SwissBanking

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Basel, April 16, 2010
J.4.6, MST/JSA

Consultative Proposals of December 2009

Dear Sirs

The Swiss Bankers Association (SBA) welcomes the opportunity to provide comments on the Consultative Documents "Strengthening the resilience of the banking sector" and "International framework for liquidity risk measurement, standards and monitoring", issued for comment by the Basel Committee on Banking Supervision on December 17 2009.

We agree that, particularly against the background of the financial crisis, improvements in the regulatory framework are needed and that a primary objective of changes in bank regulation should be to enhance the ability of banks and the banking system to absorb and be resilient in the face of adverse shocks. In formulating our views we are motivated primarily by the aim of having a sound and stable as well as well functioning international financial system.

Capital and liquidity rules, of course, play an important role in increasing the resilience of the financial markets. They are also of key importance to the daily management of all types of financial institutions. For the Swiss financial centre with its excellent track record in implementing international standards it is crucial that new standards are well balanced and carefully assessed. In this context, it is of great importance to evaluate unintended consequences of new regulations and to take into account cumulative effects.

Ensuring a level playing field by an equal implementation across and within jurisdictions forms the basis for an open and competitive environment. Common and accepted international standards will help prevent market fragmentation and protectionism.

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In sum, the Swiss Bankers Association acknowledges the need to improve capital requirements as well as liquidity standards.

Our view, however, is that differentiation between different types of financial institutions and international coordination need to be ensured. It is of paramount importance that the implementation of the revised rules occurs under an unconditional commitment to the "level playing field".

Generally, the impact of various regulatory changes must be carefully assessed from an integrated perspective that takes cumulative effects into account, also regarding a potential impact on the real economy.

In the following high-level comments, we mention corresponding suggestions and ways of improvement. For example, the proposed Leverage Ratio should be modified, especially with regard to netting, off-balance-sheet items and credit derivatives.

Appropriate grandfathering and transitional arrangements are of outstanding importance. Given the complexity of the proposed changes as well as interdependencies with the results of the Quantitative Impact Study, we suggest to have a second consultation round after calibration.

The remainder of this document is organized in three sections:

Section 1 addresses our key themes of concern. These are points that are more overarching in nature, impacting the proposals in many areas and in different ways. Our view is that focussing on these themes is crucial for realising a strengthening of the resilience of the banking industry.

The following sections develop some key specific issues in more detail. These issues are highlighted separately given their importance to the overall proposals and include our views on how to address them.

Section 2 concentrates on capital adequacy regulation, respectively, the Consultative Document “Strengthening the resilience of the banking sector”.

Section 3 is focussing on liquidity regulation, respectively, the Consultative Document “International framework for liquidity risk measurement, standards and monitoring”.

1 Key Themes of Concern

1.1 Objectives and Role of Regulation

We strongly believe that effective banking regulation has to be rooted in the reality of how banks operate in practice. This ensures that the focus and approaches of bank management and banking supervisors are naturally aligned, which promotes communication, a common understanding and the effective recognition and mitigation of material issues that may impact the financial situation of an institution. Such an alignment can be achieved both by co-opting part of bank practice into the regulatory mechanisms, e.g., the use of internal credit ratings within the IRB framework of Basel II, as well as by promoting improved practices within banks, e.g., the development and use of economic stress testing in Pillar 2. In addition, by having a good linkage between bank and regulatory practice, the new practices are more likely to be sustainable through time and provide the expected benefit.

Over the last years, the linking of internal bank practice with regulation and supervision has been discussed, with particular criticism of the role played by internal risk and pricing models in underestimating certain key risks leading up to the crisis. Indeed, as a response to the crisis, an emerging critique has been that neither bank management nor regulators can competently assess and appropriately manage the risks faced by financial institutions and that bank regulation has to be designed in a way to guard against any future extreme circumstance. In this context, we see the emergence of proposals that materially blur the line between the responsibilities of bank management on the one hand and bank regulation on the other. Examples of this include the requirements to use stress tests that are severe in nature and result in being the constraint to which a financial institution is managed.

This approach extends beyond technicalities of design and aims at imposing an orthodoxy on what constitutes good management of a financial institution. **Whilst we are supportive of improvements in risk management practices, a major learning point from the crisis is that there was no common pattern around the institutions that ran into trouble relating to the regulatory framework they operated under.** As an example, leverage was certainly a problem for some institutions, but problems occurred in countries with a record of a leverage ratio constraint (e.g., US) as well as in countries without such a constraint before the crisis (e.g., UK, Germany, Switzerland).

Moreover, different types of banks have been hit by the crisis, including regional banks, saving institutions, mortgage banks, state controlled banks, investment banks, universal banks, cross-border active banks and domestically oriented banks. One main differentiator between the troubled institutions and those that navigated the crisis well seems to be the judgement and decision making of the senior management of the institutions. Certainly, of course, robust and well executed risk and capital planning practices were a major contributor to this effective management. However, there were also several institutions that prior to the crisis were recognised widely as market leading in their risk practices and that nevertheless had material issues as the market crisis unfolded. **The point is that there needs to be a change in emphasis from promoting wholly quantitative constraints to a regime in which the evaluation of qualitative aspects plays a more prominent role.**

As a general rule, changes to minimum capital calculations should reinforce incentives to adopt effective risk management practices and reflect an accurate assessment of the underlying risks. We are concerned that relative risk differentials that are not supported by evidence can create distortions and incentives to arbitrage the framework. Incorporating additional elements and conservatism into these calculations can ultimately be counter-productive.

Generally, the crisis does not discredit the quantification of risk as an objective. We feel that measures of risk must be interpreted cautiously and multiple types of measures should be employed where possible. The regulatory capital framework should encourage greater rigor in the identification and measurement of different categories of risks.

Regarding pro-cyclicality, it cannot be expected that changes to capital and liquidity standards (nor other regulatory reform efforts) will completely banish credit and economic cycles. For example, we are sceptical that efforts to vary minimum capital standards counter-cyclically in mechanical fashion in response to economic and financial conditions can achieve market credibility.

In particular, we believe that supervisors must go further during periods of robust economic growth and financial euphoria to constrain the forces that encourage banks to excess. We acknowledge that this is far from being easy and therefore support the Basel Committee focussing increased efforts on improving the effectiveness and accountability of banking supervision.

The importance of strong and conservative liquidity risk management has been amply demonstrated during the crisis, but the Basel Committee's liquidity proposals applied on a global scale risk repudiating the very nature of banks in relation to maturity transformation and provision of liquidity to the non-financial sector.

We basically welcome the increased focus of supervisors on liquidity risk management. and support the Basel Committee's efforts to establish internationally coordinated standards for liquidity regulation, in contrast to independent efforts by national regulators to enforce liquidity risk frameworks on a national basis.

However, we feel that highly prescriptive and stringent regulation imposed all at once on a global scale will undermine banks' abilities to properly manage their liquidity risks according to their understanding of the industry, their products and their clients. **Therefore, we strongly encourage that supervisors instead focus close supervisory oversight on banks' internal liquidity risk models in order to comprehensively and adequately measure all inherent risks.** Banks should incorporate assumptions based on evidence and experience which they should be required to document.

We fear that the proposals in their current form could have lasting and significant impacts on the global economy. Application of globally uniform and stringent liquidity requirements, both with respect to the composition of "liquid" assets and in relation to restrictions on maturity transformation, are likely to worsen the potential for herd behaviour by banks during future stress episodes creating the very situations

supervisors and banks wish to avoid. Moreover, under the proposed regime, liquidity risks could be transferred to institutions that do not fall under this regulation, potentially increasing the vulnerability of the financial system.

1.2 International Coordination and Level Playing Field

It is of paramount importance that the implementation of the revised rules occurs under an unconditional commitment to the "level playing field". We believe the Committee should ensure a consistent and effective global application of the revised framework. This will require promoting greater convergence by addressing the significance of the level of interaction between accounting and regulatory regimes.

Given that one of the goals of the consultation package is to strengthen global capital and liquidity standards, focussing on actual implementation seems crucial. Of course, we recommend that differentiation between different types of financial institutions, especially in the context of the menu approach, be ensured. We support the concept of common implementation of equivalent standards in all major markets to all major market participants. Thereby, we realise the difficulties for the Basel Committee as far as non-banks are involved. Nevertheless, there also remain substantial deficits of implementation within the banking sector. US banks, for example, are still not required to fully comply with Basel II.

Transparency regarding the status of implementation could be achieved, e.g., via an annual implementation report which sets out in reasonable detail the Basel Committee’s assessment of how new standards are being adopted. This would also make it fairly straightforward to highlight those jurisdictions where the standards have been implemented in a less than comprehensive manner as well as those locations where the local implementation exceeds the expectations set out in the global standard. This is, of course, especially relevant for Switzerland which has a track record of super equivalence with extra layers of conservatism being added by national supervisory authorities.

To be practical, in our view it is worth expanding on the dimensions that seem important to maintain global consistency:

- Timing: The timing of implementation is both easy to monitor and essential to ensuring comparable implementation.
- Content: An important measure to ensure global consistency is to require each national authority to self assess their national implementation against the global standards set by the Basel Committee and to discuss any major divergences.
- Constraints: Finally, the value of the new set of standards will depend on the financial constraints set against them. National authorities should endeavour to develop an implementation where the constraints are systematically and consistently applied.
- Incentives: To ensure implementation, the Basel Committee could disclose an annual implementation report setting out an assessment of how individual jurisdictions implement the new standards in relation to the agreed international timetable.

Potential conflicts between global accounting regimes (US GAAP and IFRS in particular) and the approach to regulatory constraints are not new. However, the crisis period has brought some of these conflicts more sharply into focus. The proposals in the consultation package materially increase the level of interaction and inter-dependence between accounting and regulatory requirements. These effects are very material and well known inconsistencies in accounting regimes can have dramatic impacts on the regulatory outcome. Example areas range from the treatment of netting (for derivatives, repo and securities financing) to permissible forward looking proposals.

We acknowledge the coordination of the Basel Committee with the accounting authorities on these points of intersection. However, we are concerned that the guiding principle around fair value in international accounting regimes is in conflict with the weight towards conservatism in the current and any future regulatory framework. **In addition, different national accounting regimes could undermine the consistency and integrity of disclosed regulatory metrics. It is essential that these differences be ironed out in order to avoid national accounting regime specificities undermining the integrity of a global regulatory regime and conflicting objectives and standards between accounting and regulatory regimes weakening the resilience of the banking industry.** In case such a convergence cannot be established at the accounting level, the global regulatory regime should explicitly integrate jurisdiction-specific adjustments to the accounting based inputs in order to ensure consistency and comparability.

1.3 Suggestions for Procedure and Transition

It will come as no surprise that banks will find it very difficult to implement the complex and wide ranging set of proposals over the timescale set out. We appreciate the Basel Committee's acknowledgement of the need for appropriate phase-in and grand-fathering measures. However, the changes being made to the definition of capital, risk weighted assets and the introduction of a Leverage Ratio have complex interactions such that we are concerned of unintended negative impacts. Additionally, substantial changes in accounting standards are also to be expected. With a view to the scope and potential impact of the proposals, it is critical to assess them carefully in the context of the multiple responses to the crisis that have been initiated or proposed in the public and private sectors.

Given the far reaching effect of the proposals at the level of firms, markets and the economy, we appreciate that the Quantitative Impact Study is in fact the key link between the conceptual discussion and the actual implementation and operations of the rules. It is imperative that quality prevails over timelines. And it is equally important that a feedback loop is provided from the results and analysis of the impact study back into the conceptual rules. More broadly, we strongly encourage the Basel Committee to incorporate mechanisms whereby the framework can continue to be reviewed and adjusted in light of experience after implementation.

Although we recognise the political environment demands a rapid pace of change, we would suggest to have a second consultation round after calibration as well as a second Quantitative Impact Study.

The proposals are more far-reaching than previous initiatives by the Basel Committee, but less time is allocated toward their finalization than in any previous initiative. We believe, therefore, that setting an implementation date (2012) is premature, unless it is understood as preliminary in nature.

We support the Committee's indication that appropriate grandfathering and transitional arrangements will be established which will ensure that the process is completed without aggravating near term stress. Grandfathering needs to be sufficiently long to avoid market disruption and unnecessary costs for issuers. In particular, transition to new minimum capital requirements needs to take into account a gradual transition period to avoid cliff effects.

2 Key Specific Issues: Capital

2.1 Capital Base Composition

Generally, the new framework should incorporate a clear role for contingent capital instruments, which if properly designed can absorb losses on a "going concern" basis. In this context, it is important for investors and other market participants that definitions of loss absorption triggers are easily comparable across institutions, particularly those based on regulatory capital ratios.

2.1.1 Grandfathering of Hybrids

The phase-out of "innovative" hybrids requires further clarification as to exactly what features are to be phased out, other than step-ups. Also it should be clarified that a bank's "economic interest" in exercising a call should be understood not only as referring to contractual funding cost but should also take into account the quality and terms of potential refinancing instruments and applicable market conditions.

Appropriate grandfathering and phase-in provisions will be essential to managing the impact of the new requirements. Grandfathering should cover all relevant elements of the new rules, including the required proportion of Tier 1 capital and a definition of its components, the "predominance" requirement, and deductions.

In designing the grandfathering and phase-in requirements, it is important that market perceptions and effects be taken into account. Grandfathering and phase-in periods will need to be defined with care in order to avoid diluting their purpose, as markets may be induced to factor in higher costs of capital well in advance of the grandfathering or phase-in date, thus burdening firms' raising of capital.

In addition, because of likely market effects, it will be advisable to implement a gradual phasing-in of the new requirements rather than create a cliff effect by reference to a final deadline. In this context, a pragmatic design with an adequate time horizon (of, e.g., 15 years) is necessary.

2.1.2 Deferred Tax Assets

We support the efforts to establish a common international standard for Deferred Tax Assets (DTA). However, the proposed deduction treatment of DTA (net of deferred tax liabilities) which "rely on future profitability of the bank to be realised" from Tier 1 (Common Equity) seems excessively prudent, particularly from a going concern perspective. Indeed, even in a gone concern scenario, DTA would often have some value. It is also notable that any DTA deduction from common equity can introduce a strong and undesirable pro-cyclical effect.

In view of stringent US GAAP / IFRS DTA recognition tests, the value frequently attributable to DTA even in a gone concern scenario, and recognizing inherent differences between DTA on net operating losses (NOL) and DTA on timing differences, a full DTA deduction is not justified. Deductions should at least be limited to DTA arising on NOL only. The disallowance of NOL DTA should only be partial. Furthermore, the disallowance should not be fully deducted from Tier 1 capital. Instead, an element should also be allocated against Tier 2 capital. Transitional provisions should be introduced, deferring the application of the rule beyond 2012 and providing for a phased reduction in allowable NOL DTA as a percentage of capital.

2.1.3 Pension Liabilities and Assets

The proposed deduction of defined benefit pension fund liabilities and certain defined benefit pension fund assets from common equity seems inappropriate from a going concern perspective. The deduction is not fully considering the long-term nature of pension plans and can add significant short-term volatility to regulatory capital. Particularly in situations where the pension is legally separate and the employer has no legal obligation, the proposed treatment seems too far reaching.

2.2 Capital Charge for CVA

The Consultative Document includes for the first time a proposal to charge capital for the volatility of the Credit Valuation Adjustment (CVA). We basically support the requirement to appropriately capitalize for the risk resulting from the volatility of credit valuations.

The marked to market CVA relates to trading book assets. **Therefore, we recommend applying a regulatory capital treatment of CVA consistently with other similar trading book risks and refraining from a banking book capital treatment.**

We also note that the currently proposed rule is excessively conservative with respect to calibration and recognition of hedging. Should a banking book based ruling for CVA be maintained, we recommend to materially reduce the calibration of the CVA charge and widen the scope of recognition of prudential risk hedging.

2.3 Leverage Ratio

2.3.1 General Remarks

The introduction of a global Leverage Ratio provides an additional safeguard, provided that it is defined to ensure consistent application across differentiated accounting regimes, calibrated such that it is rarely the binding constraint, and focused narrowly on a comparison of balance sheet size with capital.

However, the introduction of a Leverage Ratio has the potential to discourage banks from the lowest-risk activities including sovereign finance and traditional banking book activities and care needs to be taken to avoid unintended consequences. Especially, incorporating the gross notional amounts of trading positions within a leverage ratio will significantly distort and dilute the value that a traditional leverage ratio has.

In sum, we are concerned that the proposed rules will not be understood and potentially confuse market participants. As an alternative to introducing a fully new methodology and in order to foster confidence in financial markets, we suggest to consider referring to existing minimum ratio approaches, as applied, e.g., in the US or in Switzerland. Additionally, the Leverage Ratio requirements should be moved into Pillar 2, respectively, it should be assured that they be treated in the same Pillar across countries.

One objective of a Leverage Ratio, as described in the Consultative Document, is to avoid the destabilizing effects of a deleveraging process on the financial system. It should, therefore, follow that items for which no destabilizing effect is expected are excluded from the Leverage Ratio. This would particularly apply to cash and cash-like instruments (liquid assets).

Efforts to harmonize rules across different accounting regimes in the context of the Leverage Ratio have to be welcomed. However, we disagree with the overly simplistic and undifferentiated treatment of netting, derivatives and off-balance-sheet items.

2.3.2 Netting

The proposed rules introduce a simplistic standard overriding the basic principles of international accounting and regulatory netting which have evolved over decades. In its current form, they will artificially overstate risk exposures of banks and potentially cause confusion and uncertainty rather than promoting confidence.

We support the alignment of netting rules between the different accounting standards for Leverage Ratio purposes. Prohibiting netting entirely, however, is excessively penalizing and would result in negative incentives for adequate risk management and the use of central counterparties that require users to daily margin based on net exposures. Taking no account of netting would artificially increase total assets and decrease the Leverage Ratio. In addition, un-netted derivative volumes typically increase in market downturn situations. Disallowing netting would, therefore, also reinforce pro-cyclicality.

Currently, three different major netting sets are used in the market: US GAAP, IFRS and Basel II. The proposed rules would introduce a further new concept, which creates an unduly operational burden on banks without an apparent supervisory benefit. The Basel II regulatory netting rules are a known concept and already in use at banks globally, irrespective of the accounting standard applied. **Against this background of international comparability, we strongly recommend applying the Basel II netting rules also for purposes of Leverage Ratio calculation,** only allowing banks to net exposures arising from transactions executed in netting-friendly jurisdictions. In this respect, legal enforceability of netting would be determined by either internal or external legal opinions.

2.3.3 Off-Balance-Sheet Items

Not applying conversion factors, and hence treating off-balance-sheet items as on-balance-sheet items, does not properly reflect the real risk situation.

The leverage stemming from off-balance-sheet exposures should, if at all, be captured by a separate off-balance Leverage Ratio calculation recognizing distinct likelihoods of commitments being drawn. Otherwise, if included in the balance sheet Leverage Ratio calculation, conversion factors, as currently applied for regulatory reporting, should be used to achieve a more appropriate reflection of risks.

2.3.4 Credit Derivatives

The addition of sold credit protection without recognising hedges creates an inconsistency with the trading book treatment of sold credit derivatives, potentially negatively impacting the entire credit hedging market, due to the disproportionate capital requirements for protection providers. This will increase general lending costs and reduce the number of banks being able to sell credit protection. Given that material market participants, such as insurance companies and hedge funds, are not subject to banking regulation, the proposed rules may even lead to an undesirable risk shift.

For the calculation of the Leverage Ratio, we thus recommend to add credit derivatives, if at all, to total assets on a net basis, i.e., after application of the hedging impact of bought protection. This would ensure a credit risk neutral calculation that results in net (real) exposures without systematic double-counting. Other risks than credit risk, such as operational risk, continue to be captured by the risk-based capital rules. We believe this recommendation reflects the spirit of a going concern ratio.

3 Key Specific Issues: Liquidity

3.1 General Remarks

We are concerned about potential adverse effects which the framework might provoke if strictly applied in the currently proposed and rigid format. In normal times, the liquidity transformation function of the financial sector could be adversely affected, with negative consequences for economic growth. In times of market stress,

the framework might also perform below expectations due to pro-cyclical and herd-like reactions of financial institutions.

Consequently, and in relation with the proposed narrow definition of the liquid asset pool, the value of a liquidity buffer may seriously decline in times of systemic crises. Particularly, the buffer of liquid assets is too narrowly defined with a high reliance on sovereign and public debt. This could enhance segmentation in securities markets putting corporate debt at a systematic disadvantage in relation to public debt.

3.2 Liquidity Coverage Ratio

We support the requirement for a short-term liquidity measure. We are, however, concerned that the definition of highly liquid assets according to the consultative paper is too narrow and therefore may have systemic consequences (restricted ability to lend to the economy).

In a stress scenario, it will typically be possible to liquidate more assets than the ones currently defined as highly liquid assets. Furthermore, banks may have the ability to draw down on facilities with central banks. **Therefore, we recommend that the Liquidity Coverage Ratio is adjusted to account for supplementary actions which banks may take to increase their liquidity base.**

3.3 Net Stable Funding Ratio

In this context, too, the proposed detailed and stringent rules would significantly reduce the ability of banks to manage liquidity effectively. For example, classical retail banks may exhibit substantial funding gaps given the proposed treatment of deposits.

Symmetry in the treatment of assets and liabilities with regard to the outflow assumptions needs to be ensured. The current proposals do not provide clear guidance on how balance sheet items are to be mapped under “other liabilities” and “other assets”. **We suggest clarifying these issues and establishing a consistent treatment of these items.**

3.4 Global Standards

The proposals of the Basel Committee aim at establishing a globally consistent framework for liquidity risk measurement, standards and monitoring. In this regard, we note that the European Union, in its Capital Requirements Directive (CRD 4), is proposing changes to the current Directive which do not provide for equal treatment of EU and non-EU banks.

Especially, CRD 4 explicitly disallows a self-sufficiency waiver for non-EU banks, even if they otherwise fulfill conditions for waiver applicable to EU banks. As a consequence, each branch or subsidiary of a non-EU bank will have to fulfill liquidity requirements individually, which is potentially increasing costs of funding for the Group and reducing the competitiveness of local branches and subsidiaries versus EU peers. Such

asymmetries could endanger the implementation of a global liquidity standard and undermine the resilience of the global financial sector.

We thus welcome the Basel Committee cooperating closely with local regulators to ensure that its global standard is consistently implemented across jurisdictions and provides symmetric treatment of banks independently of their country of incorporation.

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We are confident that improving capital and liquidity requirements will substantially contribute to the stability and reputation of the banking system. Our association is, of course, ready to actively participate in this process.

We would like to thank you very much for the opportunity to present our views. Please do not hesitate to contact us in case of additional questions or requests.

Yours sincerely,
Swiss Bankers Association

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