Warsaw, 16 April 2010

KNF – Polish Financial Supervision Authority

Response to

“Strengthening the resilience of the banking sector”
Consultative Document
presented by Basel Committee on Banking Supervision

The KNF-Polish Financial Supervision Authority welcomes the opportunity to comment on the Basel Committee proposals on capital and liquidity requirements. This note provides our assessment on the ideas outlined in the document entitled “Strengthening the resilience of the banking sector”. Comments on the document entitled “International framework for liquidity risk measurement, standards and monitoring” are delivered separately.

1. The Committee’s proposals to simplify the capital structure of banks (section II.1) seem to be justified. Eliminating the division between upper and lower Tier 2 and erasing Tier 3 will help enhance transparency of these categories and, even more importantly, allow for the capital to serve its basic purpose – covering unexpected loses. At the same time, more simple rules of calculating the capital will make abuses more difficult and make it easier for banks to manage their capital structure and for supervisors to conduct their assessment.

2. In our view, the permission for an early redemption of the hybrid instruments *(call option)* is not justified from the macro-prudential point of view, as it could lead to a considerable reduction of the level of capitals at a given moment.

3. From the perspective of supervision over smaller banks (including cooperatives), new limits and minimum capital adequacy requirements may be questionable. Possible impact of the recommended changes should be thoroughly analysed. The proposed approach can in fact create a higher risk of banks intentionally shifting exposures to inappropriate categories.

4. The KNF welcomes the Committee’s attempt to minimize counterparty credit risk (section II.2). Mismanagement of this type of risk has contributed to most of the losses incurred during the recent crisis. More specifically, for the measures outlined in paragraph 116:
- we believe that the requirement to calculate the Effective EPE metric on data that includes a period of stress has been sufficiently justified by experiences of the late 2008;
- we support the idea to incorporate a capital add-on to better capture CVA risk but have doubts concerning details of the measure. According to the consultative document, in Poland,

alike in other less developed markets where CDS spread is not available, the proxy spread used to determine the CVA for fair-value accounting purposes should be used as the spread of the bond. The accuracy of the capital requirement would then rest on how precisely and on what assumptions the proxy spread was calculated, which is not what we would exactly want to see;

- we tentatively endorse the proposal to establish a capital charge for specific wrong-way risk even if there are no details on the table to comment on. At this stage we may point out that in situations of high specific wrong-way risk (when, for instance, a credit is secured by shares of the borrower) the capital charge should be at least proportional to the maximum loss to be incurred should the obligation not be fulfilled.
- similarly, we agree that applying a multiplier to asset value correlation generally is an appropriate answer to losses suffered by banks during the financial crisis. We think, however, that in the European Union the large exposures issue has been sufficiently regulated by the CRD II and the guidelines of the Committee of European Banking Supervisors.
- we think that extending the margin period of risk to 20 days for OTC derivatives and certain securities financing transactions netting sets (amounting to over 5,000 trades, having illiquid collateral, or representing hard-to-replace derivatives) would only make the regulation more realistic, at the same time increasing the capital requirement for these transactions. To apply longer margin periods we would need accurate assumptions in regard to volatility, as estimates of an underlying instrument volatility often determine margin netting sets (especially in case of less liquid instruments or more complex structures). The important related question is whether the volatility will be assessed on a basis of identical period of 20 days, or the period will be shorter (e.g. 10 days).

5. In respect to the proposed leverage ratio (section II.3), we support designing a measure complementary to the ratios based on risk-weighted assets. The ratio should be defined and calibrated very carefully. Impact assessment should be conducted for each country separately. Also, the ratio should be adjusted to the size and profile of various types of financial institutions.

It is important that the leverage ratio cannot be abused by transfer of assets outside a balance sheet. The denominator should comprise also all items that, for instance, have been moved to special purpose vehicles but that still create some risk for the bank (including reputational risk).

As for the numerator, core Tier 1 capital, being of the best quality, should be used. Capital of this category is the most effective during crises, has the highest loss absorbency and determines a bank's ability to continue operations.

National supervisors should be able, in certain circumstances, to require a lower or higher leverage ratio.

6. The proposed concept of capital buffer, if realized, would certainly boost capital adequacy of banks. In our opinion, however, it is too early to prejudge that the existing capital adequacy framework is more procyclical than we thought. Especially that the new solution has some

drawbacks. It can, for instance, discourage banks from prudent assessment of a borrower's credit worthiness, as they will be aware of the huge capital cushion. Furthermore, the proposed measure will make credit risk capital requirements more complicated and less transparent.
That said, the proposal is worth working at. To be effective and not counterproductive, different buffers could be established depending on structure and size of banks. To really play their role, the buffers should be applied at the level of individual institutions.

7. The Committee has joined the debate on the potential additional capital and liquidity requirements for systemically important banks (section I.1, letter e). We would be happy to see that a product of its work will not impinge on the principle of equal treatment of the businesses.

8. The measures with which the Committee addresses the systemic risk arising from the interconnectedness of banks and other financial institutions through the derivatives markets would possibly limit turbulence in the financial systems in case of sudden shocks. What should be avoided is overregulation of credit derivatives and securitised products markets. Such a result would be dangerous also because it could paradoxically encourage banks to search for new products with even more complicated risk profile. It could also be noted that changes in capital requirements connected to trading book might trigger temptation of regulatory arbitrage, that is of shifting instruments between banking and trading books.