. In practice, though, this would constitute no more than a modest step in the direction of the risk-sensitivity that we advocate in this response.

In summary, among the many overlapping counterparty risk measures, the CVA charge raises the most questions. We note that the charge:

a) appears to have a disproportionate, multiplier impact on charges for counterparty risk;

b) is, via the 'bond equivalent', risk-insensitive and so does not mesh well with hedging practice;

c) does not reflect the current variety in balance-sheet impact registered by firms, under diverse accounting regimes;

d) could, in principle, reflect the modelling of CVA together with other trading book risks.

Our response on CVA is built on the premise that (demonstrably prudent) hedging of counterparty risk should lead to a lower capital charge. This would include some recognition of hedging of the systematic component of credit spread risk. We also note the double counting with the existing 'maturity adjustment' in Basel II and the ultra-conservative treatment of maturity within the bond equivalent.

Stressed EEPE

On Stressed EEPE, while we recognise the overall objective, we believe greater clarity is needed as to the role that could be played by a) back-testing and b) the Pillar II stress charge.

Asset Value Correlation

As regards Asset Value Correlation, we believe that the incentives for looking at this, as well as the calibration merit further careful consideration. The measure allows for no distinction between quality of financial counterparty; and appears to ignore the changes in practice as regards collateral and central clearing, which mitigate and reduce the 'interconnectedness' the charge is presumably targeting. It is hard to comment more fully, without access to the data on which the Committee has based its proposal. We do, however question the inclusion of a strong *dis*-incentive for financial firms to face each other, particularly when the liquidity regime already strengthens firms' resources, let alone the further measures that are contemplated in relation to systemically important banks (*paragraph* 47).

On all of these items, more detail follows. We also take this opportunity to mention briefly some points on some other issues.

Overall

Overall, we would note that the CP contains a very large number of measures, each of which may have some merit in its own right but whose integrated, cumulative effect is not yet clear. If, taken piecemeal, the effect is to put a strain on the economy (because of a need for increased capital raising, *whatever* the stage of the economic cycle) and to damage the effectiveness of risk-transfer markets, we do not believe either outcome to be desirable.

Clearly, there is scope within the QIS exercise to take stock of relative allocations, as well as overall levels of capital (taking into account the changes to the Trading Book treatment, published in July 2009). We assume that will take into account the incentive issues we mention in this response.

CCPs

For CCPs, we believe that there has been a clear and demonstrably strong move towards central clearing, which was accelerated by but not fundamentally driven by the crisis. We fully accept that there should be a relative incentive to face a CCP (provided, of course, that the CCP adheres to reasonable international standards set by CPSS-IOSCO and, in particular, does not undertake the clearing of contracts that would be inherently unsafe to clear centrally). We would, however, caution against penalising contracts that are not centrally cleared, since by definition this would include the very tailored contracts that are most valued by end-customers.

With regard to CCPs, we would note that *paragraph* 121 switches terminology from 'zero EAD' to 'zero percent risk weight' part way through, and would suggest that 'zero EAD' captures the desired intent.

Margin period of risk

Increasing the margin period of risk makes sense for portfolios that include illiquid transactions (or collateral). We suggest, however, that the introduction of materiality thresholds and note that a large portfolio is not necessarily synonymous with difficulty in valuing contracts or replacing them (particularly on a net basis, using risk-factor assessments). Moreover, industry has made significant progress in implementing both portfolio reconciliation (obviating disputes about trade *population*) and dispute resolution (addressing disputes about trade *value*)[23]

Securitisation in repos

We further note that penalties for using securitisations in repos will slow the access of firms to alternative sources of funding, which in some cases may prolong the burden on the taxpayer. This is particularly important since repo of securitisation tranches can work well, as has been the case in 2010; in other words, while it is important to reflect experiences from stressed situations, it is right to recognise these as extreme rather than the norm.

1. ***CVA***

Capitalizing for Unexpected Loss Arising from Variation in CVA

BCBS 164, page 5, paragraph 21, "Banks will be subject to a capital charge for mark-to-market losses associated with a deterioration in the creditworthiness of a counterparty. While the current Basel II standard covers the risk of counterparty default, it does not address such CVA risk, which has been ***a greater source of losses than those arising from outright defaults****."*

BCBS 164, page 28, paragraph 114, "Mark-to-market losses due to credit valuation adjustments were not directly capitalised. Roughly two-thirds of CCR losses were due to CVA losses and only about one-third were due to actual defaults."

BCBS 164 correctly references the large losses faced by (numerically) a small proportion of the overall industry. It attempts to characterise these risks with a single approach, that will (per *paragraph* 20, page 5) "provide incentives to strengthen the risk management of counterparty credit exposures." The industry concurs with this goal, with particular emphasis on recognising demonstrably effective hedges of such exposures. However, it is already clear the impact of the charge as currently drafted will be disproportionate. Moreover, capital requirements should assess the propensity for the unhedged portion of a trading or banking book risk to generate unexpected losses. The capital requirements themselves should not introduce new risks, and firms should certainly not be penalized for hedging. Without recognising the differentiating factors within the industry that drive management of, and practices around CVA, the consultative paper both introduces new risks (through an unhedgeable, procyclical, spread-sensitive capital charge); and fails to incentivise prudential risk management and hedging where appropriate. Depending on the exact impact, it may also reduce the availability of hedging services to the real

[23] viz: www.isda.org/c_and_a/pdf/ISDA-Collateral-Committee-Dispute-Resolution-Proposal-Briefing.pdf.

economy. Industry analysis already suggests that, as currently proposed, the CVA charge *on its own* will be likely to require firms to raise new capital.

The intended goals of the industry, as reflected in this response, are:

- Recognise that a firm which hedges against changes in credit should face a lower charge than one that does not.
- Ensure a charge that is proportionate to the risk.
- Recognise the progress made by the industry during, and since the crisis to address the proper characterisation and measurement of the risks faced.
- Recognise the need for demarcation of trading book and banking book treatments for CCR.
- Recognise that where firms assign positions differentially to trading and banking book, different capital treatments may be necessary.
- Progress towards a capital framework across trading and banking book that does not penalize hedging.
- Progress towards a capital framework where the sum total of capital components is reflective of the overall balance-sheet risk faced by firms over a one-year horizon.

Preliminary estimates from the industry suggest that the proposals could result in a very large increase in counterparty credit risk capital, even where largely hedged. This is disproportionate to the risk. The bond equivalent CVA defined by the CP is also disjoint from the real balance-sheet risks faced by firms, and represents a blunt tool with which to increase capital requirements. The industry clearly recognizes, and fully accepts the requirement to appropriately capitalize for *unexpected* variation in P/L arising from movements in the CVA. We also note, however, that since the crisis, tens of millions of dollars have been spent increasing the risk management capabilities at all firms.

Central to the industry's argument is the recognition that, where *marked-to-market*, counterparty credit risk is a *trading book* risk; where the risk is accounted for using non-market based approaches, it is a *banking book* risk. Firms should not be penalized for hedging in the capital constructs and, when comparing the same portfolio with the same counterparty across two firms, the firm that has existing hedges should hold less capital than the firm that does not. However, care must also be taken when comparing different firms on different treatments (trading book or banking book).

On the Validity of "*Same Counterparty, Same Portfolio = Same Risk = Same Capital*"

It is clear that the loss distribution arising from default at some future date T is theoretically dependent only on the counterparty credit and the portfolio of derivatives. However, the moment we introduce a risk horizon $t < T$ and ask ourselves, "What is the capital required to buffer the firm against unexpected variation in P&L until t?", then the balance-sheet risk (and hence capital requirement) faced by the firm depends directly on its choice of market-value adjustment. The more volatile the measure, the greater the need to hedge the measure, in order to avoid bankruptcy between today and time t. Of two firms opting for different treatments (trading/banking book), if one firm cannot survive to time t, it is irrelevant that ultimately the loss distribution is the same for both upon default of the counterparty.

This undermines the quoted principle above: It is therefore precisely the difference in chosen approach that led to the mark-to-market losses referenced by the CP; it is also why a single approach may not truly be able to 'look through the accounting' and describe the potential for unexpected variation in P&L over the next year.

Globally, firms opt for one (or more) of four approaches to the problem of provisioning for expected counterparty default loss.

1. No adjustment.
2. A through-the-cycle adjustment, based on expected exposure and a historic loss-norm, calibrated from firms' histories of PD and LGD experience.
3. A market-implied adjustment to the mark-to-market of the derivative contracts in question.
4. A model-based, forward-looking EL adjustment, calibrated to estimates of PD that use both CDS spreads and historic values as input to the model.

Within each firm, different treatments are applied. These treatments are reflective of the relevant accounting standards that apply; these broadly follow IFRS outside the US, or FAS within. Rarely is a single approach ubiquitously applied across a group; BCBS, in applying the proposal across the board, fails to recognise that potential balance-sheet losses, arising from unhedged variability in CVA, are limited to the scope of application of each method. Firms simply will not register the impact that the proposal, as a broad measure, intimates. Moreover, in creating a third (yet another) valuation of expected loss[24] through the bond-equivalent CVA, the proposal creates fictitious risks that are not present in the way risk is valued or hedged in firms today.

One area of particular focus must be the maturity adjustment in the existing Basel II framework. As detailed in the BIS publication, *An Explanatory Note on the Basel II IRB Risk Weight Functions*, the maturity adjustment was calibrated to incorporate the 'mark-to-market valuation of credits'. In particular, it relates to 'potential down-grades and loss of market value of loans'. To some extent, therefore, this already captures some of the sensitivity of the CVA. The consultative paper goes further in trying to isolate the spread sensitivity, and to some extent, the cross-sensitivity of CVA to both market and credit movements, but fails to address the maturity adjustment.

The remainder of this CVA-focused comment is as follows: We look first at the Consultation's proposal against these goals through the bond-equivalent CVA. We then discuss, in turn, the banking book and trading book. We look at how the sum of capital components must make sense, and then consider the nature of fallback approaches. All approaches are dependent on the recognition of the reduction in jump-to-default risk from single-name credit hedges (and equivalents). Therefore, we follow the main proposals with a discussion of single-name default swaps. Whatever the chosen approach, we recognise the need for a framework where the underlying assumptions of diversification behind the EPE measure are well-founded, and specific wrong-way risks are addressed more fully.

The Bond-Equivalent CVA

[24] Besides the actual accounting definition and the regulatory expected loss.

A new standalone, credit sensitive capital charge creates multiple undesirable consequences and, contrary to the stated intention of the CP, *reduces* the incentive for firms to prudentially manage and/or hedge their risk. We consider a few of the implications here.

For firms with no CVA, the proposal to capitalise CVA in this way bears few similarities with the real risk. Indeed, the proposal actually creates new risks for these firms, and will spur the need to hedge regulatory capital in markets that simply may not support the necessary credit instruments (which will drive 'skew' in credit indices). These firms treat CCR as a banking book risk, and the EAD framework and maturity adjustment provide adequate accounting in the capital calculations.

For firms applying a through-the-cycle adjustment, it is clear that they do not have this spread risk either; rather, it is the risk of rating transition or downgrade in the loss-norm that largely drives an adjustment through net income. The stability of their PD and LGD estimates drives the potential for loss associated with deterioration in creditworthiness of their counterparty. Again, the fictitious risks created here will skew credit markets.

Moreover, it is important to recall that the through-the-cycle approach to CCR is conceptually identical to the standard approach of the wholesale loan portfolio. It is also the underlying assumption of the current IMM rules for CCR. Of course, the one material difference between a loan portfolio and a CCR portfolio is the dynamic and stochastic nature of CCR exposure. That is already captured and modelled in the IMM via (α x EEPE) and the effective maturity M.

If the proposal was adopted verbatim, a firm with no CVA, or one opting for a through-the-cycle methodology, would quickly find itself running a large, potentially unhedgeable, *procyclical* CS01 risk in its capital charge. The very reason the firm opted for the approach in question is likely the lack of a deep market for single-name hedge instruments for the counterparty risk in question; one might extrapolate that the firm would be forced to hedge the new charge with index positions if available — however, the index hedge (being excluded from the bond-equivalent CVA calculation) would, itself, become an unbalanced market risk in the firm's trading book charge (either VaR or SMM), requiring additional capital!

For firms applying a market-implied CVA, the Consultation ignores the fact that spread sensitivities are, by definition, already available from the calculation of CVA. The proposal in the CP also creates a bond position which materially differs from the economic risk faced (see Appendix 1). In particular, the Consultation approximates the credit sensitivity as a function of exposure only (EAD and effective maturity), when in reality, the spread sensitivity is a function of exposure *and* prevailing spread. As outlined in Appendix 1, it is also clear that the sensitivity of the CVA to changes in market rates is equally important as the spread sensitivity. A firm with a market-implied CVA would therefore see every hedged position become unhedged for capital purposes, due to the difference between the real CS01, and the fictitious risk of the bond equivalent.

Critically, all market vectors and many credit sensitivities would also become unbalanced in the market risk VaR, suggesting a potential for trading loss that is not reflective of the real risk. In stable, low-spread environments, the principal sensitivity of the market-implied CVA is to market vectors and the vega-risk represented by the exposure profile; in volatile, high-spread environments, the sensitivity is geared more to the joint movement of credit and market vectors (with the market sensitivities converging to that of the underlying derivative in the limit).

Carving out the single-name hedges from VaR leaves behind a significantly misrepresented, unbalanced risk in the trading book VaR.

In general, the rationale for a standalone VaR is flawed; there are a multitude of instruments that provide economic offset to CVA movements, in particular when the idiosyncratic risk of jump-to-default is carved out, as it is with the banking book treatment of EAD. Furthermore, the bond-equivalent prescription misstates, and potentially understates, the market-sensitivity of the CVA.

All standalone VaR approaches create opportunities for arbitrage, and in marked contrast to the CP, the focal point should not be so much the perception that VaR of CVA conceals risk, but rather the assessment of the jump-to-default measure against:

- The implicit diversification assumptions and the potential for concentrated risks.
- The potential for wrong-way risk.
- The correct calibration of the maturity adjustment to capture market sensitivity of the CVA.

Furthermore, the annualisation (5x) and scaling (3x) embedded in the proposal are not consistent with the trading book regime, with which the CP seeks to attain alignment. The rationale for the scaling in the trading book VaR equates to a 99.9%, one-year principle, with which the industry agrees. However, the two scaling factors put this approach well beyond that tail estimate. For a normal distribution, the 99.9%, 250-day VaR is circa 6.6 times the 99%, 10-day VaR; *not* (5x3 =) 15 times. Taking into account the addition of Stressed VaR, and the reality of fat tail effects, this is an extreme measure.

In summary, therefore, the bond equivalent CVA:

- assumes that spread risk hedges are most important, whereas industry analysis (*see Appendix 1, Example B, Table 1*) suggests that rates and volatility hedges together are generally larger in magnitude than spread hedges;
- entails double counting with the maturity adjustment in the existing Basel II framework;
- does not recognise the difference between trading and banking book approaches to the management of risk;
- further penalizes hedging by isolating the single name hedges; and,
- with no corresponding adjustment of jump-to-default risk for the benefit of hedges in the banking book construct, is strictly additive to the capital.

Industry therefore firmly believes that the deficiencies of the bond equivalent approach run much deeper than questions as to how it is calibrated. Merely adjusting the scaling factors, for example, would not address its shortcomings, because it would remain misaligned with both risk and the hedges of that risk.

It might, of course, be possible in theory to re-engineer the bond equivalent approach, taking due account of the ways in which it is deficient and addressing each of them in turn (as illustrated below). Once one goes down this route, however, it logically and rapidly leads one towards the market-implied approach we outline in this response, or its banking-book equivalent.

1. The additional capital charge could be calculated based on the actual CS01 of the firm wherever possible:
    a. For firms that calculate a market-implied CVA, use the actual CS01.
    b. For firms that calculate a through-the-cycle CVA, the CS01 should be scaled accordingly.
    c. For firms that do not calculate a CVA, but do have an IMM permission, this can be inferred from their EPE profile.
2. For firms with a VaR approval for general and specific market risk, subject to national supervisory permission, the charge should be based on a suitably conservative integration with the existing VaR, or on a standalone basis otherwise.
3. The charge could be based on 10-day VaR and Stressed VaR, but not IRC.
4. The 10-day VaR and Stressed VaR could be scaled by 3, to be consistent with the market risk standard, and to avoid arbitrage of the rules.
5. For those firms with an IMM permission under the IRB framework, and for whom the integrated VaR is permitted, the effective maturity should be set to 1 in the calculation of the jump-to-default, EPE-based capital component, since the market sensitivity of the CVA is captured in the VaR.
6. For those firms with an IMM permission under the IRB framework, and for whom the integrated VaR is not permitted, the effective maturity could be recalibrated to isolate only the market sensitivity of the CVA.
7. Any such approach could work at the level of netting set, rather than counterparty. This mirrors the calculation of counterparty credit risk capital and ensures greater sensitivity to amounts that would actually be realised through netting. Moreover, the maturity of the 'bond' could be the capped effective maturity, as 5 years is a reasonably long forecasting horizon and the CDS market is not necessarily so liquid for transactions with a maturity significantly longer than 5 years.

For Firms Opting for a Banking Book treatment for CCR

Firms that apply banking book treatment to CCR are not necessarily subject to the same balance-sheet risks over a one-year horizon as those applying an unhedged trading book treatment.

Ubiquitously, firms should defend the assumption of diversification underpinning the EPE framework if they choose to apply it, or look to alternative measures to capture concentrations of, or specific wrong-way risk; the CEM approach naturally errs towards a higher measure of EAD, whilst the EPE framework has the alpha multiplier. The fragmented, piecemeal approach taken by the Consultation to addressing these fundamental issues clouds the overall assessment of whether the risks are adequately capitalised.

Firms with no reserve methodology are not subject to the same volatility arising from a variation in reserve, but are exposed to the full jump-to-default distribution. Under *paragraph* 43 of International Convergence of Capital Measurement and Capital Standards, the addition of regulatory expected loss to Tier 1 and Tier 2 capital requirements provides the basis for an adequate capital measure, when combined with the EAD-based measure of jump-to-default risk, and the full maturity adjustment M. However, the industry does accept that the overall

incentives of this approach are not yet aligned with the stated aim of strengthening risk management practice.

Firms with a through-the-cycle approach are subject to variation arising from changes in exposure, PD and LGD. The industry has developed the CVA Variability Charge (CVC) proposal to address this. The stated aims of this proposal are, in addition to those above:

- Model to capture the unexpected loss of potential variability in CVA due to changes in quality of counterparty.
- In keeping with the bond-equivalent CVA, the expected exposure profile remains constant.
- Soundness standard of 99.9 percentile 1-year, in line with the banking book treatment under Basel II.
- Aim for a stable capital charge, in line with the through-the-cycle approach.
- Incorporate credit correlations explicitly in the model. Stress testing can then help identify the impact of wrong-way risks.
- The single name hedges can be directly modelled in the exposure calculation leaving only the residual exposure for the CVA calculation.

The CVC approach involves defining a discrete set of credit states that counterparties can migrate between. The 'defaulted' state is excluded, since this is accommodated by the EPE charge. The CVC approach focuses solely on the credit worthiness and how a change impacts the CVA. It is therefore predicated on the existing maturity adjustment being appropriately calibrated to capture the market sensitivity of the CVA. In the case where CVA charges are calculated using a historical probability based transition matrix, the credit states are already well defined and correspond to either internal or external ratings.

For all counterparties, the change in CVA caused by counterparty migration across credit states (i.e. moving from one rating category to another) must be calculated. The CVA will increase as the credit state worsens, and vice versa when credit states improve, with no change in CVA as long as the counterparty remains in the same credit state. For each counterparty, one would generate a set of numbers representing the change in CVA corresponding to the pre-defined credit states.

Where there is a single counterparty in the portfolio, the change in CVA relating to the worst credit state represents the CVC because of the extreme choice of confidence interval. However, in a larger portfolio, the diversification among the counterparties will be a key driver in assessing the CVC as the change in CVA in a given scenario could be different for each counterparty within the portfolio.

To account for this correlation, a Monte-Carlo approach might be adopted where, in each trial, we draw the credit states for all counterparties in a correlated fashion. The banking book IRB approach uses a single factor with correlation calibration in the range of 12%-24% depending on rating. More granular correlations could be defined, involving grouping counterparties by, for example, sector, rating, region, country and then determining the correlations between groupings. Internal models for credit correlation should be subject to the same standards of validation and integrity as for other IRB models.

At the end of each trial the sum of change in CVA due to the migration of credit states for all counterparties is calculated. The process is then repeated until we have performed enough trials to obtain a stable distribution from which we can extract losses for a required confidence interval as the CVC measure.

For Firms Opting for a Trading Book Treatment to CCR

Over the last fifteen years, large banks have spent substantial resources to enhance their capabilities to measure, price and manage counterparty credit risks. During the same period, an expanding credit derivative market (especially for vanilla index and single-name CDS) has created opportunities for the risk management of counterparty credit risk as a trading book operation with active hedging.

Most large derivatives dealers have built sophisticated risk management systems and have established trading desks that are dedicated to the pricing and management of their counterparty risks. Those desks have executed large amounts of hedges against the CVAs, to the tune of tens of billion of dollars in CDS notional amounts.

The banks that marked to market their CVAs experienced severe CVA volatility during the 2007-8 financial crisis, especially during the fourth quarter of 2008. The variability of their CVAs reflected the turbulence in the markets and, to the extent that their CVAs were un-hedged, the banks' P&Ls were impacted, in some cases quite negatively and severely.

We recommend that the regulatory capital treatment of portfolios of counterparty risks that are marked to market and managed within a trading book regime be consistent with other similar trading risks.

Our proposal has the following stated aims, above and beyond those stated above:

- To be consistent with the actual risk measurement and management practices of the banks.
- To align the risk measurement and stress testing capabilities to what drives capital charge.
- To set proper economic incentives for active hedging and mitigation of counterparty credit risks.
- To provide a platform for identification, and stress testing of specific wrong-way risks.

Specifically, we recommend that the regulatory capital on counterparty risks should be assessed by including the CVA (and all its single-name, credit index and other hedges) in the trading VaR, stressed VaR, and IRC frameworks. The adoption of the trading book regime comprising these three elements is now considered robust. In this way, the CVA risks and hedges would be treated as integral parts of the full trading book and would be measured within the full trading book context. Currently, the hedges of the CVA reside in the trading book but the CVA does not. This creates a very material split-hedge problem that will in practice penalize banks that do hedge the CVA.

The IRC framework is analogous to the IRB Asymptotic Single Risk Factor (ASRF) model that is used to calculate the Risk Weights in the banking book but it has the advantage that it captures the concentrations (granularity) of the portfolio of exposures. We recognize the importance of setting the liquidity horizons of the various CVA risks correctly and the dependencies between

market prices and counterparty credit need to be modelled appropriately to capture the right and wrong-way risk effects.

The IRC framework has the following stated aims:

- Capture the jump-to-default risk, based on the appropriate liquidity horizon.
- Be consistent with the wider trading book regime; assume no further hedging over the liquidity horizon.
- Integrate the effect of both market and credit vectors on the jump-to-default calculation.
- Integrate the effect of both market and credit vectors into the VaR component.
- Address concentration risks.
- Address specific wrong-way risks.

The industry feels that this is a practical goal: The modelling of CVA within the trading book frameworks is not more complex than the modelling of other hybrid credit risks that exist in the trading book. In that sense, VaR and IRC of CVA are not more complex than the current applications of those models to other derivative products in the trading book. Indeed, some banks already include CVA and its hedges in their VaR models (both internally, and in some cases, for regulatory purposes, to prevent mis-statement of their market risk). Furthermore, the full integration of the market sensitivities into VaR and IRC correctly removes the need for the maturity adjustment and the requirement to approximate the cross-gamma of risk to joint credit and market movements.

In addition, when a firm marks-to-market CVA and captures both the credit and market-risk deltas in VaR, there is a strong argument to also include DVA market-risk sensitivities in VaR. These provide an effective partial hedge to the market sensitivities of the CVA. Large banks measure and manage CVA risks as integral parts of their overall trading risks. At times, long credit positions in the CVA book are used to offset short credit positions in other portions of the trading book, as part of the overall risk management strategy.

A further advantage of an integrated approach is that stress tests bind the capital impact more closely to with the potential economic risk to the firm, strengthening the alignment of senior management's risk appetite to the day-to-day management of counterparty risk within the firm's risk culture.

On the Double-Counting Issues, and the Sum Total of Capital Components

With regard to the role of CVA as a dynamic provision, the consultative paper clarifies and removes the perceived incentive to provision at low levels, by deducting any shortfall of provisions against expected loss under the IRB approach 100% from the common equity component of Tier 1 capital. Where the provision is in excess of the regulatory expected loss, however, the current framework allows for a deduction of the excess only from Tier 2 requirements, and subject to a cap. Given the new explicit charge for the variability in CVA proposed even where CVA is not measured today, it seems prudent to re-evaluate the role of CVA vis-à-vis a Tier 1 or Tier 2 deduction, and in particular the caps.

Tier 2, as an expression of gone-concern capital structure, is not the correct place to account for a forward-looking dynamic provision. If a default occurs, the CVA is available to offset in whole,

or part, the loss when a claim needs to be provisioned. In that respect, for the part of the loss where a bank holds an amount of CVA, it is unnecessary to have a capital charge, as the CVA is already reserved for that loss. As CVAs are fully dedicated for well-identified counterparties, the industry proposes that the excess of CVA over regulatory expected loss be incorporated as a direct deduction from CCR capital charge rather than being made eligible to Tier 2 capital; this provides stronger incentives to provision and adhere to the governance and validation standards that underpin the forward-looking modelling of exposure. The knock-on effect is stronger risk management practices across the industry.

It is clear to the industry that additionally capitalising against unexpected variation in CVA introduces a further concern, namely that losses cannot arise from both a change in CVA and a default at the same time:

- The fully integrated trading book approach deals with this through the IRC component in fully assessing the jump-to-default risk net of hedges.
- For other approaches, there would be a double counting between, on the one hand, the base amount of CVA plus the new capital charge to reflect the potential increase of CVA; and, on the other hand, the regulatory expected loss and unexpected loss for counterparty risk. In no real scenario would a bank make a loss due to the CVA in addition to a jump-to-default loss. Industry urges regulators to take this double-counting effect into account.

Recognition of Vanilla CDS Hedges to CCR

An important step towards more effective management of counterparty credit risk, irrespective of trading or banking book treatment, would be to recognise designated CDS hedges as also offsetting the EAD of counterparty credit risk calculated under Annex 4 of the existing Basel II text (BCBS128). While *paragraph* 7 of Annex 4 allows CDS hedges in principle, the recognition requirements do not generally permit any regulatory effectiveness of hedges, even though there are valid economic arguments that CDS are an effective cover of CCR and thus should be prudentially recognised.

The CDS market has simplified and further standardised default swaps, in response to the needs of the financial markets to provide effective transfer of risk. This is illustrated inter alia by the presence of central counterparties in this marketplace. The following points illustrate the economic validity of CDS as hedges of CCR:

1. Case where there is a public credit event (Bankruptcy or Failure to Pay):
    - Straightforward. The Master cross-accelerates and will be closed out. The termination value is a claim that is pari passu with other unsubordinated claims of the defaulted counterparty.
    - The CDS then makes use of the Determinations Committee and the established protocol to ascribe a value to unsubordinated assets. This is the same situation as for bank loans.
2. Case where there is a public credit event (Restructuring):
    - For a bond or syndicated loan, the meaning of Restructuring has a clear inference. Restructuring relies on observable tests in the public domain, such as principal deferral or reduction in interest rates for example.

- This logic is unclear for a Master. To highlight this ambiguity, consider a few situations:
    i. A reduction in interest rates may be a feature of a derivative contract.
    ii. Contractual terms involving interest rates could be changed, but the net present value of the payment streams may be unaffected.
    iii. A derivative contract does not have a notional principal value and so the idea of an actual principal deferral has no meaning.
- Requiring a CDS to cover Restructuring for a bilateral obligation implies that the holder of the bilateral obligation is able to trigger the Restructuring event. However, leaving this assertion to the holder of the bilateral contract would subject the CDS seller to an abusive triggering that may not objectively be related to a credit event.
- More importantly, assuming that a counterparty to a derivative contract is 'credit challenged', then a change in the timing of derivative payments, for example, is a choice and not an obligation of the stronger party. In effect the stronger party has, of its own accord, given up its right to early terminate and require immediate payment (which, if not made, which would constitute a failure to pay).

3. Case where there is no public credit event but we face a close-out under a Master:
    - Where a genuine credit event has arisen, if the claim is unpaid, the unpaid party has the ability to go to court and petition for bankruptcy of the counterparty. That event cannot stay private and it will become a public credit event.
    - In recognising that there can be a timing delay between petitioning the courts and when the credit event information becomes public, we would propose that in the case of bilateral exposures that the maturity of a standard CDS used for hedging purposes be considered 6 months shorter than its scheduled maturity.
4. Case where there is a credit event but the claim cannot be delivered into a CDS contract:
    - Not relevant. Standardisation of CDS, notably through the Big Bang protocol and use of the Determinations Committee and the growth of the CDS market mean that cash settlement has largely supplanted physical settlement as the method for valuing defaulted obligations.

CVA / Appendix 1: Observations on the Bond Equivalent CVA

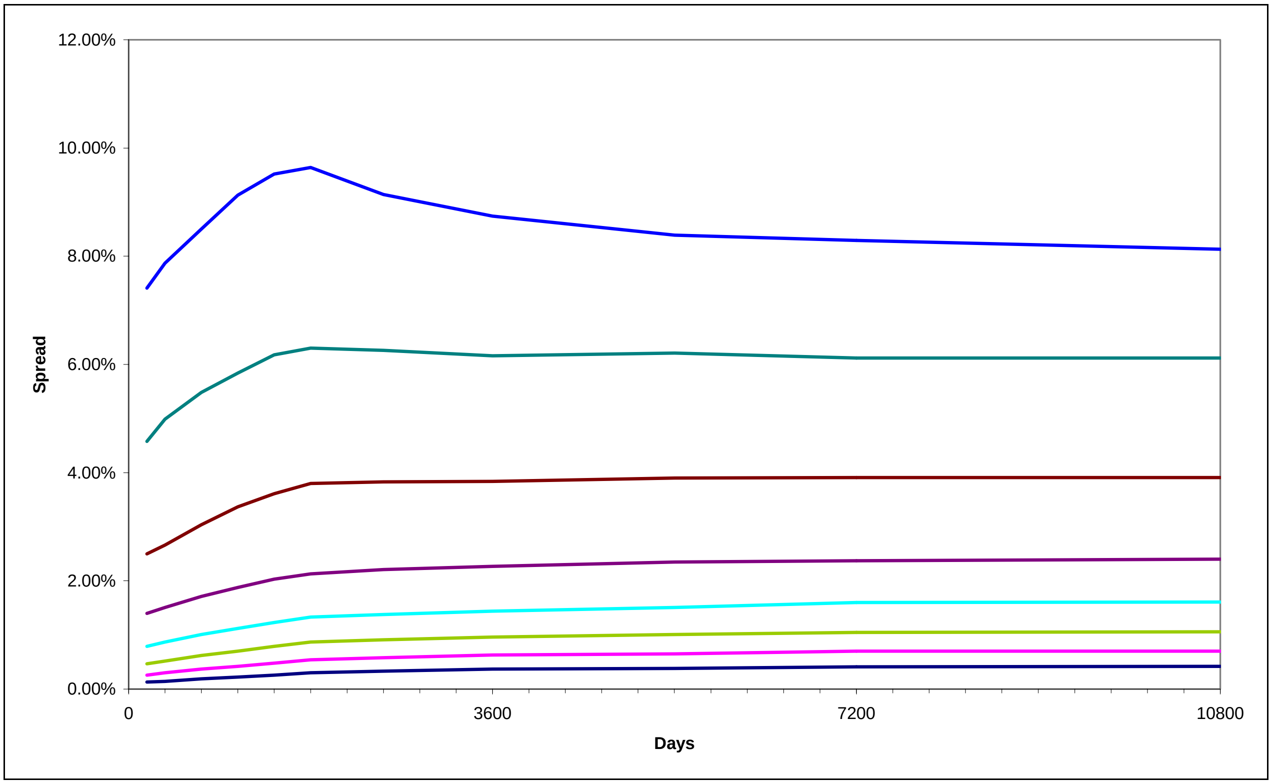
A Zero-Coupon Bond Is a Poor Approximation of CVA Risk

The purpose of the following examples is to show how various aspects of the bond-equivalent CVA lead to a crude and erroneous picture of the market implied CVA. We believe that the QIS comprehensive results will confirm this point quite strongly.

Example A

Here we take a $100MM, 10yr pay fixed swap at-the-money, settling annually, with rates modelled lognormally with a volatility of 20% and drifting to forward rates. We look at the

spread sensitivity of the CVA to a 1bp parallel shift of the par CDS spread, a 1bp parallel shift of interest rates, and a 1% absolute increase in volatility. We define eight levels of starting spreads (from Level 1 being the lowest to Level 8 being the highest), stratifying the market place:



The CS01 for the CVA with each of these spreads is then compared to that of the bond-equivalent. EAD, CVA and sensitivities are expressed in $.

In the table below we compare the sensitivities of the CVA with the Bond-Equivalent. EAD is $2.082MM.

Level	CVA	CS01	DV01	VEGA	BE CS01
L1	155,749	3,957	920	1,504	1,512
L2	261,120	3,800	1,607	2,601	1,396
L3	390,813	3,606	2,496	3,998	1,262
L4	563,871	3,343	3,724	5,917	1,080
L5	834,948	2,926	5,750	9,036	866
L6	1,272,264	2,249	9,249	14,358	560
L7	1,718,218	1,497	13,736	20,882	299
L8	2,037,644	896	18,081	26,851	168

From the table, it is clear that the Bond-Equivalent fails to capture the nature of the risks faced.

Example B

In this example, we assume that the bank is receiving fixed in a plain vanilla USD interest rate swap. We choose a trade in which the bank is receiving fixed since exposure to the counterparty will rise at the same time the counterparty's credit quality is worsening (assuming that official

rates will be lowered in such an environment). We assume paths of interest rates, volatility, and spreads over a hypothetical 2 year period consistent with the recent financial crisis. We assume that the 10-year swap rate is 4.6% at the inception of the trade and that implied volatility is 20%. The counterparty's initial credit spread is 100 basis points. Although CVA is in reality hedged very frequently, such as daily, we calculate the CVA and the sensitivities to the risk factors, i.e., interest rates, volatility, and credit spreads on a monthly basis for simplicity. We then calculate hedges to those risk factors and compare to mark-to-market changes in the CVA. Table 1 reports the results.

Notional of Swap ($MM)	100
Tenor of Swap (yrs)	10
Forward Swap Rate	4.60%
Fixed Swap Rate	4.60%
Current Swap Rate	4.60%
Swap Rate Volatility	20%
Spread (bps)	100.00%

	Market Data			Sensitivities				Hedges				
Year	**Swap Rate**	**Swap Vol**	**Spread**	**Rate dv01**	**Spread sv01**	**Vol dv01**	**CVA**	**Rates**	**Spread**	**Vol**	**Total**	**CVA Change**
0	4.60%	20%	100	-1608	1917	101	205,279	0	0	0	0	0
0.08	4.43%	23%	125	-2184	2343	120	318,157	27,336	47,925	30,300	105,561	112,878
0.17	4.27%	26%	150	-2776	2748	135	454,055	34,944	58,575	36,000	129,519	135,898
0.25	4.10%	29%	175	-3375	3129	148	611,236	47,192	68,700	40,500	156,392	157,181
0.33	3.93%	32%	200	-3976	3486	157	788,296	57,375	78,225	44,400	180,000	177,060
0.42	3.77%	35%	225	-4577	3816	165	983,202	63,616	87,150	47,100	197,866	194,906
0.50	3.60%	38%	250	-5173	4121	169	1,194,222	77,809	95,400	49,500	222,709	211,020
0.58	3.43%	40%	275	-5767	4403	172	1,420,363	87,941	103,025	33,800	224,766	226,141
0.67	3.27%	43%	300	-6355	4662	173	1,659,560	92,272	110,075	51,600	253,947	239,197
0.75	3.10%	46%	325	-6938	4899	173	1,910,327	108,035	116,550	51,900	276,485	250,767
0.83	2.89%	49%	350	-7518	5117	170	2,172,223	143,617	122,475	51,900	317,992	261,896
0.92	2.77%	52%	375	-8092	5315	167	2,443,174	92,471	127,925	51,000	271,396	270,951
1.00	2.60%	55%	400	-8662	5496	162	2,721,962	137,564	132,875	50,100	320,539	278,788
1.08	2.68%	52%	375	-8050	5307	155	2,427,120	- 69,296	- 137,400	- 48,600	- 255,296	- 294,842
1.17	2.77%	49%	350	-7448	5109	147	2,148,239	- 72,450	- 132,675	- 46,500	- 251,625	- 278,881
1.25	2.85%	46%	325	-6858	4902	139	1,885,582	- 59,584	- 127,725	- 44,100	- 231,409	- 262,657
1.33	2.93%	43%	300	-6280	4687	130	1,640,244	- 54,864	- 122,550	- 41,700	- 219,114	- 245,338
1.42	3.02%	40%	275	-5712	4463	120	1,411,411	- 56,520	- 117,175	- 39,000	- 212,695	- 228,833
1.50	3.10%	38%	250	-5155	4231	110	1,199,264	- 45,696	- 111,575	- 24,000	- 181,271	- 212,147
1.58	3.18%	35%	225	-4609	3992	100	1,004,540	- 41,240	- 105,775	- 33,000	- 180,015	- 194,724
1.67	3.27%	32%	200	-4072	3746	89	826,572	- 41,481	- 99,800	- 30,000	- 171,281	- 177,968
1.75	3.35%	29%	175	-3545	3493	77	665,420	- 32,576	- 93,650	- 26,700	- 152,926	- 161,152
1.83	3.43%	26%	150	-3027	3235	66	521,442	- 28,360	- 87,325	- 23,100	- 138,785	- 143,978
1.92	3.52%	23%	125	-2517	2972	54	394,088	- 27,243	- 80,875	- 19,800	- 127,918	- 127,354
2.00	3.60%	20%	100	-2014	2704	42	283,260	- 20,136	- 74,300	- 16,200	- 110,636	- 110,828

As can be seen in the above table, we assume that interest rates, volatilities, and spreads follow a pattern similar to their dynamics over 2008 and 2009. At the beginning of each month, we calculate the rates, spread, and volatility sensitivity of the CVA. These sensitivities are defined to be the dollar change in the value of the CVA given a 1 basis point increase in the underlying risk factor. We also calculate the CVA at the beginning each month. We then assume that we put on trades for each risk factor equal to the CVA sensitivities to be hedged. We then calculate the change in value of these hedges as well as the change in value of the CVA.

Although the bond-equivalent approach makes the assumption that spread risk hedges are most important, a glance at the results in Table 1 suggests that rates and volatility hedges together are generally larger in magnitude than spread hedges.

Example C

To get a sense of the magnitude of the potential double counting between the CVA charge and the existing IRB treatment of maturity, we consider a simple portfolio comprised of 1000 BBB-rated counterparties, all of whom have a single trade in their portfolio –a 10-year USD $100 million interest rate swap. We assume that interest rate volatility is 20% in order to compute EEPE and that there are no CVA hedges. We use 18 basis points for the probability of default, the 1983-2008 1-year Moody's average for a BBB-rated counterparty. We also assume that LGD is 65%. The table below shows the regulatory capital calculations using the five year maturity cap.

Capital with M = 1	86,759,696
Adjustment to M = 5	110,866,872
Total Capital	197,626,568

Total credit regulatory capital for this portfolio would be $198 million. Using a one year maturity, total capital would have been $87 million, implying a mark-to-market add-on of $111 million for maturity implicit in the current Basel II capital formula.

To compare this add on to the proposed bond-equivalent VaR add on, we use a simple linear VaR model in which we specify a bond-equivalent notional equal to EEPE of the trade with a 5-year maturity. We assume spread correlation is 40% and calculate VaR for a range of typical BBB credit spreads between 50 and 100 basis points. The table below reports the results.

Spread (bps)	50	60	70	80	90	100
Spread Correlation	40%	40%	40%	40%	40%	40%
Spread Volatility	32%	32%	32%	32%	32%	32%
99.9% 1-year VaR	68,361,905	82,034,286	95,706,667	109,379,048	123,051,429	136,723,810

The results in the above table suggest that under ordinary circumstances the mark-to-market adjustment already built into the Basel II IRB formula covers the proposed bond-equivalent risk fairly well. These results are not surprising given the calibration done by the regulatory community to ensure that the maturity adjustment is quantitatively reasonable. But, the results do serve as a reminder that CVA mark-to-market risk can be accounted for in the current framework. Of course, during a stressed environment in which the level of spreads or volatilities is larger, particularly for firms that are using risk-neutral exposure models, the bond-equivalent add on could be larger than the mark-to-market maturity adjustment add on in the Basel II formula.

Example D

Consider the expected exposure profile of the bank's exposure to counterparty XYZ. The shape of the exposure profile below is typical of counterparties with large portfolios of trades. As time evolves, the expected exposure declines because the in-the-money cash flows roll off. The exposure forms one part of a group of netting-sets with differing effective maturities.

For this profile:

- CE = $100 M
- EAD = $140 M
- M = 5 years (set exogenously by the longest netting set of the counterparty)

Assuming:

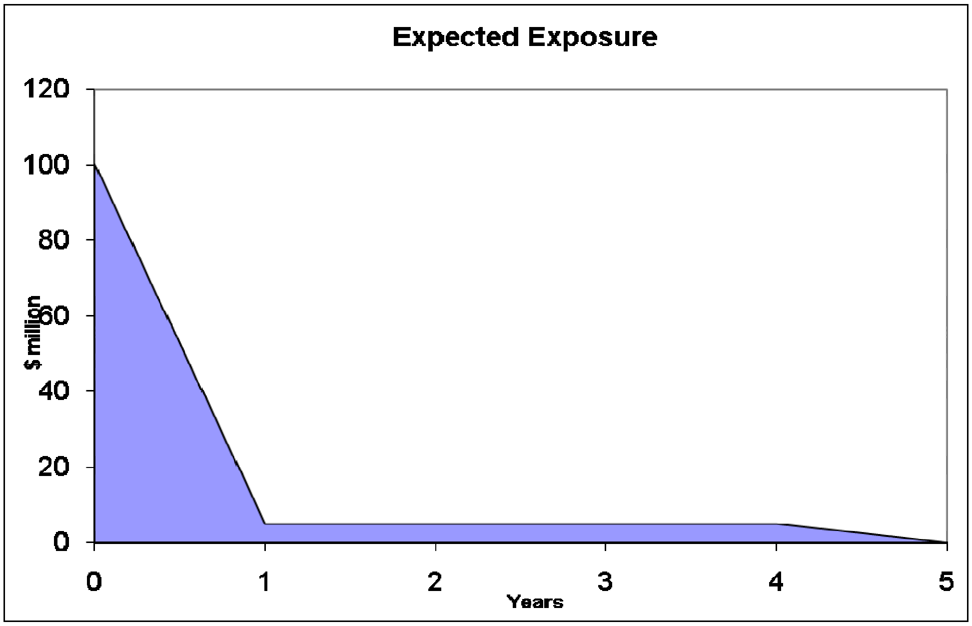
- Interest rate = 4% flat
- Credit spread of the counterparty = 2% flat

We calculate:

- CVA = $4.49 M
- The CS01 of the CVA is $0.0215 M per bp.
- The CS01 of the zero coupon bond equivalent is $0.0511 M per bp.

<u>Thus, the bond equivalent CS01 is 2.4 times the correct CVA CS01.</u>

Consider the following expected exposure profile of the bank's exposure for another netting-set with XYZ. This profile is typical of counterparties with whom we have many short-term trades and a small number of long-term ones.



For this profile:

- CE = \$100 M
- EAD = \$140 M
- M = 5 years (set exogenously by the longest netting set of the counterparty)

Assuming:

- Interest rate = 4% flat
- Credit spread of the counterparty = 2% flat

We calculate:

- CVA = \$1.30 M
- The CS01 of the CVA is \$0.0063 M per bp.
- The CS01 of the zero coupon bond equivalent is \$0.0511 M per bp.

<u>Thus, the bond equivalent CS01 is 8.1 times the correct CVA CS01.</u>

In summary, the use of the longest maturity for any netting-set significantly overstates the CVA spread risk.

2. *Effective EPE with stressed parameters to address general wrong-way risk*

The CP sets out suggested changes, to address problems seen in respect of general wrong-way risk (WWR – Par 118 – 122). The concern in respect of this risk is shared by the industry, even though it has been notably difficult to quantify WWR historically. The opportunity to work with the regulators in ways to assess and capitalise this type of residual risk is welcomed.

The proposal to take the higher of current market factors and stressed market factors is clearly appealing, as it is simple in concept and prevents a benign market environment from unjustifiably and increasingly impacting results, as historic spikes fall out of the time series used.

It is, however, noteworthy that the pillar 2 stress test charge should already take potential wrong-way risks into account through the stress scenarios envisaged and there is, therefore, a risk that a stressed EPE charge – which would be computationally highly intensive – is duplicative.

For a number of reasons, we believe that EPE based on stressed inputs may not produce the intended benefits and may even increase overall risk.

- Where the stressed charge dominates, the use test may be weakened, as it is unlikely to be adopted for credit sanctioning purposes. Credit risk management already considers tail values on a client by client basis.
- It will become harder for firms to manage exposures; undertaking additional trades to offset risk based on current market factors could potentially increase the exposure of a stressed EPE basis due to differences in correlations. Furthermore, clients are unlikely to be willing to post initial margin against stress volatility instead of current or market implied volatilities.

Industry would add that the main (and most credible) tool to demonstrate EPE validity is back-testing, on which a regulatory approach is of course still in development. We consider that materiality of the use of a stressed EPE should be reviewed, once a) results of the QIS are known and b) a back-testing framework is published.

3. *AVC for Financial Institutions*

Our members have shown considerable interest in the proposal to increase AVCs for categories of financial institutions. The CP suggests that empirical work has been performed, yet more is required. The CP suggests that the definitions of 'large' and 'systemically important' require further thought and consultation, itself suggesting that the interpretation of the empirical work has been inconclusive in this regard.

The CP also suggests uncertainty remains in areas such as the inverse relationship between low PD and high correlation. In the absence of a published, detailed study, it is hard for the industry members to arrive at any conclusion with regard the assertion of the CP. Noting the lead time to integrating the new capital constructs, the members feel that the details of a full and comprehensive study should be agreed with the industry prior to the analysis being performed, and then published for comment by the Committee.

It is not clear to the industry members how a snapshot of the impact within the QIS can better inform the outstanding decisions.

At the same time we note the rapidly increasing use of central counterparties, reducing the apparent 'interconnectedness' of financial institutions that is presumably one target for the AVC charge in the first place. We also observe the possibility of increased incentives *not* to face financial firms, which could reduce the 'network efficiency' of the market while increasing relative exposures elsewhere.

We include some specific observations related to the CP.

BCBS 164, pg 6, para 21, "Moreover, to address the systemic risk within the financial sector, the Committee also is proposing to raise the risk weights on exposures to financial institutions relative to the non-financial corporate sector, as financial exposures are more highly correlated than non-financial ones. It is conducting further analysis of the appropriate calibration as part of the impact assessment."

BCBS 164, pg 10, para 48, "In addition, refinements to the Basel II risk weighting functions can be made to directly address the risks created by systemically important banks (see for example the proposal in Section II.2 to increase the asset value correlation for exposures to large financial institutions relative to those for non-financial corporate exposures…"

The industry is keen to learn further how the Committee performed an analysis of AVCs, given the opacity of many accounting approaches across the markets, and the greater or lesser degrees to which exposures are hedged and managed by financial institutions. The industry is also keen to understand how financial and non-financial institutions have been brought together comparatively.

BCBS 164, pg 28, para 114, "Large financial institutions were more interconnected than currently reflected in the capital framework. As a result, when markets entered the downturn, banks' counterparty exposure to other financial firms also increased. The evidence suggests that the asset values of financial firms are, on a relative basis, more correlated than those of non-financial firms. As such, this higher degree of correlation with the market needs to be reflected in the asset value correlations. The Committee, based on its empirical work, found evidence that asset value correlations were at least 25% higher for financial firms than for non-financial firms."

Exposures amongst a large proportion of 'systemically important' and 'large' financial institutions is collateralised. The increase of these exposures is a function of market volatility, and the relationship between market volatility and exposure is attributed to general wrong way risk by the CP (pg 28, para 114), not asset-value correlation or interconnectedness. The alpha multiplier in the existing IMM framework, intended to capture general wrong way risk, is untouched by the CP. The industry members can only speculate on the approach used by the Committee to arrive at the Consultation's conclusion. However, recalling the RMMG Survey Information from July 2009, it is hard to conceive how market driven exposure measures lead to an AVC conclusion that spans both trading and banking book positions. Considering further the many methods that can be used to derive AVCs from equity prices, the data is inherently flawed by other market influences at the height of the crisis, namely speculation, market rumour and fear. The dislocation in traded availability of credit derivatives and equity prices through the crisis can also mislead in determining the level of underlying interconnectedness across financial institutions.

BCBS 164, pg 30, para 116, "Apply a multiplier of 1.25 to the asset value correlation of exposures to regulated financial firms (with assets of at least $25 billion) and to all exposures to unregulated financial firms (regardless of size). The Committee continues to conduct analysis to assess the appropriate calibration of the proposed multiplier and asset size threshold."

BCBS 164, pg 36, para 135, "During the crisis, financial institutions' credit quality deteriorated in a highly correlated manner and they proved to be relatively more sensitive to systemic risk than non-financial firms. As a result, financial institutions were more correlated than reflected in the current Basel II IRB framework. The work conducted by the Committee indicates that asset value correlations for financial firms were, in relative terms, 25% or more higher than for non-financial firms, and the Committee is of the view that this higher degree of correlation with the market needs to be reflected in the IRB capital framework. For this reason, the Committee is proposing that a multiplier of 1.25 be applied to the AVC of financial firms. Under this proposal, the AVCs between financial firms would range from 15% to 30%, as opposed to the 12-to-24% range currently set forth in the Basel II framework. The Committee is conducting further analysis on the appropriate calibration of this proposed multiplier."

BCBS 164, pg 37, para 136, "The definition of financial firms would be broadly defined to include banks, broker-dealers, insurance companies, and highly leveraged entities, such as hedge funds and financial guarantors, since all of these firms exhibited heightened sensitivity during the crisis. Exposures to smaller banks, broker-dealers and insurance companies did not exhibit this sensitivity to the same extent. As a result, the Committee is proposing to limit the application of the multiplier to exposures to banks, broker-dealers and insurance companies with assets of $25 billion or more. It is conducting additional analysis to verify the appropriate calibration of the proposed threshold. Under this proposal, exposures to unregulated financial intermediaries, including highly leveraged entities that derive the majority of their revenues from financial activities, such as hedge funds and financial guarantors, would always be subject to higher AVCs, regardless of asset size. The Committee is seeking comments from the industry and other stakeholders on the appropriate definitions for regulated and unregulated financial institutions, and will seek to capture consistent data using possible definitions during the 2010 impact assessment."

The industry members are willing to work with the Committee to help categorise the definitions of regulated and unregulated financial institutions, noting the differences in accounting treatment across the many markets around the world.

BCBS 164, pg 37, para 137, "While the higher AVC was evident in counterparty exposures, the effect was not limited to such exposures, but extended to other exposures between financial institutions such as interbank lending, which also experienced system wide stress. Furthermore, default on any of these financial exposures leads to default on all other such exposures. For this reason, the Committee proposes that the multiplier on the AVC parameter be applied to all financial exposures under the IRB approach, subject to the above $25 billion limit."

The CP again alludes to the conclusion of a higher AVC driven by counterparty exposure. The relationship between counterparty exposure and market volatility is not evidenced by other forms of near-term risk such as interbank lending, settlement and clearing lines. The conclusion that an AVC multiplier should be broadly applied across credit and counterparty exposures is not wholly supported by the language used in the CP.

BCBS 164, pg 37, para 138, "The Committee is aware that the proposed 25% increase in AVC could result in a percentage increase in capital requirements that is actually higher due to the nonlinear relation between capital and AVC. The effect is more pronounced for the low PD and high AVC counterparties for whom capital could increase by approximately 35%"

BCBS 164, pg 38, para 140, "The Committee welcomes comments on the definition of unregulated financial institutions. The Committee believes that further work on the absolute level of AVCs and on the assumption of an inverse relation between PDs and AVCs is required."

The industry members are keen to engage with the Committee on both aspects.

*4. **Collateral***

In recent years, firms have heavily invested in their collateral management units, processes and systems, and have worked with industry and regulators to strengthen collateral management throughout the industry. Examples are the dispute resolution protocol, standardized electronic messaging for margin calls and reconciliation requirements imposed by regulators (Fed reconciliation).

With this in mind, industry welcomes the proposed rules to strengthen collateral management units, as the majority of the proposed changes have already been implemented by industry.

However, industry does not agree with all circumstances where the margin period of risk is to be increased.

Large netting sets

Counterparties with big portfolios are usually counterparties with large credit lines, i.e. counterparties with good credit quality. Firms wouldn't have as many trades with them if they were not comfortable with having such large portfolios with these counterparties. Also, since the credit crisis, regulators have imposed reconciliation requirements on the "Fed 14" counterparties - daily reconciliation for all Fed 14 counterparties with more than 500 transactions and monthly reconciliation for all counterparties with more than 1000 trades. This is complemented by extensive regular reporting. These reconciliation requirements improve data quality, significantly reduce the risk of disputes, make sure that the portfolios are tightly managed and would support a quick closing out of such positions. N.B. that a large netting set does not mean that every transaction has to be closed out separately, but that the position is closed out on a net-market-risk basis, which requires orders of magnitude fewer transactions.

An arbitrary threshold defining a large netting set will only lead to an incentive for firms to split these netting sets into smaller ones, actually reducing the netting effect and increasing risk. Industry therefore suggests not to introduce increased margin periods of risk for large netting sets.

Disputes

Industry has already been active and is – led by ISDA - currently implementing the Dispute Resolution Protocol. Using this protocol should considerably reduce the time for resolution of a dispute, i.e. there should be fewer instances where a doubled margin period of risk needs to be triggered.

We would however suggest introducing a materiality threshold, so that the margin period of risk is not doubled because of a few minor disputes in the past. Industry will be proposing a consistent framework for dispute reporting to regulators by May 31st, which will include such thresholds. We suggest using these thresholds when determining whether the margin period of risk should be doubled or not.

Illiquid contracts or collateral

Industry accepts that there is a possibility that these positions cannot be closed out quickly and accepts that the margin period of risk will double in these cases. However, similar to netting sets with disputes industry suggests introducing a materiality threshold

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Annex 2

IIF Comments on the Basel Committee Consultative Document *International Framework for Liquidity Risk Measurement, Standards and Monitoring*

I. Introduction

1. The IIF has been active in promoting improved practices and greater attention to liquidity-risk matters since publication of *Principles of Liquidity Risk Management* in March 2007 (updated in 2008 and 2009 reports).[1]

2. In that connection, the Institute embraced the Basel Committee on Banking Supervision's (BCBS) *Principles for Liquidity Risk Management and Supervision* (Basel *Principles*), which is broadly consistent in thrust and philosophy with the Institute's own work. It has also welcomed the constructive contributions of the Committee of European Bank Supervisors (CEBS) to development of thinking on more robust liquidity-risk management.[2] The Institute welcomes and supports, subject to the comments below, the BCBS's work to promote consistency and rigor in international liquidity-risk regulation and supervision as an essential element of a more resilient post-crisis international financial system.[3] In the same way, the IIF supports introduction of globally consistent quantitative regulatory liquidity approach that would be binding for a short survival period, with a consistent but firm-specific approach for the longer period, in both cases subject to revisions to achieve more risk-based assumptions and parameters. Italicized references to *paragraphs* in this discussion refer to numbered paragraphs of the Consultative Document.

3. This process of creating new standards across the global financial industry is a good opportunity for supervisors to build a strong, efficient liquidity monitoring system that creates level playing field for firms across countries. Because of the very substantial impact any new standards from Basel will have on the industry and, more importantly, on the greater world economy as a whole, the IIF hopes to work constructively with the BCBS to create an effective liquidity risk management framework that will stand the test of future cycles and create appropriate incentives.

4. The specific comments on the Consultative Document set out below are offered in continuation of the analysis of liquidity issues of the IIF's prior reports. Even before the crisis, the 2007 report illustrated risks and issues that needed attention in the liquidity sphere, and the comments here should be understood as reflecting the

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[1] See Subsection 3.6 of the IIF Report *Restoring Confidence, Creating Resilience,* July 2009; and Section II of the IIF Report *Reform in the Financial Services Industry,* December 2009.

[2] See CEBS *Guidelines on Liquidity Buffers and Survival Periods*, 9 December 2009.

[3] That the standards are intended to establish minimum levels of liquidity for internationally active banks, and the reasons for it, as discussed in *paragraph 5* is understood; however, it will also be important for national supervisors to use their power to top up international requirements sparingly, only when required to meet locally specific needs. If there were to be widespread "goldplating" of the international standards, the international market as a whole could easily be unduly fragmented and global growth trammeled by local requirements that, however conservative they might appear on a local basis, would have impacts beyond the local market.

determination of the industry in general and the members of the Institute in particular to support a much more robust regime for management and regulation of liquidity risks than existed prior to July 2007, when liquidity crisis first hit in full force.

5. The Institute's work on reviewing the implementation of its Recommendations on liquidity-risk governance and management and other crisis-related issues demonstrates that substantial progress has already been made internally by firms in strengthening their liquidity-risk management along the lines of the principles set forth by Basel and the IIF, although ongoing work and investment is required.[4]

6. Given their scope, their comprehensiveness, and the fact that they represent a new departure in international regulation, it is especially important to look at the macroeconomic impact the liquidity proposals would have if implemented without modification, to focus on some of the implicit trade-offs and to note proportionality and level-playing-field concerns. The proposals represent a major new step that needs to be taken carefully. Initial indications from the market and firms' reports of their work on the QIS are that, if adopted as proposed, the liquidity proposals alone would have a very substantial impact on the amount, nature, and structure of firms' liquid assets, requiring additional trillions of Euros of term funding past one year.[5] While firms support the concept of building up appropriate buffers, and the IIF work cited above provides guidance to that effort, the impact on the markets and on the credit capacity of the system, both during the transition and when the world returns to a more stable economy, would be very great indeed. Therefore, the analysis of the initial and any follow-up QIS data, along with the Committee's top-down assessment of economic impacts, will be critical. Even more critical will be the calibration of the final rules, which may affect the health of the global system for years, and an orderly phase-in of the new regime.

7. IIF comments further aim to ensure the new standards do not place unduly serious restrictions on the ability of banks to play their fundamental role of maturity transformation for the benefit of retail, commercial and wholesale clients, contribute to rather than detract from the liquidity of markets, and offer credit in well-controlled but sufficient amounts to ensure a steady recovery and then sustained growth to the world economy. However, all comments remain based on the recognition of the necessity of sound, consistent international liquidity-risk regulation. Many comments are intended to suggest more workable solutions from the point of view of professional liquidity-risk managers. Suggestions are very much intended to be within the spirit of the Basel *Principles* on liquidity.

[4] Appendix I. of the IIF *Reform in the Financial Services Industry* Report details the findings of an Ernst & Young survey of senior-level executives of IIF member firms on the progress of implementing industry best practices, while Section II gives these findings wider context.

[5] Various entities are studying this issue, and substantial estimates are emerging. As one example, the liquidity-risk consultancy Liquidatum, on the basis of 2008 data from about 100 global banks (but excluding Japan) estimated a cumulative shortfall of NSFR requirements of EUR 3.3 trillion. It also notes that, overall, and reflecting methodological limitations affecting the aggregation, firms' numbers were "bleaker" than its own. (Source: memorandum from Liquidatum.) The Institute has been considering separately the cumulative macroeconomic effect of current regulatory reforms and will make the results of that analysis available to the BCBS and the FSB.

8. The Consultative Document lays out proposals for two binding ratios – a Net Stable Funding Ratio (NSFR) and a Liquidity Coverage Ratio (LCR) – that supervisors would implement, and four common metrics that would be used to monitor firms' liquidity positions. It is appropriate to look both at a short-term liquidity coverage ratio to assure that major firms will have immediate liquidity to survive extreme stress, and longer-term funding and mismatch issues. Ratios along the lines of those proposed are conceptually suitable for the purpose of ensuring firms have enough liquidity to handle both short acute survival periods and long periods of stress; however, many details, such as what qualifies as a liquid asset and the stress scenarios to which the ratios are calibrated, need very careful examination for the broad impact they are likely to have on firms, borrowers and users of financial products, global liquidity, markets, and the availability of credit to a global economy. In addition, as developed further below, the two proposed principal metrics, even when supplemented by the other proposed metrics cannot fully capture the liquidity situation of any one firm; thus any and all such metrics must be used with caution, however useful they may be in casting light on different aspects of the liquidity situation of each firm.

9. The two types of measure proposed to evaluate liquidity are only two tools among many, as the Consultative Document and the Basel *Principles* recognize. Because of the standardization of assumptions, the measures will not be fully adapted to a firm's mix of business, geographical scope, and participation in markets. Moreover, these two tools alone will never be enough to analyze, manage, or supervise a firm's liquidity situation. This needs to be kept in mind in mind in finalizing the proposals, and is the fundamental reason for advocating a "Pillar 2" approach to the NSFR, for many of the specific changes suggested for both ratios, and for advising caution on disclosure requirements, as explained in these comments. To this end, there needs to be more emphasis on improving the dialogue between firms and supervisors, with more emphasis on sound supervision of the liquidity process in each firm, and less emphasis on locking in formulaic, a-priori assumptions that can only be crude approximations as applied to each firm's situation.

10. In finalizing the requirements, the Committee will have to do some delicate balancing between tighter liquidity requirements, as they interact with the new capital requirements, changing accounting standards, other new regulatory and market rules (e.g. for securitization and mutual funds), and the ability of firms to employ resources productively in providing credit to society and sustain liquid markets. It will also be necessary to reconsider the role of central banks in liquidity provision in future "normal" markets, and in future systemic situations even if – as is stressed at several points – it is important to maintain "constructive ambiguity" around lender-of-last resort measures that may be made available to assist banks that get into idiosyncratic difficulties. As a matter of basic approach, and to make the proposed measures more realistic and feasible, these comments will argue that the scenarios should be reconceived with the aim of requiring firms to survive a firm-specific shock and an initial or moderate systemic shock, but with a more realistic view of the role of central

banks in a longer term systemic event of the type that is envisioned in the current proposals.

II. Basic Issues

The Right Level of Insurance

11. While many technical aspects of the proposals as published in December need debate among experts, underlying all of the issues raised in this commentary is the question of the right size of liquidity buffers as "insurance" against systemic shocks the banking system should bear. The Institute certainly accepts that much improvement in liquidity risk-management over what existed before July 2007 is in order and that greater insurance against future crises will have to come from the private sector, to protect taxpayers.

12. It is undisputed that firms must be responsible if they fall into idiosyncratic problems, and thus a rigorous LCR is appropriate for all firms, as a critical ratio among the suite of other metrics. Good risk management certainly requires firms to have sight of the issues covered by the proposals, but it is equally true that there are limits to the amount of liquid assets banks should be required to hold to self-insure against severe systemic shocks. If it is true that firms and the system were "underinsured" before July 2007, there is now a danger that firms and the system risk becoming "insurance poor" owing to the social cost of over-insurance. As the Bank of Canada recently observed,

> Clearly it would be prohibitively inefficient, if not impossible for [a financial institution] to fully protect itself against systemic shocks. Thus, to balance the costs and benefits of liquid assets … consistent with the BCBS *Principles* for liquidity management, the objective of a macroprudential tool, such as a liquidity standard should be for [financial institutions] to protect themselves against their own institution-specific liquidity and funding shocks, as well as most adverse market shocks … Institution-specified shocks occur much more frequently than systemic ones. In the case of the former, there must be consequences for not adhering to the standards if supervisors are to encourage the prudent management of liquidity risk and mitigate moral hazard … the challenge comes when the event is a systemic shock, as occurred in the autumn of 2008. In this period of heightened aversion to credit risk, [financial institutions] saw their access to funding markets evaporate … Uncertainty regarding future access to funding boosted [financial institutions'] demand for liquid assets, which, at a systemic level, could only be met either by increased issuance of government debt or by liquidity supplied by central banks. In such circumstances, the liquidity positions of [financial institutions] relative to a regulatory liquidity standard … may deteriorate, but that deterioration is an indication of systemic stress…. Attempts by [financial institutions] to collectively reduce credit supply could result in customers withdrawing funds from the system to service their own obligations. This, in turn would aggravate the funding pressures on the financial system as a whole … Therefore, while there must be consequences for [financial institutions]

> that fall below the standards in most periods, from a macroprudential perspective, it is extremely unhelpful if, in an exceptional period of systemic stress, the liquidity standards give [financial institutions] an incentive to disengage (more than they otherwise would) from funding markets and decrease their market-making activities.[6]

13. There is clearly a difficult balancing to be accomplished here, but the Institute has concluded that the level of protection sought by using the extreme scenario assumptions proposed in both the LCR and NSFR is excessive, especially when viewed at the aggregate of all banks, given the circular nature of money.[7]
    - Putting aside the fact that the scenarios are unrealistic in assuming extreme conditions with central banks playing only their most basic roles, they also border on the unworkable because of the asymmetries among the assumptions: as will be discussed in detail, the assumptions with respect to liquidity demands on banks and resources available to banks are sometimes contradictory in important ways.
    - All banks in a system cannot all lose deposits or all be drawn on at the same time without some banks' benefiting from such flows.
    - The Institute is especially concerned with NSFR; where a stress is assumed to last for one year, and no consideration is given to potential adjustments that firms would make to strategy and balance sheets in the interim should such stress occur.
    - Moreover, in a systemic crisis, LCR and NSFR would be procyclical because wholesale investors tend to reduce the term of their investments, totally outside of bank control, putting pressure on banks to compensate for deteriorating LCR and NSFR by reducing other illiquid assets, including loans. They would also be procyclical in inducing large, simultaneous liquidations of the same assets at the same time by many firms, and giving additional incentives to change lending or asset portfolios in the same direction at the same time.
    - Both the LCR and the NSFR suggest scenarios where the central bank role in markets would be greater than the stated provisions allow, in the LCR because of the cumulative requirement for market liquidity and central-bank eligibility, and in the NSFR because of exclusion of any but normal open-market operations from consideration (and incorporation of LCR definitions). While banks should clearly *exclude* any consideration of lender-of-last-resort support to the individual firm by central banks in their liquidity planning, the scenarios are impliedly so systemic that it would be unrealistic to assume central banks would not be present.

14. The NSFR, with its apparent assumption of considerable systemic stress, implies that the private sector is being asked to bear a very substantial part of the cost of insuring against a systemic event outside of the control of any firm. While it is undoubtedly correct for firms to shoulder a meaningful part of this cost, the effects of the dead weight of that cost under the proposal as published, given the effects on markets and on

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[6] Bank of Canada, *Financial System Review*, December 2009, pp. 38-9, citations omitted. See also David Longworth, "Bank of Canada Liquidity Facilities: Past, Present and Future", February 17, 2010, at p. 8 and notes 17-21.

[7] As pointed out in the detailed discussion of *paragraphs 78-84* in these comments, the NSFR is ostensibly based on a firm-specific scenario, but the assumptions underlying the NSFR clearly indicate severe systemic conditions.

firms' ability to generate credit, appear excessive. Getting the balance right is a matter of policy, but the Institute can only suggest that, as the central banks and supervisors consider the "new normal" of central bank market policies and market-emergency facilities (not lender of last resort facilities for individual firms), the right policy response would be to find a more balanced allocation of burdens than the present proposal implies**.** See Liquidity Appendix A setting out considerations applicable to the central banks' role in the new regime.

15. Thus, to reiterate, the proposals should be refocused on requiring liquidity resources to be structured to allow a solvent institution to survive a substantial but plausible institution-specific shock, or to withstand some degree of systemic disturbance or shock without central-bank support. In an actual systemic situation, the role of the central banks should not be assumed away, especially for the NSFR, given some of the assumptions embedded in the mandated scenarios (e.g., disappearance of secured-funding markets for all assets other than the highest quality and the disruption of FX markets foreseen by *paragraph 134*). This more realistic approach, with the changes of assumptions that would follow from it, would allow for an effective prudential liquidity-risk regime that would at the same time be efficient in terms of its overall effects on firms as actors in the system and reasonable in terms of its effects on the broader economy.

Interdependencies

16. The liquidity crisis has shown interdependencies between economic agents that need to be taken into account: banks, clients, central banks, non-bank financial institutions, rating agencies, and real-economy participants. There are several problems here.
    - First, the Consultative Document does not take account of many of these dependencies, The Institute considers that the final liquidity and capital frameworks need to be designed and calibrated with all such interdependencies in mind, after consideration of the QIS, the Committee's top-down study, and full analysis of the cumulative impacts of regulatory change on the international financial system and the real economy.
    - Second, the effects of the proposals on eligibility of collateral and asset correlations, and market effects generally need to be taken into account.
    - Third, a substantial amount of industry and regulatory work is going into improving the institutional and legal infrastructure of the markets to improve the overall resiliency of the system, and to manage the interconnectedness of firms through the international financial system (e.g. central counterparties for many derivatives; new resolution regimes, improved internal risk management). Yet the Consultative Document appears to be based on assumptions that the system will work as it did before July 2007, ignoring the very substantial changes that have occurred or are occurring.
    - Fourth, liquidity is by definition a creation of market interactions; to the extent that banks are constrained in their ability to engage in maturity transformation and provide liquidity to clients, the result will be some combination of a reduction of overall liquidity, relegation of liquidity-risk management to entities not regulated as

banks, or a significant shift of liquidity risk and liquidity management back to the corporate sector.

- Fifth, there are significant, but perhaps not yet fully understood, implications for the future role in systemic stability of central banks. See Liquidity Appendix A.

Risk-Management Implications of Required Ratios; Implementation

17. The high degree of specificity of the scenarios on which the proposal is built tends to a substantial degree to take away from the institution the ability to set its own risk appetite and, by obvious inference, dictates the way the liquidity spectrum is to be differentiated, and priced. Much of the discussion of the origins of the crisis has focused, rightly, on governance issues, and there is now a much greater emphasis on the duty of each firm and its board to take responsibility for, and make clear, its risk appetite, subject to improved risk and liquidity-risk management and strong supervision. It is therefore ironic if regulation pushes all major firms to adopt similar policies, and adhere to the same minima, with the risks highly correlated responses by banks and overall increased market correlation that implies.

18. As the Basel 2008 *Principles* recognize, managing liquidity risk has to be a matter of internal risk management in the first instance, well tailored to the firm's mix of business, business models, and the markets in which it participates. This principle has been reiterated by national authorities, including in the recently issued *Interagency Policy Statement on Funding and Liquidity Risk Management* of the US banking agencies. The present proposal risks diminishing the relevance and impeding the development of liquidity risk management, including the appropriate internal pricing of liquidity on a risk basis, at a time when firms have made substantial strides to correct the deficiencies of the pre-crisis period. Firms would be required to manage to the LCR and NSFR, based on highly conservative assumptions that are often both rigid and unrealistic. Although notionally firms would continue to have to develop their own policies, limits, methodologies and stress tests in accordance with the Basel *Principles*, and although those internal procedures, if well designed, would provide superior liquidity-risk management, the presence of regulatory metrics operating as binding constraints will inevitably limit both the relevance of and management interest in the internal processes.

19. The formal framework imposed by arbitrary, mandatory assumptions, together with the difficulty of managing tightly defined categories of assets and funding sources, will rigidify the liquidity management of banks, yet, as discussed elsewhere, liquidity-risk management has made significant progress since the crisis, in accord with the Basel *Principles*. While it is entirely appropriate for the regulators to be concerned about the quality of liquidity-risk management, and it should be a priority of supervision, layering on more and more conservatism (as opposed to prudent procedures and tests) ultimately becomes counterproductive. As liquidity-risk management is now a much more integral part of risk management since the crisis, the broad credit and business policies of banks will be changed as well. Looking only at liquidity issues, it will be important

to assess the effects on the liquidity characteristics of markets, and this requires a broad dialogue based on close analysis by both private and public sectors.

20. It is striking that some of the basic incentives of the Basel capital framework seem to be missing on the liquidity side. Good behavior such as improving funding capabilities and capacities, improving liquidity-risk management, and improving asset liquidity should be reflected, in a risk-based manner, in the framework, allowing banks that can demonstrate sound practices and a solid position to use more realistic assumptions (greater risk-taking by other firms should of course receive appropriate, risk-based treatment). The BCBS should, instead of the rather rigid approach proposed, develop a framework that would stress all firms to comparable confidence levels with, where justified, different ranges of rigorous but objectively appropriate numerical assumptions for different banks and countries.

21. Moreover, requiring the major firms of the entire global industry to conduct liquidity-risk management on the basis of the same assumptions applied to the same ratios creates an obvious degree of model risk. Combined with the various capital requirements, these proposals may well contribute to additional cyclicality because banks will have less flexibility to respond to changing market conditions, and will broadly all be responding to the same supervisory incentives, regardless of individual facts and circumstances that might otherwise tend to mitigate the tendency for all players to move in unison in a crisis. For example, too-strict requirements could cause serious market problems and exacerbate crises if, for example, downgrade of a sovereign credit had a cliff effect on paper widely held by many firms.

22. Although to some extent the liquidity-risk systems developed or being developed or adapted under the Basel *Principles* can be the starting points for these developments, the IT demands of the new regime, especially if it remains highly prescriptive, should not be underestimated. Development of systems solutions for implementation of the new liquidity requirements will take time, depending on the scope and complexity of the final package, varying somewhat with the starting point and the complexity of each firm. Among the issues are:
    - The highly prescriptive ratio framework asks for data in ways it is not commonly collected.
    - To meet the new formulae, new forms of contractual maturity balance sheets would be needed, as would details on interest paid and received, funding sources by client, available unencumbered assets, differentiation between various types of depositors (e.g., insured vs. non-insured deposits).
    - Several firms' experience with the QIS indicates that a significant retooling of management information systems would be required.
    - Although the conceptual basis of the framework is similar to many firms' internal models and systems, in line with the Basel *Principles*, the divergences, especially of data requirements, would create significant differences from the way many institutions are managed.

Consequential Effects of the Rules as Proposed

23. The consequential effects of the ratios as initially proposed are likely to be many and varied. This discussion does not purport to identify all the possible consequences, nor can it identify all the unintended consequences that would emerge from the very complex process of not only firms' but the system's adjustment to the new capital and liquidity regime. There are many chicken-and-egg relationships in projecting the impact of the new regime, because elements feed back on each other, and firms are likely to change their patterns of business or even whole business models in response, which in turn would affect the net impact of the new regime. It is clear that the QIS as published will not be able to assess all these interactions, either within the liquidity proposals or between the capital and liquidity proposals. It is thus essential that a solid economic analysis of the cumulative effects of all proposed or likely regulatory changes be factored into the finalization of both sets of proposals.

24. Of course, the often-major investment in specific systems or in adaptations of existing systems for these purposes can only be undertaken with confidence once regulatory requirements are clear and interpretations are understood. As it will take time for many firms to develop systems to support the LCR and NSFR calculations (at least as proposed) with full rigor, the early phases of implementation and impact quantification will necessarily involve some substantial degree of approximation. It will therefore be important for the BCBS to gather data over time in order to understand the requirements' impact more fully than will be possible on the basis of the initial QIS, which be necessity includes many assumptions and approximations. Thus, it will be essential for the BCBS to re-propose the final liquidity package for public comment so that the actual requirements for, and impact of, its final configuration can be understood.

Market Effects

25. The proposals would profoundly change the markets for virtually all sorts of assets, eligible and ineligible, with the impact depending significantly on the ultimate definition of buffer-eligible assets. A too-narrow definition (as discussed in the next section) will inevitably increase concentration in eligible assets, increasing the chance that they will become relatively less liquid. Each assumption or requirement will have a direct effect on pricing, especially for assets not deemed liquid, and thus needs to be evaluated carefully in market terms. As discussed further below, there could be very real but unnecessary detrimental effects on assets such as covered bonds that are important to recovery. Further, the need to source additional long-term funding would be hindered by the reduced ability of financial firms to hold the debt of banks. Evidence for the modeling assumptions proposed should be opened for debate by market practitioners, in order to minimize market effects while still pursuing the goal of available liquidity. In conducting that analysis, improved regulation and internal liquidity-risk management should be taken into account, and the downsides of the pre-crisis markets should not be taken as givens.

26. A too-restrictive definition of eligible assets when there will be an expectation of maintaining large portfolios of such assets for liquidity-buffer purposes will necessarily affect the markets for both eligible and ineligible assets. Eligible assets, if defined too narrowly, may actually become significantly less liquid, as they will need to be held in large amounts for liquidity-buffer purposes, while demand for ineligible assets may diminish, with predictable market effects. A rush for any reason to sell or repo concentrated assets that are held in large quantities by all significant institutions would likely trigger or further propagate a systemic crisis by signaling, potentially incorrectly, a bank-specific problem, leading to depressed prices and wide spillover effects. As discussed in the Institute's comments on the leverage ratio, one of the crucial questions of the new regulatory regime will be the mutual effects of liquidity requirements and the leverage ratio: depending on the final configuration of both, the effects of such interaction could be enormous.

27. If most firms hold the same narrow range of "highly liquid" assets eligible under the Basel framework, as proposed at *paragraphs 28-34*, in the event of a systemic crisis, it would imply that all banks might need to liquidate the same range of assets at the same time, which would drive prices down, potentially leading to a liquidity gridlock, and exacerbation of a developing crisis, especially if the crisis had its origin in macroeconomic issues such as budgetary problems of large governments. Similarly, there would be the danger of similar action by many institutions if an asset were downgraded or otherwise changed its liquidity characteristics. Thus, being too restrictive in establishing the acceptable composition of liquidity buffers would risk undermining the very purposes of any buffer requirement if needed in a crisis.

28. The stress put on retail deposits would be likely to change the liquidity characteristics of those deposits, as firms would compete for the same, relatively inelastic pool of deposit business.[8] As also discussed in some detail, the imposition of a liquidity template on the spectrum of retail to wholesale liabilities would strain banks' relationships with reliable customers, narrow the product choices banks can offer, and distort the market in ways that could be avoided if the same goals are required to be achieved by more supple means, allowing banks to manage their liabilities and their product offerings within the general guidelines of the Basel *Principles*.

29. The higher cost of funds that the proposals would entail for the banking system will have to be reflected either in costs charged through to retail and wholesale clients, or in reduced lending and market-making, in reduced profitability and returns to equity investors (reducing investor appetite for bank equity at a time when the industry will be under pressure to increase equity), or, most likely, some combination of the three. Any

[8] As a speech by Ric Battellino, Deputy Governor of the Reserve Bank of Australia, points out, there are limits to bank's ability to lift deposit ratios, even by bidding aggressively for them in competition with other banks. For the banking sector as a whole, there is even less flexibility to attract funding to deposits from securities and other placements, given that a range of structural, economic and cultural factors shape the composition of the financial system. Moreover, inflows to deposits may occur at periods of high risk-aversion, but may be reversed as confidence returns. Remarks to the 22nd Australasian Finance and Banking Conference, December 16, 2009, p. 5.

combination would contribute to dampening economic activity generally. It is essential that the BCBS keep these effects in mind as it calibrates the numerous different moving parts that make up the two ratios.

30. The LCR and NSFR as proposed would materially affect trading businesses, especially those dealing in deemed non-high quality or presumptively less-liquid instruments, regardless of whether owned outright or traded in secured funding markets. Bank market-making and repo activity will very likely have to be reduced because of the need to hold more, and longer-term, high-quality assets to support dealing in other than "high quality" instruments. They will always have to be funded for at least 30 days and to a large extent partly or fully past one year (unless maturing sooner), which will be much costlier. While reduction of such assets and related financing transactions on the balance sheets of banks may be an intended outcome of the proposal, the risk of other, unintended, consequences, including possible reduction of bank balance sheets far more rapidly and forcefully than intended, requires careful consideration given its potential impact on borrowers, markets and the broader economy.

31. Impeding market-making will negatively affect the recovery of markets and the prices of instruments in several important markets, and restricting banks' ability to hold them on balance sheet will change the fundamentals of certain markets. This will have secondary effects on issuers, markets and the broader economy. Inability to treat certain asset classes as liquid under the scenarios would result in less secured financing activity, with reduced attraction of the asset class. This would raise costs, especially for smaller and lower-rated companies. There is in fact a kind of circularity about this because branding any class of traded assets as insufficiently liquid would tend to reduce its liquidity, on a self-fulfilling basis.

High Quality Liquid Assets too narrowly defined

32. The very narrow definition of "high quality" liquid assets eligible for the LCR poses a number of problems, in addition to the general market problems already discussed. The following basic observations complement the specific comments on *paragraphs 34* and related parts of the proposal.

33. A thorny but utterly critical issue is the role of central bank eligibility in the two ratios. Central-bank eligibility is appropriately an important criterion of liquidity for the LCR as written, but the severity of the LCR scenario makes it important to include more central-bank eligible assets (see the comments on *paragraph 31*). The NSFR incorporates LCR "highly liquid" requirements to an extent that is excessive given the quite different purposes of an acute short-term survival ratio and a longer-term mismatch management tool. These differences should be taken more into account in reconceptualizing the NSFR, along the lines suggested herein (see the comments on *paragraphs 78ff).* In the NSFR, the exclusion of a broad swath of central bank finance pursuant to *paragraph 84* is inconsistent with the severity of the scenario postulated,[9] and also needs to be rethought, balancing concerns of moral hazard with a realistic

[9] See the discussion below of *paragraphs 78-84*.

assessment of how such a severe scenario would actually unfold, as some central-bank authorities have already pointed out.

34. The definition of high-quality assets has a strong bias toward sovereign debt. This implies ongoing effects on the market that need to be considered. Right now, thanks to various governmental efforts to support national economies, there is a large supply of sovereign debt that can be used for this purpose in most, but not all, markets; however, once governments stabilize their economies and efforts are made to reduce national debt, a shortage of available assets that are considered eligible could develop, compounding other concerns explained here.[10] In addition, the proposals mandate a material increase in firms' exposure to sovereign credit risk for incremental high-quality liquid asset buffers at a time when sovereign credit quality is deteriorating. There is no stated ratings requirement for relevant sovereign debt in *paragraph 34* or elsewhere, but such is implied by the 0% risk weighting (which applies to sovereign obligations in *paragraph 34(c)* (though not in *paragraph 34 (d)*) firms are concerned about the resulting concentrations and the need to respond, either for internal risk-management reasons or for these or other supervisory reasons, to a ratings downgrade.

35. A definition of acceptable liquid assets substantially focused on sovereign debt, as proposed, would also affect the market both for banks as issuers and for non-financial corporate issuers. Aside from the danger of crowding out because of the additional demand for sovereign paper, financial firms would find it more difficult and costly to issue the paper that will be required to meet the new requirements because of the deemed lack of liquidity of their obligations in both the Basel capital and liquidity proposals. Smaller banks have historically used the paper of larger institutions in part for liquidity purposes; if this is no longer possible, the ability of the large institutions to fund themselves will necessarily be changed. These market changes will occur as a result of the proposals at the same time that money market funds, a major source of bank funding, are being required to reduce the duration and increase the quality of their holdings, again changing the basic characteristics of the markets.[11]

36. Moreover, shifting bank investment from the traditional array of assets toward a substantially increased focus on sovereign paper is likely to affect the ability of corporate issuers to finance in customary markets, shifting part of their demand for credit back to the bank sector at exactly the same time that banks may need to constrain their lending to meet the new liquidity requirements (the effects of which would be compounded by the proposed leverage ratio). Greater demand by corporate borrowers and other recent public-market issuers for bank loans would further exacerbate the pressure on banks' total term funding needs, and increasing demand against limited supply would have the normal effect.

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[10] It may be noted that the stock of sovereign debt in some markets such as Australia's is already limited.

[11] Separately, a narrower scope of eligible assets would have effects on the competitive position of smaller banks. If small banks that have been placing their deposits in bank paper can no longer do so for liquidity reasons, and instead have to buy government debt that yields less, their internal transfer pricing curve will go from being bank-curve driven to government-curve driven. They will be able to pay less for deposits to keep spreads the same, or sacrifice profitability and competitiveness.

37. As a heuristic device, it is possible to envision various ways to widen the currently very narrow requirements for liquid assets. This could be done by a combination of
   - accepting a wider range of assets as liquid, including more assets that would be included subject to appropriate haircuts;
   - recognizing the reality of a spectrum of liquidity even within the LCR survival period; and
   - Allowing liquidity value to be ascribed to the next level of liquid assets in the denominator of the LCR: at present highly liquid assets appear not to be given any value.[12]

   Each of these remedies is worth considering; however, because of the market effects of the very narrow range of acceptable assets, it will be essential to broaden acceptance as part of any combination of measures.

38. It is important to stress that, in making the points in the foregoing paragraphs, the Institute does not mean to downplay liquidity risks or advocate a return to business as usual before July 2007, or complete laissez faire in the assets that are counted for liquidity buffers. Clearly, some assets were so counted before the crisis that should not have been (such as highly rated tranches of ABS and CDOs); however, the market effects of defining the new rules too narrowly will be great, especially at a time of recovery. And the experience of liquidity-risk managers is that legitimate liquidity concerns (as expressed by the IIF 2007 recommendations and the Basel *Principles*) can be met with a somewhat broader range of assets, on a conservative basis, especially for the longer time horizons.

39. As the Committee notes at *paragraph 29*, there are significant trade-offs between the severity of the stress scenario and the definition of eligible liquid assets, and it is essential that the final calibration be sufficiently conservative to induce prudent liquidity practices while minimizing the negative impact of liquidity standards on the financial system and the broader economy. That the Committee is evaluating both a very narrow definition and a somewhat broader definition is applauded; however, the Institute's Liquidity Working Group is concerned that too much emphasis is given to the narrower approach which, if adopted, would be a significant cause for worry.

40. The possibility of a definition that would include a broader range of obligations such as certain corporate and covered bonds as suggested by *paragraphs 36 and 37* is constructive, but the proposed haircuts are highly and unnecessarily conservative. As discussed further in the specific discussion of those paragraphs, this requires a more flexible and market-realistic assessment of the alternative assets that would be allowed. Such assessment could certainly include the 2007-2009 period. Particularly as one goes out the liquidity spectrum, either toward day 30, even in a market-wide stress scenario, or certainly toward the one year horizon, more and more assets should be acceptable, subject to risk-based analysis and haircuts. Certainly, many corporate bonds and listed equities are liquid and have remained so during the crisis, and this needs to be

[12] See the discussion of *paragraphs 38-40* regarding net cash inflows.

considered in finalizing both the numerator and the denominator of the ratio. Expansion of eligible liquid assets should be a first priority, given the stakes of too-narrow a definition.

Runoff and Rollover Assumptions are too rigid and too severe

41. Prior IIF liquidity reports have stressed that ratios and metrics would be most effective – and avoid potentially misleading results – if tailored to each firm's mix of businesses and risks, subject to good supervision and general principles intended to achieve broad, global consistency and a level playing field. This is of course easy to say and hard to achieve, but that fact does not diminish the force of the point.[13]

42. As a result, there is serious concern with the apparent assumption of the Consultative Document that harmonization, consistency and a level playing field must be achieved by using the same numerical assumptions for every bank in every country for all on- and off- balance sheet categories. Recent history has clearly shown again that banks and countries can be affected very differently by a crisis. More reliance on empirical evidence, good internal data and risk management, and informed judgment on future expectations, all under strong supervisory challenge, is clearly indicated, rather than top-down formulae. This is particularly of concern given the scope of the constraints imposed by the NSFR on legitimate maturity transformation.

43. The NSFR postulates an extreme situation, assuming that all bad things can and will happen at once and can and will be sustained for the entire period. For example, in other assets and liabilities, derivative-related assets are assumed to be totally illiquid while derivative-related liabilities are assumed to be immediate outflows.[14] This is highly implausible but basing the requirements on these assumptions has very material consequences. In some instances, assumptions are based on distinguishing factors that are questionable and appear arbitrary, certainly without any discussion of their empirical basis. Examples would include deposit run-off rates by size of SME, deposit insurance, domestic vs. foreign currency, operational relationships, etc. At the very least, these assumptions need to be explained and justified; in fact, the rigidity and ex-ante nature of these assumptions across the broad swathe of financial institutions demonstrates, in the view of the Institute's Working Group on Liquidity, the need for a new approach, one more based on conservative assumptions within the experience and market conditions of each firm. As new guidelines on assumptions are developed, they should take into account their impact on markets, affected products, and credit generally, after consultation among the relevant public authorities, and the industry.

[13] But the progress already demonstrated by the IIF and Ernst & Young work on implementation of recommendations for improved liquidity-risk management suggests that a fundamental shift of emphasis back toward the Basel Principles on liquidity-risk management should be feasible. See Section II of *Reform in the Financial Services Industry.*

[14] The QIS indicates that this is intended to be netted, but that needs to be clarified in the document, also taking into account collateral pledged or received against the net position.

44. Many of the assumptions exceed the experience of the recent crisis: the general assumption that short-term wholesale funding and repo markets would be largely eliminated for all counterparties has been not borne out by the crisis (although of course market conditions were very challenging), but appears to be the rationale for mandating that essentially the entire funding needs of basic businesses be covered by sovereign-debt liquidity portfolios. In fact, while firms that were spiraling down did face specific problems, wholesale funding and repo markets remained available, albeit at shorter maturities. Non-government-guaranteed agency debt, agency-backed mortgage paper, highly rated bank debt and equities are all treated far more harshly than actual experience would justify. As discussed elsewhere, the reorientation of much bank investment to sovereign debt will necessarily impose higher additional costs on other asset classes; lead to decline of demand for non-eligible assets; and perhaps artificially affect sovereign bond yields, possibly with other unintended consequences as well.

45. In addition, as discussed further below, the starting points for firms in terms of capital and liquidity strength, as well as mix of business and relevant markets for each firm need to be considered if the framework is to be truly risk-based. If not, stronger firms would be held to the same worst case, one-size-fits-all assumptions and measurement standards as weaker ones, materially disadvantaging them on a relative basis, and detracting from their ability to be sources of strength in deteriorating markets. Common numerical assumptions may be expedient and seemingly universal but will set the wrong incentive system for firms, and probably have unintended consequences that may be difficult to project at this stage.

III. A Modified Approach

Differences Needed in LCR and NSFR Implementation.

46. Taking a step back from the many issues posed by the current proposal, there should be a clear differentiation between the approaches taken in the LCR and the NSFR. Subject to specific comments, the concept of the LCR makes sense: it should be fairly stringent and require banks to cope over the chosen survival horizon with an idiosyncratic crisis and the beginnings of a systemic crisis. For that reason, it may be acceptable to standardize insofar as possible the LCR assumption set (which should, however, be more risk-based than the current assumptions) and to implement it as a binding constraint on a fixed-ratio basis.

47. While the Institute supports the idea that a bank must carefully monitor its maturity transformation, maturity mismatches, and long-term funding needs, the NSFR, at the very least, should include the leeway to accommodate each bank's specificities. Many members are concerned that, as proposed, it would limit maturity transformation to an extent that undermines the basic purpose and role of banks, if it does not result in "reverse transformation." [15] As the Institute has long pointed out, and as indeed many

[15] The Institute shares the concern recently expressed concerns of the UK FSA "… that the NSFR makes unsupported ex-ante claims about the future liquidity of assets, and contains unwelcome macro-prudential incentives by assuming a large scale and simultaneous liquidation by firms of securities and encouraging firms to change their

official-sector pronouncements such as the recent US Interagency Policy Statement acknowledge, liquidity-risk management depends on many firm-specific liquidity characteristics of business model, mix of business, market participation, market status, and the like. Unlike the LCR, the NSFR should not be hard-coded, and even more than the LCR, it is only useful if considered in conjunction with other metrics appropriate to the given firm. Even if a fixed, Pillar-1 type of approach were desired, the NSFR proposal serves mainly to show the difficulties: it is highly prescriptive, yet far from granular enough to support a highly prescriptive regime. Thus, a Pillar-2 type of approach, much more akin to the Basel *Principles* but with guidelines for the supervision of an internal models approach is the only way feasible for the NSFR, at least at this stage. Such an approach would, as a matter of course, include intensive and more sophisticated supervisory review, stress testing as already required by the Basel *Principles* and the present proposals, and good coordination through colleges.[16] A more appropriate and sustainable system would foresee a better balance between regulation and supervision than does the current draft of the NSFR proposals.

Making Buffers Usable

48. A point of great concern to the industry is that the resources required by the LCR and NSFR, to fulfill their purpose, must be usable. The importance of making "buffers" usable is especially critical liquidity purposes, where very quick reactions to developments may be required, and demands in a stress situation may be both very large and hard to anticipate. Setting minimum, stress-based LCR in particular, could be self-defeating if firms were not permitted to fall below the minimum, either by regulatory requirement or market pressure (see the discussion of disclosures, below).

49. To make buffers usable there must be some flexibility in the administration of the ratios, so as to dampen rather than compound the market forces developing in a crisis. It is important for the BCBS to make this explicit. The Reserve Bank of New Zealand recently made a statement of the type necessary: "Liquid assets and committed funding lines are held to support a bank's ongoing ability to meet obligations in the event of stress. Should a bank need to liquefy such assets or draw down such lines to meet its obligations, then the Reserve Bank recognizes this should be done even where doing so would breach the minimum regulatory requirements. … The Reserve Bank would then discuss the process for returning to compliance with the ongoing minimum quantitative requirements. … The Reserve Bank would also discuss what information might be disclosed about the breach, the reasons for the breach, and the path to re-attaining compliance."[17]

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lending to the form of marketable securities rather than non-marketable retail and corporate lending, which may impact lending to the 'real economy.'" UK FSA, *Financial Risk Outlook 2010,* p. 35.

[16] A version of this intensified supervisory role and review has worked well in Japan since the crisis of the 1990s.

[17] Reserve Bank of New Zealand, Liquidity Policy, Prudential Supervision Department Document BS13, October 20, 1009, paragraphs 37-38. Similarly, the Bank of Canada recently stressed that the purpose of a pool of liquid assets is to permit financial institutions to use them when a shock occurs, with shortfalls being addressed in consultation with supervisors. Bank of Canada Financial System Review, December 2009, p. 38. By the same token, the European Commission has stated that, despite current wording that would purport to require firms to meet standards at all times, realistically, under stress, a firm could fall under the requirements; as a result, firms would

Need for further analysis and consultation

50. The consequences of the liquidity framework for the whole economy need to be carefully analyzed. The Quantitative Impact Study (QIS) will certainly help in measuring the impacts for banks but will not enable to anticipate how banks would adapt their business models to the changes in the regulation. The IIF is pleased that the Committee is also doing a top-down study of more comprehensive potential effects of its proposed capital and liquidity changes, hopes to contribute to that discussion via its own comprehensive impact study.

51. Yet the complexity of the combined capital and liquidity proposals and their impact on the overall system and economy suggest that the necessarily tentative initial studies are not likely to be sufficient. This is especially important on the liquidity side, where there is less depth of intensive work to draw upon than on the capital side, and where more is new when put in the guise of a comprehensive regulatory mandate. Therefore, it will be necessary to undertake a second round of QIS and cumulative-impact studies once the final package is available for formal proposal at the end of 2010. At that time, it may be useful for these studies to be complemented by both close discussions between colleges and individual banks and by dialogue between the industry and the Committee's liquidity experts, to assure that all aspects and impacts of the changes are considered. At a more technical level, such industry interaction could consider the details of the calculation of the LCR and NSFR, which need close, empirical examination and discussion. As the industry has not had the benefit of the empirical evidence on which the Committee based its decisions, it would be highly beneficial to the understanding, acceptance, and implementation of the final framework if there could be a focused discussion of the outcome of the Committee's deliberations, before finalization.

52. As a factual and analytical matter, all the various specific quantitative assumptions, such as run-off percentages, require examination and discussion. It would be quite helpful to the industry in understanding the proposals to have an explanation of how these specifics have been derived. The Institute would also hope that a constructive debate on these specifics with senior experts who are involved with liquidity every day of their professional lives would help the Committee to refine the proposals, to arrive at an effective but also efficient final approach.

53. This is critical because ultimately what is at stake is not only how various assets and liabilities would be treated in LCR and NSFR, but how the same assets and liabilities would be repriced to reflect their new assumed liquidity value, which will impact related funding strategies, products and markets.

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need to restore compliance over a relatively short timeframe (presumably taking into account the extent and depth of any systemic issues) and to work with their supervisors to define a plan for restoration of compliance. Commission Services Staff Working Document, "Possible Further Changes to the Capital Requirements Directive", 2010, paragraph 3.

54. The IIF would urge the BCBS to examine closely the recently released CEBS guidance on liquidity buffers for a more effective way to create the necessary stress scenario, and the CEBS "ID Card".[18] In its standards, CEBS requires that the firm define the scenario in concert with its college of supervisors, so that the scenario reflects the specific business lines the firm is engaged in and the previous experience the firm has operating in its different jurisdictions.

Certain Special Situations

55. Certain cooperative and savings banks or other special-company structures are substantially integrated by brand name and governance, but are structured through cross-holdings and guarantees of entities within an overall structure that is nevertheless substantially integrated economically. Within such a decentralized cooperative structure, there will be liquidity flows from the deposit-taking entities to the central institution, and among the entities. The Committee has acknowledged in its capital proposals that the needs of non-corporate entities need to be taken into account, to achieve the same effects as for banks with ordinary commercial forms of organization. Affected banks have deep roots in their sectors and provide services on a well-established and well-understood business model. These banks will require clarification of the rules for intragroup transactions, but this can be done without compromise of supervisory goals. Clarification of application of the rules to these situations should be on a transparent basis, so that other regulators and investors understand them. Such adjustments should serve to put such institutions on a comparable basis with their commercial competitors, without disfavoring a form of organization that has long served their markets.

IV. Transition Issues

Phase in

56. Subject to revision of the proposals of the Consultative Document, and even assuming ongoing progress on implementation of the Basel *Principles*, it is likely to be necessary for the new liquidity regime to be phased in over time, a need the BCBS certainly recognizes in general terms. Again, the scope of the new regime, the magnitude of the changes, and the newness of much of what will be required suggest caution in evaluation and phase-in. While a "feasible pace of adjustment", to quote the UK FSA, can only be determined on the basis of robust QIS analysis, with reference to a final set of proposed liquidity and capital regulations, the timing and phasing in of full implementation of the final liquidity framework will definitely require careful attention to (a) its interactions with the capital framework (especially the leverage ratio as finally calibrated), (b) the central banks' exit from extraordinary monetary and market-support interventions, (c) reopening of the securitization markets (or analysis of replacement credit sources in the event those markets appear unlikely to play as full a role in future markets as in the past); and (d) assessment of whether robust global GDP growth has

[18] See CEBS *Guidelines on Liquidity Buffers and Survival Periods*, and CEBS *Liquidity Identity Card*, June 2009.

been achieved (two consecutive years of growth in major markets would give confidence that a reasonable final liquidity framework could be introduced in conditions that would allow the banks, central banks, and supervisory authorities to manage the impact thereof).[19] As discussed above, firms will require time to adjust systems and data collection once the final requirements are known.

Consistent Implementation; Role of Colleges

57. Whether for the liquidity, capital or any other such far-reaching regimes, a significant risk to any firm, especially for internationally active firms in capital markets businesses, is inconsistent, asynchronous, or asymmetric implementation across jurisdictions. Firms in countries that are early or stricter adopters of stringent standards would be especially vulnerable versus firms of other major countries with which they compete. The more conservative the proposals are when compared to current practices, the more this will be relevant. Thus, consistent adoption, implementation, and interpretation across the major markets will be critical to the success of any new regime. A patchwork of country-specific liquidity regimes and reporting requirements would in many ways be the worst possible outcome, as indeed the G20 principles calling for global standards recognize. This is important for level playing-field issues, but equally important to assure consistent, high-quality and effective standards across the global system.

58. Some of the concerns reflected in the Consultative Document that, as seen above, can appear troublesome to the industry, ought to be attenuated by good coordination of supervision through the colleges of supervisors of major international firms. While the role of colleges in supervision of liquidity is not yet fully developed, it is clear that that role, as envisioned by the FSB and the Basel Committee's Standards Implementation Group. As discussed above, it is essential that the NSFR be put on a more "Pillar-2" type of basis, and this in turn should involve a substantial role for colleges in review of banks' liquidity-risk management, stress testing and general implementation of the Basel *Principles.*

59. Consistent supervision through well-functioning colleges could contribute to the overall liquidity of the global system by creating conditions that would permit expanding the scope of group-wide liquidity-risk management within firms, under the supervision of home supervisors, while giving assurances to host supervisors that the group as a whole would be well-supervised.[20] As international banks tend to manage funding centrally in

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[19] See also the comment on *paragraph* 84. See, UK FSA, *Financial Risk Outlook 2010,* pp 30-36 on the challenges, including the inadequacy of likely deposit availability and issues of finding longer term sustainable funding in the transition to the desired new liquidity regime.

[20] The Institute's prior reports on liquidity have stressed that banks have different models for liquidity-risk management, but many have concluded that focus of liquidity management at the group level is likely to be most efficient for the group as a whole, and also contribute to global stability by maximizing the ability of the group to maintain an internal market in liquidity, allowing it to deploy resources where most needed, with minimum frictions. Of course, the need to respect local regulations, particularly insofar as local currencies are concerned, is also

the deepest and most reliable available markets, especially in the major currencies, optimizing maturities in line with new regulations and changing needs will not be easy, and care should be taken not to lessen banks' abilities to manage funding liquidity any more than necessary. "Trapped pools of liquidity" will become an even greater concern than when the IIF raised the issue in 2007, as new regulations come on line. Colleges offer a well-supervised means to attenuate that burden on global liquidity.[21]

60. Colleges should both foster and benefit by greater harmonization of liquidity reporting requirements, on a globally consistent basis, but with firm-specific information and metrics appropriate to the group, perhaps based where appropriate on a selection of parameters from a commonly agreed menu. As noted elsewhere, the most appropriate metrics and parameters will vary from firm to firm depending on its markets and businesses, but colleges should be able to manage this process with banks on a transparent and comprehensible basis.

Reporting and Disclosure

61. Although the discussion of disclosure at *paragraph 135* is quite abbreviated, it has extensive implications. Data and IT issues have already been discussed above. The Committee needs to be aware of these issues that firms will face as the new guidelines are implemented, and be ready to consider whether more complex and detailed requirements result in improvements in risk measurement that justify these investments.

62. Any planning for public disclosures with respect to the LCR, NSFR, or any aspect of liquidity must include the fact that disclosing specific contractual cash flows and mismatches would be more misleading than helpful to investors, and potentially damaging to the stability of firms and markets. Normal cash flows through a firm may be subject to seasonal or business-cycle variations. Disclosing liquidity-risk specifics

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recognized, and is addressed in the discussion of Recommendation 9 of the IIF *Principles of Liquidity Risk Management*, March 2007.

[21] Since 2007, the Institute has pointed out the danger that "trapped pools of liquidity" in national jurisdictions would lessen overall resilience in the global system. It has since expressed concern about certain liquidity proposals, such as those of the UKFSA last year, which would tend to increase the fragmentation of liquidity within groups and across the global system. While the European Commission's comments on the Basel liquidity proposals are often helpful, paragraph 19 of its commentary is highly disturbing. That paragraph would appear to preclude the waivers for well regulated international groups that even the UK FSA's very conservative proposals permit. It states that "The Commission services currently do not envisage making available a waiver for individual firms' liquidity requirements based on consolidated supervision over a group comprising entities outside the EEA because the condition of free asset transferability … could not be met for groups including institutions outside the EEA." This is not the place to engage in a detailed debate with the EC, but this approach bodes ill for the integration and health of the international system, and the vital role multinational groups play in managing liquidity, as described in the Institute's prior reports. (See: Commission Services Staff Working Document, Possible Further Changes to the Capital Requirements Directive, 2010, paragraph 19). The BCBS should, in contrast, take note of the comments of the head of the IMF: "… major banks manage their funding and lending risks globally. If banks have to lock up pools of liquidity in every national jurisdiction, their capacity for intermediating capital across borers could fall, and their charges for doing so rise, to the detriment of the world economy. Such considerations need to be thought through and debated at the multilateral level prior to agreeing reforms, even ones that seem perfectly reasonable, in any one particular direction." Dominique Strauss-Kahn, "Nations must think globally on finance reform", *Financial Times*, February 18, 2010.

would tend to be procyclical as it could trigger a spiraling crisis if data are misinterpreted: the financial community can trigger a wider crisis just by withdrawing funding from a given institution.

63. In particular, disclosing a liquidity buffer near, at, or below the regulatory minimum would immediately suggest to the market a serious problem, possibly triggering a run, yet the point of having a buffer is so that assets can be used in appropriate circumstances (such as response to macroprudential developments, a rogue trader or perhaps unfounded rumors against the firm) and there will be a period when a bank needs to marshal all its liquidity resources, in consultation with its supervisor but necessarily without immediate disclosure, to deal with the situation.

64. It might be, for example, that a firm could slip for good and non-threatening reasons from 115% to 105% of its LCR. While the supervisor should be aware of this, disclosure of the change – which could be highly misleading if read as an index of serious liquidity problems – could trigger an assault on the firm and drive it down, whereas, in fact, it might operate quite comfortably for a time at 105% and gradually increase its buffer from there. The disclosure could thus defeat the purposes of the liquidity framework. Similarly, any disclosure of NSFR numbers could give a flawed picture, given the rigidity of the assumptions, which may distort the actual situation of any given firm.

65. Moreover, while the intention may be to allow banks temporarily to reduce their level of high-quality liquid assets below the minimum in certain circumstances, in practice, rating agencies and investors are unlikely to let banks do so without material consequences under any circumstances. Hence this earmarked pool of liquid assets will essentially become encumbered at all times unless a bank is in the direst of circumstances where its ‘going concern’ is questionable. The buffers banks currently hold are in line with their internal policy. They can within defined governance processes use them as needed in rare stress or unusual operating circumstances without attracting unwarranted attention.

66. In thinking about appropriate disclosures, there is a fundamental difference between the capital side and the liquidity side. Whereas disclosure of a capital number, or even a VaR amount (though that can be misleading for other reasons) can be communicated to the market as a given, liquidity “facts” depend very much on the firm’s interactions with the market; thus an ill-considered disclosure can have drastic and unwarranted, and immediate effects on the firm and on the market itself. The wrong disclosure at the wrong time could be highly procyclical, exacerbating downturn events or setting off snowball effects.

67. As a general matter, it would be preferable that specific and timely liquidity-risk disclosures be limited to supervisors (both home and host supervisors), except perhaps insofar as disclosure of backward-looking ranges of experience may be valuable for

investors' evaluation of firms' liquidity-risk management.[22] Alternatively or additionally, auditors could be required to certify the banks' compliance with regulatory liquidity requirements throughout the year, without quantification. This would allow institutions in rare circumstances to slip below 100% compliance for valid liquidity reasons so long as they do so with regulatory approval.

68. The Banking Supervision Committee report on Stress Testing (European Central Bank) of November 2008 included a valid warning on this subject, concluding that "While more disclosure, in particular on banks' liquidity risk management, is generally to be encouraged, the BSC considers that, in the case of liquidity stress test results, the detrimental effects of mandatory public disclosure are likely to outweigh the benefits."

69. As a related matter, it would be helpful if the BCBS and the SIG foster international harmonization of reporting requirements mandated by the Basel framework: this will avoid the burdens, potential errors, and possibility for confusion or inconsistent interpretation that are predicable if formats are not consistent.

V. Specific Points and Questions on the Proposal

A Globally Consistent Approach

Paragraph 10: The concept of adjustment to take account of jurisdiction-specific issues, notably the behavior (run-off rates) of deposits and the implications of local deposit guarantees, is very important and consistent with the Institute's view that effective liquidity-risk regulation must take into account actual, rather than assumed, variables applicable to each country and, importantly, to each bank. However, there is the obvious trade-off between this flexibility and the level playing field and it is suggested that, in addition to clear delineation of the relevant rules (not necessarily a-priority parameters applicable regardless of firms' circumstances) in local regulations, there ought to be concentration of approaches, perhaps through the Basel Committee's Standards Implementation Group or the FSB, which should develop rigorous approaches to peer analysis to assure that justifiably different approaches in national contests achieve comparable outcomes.. Adjustments should be made because they are justifiable on a risk-based, objective basis not for preferential or prejudicial reasons. As noted below, each firm's college of supervisors can play a significant role in the required balancing. In any case, as discussed above, it is highly important to avoid asynchronous or asymmetrical implementation of the liquidity regime across the G20 countries.

Paragraph 15: As discussed elsewhere, while it is appropriate under many circumstances to take account of jurisdiction-specific conditions, the overall goal should remain to achieve as great consistency as possible across jurisdictions. This of course will not be easy and the Committee is right to focus on transparency of the approach taken by national regulators; it

[22] For a further discussion of liquidity disclosure issues, see Recommendation 13 of the IIF *Principles of Liquidity Risk Management* and Section VI on Transparency and Disclosure Issues of the *IIF Final Report of the IIF Committee on Market Best Practices*, July 2008.

should also, however, be a priority of the Committee and of the SIG, as of the FSB, to maximize the convergence of supervisory practices over time.

For this purpose, the Committee should establish supervisory norms that are as clear as possible, with national supervisors to take a "conform or explain" approach whenever national requirements deviate from international guidelines (including by being more stringent).

Liquidity Coverage Ratio

Paragraphs 20-24. The IIF recognizes the need for a short-term survival ratio to ensure firms maintain sufficient liquidity to endure an acute stress period. Liquidity shocks proved fatal to certain firms over the past two years, and as a result, firms have already put serious effort into improving their ability to survive such short-term conditions. However, the approach and assumptions in the Consultative Document are extremely conservative in many respects and will therefore have a number of serious consequences for the industry and the economy, as well as for firms. It is obvious, but worth stating, that conservatism in this context has a price, and one of the Committee's most difficult tasks will be to be to make trade offs between conservatism and future liquidity (and economic growth) in the system, especially in the context of the overall complex of capital and other changes. The Institute is of the view that a responsible and reasonable balance can be achieved while managing down the likely negative effects of a very conservative approach.

While a good case can be made for a 30-day survival period, firms' ability to manage resources over that period even in stressed times should be recognized.[23] Widening somewhat the assets receiving liquidity value would reflect fact that over such period the market would react naturally to the initial stress event, providing a context in which all firms, except any firm that actually failed in the first event, would react.[24] One solution would be to provide that the LCR could include X% of "highly liquid" assets, relatively narrowly defined (though not so narrowly as in the current proposal) and Y% of a somewhat broader range of liquid assets. The proportions might be 50%-50% or 60%-40%. The buffer "portfolio" thus created would reflect what banks could do with such assets in the one-month period (some in the second category might require slightly more time to monetize), and this would be one way of reducing the impact that the present proposal's "highly liquid" definition would have on the markets for such assets.

Paragraph 22. Although described as a "minimum", the scenario is unrealistic in ways that are ultimately misleading – it is a scenario where every adverse event that happened during the recent crisis is assumed to happen to each firm. Stress scenarios should not be built as simple aggregations of the worst potential outcomes for each product and market by the most affected firms and countries unless it is reasonably plausible that these may all happen at the same time to all relevant firms, even well-managed firms, and countries. There are likely to be a number of instances where these assumptions and consequences are mutually exclusive given the nature of the scenario, firm, country and markets of operation. Major runs (as in Lehman, Bear Stearns or

[23] See CEBS *Guidelines on Liquidity Buffers and Survival Periods*, Guidelines 3 and 4, distinguishing the higher degree of confidence require for the very short term, within the 30 day survival period.

[24] It should be noted that, presumably, firms would be applying the "recovery" plans that that they are now developing, and the authorities would be applying the new "resolution" plans to any firm that actually failed.

Northern Rock) only occur when the firm is in extremis, no longer in survival mode: it could not be the case that all firms would be in such a condition at the same time, and in any case, deposit insurance and resolution regimes, which vary by country, would mitigate some of the effects, adding to the unreality of the maximally bad assumptions.

The scenario is noticeable for its lack of distinction between firms, despite substantially differing starting circumstances. For example, the three-notch downgrade of the credit rating will have drastically different market consequences for a BB firm than for an AAA firm, and this should be reflected in the framework.

Furthermore, for stronger firms, and based on stress testing reported by such firms, assuming a full loss of unsecured wholesale funding capacity and secured funding capacity for all non-eligible assets (especially equities) after a three-notch downgrade is very extreme given that the firm would still be rated well into investment grade. The exact effects would, of course, depend on market conditions, the degree of systemic stress, and each firm's funding diversification and general strength; however, the proposals does not reflect the likely effects on a strong firm, and in some ways discriminates against stronger firms in the calculation.

Moreover, in a broad, systemic event, stronger firms have the benefit of a flight to quality by market participants, which may appropriately be assumed away for these purposes, but further shows the inappropriateness of disregarding the different points from which firms would start in a general crisis. Specific situations will affect different banks differently, but it must be kept in mind that non-bank companies do not have access to central banks and must keep their funds someplace, even in the direst crisis. Thus, they will move toward the soundest banks, as indeed there was a dramatic move out of US money-market funds to banks in the aftermath of the Lehman failure.

Stock of High Quality Liquid Assets

Paragraph 26, footnote 5: High-quality assets hedged with a derivative to mitigate the IRR of the liquid asset should not be considered tied. Any assets that are repoable should not lose their eligibility because they may otherwise be tied in some sense. The current description of tied assets as encumbered assets will potentially result in some assets that could be monetized being excluded for no good reason. This needs further discussion. See also the comments on *paragraph 75.*

Paragraphs 27, 28, 29. It should be noted that meeting the test that "assets should be liquid in markets during a time of stress" is a subjective one and will require the application of judgment by firms (and supervisors).

It is important to note that the balance of the proposal narrows the basic test of "assets liquid in markets during a time of stress" because the requirements at *paragraph 34*, such as 0% Basel risk-weighting, would rule out many assets that actually proved to be resilient sources of liquidity during the 2007-9 crises. The other assets that performed well in the crisis period in liquidity terms, such as US agency debt, US agency mortgage-backed securities, good-quality equities, and many investment-grade corporate obligations, would, of course, need to be subject

to reasonable (but not exaggerated) haircuts. The same point applies with respect to additional assets that are very tentatively raised for consideration at *paragraphs 35-37*: there are many assets that in fact remained robustly liquid during the crisis, as discussed further below.

More fundamentally, there is no stated empirical basis for the conclusion that a 0% Basel risk weighting would necessarily correlate with high liquidity: other assets treated otherwise for capital purposes may fit the bill just as well. Moreover, correlating credit ratings with liquidity issues may increase cyclicality and systemic risk. This is a topic that requires objective study and discussion with the industry.

Paragraphs 29, 34. There can be no assurance that there will "always" be committed market-makers: this can only be a matter of judgment, based on experience. In addition, the proposed LCR assumption sets would act as a disincentive to market-making activity on those assets that are excluded from the definition of "high quality" liquid assets for LCR purposes.

Paragraph 29: See the general comments in the first part of this paper on the critical tradeoffs the Committee faces.

From a macroeconomic perspective there will be material unintended consequences if bank paper is not eligible for the liquid assets buffer or as an inflow in the LCR denominator in any time period for any amounts. This proposal requires banks to maintain a much more conservative term funding profile, which can only be done at the margin by issuing more term debt or selling core assets (once core deposits are maximized). Bank treasuries are important buyers of other banks' debt: considered as whole, this fact helps the banking system by channeling excess liquidity to where it is needed and adds a degree of diversification to funding sources (deposit funding from another bank ultimately comes from non-bank sources; deposit funding from smaller banks is important to both parties' liquidity management). This proposal will materially reduce the appetite for other bank debt. Furthermore, by limiting the scope of other non-government debt that can be held in liquid assets buffers and applying very large haircuts if eligible, this will reduce demand for such debt and the recovery of these markets, which will result in more demands for bank loans by these issuers, which will further compound the issue the bank faces in raising money.[25] Moreover, under the NSFR, banks will have to raise more term funds at a time when their debt will therefore be in less demand.

In smaller markets, it will not be possible to meet a strict construction of the criteria of "low market concentration" and a "diverse group of buyers and sellers." This has not, however, diminished the reliable liquidity of market such as those of Australia or Canada.

Paragraph 31. The Committee is right to make allowances for circumstances where non-central-bank-eligible assets might nonetheless be appropriate for liquidity buffers (as argued with respect to *paragraph 29,* more such assets would be liquid within the 30-day time horizon of the LCR).

While the reasons for requiring some degree of market liquidity as well as central-bank eligibility are understood for purposes of LCR planning, the LCR is draconian in the extent of

[25] Note that, in most countries and in the European Union, large-exposures rule set limits on concentration risk in inter-bank funding.

market factors required (as discussed further below), and might be interpreted to exclude assets eligible for ordinary-course-of-business functions of central banks (especially in markets where private markets are weak), in addition to the lender-of-last resort functions that were probably intended to be excluded.[26] Supervisors should have greater latitude to accept central-bank eligible assets. For level playing field purpose, exercise of such flexibility might be subject to periodic vetting through the SIG or the corresponding FSB Standing Committee for Standards Implementation, as should the flexibility for supervisors in countries with narrow lists of central-bank eligible assets foreseen by *footnote* 7.

Paragraph 32: The reasons for the concern about availability of buffer assets for buffer purposes are understood, but the proposed language is too rigid in that it seems to dictate an internal control pattern that may not always be necessary, and it sets too rigid a "sole intent" test. Given good controls and systems, there is no reason why an unencumbered asset held in another part of the bank should not be considered available for buffer purposes or considered a cash inflow in the LCR denominator, provided that it cannot be used for other purposes without sufficient notice and clearance. Similarly, long liquid-asset positions hedged with short liquid-asset positions or long-asset positions hedged with derivatives should not be considered encumbered as long as repo markets are reasonably expected to be available to monetize the long positions or liquid markets exist to exit each leg of the trade, either individually or through a single price for both sides.

It is appropriate (and consistent with IIF recommendations) to test the usability of assets by periodic repo or sale transactions, where feasible under market circumstances. In certain circumstances, it may be that a bank would prefer to do this by demonstrating sales or repos of same or similar assets held in other portfolios, and it should be made clear that this would be sufficient. Also, it is likely that for some assets, repos rather than sales are more likely; the assumption is that repos alone would meet the requirement, but perhaps that could be confirmed. These points of relative detail may affect accounting and choices for hedging strategies.

Paragraph 33: Under many circumstances, it is appropriate for groups to hold buffer assets centrally, which should be sufficient to meet the needs in significant currencies, subject to the ability, having regard for applicable legal and regulatory restrictions to transfer the proceeds of liquid assets across borders and, if applicable, demonstrating to host supervisors the ability and intent to use such assets to support relevant entities.

The strict rule requiring currency needs to be met in each currency is excessively conservative, especially looking at closely tied currencies (e.g. EUR/DKK), where, subject to appropriate haircuts, a portion of surplus liquidity in one currency should be available for purposes of the other. See also *paragraph 134*.[27]

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[26] See Liquidity Appendix A on central bank issues.

[27] The European Commission services have commented that, while firms need to be able to meet their liquidity needs in each currency, they would not suggest requiring the LCR to be calculated per currency, but rather that "the adequate currency distribution of buffer asset should be left to institutions, subject to supervisory review." This is an appropriate approach. Commission Services Staff Working Document, *Possible Further Changes to the Capital Requirements Directive*, April 2010, paragraph 6.

Definition of Liquid Assets

General comments on the issues raised by the very narrow definition of liquid assets are set out in part II of this paper.

Paragraph 35: As noted above with respect to *paragraph 27*, experience shows that many assets in fact remained liquid in the crisis, and the final liquidity framework should take that experience into account, with, of course, a reasonable degree of conservatism. The other assets that performed well in the crisis period in liquidity terms, such as many investment-grade corporate obligations, would, of course, need to be subject to reasonable (but not exaggerated) haircuts and possible portfolio limits.

While the BCBS might not wish to include certain assets, such as equities and certain securitizations, in the liquid asset buffer as such, it should also recognize that listed equities and many, more vanilla securitizations, continued to be liquid and easily valued (albeit subject to increased volatility) during the crisis, and hence should get "liquidity credit" within the 30-day survival period in the denominator of the ratio, even if not part of the buffer. See comments on *paragraphs 85 and 91.*

Regardless of the final decisions on these points, consideration should be given to phasing in the requirements, in effect grandfathering portions of current portfolios, to make the transition more manageable.

Paragraphs 34, 36, 37: Government-guaranteed obligations and obligations of municipalities (local governments and Public Sector Entities) should be given some liquidity value under 30 days regardless of the depth of repo markets if otherwise easy to monetize. In any case, a modified approach to the inclusion of assets within the 30-day survival horizon, as suggested in the discussion of *paragraphs 20-14* above would help allow for a balanced approach.

This should be clarified to include obligations such as US agencies' obligations. The present language is interpreted to include GNMA paper but not FNMA or FHLMC paper. The consequences of not giving any value under 30 days to any substantial portion of such classes of obligations needs careful evaluation as a part of assessment of the cumulative impact of reforms on the economy, as well as on banks' liquidity. Similarly, assets should be considered liquid where there is readily available secured funding from government-sponsored sources, such as the Federal Home Loan Banks in the US, or analogous institutions in other countries. Obviously, the principles finally issued by Basel should be general and not jurisdiction-specific; nonetheless, the structure of existing markets must also be taken into account and it is difficult to see how major components of the liquidity base of any national market could be excluded. Thus, a way must be found to include US agency paper and analogous structures that are material to the markets of other countries.[28]

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[28] It is notable that the recently issued interagency guidance on liquidity (implementing the Basel *Principles*) would treat such securities as liquid. See: Board of Governors of the Federal Reserve System, et al., *Policy Statement on Funding and Liquidity Risk Management,* March 17, 2010. While the industry welcomes the position taken by the US agencies on such assets, the risk of fragmentation of the market that would result from different positions' being

Appropriate highly liquid equity and corporate bonds should also be considered as liquid assets, with meaningful but reasonable and evidence-based haircuts. The haircuts proposed here appear unrealistic. While haircuts should be conservative, they should also be within reason: this is a subject for debate and discussion with the industry.

As recent experience with certain European government bonds shows, there is no sure thing in the markets in which liquidity management must operate; therefore, allowance of well-controlled diversification in demonstrably liquid assets will add assurances if not total certainty to the process in the future. That highly rated but fundamentally illiquid assets were used in the past does not mean that the same mistakes cannot be avoided in the future; the danger here is the opposite one, of throwing out the benefits of diversification in an uncertain world.

Application of the proposed conditions should consider the characteristics and data availability of each product. The criteria set for eligibility as proposed would be very difficult to apply and are subject to different interpretations. For instance, corporate bonds in general and CP should be differentiated as liquid assets, and the bid-asked-yield spread should not be applied to CP (which has higher spreads in general). Some obvious criteria of liquidity are overlooked, for example the inclusion of investment-grade securities and liquid equities in major indices. Furthermore, given the infrastructure improvements already being developed as a result of industry and supervisory initiatives, the behavior of certain assets may be expected to change in future crises, and the quality of infrastructure, and of risk mitigation, should also be taken into consideration. Haircuts should consider market characteristics (e.g. haircuts might be different in the New York, London and Tokyo markets).

Moreover, the requirement of data to cover ten years would appear to exclude many instruments and (taken literally) new issuances. It seems doubtful that the Committee's intent was to narrow the possible eligibility of such assets drastically. A more appropriate requirement might be to refer to satisfaction of supervisors that data on the class of instruments is sufficient to justify a conclusion that liquidity standards are met. Among other things, such requirements might include a requirement that the firm demonstrate sufficient experience and participation in the relevant market (whether by sale and purchase transactions or repos, or other use of the instruments as collateral), as recommended by the IIF 2007 liquidity recommendations.

It is striking that gold is not recognized as having any liquidity value, whereas gold is virtually always liquefiable for cash and tends to benefit from a perceived "safe haven" status during crises (so that price volatility would normally be upwards).

As discussed above, the industry is of the view that a broader range of liquid assets should be allowed; in that connection, the multiplication factor for additional assets that are central-bank eligible should be differentiated in Annex 1 to reflect the boost to liquidity given by central-bank eligibility (cf. *paragraph 31*).

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taken on implementation or interpretation of the final Basel rules on liquidity is perhaps illustrated by the divergence between the Basel proposal and the US guidance.

Assets that are not “part of the solution” become “part of the problem” in liquidity calculations, with effects on all market participants, starting at the retail level.

Paragraph 37. A possible further development of the model would recognize the different risks inherent in the different covered bonds, on a more granular basis than that reflected in the proposed haircuts. This could be achieved recognizing quality grades more closely, supplemented by reference to maturities. This would give high-quality covered bonds more differentiated, appropriate and realistic treatment in relation to their credit and market characteristics. While the Committee will perhaps be reluctant to base such gradations purely on ratings, given recent experience, it should be noted that ratings of such instruments have remained much more reliable than ratings of structured transactions and, in any case, firms would be required to evaluate the underlying credit characteristics for themselves in accordance with other parts of the proposals, or could use internal ratings.

Covered bond legislation, rules and markets have been developed in cooperation with regulators, central banks and the financial sector –in places such as the European Union and Canada - to ensure a robust and efficient funding instrument for banks in order for banks to be able to provide attractive financing terms for mortgage and real estate loans. Defining covered bonds as illiquid (or applying large haircuts to their liquidity value) would be counterproductive and undermine the purposes of the covered bond product. Many forms of covered bonds have very long and well understood characteristics, with well-defined criteria for the underlying obligations, and hence their credit characteristics are well understood (and not just from ratings).[29] In addition, in some countries, state guarantees of underlying mortgages give further assurances of quality.

Without modification, the proposal would have a severe negative impact on the financing of retail real estate as well as SME and commercial property in many countries. As covered bonds would lose value because of decreased demand as a consequence of this proposal, directly higher financing costs to consumers can be expected. Such a negative impact on the housing market may spill over into the wider economy, impeding recovery in the short run, and creating unnecessary social burdens on households in the longer run.

Net Cash Inflows

Paragraphs 38-40. There is a need to dissociate the discussion of what liquid assets should be considered high quality from what cash inflow value other liquid assets should receive in the first 30 days in the LCR denominator, even if they do not qualify for the LCR buffer (numerator). Especially over the longer periods, non-buffer assets, such as equities and many fixed-income securities would have realizable inflow value that cannot logically be disregarded though, of

[29] Footnote 11 on page 10 of the Consultative Document appears to require that, to be treated as “covered bonds” for these purposes, they would have to be “subject by law to special supervision.” This is not clear and may not be the case in all present or future covered-bond legislation: such a requirement should not be included unless it clearly relates to liquidity, which seems unlikely as a general proposition given the other characteristics of covered bonds and covered-bond markets. Note, moreover, that regulation of underlying mortgages is being tightened in many countries, which will have a substantial impact on the quality of inputs not only to covered bonds but to various forms of government-backed and private securitizations. See Chapter 3 of Basel Committee on Banking Supervision Joint Forum *Review of the Differentiated Nature and Scope of Financial Supervision*, January 2010.

course, appropriate haircuts need to apply to inflow assumptions. Many such equities or other securities would be hedged, with counterparty exposures either covered by collateral (if OTC) or covered by a central counterparty. Thus, such positions are essentially market- and liquidity-risk neutral once funded because a loss of value is offset by a gain in variation margin or collateral.

Giving no value to long equities hedged with exchange-traded short futures positions assumes that the relevant clearing system would fail to deliver the long equity position at settlement date into a short futures position. Aside from being analytically questionable from a risk viewpoint, this result seems counterproductive to the broad supervisory and industry goals of reducing risk, improving risk management, and encouraging use of central counterparties or robust risk mitigation.

The treatment of other relatively liquid assets such as many equities and corporate bonds also needs to take into account that banks hedge against their down-side risks, and often use long/short strategies that translate into realizable value with relatively low value volatility as a loss on one side of the trade is offset by a gain on the other side, all executable in short time frames.

Paragraph 40: This paragraph, which requires the assets in the buffer to be unencumbered and freely available, needs clarification. The BCBS also states that the bonds are "*…not held as a hedge for any other exposure*". Taken literally, such a requirement would in some circumstances exclude assets initially bought to serve as a buffer. Assume the acquisition of a three-year fixed-rate government bond funded by issuing a three-year fixed-rate bank obligation. This eliminates the interest rate risk, but the acquired bond is actually a hedge of the interest risk. Should this exclude the government bond from the buffer? If so this would imply that only variable rate government bond can constitute the buffer without incurring material interest-rate risk. Many other examples exist where bonds or derivatives are used to hedge market risk, but where the hedge position by the bond could easily be replaced or repoed. Therefore, the hedge in itself should not eliminate the bond as part of the buffer.

Cash Outflows; Deposit Run-offs

The strict, universal definition of run-off rates defined in *paragraphs 41-59* cannot fully reflect customer behavior. Such qualitative definitions do not appear to be based on historical studies or empirical data, nor are the apparent assumptions for added conservatism explained. Clearly banks have had very different experiences, from runs on some banks to flight-to-quality inflows. There is no silver bullet here, but the need to make assumptions requires debate, especially if stringent and binding regulatory minima are to be based on such assumptions. While the Institute's Liquidity Working Group would be interested to discuss the bases of the assumptions made, it seems unlikely that uniform rates will be determinable pragmatically in real transactional terms, which vary widely across different countries, given that legislation, business customs, and customer behavior differ and, moreover, may change over time. The credit quality of an institution would also affect its run-off rates.

Customer behavior can be projected with reasonable accuracy from each bank's historical data for normal or somewhat-stressed times; of course, further informed judgment on the potential impact of a severe shock must be applied to reach appropriately conservative conclusions. Nonetheless, the actual data have become more robust thanks to the recent crisis and will continue to improve over time. For firms with a robust data collection system, the BCBS ought to allow an option to adopt an appropriate quantitative approach to define the run-off ratio of the various types of funding.

Banks are especially concerned about the degree of deposit runoff assumed for corporate deposits and deposits from financial institutions that have operational or transactional accounts or established business relationships. Experience over the crisis shows that substantial financial-institution and other institutional deposits continued to provide liquidity where based on strong underlying relationships. Not enough recognition is given to the liquidity value of "core businesses" or relationships based on payments, custodial, and securities-settlement accounts. Moreover, "financial institutions" is far too broad a category: if the present approach is maintained, it would need to be broken down by type of institution (insurance company; asset manager; broker-dealer; central bank, etc.).

The industry believes the assumptions could be much less rigid and binary. For example, the 10 or 100% assumptions for credit or liquidity lines in *paragraph 66* are too binary. Assigning no liquidity value to many assets not deemed to be "high quality" under the framework in any time period is not consistent with a risk-based approach, and the cliff effects are likely to have unanticipated consequences. The recent CEBS paper on Liquid Asset buffers proposes a much more flexible approach.[30]

The Consultative Document mandates up to 100% run-off rates for certain types of wholesale relationship deposits, even if deep and at times exclusive relationships exist, and 100% loss of secured funding access for other than "high quality" liquid assets, which will render such short term funding ineffective. These rates are not reflective of the real, observed historical experience of many firms under stress, which will now be penalized because of the actions of less-well-run institutions or market liquidity issues experienced in markets many banks do not use.

These assumptions would have a very serious effect on such markets, even when properly functioning. If firms continue to use these markets, they will face a liquidity gap that would need to be covered with recognized high-quality assets. While conservative risk management

[30]Taken from Annex 1 - "Cash flows and Counterbalancing Capacity" – of CEBS *Guidelines on Liquidity Buffers and Survival Periods:* "Institutions should develop cash-flow projections covering expected cash inflows and outflows and expected counterbalancing capacity. **The breakdown into individual lines of categories of flows should be individual by bank and should reflect its business model, size, and complexity**… Within each line, a further allocation of flows to the different time horizons in which they are expected to occur should be applied… When determining expected cash flows and counterbalancing capacity, institutions should distinguish between contractual and behavioural flows and choose the most appropriate or most conservative type in estimating their liquidity situation over time… Two types of cash-flow projections should be made, one under business-as-usual assumptions for day-to-day liquidity management purposes, and one under stressed conditions, following various stressed scenarios for liquidity risk management purposes… **The number of scenarios, their granularity in terms of the business, and the positions/sources should adequately reflect the level of complexity, the business model, and the size of the individual institution**.

does need to be applied to wholesale funding sources, the assumptions are too rigid and too undifferentiated to serve their purpose or, to put it another way, the implied disruptions of firms' funding and of markets are disproportionate, and go well beyond the needs of prudent liquidity management.

As banks move to respond to the regulatory incentives created by the new standards, rate-driven competition for retail deposits would increase, which in turn would likely lead to reduced stickiness – depositors would tend to be induced to move money between banks and money-market funds at a higher and perhaps more volatile rate. The result of adding regulatory incentives to normal competition would accelerate turning what should be a stable source of funding into a less stable one. Systemic dependency on deposit insurance would increase.

Furthermore, it is likely that focusing on increased retail deposit funding will induce banks to prioritize those businesses that are self-funded, or that can be associated with retail or small-business deposit gathering. This in turn could produce a bias toward firms' home markets, except where foreign business is retail- or SME- based (usually as a result of an acquisition), i.e. where low run-off rates are assumed. Thus, there may be some effect of retrenchment from overseas lending, especially corporate lending, if a foreign firm has no significant relationship deposit-raising capabilities in a given country and lending needs to be fully funded internally or with third-party wholesale funding on a NSFR-neutral basis, which could be problematic for certain emerging markets.

There would be a material impact on wholesale deposits not held for 'operational' purposes by large relationship clients (75% run-off rate) and from financial corporates, fiduciaries and beneficiaries (100% run-off rates), when some of these deposits have demonstrated good core/relationship value (e.g., business, payments, custodial and securities settlement accounts), as described in *paragraphs 54-55*. This will affect the liquidity value attributed to these deposits, the price banks can pay for these balances, and the types of assets they can buy.

By drawing stark lines regarding different funding sources, the BCBS would end up pushing banks from one funding source to another without consideration for their business models or quality of liquidity management (or impact on clients). The effect on the pricing and markets for the different kinds of funding need to be fully understood before such guidelines can be seriously considered and implemented.

In addition, there is a danger of creating specific problems for those financial institutions – including notably custodians and infrastructure providers -- that take deposits primarily or solely from other financial institutions (and thus, whose deposit bases would be made up primarily from the 100% run-off rate category). Their NIM would be materially reduced as most of their assets would need to qualify for preferential LCR treatment to stay liquidity neutral. Given the role of such institutions in the overall system, should they be expected to lose all of their deposits in a short-term crisis when a substantial portion of deposits is held for operational purposes by clients? Should there be a special "tax" in the form of liquidity requirements not adapted to their business on the vital, tightly risk-managed, and generally highly regulated functions that they perform in the overall system? Of course, additional costs will have to be priced into their service offerings and thus charged back to users, increasing infrastructure costs at a time when

infrastructure should be strengthened. Of course, risk management of such institutions needs to be risk based and carefully designed, but it is not at all clear that there are gaps in the management of such institutions that would justify the effects of the proposals on them.

If these rigid parameters are included in the final requirements, it will be important to provide for quantitative validation and some means of flexibility over time to assure their ongoing effectiveness.

Paragraph 41: The highly prescriptive minimum outflow levels require discussion. Liquidity risk in deposits reflects the liquidity risk spectrum associated with different classes of depositor, which is often met by offering different types of product. While it is important – as pointed out in prior IIF liquidity work – to be discriminating in assessing depositor behavior, there is also the danger that the proposed rules will work to segment the liquidity risk spectrum in a rigid, and ultimately counterproductive, way. Pricing will follow the segmentation and flexibility to design products with appropriate risk/reward characteristics that fully reflect liquidity risk will be reduced.

While they provide a simply calculated metric, the 7.5% and 15% levels are necessarily arbitrary and, as mentioned in the general discussion above, it would be preferable for each firm to be able to determine its own allocation of the spectrum of stability across the different types of depositors, with the minimum for each class to be decided by the firm under supervision of its regulator, depending on risk experience, a conservative analysis of the firm's sources of funding and market standing, and the categorization of the spectrum the firm has adopted. Similar comments would apply to the small business and other types of customers for which the very granular treatment here implies the same effects of petrifying a view of the liquidity spectrum. See *paragraphs 45-55*.

Conceptually, consistency must be achieved by subjecting each firm to comparable confidence levels, not by using common but only crudely applicable numerical factors. What is needed is a Basel II approach, not a Basel I approach.

Trusts with principal guarantees should be treated similarly to retail deposits. This is a deposit-like, mainly retail product in Japan. Although invested in trust, the principal is guaranteed by the bank and the basics are very similar to deposits, with variable interest (dividends). The Japanese banks treat them similarly to deposits for risk-management purposes and there is no reason not to treat them as deposits for liquidity purposes. There may be other similar products in other countries that would require similar analysis.

Deposit guarantee schemes are not the only determinants of the stickiness of retail deposits, or of run-off rates. Other key factors merit attention, including the nature and history of the market, national culture with respect to household finances, number of competitors, etc. This is recognized in the last sentence of 41(a), which notes correctly that the presence of deposit guarantees alone are not sufficient to render deposits "stable" (for example, in the case of brokered deposits), but the converse is also true: the reality in some jurisdictions may be that deposits are highly "sticky" regardless of the quality of the deposit guarantee scheme.

In addition it is not clear that sole proprietorships and partnerships should be excluded a priori. Such small businesses often have similar behavioral characteristics with respect to deposits to individual retail depositors.

The existence of allocated collateral in both directions needs to be taken into account as well: deposits can be collateralized (and hence treated as insured), and deposits can be pledged as collateral for loans, and thus should be considered fully sticky.

A less rigid but more systemically supple approach would be to require firms to justify to regulators their behavioral overlays (run offs), with reference to common, consistent and harmonized principles. There would then be scope for firms themselves to set out the basis on which they split the liquidity spectrum, and to price it accordingly. It would also allow better recognition of those situations where substantial amounts of stable deposits are in fact available. Needless to say, regulators would have the right to challenge firms' treatments, particularly if the appear to be underpricing or underestimating risk. If the BCBS should decide to stick with top-down run-off rates and other assumptions, they should be justified empirically insofar as possible through extensive data-gathering, and the arguments for generalizing the levels chosen opened to expert debate.

Paragraph 43: It is not obvious that as a fixed rule deposits with a withdrawal penalty not greater than loss of interest should not receive full stable treatment in the under-30-days' scenario: it may be appropriate in some markets and circumstances to treat them the same as term deposits that have greater penalties and are treated consistently with the term of their funding. As with other deposits, including demand or notice-period deposits, the characteristic of "stickiness" is generally not directly related to contractual terms; rather it has to do with the relationship with the depositor, how the deposit was gathered (e.g. brokered deposits), the initial strength of a bank suffering a downgrade (a downgrade of an AA bank would have less impact than a downgrade that put the bank substantially into the non-investment-grade category, for example), the applicable terms of deposit insurance, etc. Thus, while it would be appropriate to consider more or less stringent withdrawal penalties in assessing stickiness, there is no reason to establish a hard-and-fast rule based on the magnitude of such penalties.

Paragraph 46: The criteria for "callability" should be developed further. Calls may be driven by market criteria, not just the discretion of the holder. Thus, insofar as the call is based on market-driven criteria, run-off assumptions should be assessed on risk-based approach. Call options in the discretion of the holder should be dealt with as for any other obligations to the same category of holder.

Paragraph 49: The threshold defining small business is too low for many countries: substituting €10mm in lieu of the suggested €1mm of total aggregated funding from a small business customer would make more sense in many cases; however, the best approach would be not to set an a-priori threshold, but to allow banks to define and justify their classifications under applicable facts and circumstances.

Paragraph 51: Funding through trusts without principal guarantee, but of which the bank acts as trustee, should be treated in parallel with *paragraph 51*. Funding through trusts with principal guarantees should be covered by the four categories mentioned in B(ii) (*paragraphs 48-56*).

Paragraphs 54, 55. The assumed 75% run-off rate for wholesale deposits not held for operational purposes by large clients and the 100% rate for financials and fiduciaries goes against the experience of most banks participating in IIF discussions, where substantial portions of such deposits have strong, demonstrated relationship value, and are associated with a pattern of "core" business.[31] Even deposits for such clients not held for operational purposes will often be managed consistently with a "core business" relationship pattern, compounded by the fact that relationships with such clients often include term investment with the same bank past the one-year horizon. The liquidity value resulting from these run-off rates could affect the price banks can pay for such balances, paradoxically undermining the strength of relationships with important depositors, creating a sort of self-fulfilling prophecy of reduced liquidity and access to funding.

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A similar set of considerations applies in respect of mutual funds such as UCITS or asset managers: the run-off factor of 100% applied to cash accounts would be extreme. With respect to a firm-specific shock, even of three notches, the immediate impact would be affected by the depository bank's starting rating (as discussed elsewhere): especially for the higher-rated depositories (and regulatory requirements or commercial considerations may create a preference therefore), it is highly unlikely that all funds would or could as a practical matter be withdrawn so quickly. Looking at the related issue of the effects of market shocks on the fund, it would be nearly unprecedented for all shareholders to redeem shares in a single fund simultaneously; a broad movement to redeem many mutual funds or UCITS or asset managers would suggest a move of cash into (higher quality) bank deposits; therefore, the extreme assumptions are both unrealistic and potentially destructive.

Paragraphs 55, 86: Experience in several countries suggests that a 100% run-off of market funding assumption is unrealistic, except in case of an actual failure of a firm; this is especially evident in the NSFR zone, so the problem should be covered primarily under the LCR part of the framework. During the recent crisis, wholesale funding markets remained available, albeit at shorter maturities. Moreover, in order not to create disincentives to interbank funding, an appropriate amount of market funding shorter than a year should be eligible to be counted as stable funding. It is factually wrong to assume that all wholesale funding is "hot money". If the prescriptive approach is to be maintained, then there should be a more granular approach with different appropriate segmentation. Furthermore, the commercial consequences of a rule that could radically change the market need to be considered carefully.

Secured Funding Run-off

Paragraph 57: In considering secured transactions, it is advisable to develop rules that make clear the separation of the receipt of cash flow from the debtor and from the underlying security.

[31] It needs to be clarified what constitutes "operational purposes": does this cover the full gamut of payments, custodial, and securities-settlement accounts, and would it extend to other types of business?

The maturity of a repo of high-quality assets should be treated as an outflow of cash and an inflow of securities, and conversely maturity of a reverse would entail the outflow of securities and inflow of cash. The outflows and outflows of cash at termination of such transactions should be seen as unsecured inflows, and the return of the collateral treated as a cash transaction. By netting the cash positions and the collateral positions, and separating them, firms and regulators will be given a more realistic view of the firm's liquidity-risk situation, subject to counterparty risk, which is addressed elsewhere. See also the discussion of *paragraph 75.*

Paragraphs 57-59: Under the proposed rules, firms that use short term secured funding markets for liquid assets not deemed to be "high quality" under the framework would create a LCR gap that would have to be closed by buying high-quality liquid assets and funding them for terms past 30 days. As this would result in a very substantial increase in the size of the balance sheet, firms will, as intended, instead have to stop short-term secured funding of these assets and use long-term secured or unsecured funding. Similarly, where <u>term</u> secured <u>lending</u> against non-"high quality" liquid assets is conducted, because loss of access to secured funding is assumed, these transactions will also have to be funded with matching term secured or unsecured funding. In both cases, this will materially discourage usage of secured funding markets for non-"high quality" assets (as liabilities or assets), which will not only lead to reduced funding access and diversification for banks and their clients for such assets but ultimately undercut their desire to hold such assets, with negative impact on their price.

While the Committee's intent to discourage excessive reliance upon short-term secured funding of longer assets is clear and appropriate, further discussion is required to get the balance right, or at least the judgments on tradeoffs need to be made clear to policy makers and the public.[32]

Paragraph 58: Assuming that there will be absolutely no rollover of those repoed assets excluded from the high-quality liquid category is too extreme for all scenarios but the last death throes of a firm (cf. Bear Stearns), and hence too extreme for the longer time horizons. The experience of the crisis was that the repo markets remained very active for a far wider scope of securities than the eligible-assets category defined by the chart. There is no empirical evidence to support a 100% loss of funding across every asset class that is not 0% risk weighted. Also, it is confusing to refer to reverse repo transactions in this paragraph, which seems to be intended to refer to liability transactions.

Paragraph 59: Funding through central bank operations available in the ordinary course should be treated as likely to roll over, hence placed in the 0% category.

Paragraph 62: While there is a case for national discretion as to valuation changes on derivatives, it is not clear why this particular outflow would be subject to such discretion when so many other elements are prescriptive. The rationale for discretion here may well apply more widely.

Paragraph 63: The Institute finds the 20% haircut on non-highly liquid collateral overly prescriptive and overly conservative. In the collateral margining process, securities collateral is

[32] See also the comment regarding *paragraph* 75 below: the proposal does not sufficiently distinguish transactions by their economic purposes, and hence sweeps too much into the very general rule.

haircut already, according to the liquidity of the asset. The rationale for applying the mandated haircut appears to be the intent to protect the collateral-receiving firm from losses in market value of the posted collateral asset. While the industry and regulators may need to discuss the appropriate haircuts, market practice in the collateral margining process takes into account historic volatility and price variance of collateral assets, and of course market practice reflects the experience of the crisis. Depending on the maturity of the bonds, there are already haircuts in the area of 20% being applied to corporate debt, even with ratings above AA-/Aa3. In short, less-liquid collateral already attracts higher haircuts and still needs to be marked to market on a regular basis. Therefore, a market-based solution seems appropriate.

Paragraph 65: Should banks plan for a full loss of access to regular securitization programs run by public-sector or quasi-public-sector entities? Looking at the cumulative impact of reforms, would the proposed treatment of ABS, which is at the extreme of plausibility, not unduly penalize the widely sought revival of such markets?

Paragraph 66 (c and (d): For liquidity and credit lines, all banks have experience regarding amounts of draws in stress scenarios – even recent events have shown that the actual amount is not close to 100% for the last two categories. In many cases, such facilities are used as working capital and stress does not lead to increased drawdowns to any great extent.

As to facilities granted to finance companies, a distinction should be made between those to banks (or bank SPVs) and those to other financial businesses. Whatever treatment may be appropriate to banks and bank SPVs, it is important to the analysis that other financial entities are likely to be closer to other corporate clients than to banks. Furthermore, whereas the banks and bank SPV category may require a different sort of analysis from other financial entities, the worst experience of any entity during the crisis should not be assumed to apply to all such entities, when many had less-severe experiences, for predictable reasons. For example, the portion of each firm's ABCP conduit contingent liquidity exposures that materialized during the crisis (via draws on liquidity lines or ABCP purchases on balance-sheet) varied considerably depending on a number of factors: national market; types of liquidity lines; types and diversification of purchased assets; credit quality of assets, average term of ABCP tenor, financial strength of the liquidity-lines provider, and central-bank eligibility.

For liquidity support to ABCP that enjoy the bank's full support and of which the underlying assets are diversified client account receivables, assuming a 100% draw would be excessive. QIS data collection could be considered in order to set the appropriate draw-down rate per ABCP category. Using these assumptions would kill an important and useful market; unless such is the intent, a more risk-sensitive approach must be devised.

It is suggested that the BCBS work with firms to make sure the final numbers reflect, perhaps with some adjustment for conservatism, the actual experience of the market during the crisis, rather than merely the weakest firms; in addition, some degree of differentiation of the different categories enumerated may be empirically necessary.

Categorizing a line as "credit" or "liquidity" is not always clear cut. Many lines have multiple purposes regardless of label, and their treatment for these purposes should follow substance, not

form. For present purposes, the paper should clarify that only liquidity lines that support paper maturing within 30 days need to be considered, as those supporting maturities past 30 days cannot be drawn in the first 30 days.

The backup line drawdown assumptions need to be refined. The 100% assumption for financial institutions should be lowered to at least 50% and the experience of certain banks and markets would justify a lower percentage; similarly, it should be no more than 25% for non- financial institutions, subject to further analysis and justification of the level chosen. The crisis has shown that financial institutions deleverage in time of liquidity crisis, and corporate clients stop their investment programs. These behavioral facts should be taken into account in an appropriately conservative manner.

No consideration is given to portfolio effects in choosing a 100% draw assumption for liquidity and some credit lines. From an aggregate perspective, this is clearly not a market-based assumption, as no consideration is given to where the money from drawn from each bank will end up. It is implicitly assumed that none of this money will end up back with any of the banks in the system, or put another way, that the money will disappears or is absorbed by central banks. This is clearly unrealistic, and ultimately destructive.

Overall the appetite for banks to offer credit and liquidity lines would be diminished, probably greatly, and clients would have to pay for much higher costs, which would likely lead to a material reduction in these types of lines, thus transferring liquidity risk out of the banking sector to the corporate sector. Yet provision of such lines is one of the most important social functions of banks, and one of the efficiencies that they provide to the corporate sector and to society.[33]

Paragraphs 67-9, 91: The treatment of off-balance-sheet exposures merits reconsideration because of excessively rigid assumptions based on a selective reading of recent experience.

It should be recognized that that experience will drastically affect market expectations and legal documentation in the future, as will significantly changed accounting requirements. Such steps will generally make it clearer where firms have ongoing obligations, making the assumption that things will be the same in the future both unrealistic and distortive.

The language describing “associations with, or sponsorship of, products sold or services provided that may require the support or extension of funds in the future” is much too vague: while implicitly this is an area where each firm will have to discuss its products and services with its supervisor, review of the actual legal and marketing documentation for each product or service may or may not support the assumption that support would be given: general assumptions about such products, and about reputational risk reactions generally, may change over time or, as stated above, with the severity of a crisis.

It is particularly troubling that “unconditionally revocable ‘uncommitted’ credit and liquidity facilities are ipso-facto included in the list. National culture and practice, as well as extra-

[33] See Douglas J. Elliott “A Further Exploration of Bank Capital Requirements: Effects of Competition from Other Financial Sectors and Effects of Size of Bank or Borrower and of Loan Type.” Brookings Institution, 28 January 2010, Part 1.

contractual legal strictures and market expectations, vary, but “uncommitted” is indeed “uncommitted” in many circumstances. Further, there would be a difficult question as to what exactly constitutes an “uncommitted” facility: does it include every advised line or consumer credit-card account, or informal guidance given from time to time to a client? There is a danger this might be read much more broadly than intended, or would be reasonable. Moreover, the result could be to discourage documented unconditionally revocable uncommitted facilities, reducing firms and clients to “handshake” arrangements that would be less satisfactory for both parties and result in weaker oversight by control functions.

Each of the enumerated items requires intelligent review and, while it is well to offer guidance as to the types of items that might be looked at, it should be made clear that whether these items need to be included in the analysis for these purposes requires a specific facts-and-circumstances analysis, to be reviewed as appropriate by the supervisor in accordance with internationally understood standards.

In particular, the Committee should consider whether the treatment of trade-related guarantees, letters of credit, and other trade-finance instruments is appropriate. The final conclusions of the April G20 Meeting explicitly indicated that G20 leaders *“(…) will ensure availability of at least $250 billion over the next two years to support trade finance through our export credit and investment agencies and through the MDBs. We also ask our regulators to make use of available flexibility in capital requirements for trade finance.”* While this mandate should of course not override prudential considerations, it does reinforce the question whether, given the actual risks of trade finance, the proposed treatment is not excessively conservative and likely, on balance, to discourage or lead to unattractive pricing of trade finance products, without corresponding prudential necessity.

The same sort of review of the appropriateness of the proposed liquidity treatment should of course be extended to all other sorts of contingent funding products covered by *paragraph 69*. An example of the type of guarantee that serves an important economic purpose and needs to be reviewed for more appropriate treatment under the liquidity regime would be guarantees of building construction. It is difficult to see why it should be assumed that there would be a demand on such a guarantee within a one month period after the eruption of a financial liquidity crisis. There may of course be draws upon such guarantees depending on the nature of a crisis, but they are likely to be spread out over time and there is no evident reason to assume outflows in the short term, especially as such guarantees can usually be drawn only under very specific, specified conditions.

The very broad language of *paragraph 69* also refers to money-market mutual funds and stable-value funds as “non-contractual obligations”. The assumption is that a bank would be faced with client demand for payment if a fund managed by an affiliated asset manager were unable to meet withdrawal demands. While one money-market fund that was highly concentrated in paper of Lehman did famously “break the buck”, and while there may have been other isolated instances where, for reasons related to the investment policies of particular funds, affiliated firms did have to intervene during the critical points of the crisis to avoid “breaking the buck”, the present language seems to be backward-looking, rather than forward-looking. While the risk that a firm would chose to support such a fund cannot be dismissed altogether, the chances of such an

event's happening will certainly be much diminished in future, given the substantial revision and tightening of regulation of such funds in the US, EU, and other markets. It is thus much less likely that the illiquidity or concentration problems that were seen in the crisis will recur. This is not to say that prudent risk management and supervisory dialogue pursuant to *paragraph 68* should not consider the possibility, but *paragraph 69* as written is too broad-brush and should be qualified to avoid overly broad assumptions or conclusions. For purposes of *paragraph 68,* other regulatory regimes should also be taken into account, along with behavioral patterns and indeed all relevant facts and circumstances.

Parallel issues with respect to the NSFR arise under *paragraph 91*, but it appropriately leaves the treatment of other contingent funding obligations to a discussion with the national supervisor depending on the facts and circumstances.

There is a risk of double counting between *paragraphs 66 and 69*. Banks that provide committed liquidity to variable-rate demand notes issuers and have to assume they get drawn should not also be asked to assume that they will buy back the paper. It should be one or the other.

Treating intragroup inflows and outflows raise another issue. Treating intragroup inflows and outflows as if they arose from third-party transactions and commitments does not comport with banks' experience, which is that such flows would be maintained except in the most extraordinary circumstances (historically much more likely to have to do with political conditions in host countries than with the condition of the group) and would greatly burden good liquidity risk management. Moreover, as the European Commission's services have pointed out, treating intragroup transactions as if they were transactions between third parties creates anomalies because of the conservatism of LCR assumptions because the entity would have to assume outflows from drawing down lines by one entity in the group while not being allowed to assume corresponding influxes from the group. The sum of the requirements at the group level would then exceed the consolidated group level requirement, "in consequence dis-incentivising group liquidity support commitments." [34] In other words, within a group of multiple entities, liquidity should not be assumed to disappear on a consolidated basis: if one unit has an outflow, another should show an inflow.

Paragraph 71ff. The discussion of cash inflows needs more attention. As discussed above with respect to the definition of liquid assets, many non-high-quality assets were shown to be resilient and reliably liquid throughout the crisis, albeit subject to price volatility. It should be made clear that inflows in respect of listed equities and liquid corporate debt (especially those included in recognized indices) will "count" to some degree for inflow purposes under 30 days.

Paragraph 72: This paragraph seems out of place and should perhaps be relocated to the section on monitoring tools.

Paragraph 75: Why are reverse repos of high quality liquid assets not cash inflows? Even if outflows for related liabilities are not required per *paragraph 59*, this does not help firms that are net lenders or straight lenders of cash through such transactions. The problem is that the current

[34] European Commission Services, Staff Working Document, "Possible Future changes to the Capital Requirements Directive", 2010, paragraph 21. See also the discussion of *paragraphs 133-134*, below.

proposed rules are not appropriate for all uses of repos and reverses: for example, especially where a reverse repo of high-quality assets is used as a cash-management tool to lend surplus cash, it ought to be given cash inflow-value. Holding short-term reverse repos against liquid collateral is in fact one very efficient manner to maintain a stock of highly liquid assets. In addition, it would be expected that firms would be able to manage their overall portfolios of transactions at least partially to meet their needs under stress circumstances, so the assumption is unduly harsh as well as being simply inappropriate for some transactions.

Paragraph 76: The assumption that bank counterparties might not be in a position to, or even decide not to honor, facilities held by a bank is not totally unrealistic, but focus for liquidity purposes only on the rare and extreme case where this might be true will likely have the effect of discouraging firms from entering into such arrangements, which can be beneficial under many circumstances, especially for smaller firms. Aside from legal obligations, firms would have every business reason to honor such commitments if they possibly can. It is troubling that a supervisory framework assumes non-compliance with legally binding obligations.

Furthermore, if this paragraph is intended to apply to intragroup transactions, it becomes all the more unrealistic, and damaging to group liquidity management, especially with emerging-market subsidiaries. The circumstances in which a group would not honor such a commitment to a subsidiary would be highly unusual, and, historically, based on political disruption in the host country. The assumption therefore has little to do with the type of stress scenario the proposal addresses.

Net Stable Funding Ratio

Paragraphs 78-83. The general objectives of the NSFR are to discourage excessive reliance on short-term funding and to move institutions toward more medium and term funding. It is obvious that some institutions did become improvidently reliant on short-term, wholesale funding, and that appropriate attention to maturity transformation and longer-term funding is certainly a useful as part of a suite of metrics for measuring liquidity risks in banks. Whereas a high degree of rigor is called for in looking at a short-term survival period, defining appropriate assumptions for a longer-term measure to address the goals addressed by the present draft NSFR requires a different perspective, focused not only on survival but also on the appropriate role of maturity transformation in the system.

There is a risk in taking what might have been a simple and useful metric and making it a detailed, mandatory ratio, as appears to have happened in developing the current draft of the NSFR concept. Maturity transformation has for centuries been the basic social function of banks. In setting their risk appetites, firms must balance an appropriate level of prudence against a desired level of maturity transformation, and of course this process must be subject to prudential supervision.

The proposed ratio is highly prescriptive and yet, if a prescriptive approach were truly justifiable, it would not be detailed enough to be applied effectively or even-handedly. The application of worst-case assumptions, disregarding many nuances and subsets, would raise funding costs substantially, without adding the risk-management value of internal structural funding measures

banks already run, which are often much more granular. In the final definition and calibration of the NSFR, more attention should be paid to how the ratio would actually work on banks' balance sheets, how it would intersect with capital-markets developments, and the effects it would have on the real economy.

The scenario as described at *paragraph 83* is ostensibly firm-specific; however, the assumptions underlying the NSFR clearly indicate severe systemic conditions affecting certain parts of the balance sheet. If there were no market-wide stress going on simultaneously with the firm-specific issues described in *paragraph 83*, then the marketability of assets would be much greater and the haircuts mandated by the NSFR should be nearer to actual market experience. The behavioral assumptions are also inconsistent and need to be made coherent with the intended scenario (firm-specific as stated, or broader, more market-wide crisis, as implied by the numbers). Assumptions as to renewal of lending need to be made more realistic by reflecting more credibly clients' winding down their activity and reducing borrowing or transferring activity otherwise (especially given the implied background of market-wide crisis). As stated in the Institute's general comments, the 100% requirement for the NSFR at one year under "conditions of extended stress" implies that the banking sector is being required to be an uneconomic and counterproductive "insurance" burden against systemic risk.

An extended one-year stress scenario as postulated is not realistic as a bank, even under stress, would have the time and incentive to change its business strategy and balance sheet and to put into action contingency funding plans (and, in more extreme circumstances, the new recovery plans being discussed with the official sector); in case of a system-wide stress, broader environmental changes would also be likely. The scenario inappropriately assumes that banks would be unable to take corrective action within a full year to address structural liquidity gaps.

There has been a kitchen-sink approach to the assumptions, effectively postulating that all the worst happens to all firms, yet this is manifestly unrealistic for the reasons discussed above, and even less appropriate for the longer-term scenario, which impinges most directly upon maturity transformation. Assumptions appropriate for the short-term survival period may disproportionate or unduly constraining over the longer period. This in itself is a reason why the NSFR should be used as a tool for discussion and analysis on a Pillar 2 basis, but not to prescribe funding requirements.

Given a one-year period, there ought to be a recalibration of requirements and stress assumptions to reflect more reasonably how individual firms and markets would evolve over such a period of even severe stress. Although the recent crisis has been of very long duration, firms were able to take a number of actions to react to the crisis, and, of course, public sector facilities became available. The NSFR should thus provide for evolution over time, as firms would certainly scale back or change activities to respond to the crisis; recognize the effects of the liquidity spectrum; and permit appropriate differentiation among firms depending on their strength, business, and market roles. Also, the cost to the system if not to individual institutions of carrying a very conservative NSFR out to a one-year horizon needs careful consideration.

The proposal overlooks the fact that the calculation results of the NSFR would be dependent on the type of businesses conducted by a given firm. If banks are required to be applying the ratio

with same assumptions, there would be a wide range of outcomes that would not in fact be comparable despite the facial consistency of the assumptions as proposed.

Outcomes would likely, even more seriously, be misleading. Given that results would be dependent on the type of the business, there is no assurance that they would illustrate the actual soundness of a firm's liquidity positions. For example, a simple commercial bank-type business, which is an intermediary function between loans and deposits, might appear from the single NSFR threshold to have a poor long-term liquidity structure, which would not in fact be true.

If the BCBS concludes assumption of a high degree of environmental stress for the longer period is necessary, then the factors are not consistent, a high run-off rate is assumed on the deposit side, but the lending side appears to assume a normal market environment, i.e. loans will be rolled over, without any reflection of normal lender or borrower behavior under such circumstances.

As mentioned in *paragraphs 17 and 78*, the NSFR is intended to be the complementary standard to address longer-term structural liquidity mismatches, which would complement LCR. As a result, any NSFR should be designed to be monitored without a prescriptive threshold beyond the separate LCR. Supervisory assessment of the results of each firm's NSFR in light of the nature of its business and exposures should be sufficient to provide the basis of supervision of its long-term liquidity positions.

It is appropriate and consistent with the Institute's liquidity analysis since 2007 to stress that firms should *not* plan to rely on lender-of-last-resort facilities from central banks, and generally should not rely on central banks as primary sources of funding, but it is not realistic to assume, especially after the current crisis, that no central bank facilities would be available to help cope with a severe systemic crisis such as seems to be postulated (constructive ambiguity should of course be maintained for lender of last resort facilities made available in firm-specific events, which should not be taken into account in determining the NSFR). Therefore, while the perils of moral hazard are recognized, the one-year NSFR period cannot be realistically calibrated for a severe systemic event without taking generally available central bank facilities into account to some degree, especially after the initial shock.[35] Or alternatively, assumptions should be modulated to reflect a degree of systemic stress where central banks would not be expected to intervene, to be consistent with the preclusion of any reliance on central bank support (putting aside open-market operations) from the scenario.[36]

The obvious conclusion regardless of how the final scenario is described – as already suggested in the general discussion section of these comments -- is that the NSFR should be replaced with a set of principles under which firms *and supervisors* could work out together an appropriate NSFR approach for each firm taking into account its initial strength, mix of business, roles in markets, funding sources and funding patterns, and the like, and devise a rigorous but realistic scenario for the firm to work through a lengthy period of idiosyncratic crisis and also a period of

[35] Cf. the Bank of Canada materials cited at footnote 6 above.
[36] See Liquidity Appendix A regarding central-bank concerns.

systemic crisis, subject to reasonable assumptions about what each firm could accomplish during such a crisis.

This process would be similar to the ICAAP process in that each firm would have the task of making appropriate assumptions and stress tests for its own situation, subject to rigorous, ongoing supervisory challenge. The role of risk management would be augmented relative to the NSFR as proposed because more would depend on the firm's ability to model its likely situation, to propose appropriate haircuts for different types of assets, and to make realistically conservative, but realistic, assumptions about its deposit and other funding sources. To reiterate, the assumptions about retail deposit behavior appear unsupported from the viewpoint of any national experience, and this is dramatically the case for the deposit performance in certain countries - precisely those where banks are still able to rely extensively on deposits and deposits remain highly stable.

Such an approach would bring the liquidity requirements into the world of the augmented and reinforced Basel II, recognizing the substantial investments and improvements in liquidity-risk management firms have made over the past year, and also the substantial new focus on liquidity of supervisors. It would encourage ongoing improvement in both internal risk management and supervision, rather than locking in rigid rules based on rough assumptions.

Paragraph 84: While, as already stressed, it is appropriate that firms should not plan to rely on lender-of-last-resort facilities from central banks, and generally should not rely on central banks as primary sources of funding, the rule of disregarding extended borrowing from central bank facilities outside of normal open-market operations would turn out to be too rigid. As already discussed, it is implausible that a year-long stress scenario of the severity postulated for the NSFR would be allowed to proceed without some degree of central bank systemic intervention. The severe systemic assumption of substantial closure of secured funding markets for assets not considered "high quality" and the degree of disruption in the FX markets implied by *paragraph 134* are not consistent with the assumption of no access to special central bank facilities responding to systemic situations: recent statements from some central banks indicate that some level of intervention in severe systemic stresses would be reasonable to expect (keeping in mind that this would not extend to lender-of-last resort assistance to a bank facing idiosyncratic, as opposed to, systemic situations).

As discussed in Liquidity Appendix A on central-bank considerations, supervisors and central banks need to consider the "new normal" role of central banks, and provide constructive clarity about it. While central bank facilities should not be firms' first resort in any moment of stress, the system cannot assume liquidity would always be available in private markets, even with highest quality collateral and even for fundamentally sound firms. Firms should, as the Institute has always insisted, plan to be self-sufficient for most conceivable firm-specific stress scenarios, with lender-of-last resort facilities kept within the conditions defined by Bagehot. But, while it is to be hoped that the panoply of capital, liquidity, macroprudential, and other regulatory changes being developed will substantially reduce the likelihood of future systemic events, some level of liquidity (not solvency) public-sector involvement in material systemic stresses is a necessary assumption.[37]

[37] Cf. the Bank of Canada materials cited at footnote 6 above.

It should therefore be possible for central bank facilities available to the market generally to be taken into greater account in calculating the NSFR, with central-bank eligibility being taken into account for determining liquidity for most purposes, including determining RSF factors. While acceptance that banks will include in their planning "regular open market operations" is welcome, the exclusion of additional operations of central banks that are available generally to the market may lead to excessively narrow interpretations. In particular, the final language should not exclude central bank operations intended to allocate money supply through the market (recognizing that major institutions often act as conduits to smaller or affiliated banks for that purpose).

As already noted in comments on *paragraph 34,* assets should also be considered liquid where there is readily available funding from government-sponsored sources in the normal course of business. Among other things, not doing this will undermine public-sector efforts to encourage and support certain kinds of mortgage-related assets, with obvious social implications, and perhaps also undercut central bank facilities designed to provide additional liquidity insurance to the banking system.

Part of the solution would be to put the NSFR on a more realistic footing, as discussed in this paper, requiring firms to plan for their own idiosyncratic stress and for incipient or moderate systemic stress, but not to impose the most stringent assumptions and then also impose the implausible hypothesis of no central bank support of the system, as this paragraph does. But, beyond that, *paragraph 84* needs to be made much more supple.

Regardless of the results of such analysis, there will certainly be a lengthy transition period away from the extraordinary central bank measures of the past two years and some form of grandfathering or phased change will be required.

Paragraphs 86-89. Derivatives contracts are not represented as either sources or uses of funding, despite their importance to many firms. While it is understood that derivatives are under a cloud politically as a result of the crisis, the approach taken of apparently[38] requiring 100% support on the one hand, and assuming 0% support value on the other, is at odds with the real economics of such transactions.[39] Many other aspects of the Committee's December proposals and the July, 2009 Trading Book proposals address counterparty-risk and general concerns about derivatives, many of which will in the future be on CCPs and all of which will be subject to tighter collateral and capital requirements. Therefore, given the real economic importance of a vital market in derivatives such as FX, interest-rate, and commodities derivatives, and given the way these contracts actually function in banks' books, the proposed treatment is unduly restrictive and will penalize important activity. While credit-default swaps have become controversial, they too provide vital hedging functions for many types of firms, and should not be penalized in the liquidity framework because of environmental concerns.

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[38] Should the market value of derivative be considered to fall under the broad "other liabilities" and "other assets"? The text is unclear.

[39] The QIS appears to indicate that a net amount is intended to be used in calculating the ratio; this should be clarified in the final document, taking into account collateral pledged or received against the net position.

Especially for the NSFR, an objective and empirical analysis should be the basis of the treatment of any asset class, including different types of derivatives.

The NSFR requirements as drafted could also have serious consequences for covered bond markets. There is no ASF assigned to covered bonds with a remaining maturity below one year. This appears to mean that the covered-bond pool would require overfunding by a factor of two, and, in effect, that would have to be unsecured funding as the covered pool cannot, of course, be pledged twice. In other words, the bank would have to raise new (unsecured) funding for NSFR purposes, even though the covered bonds, of course, remain funded in fact. This would also lead to a significant inflation of banks' balance sheets as outstanding covered bonds generally cannot be called before their due dates, but the bank would need to find another investment for the additional funding (an investment within the NSFR requirements, of course; notice that, at least on the present proposal, the bank's leverage ratio would also be affected).

Table 1: On category 1 (ASF 100%), it should be made clear that the maturity is residual maturity. In addition, is there not duplication of the effect of the deduction of intangibles for purposes of the composition of capital, with 100% weighting for liquidity purposes on the asset side?

On category 2 (ASF 85%), note that:

- This is double the 7.5% runoff used for such deposits in the LCR, although the definition of relevant retail deposits is incorporated from the LCR. This is unrealistic given the experience of the firms that participated in developing these comments.
- An explanation of the basis for the weighting would be welcome and useful to understanding the proposal, given that banks would take steps (such as increasing pricing) to make back the deficit.
- As already discussed above, the need to stress stable deposits in the NSFR is not at all evident, and complicates both the analysis and the impact of the ratio.

On category 3 (ASF factor 70%) introducing stress test percentages for this relatively sticky funding gives the ratio a misleading degree of accuracy.

On categories 4 and 5, the runoff assumptions for non-financial corporate obligors are far too severe.

The assumptions on secured funding of less than one year should be broken down by the types of security provided. The nil factor for secured funding less than one year needs reconsideration as it appears to deny all rollover through the NSFR period, which is all the more questionable if the NSFR is taken at face value as based on idiosyncratic stress.

The RSF table is not clear as to the treatment of the corresponding reverse repo transactions.

Paragraph 89 With respect to *Table 2,* the RSF factors proposed are substantially more conservative than the comparable factors applied by firms, even after the conservative revisions of liquidity-risk management that the crisis has occasioned. A review of banks' policies with colleges would show the discrepancy and, even if the Committee were to decide to be

substantially more conservative than even the most conservative firms, the discrepancy in the present proposal between the proposal and post-crisis prudent practice is disproportionate.

Why are reverse repos not included, both for eligible and non-eligible assets, especially if not associated with a repo or a short sale security but used for cash management purposes?

The lack of reasonable and appropriate treatment of reverse repos (including overnight) appears unintentional but might create incentives for firms to increase credit exposure in the form of unsecured bank deposits, to get the benefit of the 0% RSF for cash, with resulting distortion of both the market and internal risk management, without an obvious or necessary prudential reason for doing so.

The 0% RSF factor should include clearing and settlement accounts.

Query the application of the "unencumbered" restriction on several categories: does it make sense that a liquid sovereign bond cannot be accorded the 5% RSF factor while at the same time the funding it gives access to is not considered stable.

Several members believe that the 5% RSF category should include US agency paper, as discussed in the general discussion section of these comments.

In addition, as discussed above, some means to smoothen the cliff-effect in case of a downgrade of the sovereign paper accorded a 5% RSF here is required.

The 50% RSF factor for gold seems extreme, given gold's well-established role as a haven in crises.

Match-funded, non-renewable loans, including those with a maturity of less than one year, should be treated the same as non-renewable loans to financial companies with a similar maturity (i.e., receive a zero RSF factor). A non-renewable loan with a maturity of one year or less that is match-funded poses no refinancing or structural funding mismatch risk. Imposing a requirement to hold longer-term funding for such loans would result in increase in the cost of such loans, which would result in higher financing costs to clients, with no prudential justification.

Paragraph 107. The 1% of liabilities threshold used for determining a "significant counterparty" for concentration purposes would be inappropriately low for many banks, and certainly for smaller banks. Funding concentrations should be assessed on the basis of the bank's overall liabilities and balance-sheet composition.

Paragraph 113. It is true that "it is not possible to identify the actual funding counterparty for each type of many types of debt." However, this fact suggests that the utility of the significant-counterparty metric will be highly limited, at least in its current form. Thus, it should be made even clearer that, as the present text implies, this metric would have to be used with caution and should not be over-interpreted.

Paragraphs 133: Application of the liquidity standards and monitoring tools to individual subsidiaries of internationally active banks may be detrimental to liquidity when viewed in the context of the consolidated organization. Overseas entities may be required to bolster their stock of liquid assets to satisfy the requirements of the standards, which could be costly and inefficient. Such liquidity may effectively be "trapped" at the subsidiary level in the event of a crisis at the parent entity, or another subsidiary, due to legal or operational restrictions on transfer. Such restrictions may actually exacerbate a shock to the financial system instead of alleviating pressure.[40]

As a recent central bank discussion has pointed out, local liquidity requirements may in the short run benefit individual jurisdictions if they have concerns about the ability and willingness of foreign parents to provide liquidity support to affiliates, but such requirements reduce the ability of a subsidiary or branch to draw upon the resources of the parent in times of stress and could increase global liquidity requirements and raise the cost of financial intermediation, resulting in a reduction of the supply of credit globally.[41]

As the proposal does not distinguish intragroup funding to subsidiaries from third-party funding, even for the NSFR calculation (0% ASF per *paragraph 86*), application at the local level to subsidiaries would be severely burdensome and not at all realistic given likely affiliate funding patterns. Moreover, it would penalize activity by foreign-parented banks in emerging markets, including Central and Eastern Europe without an objective basis. Whereas in fact parents continued to support such subsidiaries despite difficult circumstances, and the IMF was, it is understood, willing to assume intragroup rollover rates of 80% or more, treatment of the local entity on the currently proposed basis would a significant an unnecessary burden on cross-border activity.

Paragraph 134. The assumption that currencies that are normally highly convertible will not be in times of stress is extreme and unrealistic, especially for short-term FX markets. Markets in important currencies continued to be made throughout the crisis. Although prices were volatile, liquidity did not disappear. Risk-based risk management requires close attention to the market characteristics of all currencies, on an ongoing basis, as discussed in the 2007 IIF liquidity report. It is true that there were FX difficulties encountered in the 2007-8 crisis that required creation of extraordinary currency swap arrangements; however, it is worth keeping in mind that certain of these were never used, and the USD/EUR problem reflected unavoidable time-zone constraints and structural mismatches in USD debits and credits. These were serious in the crisis context, but reflect different infrastructural issues and do not justify the assumptions made in this paragraph.

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[40] "Pooling liquidity has long been recognized as a useful way for [financial institutions] to manage their exposures to idiosyncratic funding shocks, since the risk of all [financial intuitions (or all entities with [a financial institution] group) being exposed to shock at the same time is fairly low. However the benefits of pooling are reduced incases of systemic shocks, since most [financial institutions] (or all entities within the same [financial institution] would be exposed to the same shock at the same time." Bank of Canada, *Financial System Review*, December 2009, p.39, n. 9. That the benefits of pooling are less evident in a system-wide crisis is another illustration of the limitations on the ability of any one financial institution to manage the impacts of a systemic crisis.

[41] Bank of Canada, *Financial System Review*, December 2009, p. 38. See also Dominque Strauss-Kahn, "Nations must think globally on finance reform", *Financial Times, February* 18, 2010.

Annex 2. Conforming changes would need to be made in Annex 2 to accommodate many of the foregoing comments. In addition, the following points of Annex 2 require specific attention:

- Fifth bullet, page 34: If a bank lends cash to another financial firm and receives collateral not deemed to be "high quality" with maturities past one year, the loan is classified as receiving "no cash inflow" under one year. If the same loan is not collateralized, it is classified as 100% cash inflow. Collateralization should not worsen liquidity treatment.
- Seventh bullet, page 34: Most covered bonds are issued by banks. Is it the intent to exclude covered bonds issued by banks?
- First bullet, page 35: This paragraph states all criteria must be met to qualify for 50% RSF, yet some of the criteria would not apply to some of the assets in question (e.g. gold and bonds are for the most part not listed on exchanges; equities are generally not eligible at central banks). Clarification is also required whether the exclusion of bank equities would apply insofar as bank equities are included in an index.

Monitoring tools

Paragraphs 123-29. Common metrics and reporting are to be encouraged, as they make cooperation among supervisors easier and reduce the reporting burden on firms. Nevertheless, the proposed metrics in Part III of the Consultative Document should be kept open-ended and flexible enough that, on the one hand, firms do not become locked in to certain metrics that might eclipse other metrics appropriate to their specific mix of risks and businesses (and a lesson of the crisis is that management can be distracted by a too-rigid or inappropriate set of metrics), and, on the other hand, that supervisors are not misled by an overly conclusory approach in the use of such metrics in their micro- and macroprudential tasks.

It is also important to recognize that there are many metrics that should be used to measure, monitor and assess a bank's liquidity risk. The absolute level of one metric can be misleading; what is more important is the trend in a metric and how it moves with respect to other metrics. For example, liquidity coverage type ratio of a bank with a small number of depositors might be expected to be higher than a bank with a large and well-diversified portfolio of depositors. It is therefore essential that liquidity-risk managers as well as supervisors look at additional metrics beyond the LCR and NSFR.

Liquidity Appendix A

Considerations Regarding Central-Bank Eligibility of Assets

It will be essential for the Basel Committee to work with national central banks, perhaps through the FSB, to clarify to the maximum extent possible the future role of central banks during normal times and during crises. At the moment, there is considerable ambiguity and uncertainty about what the "new normal" role of central banks will be, as well as variability of collateral requirements and asset eligibility under different central banks.

Both the LCR and the NSFR severely narrow the assumed use of business-as-usual central bank facilities. It is appropriate that the framework excludes lender-of-last-resort facilities from liquidity planning, but there needs to be clarity regarding the availability of central-bank liquidity to the market. Draconian exclusion of the central bank role in the markets from the buffer process could conflict with the role of central banks in the post-crisis world, or achievement of their liquidity-policy goals, and therefore needs careful thought.

Under the LCR, central-bank eligibility is appropriately recognized as a readily-available source of liquidity; however, there are two issues with the approach taken. First, as the discussion at *paragraphs 26-34* indicates, the proposal requires a very substantial degree of market liquidity, *as well as* central-bank eligibility, for LCR liquid assets (under most circumstances). While the reasons for requiring some degree of market liquidity as well as central-bank eligibility are understood given the incentives the Committee wants to create, the LCR as written might be interpreted to exclude assets eligible for ordinary-course-of-business functions of central banks (especially in markets where private markets are weak). The restrictions would go well beyond the exclusion of lender-of-last resort financing that seems to have been intended to be excluded (as would be warranted). If there could be a clear delineation of conditions regarding access to central bank facilities, then defining which assets are high quality would be much easier for supervisors. In any case, supervisors should have greater latitude to accept central-bank eligible assets for liquidity-buffer purposes.

Conversely, central-bank eligibility need not be a necessary criterion for a highly liquid asset. Looking at the LCR analytically, and as suggested in the main text, it makes sense, even within the 30-day survival period, to recognize a spectrum of liquidity. Central-bank eligibility is more likely to be essential at the short end, though it may be less essential out to the 30-day horizon (and certainly over the NSFR horizon), as firms will generally be able to marshal their resources to monetize assets given somewhat more time to do so.[42]

Similarly, the issues covered in the discussion in the main text of *paragraph 84* about the role of central-bank eligibility in NSFR calculations would be greatly simplified if terms and conditions of central-bank normal and systemic facilities (as opposed to single-bank lender of last resort

[42] The text of the Consultative Document already recognizes, at footnote 7, a degree of flexibility for supervisors in countries with narrow lists of central-bank eligible assets to accept non-central bank eligible assets. There should be similar flexibility to accept central-bank eligible assets with somewhat lesser degrees of market liquidity, especially where private markets are thin. For level playing field purpose, exercise of such flexibility might be subject to periodic vetting through the SIG or the corresponding FSB Standing Committee for Standards Implementation.

facilities) were more consistent globally. As discussed, the NSFR appears to postulate such a severe degree of stress over a one-year period that totally excluding central bank action for systemic purposes is highly unrealistic.

It is recognized that addressing the "new normal" for central banks' roles raises a broad range of difficult questions; however, given the experience of the crisis, these issues need to be addressed as a matter of priority. The IIF has called since its 2007 liquidity report for clarification and convergence of central banks' policies for systemic crises, including the range of eligible instruments, on a basis of "constructive clarity", while maintaining "constructive ambiguity" for firm-specific lender-of-last-resort actions.[43]

A recent discussion from the Bank of Canada provides a useful structure of principles for approaching the "new normal" and possible future liquidity interventions, based on limited but flexible intervention and the use of sound supervision of liquidity-risk management. It makes clear the need to differentiate tools for market-wide liquidity problems from intervention in bank idiosyncratic situations. It also helpfully discusses ways in which the return of markets can be facilitated, despite intervention in systemic situations, and means to mitigate moral hazard.[44]

It is to be hoped that the central banks will work to maximize the compatibility of their requirements and facilitate interoperability of collateral wherever possible. Any steps toward greater international consistency of central-bank acceptable collateral would help building truly liquid, robust, and reliable buffers.

As it stands, the Basel liquidity proposals virtually assume away any "new normal" role of central banks, both by providing liquidity for a wider range of assets than now included within the LCR criteria as written, and by excluding from NSFR consideration any central bank programs other than traditional open-market operations. Again, the reasons for excluding lender-of-last-resort discount window usage are obvious and not in dispute. But the proposal seems to carry the danger of narrowing the central banks' room for maneuver as the "new normal" evolves in post-crisis conditions because the banks' ability to make full use of new facilities will be limited by the new liquidity requirements.

[43] See Considerations for the Official Sector E and F of the IIF *Principles of Liquidity Risk Management*, March 2007; Subsection III.C of the IIF *Final Report of the Committee on Market Best Practices*, July 2008; and Section II. of the IIF *Reform in the Financial Services Industry*, December 2009.
[44] David Longworth, "Bank of Canada Liquidity Facilities: Past, Present and Future", February 2009.

Annex 3

INSTITUTE OF INTERNATIONAL FINANCE
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April 2010

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Annex 4

INSTITUTE OF INTERNATIONAL FINANCE

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Bank of Montreal

Mr. Robert Le Blanc
Risk Director
Barclays Capital

Mr. Manuel Castro
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Mr. Christian Lajoie
Head of Group Supervision Issues
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China International Capital Corporation

Mr. Tom Woods
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Enterprise Risk Management
FirstRand Bank

Mr. Filip Dierckx
Chief Executive Officer
Fortis Bank

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Director and House Counsel, Banking Regulatory Affairs
General Electric

Mr. Rolf Marquardt
CRO, Head of Risk Control
Handelsbanken

Dr. Hazel V. Taylor
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HSBC Holdings plc

Mr. Koos Timmermans
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Norinchukin Group

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Raiffeisen Zentralbank Osterreich AG

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Royal Bank of Canada

Mr. Nathan Bostock
Head of Restructuring and Risk
Royal Bank of Scotland

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