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Secretariat of the Basel Committee on Banking Supervision
Bank for International Settlements
Centralbahnplatz 2
CH-4002 Basel
Switzerland

Dear Sir/Madam,

Re: Comments to the Basel Committee on Banking Supervision consultative papers – *Strengthening the resilience of the banking sector* and *International framework for liquidity risk measurement, standards and monitoring*, released December 17

While supportive of international regulatory reform, we believe that substantial work is needed to refine the proposals to achieve a balanced outcome that strengthens the international regulatory framework without compromising economic activity. We agree that the quality and quantity of capital in the overall banking system was inconsistent across jurisdictions and that the industry would benefit from improvements in liquidity and other risk management practices. However, any response should consider that some institutions, including Canadian banks, remained well-capitalized and able to manage their liquidity and other financing requirements through the recent crisis.

We are concerned that insufficient consideration appears to have been accorded to the intersection of capital, leverage, liquidity and pro-cyclicality proposals, as well as to the cumulative impact on borrowing costs, credit availability, financial system operations, and the broader economy. Although still provisional, early industry estimates point towards disproportionately high capital and funding requirements and overly conservative leverage constraints.

We highlight the following issues for consideration by the Basel Committee.

1. **Adverse financial and economic impacts:** The proposed reforms will increase the costs of capital and funding for virtually all financial institutions. This will result in a combination of higher borrowing costs for end users of credit and a reduction in the overall availability of credit in the system. The number, magnitude and scope of reforms, as well as their uncertain secondary and tertiary impacts, raise serious concerns. For example, assuming implementation of the proposals in

their current form, our initial analysis shows that the cost of providing credit, even for an uncommitted facility, could increase materially. This impacts not only a wide range of wholesale lending activities, but traditional lines of business, such as commercial lending and general retail credit that rely heavily on banking services. Other areas such as municipal and provincial government financing would also be affected.

Besides increasing borrowing and servicing costs, banks may have little choice but to scale-down or exit some businesses where unduly punitive capital and liquidity treatment creates disincentives for continued participation. This has the potential both to reduce consumer choice and limit opportunities for a bank to diversify its operations.

2. **Impacts on risk management:** The proposals are likely to constrain the ability of both banks and their clients to transfer and manage risks effectively, as some businesses or products become uneconomical and as tested and effective mechanisms for risk mitigation such as netting are no longer rewarded. By reducing a bank's capacity to act as a financial intermediary, risks will likely be shifted to the corporate and consumer sectors and potentially, to unregulated shadow-banking activities.
3. **Consultative process:** Given the importance of the proposed reforms and the magnitude of the likely economic and financial impacts, we are concerned with the short time periods being allowed for the completion of the Quantitative Impact Study (QIS) and subsequent calibration. While the QIS captures primary impacts from the Committee's proposals, it does not capture secondary or tertiary impacts on product pricing, individual businesses, markets and the economy. The compressed timeline provides limited opportunity for review, consultation and consideration of possible alternatives. Canadian banks have the further complication of determining the impact of the pending adoption of IFRS on the calibration.
4. **Implementation considerations (including asymmetric implementation):** Unless the final rules are implemented at the same time and enforced in much the same manner by regulators around the world, the Basel Committee will not achieve its stated objectives. Moreover, banks in "first-mover" jurisdictions would be competitively disadvantaged.

We believe specific modifications to the Basel Committee's Capital and Liquidity proposals are needed in the following areas.

1. **Liquidity Ratios**: Problems with the liquidity proposals stem mostly from the excessively conservative stress scenario used to set the minimum global standards and the lack of risk sensitivity underlying the proposed metrics. The proposed stress scenario used to measure liquidity risk is inherently inconsistent, combines systemic and idiosyncratic shocks, and assumes both can occur concurrently across the entire financial industry without any central bank intervention. Stress scenarios should not be created from the worst possible outcomes for every parameter addressed since it is extremely unlikely that these outcomes could occur concurrently. Nor should those results be used to set benchmarks or define minimum industry standards. In addition to the potentially adverse economic consequences, managing liquidity according to this extreme stress scenario will constrain the traditional role of banks in maturity transformation.

   The assumptions for many of the parameters and cash flow categories used in the calculation of the Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio (NSFR) are overly conservative, not risk-based, lack empirical foundation and are too simplistic to facilitate meaningful measurements across institutions. We cite particular concerns relating to:
   a) The assumption that all banks concurrently lose all access to unsecured wholesale funding and secured funding for essentially all but sovereign securities.

b) A very narrow definition of liquid assets that affords no liquidity value to assets with demonstrated and proven market liquidity (e.g. agency securities, equities and Canadian Government Insured MBS).

c) The severe deposit run offs assumed by this scenario cannot occur concurrently across all banks.

d) The lack of any risk-based considerations give the metrics a one-size fits all character that fails to recognize the differences in liquidity practices and risk profiles of each bank (e.g. 100% draws on committed liquidity lines).

In addition to suggestions for various substantive and technical amendments, we think it essential that a gradual approach be adopted for rolling-out the new liquidity requirements. For the reasons stated above, the QIS is an insufficient process for calibrating this measure. Our recommendation would be to re-position the new liquidity requirements under Pillar 2 until a better understanding of the impact and ramifications of these new regulatory metrics can be achieved. This approach would allow regulators more time to assess the impacts and deal effectively with unanticipated outcomes, possibly through re-calibration.

2. **Definition of Capital:** While we understand the Basel Committee's desire to raise the quality, consistency and transparency of capital, we advocate for a more balanced approach that takes into account the following:

   a) Tier 1 Capital: The Basel Committee's focus on common equity ignores the benefits provided the financial system of a deep and varied investor base that differing capital instruments provide. We acknowledge that common equity should be the dominant form of Tier 1 capital. However, the limit on the non-common component should be set at a sufficiently high level and with allowance for a more flexible range of features (e.g. a long-dated instrument with a lock-in extension feature at maturity) that allows financial institutions the flexibility to access a wide investor base. Indeed, the Office of the Superintendent of Financial Institutions' (OSFI) limit of 40% non-common Tier 1 capital allowed Canadian banks to access sufficient capital during the financial crisis.

   b) Capital Deductions: Deductions should be determined on a granular level, with consideration to their realizable value. Specifically,

      - The proposed deduction of investments in common stock in other financial institutions is very punitive as it assumes no realizable value of all these holdings. At minimum, all long and short security positions should be netted.
      - Deferred tax assets should be afforded an appropriate residual value allowance.

3. **Calculation of Risk-Weighted Assets - Credit Valuation Adjustment (CVA):** The proposed approach to underpin the income volatility with capital has fundamental design flaws. The proposed "Bond Equivalent" approach does not have appropriate sensitivity to economic risk. Nor does the proposal adequately allow for capital reductions through the use of prudent hedges. For example, the use of certain hedges actually results in an increase of regulatory capital requirements thus providing a disincentive for banks to manage their income volatility from changes in CVA. Finally, we feel that if the proposal is adopted it will negatively impact both the pricing and availability of derivatives to bona fide end users who use these products for efficient funding and managing foreign exchange and price risks.

   We would recommend that the CVA capital framework allow for a more risk-sensitive approach that does not penalize prudential hedging of CVA risk.

4. **Leverage Ratio:** Although the Basel Committee's intent is to introduce the leverage ratio as a supplementary measure, the construction of the proposed ratio using only common equity or Tier 1, yields measures that appear excessive and unrepresentative of actual leverage. We are concerned that this measure could become a binding Pillar 1 constraint, overriding other risk-based capital measures. We advocate designing the leverage ratio as a back-stop measure, along the lines of the existing OSFI leverage ratio. Specifically, we recommend that:
    a) The capital measure of the ratio be to total regulatory capital rather than common equity or Tier 1 capital;
    b) Netting of derivatives continue to be permitted in accordance with Basel II standards;
    c) Unconditionally cancellable commitments should be excluded from the exposure measure; other undrawn commitments should also be excluded. If included, the credit conversion factors should be reduced from 100%, at least to the Standardized Basel II percentages.

5. **Pro-cyclicality:** While both capital and provisions play a role in addressing pro-cyclicality, we believe the current proposals lack sufficient clarity and will likely result in some double counting. As proposed, adjusted PDs, loan provisions and capital buffers (both micro and macro), together with current approaches to Pillar 2 capital add-ons, would in many cases address the same issues and vastly overstate capital requirements. Moreover, it is not clear how such a countercyclical capital buffer system could be designed and implemented in a consistent and harmonious fashion across multiple jurisdictions. For these reasons, we suggest that the pro-cyclicality proposals continue to be developed for potential implementation at a later date.

We appreciate the opportunity to comment on the proposed reforms. Please do not hesitate to contact us should you wish to discuss our comments in greater detail.

Yours truly,

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cc: Julie Dickson, Superintendent of the Office of the Superintendent of Financial Institutions (OSFI)
Mark White, Assistant Superintendent, Regulation, OSFI
Dr. Ben Gully, Managing Director, Risk Measurement and Analytics Assessment Services, OSFI

Janice Fukakusa, Chief Administrative Officer & Chief Financial Officer, RBC
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