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April 16th, 2010

MACQUARIE

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

baselcommittee@bis.org

Dear Sir/Madam,

Strengthening the resilience of the banking sector

Macquarie Bank Limited ('Macquarie') appreciates the opportunity to make a submission to the Basel Committee on Banking Supervision in response to its consultative document *Strengthening the resilience of the banking sector*, issued for commentary in December 2009.

Macquarie Group is a global provider of banking, financial, advisory, investment and funds management services. Macquarie Group's main business focus is making returns by providing a diversified range of services to clients. Macquarie Group acts on behalf of institutional, corporate and retail clients and counterparties around the world. Macquarie Group Limited is listed in Australia (ASX:MQG; ADR:MQBKY) and is regulated by the Australian Prudential Regulation Authority ('APRA') as the owner of Macquarie Bank Limited, an authorised deposit taker. Founded in 1969, Macquarie Group employs approximately 14,400 people in more than 70 office locations in 28 countries. Including the recent acquisition of Delaware Investments, Macquarie Group had assets under management of $A342 billion at 31 December 2009.

Macquarie supports the overall objectives of the Committee as outlined in the *Resilience* consultation paper. However, there are a number of areas where we believe the proposed measures could or should be refined to enhance the practical application of these objectives.

Macquarie has been working closely with the Australian Bankers' Association ('ABA') and has contributed to the association's industry-wide submission. We support the points raised by the ABA, and we have prepared this submission to discuss more fully certain areas where we have an additional contribution to make. We ask the Committee to consider the specific recommendations outlined below as it finalises the changes to the regulatory capital framework.

Executive Summary

The key areas where Macquarie believes the proposals could be refined are:

- **Limits and minima**: The new limits and minima relating to Common Equity, Tier 1 and total capital ratios should account for both the proposed capital conservation buffers and individual bank buffers that are typically maintained above regulated minima.
- **Grandfathering**: We understand that grandfathering agreements will be reached with local regulators, but we suggest the Committee set out principles to ensure a measure of consistency across jurisdictions.
- **Minority interest:** We believe minority interest should be available to absorb risk in the subsidiary to which it relates. Accordingly, we recommend allowing for a corresponding adjustment to the underlying RWA and capital deductions.
- **Going vs. gone concern deductions:** We appreciate the desire for simplicity in this area but suggest that the proposed deduction regime is inconsistent with the roles of Tier 1 capital (going concern) and Tier 2 capital (gone concern), which the Committee has usefully clarified. Assets such as deferred tax assets and capitalised software expenses may be worth nothing in the event of insolvency, but are unlikely to systematically drop in value to zero while the bank remains a going concern. We propose a regime where such assets are risk weighted according to their potential to fall in value in a going-concern situation, with the balance of the asset's face value taken as a deduction from Tier 2.
- **Holdings in financial institutions:** Macquarie suggests that trading book positions be excluded from the scope of the corresponding deduction for investments in the capital of financial institutions. Macquarie also suggests that the Committee clarify that long-term holdings of common stock of financial institutions should not be eligible for trading book classification. If the Committee concludes that trading book positions are still included in the scope of the deduction, then we suggest that all derivative positions be included in the calculation of positions to determine the deduction (irrespective of whether the positions involve counterparty risk). Further, the definition of 'financial institutions' should in this context be limited to banks.
- **Credit valuation adjustments ('CVA'):** The principal method proposed (bond-equivalent) is sound in principle but the suggested implementation is excessively conservative. We suggest it be calibrated to yield a more reasonable measure of the risk, for example by: using weighted-average rather than maximum maturity across netting sets, dropping the proposed additional multiplier of 5 applied to the market risk charge, and ensuring the risk-reducing effect of margining is appropriately reflected.
- **Leverage ratio:** Macquarie strongly advocates calibrating the leverage ratio as a supplementary metric rather than a binding constraint. We recommend keeping this metric as part of the Pillar 2 framework, rather than migrating to a Pillar 1 treatment, as is currently planned. The ratio will require significant adjustments to accounting figures if it is to allow for fair comparisons across jurisdictions.
- **Capital conservation buffers:** We caution that the proposed measure will effectively translate into a new minimum capital requirement. We advocate dealing with this matter as part of the supervisory review process under Pillar 2.

Key Issues

Raising the quality, consistency and transparency of the capital base

82. Limits

We welcome the Committee's objective of simplifying the current system of limits and minima, and understand that outcomes from the impact study will provide guidance as to appropriate calibration levels. It is important that the calibration of the minimum ratios allow for the presence of the capital conservation buffer, as well as the fact that banks will, in practice, hold capital in excess of the capital conservation buffer. In other words, there will be 'buffers on buffers.'

RECOMMENDATION

The minima should be set with the understanding that actual capital ratios will be forced to be significantly higher than the prescribed minimum ratios.

84. Grandfathering and transitional provisions

In light of the breadth of the proposed changes, the Basel Committee is encouraging institutions to enter into direct negotiations with the local regulator to determine what, if any, grandfathering arrangements will be made for existing, previously approved capital instruments. Macquarie will submit a specific proposal to APRA regarding our existing instruments, but we wish to share some thoughts for the Committee's consideration.

As outlined in the ABA's submission, uniform implementation of grandfathering requirements across jurisdictions would seem sensible, given the risk of regulatory arbitrage between countries. Similarly we believe it is critical that due consideration be given to appropriate transition periods, and that phase-in to the new framework be adopted consistently across countries.

RECOMMENDATION

Grandfathering and transition periods should be consistent across countries to ensure as smooth a transition as possible to the new regulatory framework. We suggest the Committee set out principles to ensure a measure of consistency across jurisdictions.

95. Minority interest

In the proposed framework, minority interest will not be eligible for inclusion in the predominant form of Tier 1. Macquarie understands the rationale behind this change, but believes minority interest should at the very least be available to absorb risk in the subsidiary to which it relates.

RECOMMENDATION

There should be a corresponding adjustment to the underlying risk-weighted assets and capital deductions – such as a pro-rata adjustment in line with the minority interest holdings.

97-98. Going vs. gone concern deductions

The Committee has clarified the roles of Tier 1 and Tier 2 capital: in the case of Tier 1, to absorb losses on a going concern basis, and in the case of Tier 2, to absorb losses in a gone concern situation. It would, therefore, seem appropriate to require that losses that might be incurred in a stress scenario be supported by Tier 1 capital in order to avoid insolvency, while additional losses that would arise in the event of insolvency could be supported by Tier 2 capital.

We understand that the Committee might find it prudent to assume that assets such as goodwill, deferred acquisition costs and deferred tax assets have no value in the event of insolvency, and hence require 100% capital backing. However, these assets will still have substantial value in a severe stress scenario, as long as the other losses of the company have been covered so that the company is still considered a going concern.

This suggests that the appropriate treatment of such assets is to require backing by Tier 1 capital to the extent that the assets would be written down in the severe stress scenario contemplated in the capital rules (i.e. a 99.9^{th} percentile systemic downturn), and by Tier 2 capital for the remainder of the assets' balances. Within the going vs. gone concern framework this is logically achieved by risk-weighting such assets according to their potential for loss of value in a going concern situation, with the balance of the asset's face value taken as a deduction from Tier 2.

RECOMMENDATION

We recommend that all assets be risk-weighted according to their potential for loss of value in a going concern situation, and that, for assets judged likely to be worth nothing in a gone concern situation (goodwill, deferred tax assets, capitalised software expenses), the balance of the asset's face value be taken as a deduction from Tier 2 capital.

Absent this, a 50/50 deduction treatment would seem appropriate for goodwill, deferred tax assets, etc., as 50% seems a reasonably conservative estimate of the expected write-down on such assets in a stress scenario. Alternatively the Committee could consider an adjustment to the amount deducted from Common Equity to account for the residual value that these assets maintain in a stressed going-concern scenario, or a risk weighting less than 1250%.

To address the concentration risk posed by particularly large balances of goodwill or deferred tax assets, we suggest this approach be supplemented by limits above which the entire asset generates a deduction from Tier 1 capital (such as those applied to equity investments).

108. 1250% risk-weighting

The Committee proposes that certain assets be risk-weighted at 1250%, presumably to ensure 100% capital backing.

RECOMMENDATION

If the minimum total capital ratio (z) is set above 8%, the 1250% risk weight should be reduced (to 1/z) in order to achieve the goal of 100% capital backing but avoid specifying a level of capital backing which exceeds the face value of the asset.

101. Investments in the capital of certain Financial Institutions which are outside the regulatory scope of consolidation

The Committee is proposing a "corresponding deduction approach" to non-consolidated investments in the capital of other banks, financial institutions and insurance entities. The proposed deduction is to be applied to banking book and trading book positions.

Macquarie understands that the purpose of the deduction is to remove the double-counting of capital in the financial sector. This arises when one financial institution holds a stake in another, so that losses made in the investee company that reduce the value of its equity will cause losses in the investor company. If the stake is hedged, however, the investor company will experience no loss (ignoring credit risk on the hedge). This suggests that to avoid double-counting, positions held in the banking book should be deducted. It could also be argued that trading book positions should be subject to the same treatment, but in practice we believe that this is unnecessary given their short-term nature and the liquidity requirements for inclusion in the trading book.

The potential concern that long-term investments are held in the trading book can be addressed via oversight of the banks' regulatory classification process, which ensures long-term investments are excluded from the trading book. If trading book holdings remain within the scope of this deduction, then only those positions which give rise to genuine risk should be included. In trading books, stock positions are often a hedge for other transactions, or are themselves hedged by other transactions. It is important that an arbitrary or prescriptive set of rules not override the economic substance of hedged positions.

The proposal further specifies that gross long positions may be deducted net of short positions only if these positions involve no counterparty risk. Macquarie believes the application of this rule may have unintended adverse consequences on the viability of legitimate trading strategies and/or investment products currently issued by financial institutions. Specifically:

- Financial institution stocks are commonly included in trading strategies (such as index arbitrage) which add liquidity and efficiency to equity markets. Some of these strategies may include instruments that involve counterparty risk
- Trading book positions over financial institution stocks are often taken to hedge derivative products issued to investors in the financial sector. Some of these products, such as swaps and options, involve counterparty risk.

If financial institutions are required to take capital deductions for executing these strategies and products, it is highly likely that they will curtail their use.

These unintended adverse consequences can be readily addressed by allowing short positions as an offset. At a minimum, 'no counterparty risk' should cover all transactions dealt through recognised exchanges. Further, short positions which involve counterparty risk should also be accepted as an offset, unless the counterparty risk is clearly correlated with the underlying security. We note that capital is required to be held behind the counterparty risk associated with derivatives, and that it is extreme to assume that all counterparties associated with transactions dealt over all financial institution stocks will simultaneously default – this did not occur during the recent crisis.

Finally, the scope of deductions should only extend to other banks, and not insurance companies. Even during the recent crisis, there was not 100% correlation between the banking and insurance sectors.

RECOMMENDATION

Macquarie suggests that trading book positions be excluded from the scope of the corresponding deduction for investments in the capital of financial institutions. Macquarie also suggests that the Committee clarify that long-term holdings of common stock of financial institutions should not be eligible for trading book classification. If the Committee concludes that trading book positions are still included in the scope of the deduction, then we suggest that all derivative positions be included in the calculation of positions to determine the deduction (irrespective of whether the positions involve counterparty risk).

We further recommend that 'financial institutions' be defined in this context to include only banks.

Risk Coverage

123. Credit valuation adjustment ('CVA') capital charge

The Committee seeks to require capital to be held to cover the mark-to-market accounting losses that can be experienced in the form of increased credit value adjustments (CVAs) which could arise as a consequence of widening credit spreads. The bond-equivalent methodology – as revised in the QIS document – seems reasonable in principle, but as specified contains multiple areas of conservatism that compound and lead to a capital charge out of all proportion to the risk. Specifically:

- Taking the maturity of a bond-equivalent to be the longest effective maturity across all netting sets will overstate the CVA result. It will also induce volatility in the measure, e.g. in the circumstance where one small long-dated position is added to or removed from a counterparty where most trades are short-dated;
- Losses associated with CVA risk for short-term trades (< 1 year) will not necessarily be realised over the one-year capital modelling horizon, i.e. assuming we hold to maturity, the CVA will be released to P&L (default risk is already captured);
- Margining significantly reduces potential credit exposure, but this is not recognised for Current Exposure Method ('CEM') banks; and
- It is proposed that a factor of 5 be applied to the market risk charge to take the answer to a notional one-year horizon. However, factors of between 3 and 4 have already been applied in computing market risk charges from VaR, and furthermore, Stressed VaR is added to VaR in computing these charges. The proposed additional multiplier of 5 leads to the CVA risk charge being more than 30 times the 10-day 99^{th} percentile VaR (presuming SVaR is at least as large as VaR). This leads to the CVA risk charge being based on spread movements many times greater than those experienced in the Global Financial Crisis.

RECOMMENDATION

The bond-equivalent method should be calibrated to yield a more reasonable measure of the risk, for example by:

- Using an exposure-weighted average maturity rather than maximum maturity across netting sets;
- Dropping the additional multiplier of 5, thereby computing CVA risk in a manner consistent with how market risk on an actual bond portfolio would be computed (as VaR plus Stressed VaR multiplied by a factor in the range of 3-4)[1];
- For CEM banks, possibly adjusting exposures to reflect any margining arrangements in place.

In addition, alternative methods need to be developed for banks on the standard approach to market risk, as neither of the two proposed bond-equivalent approaches (PV and EAD) can in principle capture both spread risk and interest rate risk on CVA appropriately, and neither yields a reasonable answer. The stylised VaR method may be appropriate for such banks.

164. PD Estimates for Highly Leveraged Counterparties

The consultation document proposes a revision to paragraph 285 of the Basel framework to include *"PD estimates for counterparties that are highly leveraged or for counterparties whose assets are predominantly traded assets should reflect the performance of the counterparty's assets based on periods of stressed volatilities."*

Whilst Macquarie understands the reasons for adding a qualitative requirement and agrees with this conceptually, we do not believe the proposed approach is appropriate. A separate PD scale from that used for the Corporate Bank and Sovereign portfolio is adding an unnecessary level of complexity. Additionally, a separate PD scale is unlikely to be able to be subject to rigorous validation, given the lack of statistically significant data because of small portfolio sizes.

RECOMMENDATION

A more appropriate way to adjust PD estimates for highly leveraged entities would be to have ratings templates for these industries that include mechanisms to ensure that the overall rating generated is at the lower end of the scale, resulting in higher PDs.

196. Reassessment of eligibility criteria for ECAIs

The Committee is developing proposals to incorporate the IOSCO Code of Conduct Fundamentals for Credit Rating Agencies into the Basel II framework's eligibility requirements to use ECAI assessments. Specifically, the consultation document advocates strengthening eligibility criteria for ECAI.

In particular, the Committee suggests that "*the individual assessments, the key elements underlining the assessments and whether the issuer participated in the assessment process [be made] publicly available on a non-selective basis, unless*

[1] A first-principles analysis yields a similar result (VaR plus Stressed VaR multiplied by 4):
(x 5) to go from 10 days to 1 year
(x 1.6) to go from 99th to 99.9th percentile - allowing for a degree of non-normality
(÷ 2) to adjust for the fact that VaR and Stressed VaR are being added

they are private assessments provided only to the issuer. In addition, the general procedures, methodologies and assumptions for arriving at assessments used by the ECAI should be publicly available." The proposed amendment to 565(b) specifies that external credit assessments that are not publicly available would not be useable in the securitisation framework.

While we support the drive for consistency and transparency of methodologies, there is a challenge in defining what constitutes adequate levels of disclosure for ratings agencies. There will need to be significant industry, ECAI and regulator discussion and consultation around this point prior to implementation.

Leverage Ratio

Macquarie understands and supports the long-term objectives driving the introduction of the leverage ratio. We understand that the proposed ratio is being introduced as a supplementary measure to the risk-based framework, with a view to migrating to a Pillar 1 treatment upon appropriate calibration. In line with the ABA, we see a number of issues with the ratio and therefore strongly advocate keeping this metric as a non-binding 'backstop' measure to prevent extreme leverage.

Our concerns centre on four main points. First of all, because the ratio reflects balance sheet make-up (e.g. amount of gross matched derivative assets and liabilities or securitised assets relative to other banks) and is not risk-sensitive, it will be very difficult to properly calibrate between banks.

Further, we believe that implementation of the ratio as it is currently designed could have unintended consequences and counter-intuitive outcomes such as:

- Creating an incentive to move exposures off balance sheet – via, for example, non-consolidated SPVs - which would *decrease* transparency.
- Matched assets and liabilities (e.g. from repos) that do not generate a funding requirement will increase the leverage ratio.
- Cash and liquids that can be used to offset borrowings will increase the leverage ratio and provide an incentive to hold fewer such instruments, which does not seem to be the appropriate outcome. For this reason, we recommend excluding cash and cash-like instruments from the exposure measure.
- Creating an incentive to increase risky assets if the leverage ratio becomes a constraint over risk-based ratios.

Differences in accounting standards need to be properly accounted for in order to ensure ratio comparability across jurisdictions. While this is one of the Committee's stated objective in designing the ratio (205), the main approach for securitised assets is based on the accounting treatment (222) which will lead to significant differences, since IFRS includes them, but US GAAP excludes them from the balance sheet.

Finally, we believe the leverage ratio could have an amplifying effect on procyclicality, which is obviously counter to the Committee's longer-term objectives. A reduction in the capital base through losses would result in an increase in the leverage ratio, which could force the selling of assets.

RECOMMENDATION

Macquarie strongly advocates maintaining the leverage ratio as a supplementary metric rather than a binding constraint As it is currently designed, the leverage ratio could have unintended consequences that go counter to the Committee's objectives, such as increasing risky assets. In order to allow for meaningful comparisons, the definition of the leverage ratio must be harmonised internationally and adjusted for difference in accounting approaches.

We recommend excluding cash and liquids from the exposure measure of the ratio.

Procyclicality

239-242. Cyclicality of the minimum requirement

From Macquarie's perspective, there does not appear to be much empirical evidence to indicate that cyclicality of the minimum requirement contributed to the recent crisis. We would therefore recommend against adopting either of the proposed approaches. Each involves applying rather coarsely determined multipliers to assessed PDs, and the resulting distortion of regulatory capital requirements would have an adverse effect on the use of capital estimates in deal-level decision-making – thereby hindering the supervisory 'use test'.

We believe the theoretical possibility of procyclicality in the minimum requirement is better addressed through other means already available to regulators under Basel II, such as through the adoption of through-the-cycle ratings for capital adequacy purposes.

RECOMMENDATION

Neither of the proposed methods for reducing cyclicality of the minimum capital requirement should be implemented. The Committee should consider mandating the use of through-the-cycle ratings for capital adequacy purposes.

247. Building buffers through capital conservation

Part (c) of the Procyclicality section addresses proposals to ensure that banks build up capital buffers outside periods of stress which can be drawn down as losses are incurred.

The Committee has emphasised in Paragraph 257 that it does not want '*to impose constraints for entering the range that would be so restrictive as to result in the range being viewed as establishing a new minimum capital requirement.*' However, if the numbers shown in Paragraph 258 are representative of the final buffer levels, the proposed changes will be harsh and would effectively result in a new minimum capital requirement.

While we understand that these figures are illustrative and subject to calibration, they are quite severe. Given that the conservation applies to earnings, distributions, and variable remuneration, immediately cutting in to 40% in the first bracket is material. As an example, if an investment bank typically pays out 40% of pre-tax profits in variable remuneration, then pays 30% tax, then pays a 50% dividend, the percentage of pre-tax, pre-bonus earnings that is retained in a typical year is only about 21%. Requiring retention of 40% is therefore a very significant restriction. Accordingly, we would recommend a more gradual calibration of the conservation ratios.

The proposed distribution constraints described in Paragraph 259 are substantial: *'the guiding principle is that the buffer must be large enough to enable banks to remain above the minimum requirement in the face of losses expected to be incurred in a feasibly severe downturn.'* The principle outlined here is essentially a form of 'stress test,' and hence very significant as a buffer. Given that banks will impose their own buffers above this level, there will effectively be *buffers on buffers,* and actual capital ratios will be significantly higher than the headline x%, y%, and z% ratios. As noted earlier, we would expect that the new minima will account for this.

As an alternative, we suggest that the Committee consider a measure akin to APRA's *profits test*, which stipulates requirements that must be met in order to pay dividends. Because it focuses on current year after-tax earnings, the test addresses some of the concerns raised in paragraphs 251 (using future predictions of recovery as a justification for distributions) and 252 (using distributions to signal financial strength) of the *Resilience* document.

Finally, in addition to concerns about buffers on buffers, we caution that the proposed measures effectively equate to a transfer of significant capital management responsibility from the bank to regulators.

RECOMMENDATION

Rather than the proposed prescriptive approach that will effectively increase the minimum capital requirement, we strongly advocate implementation of capital buffers as part of Pillar 2, allowing local supervisors to engage in robust discussion directly with banks.

If the proposed measure is adopted, we recommend a more gradual calibration of the conservation ratios.

In closing, we note that our recommendations are consistent with an effective implementation of the Basel II principles. First, consistent application of the changes across jurisdictions will be key to ensuring a smooth transition, and preventing any form of regulatory arbitrage. This relates not only to phase-in and grandfathering periods, but also to application of the proposed changes. Such harmonisation is essential to fulfilling the promise of Pillar 3 – market discipline.

Secondly, we believe that it is important to maintain the primacy of the risk-based minimum capital requirements in Pillar 1, and propose that measures such as the leverage ratio and capital conservation buffers would be more effective as part of the supervisory review process – Pillar 2. Adoption of an overly prescriptive approach is likely to be counter-productive.

Should you have any questions regarding Macquarie's comments, please do not hesitate to contact me on +61 2 8232 4025 or via email at Stephen.Allen@macquarie.com

Yours sincerely,

Stephen Allen

Chief Risk Officer