

Basel Committee on Banking Supervision

Consultative proposals to strengthen the resilience of the banking sector

16 April 2010

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Dear Sirs

Consultative proposals to strengthen the resilience of the banking sector

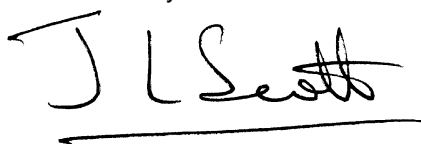
PricewaterhouseCoopers welcomes the opportunity to provide feedback on the two consultation papers issued in December 2009 entitled 'Strengthening the Resilience of the Banking Sector'; and 'International Framework for Liquidity Risk Measurement, Standards and Monitoring'.

We welcome the aims of the BCBS proposals which build on the extensive steps that the banking sector has already taken to strengthen capital ratios, to lower leverage and to reduce liquidity risk. While we agree with the direction of the proposals and many of the components, we also have important concerns that we believe the Committee should consider carefully. In particular:

- The combined effects of the proposed higher capital requirements and the proliferation of buffers are overly conservative and lack transparency.
- There is no discussion of what constitutes an appropriate level of capital and liquidity in the financial system: this is an ideal time to make an assessment.
- Capital is expensive and needs to be compensated adequately for investors to invest to support regulatory objectives. This must be recognised explicitly in the Committee's deliberations and proposals.
- The macroeconomic consequences of the proposals need to be carefully evaluated as do calibration and the timescales envisaged for transition.
- The differing objectives of financial and regulatory reporting lead us to question whether one set of standards can satisfy the requirements of shareholders and regulators.
- Further consideration needs to be given to systemic factors with less focus on a mechanical capital regime and formulaic liquidity requirements and more focus on developing a balanced range of regulatory tools.

We would be pleased to discuss our comments further with you should you wish. In the first instance please contact me on +44 (0) 20 7804 2304.

Yours faithfully



Jeremy Scott, Global Financial Services Leader

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1 Summary

1.1 Introduction

In this section we provide overarching comments and summarise our key observations and recommendations.

Our detailed comments in the following sections deal particularly with the capital proposals, with separate sections devoted to other selected key aspects. We also comment on accounting considerations and the proposals on liquidity. In the section on counterparty credit risk we also provide observations on the trading book amendments which were agreed last year and that interact with the current proposals.

1.2 Overarching comments

We discuss the main aspects below and would like to make the following introductory comments:

- When taken separately, a good case can be made for each proposal. However, when we look at the package of proposals as a whole we believe [that the combined effect of the proposed higher requirements and the proliferation of buffers are overly conservative and lack transparency](#).
- Underlying this, [there is no discussion of what constitutes an appropriate level of capital in the financial system](#). Basel II aimed to leave the overall level of capital at the level of Basel I, but at that time there was no explicit review to establish whether this level was correct. The new proposals provide an opportunity to conduct a fundamental re-appraisal of the overall required level of capital and we believe this opportunity should not be missed. Without such a review, there is a general sense that more capital is required in the system as a whole but there is no supporting research as to what the limit should be, above which inefficiencies result for banks, customers and the wider economy.
- [Capital is expensive and needs to be adequately compensated for investors to invest. This must be recognised explicitly in the Committee's deliberations and proposals](#). At the same time that returns on capital are being reduced significantly through, for example, higher capital requirements together with higher liquidity requirements, charges for deposit protection insurance and resolution funds, the industry is being asked to either de-lever or raise more capital.
- [The macroeconomic consequences of the proposals need to be carefully evaluated as does their calibration](#). As we note at various points in our responses below, there are various issues where the risk of unintended consequences needs to be carefully considered. We also question whether it is possible to carry out a 'comprehensive impact assessment' in the first half of 2010, as suggested in the paper. The current QIS is gathering information to support calibration. In some cases this can be done (e.g. definition of capital and market risk) as the proposals are concrete – in others this is not yet the case as the rules are yet to be finalised.
- [We are concerned about the current timescales for transition envisaged by the Committee](#). We believe it could be potentially damaging to the economy to implement at speed given the direct effects of the proposals on, for example, lending capacity to finance growth of the economy. While we believe that while it may be possible by 2012 to have developed consensus on potential changes and their calibration, successful implementation is likely to be best accomplished over an extended period.
- [The differing objectives of financial and regulatory reporting lead us to question whether one set of standards can satisfy the requirements of shareholders and regulators](#). The Committee wishes to harmonise regulation with

accounting standards but the differing objectives of financial statements, produced on a “going concern” primarily for shareholders, and regulatory returns, which consider a “gone concern” basis will be challenging to reconcile. The proposals need to reflect these points of principle.

1.3 Quality, consistency and transparency of capital

We agree that the existing definition of capital is flawed. In principle [we support the strengthening of eligibility criteria for Tier 1, the simplification of Tier 2 and the elimination of Tier 3](#). We also agree that the current ‘8% total capital, or which at least half Tier 1’ should be replaced with explicit minima for core Tier 1, total Tier 1 and total capital.

We believe it is debatable whether all deductions from capital should be made from common equity as this contradicts the distinction between going concern and gone concern. For example, certain items, such as deferred tax assets, can have considerable value to an organisation as long as it is a going concern. Indeed accounting standards require an assessment of recoverability before such assets can be recognised. On the other hand, we agree that items that are constructs of consolidated accounts (such as goodwill) should be deducted.

Incidentally, in evaluating the impact of changes to capital ratios it will be important to present the comparisons consistently in terms of ‘old capital currency’ and ‘new capital currency’. A 1% increase in the core Tier 1 ratio under ‘Basel III’ definitions is worth a lot more than a 1% increase under existing definitions.

[As regards capital buffers, the proposals suffer from layered conservatism and propose a complex mechanistic approach.](#)

On top of stricter rules for risk-weights, higher minimum capital ratios and a greater focus on core equity, the proposals call for four buffers: (i) a counter-cyclical capital buffer; (ii) buffer ranges in which certain restrictions on capital distributions will apply; (iii) additional buffers under the ‘macro prudential approach’ to be detailed later this year; and (iv) possible additional capital buffers for ‘systemically relevant, cross-border institutions’.

We believe that a simpler approach should be developed that reflects higher minimum capital ratios and higher risk weights for certain assets (as are proposed) as well as the factors mentioned above, but adopts a less ruthlessly additive philosophy and leaves more room for regulator discretion.

We agree that there should be minimum Core Tier 1, Total Tier 1 and overall capital ratios for all banks. Each bank, together with its supervisor, as part of its Pillar 2 assessment, should ascertain what additional capital level it requires to cover a combination of:

- (i) Planned business development, growth and distribution policy;
- (ii) Normal market cycles; and
- (iii) Stress.

and express this as a minimum capital ratio to be held over the cycle and a buffer which can be used to absorb stress (this could be expressed as a capital ratio range).

In doing this the supervisor would clearly need to have regard to macro-prudential supervision and business cycle effects, applied top down to systemically important banks, not embedded in a layered capital mechanism applied by every bank. [The supervisor’s focus in macro-prudential supervision should be on the quality of its own macro judgments and the wide array of tools it at its disposal, not just implementing a complex capital buffer mechanism at a bank level.](#)

We believe that these [capital buffers need to be institution-specific \(via Pillar 2\)](#), not one-size-fits-all. Not only are all institutions different (through, for example differences in business models, balance sheet structures, market contexts, risk appetite, corporate organisation and governance), we believe that imposing a one-size-fits-all approach could have adverse unintended consequences.

If buffers are set sufficiently high to cover the most risky institutions, a one-size approach would penalise low-risk institutions and effectively force them to become more risky to get the required return on their capital. If set at a lower level, then opportunities for arbitrage across different business models and markets can (and will) be exploited.

1.4 Leverage ratio

We agree in principle with the introduction of a leverage ratio, and we note that one of the probable causes of the recent financial crisis was the relaxation of the leverage ratio for US broker-dealers (but not for banks) in 2004.

[For many banks the leverage ratio \(as proposed\) could become the limiting constraint](#) (as opposed to the target capital ratios). In turn [this could trigger de-leveraging that could have a significant macroeconomic impact](#). Therefore the definition of the leverage ratio, its calibration and its interaction with accounting standards are vital issues to address. Leverage ratios also need to be calibrated within the context of accounting standards (e.g. US GAAP and IFRS) and business models (e.g. trading activities and retail banking).

There is also an important interaction with the higher levels of liquid assets to be held, which can inflate the leverage ratio calculation for no good reason. We recommend that liquid assets be excluded from the calculation of the leverage ratio.

1.5 Accounting considerations

There is a very important interaction between the Committee's proposals and changes being debated to accounting standards. [The accounting and prudential frameworks have different objectives](#). While accounting standards are aimed at providing a 'fairly presents' view of the financial status of a institution, primarily in the eyes of the shareholders, i.e. an objective assessment of a current situation on a going-concern basis, prudential regulators are concerned with the stability of a financial institution and the financial system as a whole, plus increasingly the systemic risk posed by an institution poses in the event of its failure.

As such, there is a natural conflict between accounting and regulatory world-views, specifically in the areas of provisioning and asset valuation. [The Committee needs to recognise openly the differing objectives and audiences of the financial statements and the regulatory returns and rationalise similarities and differences of approach](#). We believe that it is questionable whether one set of standards could meet both sets of objectives.

We recommend that the Committee and accounting standards bodies should seek to eliminate or minimize the effect of any inconsistencies in their guidance except where necessary to reflect different objectives and audiences.

1.6 Procyclicality

Procyclicality cannot be eliminated from banks' capital requirements, as this is neither possible nor desirable under a risk-sensitive capital regime. Each bank is likely to take amore prudent line when markets are vulnerable, and even with efforts to bring in more countercyclical measures we expect procyclical effects to remain. Countercyclical adjustments are difficult to calibrate given the requirement for long runs of data to do so. We believe that [it is essential to determine the true impact of the procyclicality of minimum capital requirements via an ongoing study](#).

In the meantime, any necessary adjustments could be undertaken under a potentially-reinforced Pillar 2 framework (as is already the case in some jurisdictions).

This would also be in line with the recommendation of the Committee of European Banking Supervisors to include any forward-looking capital buffers within the boundaries of the existing Pillar 2 framework²; in particular it allows for flexibility of application of the supervisory tools to take into account differences in individual institutions' business models and the sophistication and quality of their risk management frameworks.

1.7 Capital conservation

We do not favour a mechanical approach to setting capital conservation buffers. Where appropriate we recommend that [the supervisory evaluation of ICAAPs should be strengthened and the role of Pillar 2 given greater importance rather than introducing formulaic rules](#). In particular, supervisors may wish to augment their current approach to Pillar 2 with additional considerations regarding distributions. In addition, supervisors need to factor macro-prudential risks into their Pillar 2 assessments for systemically important banks.

1.8 Counterparty credit risk

We support the Committee's overall goal of improving transparency and orderly functioning of the derivatives markets in order to mitigate the risks that banks can absorb in times of economic and/or market stress. However, [we have reservations regarding the severity of some of the proposals as well as the speed proposed for their implementation](#).

We believe that firms should continue to enjoy sufficient flexibility in developing and applying tools for managing risks that are commensurate with their business profile rather than "fixing" industry-wide requirements that might also endanger a level playing-field and could have unintended negative consequences for the end-users in the wider economy.

There are several aspects to the proposed framework that we believe require careful consideration prior to adoption of the rules given (i) potentially "excessive" capital buffering resulting from the combination of rules related to individual areas and (ii) the need for further clarifications in the proposed methodology including the elimination of gaps.

We see many benefits in encouraging the use of central counterparties (CCPs). However, this creates a significant concentration of risk in the industry: banks and regulators will have to deal with all the "monoculture" dangers that then arise. Enhanced supervision of the CCPs and increased capital and liquidity requirements have a role to play, but the wider risks around the CCP need very careful consideration. As others have commented, [lender of last resort and implied government support issues arise and these should be made transparent to the users and the governments](#).

In relation to the trading book, we recommend that BCBS emphasise in its guidance to supervisors that risk sensitivity should be retained as a guiding principle and recognise that over-conservative capital allocations are potentially as damaging to the future effectiveness of the prudential framework as under-measurement of risk.

We also recommend a detailed impact assessment of the combined capital and liquidity impact of the full suite of reforms and proposals, specifically for trading book activity, and impact on financial markets.

² Committee of European Banking Supervisors, Position paper on a countercyclical capital buffer, July 2009

1.9 Liquidity

We see it as a high priority to complement the proposed quantitative liquidity requirements with efforts to harmonise the international liquidity risk regulatory and supervisory frameworks.

We suggest that the quantitative measures be incorporated within the BIS 'Principles for Sound Liquidity Risk Management and Supervision' so that the qualitative and quantitative requirements are both understood and applied coherently. [There is a risk that there will be a return to a 'tick the box' approach \(both by banks and supervisors\) if the quantitative measures takes precedence over broader liquidity risk management principles.](#) In addition, an overly prescriptive approach has the potential to create systemic risk if it is applied uniformly. We believe that it is essential to develop clear Pillar 2 liquidity requirements to address these issues.

1.10 Systemic effects

The present proposals focus on a bottom-up assessment of the capital and liquidity levels of individual banks rather than considering the stability of the system as a whole in a structured way. [There needs to be a move away from such a focus on a mechanical capital regime and formulaic liquidity requirements and towards the use of a more balanced range of regulatory tools.](#) Raising capital levels should be a final option, not the first: more capital is usually not the answer, and it may be a very expensive option for the local and global economies as well as the banks themselves.

Given that the overall aim of the proposals is to prevent systemic financial crises, the focus on the micro perspective needs to be complemented with a clear view from the Committee of what is required from a macro perspective. We suggest that the macro perspective should be considered from a number of angles including:

- Use of systemic tools;
- Oversight of market-wide macroeconomic indicators; and,
- Awareness of market distortions caused by regulation.

As an example of the use of the right tools, we would take the question of excessive credit growth. Here we support the need to identify appropriate macro indicators and to take timely action. We recommend that the emphasis should be on timely preventive action, not necessarily more capital buffers. We suggest that actions such as requiring the tightening of underwriting standards and liquidity supervision would be a lot more effective than using the blunt and expensive insurance of capital.

2 Quality, consistency and transparency of capital

2.1 Introduction

We agree with the basis of your diagnosis, namely that the existing definition of capital is flawed in that regulatory adjustments generally are not applied to common equity and that there is no harmonised and consistently defined list of regulatory adjustments. We also agree with the concept of splitting capital into ‘going concern’ and ‘gone concern’ capital; indeed, balance sheet and credit managers in the industry have been aware of this for many years.

In principle we support the strengthening of eligibility criteria for Tier 1, the simplification of Tier 2 and the elimination of Tier 3. We agree that on a going concern basis it is only common equity that can absorb losses. We also agree that the current “8% total capital, or which at least half Tier 1” should be replaced with explicit minima for core Tier 1, total Tier 1 and total capital. That is how the rating agencies and most prudent bankers look at capital ratios.

In evaluating the impact of changes to capital ratios it will be important to present the comparisons consistently in terms of “old capital currency” and “new capital currency”. A 1% increase in the core Tier1 ratio under the “Basel III” definitions is a worth a lot more than a 1% increase under existing definitions.

We believe it open for debate whether all deductions from capital should be made from common equity (para 73). This in fact contradicts the efforts to make a clear distinction between going concern and gone concern. Particularly in the case of assets that are deducted, it is relevant to assess whether the asset has any value in a ‘going concern’ context as opposed to a ‘gone concern’ context. Certain items – such as deferred tax assets – can have considerable value to an organisation as long as it is a going concern, as the term ‘going concern’ means that there is an expectation of a return to profitability against which past tax losses can be offset. Indeed accounting standards require an assessment of recoverability before such assets can be recognised. On the other hand, we do agree that items that are constructs of consolidated accounts (such as goodwill, but subject to eliminating the relevant underlying RWAs) should be deducted.

2.2 Detailed comments and recommendations

Our views on the specific items listed are:

Stock surplus (§94)	Agree, as this closes an existing loophole
Minority interest (§95)	Agree that this is not available to support risks outside the subsidiary to which it relates. However, total exclusion would be a significant and unwarranted barrier to banks opening up in territories where local equity involvement is required or advantageous. As a result it should be clear that the proportion of RWAs in the subsidiary in question should also be excluded from the capital adequacy computation.
Unrealised gains and losses (§96)	<p>We do not agree that these should never be adjusted for. Unrealised gains only exhibit loss-absorbing characteristics against losses on the instruments to which they relate (e.g. an unrealised gain on an equity cannot be used to absorb a credit loss, unless the equity can be sold to realise the gain – this is appropriate only for liquid, trading positions).</p> <p>We suggest that the inclusion of unrealised gains be limited to the capital required to be held against the same items; losses should be fully deducted. We suggest that any unrealised gains on assets that are not readily realisable should be excluded from capital. This would only apply to such items not held in the trading book but available for sale.</p> <p>This would only apply to items not held in the trading book or available for sale, as these are (1) marked to market and (2) can be sold at any time.</p>
Goodwill and intangibles (§97)	Agree. Goodwill exists usually only at the consolidated level, whereas in periods of stress it is the legal entity which matters. At the legal entity level, goodwill is usually a component of investment in subsidiaries. Where the regulated entity is looked at on a consolidated basis, the goodwill should be

	<p>deducted. Where the regulated entity is looked at on a standalone basis, the component of investment in subsidiaries which exceeds the book value of the subsidiaries' tangible net assets at acquisition (i.e. the proportion which is treated as goodwill in the consolidated accounts) should be deducted from core equity, as is the practice of many supervisors today.</p> <p>"Other intangibles" is too broad and needs to be clarified. For example, some jurisdictions have taken this to include mortgage servicing rights, which are a purchased form of future cash flows (not dissimilar to many other financial products). In other cases the embedded values of life policies are treated as intangible. The Committee should be more specific as to what other intangibles covers. These could be treated as RWAs, if necessary at a 1250% risk weight (or whatever percentage is commensurate with the final decision on minimum capital levels), as this is cleaner and more transparent (see below).</p>
Deferred tax assets (DTAs)(§98-99)	While we agree that DTAs (except those that arise merely from timing differences) may not be recoverable if a bank continues to make losses, full deduction from common equity is too severe, as it implies that DTAs are not recoverable in a bank which is still a going concern. This is a typical example of a 'gone concern' item, as DTAs will only be worthless if the bank goes into bankruptcy.
Treasury stock (§100)	Agree – this does not represent capital
Unconsolidated investments in financial entities (§101)	Agree with the "corresponding deduction approach". This implies that for the standalone capital adequacy assessment, any investment in excess of the net assets of the subsidiary (which is recognised as goodwill in the consolidated accounts) should be deducted from core Tier 1.
Expected loss shortfall (§102-103)	<p>We agree that any shortfall should be deducted from equity, as this is where the expected losses will be absorbed when they materialise. However, the Committee needs to ensure that the proposed approach is aligned with possible accounting changes. We also note that under the current accounting proposals the definition of EL is not the same as under Basel II. Most notably, the accounting proposals cover cumulative EL whereas Basel II only includes one year's EL. The Committee should clarify whether the existing EL definition will remain at one year, or whether it will be aligned with the accounting rules when they change.</p> <p>It is also not clear what will happen in the meantime for banks under the Standardised Approach for credit risk, as these banks do not compute EL. The Committee could require banks to compute EL irrespective of whether they are IRB banks. The basis for doing this would need careful consideration. Implementation in less sophisticated banks could be by way of percentages set by the BCBS based on actual data from relevant IRB banks in relevant economies, with an appropriate level of conservatism.</p>
Cash flow hedge reserve (§104)	While we can understand the logic of this, there may be an unintended consequence in that it may discourage hedging, which is not to be recommended. However, this will need to be reconsidered to the extent the accounting standard setters revise hedge accounting in the future.
Own liabilities (§105)	Agree
Defined pension funds (§106)	<p>This area requires further clarification. A full pension fund obligation risk (i.e. effectively marking the fund to market and adjusting the available capital for any surplus/shortfall) would lead to possibly unnecessary and counter-productive pro-cyclical volatility in capital ratios. Supervisors could be required to adjust for this in the Pillar 2 assessment.</p> <p>The Committee should also clarify the treatment of liabilities. As written, the paper suggests that unfunded pension fund liabilities should not be adjusted.</p>
Remaining 50:50 deductions (§107)	<p>Agree that these should be removed and treated as 1250% risk-weighted assets instead – it makes everything much neater.</p> <p>However, the percentage may need to change, as 1250% reflects a minimum capital requirement of 8% - to maintain the 'dollar for dollar' equivalence the percentage used here, and elsewhere in the existing Basel II rules.</p>
"Other" category of RWAs (Additional point not covered in the consultation paper)	We also recommend that a fourth category of RWAs be added to the existing credit, market and operational risks. Currently, the 'credit' category includes all of the non-credit obligation assets such as fixed assets) which are not actually credit risk. These could be moved to a fourth category, "other". The 1250% (or other percentage – see above) risk weighted assets for securitisation, equity exposures and

non-payment/delivery on non-DVP transactions would be included in credit RWAs, and the significant investments in commercial entities in the 'other' category

Contingent capital (§91)

We support the interest in the industry and of supervisors in the concept of contingent capital. However, there is a risk here that a broad principles-based approach such as was previously adopted for hybrid equity may lead (again) to a proliferation of different instruments. More fundamentally, it is not yet known whether these new instruments will operate as designed in a future crisis, nor whether they will become more attractively priced by the markets as more are issued. Some argue, for example, that as a bank approaches the trigger level, this could have a destabilising effect on the share price, funding costs and the bank's ability to source new debt. This topic will benefit from ongoing monitoring and requires further evaluation as to how contingent capital should be treated in a bank's capital base.

3 Leverage ratio

3.1 Introduction

We agree in principle with the introduction of a leverage ratio, and we note that one of (many) the probable causes of the recent financial crisis was the relaxation of the leverage ratio for US broker-dealers (but not for banks) in 2004.

For many banks the leverage ratio (as proposed) could become the limiting constraint (as opposed to the target capital ratios). It could thus impact business expansion plans for banks and in turn trigger de-leveraging that could have a significant macroeconomic impact.

3.2 Comments

Repos and netting

We agree that repos are a form of borrowing (§§220-221), and that they should not be netted for the purposes of determining the leverage ratio. However, we would point out that the current US leverage ratio follows the US accounting treatment, which generally allows for netting of repos and derivative contracts with the same counterparty. The rules under International Accounting Standards are different. When determining the actual percentage of the leverage ratio this important distinction should be taken into account, as without netting the US ratio would need to be higher than it is today.

We note that any move to not allowing netting for the leverage ratio would tend to discourage banks from putting in place netting agreements, where the leverage ratio is a binding constraint.

Derivatives

On derivatives, we do not believe the future value should be factored into the leverage ratio (§228). The leverage ratio is by definition a non-risk-adjusted measure of current assets versus current borrowing. If adjustments for potential future changes in value are to be included, there is no clear line between the present and the future, and risk assessments start to work their way into the ratio. Banks should be free to take whatever measures they need to take to maintain their current leverage ratios and not be arbitrarily penalised for assessments of future risks.

Off-balance-sheet items

We have a similar view on the 100% conversion factor for off-balance-sheet (OBS) items such as letters of credit and the value of credit protection sold (§§230-235), as this does not take into account the practice only a small proportion of these will become deliverable in the future. We agree that some limitation on OBS exposures is needed to prevent unwanted leverage building up in this way (we note that the current US regime only reflects on balance sheet items), using a 100% conversion factor is too severe and should be re-considered. As the leverage ratio is likely to become one of the most important constraints on banks capital levels, adopting a 100% conversion factor makes these items identical to on-balance sheet items, and this could have potential negative macro-economic effects as banks will effectively have to charge their customers the same for a guarantee as they would, say, for an outright loan (as both will consume equal amounts of capital).

Undrawn commitments

The proposed aggressive treatment of undrawn lending commitments would have a similar effect, particularly on the ability of banks to provide corporates with the degree of potential borrowing capacity that they need. In addition, treating unsettled and failed trades in the normal course of settlement with a 100% factor would have a major effect for brokerage

firms. We recommend that for normal (i.e. short term) settlement periods these should be excluded. There are important level-playing field issues between banks with and without trading books as the application of the same ratio to a trading book with gross assets and liabilities appears impossible. Given Basel will not just be implemented for globally active banks in most territories this issue needs to be considered by the Committee.

3.3 Recommendations

We recommend that the definition of the leverage ratio, its calibration and its interaction with accounting standards are vitally important issues to be addressed before ratios are imposed.

There is an important interaction of the leverage ratio with the higher levels of liquid assets to be held, which can inflate the ratio calculation. We recommend that liquid assets be defined (as in the liquidity proposals) and excluded.

We also question whether an identical leverage ratio level can be used for fundamentally different business models. For example, there are clear differences between fully securitising mortgages and having them off balance sheet and a model of funding them with mortgage-backed bonds but leaving them on balance sheet. We recommend that the Committee consider differential calibration levels that take these differences into account.

4 Accounting considerations

4.1 Introduction

The Basel Committee proposals are being considered at the same time that the accounting setting bodies are considering significant changes to accounting standards that will affect banks' financial statements. Without co-ordination, the accounting changes could result in unintended consequences to the regulatory capital levels and capital ratios of banks.

The International Accounting Standards Board ("IASB") and the US Financial Accounting Standards Board ("FASB") are proposing fundamental changes to International Financial Reporting Standards ("IFRS") and US Generally Accepted Accounting Practices ("US GAAP") respectively. The areas affected include financial instruments (i.e. classification/measurement, impairment and hedging), "own credit risk" in financial liabilities, de-recognition of assets through securitization or sale, and consolidation (of Special Purpose Entities – "SPEs"). These are largely scheduled to be issued in the period to the middle of 2011.

Our specific comments below highlight examples of the (i) Proposed Basel II Changes that we believe require further clarification and (ii) recently issued and future changes to IFRS and US GAAP.

4.2 Proposed Basel II Changes requiring further clarification

The following three areas require clarification:

Definition of capital

One of the most significant Proposed Basel II Changes requires Tier 1 capital to be predominantly in the form of common shares and retained earnings, with more restrictive provisions for the inclusion of hybrid instruments. Additional guidance will be needed to clarify capital treatment when an instrument qualifies as equity under the corresponding accounting guidance but does not under the Basel proposals.

In addition, the Committee should consider the impact of accounting policy choices on the calculation of capital under the Basel II Framework. For example, the current IFRS guidance on pensions provides for alternative treatments that permit both deferred (i.e. the "corridor approach") – for now at least - and current recognition in the balance sheet of the effects of changes in the defined benefit pension liability. Each would have a different effect on the calculation of capital.

Credit Valuation Adjustment

The Proposed Basel II Changes include a number of provisions intended to more effectively address risks related to trading book and securitisation exposures. One of these would require a capital "add-on" (or "market risk capital charge") related to the credit valuation adjustment ("CVA"). This requirement could potentially result in a double-counting of the CVA in the capital calculation, as a similar CVA adjustment is required to be recorded in income under IFRS and US GAAP.

Leverage ratio

The calculation of the leverage ratio requires the inclusion of derivatives and repos exposures on a gross basis, suggesting that netting will be prohibited.

If the intent of the guidance was to permit netting under certain circumstances, this should be clarified. Further, the Committee should recognise that, while the related principles under IFRS and US GAAP are similar, the more restrictive

IFRS guidance requires banks reporting under IFRS to report significantly more of these exposures on a gross basis – giving rise to much higher leverage ratios.

Differing accounting guidance could result in both inconsistent capital levels and opportunities for capital arbitrage based on the selection of an accounting basis – unless these issues are addressed and common definitions for capital purposes adopted.

4.3 Changes to IFRS and US GAAP

The Basel II Framework relies heavily on financial information prepared by banks in accordance with their selected accounting framework. Through the first half of 2011, the IASB and the FASB are scheduled to issue new accounting guidance in many of the areas on which the Basel II Framework relies for capital calculations. The areas to which we suggest the Committee pay particular attention are discussed below.

Classification and measurement of financial assets

In late 2009, the IASB issued IFRS 9 *Financial Instruments*, which established a fundamentally new accounting model for the classification and measurement of financial assets. Broadly, this model, which may be adopted in any year through to 2013, requires financial assets to be classified and accounted for at either fair value or amortized cost.

Perhaps the most significant change to the current guidance is that, with a limited exception for certain equity instruments, the available-for-sale (“AFS”) category will be eliminated. Instruments classified as AFS are currently measured at fair value, with changes in the FV recorded in other comprehensive income (“OCI”), a component of equity. The elimination of the AFS classification could significantly change the nature and extent of amounts recorded in OCI with more profits and losses included in income.

The new classification requirements could result in different capital treatment for the same security before and after the changes.

Impairment model

The IASB has proposed an Expected Cash Flow (“ECF”) model to replace the current incurred loss model, which will incorporate estimates of losses over the entire lives of loans into the determination of loan loss provisions. Likewise, the FASB is discussing a new impairment model based on a revised incurred loss principle, which will eliminate the probability criterion from the estimate of loan losses and result in provisions being recognised sooner. While many observers believe that the accounting guidance being considered will be subject to continued change, it is likely that the impairment amounts determined under either model will generally result in larger, earlier impairment amounts than currently. However the precise impacts will depend, in part, on the timing of introduction relative to the economic cycle.

The Basel proposals related to counter-cyclical buffers do not provide sufficient detail, with respect to, for example, the treatment of “excess” and “shortfall” provisions in calculating Tier 1 capital, to enable banks to assess fully and model the potential effects of these changes in accounting guidance. Further, the Basel proposals do not provide for any reassessment of the continued adequacy of the proposed capital buffers after a fundamental accounting change.

Hedge accounting

The FASB and IASB propose to amend hedge accounting guidance. The discussions on hedging are still at an early stage, but these amendments could significantly affect the way banks account for their hedges. There are proposals to

account for changes in the fair value of derivatives used in fair value hedges through OCI, rather than income, and to significantly reduce reliance on quantitative hedge effectiveness criteria. The implications of this could be complex and require careful evaluation. Different accounting policy choices could result in different capital treatment

Measurement of financial liabilities

The IASB issued a discussion paper in 2009 seeking comments on the current accounting guidance for financial liabilities (such as a bank's own debt). In its most recent deliberations, the IASB has tentatively decided to retain the current accounting guidance related to financial liabilities, except in cases where they are accounted for at fair value. In these cases, the portion of the fair value change attributable to OCI will be recorded in OCI, rather than income. At a minimum, conforming changes will need to be made to the Basel II Framework to ensure that the rules clearly state how fair value changes recorded in OCI are treated. The Committee should also consider whether this change could affect other elements of the Basel II Framework.

Derecognition of financial assets

The IASB is deliberating on fundamental changes to the accounting for derecognition of financial assets. The IASB is expected to issue new guidance during the first half of 2011.

The proposed changes, which are subject to discussion and consultation before being issued, may result in more transfers of financial assets qualifying for derecognition (that is, moving off balance sheet). Under this proposal, a financial asset would be derecognised in its entirety when the holder ceases to have access to all its economic benefits. Any contractual assets or liabilities assumed or retained in the transaction would be recorded at fair value.

The proposed leverage ratio requires that the on- or off-balance sheet treatment of securitization exposures should follow the accounting treatment. If the new IASB derecognition guidance results in more assets qualifying for derecognition, we recommend that the Committee consider recalibration of the leverage ratio accordingly.

Consolidation

The IASB is still deliberating changes to its guidance on consolidation, which could have a substantial impact on regulatory capital in general and the Tier 1 capital ratio. In particular, the consolidation guidance currently being deliberated by the IASB may result in more entities being consolidated. This would increase the impact of the proposed minority interest deductions. In addition the consolidation rules may also impact the leverage ratio by increasing total assets. The Basel Committee needs to consider whether the accounting and regulatory regimes would be brought into line in this area, or whether differences would be appropriate.

4.4 Recommendations

As discussed above, banks will be implementing a number of significant accounting changes over the next few years, in addition to changes to Basel II. These will have a range of impact on banks' regulatory capital calculations. Changing regulatory capital rules that rely on financial items subject to changes in accounting guidance might prove very challenging for banks from an operational perspective. This may result in unintended effects, such as the weakening of internal controls over financial reporting and capital management. Likewise, the introduction of concurrent changes to accounting rules and regulatory capital may impair banks' ability to forecast capital availability and manage capital requirements.

To address this, one suggestion would be to conduct an impact study on a limited sample of banks to assess the impact of the combination between the new regulatory and accounting rules. Another suggestion could be for the Committee to consider developing rules in such a way that they neutralise the impact of these changes on regulatory capital and other differences between the accounting standards. This would have the benefit of creating a more even playing field, but the operational complexity would be increased significantly.

The most efficient approach would be for banks to address both regulatory and accounting changes through a single process. In order to do this, though, the Basel Committee and accounting standard-setters would need to coordinate the timing of the mandated adoption of their guidance. Further, they should seek to eliminate or minimize the effect of any inconsistencies in their guidance except where necessary to reflect different objectives and audiences (for example approaches to valuations and provisions).

5 Procyclicality

5.1 Introduction

The Basel Committee's proposals include four separate measures to address potential procyclicality in the existing framework, namely:

- Measures to address the cyclicity in the minimum capital requirements;
- Forward looking provisioning;
- Building buffers through capital conservation; and
- Limiting excessive credit growth.

We agree with the need to address risk management and capital implications across the economic cycle. The effects of economic cycles on risk and capital need to be carefully analysed, understood and managed by financial institutions as part of their ongoing risk and capital management efforts³. However, it should be noted that this does not mean that cyclicity will be eliminated from banks' capital requirements, as this is neither possible nor desirable within the objective of a risk-sensitive capital regime.

As the Basel Committee itself recognises in §240 of the Consultative Document, data on the actual level of procyclicality in the regulatory framework are at this point scarce and inconclusive and 'it is still too early to opine on whether the Basel II framework is proving to be more cyclical than expected'⁴. It is therefore questionable to what extent the current proposals on limiting procyclicality can be calibrated on the basis of the data collection as part of your comprehensive Quantitative Impact Study. In our opinion, until the Committee has obtained a better idea of the actual impact of procyclicality on capital requirements, such calibration is unreliable and premature.

In addition, any point-in-time QIS is unlikely to be able to capture the relationship between capital requirements and available capital as they develop over time through an economic cycle. This can only be fully understood by careful modelling of forward-looking scenarios, such as those that are required by a number of regulators as part of the ICAAP under Pillar 2.

We also agree with the need to use measures that affect both expected and unexpected losses, through provisioning and capital, to address potential procyclicality. Nevertheless, the current proposals run the risk of double-counting by combining adjusted PDs, more forward-looking provisions, capital conservation ranges and the current framework of Pillar 2 capital add-ons without explicitly specifying how the interaction and possible double counting between these elements should be accommodated. The adjustments sometimes address the same issues and their combination is likely to result in overstating actual capital requirements (potentially significantly). However, the actual effects of the proposals cannot be fully evaluated at this stage, given the lack of technical detail on the various proposals, in particular on provisions and capital conservation buffers.

³ This topic has been discussed in detail in a paper on 'Risk Management Across Economic Cycles' in the recent report "Reform in the Financial Services Industry: Strengthening Practices for a More Stable System" by the Institute of International Finance.

⁴ In its recent consultation on 'Possible Future Changes to the Capital Requirements Directive', the European Commission has also indicated that it considers it too early to fully assess the cyclicity of the minimum capital requirement and that it will consider additional measures to dampen any cyclicity only at a later stage. It should also be noted that, as a consequence of this assessment, the Commission has not included the approach proposed by the Basel Committee in relation to the use of historic PDs in its own consultation.

As a final point, we believe that the Committee needs to state its objectives with respect to the proposed measures, i.e. are they geared at counteracting procyclicality or are they merely intended to ‘smooth’ capital requirements over the economic cycle? While the objective of the capital conservation proposals probably falls into the first category (although it is not yet clear how they will actually act counter-cyclically over time), the measures geared at a less cyclical minimum capital requirement will only make the capital requirements less volatile across a cycle. It is, in our view, debatable whether such a measure is compatible with the original objective of a more risk-sensitive capital requirement, as the proposals simply appear to establish a new minimum capital level (based on ‘downturn’ inputs), which is less risk-sensitive than the current rules.

The following sections contain detailed comments on each of the proposed measures to address procyclicality.

5.2 Cyclicity of the minimum requirements (§§239-242)

The objective of the current proposals is to find measures that would dampen the cyclicity of the Pillar 1 minimum capital requirements. It should be noted here that the proposals only address the cyclicity of the minimum capital requirements for credit risk and only apply to the IRB approach. There are potentially additional procyclical sensitivities related to the changes in the definition of capital, e.g. through the deduction of deferred tax assets from the available capital base; also, lower interest rates during a recession could drive higher pension fund liabilities, which would reduce the available capital base through the proposed required deductions.

There is, however, also a level of cyclicity in capital requirements under the Standardised Approach, particularly for institutions whose portfolios mainly constitute externally rated counterparties. In some countries, where local rating agencies have been approved for rating SME-type borrowers (e.g. in France), this could potentially have a relatively large effect. We believe that the Committee should also address the effects of cyclicity under the Standardised Approach as part of its calibration exercise.

A number of approaches to dampen potential procyclicality have been discussed over the past two years or so. The Committee makes specific reference to the work conducted by CEBS and the UK FSA’s ‘variable scalar’ approach; however, it also recognises that none of the proposals has so far gained common acceptance from either the industry or supervisors and all of them are still very much under development.

The Committee is currently assessing two specific proposals for adjusting the PD under the IRB approach, namely to either use the highest average PD for each exposure class or to use an average of historic PD estimates for each exposure class.

We have reservations related to both of these approaches, some of which stem from purely practical considerations while others relate more to their compatibility with the overall risk-based Basel II framework and state-of-the-art risk management in financial institutions.

From a practical perspective, it is unclear what exactly is meant by ‘historic’; in particular, there is no specification of the length of the time period over which such ‘historic’ observations should be collected. Absent such specification, different institutions could use different ‘historic’ periods, which could lead to different PD estimates being applied to similar portfolios and hence create level-playing-field issues across institutions. Even if a historic period were to be specified, institutions may not have sufficient data available to apply such calculations consistently to all of their exposure classes across all jurisdictions in which they are active.

Another practical point to consider is the actual implementation of the use of historic PDs in the capital calculation. While such historical PDs might be determined in aggregate by exposure class (which also appears to be the intention of the requirement), it will be necessary to determine these for each PD grade of an institution's rating system in order to implement the capital calculation in practice and it is unclear to us how this could be accomplished short of requiring historic PDs by rating class, which will be almost impossible to achieve. This also raises additional questions with respect to the validation requirements of such 'historic' PD estimates, i.e. will they be subject to the same validation standards as the currently used IRB parameters? Could less robust validation results than those achieved for the existing IRB models potentially endanger an institution's IRB accreditation?

From a risk management perspective, the use of historic data (whether the highest observed PD or an average of historic PDs) ignores changes in the composition of banks' portfolios over time as well as any improvements in risk management practices made by institutions in reaction to, for example, particularly high losses in a specific area of activity. This runs against the explicit objective of the Basel Committee to encourage banks to improve their risk management practices over time. The requirement for capital estimates to be based on historic PDs would also take away the incentive for banks to improve their risk measures over time as they would still be 'locked' into the use of the historic figures for capital calculation purposes.

The inclusion of what constitutes, in effect, downturn PD estimates in the capital calculation formula also undermines banks' internal risk management practices, as the resulting capital amounts would potentially lack credibility with management and affect the use test of the risk parameters. The most likely outcome would be for banks to have to produce two separate sets of calculations, one for regulatory capital purposes and one for internal risk management, which are likely to be further apart from current differences between regulatory and economic capital models in use in financial institutions.

The introduction of downturn measures into the capital calculation would also affect transparency unless Pillar 3 disclosures are amended.

Recommendations

Procyclicality adjustments are difficult to calibrate given the requirement for long runs of data to do so. We believe that it is essential to conduct on-going analyses to determine to what extent procyclicality of minimum capital requirements is a real issue.

In the meantime, any necessary adjustments could be undertaken under a potentially-reinforced Pillar 2 framework (as is already the case in some jurisdictions; e.g. the variable scalar approach of the FSA mentioned in the introduction is currently used under the Pillar 2 framework).

This would also be in line with the recommendation of CEBS to include any forward-looking capital buffers within the boundaries of the existing Pillar 2 framework⁵, in particular as it allows for flexibility of application of the supervisory tools to take into account differences in individual institutions' business models and the sophistication and quality of their risk management frameworks.

⁵ Committee of European Banking Supervisors, Position paper on a countercyclical capital buffer, July 2009

5.3 Forward looking provisioning (§§243-246)

The Committee is advocating a change in accounting standards towards an expected loss approach in order to ensure that accounting impairment provisions become more forward-looking and, as a result, less procyclical than the current incurred loss approach. As discussed in the section on Accounting Considerations, In order to achieve this objective, an alignment of accounting standards between different standard setters (most importantly the FASB and the IASB) as well as an alignment in methodologies between accounting and regulatory standards will need to be achieved.

This raises a fundamental issue as to the objective of accounting standards versus prudential regulation. While accounting standards are aimed at providing a ‘true and fair view’ of the financial status of a corporation, i.e. an objective assessment of a current situation, prudential regulators are concerned with the stability of a financial institution (and the financial system as a whole) and are thus more likely to prefer a more conservative assessment of provisioning levels. As such, there is a natural conflict between accounting and regulatory rules for provisioning and it is – in our opinion – questionable whether these two different objectives can, and should, be reconciled within the same framework.

Current proposals by accounting standard setters to reform provisioning rules do represent a move away from a purely incurred loss model. However, the ‘expected loss’ concept currently included in the proposals is different from the notion of expected loss as expressed in the Basel II framework and, in our opinion, does not sufficiently address the issue of procyclicality. While the mechanism for determining provisions is changed to include more forward-looking aspects, a change in future expectations would still trigger a cyclical change in provisioning levels.

Recommendations

Given the current status of the discussions within accounting standard setters as well as between the Basel Committee and the standard setters, it is not possible to comment conclusively on the merits of a forward-looking approach to provisioning as the details of this approach are not yet known. It is, therefore, imperative that the impact of any change to the provisioning rules and its interaction with regulatory capital requirements be assessed once the final accounting proposals / rules are known. This is unlikely to be possible before the end of 2010 and the Committee should take this into account when finalising the current revisions to Basel II.

It should also be noted that the European Commission is currently consulting on a ‘simplified’ method for the calculation of through-the-cycle provisions as part of a revised regulatory framework⁶. In order to ensure a level playing field across all major financial centres, we suggest that the approaches be harmonised.

As with the proposals for changes to the minimum capital requirements, it will be important to consider how these will be implemented for institutions operating under the Standardised Approach for credit risk, as any method using estimates of ‘expected loss’ would normally rely on estimates for PD and LGD, which would not normally be available to non-IRB institutions. (See also our discussion on Expected Loss Shortfall).

⁶ Commission Services Staff Working Document, ‘Possible Further Changes to the Capital Requirements Directive’

6 Capital conservation

6.1 Introduction

The proposals aim to limit banks' ability to make distributions when Tier 1 capital buffers are below a certain level. Distributions cover dividends, share buybacks and discretionary bonuses to staff.

A capital conservation range would be established above the minimum requirement. The buffer is still to be calibrated but that the paper indicates that, depending on the level of buffer relative to target, a "Minimum Capital Conservation Ratio" (MCCR), will limit the percentage of earnings that may be distributed. For example, if the buffer is below 25% of target, a bank will not be allowed to pay any dividend or discretionary employee bonuses.

The detail is unclear to us but it appears that the concept of a capital conservation range could effectively establish a formal trigger level above the Pillar 2 figure. This would then be complemented through the MCCR by a constraint on payouts to investors and employees, with the idea that this protects depositors.

§§260-262 also describe the Basel Committee's position on "excessive credit growth" and propose that macroeconomic indicators, such as level of credit to GDP, should be used to trigger increases in capital buffers.

The MCCR concept is a mechanistic calculation based on a single period view of capital requirements. We believe that this will be a blunt tool indifferent to bank strategy, risk profile, capital plans and future prospects. As a result it could have unintended consequences. Further, if the MCCR is an addition to Pillar 2 the Pillar 2 figure (which is generally confidential between a bank and its supervisor) could become disclosed as a result of the MCCR process.

It is also important to recognise that the trend to deferred bonuses and the stronger role of the risk function in designing compensation structures and assessing reward means that the issue of inappropriate bonus distributions is also being addressed by other changes.

6.2 Impact on banks

Bank management needs to balance the interests of various stakeholders in its capital management and distribution policy (principally regulators, investors, rating agencies and employees). Where the bank is listed the board is constrained by the listing and disclosure rules. The judgements involved in getting to the "right" capital level in this context are difficult and nuanced: arbitrary formulae play a very minor role.

The rationale for the capital conservation proposal seems to be the Basel Committee's implicit assumption that banks could consciously make payouts that may endanger their regulatory minima. Although it is true that some management teams made mistakes in the crisis, we believe that such an assumption dividend payments is fundamentally incorrect – the penalties for breaching regulatory minima are severe and, in our experience, banks seek to avoid these at all costs.

Dividend policy is a key part of a bank's relationship with the equity markets (the ultimate providers of Tier 1 capital) and carries important signalling power about the future prospects of an institution. Cuts in dividends or reductions in dividend growth rate usually lead to share price falls and an unwillingness to invest. This is why many institutions reduce dividends as a last resort. Bank management is responsible for managing this relationship and we believe that it would be dangerous to allow arbitrary rules to interfere with it.

Further, a move into “conservation” status could trigger equity market uncertainty and difficulties in raising equity and debt. In addition the proposals would lead to arbitrary bonus constraints that could cause key employees to leave. A bank that is in trouble could then fall into a downward spiral.

6.3 Supervision

The ICAAP process provides supervisors with clear insights into the risks and capital plans of the banks and the SREP provides the mechanism to influence capital buffers.

In many countries, under Pillar 2 banks are given guidance by the supervisor as to how much capital they are required to hold above the Pillar 1 minimum. Banks then normally set internal targets above the Pillar 2 figure to ensure that they do not breach the regulatory minimum. The level of the resultant buffer depends on the bank’s risk appetite and its strategy. For example a well-established mature business will be able to accommodate a higher dividend payout than a fast growing new entrant. We believe the supervisory process in many countries already provides the framework for supervisors to flag concerns about payouts. In those where it does not we suggest that the approach be amended accordingly.

We note that §259 says that:

“Although the buffer must be capable of being drawn down, banks should not choose in normal times to forgo discretionary distribution to operate in the buffer range simply to compete with other banks and win market share. To ensure that this does not happen, supervisors would have the additional discretion to impose time limits on banks operating within the buffer range on a case-by-case basis. In any case, supervisors would ensure that the capital plans of banks seek to rebuild buffers over an appropriate timeframe.”

This implies that supervisors are seeking the right to dictate dividend payout policy when a bank is operating within the constraints. We believe that this proposal would be an inappropriate extension of supervisory powers. In our view competitive strategy is the responsibility of bank management and such a proposal blurs the boundaries. Further, there could be listing and fiduciary duty issues on directors that would conflict with the proposed regime.

6.4 Recommendation

While we support stronger supervision, we believe existing supervisory processes and sanctions are sufficient and that an additional payout constraint is unnecessary. We also believe that payout policy should be left to bank boards who are in the best position to weigh the interests of different stakeholders.

Where appropriate we recommend that the supervisory evaluation of ICAAPs should be strengthened and the role of Pillar 2 given greater importance rather than introducing formulaic rules. In particular, supervisors may wish to augment their current approach to Pillar 2 with additional considerations regarding distributions.

On the question of excessive credit growth, we support the need to identify appropriate macro indicators and to take timely action. However we suggest that actions such requiring the tightening of underwriting standards and reducing credit supply would be a lot more effective than using the blunt and expensive insurance of capital. We recommend that the emphasis should be on timely preventative action, not even more capital buffers. We discuss some of these issues more fully in the section on Systemic Effects.

7 Counterparty credit risk

7.1 Introduction

We support the objectives of the proposals on the treatment of counterparty credit risk (CCR) which are meant to formalise links between market risk and credit risk, make further improvements in risk management practices (such as collateral margining, stress scenarios and back-testing to better capture extreme events and wrong-way risks), and to develop market architecture to raise transparency and discipline by providing incentives for the use of Central Counterparties (CCPs).

There are several aspects to the proposed framework that we believe require careful consideration prior to adoption of the rules given (i) potentially "excessive" capital buffering resulting from the combination of rules related to individual areas and (ii) the need for further clarifications in the proposed methodology.

7.2 Counterparty credit risk

Credit Valuation Adjustments

Under the proposal, a "bond-equivalent of the counterparty exposure" approach is introduced which aims to better capture CVA losses. With this new calculation that includes the counterparty's CDS spread in the formula, the "spread risk" of CVA is quantified and reflected. As market changes in the CDS spreads would alter bond values, the argument is that it should provide an incentive for banks to hedge the derived CVA risk.

Although the proxy represents a "market index", the use of the proxy results in a duplication of the capital charge derived from market risk measurement. On the one hand, a general market risk charge is applied to the bond-equivalent amounts and associated CDS hedges but separately from the rest of the market risk exposures captured ("CVA" per se), while the method is exogenous to the firm's overall VaR methodology. We consider that such dichotomy could stifle risk management development as it does not encourage progress with the different (modelling) methodologies and solutions to CVA that firms have been developing on the basis of data availability, business needs and type of product. An additional point to consider in this regard is that more advanced firms calculate DVA, which has been excluded in the current QIS.

Multiplier for the asset value correlation for large financial institutions (§§135-140)

We view the introduction of a multiplier of 1.25 to be applied to the asset value correlation (AVC) of large financial institutions as problematic for a number of reasons. First of all, basing the multiplier purely on the size of the financial institution (with the exception of unregulated financial intermediaries) is actually at odds with the stated reason for introducing the multiplier, namely the interconnectedness of financial institutions.

As the Committee has indicated, the financial crisis showed that financial institutions' credit quality deteriorated in a highly correlated manner and banks proved to be relatively more sensitive to systemic risk than non-financial firms. However, this was not only the case for large financial institutions with assets in excess of USD 25bn but holds equally true for smaller banks. For example, the vast majority of the banks that failed in the US were small and only active regionally but clearly the correlation between them was relatively high, predominantly due to their common dependence on property lending in the region. Therefore, correlations of smaller banks in regional markets that are more intertwined may also be high and merit additional capital charges under the same logic.

At a more fundamental level, the introduction of the higher AVC to financial institutions is presented as though the financial crisis was the first event to show that correlations between financial firms are higher than those between, for example, corporate borrowers and this is used as the justification for the multiplier. The fact that financials exhibit higher

AVC than corporates, has been well known in the industry for many years and has been incorporated into banks' internal economic capital models. Given the analytic work undertaken during the initial calibration of the IRB formula for corporates, banks and sovereigns, we assume that the AVC included in the formula represents an average for a typical wholesale portfolio. As such, this average correlation could be lower than the actual AVC for banks but higher than the actual AVC for corporates. Unilaterally changing the AVC for banks by using the 1.25 multiplier increases the average AVC for the wholesale IRB formula and thus calls into question the accuracy of the original IRB calibration, which had not hitherto been challenged.

We also have practical concerns with the application of the multiplier, as what constitutes 'non regulated entities' will vary between jurisdictions and could therefore lead to level-playing field issues. In addition, the need to identify for all counterparties whether or not they fall into the non regulated category puts a significant burden on financial institutions with respect to the implementation of the proposed rules.

On a final note, the application of the AVC multiplier to all financial exposures under the IRB approach (again subject to the \$25bn asset size limit) is also problematic as it can result in unintended consequences. For example, the application of this higher AVC would also capture trade finance transactions, which rely to a large extent on letters of credit issued and/or confirmed by such large financial institutions. We do not believe that capital requirements for trade finance transactions have been shown to be too low during the financial crisis; on the contrary, there is significant industry activity to suggest that these may even be calibrated at too high a level. The application of the higher AVC and hence higher capital requirements to these transactions could increase the cost of trade letters of credit for the ultimate end-user, i.e. the importers and exporters. As a result, the Committee may wish to consider applying a multiplier to specific types of transactions (e.g. derivatives) rather than all transactions with specific counterparties.

Increase the margin period of risk (§§150-155)

In extending the margin period of risk to 20 days for both OTC derivatives and securities financing transactions for netting sets that are large and have "illiquid" collateral — a term that is not defined — we find a lack of explanation in the methodology as to how the threshold for the size of the sets (5,000) was determined. It is unclear how this "one-size-fits-all" takes into account the diversity of business conducted in the market, either in terms of the trading volumes of firms or product types. The Committee is also introducing proposals for adding qualitative collateral requirements so as to ensure that sufficient resources (people and systems) are devoted to the orderly operation of margin agreements. We believe these should constitute the first and core line of defence towards reducing the close-out risk horizons. The suggested rules for strengthening the qualitative element in collateral management policies such as the control, monitoring and reporting risk from margin agreements to senior management and of the concentrations of asset classes and the reuse of collateral assets somewhat overrides the need to set bright line indicators.

Other incentives to discourage longer close-outs such as doubling the applicable margin period of risk for the affected netting set when banks have a history of margin call disputes, also provide a direct and targeted mechanism for identifying individual firm or trade set problems.

Finally, the lengthening of the margin periods as a reaction to problems observed during the crisis ignores the very substantial investments made by financial institutions over the past two years. Significant improvements in collateral management systems and processes have been implemented already, although we acknowledge further efforts are necessary and not all institutions have proceeded at the same pace. However, penalties for insufficient attention to these processes should be institution-specific and might, therefore, be better implemented through individual add-ons under the Pillar 2 framework.

Central counterparties (§§165-167)

We see many benefits in encouraging the use of central counterparties (CCPs). However, they imply a very significant concentration of risk in the industry, and banks and regulators will have to deal with all the "monoculture" dangers that then arise. Enhanced supervision of the CCPs and increased capital and liquidity requirements have a role to play, but the wider risks around the CCP need very careful consideration. As others have commented, lender of last resort and implied government support issues arise here and these should be made very transparent to the users and the governments.

While we share the industry's belief that increased use of Central Counterparties (CCPs) will play an important role in reducing systemic risks, the introduction of significantly higher capital requirements against such exposures if completed on a bilateral basis, is perhaps too severe a measure at this stage that could reduce activity in derivative trading and inadvertently, liquidity.

OTC derivative trading through the use of CCPs and on a bilateral basis will both continue to be common. Consequently, the focus of a forward looking approach to risk management should remain on the development of positive attributes and benefits for the use of CCPs as opposed to "penalties" for discontinuing the bilateral relationships. In particular, we would encourage a more detailed consideration for introducing capital requirements to disincentivise bilateral trading in view of the timeframe necessary for CCPs themselves to come into compliance with enhanced standards which are to be issued "at a later" date by the Committee on Payment and Settlement Systems (CPSS) and the International Organization of Securities Commissions (IOSCO).

In addition, it will be necessary to consider the impact of higher capital charges for bilateral transactions with counterparties that are not financial institutions. While a – potentially large – proportion of derivatives traded between financial institutions could benefit from standardisation as a prerequisite of moving them onto CCPs, and this standardisation is also in the interests of the industry, there will remain a need for bespoke derivatives to cater for the specific needs of end-users, particularly where these are industrial corporations trying to hedge the economic risks in their businesses (e.g. through fuel derivatives and the like). Increasing the capital requirements for these transactions, which played no part in the financial crisis, appears an overly draconian response to the perceived problem with OTC derivative transactions.

External Credit Assessment Institutions (ECAIs) and Ratings (§§178-201)

The introduction of transparent and stringent criteria for rating agencies (e.g. recognition process, international access, disclosure etc) and the adoption of the IOSCO Code of Conduct Fundamentals for Credit Rating Agencies are a welcome supplement to the Committee's recommendations as they formalize regulatory parameters for the safeguarding of independent operations by the rating firms and establish convergence for their oversight by national supervisors. The use of external ratings as a relatively standardized, harmonized and independent measure of the credit quality of a counterparty has allowed financial institutions to widely incorporate them in their risk management processes. As such, proposals to minimize "cliff effects" including that in guarantees (elimination of the A- minimum requirement) remove bias towards less conservative approaches for risk recognition.

Robust risk measures take more into account than the capital charge derived from public ratings. For this reason, we support firms in continuing to develop a strong corporate culture for own independent internal assessment of risks on an ongoing basis. It remains critical however over the medium-term that market confidence is restored in the validity of external ratings in order for example, the securitization market to become revitalized. Under a well-defined and properly supervised rating industry framework, the current exclusion of re-securitisations as eligible financial collateral irrespective

of their credit ratings would come to denote a permanent lack of faith for ratings within the endorsed capital adequacy framework.

Conclusion

We support the Committee's overall goal of improving transparency and orderly functioning of the derivatives markets in order to mitigate the risks that banks can absorb in times of economic and/or market stress. However, we have reservations regarding the severity of some of the proposals as well as the speed proposed for their implementation.

We believe that the Committee's proposals for the enhancement of back testing and stress testing scenarios (§§168-177) in order to capture risk factors positively correlated with counterparty creditworthiness, including wrong way risks, represent the core of the changes necessary to better analyze and manage counterparty credit risk. We believe that firms should continue to enjoy sufficient flexibility in developing and applying tools for managing risks that are commensurate with their business profile rather than "fixing" industry-wide requirements that might also endanger a level playing-field and could have unintended negative consequences for the end-users in the wider economy.

We support the objectives of the proposals on the treatment of counterparty credit risk (CCR) which are to formalise links between market risks and credit risks; make further improvements in risk management practices (such as collateral margining, stress scenarios and back-testing to better capture extreme events and wrong-way risks); and to develop market architecture to raise transparency and discipline by providing incentives for the use of Central Counterparties (CCPs).

There are several aspects to the proposed framework that we believe require careful consideration prior to adoption of the rules given (i) potentially "excessive" capital buffering resulting from the combination of rules related to individual areas and (ii) the need for further clarifications in the proposed methodology including the elimination of gaps.

7.3 Observations on trading book amendments

Closely related to CCR are the July 2009 Trading Book Amendments that have already been agreed. Taken together, the July and December 2009 Basel releases are having a substantial impact on banks with trading activities.

In particular, the strengthening of capital requirements for specific issuer risk in the trading book provides a real capital constraint on the origination of structured and synthetic credit risk. The intent expressed by supervisors to extend the perimeter of prudential regulation is also welcome, and is critical to the real effectiveness of trading book and other reform.

However we have a concern with the magnitude of the cumulative impact of the reforms on trading activities. Incorrectly calibrated, the current proposals have the potential to damage financial markets, and consequently the real economy. Increased capital and liquidity costs will inevitably find their way into bid/offer spreads, increasing the costs of capital market participation for "end users".

We acknowledge that this may simply be more appropriate "pricing for risk" - a cost that end users must bear. However we also see a risk that some critical financial market activities will simply become uneconomic, with fewer market participants willing to make deep and liquid markets in some securities. The resultant additional cost to end users could adversely impact the efficient functioning of financial markets – upon which the real economy relies for efficient capital, funding and risk mitigation solutions.

Impact on trading activities

Banks with trading activities are significantly impacted by the cumulative impact of the July 2009 Basel amendments and December 2009 Basel proposals. The following changes have specific impacts on trading activities:

- Increased capital requirements arising from July 2009 amendments, including the introduction of:
 - Stressed VaR (additive to current VaR)
 - Incremental Risk Capital
 - Additional regulatory valuation adjustments for less liquid instruments
- Increased capital and liquidity requirements from December 2009 proposals:
 - Additional capital buffers – these are also likely to incorporate further bank-wide stress testing - and will therefore naturally include further stress testing of trading activity.
 - Banks with substantial trading activities are also likely to be systemically important – and so requiring additional capital and liquidity buffers.
 - The new liquidity requirements will also substantially impact trading activities. Short-term position-taking and market-making in assets which fall outside of the narrower definition of qualifying liquid assets will be disproportionately impacted by the requirement to hold substantial amounts of term funding to support such activity.

The cumulative impact of these changes on banks may have unintended consequences. One is the prospect of banks being incentivised to include more activity in the banking book, away from potentially more onerous trading book capital requirements, but also away from the associated trading book governance and oversight, including the discipline of daily MTM and limit monitoring.

Another is a renewed incentive to arbitrage regulation. In our view, trading book capital requirements should be intuitive, not overly conservative, and conceptually sound at transaction (or portfolio) level. In doing so they provide an effective “on the ground” defence against arbitrage and the gaming of regulation.

The reforms also run the risk of over-focussing banks (and supervisors) on quantitative measures, and overlooking more critical and effective means of controlling trading activities. Just as important as capital in achieving prudential objectives is institution-specific culture and governance with respect to trading activities. This is naturally an area where capital is not the most effective form of defence. For example, during the global financial crisis we noted instances where robust stress tests were being conducted by risk management, however the results were not being escalated to senior management. Additionally many organisations did not adequately assess the likely performance of their business lines under stressed conditions, before making decisions to expand volumes.

Recommendations

We believe that supervisors should resist the understandable reaction to apply excessively conservative capital requirements to trading activities. The trading book prudential framework and capital requirements need to be risk sensitive to minimise arbitrage opportunities, and so remain effective in the long term. That is, it needs to be transparent to financial market participants that trading book capital is broadly correlated with the level of economic risk, albeit overlaid with justifiable conservatism.

We recommend that the BCBS consider the following with respect to trading book activities:

- Conduct a detailed impact assessment of the combined capital and liquidity impact of the full suite of reforms and proposals, specifically for trading book activity, and impact on financial markets. While this may use inputs from the current QIS, this should be extended to consider the potential impact on the operation of financial markets in support of the real economy.
- Ensure the use of stressed inputs in “bottom up” calculations are appropriately calibrated and are not overly conservative – limit the potential level of double counting (e.g. stress test upon stress test, buffer upon buffer) which may arise for trading activities.
- Emphasise in BCBS guidance to supervisors that when implementing reforms (and when assessing future financial market innovation) risk sensitivity should be retained as a guiding principle – recognising that over-conservatism is potentially as damaging to the future effectiveness of the prudential framework as under-measurement of risk.
- Ensure that the trading book / banking book boundary is effectively controlled – so that the trading book only includes genuine trading activity.

8 Liquidity

8.1 Introduction

The recent financial crisis has not only illustrated the devastating potential impact of liquidity risk, but also the inadequacy of the liquidity risk management frameworks established by a significant percentage of financial institutions. That is to say, regulations and bank management proved inadequate to measure, understand and control the dynamics of shocks to cash flows, funding structures, liquid asset reserves and contingency planning in the periods of stress that robust liquidity risk management is designed to address. While the BIS and regulators have maintained guidelines and rules for the management of liquidity risk for many years, it is apparent that further strengthening and explicit quantitative requirements measures are appropriate.

The introduction of explicit quantitative measures such as the Liquidity Coverage Ratio (LCR) and the Net Stable Funding Ratio (NSFR), supported by other monitoring metrics, will establish base measures to enable application of a consistent platform for regulation of liquidity risk by capturing key perspectives of short term cash flow resilience, longer term funding stability and concentration of funding sources.

However, we believe that it is equally important that the BIS-proposed 'International framework for liquidity risk management, measurement and monitoring' (Dec 2009) be read with, or better, be incorporated within the Basel 'Principles for Sound Liquidity Risk Management and Supervision' (Sep 2008). Arguably, the Dec 2009 document is a subset of the requirements of the Principles (which were first established a decade ago). In our view a single cohesive framework should be maintained to guard against reduced focus on the Principles at the expense of a 'tick the box' treatment of the new quantitative measures.

8.2 Approach

Measures

The proposed standards and metrics are suitable concepts for measuring and underpinning minimum levels of liquidity in case of short-term stress, as well as the soundness of overall longer-term funding structures. These metrics are not new and are already used by any bank with a liquidity risk management framework. A key benefit of them being explicitly mandated and defined should be more globally-consistent application and insights for regulators (if implemented with minimal national adjustment). The fact that the Basel Committee Survey found 25 different measures of liquidity used by regulators around the globe highlights the challenge of achieving a base level of consistent minimum standards (ref: Dec 2009 §14, page 3).

Systemic risk of prescription

An aspect for consideration is the potential threat inherent to the prescriptive nature of the regulatory proposal regarding liquidity risk. Obliging financial institutions to adhere to a stringent set of regulatory requirements may lead to similar responses by individual institutions to achieve compliance. This could result in significant correlations across financial markets (e.g. concentrations in holding of eligible assets, concentration in certain funding markets, etc.) and in increased procyclicality. For example, significant concentrations in OECD government bonds would likely arise during a period when governments are under pressure due to fiscal imbalances. The resulting increase in exposure to sovereign risk could be a significant threat, because a government downgrade or even default (c.f. the state of Argentina at the turn of the millennium) could potentially trigger a systemic crisis.

One size does not fit all

The “one-size-fits-all” approach adopted by the Committee does not take into account the diversity of business models in the financial industry (e.g. custodians and infrastructure providers would be penalised, as these institutions often take deposits primarily from financial institutions, which would largely be assigned to the 100% run-off rate category). Secondly, the efforts of firms to develop internal methodologies and procedures tailored to their individual business models become redundant seeing they will have to adhere to the obligatory standards and metrics set forth by the BIS. There will need to be closer involvement by regulators in how the business and funding models work to ensure the regime does not result in a move to a formula approach.

Lack of transparency

There is a lack of explanation on how the assumptions underlying both the LCR and the NSFR were derived, making them appear arbitrary. It would greatly help the market's understanding of the standards if some explanation would be provided on how the Committee developed these parameters. It is important to recall that the use of untested or unquestioned assumptions within risk models contributed to their lack of predictability and usefulness to accurately measure risks. Banks should be encouraged to continuously study actual portfolio behaviour and incorporate new insights into their risk models rather than revert to using solely regulatory prescribed assumptions. This is particularly the case of estimating the “stickiness” of both retail and wholesale deposits, as this can be a critical factor in evaluating potential cash outflows and the corresponding liquid asset coverage.

Stress is too severe

A liquidity buffer is an essential element of an institution's liquidity risk management framework, but we believe that the stress scenario proposed in order to calibrate the liquidity coverage ratio is too severe, aggregating a severe idiosyncratic and a systemic crisis. This is worse than what most institutions experienced during the recent extreme crisis. Furthermore, we think that the 3-notch downgrade is unworkable, as, firstly, the effects would be very different for an AAA rated institution compared with, say, a BBB rated institution; and, secondly ratings changes are very much a lagging indicator.

Narrow definition of eligible assets

There is a danger in an overly narrow definition of eligible liquid assets. Markets for these assets could potentially become less liquid due to pooling of these assets by financial institutions, accompanied by reduced incentives for holding non-eligible assets. This could distort the pricing and potentially further raise the relative cost of bank funding.

Scope of application

The scope of application of the proposed standards and metrics merits discussion. In case of the LCR, internationally active groups might be subject to trapped pools of liquidity in subsidiaries, which could complicate the management of crisis situations, and potentially lead to excessive costs. As a point of detail we note an inconsistency in the treatment of deposits, loans and commitments between group entities, which was pointed out by European Commission Staff Services⁷. The Commission describes the example of one group entity having to assume an outflow due to a drawdown of a liquidity line by another group entity, which, in turn, is not permitted to consider a correspondent inflow.

⁷ European Commission Staff Services Working Document, “Possible further changes to the capital requirements directive”, paragraph 21

The proposed standard also states that it 'should be applied to all internationally active banks on a consolidated basis, but may be used for other banks and on any subset of entities of internationally active banks as well to ensure greater consistency and a level playing field between domestic and cross-border banks' (ref. §133). We question the need to differentiate between an internationally active bank and a domestic bank. Would the proposed scope of application definition have captured, for example, Washington Mutual?

8.3 Bank impact

Banks should have a level of investment in their liquidity risk management capabilities commensurate with their size, complexity and risk appetite. This investment starts with the level of time and attention paid to understand and prioritise liquidity risk management at Board and senior executive level. This first step can be achieved with minimal cost.

The costs will be greater, when adapting bank operations, which requires an adequate level of appropriately skilled resources and IT tools. We note that in PricewaterhouseCoopers recent 'Balance sheet management benchmarking survey – Status of balance sheet management practices among international banks – 2009' that a large proportion of respondent banks have indicated that they are planning to implement new liquidity management systems and are making major improvements to their liquidity risk reporting in terms of granularity.

For many institutions the proposals require significant investment and time, particularly when considering the technical challenges to obtain, cleanse and analyse significant data sets. These basic steps are needed to get an accurate cash flow projection on a daily basis, before progressing to developing valid scenario assumptions.

In addition to the costs associated to the implementation of the proposed standards and metrics, there would also be considerable indirect costs, notably linked to the necessary changes in the funding structure as well as in the composition of the asset portfolios held by institutions. Banks would not only have less incentive to hold certain assets, but would also potentially cease providing certain services important to both retail and institutional clients. Furthermore, it is likely that funding costs may increase via maturity transformation, excessive liquidity buffers and potential price distortions. Also, the apparent stability of retail funding may be undermined if deposit price wars develop and encourage such depositors to be much more price sensitive.

As far as the NSFR is concerned, we see a risk in pursuing a Pillar 1 - type approach. The financial industry comprises a large number of different institutions, with of a broad spectrum of divergent business models. These result in significant differences in the funding structure and strategy of institutions. A prescriptive approach which does not recognise these differences may create distortions for the financial industry and, quite possibly, to the broader economy.

In particular, we perceive a significant risk in the discrimination of funding provided by financial counterparties, as this is likely to raise funding costs. Furthermore, we would like to highlight a potential funding problem due to the interaction of the LCR and the NSFR. The stated objective of the NSFR is to increase the stability of an institution's funding sources, thus implying a lengthening of funding maturities. As bank bonds and notes are not eligible for the liquidity buffer, the investor base for longer-term bank debt is narrow. This may prove to be a significant obstacle to one of the most important funding sources for banks.

There are several potential repercussions which merit careful consideration. First of all, the rise in the funding costs of banks may decrease the supply of credit (or increase its price). Furthermore, the demand of banks for securities issued by corporates is likely to decline, restricting access to an important source of funding for this sector. An unintended

consequence of reducing industry access to bank funding might be a relocation of some funding activities to the corporate sector or unregulated entities – possibly a new shadow banking system.

8.4 Supervision

One of the key challenges in making these proposals effective will be achieving sufficient consistency across regulatory jurisdictions. If this is not achieved, there will be potential impacts on the competitiveness of financial markets. In addition domestic political considerations may distort the implementation of the proposals and, thus, limit the ability to measure and monitor liquidity risk for banks operating beyond their home jurisdiction. An example of these differences may be seen in the respective take up and application of the BIS ‘Sound Practices for Managing Liquidity Risk in Banking Organisations’ (Feb 2000) by regulators around the world (and the vigour applied in relevant regulatory standards and supervision).

Supervisors will receive significant amounts of data and information from banks, which have to be interpreted and acted upon (ref. §132). It is therefore important to ensure supervisors have appropriate resources, including adequate systems and competent staff, to be able to carry out this function.

A significant increase in liquidity reporting does not replace the need for technical skill and experience to: interpret liquidity data; understand macro issues in the broader economy and financial markets; and, evaluate a bank’s operations and risk management capabilities through regular inspection. The banks who responded to our survey saw these areas as the biggest challenges for supervisors.

8.5 Recommendations

We see it as a high priority to complement the quantitative requirements with efforts to better harmonise the international liquidity risk regulatory and supervisory frameworks. As with the capital proposals, there should also be an in-depth impact study to understand the costs and benefits of the proposals for the banking system and the broader economy.

We suggest that the quantitative measures be incorporated within the BIS ‘Principles for Sound Liquidity Risk Management and Supervision’ so that the qualitative and quantitative requirements are applied and understood coherently. There is a risk that there will be a return to a ‘tick the box’ approach if focus (both by banks and supervisors) – particularly if the quantitative measures takes precedence over broader liquidity risk management principles. We believe that is essential to develop clear Pillar 2 liquidity requirements to do this.

We thus emphasise particularly the need for supervisors to develop an understanding of liquidity models and balance sheet structuring of banks. The quantitative supervision should only be seen as a back up to this assessment process.

Allowing financial institutions some degree of freedom in implementing regulatory requirements can incentivise them to improve liquidity risk management frameworks beyond the regulatory minimum. Nevertheless, we agree that the LCR should be suitably stringent to ensure that the new measures are prudently applied. In principle, it is reasonable for common assumptions to apply across different jurisdictions. However, we believe individual elements should be reviewed to make allowance for some level of self-determination. For example, the prescribed parameters regarding deposits fail to take into consideration that counterparty behaviour diverges due to a variety of factors, including elements specific to individual countries, types of counterparties as well as the nature of the relationship. We therefore recommend that the committee should either grant banks the flexibility to determine their individual counterparty categories and appropriate run-off factors. Alternatively supervisors could be more granular in the categorisation of counterparties, taking these factors into account.

We also urge the Committee to reconsider excluding bonds issued by financial institutions from the liquidity coverage ratio. While we understand the “wrong-way” risk inherent in these assets, this form of funding is important to the financial system. Assigning no liquidity value to these assets is not only overly conservative, but might induce a massive sale, putting the balance sheets of institutions under pressure. We agree that in the acute phase of a liquidity shock, only assets meeting strict criteria should be eligible.

However, we believe that the definition of liquid assets should be refined for a chronic stress (i.e. the longer end of the 30-day survival horizon). We suggest that this should be supported by detailed analysis of market liquidity and discussion with the industry. Relevant examples include ‘Pfandbrief’ and similar types of covered bond instruments which are issued by banks but clearly of high quality, very liquid and low risk.

Regarding the NSFR, we believe a review of the assumptions should be undertaken, especially in order to reflect the potential adjustments individual firms would initiate over the one-year horizon of the persistent stress, for example by adapting their business models. Furthermore, the significant RSF-factors should be reassessed taking into consideration the idiosyncratic nature of the NSFR. We believe that assuming normally functioning markets, tradable securities should be subject to more realistic factors.

In addition to the quantitative impact studies currently underway, we advocate additional evaluation of the risk management frameworks and IT infrastructures that financial institutions have in place. This is necessary to provide realistic timelines for manageable implementation of the new regulatory requirements.

Finally, we would recommend assessing the linkages between the liquidity risk proposals and the proposed capital reforms (e.g. between the liquidity standards and the leverage ratio) and the interplay of liquidity risk with other risk classes within the Basel II framework. Areas to consider are for example, i) references to liquidity risk within Pillar 2 and the Supervisory Review Process, ii) runoff assumptions for Interest Rate Risk in the Banking Book, iii) asset liquidity haircut assumptions within Market Risk, and iv) Pillar 3 disclosures regarding restrictions on transferability of funds within consolidated groups.

9 Systemic effects

9.1 Introduction

In recent months there has been a growing recognition of the interconnectedness of various elements that have been proposed to increase the stability of the financial system. We welcome this trend and point to the need to make time for a considered debate on the balance that needs to be achieved. For example, the benefits from diversity amongst banks as against a homogeneous monoculture were considered by Andrew Haldane (Bank of England) on 3 March 2010 in a speech in Hong Kong to the Institute of Regulation and Risk.

In this context we feel there needs to be a move away from an excessive focus on a mechanical and formulaic capital regime to a more balanced solution. Raising capital levels should be the final option, not the first: capital is usually not the answer, and it may be a very expensive one for the economy as well as the banks. In the case of the failure of Lehman Brothers, tougher liquidity monitoring and quick yet effective legal resolution mechanisms would perhaps have been far more effective tools than layering on capital requirements. Similarly, the collapse of Northern Rock was more an issue of the dependence of the business model on ready access to liquidity via securitisation markets than the level of the bank's capital.

Looking forward, supervisors should perhaps focus more on the macro issues: for example the stability and growth of the international economy; the banking sector's role in providing a store of value for individuals and businesses; new asset bubbles; and macro-imbalances. An essentially static and mechanical capital-based regime would discourage such lateral thinking.

The present proposals thus focus on a bottom-up assessment of the capital and liquidity levels of individual banks rather than considering the stability of the system as a whole in a structured way. Given that the overall aim of the proposals is to prevent systemic financial crises, the focus on the micro perspective needs to be complemented with a clear view from the Committee of what is required from a macro perspective.

The macro perspective should be considered from five angles which we discuss below:

- (i) Use systemic tools for systemic issues;
- (ii) Focus macro supervision first on oversight of market-wide macroeconomic indicators;
- (iii) Focus on the overall impact of failure, not the risk;
- (iv) Capital is usually not the answer: raise capital levels as a final option, not the first; and,
- (v) Be aware of market distortions caused by excessive regulation.

9.2 Use systemic tools for systemic issues

The right tools used are likely to be of different forms, with macro tools to assess and manage the danger to the system, and micro tools to assess and manage the risks to the individual bank. Micro tools are the traditional tools of bank regulators applied to individual banks; macro tools are discussed in more detail below.

Put simply, designing and calibrating the system as a whole to minimise the danger of another major financial and economic crisis for as long as is possible is not the same as regulating each bank with the aim of minimum risk of loss to

its depositors - different approaches are needed. Mixing the tools results in throwing the book at the problem – layering on standards designed for different purposes, with possibly significant additional costs.

Looked at another way, one could say that the proposed regime is trying to cover the risk of a new bubble (i.e. trying to manage systemic risk) by applying tighter regulation of individual banks as a proxy for systemic assessments and actions. But if such a proxy is to be applied in this way, it has to be calibrated, and that has to be based on the regulators making ongoing statements about the future of the system, which in turn is what has been shown by experience to be so problematic (and an area where problems are always likely to be endemic). In short, the regulators would be better employed facing up to the real problem of assessing the systemic risks than treating capital as the cure-all.

In this context, there is a case for:

- Developing an approach to the oversight of systemic/macro risk based primarily around a macro view of the economy and the financial system, the risks they face, linked to a coherent view of the workings and plumbing of the financial system that supports the economy; and,
- Continuing a micro approach to the supervision of individual institutions, aimed primarily at depositor protection over the economic cycle. Such micro regulation, which is not defined further here, includes capital and liquidity requirements, as well as such important backstops for the depositor/client as depositor insurance and client money protection.

Hence for example micro-prudential supervision should be adequate to identify and oversee a bank with an inappropriate business model or an overstretched balance sheet in a “normal” market cycle (accepting for now that such can be defined). Solutions might involve a capital buffer and better controls at that bank and a more engaged supervisory process. In contrast, a severe property bubble (for example) that is identified by macro supervision, may result in systemic risk and thus may require a systemic approach to resolution. This could involve (for example): raising interest rates; subsidiarisation of certain bank’s businesses to give clarity of funding; using the tax system to take the pressure out of the bubble; changes to the scope of product regulation to dampen the property market; regulation of underwriting; limiting access to securitisation to cut off the blood supply to the bubble; enhanced deposit protection arrangements to support retail deposit taking (with appropriate cost allocation to the banks concerned); and (possibly) additional capital requirements. We do not suggest this is a complete list; it merely demonstrates that regulation of systemic risk is a complex process and the tools need to be picked carefully: capitalising each and every bank for a severe crisis may not be the most efficient or effective, way of avoiding the next crisis.

9.3 Focus macro supervision first on oversight of market-wide and macroeconomic indicators

Macro supervision demands an approach that:

- Is alert to new sources of systemic risk;
- Coordinates an international response when needed; and,
- Is separate from national politics but sensitive to national economic needs.

Such an approach could be based around agreed key indicators in each market and at different levels (global, regional and national for example). The indicators should be relatively small in number. They could include for example:

- Overall market leverage levels and concentrations of market and credit exposures;
- Banking sector aggregates;
- Credit expansion and pricing;
- Aggregates for non-bank and unregulated financial institutions;
- Key inflation data including asset price levels;
- Particular indicators for areas that indicators show to be high risk, such as property asset bubbles and property affordability, systemic concentration of assets and exposures, clearing arrangements, scope of regulation;
- Specific indicators for any other assets considered systemically important ;
- Bank cost of equity, debt and share price volatility - all vs. comparable levels for the rest of the economy;
- Other relevant systemic risk indicators;
- Stress tests of the indicators; and,
- Trends in incentive compensation.

The outputs of the macro review process will be largely actions impacting the system as a whole, or guidance, requirements and limitations aimed at broad categories of firms or specific markets.

The clarity of purpose referred to should thus allow regulators to focus on those issues that are systemically important and on using the right tool for the job. The emphasis is on the right tools for the job, not knee-jerk micro responses.

9.4 Focus on the overall impact of failure, not the risk

Some firms are systemically important, meaning the scale of their risks cannot be ignored in the macro analysis, and dealt with only via the micro as implied above. “Systemic” needs to be defined, and there are difficulties in doing so. For example, does it mean systemic to the home market – such as for a major domestic deposit taker, to the global market – such as Lehman, to certain “host” markets – such as the activities of some of the Western European banks in Eastern Europe – such as government bond markets, or some other definition?

Despite, or perhaps because of, the definitional problems, the treatment of systemic institutions needs to be addressed. In our view the primary issue in overseeing such firms is impact of failure, more than risk of failure. The regulatory objective should be to ensure that when the risk materialises (not if it materialises, since risk cannot be 100% removed even by very intrusive regulation) the impact is manageable. In short, fewer firms should be genuinely systemically important, after the “impact mitigants” come into effect.

In consequence, the mitigants need to be the focus of regulators’ attention, for example:

- Setting up a robust and swift bank resolution regime;
- Understanding banking sector interconnectedness and resulting systemic risks;
- Developing large exposures limits;
- Implementing safer group structures and intra-group financing arrangements, particularly for higher risk businesses and those demanding access to group liquidity;

- Making clearing arrangements more robust;
- Sponsoring legal clarity on operational and settlement issues;
- Pushing through liquidity management standards;
- Developing, testing and enforcing strong client asset segregation arrangements;
- Clarifying liquidity provision arrangements;

The Basel Committee's March 2010 paper, Report and recommendations of the Cross-border Bank Resolution Group, addresses many of these issues via the 10 principles.

9.5 Capital is usually not the answer: raise capital levels as a final option, not the first

We agree with the recalibration of the capital required for certain products, as the current approach undoubtedly understates their specific risks.

In addition, it is unquestionable that the overall levels and types of capital in many banks were too low for the businesses the banks were doing, and much has been done in response to the crisis to build capital to higher levels. In some cases a further capital increase for a group of banks, or an individual bank, may be needed for such firms to mitigate “their” systemic risk.

However, as a general principle, increasing overall capital requirements should be the last port of call, not the first: minimising the risk in the system as a whole, and minimising the impact of a failure are likely to be more effective areas for early focus as already discussed, with, for example, improved systems and controls also in the frame. Raising required capital levels above market norms may be an expensive admission of admission of a failure to deal with other issues.

As a specific example, increased intensity of supervision and day to day on-site supervision at systemically important banks could be far more effective in ensuring banks are limiting their risk to a level commensurate with the capital they have, than would be the blunt and expensive instrument of pushing up capital requirements across the sector.

9.6 Be aware of market distortions caused by excessive regulation

Regulation not only provides a buffer against failure; it also acts as a barrier to entry to the industry by increasing the level of fixed costs a firm faces to enter the market, and hence deprives market users of new choices and the industry of the opportunity to develop new efficiencies. Regulatory exhortation to firms in a protected market to sell better products more cheaply would not be a long term solution to a lack of real competition.

To provide more background we have advised many firms on setting up new financial services businesses, and typically find that dealing with the initial and ongoing regulatory necessities is a major constraint on their business. It is also one that few new entrants from outside the sector fully understand when they make their decision to enter the market. We have seen several that dropped out of the game as the complexity became apparent. The current efforts in some countries to bring more non-financial firms into the banking market to boost competition may well falter on this issue.

It is an open question whether the current intensity of regulation is a net “cost” or a net “benefit” to consumers – but more intensive supervision would exacerbate any market distortions and could easily create new ones. A change in the regulations should reopen the debate.

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