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Dear Sirs

Basel Committee on Banking Supervision ("Committee") Consultative Proposals to Strengthen Global Capital & Liquidity, BCBS 164 & 165

Lloyds Banking Group ("LBG") is pleased to have been given the opportunity to consider the proposals detailed in the above Committee Consultation Papers, published in December 2009. Our principal comments are set out in this letter but we also attach an appendix with more detailed remarks. We have also contributed to the UK Industry-wide joint trade associations' response.

Introduction

We recognise and understand the political (and indeed commercial) imperative to act arising from the events that have unfolded over the last 3 years. We fully support the objectives of the work being taken forward by G20 member states to reform regulation and strengthen the stability of the financial system.

While we appreciate and understand the Committee's stated high level aims and objectives **we have a number of fundamental concerns over the calibration, proposed timing and overall impact of the proposals.** Furthermore, we believe that the material incorporated here and attached to this letter gives some indication of the fact that, even though our initial consideration of the Committee's proposals has been extensive, we still have more questions than answers.

From analysis that has been performed we conclude that **the impact of the proposed capital and liquidity reforms, not only on individual banks and the banking industry as a whole but on the UK and other economies worldwide would be severe** if implemented unaltered. This would be especially severe if implemented in the timescales indicated in the consultation paper – and this analysis does not factor in other proposals such as the Resolution Levy or the eventual outcome of the debate on recognising loan losses in international accounting standards.

Our principal concerns can be expressed under the following four general themes and these are the main areas in which we see a pressing need for the Committee to move forward:

1. At a fundamental level, **there is no discussion of what constitutes an appropriate level of capital in the system, or how that level should be determined.** Basel II aimed to leave aggregate capital in the financial system at the level of Basel I, but at that time there was no explicit review to establish whether the level was appropriate. The current Basel proposals (termed as "Basel III" by various industry commentators) include

significant changes to the definition of capital, (some of which we believe could have unintended consequences and we comment on later). In this context it is essential that a fundamental re-appraisal of the appropriate level of capital in the system is completed, with particular reference to the impact on economic growth and taking into account other requirements and costs to the banking system. Without this review and at least some guiding principles as to what this level should be, there is a general sense that more capital is required but no context is provided nor limits set.

2. Until details of the proposed rules on definition of capital and measurement of risk have been fully agreed **we do not believe that it is possible to complete a 'comprehensive impact assessment'. This is certainly not feasible in the first half of 2010**, as suggested in the paper. Such an assessment, if done properly, will require the assistance of the banks in BCBS member countries, as was done for Basel II. It also requires the input of other stakeholders such as governments, central banks and leading economists.

3. The comprehensive impact assessment should address two primary questions:
    a. Given the definitions of capital and measurement of risk, what is the appropriate level of capital in the system to protect against systemic risk, while allowing banks to be both be viable and provide the various services upon which the economy relies?
    b. What is the appropriate transition path and period that will allow this end state to be reached without excessive negative economic impacts?

   We believe that the current proposed timescale for implementation (by end 2012) is unachievable and is very likely to be highly detrimental to the economy. In any case, the timetable should not be determined in advance of finalising the definition and calibration of the proposals.

4. Capital and liquidity measures are only parts of the solution to reforming regulation and supervision. **On the basis that prevention is better than cure, equal weight should be given to strengthening bank supervision.** By strengthening we do not mean that regulators should automatically take a tougher line on every individual issue leading to potentially excessive conservatism at the aggregated level. Rather we believe that there is a case for a more thoughtful approach that would incorporate the following features:

    - Developing an approach to the oversight of systemic/macro-prudential risk based on a macro view of the economy and the supporting financial system and the risks that they face;
    - Improving the micro approach to the supervision of individual institutions. Though aimed primarily at depositor protection over the economic cycle we believe that regulators should adopt a more integrated view of individual firms and consider issues in the round utilising all the tools at their disposal.
    - Better co-ordination between regulators and economic policy makers, so that the interaction between actual and potential economic and regulatory developments are fully taken into account.

These points are elaborated upon below.

Appropriate level of capital

While accepting that further work is required, it should be recognised that the industry has already taken significant steps forward. Measures have been taken to strengthen capital ratios (involving in some cases substantial recapitalisations), and to reduce liquidity risk. **Since the crisis, the banking system has become much more conservative.**

The strong impression given by the proposals is that no amount of capital is too much and as a result that there should be absolutely no room for bank failure in any future regime. There are two key points that we would wish the Committee to consider in response to this and they are as follows:

Firstly, when considering what level of capital is enough, we do not believe that the framework should be designed so that no bank can fail under any circumstances. Clearly, a framework should be put in place to unwind a failing bank in an orderly way, to avoid contagion and ensure depositor protection. Individual bank failure does not necessarily mean systemic failure, which is the threat to the economy. A capital regime should track rising levels of risk in the system, and check them by moderating the credit cycle in order to protect against systemic risk.

Second, banks that rely on shareholders have to generate (and be expected to generate) a through-the-cycle return on equity (RoE) that is greater than cost of equity (CoE). Without this return, investors will not invest and banks will have a duty to return capital to shareholders rather than continue to provide the socially useful service that they do to the economy.

Impact analysis shows that the proposed changes will cause RoE to fall significantly below CoE. As a result banks may need to change aspects of their business models. Responses are likely to fall into three main categories: reduction in the supply of credit (deleveraging) in order to return equity to shareholders; or increase in the price of credit or reductions in costs and service levels in order to achieve an RoE that is acceptable to investors.

Much existing bank lending is contracted in the back book (for example residential mortgages and corporate lending). Materially reducing lending or repricing this back book is impossible in the short term, especially as the entire sector is likely to be required by these proposals to do so simultaneously. Therefore unless considerably longer transition is catered for, **the vast bulk of the price increases resulting from the proposals will fall on new lending and lending to small and medium sized enterprises, and there will be much reduced lending capacity available.**

The deleveraging and price increases are likely to have a serious impact on the economy, reduce GDP growth and could, in certain circumstances, lead to a double-dip recession not only in the UK but worldwide. This seems inevitable if the proposals are brought in on the current timetable.

Another impact of bank deleveraging and price increases resulting from the proposals is that bank customers will look elsewhere for services currently provided by banks. This is likely to result in more financial services being provided outside regulatory control, which would increase the systemic risk from the financial sector.

We believe therefore that it is critical that the Committee work with other key stakeholders **to articulate a set of principles for the desired end state that the reforms are trying to achieve** for the banking industry and the world economy, and use this to develop the appropriate calibration, timing and transition.

Calibration, timing and transition

We believe that the Committee should consider very carefully calibration, timing and transition issues from the old to the new regime, particularly in view of where we are in the economic cycle. We expect this point to be material to many G20 members. If not calibrated (and here we include appropriate use of the 3 Pillar approach articulated in Basel II) and phased in appropriately, the **severity of the proposed new capital and liquidity requirements is highly likely to** cut off the supply of credit and **cause economic growth to falter.**

We recognise and understand the political (and indeed commercial) imperative to act arising from the events that have unfolded over the last 3 years and to deliver on the proposals agreed by the G20. We believe that the G20 commitment to agree rules by the end of 2010 could be achieved by delivering a framework which does not preclude further work being done on calibration and implementation to ensure the consequences of actions are fully worked through. Indeed the Committee recognises this need through its intent to phase in changes "as financial conditions improve and the economic recovery is assured"

We note that the current Quantitative Impact Study requests extensive detail in terms of point in time (and historic) capital and liquidity requirements. It does not ask for information on the consequences of the proposals on bank behaviour over subsequent periods. This is an important omission that needs to be addressed either by the Committee or through other mechanisms. **It is critical to assess the impact of the reforms and the timing of their implementation on the wider economy.**

Strengthening Bank Supervision

Firstly, we would make clear that by proposing improvements to the supervisory process we are not in any way abrogating management responsibility for ensuring that our own house is in order.

We have noted that there are macro and micro elements to our observations. We strongly believe that the macro approach to establish that there are suitable levels of capital in the system to sustain economic growth at different points in the cycle and that there are means of identifying potential trouble spots and taking appropriate action in advance is a key point of development within the regulatory framework. This is of course easier said than done.

As far as micro, or firm specific, regulation is concerned the G20 has committed all major centres to adopt Basel II by 2011 and some countries are further forward in this than others. This will mean that all major regulatory agencies will have access to a consistent set of regulatory tools, which should be applied consistently.

Supervisory Framework

Our view is that there is a wide range of tools and in particular a wide range of types of capital that it may be appropriate for firms and their regulators to make use of. There is inevitably, and in many senses correctly, a strong focus on the highest quality of capital, commonly known as Core Tier 1 or Common Equity capital. Putting aside the definitional issues, there is also a perception that in establishing a firm's capital requirements the default option should be to either reduce Core Tier 1 capital (by requiring deductions against resources) or increase requirement calibrations (by introducing conservatism over and above calculations). Instead we believe that some of these issues should properly be considered as deductions from gone concern capital and some that should be covered appropriately under Pillar 2 through the existing Supervisory Review processes.

Consequently, **we believe the extent of change required to Pillar 1 (minimum capital requirements) needs to be balanced against the need for improved regulatory processes** to understand firm specific risks, which feed into the confidential Pillar 2 discussions between firms and regulators under the Basel 2 framework. We believe that it is appropriate to have guidelines for capital buffers for firms and their regulators to refer to, but that the resulting buffers should form part of Pillar 2.

Below are a number of specific examples about which we are concerned:

(i) Layered conservatism

The capital proposals suffer from layered conservatism and need more transparency. On top of:

- stricter rules for risk-weights;
- possible excessive conservatism in Pillar 1 models driven by difficulty in establishing where cycle peaks and troughs are leading to regulators taking the worst case on every individual model review;
- higher minimum capital ratios and a greater focus on core equity,

the proposals call for:

a) a counter-cyclical capital buffer (which is already incorporated into Pillar 2, even if not yet fully or properly implemented);
b) buffer ranges in which certain restrictions on capital distributions will apply;
c) additional buffers under the 'macro prudential approach' to be detailed later this year; and

d) possible additional capital buffers for 'systemically important, cross-border institutions'.

In sum, this means a buffer on a buffer on a buffer (on a buffer, for the systemically important cross-border institutions). We are concerned that there is a significant degree of overlap in the purpose of the various buffer proposals, which is not recognised in the consultation document. This leads to both over-conservatism and a lack of clarity and transparency

(ii) Capital buffers

We also believe that **capital buffers need to be institution-specific, not one-size-fits-all.** Not only are all institutions different (through, for example, differences in business models, market contexts, risk appetite, corporate organisation and governance), we believe that imposing **a one-size-fits-all approach could have severe unintended consequences**:

- If set sufficiently high to cover the most risky institutions, a one-size approach would penalise low-risk institutions and force them to become more risky to earn the required return on capital. If set at a lower level, then opportunities for arbitrage across different business models and markets will be created.
- It will also get in the way of having healthy and appropriate models and risk appetites that are necessary to best serve the economy.

(iii) Leverage Ratio

Whilst we agree that there is scope for a leverage ratio to help inform the Pillar 2 debate between regulators and firms, we are strongly of the opinion that the appropriate leverage ratio for a firm will vary by business model etc. as well as by point in the economic cycle. A one-size-fits-all leverage ratio has the same issues and problems as described in relation to one-size-fits-all capital buffers above, and may have unintended consequences. Appropriately capitalised high risk institutions will have low leverage in comparison to appropriately capitalised low risk institutions. Low risk institutions will be penalised, and may have to take more risk / reduce low risk lending in order to provide an adequate return to investors.

Specific issues

Under this heading we give some specific examples of areas where we believe that further review and clarification from the Committee would be appropriate. We would note that this is not an exhaustive list and is supplemented by our detailed feedback appendix, the UK Industry-wide submission and no doubt individual submissions from our peer group firms.

Procyclicality

Some prudential deductions and filters will increase procyclicality

The proposals introduce additional **procyclical effects**, which run counter to the aims of the Committee. In particular, by deducting deferred tax assets, unrealised losses on available for sale assets and pension scheme deficits from Core Tier 1 capital the **effects of the cycle will be exacerbated and the benefits of the reforms significantly reduced**. None of these items would crystallise as losses in a going concern situation, and so requiring them to be deducted from common equity in a stress would restrict the ability of that capital to absorb real going concern losses, and thus **weaken the resilience of the banking sector**.

- Under existing accounting rules, **deferred tax assets** can only be recognised to the extent that they are realisable, and there is a high burden of proof to be met.
- Any permanent diminution in value on **available for sale assets** must be recognised as a realised loss.

These accounting rules are already conservative, and provide adequate control enforced by external audit.

- **Pension fund liabilities** are potentially subject to short term market movements in a downturn whereas the underlying assets and liabilities are all extremely long term.

The existing capital treatment of these items under Basel II is tried and tested, has been proven to work, and has not contributed to any issues in the recent crisis. The proposed deductions from core tier 1 capital are inappropriate.

Measures to counter procyclicality

Where the Committee has put forward proposals to counter procyclicality, LBG welcomes this. However, we again urge that the calibration of these is carefully considered to avoid excessive conservatism and to ensure there is no double counting, for example from forward looking provisions for expected losses, capital buffers for unexpected losses and counter cyclical measures built in to capital requirements for credit risk. Final proposals on expected losses should be driven by the outcome of the accounting debate on impairment provisioning.

Investment in the capital of insurance entities

The proposal to apply a "corresponding deduction approach" is a significant issue for bancassurers like ourselves. UK rules currently require banking led bancassurers to deduct their investment in insurance subsidiaries from total capital.

The proposal appears to indicate an assumption that the insurance business would have a zero value in a stressed going-concern situation, and that banking and insurance risks are fully correlated. While the precise value of such a business under stressed circumstances may be hard to predict, there will be substantial value to be realised, in part because of the regulation under which insurance and other financial businesses operate. Even where risks in the two sectors could be considered similar, they are not correlated (for example, interest rate risk affects asset-liability mixes quite differently, given long liabilities in insurance companies and long assets in banks).

We support the position of the European lobby that the bancassurer impact of the Basel proposals should be carved out of the proposals altogether and this matter should be transferred for consideration by a joint committee of banking and insurance supervisors.

Contingent Capital

LBG believes that contingent capital has a significant role to play. In particular, we believe that appropriately structured instruments that meet appropriate criteria for permanence and which convert to common equity at suitable pre-defined triggers, is as good as common equity and retained reserves in absorbing losses and in helping banks to remain going concerns in stressed situations. Such contingent capital should count toward meeting any common equity requirements and common equity buffer requirements. These instruments amount to built in recapitalisation at a time of stress, and the consequent capital benefit should be recognised by the regulatory regime and consequently be included in published ratios.

Liquidity

LBG is supportive of the UK joint trade association response in respect of the separate liquidity consultation "International framework for liquidity risk measurement, standards and monitoring" and we have therefore not submitted a separate response to that paper. However we would like to take this opportunity to re-iterate some of the key messages:

- One of the vital services that banks provide to the economy is maturity transformation. The proposals run the risk of making it uneconomic for banks to perform this service, meaning that it will either not be done, with associated negative impact on the economy, or will be performed by unregulated entities, multiplying the systemic risk from the financial sector as a whole.
- We understand and support the need for new standards in respect of liquidity management but again urge the Committee to ensure that the economic implications of the quantum of additional liquid assets that will need to be held across global financial systems is understood and that the new requirements are phased in over an appropriate period. This will avoid the

need for significant funds to be diverted from lending to the global and local economies and thereby reduce the knock-on impact this would have on the economic recovery.

- The cost of the new liquidity regime in terms of RoE and the consequential economic impact should not be underestimated.

In conclusion

We believe that the Committee has a once in a generation opportunity to establish a set of rules and principles that can take account of the lessons learned from recent events and form the bedrock of banking services provision for the future. This is a big task with many moving parts. While the current QIS will provide some indication of the current expected impact, it is not likely of itself to be sufficient to provide a basis for the long term calibration of prudential capital and liquidity requirements. In particular, we believe further work is required to ensure that the banking industry will consume an appropriate share of the private capital and funding that is available and **that the overall calibration of the final package is appropriate in terms of greater financial stability and support for economic growth.**

It is imperative that there is a holistic integrated view of the cumulative impact of the proposals and the impact on banks and wider economies. It is our view that the proposals as set out are currently unachievable from a practical or market perspective in the timeframes set out by the Committee. They risk causing very serious damage to our fragile economic recovery, especially if implemented within the proposed timetable, as well as having a negative impact on economic growth in the longer term.

Ongoing debate and discussion with industry on calibration and timing is essential. This will also need to take full account of he many other new requirements that are being consulted on, such as living wills, product market regulation, securitisation market reforms etc.

LBG stand ready to be fully engaged in this process and would positively wish to work with the Committee and local regulators/other stakeholders to develop and implement the right approach.

We will be happy to discuss these comments further.

Yours faithfully

Tim Tookey
Group Finance Director
Lloyds Banking Group

Detailed response to the Basel Committee on Banking Supervision Consultation Paper (CP164) "Strengthening the resilience of the banking sector"

The points below have been set out in the order in which they appear in the Committee's proposals and not in any order of significance.

Addressing systemic risk and interconnectedness

We understand the need to focus upon measures designed to reduce the frequency and severity of financial crises and the concerns over systemically important banks. We agree that the development of resolution tools and an effective framework for cross border resolution should be central elements of such measures. However any proposals in this area must ensure a level playing field across jurisdictions. We note that the need for a level playing filed is recognised by the G20 in their commitment for all major financial centres to adopt Basel II by 2011.

The application of an additional capital surcharge impacts on the competitiveness of the affected firms but it will also be cumulative to other proposed buffers which leads to the very real possibility of buffers on buffers and as a result critical restriction on firms' ability to operate.

We would expect that national supervisors would be able to identify those banks that are systemically important through their understanding of their economy and the nature of the institutions they supervise. We doubt whether a formulaic or scorecard approach would be sufficient on its own. A great deal of judgement is also likely to be required.

The Committee has said that it is reviewing policy options in this area and considering the introduction of a capital surcharge for systemically important banks. We consider the definition of 'systemically important' banks to be critically important. The definition of and applicability to any individual firm would need to be kept under review to take account of changing circumstances. As noted in the covering letter in respect of the proposals generally we also urge the Committee to clarify its overall objectives for the proposals, and take an integrated holistic view of the proposals by carrying out an impact assessment of all the proposals once fully calibrated so that their interaction and impact on individual institutions and the banking sector and, in particular on, local and global economies is known.

Introducing a global liquidity standard

We support the industry response and have therefore not commented on these proposals further here.

Impact Assessment and calibration

Given the importance of the impact assessment and calibration, we have presented our concerns on these issues in our covering letter.

Raising the quality, consistency and transparency of the capital base

Eligibility criteria for inclusion in Tier 1 (Common equity and additional going concern and Tier 2 (gone concern) Capital

Common Equity component:

We fully support the intention of the eligibility criteria for common equity capital instruments – that for joint stock companies it should consist solely of common shares.

However, the proposed eligibility criteria would in practice restrict common equity capital instruments to either a single class of ordinary shares, or two classes, with the only difference being voting rights. There are many reasons for having more than once class of ordinary shares which are different from each other, and no good reason for them not to count as share capital.

For example, during the recent crisis, recapitalisation been achieved by many firms' issuing classes of shares that are different from existing ordinary shares that have equivalent loss absorbing ability. The proposals as drafted would prevent the use of such structures in any future stress.

Eligibility criteria 1, 2 and 7 therefore need to be revisited to remove the requirement that all common equity capital securities must have equal rights.

Contingent Capital

LBG believes that contingent capital has a significant role to play. In particular, we believe that appropriately structured instruments that meet appropriate criteria for permanence and which convert to common equity at suitable pre-defined triggers, is as good as common equity and retained reserves in absorbing losses and in helping banks to remain going concerns in stressed situations. Such contingent capital should count toward meeting any common equity requirements and common equity buffer requirements. These instruments amount to built in recapitalisation at a time of stress, and the consequent capital benefit should be recognised by the regulatory regime

Tier 1 Additional Going Concern Capital:

- Tax deductibility of instruments should not be a factor -

  The tax deductibility of coupon payments does not affect a hybrid instruments ability to absorb losses and as such should not be used to assess the merits of capital quality. Furthermore, harmonisation of the global taxation rules for capital instruments will be virtually impossible – and any forced regulation through the Committee's proposals will result in an unfair advantage for some issuers over others. There should also be no restrictions imposed on the structure of on-loan instruments as we don't believe these affect capital quality. This view has also been reflected in the recent EC CRD IV proposals which make it clear that tax should not be a factor when assessing the quality of hybrid instruments.

- Alternative Coupon Settlement mechanisms (ACSM) for deferred coupons should be allowed -

  Use of traditional ACSM mechanisms for the settlement of deferred coupon payments through either i) the issuance of new equity or common equity instruments to holders or ii) paying holders the cash proceeds raised by the sale of sale of shares into the market, does not reduce the net capital position of the issuer. As such we see no reason why these mechanisms should be restricted.

- Step up should not be prohibited –

  The proposed prohibition of step-instruments should be reconsidered. Instruments with a moderate step-up in coupons provide clear benefits in terms of efficiency and also appeal to a greater investor base – thus improving the ability to recapitalise in stress. The market also has been observed to trades step-up securities on yield-to-worst basis – removing the incentive to redeem if spreads have widened to above the step up rate.

  The provisions in Annex VI 5a and 5c requiring regulatory approval and replacement of the capital (or demonstration that it is not needed) mean that this requirement for no step-up is redundant.

- Temporary write-down should be sufficient to meet ongoing loss absorption requirement

  A temporary write-down is required to maintain the normal relationship between hybrid capital holders and common equity holders. Permanent write-down mechanisms create asymmetric risk profiles for hybrid investors who will not benefit from the recovery of a financial institution unlike shareholders.

Tier 2 Capital

- Step-up: As above – a moderate step-up for Tier 2 securities should be re-considered. The provisions in Annex VI 5a and 5c requiring regulatory approval and replacement of the

capital (or demonstration that it is not needed) mean that requirement for no step-up is redundant.

- Incentives to redeem / Lock-in
  The straight-line amortisation of Tier 2 capital in the final 5-years to maturity, significantly increase the cost of this capital for issuers.
  An option of a lock-in feature which provides issues with full capital benefit for the term of the instrument but also provides regulatory discretion to prevent the capital instrument from being redeemed under a period of stress would help increase the ability of firms to increase their capital-base. For the capital instrument to be marketable to investors the trigger for 'lock-in' should be transparent and reflective of the 'gone concern' nature of the capital security.
  The amortisation treatment for dated Tier 2 instruments should be used for instruments without lock in features and issuers should have the flexibility to structure Tier 2 securities with either lock-in or call options or both when assessing their capital raising opportunities.

Grandfathering

The cut-off date for grandfathering should be the implementation date of the revised rules (and not earlier)

The Committee's proposals indicate that instruments which will not meet the new eligibility criteria for inclusion in Tier 1 would qualify for transitional provisions only if issued before 16th December 2009, the publication date of the CP. The uncertainty created by the grandfathering proposals has created significant regulatory risks for issuers and has forced many banks to postpone any public capital market issuance until further clarity is provided. Sufficient time needs to be allowed for capital raising to meet the new requirements with a view to the gradual phasing out of non eligible instruments. In respect of grandfathering existing capital instruments, we are generally supportive of the phasing out over 30 years built into the EU CRD II.

<u>Regulatory adjustments applied to regulatory capital</u>

Stock Surplus
This proposal is eminently sensible and in line with current UK rules and we fully support it.

Minority Interest
The proposals on equity minority interest appears faulty, as it causes a mismatch between risk and the capital available to absorb losses arising from those risks, as it completely excludes equity capital that can and does absorb some loss if the risks crystallize.

Equity minority interests in appropriately capitalised subsidiaries are available for absorbing losses in those subsidiaries. Full exclusion of the minority interest from the common equity without exclusion of the risk in the subsidiary from capital requirements is inappropriate and asymmetrical.

It also does not fully remove the incentive to have overcapitalised subsidiaries with minority interest, as the proposal leaves the minority interest fully in additional tier 1.

An alternative treatment – either to exclude minority interest only to the extent that it is excessive (if sub is overcapitalised then amount of minority interest is limited so that the common equity ratio of firm is not boosted. If sub is undercapitalised, no restriction); or exclude all MI, but also exclude appropriate amount of RWA (so that CT1 ratio is capped at what it would be if sub was capitalised to the same extent as the firm as a whole) would achieve the aims of the proposals without the drawbacks noted above.

Unrealised Gains and losses on debt instruments, loans and receivables, equities, own use properties and investment properties
Unrealised losses on instruments outside the trading book (i.e. classified as "available for sale") do not impact the firm's ability to operate as a going concern, as in a going concern situation the firm will continue to own and use the assets and the market value is not relevant. However, if accounting and

regulatory rules are amended to force firms to deduct unrealised losses on such assets from core tier 1 capital, these assets may precipitate a move from going concern to gone concern.

In a stress, when temporary unrealised losses grow, a requirement for going concern capital to cover such losses would mean that the going concern capital is not able to absorb real losses.

In normal conditions the proposal will make little difference to, or increase, reported capital ratios, and so will not assist in strengthening capital in preparation for a downturn. In stress the proposal would reduce core tier 1 capital and hence would weaken the resilience of the banking sector.

Goodwill and Other Intangibles
We support this proposal

Deferred Tax Assets
The proposal is that Deferred Tax Assets (DTA) which rely on future profitability of the bank be deducted from common equity.
There are strict and well understood tests for recognition of deferred tax assets in the accounts, allowing limited look forward compared to actual tax legislation. Given the long term under which DTA dependent upon future profits can in practice be realised, so long as a firm remains a going concern the deferred tax asset has full value, and so there is no good reason for deducting DTA from going concern capital. As DTA will increase in an extreme stress scenario, deduction from common equity will if anything push a firm from being a going concern to being a gone concern, i.e. increasing procyclicality and weakening the resilience of the banking sector. Depending on prevailing tax legislation, deferred tax assets will in general have value even in a gone concern situation.

Investment in Own shares
We support this proposal

Investment in capital of financial entities outside the scope of regulatory consolidation
This proposal is of particular concern to bancassurers

While the concern about "double counting of capital" makes sense with respect to investments in other banks, we strongly contest the same treatment being applied to insurance entity holdings. Insurance-company risks are on the whole not highly correlated with banking risks, 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. The bancassurance combination of insurance and banking activities continues to be attractive in some countries, permitting both competitive pricing for customers and significant risk diversification for financial groups because of the different natures and time horizons of insurance and banking risks. Even where risks in the two sectors could be considered similar, they are not 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 business would have a zero value in a stressed going-concern situation. While the precise value of such a business under stressed circumstances may be hard to predict, there will be substantial value to be realised, in part because of the regulation under which insurance and other financial businesses operate. The proposal to deduct the full amount of the equity holding is not reasonable.

We agree that international prudential practices in this area should be harmonised. We agree with the general European Lobbying position that the bancassurer impact of the Basel proposals should be carved out of the proposals altogether and this matter should be transferred for consideration by a joint Committee of banking and insurance supervisors, and any further amendment to this should be reviewed through the same joint Committee.

Shortfall of the stock of provisions to expected losses
As noted under the Forward Looking Provisioning section later in the paper we believe this proposal to be premature as until the methodologies of both the accounting and regulatory approaches to expected loss provisioning are known it is not possible to determine how any differences between the two should be treated (i.e. what tier of capital any adjustment should be applied to).

In principle, the expected loss (deducted from capital) and the unexpected loss (represented by RWA which the remaining capital is available to absorb) must be calculated consistently. Therefore, depending upon the detail of the accounting rules, we believe that it is likely to be appropriate to adjust capital for the difference between expected loss and accounting provisions. Such adjustment should be symmetrical, so that if deduction of excess expected loss is from common equity, the add back of excess accounting provisions should also be to common equity.

Cash Flow hedge reserve
We support this proposal

Gains and Losses due to changes in own credit risk on fair valued financial liabilities
We support this proposal

Defined benefit pension fund assets and liabilities
We agree that pension fund assets should be excluded from capital.
Pension fund liabilities valuations are volatile, and are not an immediate issue in a going concern situation. There is a parallel to deferred tax assets and unrealised gains and losses on debt instruments etc on which we have commented above. Like those proposals, introduction of the proposed change to pension fund liabilities would add volatility to capital supply, and thus cause procyclicality, exacerbating the problems caused by economic stress and weakening the resilience of the banking sector.

We believe that pension fund liabilities are only an immediate issue in a gone concern situation, and so it is not appropriate to hold going concern capital against them.

Remaining 50:50 deductions
Applying a 1250% risk weighting, rather than a deduction, will mean that firms need to hold more capital than 100% of the exposure, as in practice regulators will require total capital over 8%, with buffers above that. This is not appropriate. We believe that firms should have the choice of deduction rather than risk weighting on all assets.

<u>Disclosure Requirements</u>

We welcome the majority of the proposed additional disclosure requirements surrounding capital resources in para109. We already provide data covering certain elements of the proposed disclosure requirements within our Pillar 3 disclosures.

However we are concerned about the level of detail that may be expected in relation to the requirement to produce a full reconciliation of all regulatory capital elements to the accounting balance sheet. To produce a full reconciliation for each capital element seems excessive. We believe it would be better to focus the reconciliations on the Common Equity, Tier 1 and Total Capital positions, showing how these balances reconcile to the accounting balance sheet.

Risk Coverage

<u>Counterparty Credit Risk</u>

- The proposed requirement, to calculate a capital charge for volatility in the value of the credit value adjustment (CVA) for OTC derivative exposures, is likely to result in a significant increase in capital requirements, beyond that which is regarded as commensurate with the risk. Based on the current QIS exercise, this will yield a capital requirement of over four times the actual derivative

losses incurred despite being in a state of economic turmoil. This topic is the subject of ongoing scrutiny and challenge by industry, principally via trade associations. The current proposal lacks clarity in terms of granularity – applying a one-size-fits-all approach to all institutions, regardless of how their local accounting standards require them to hold CVA in their accounts, the risk in their positions and the complexity available to them in modelling the solution. Whilst we recognise that the intention is to raise capital against the potential of MTM loss, it is considered that the current approach could in certain cases lead to more capital being held than the value of the underlying asset.

- The 1.25 multiplier to the asset value correlation for large banks (Assets >$25bn). This too will result in significant increases in capital requirements (up to 20% increase in RWA) the aggregate impact of which will become clear on the finalisation of the QIS exercise. Again, whilst we recognise recent events have demonstrated that banks, in particular large banks, are more correlated than previously assumed, and that increased and higher quality capital is the Committee's intent, it should be noted that this will not only affect a bank's capital but may also affect its liquidity, as well as having implications for pricing and availability of credit for customers. In addition, we note that many of the elements of the liquidity proposals in particular are designed to reduce banks' reliance on interbank funding in times of stress. We trust that in looking at the calibration of any proposed increase in the interbank asset correlation that the impact of the other proposals will be taken into consideration.

- We welcome the proposals to minimise the cliff effects resulting from downgrades in counterparties providing credit mitigation to banks.

Leverage Ratio

Use of

We do not agree that high leverage (defined as gross assets over equity) is of itself a problem: If a firm invests only in zero-risk assets, it can safely be very highly leveraged.
Capital is only required to cover risk. The build up in leverage in the years preceding the crisis went together with a build up in risk. It was risk rather than leverage that was the problem, and it was derisking rather than deleveraging that was required as a result.

However, it is appropriate to realise that risk and balance sheet size are in general correlated, and a high leverage ratio is an indicator that a firm may have more risk than its capital can sustain. Therefore a leverage ratio, in combination with a thorough understanding of the business model and risk management practices of a firm, is useful additional information for regulators and others. A single leverage limit is not a useful tool and should be avoided. It would for example discourage narrow banks which concentrate on low risk assets and push them to increase risk, which is probably not the desired impact of the proposals.

Along with other industry participants, we believe strongly that a leverage ratio has no place in the minimum capital requirements element of a risk-based capital regime. The most appropriate place for a review of the level of leverage in a banks balance sheet is within the Pillar 2 discussions between a regulator and the bank. Following the adoption of Basel 2 in all major jurisdictions, all regulators should have access to a consistent set of regulatory tools, including an appropriately robust Pillar 2 framework. We agree with the industry that this is the appropriate place for discussions on leverage to occur.

Definitional Issues

The current proposals - taking no account of legally binding netting agreements, grossing up for repos, bringing in derivatives and possibly being based on the 'Common Equity' definition (i.e. after all deductions) will result in significantly higher leverage ratio than established definitions for the same balance sheet. There is also no clarity on how various different accounting treatments for assets evident in different jurisdictions will be dealt with.
Appropriate calibration taking this into account will therefore be required.

Procyclicality

As noted in our covering letter LBG welcomes the Committee's aim to counter cyclicality but have already highlighted key areas under the regulatory adjustments section where the proposals have the potential to significantly increase procyclicality (deferred tax assets, pension fund liabilities and unrealised gains and losses). We have significant concerns about some of the specific proposals the committee has put forward to counter procyclicality.

We support initiatives to dampen volatility of capital requirements and provisions. However we believe that the framework to counter procyclicality being proposed has the unintended consequence of encouraging local regulators to apply excessive conservatism, resulting simply in more capital (which is not necessarily less procyclical) rather than more stable capital (which is less procyclical).

Cyclicality of the Minimum requirement

The Committee puts forward two options to smooth the cyclicality of capital requirements - the FSA approach to utilise variable scalar adjustments to dampen the cyclicality of PDs and the CEBS proposal of using downturn PDs. We are supportive of a through the cycle methodology for the determination of Pillar 1 capital requirements and as such support approaches which provide more stable capital requirements (e.g. the FSA's variable scalar initiative) as long as these approaches don't introduce excessive conservatism. PDs are already calibrated to a 99.9% confidence level in Pillar 1 and therefore moving to a downturn PD value of what is a stressed parameter is neither logical nor consistent with the underlying approach to the fundamental calibration of the Basel II framework.

The concept of a downturn has not been clearly defined, which is likely to result in a lack of consistency of application. Furthermore the use of a universal downturn measure does not account for known portfolio inverse correlations, where downturn in one area is an upturn in another; this may result in additional conservatism. Conceptually the downturn PD has no practical business use and this will lead to significant challenges in demonstrating compliance with the 'use test' requirements.

The calculation of a downturn PD will be particularly difficult for portfolios that are small, bespoke and/or have limited default experience. For such portfolios a small number of actual defaults in a single year will have is disproportionate effect on PD estimates - i.e. a portfolio of 50 deals that has no defaults for five years then 10 in year six could be argued to have a 20% downturn PD rather than a 3.3% long run average.

The relationship between PD and LGD also needs to be considered as the definition of downturn may vary between the two concepts. There is generally a lag between worst PD and worst LGD rates over time.

Forward Looking Provisioning

LBG welcomes the progress being made by standard-setters towards strengthening provisioning practices (as recommended by the G20) and, in particular, proposals to incorporate more forward looking information within impairment provisions. However, consistent with many other organisations in the banking industry, we are not yet convinced that the expected cash flow (ECF) approach based on an EIR methodology as set out in the IASB's Exposure Draft is the right model.

At the time of submitting this response, the IASB's due process is incomplete. The IASB's Expert Advisory Panel is making progress at trying to resolve many of the operational and practical issues with the proposed ECF model and is also seeking to address specific issues with the EIR approach. It is therefore premature to predict the outcome of those deliberations and we reserve any formal views on the proposed ECF model until such time as the IASB due process is complete. Our further comments must be viewed in that context.

We would observe, however, that rather than reducing procyclicality, the proposed ECF model could in fact exacerbate procyclicality as the proposed ECF model is based on expected losses which might increase in a downturn. The proposal appears technically accurate but will involve the need for material judgement to be applied. The proposed ECF model would require any “catch-up” adjustments made after expected losses are initially estimated to be recognised immediately in profit or loss. Operationally, the proposed ECF model is very complex and the costs of implementation and the requisite changes required to systems and processes will be substantial.

The IASB could meet the G20 recommendation through the adoption of a far simpler model that aligns impairment provisioning with existing risk management practices and also makes greater use of existing Basel II information. The recent alternative proposal by the European Banking Federation (March 2010) combines the benefits of both the Expected Cash Flow proposal and the through the cycle Expected Loss approach. The proposal seeks to supplement the existing incurred loss calculation with a lifetime loss calculation that spreads the expected lifetime loss over the expected life of an exposure. Whilst the proposals requires some model development (and therefore costs) it allows firms to leverage their investment in risk management and would leave the existing provision calculations untouched, It remains to be seen however if the proposal will sufficiently address IASB concerns with through the cycle loan loss provisioning.

Capital Buffers

The holding of capital buffers over regulatory minimum levels is a necessary and standard practice of well run banks. Moreover, it is recognised that there will be occasions when it is appropriate for a regulator to enter into a dialogue with a bank concerning the ways the bank intends to improve or conserve the level of capital buffer it holds. That is a normal part of the relationship between regulator and firm. Importantly, though, the appropriate manner for that discussion to take place is within the Pillar 2 process on a bilateral confidential basis, not subject to public disclosure.

In that context it is wholly inappropriate to prescribe generic, ‘one size fits all’ and inflexible rules constraining the distribution policies of banks as proposed. Such an approach fails to recognise the diversity of approaches prevalent across the industry in determining capital requirements. Firms adopt a range of modelling methodologies from "point in time" to "through the cycle" which needs to be understood when sizing the quantum of any particular capital buffer. Additionally different firms have different levels of historical data and different attitudes to the appropriate level of model conservatism and a one size fits all approach may well generate unintended outcomes in terms of allowing or preventing capital distributions. It is more robust from a financial stability perspective for regulators to discuss with management on a case by case basis the capital buffers that should be in place to promote safety and soundness in the banking system. Such an approach utilises the regulatory powers that exist in the UK and as envisage by the Basel Committee under Pillar 2. LBG advocates this approach.

In addition in order to promote a level playing field across industry it would be more appropriate to provide guidance or standards as to how banks and regulatory authorities might assess the appropriate level of buffer. Accepting that this is not a straightforward task the more transparency there is around the key considerations then the easier it is for the industry to migrate to a level of practice that aligns with regulatory objectives.

Having said that, our concerns on current capital conservation buffer proposals are elaborated upon below:

Inappropriate mechanism

An individually tailored approach to buffers, administered under the pillar 2 process, is the appropriate mechanism for achieving capital conservation. If a regulator is concerned about a bank’s ability to achieve and maintain an adequate level of buffer above the regulatory minimum then the appropriate way to address that is through a confidential bilateral dialogue. The existing Pillar 2 process provides an adequate framework within which this can take place.

Even then, the decision as to what distribution policy to adopt should not be subject to a simple 'one size fits all' generic formula. There will be many issues to take into account affecting banks in different ways which such a formula will fail to address adequately. For example, paragraph 259 suggests that the standard approach would be based on Tier 1 capital. It is not clear that this particular definition of capital would universally be the most suitable

Paragraph 253 explains that the proposals are a response to the fact that during the financial crisis some banks did not follow best practice in regard to their distributions and the need to conserve capital. However, well managed banks did follow best practice and it would be inappropriate to impose the proposed inflexible constraints upon such banks that would otherwise manage their distribution policy in a responsible way and in the best interests of all stakeholders of the bank.

Disincentivices investment and potentially introduces destabilisation

The package of reforms currently being introduced for capital and liquidity will, in its current form, have a significant adverse impact upon the return on equity (RoE) achievable by the banking industry, so that the banking sector will potentially not be able to attract equity investment, and so will not be viable without potentially material changes to business models that would have a significant detrimental impact on economic recovery. The proposed public, generic and inflexible constraints on distribution policy would be an additional major disincentive to investors. This would particularly be a barrier to recapitalisation during a time of stress when buffers are depleted.

If the regulator does establish a buffer range for a bank then it is essential that this range is not publicly disclosed. There is a concern that, otherwise, as a bank 's surplus capital over the regulatory minimum approaches the buffer range, it is likely to create greater volatility in the share price and contribute to a destabilisation of the bank's financial position.

Unintentionally raises regulatory minimum capital levels

It is likely that the proposals on buffers will create an upward spiral of capital requirements, which could well increase systemic risk. As a result banks will be forced to capitalise to levels well in excess of those envisaged by the committee, and in excess of the levels justified by the risk:

- We have seen in the last crisis that banks were perceived to be inadequately capitalised with capital levels well above regulatory minima, and that perception led depositors and markets to withdraw funds.
- If regulators set public buffers above the regulatory minima, the general perception of what is adequate capital is then likely to be set at a step above that. When firms breach that higher level it could precipitate similar liquidity problems
- The liquidity problems caused purely by uninformed perceptions and misunderstandings of capital requirements, if experienced by several institutions, could tip economies into another general downturn.

<u>Excessive credit growth</u>

The rationale for developing a dynamic capital buffer is unclear. The proposal is to provide some form of additional capital protection when there are 'signs that credit has grown to excessive levels'. However, the growth of credit will automatically lead through to increased capital requirements under Pillar 1 and combined with a well defined capital buffer would result in increased levels of capital being required. We are unsure why the buffer itself should also then be reset. We would suggest that it would be preferable to focus upon the appropriate definition of the buffer in the first instance.