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

Dear Sir/Madam,

We appreciate the opportunity to comment on the December 2009 consultative document entitled *Strengthening the resilience of the banking sector* and support the Basel Committee on Banking Supervision's (the "Committee") objective to address the problems that arose during the recent financial crisis. We also support the more detailed comments on the consultative document provided by the Canadian banks through the Canadian Bankers Association ("CBA"). This letter supplements the CBA letter by providing some general perspectives on the proposal and emphasizing a few of the critical points.

We are very concerned that the total impact of all the proposed changes has not been fully considered. We encourage the Committee to focus on the most significant issues which caused the crisis, and resist the urge of trying to do too much at the expense of accomplishing very little. We believe it will be difficult to garner agreement on such a large number of proposals, especially when their cumulative impacts will significantly impede growth, and challenge the stability of economies and financial systems worldwide.

The Committee and the industry have already made great strides in remedying a number of the problems evidenced during the crisis, including substantial recapitalization of banks, the improvement of governance practices, and the deleveraging of the sector. In addition, the new market risk rules that will be implemented at the end of 2010 will significantly improve the risk capture of trading businesses that was lacking during the financial crisis. We believe the combination of these measures will have a substantial impact on the resiliency of the sector, and should be given full consideration as the Committee looks to calibrate its final rules.

General Perspective on Consultative Document

1. Package of reforms may be too blunt and have unintended consequences

While we recognize the need to change how banks are regulated, we are concerned about the expansive scope of the consultative document. We believe that fully adopting the proposals in their current form will result in significant unintended economic impacts – a less efficient, and potentially riskier, banking system, more expensive product offerings for retail and business customers, and reduced availability of credit.

From a practical standpoint, achieving worldwide agreement on these deductions will be difficult. Each country's banking system will be affected differently. Moreover, each change will require banks to raise more equity – but there is a limit to how much capital banks can raise to fund the costs of reform. The risks here are that reaching

agreement on the whole proposal may delay obtaining certainty on the rules, as well as misdirect capital which could be better deployed to address the real issues.

2. Consistent core requirements, but recognize differences in banking models/structures

In reviewing the consultative document, it appears that the experience of banking systems that performed well during the financial crisis seem to have largely been ignored. The proposal tends to focus on the issues that manifested themselves in problem jurisdictions, as opposed to the effective measures taken by regulators in more resilient banking systems. As such, we strongly encourage the Committee to consider the lessons learned and the perspectives of Canadian banking regulators, who were instrumental in ensuring that banks in Canada were well capitalized relative to their risks.

Another challenge we see in the proposal is the prescriptive, "one size fits all" approach to regulation. To ensure the strength of the global financial system, we agree that there should be consistent application of core items such as the level of capital, quality of capital, and risk capture for trading businesses. However, it is also important to recognize that global banks and banking systems are different. Canadian banks were not impacted by the same factors which caused banks in the U.S. and Europe to fail or compromised their quality of capital. Therefore, in implementing more specific aspects of the proposal, we support continuing discretion of national authorities to apply judgment to ensure the proposals result in appropriate alignment of capital requirements and underlying risks. We believe that the ability of local regulators to make decisions that are aligned with the risks and economics of the business is a fundamental component of an effective regulatory framework.

3. Banks cannot effectively manage "day-to-day" operations under a severe stress scenario

The design of the proposal, in particular the new deductions from Common Equity, assumes a "gone concern" scenario. Meanwhile, banks operate under a "going concern" model which includes holding appropriate capital to very high confidence standards for all risks. In fact, for Banks operating under Basel 2, this is a requirement which is regularly reviewed with the regulator. However, in several cases the proposal makes the underlying assumption that certain assets (e.g. substantial investments, deferred tax assets, etc.) have no value and require Banks to hold Common Equity for the full amount of the asset. We believe this is inconsistent with the overall Basel 2 principles of holding appropriate, risk-based capital. It is also worth noting that the requirement to hold capital for extremely conservative scenarios, does not necessarily mitigate against bad business decisions or poor management, which were arguably as much the cause for the financial crisis as inadequate risk capture.

4. Regulators must consider the impact of all proposals holistically

We understand that global regulators have a diverse range of concerns that reflect their own experiences during the recent financial crisis. This has been evident in the independent actions taken by some regulators in addressing specific issues such as outsized compensation, the cost of bank bailouts, and the blurred line between wholesale and retail banks. We are wary that the proposal is a product of a number of different perspectives, and as a result focuses more on individual areas of concern, as opposed to the cumulative impacts of the total proposal. With so many different items under way at once, it will be difficult for banks to adapt to the range of changes being proposed, even with lengthy transition arrangements in place. As such, we recommend the Committee prioritize rule changes and implement those that are most tied to the drivers of the financial crisis first. The Committee can then evaluate the effectiveness of these reforms in achieving its objectives, and then determine whether additional action is required or not.

Specific Items of Concern

1. Leverage Ratio

We are very concerned about the impacts of the proposal for a leverage test on all assets, whatever their risk. Under this proposal, banks would be required to hold the same amount of capital for all assets. In effect, no distinction would be made between low risk and high risk assets.

Consider the example of two banks that have the same level of capital, but dramatically different risk profiles. Bank A holds a portfolio of low risk assets that generate a low, but stable yield. Conversely, Bank B holds the same amount of higher risk assets which produce a significantly higher, but potentially more volatile return. Clearly, Bank B is rewarded for opting for a higher risk strategy by being able to earn a higher return on capital as compared to Bank A, which will earn a lower return on the same amount of capital.

In effect, financial institutions would be incented to move further out the risk curve. This would run the risk of making the financial system less stable – the complete opposite of what the Committee is aiming to achieve. In addition, Canadian banks hold the mortgages they originate, so they have a vested interest in the quality of their loans. This provides discipline to the housing market, and a cushion of reliable earnings for financial institutions. A bank-wide leverage test, unless properly calibrated, would make it uneconomic to hold mortgages on balance sheet, undermining our strength.

We recommend the Committee consider the following alternative approaches to the design of the Leverage Ratio:

a) **Total Capital should be the Capital Measure.** Total Capital is a valid basis for measuring leverage, particularly in light of the proposed improvements to the quality of Other Tier 1 and Tier 2 capital. A Tier 1 or Common Equity-based leverage ratio may not necessarily be more effective than a Canadian style Leverage Ratio (i.e. Assets-to-Capital Multiple, which measures on balance sheet assets plus direct credit substitutes to Total Capital) as demonstrated by the relative performance of U.S. vs. Canadian banks during the crisis.

b) **Exposure measure should incorporate some risk sensitivity.** Mortgages backed by a sovereign guarantee, such as government bonds and CMHC-insured mortgages in Canada, should be excluded from the exposure measure, given their low risk profile. In addition, other highly rated, liquid assets that are held to meet the new liquidity requirements should be exempt, and incorporation of undrawn credit lines should be based on actual experience during downturn periods.

c) **Leverage Ratio could be applied to only the wholesale component of the bank.** The Leverage Ratio is intended to be a backstop to guard against potential errors or omissions in risk capture models. These types of issues are generally more prevalent in models for trading businesses, while retail businesses tend to have simpler and more transparent risk management models.

2. Deduction for Holdings in Other Financial Institutions

The proposal recommends that banks take a dollar-for-dollar deduction from Common Equity for stock they hold of other financial institutions, where the bank does not have a qualifying hedge position with zero counterparty credit risk. We believe this approach is extremely punitive, particularly with respect to client market making activities, and would severely curtail trading and liquidity for capital instruments of financial institutions. At TD, our trading positions in other financial institutions are very tightly hedged (98.7%), and we already hold capital for counterparty risk associated with these hedges. Moreover, for Canadian banks, where the largest and most prolific investment dealers are bank-owned, the negative implications of this proposal would be exacerbated further, and could potentially result in less access to capital markets, a higher cost of capital (i.e. illiquidity premium), and a significantly smaller investor base (particularly as these rule changes permeate to other types of financial institutions, such as insurance companies, over time).

Furthermore the proposal would impact the hedging of stock-based compensation plans. In Canada, banks are restricted to holding no more than 1% of their own shares. As a result, banks hedge their exposure to stock-based compensation plans with total return swaps transacted with investment dealers who happen to be bank-owned. Under the proposal, it would not be economic for these trades to be facilitated by bank-owned investment dealers, leaving the banks unable to hedge their stock-based compensation. This conflicts with other policy/regulatory objectives that encourage a tighter link between pay and the long-term performance of the bank. As such, we strongly encourage the Committee to reconsider its criteria for qualifying hedge positions for financial institutions, particularly in the context of true market making activities.

3. Substantial Investments

We believe the proposal's requirement for a full deduction of substantial investments from Common Equity is inconsistent with the risk-based principles of Basel 2. A full deduction essentially assumes zero realizable value. But as part of Pillar 2 ICAAP requirements in Basel 2, banks are required to estimate potential unexpected losses in severe stress scenarios for our substantial investments, and hold appropriate capital for this risk. Consequently, regulators can review management's assessment for ICAAP purposes to determine the appropriate amount of capital to be held for substantial investments. We expect in many cases, and certainly for TD's substantial investments, this assessment will support less than a full deduction.

We also note that substantial investments can have underlying earnings streams which support the strength and intrinsic value of an institution. Moreover, the nature of the business may not be directly correlated to the financial position or performance of the rest of the bank, providing diversification benefits.

One of the pitfalls of adopting a more conservative treatment for substantial investments relative to current rules (i.e. a 50-50 deduction from Tier 1 and Tier 2 capital) is that it could trigger a change in corporate development strategies. Acquisitions of substantial investments would be more costly if they have to be capitalized 100% with Common Equity. As a result, banks may be less inclined to participate in transactions where they are unable to obtain full ownership from the outset, thus limiting opportunities for growth, economies of scale and diversification. To the extent that banks continue to be acquisitive, they may take a more aggressive stance, thereby increasing the overall risk of the bank. Neither outcome is likely desirable for national authorities, so we recommend the Committee consider the following alternatives:

a) Only a partial deduction from Common Equity to recognize the positive realizable value of an investment under a "gone concern" scenario.

b) A split of the full deduction between Tier 1 and Tier 2 capital, which is more consistent with the proposal's assumption of a "gone concern".

It is also our view that any change to the treatment of substantial investments should be made prospectively (i.e. outstanding substantial investments should continue to be treated under the current rule). The capital treatment of substantial investments is a key consideration for banks in their corporate development decisions, particularly with respect to purchase price and the form of financing. Therefore, it would not be appropriate to retroactively change a key economic consideration for past business decisions.

4. Additional Deductions from Common Equity

For some of the other proposed deductions from Common Equity, we have observed the following:

First, the requirement for a full deduction of an asset assumes zero realizable value or a liquidation scenario. This is inconsistent with the proposal for a full deduction from Common Equity or "going concern" capital. Instead, in a liquidation scenario where assets have lost their value, all components of the capital structure – Common Equity, Other Tier 1, and Tier 2 capital – are available to support loss coverage.

Second, we believe a number of proposals have the potential to incent banks to behave in a way that may be contradictory to other government policy or stated regulatory objectives. An obvious motivation would be to minimize the deductions from Common Equity. In the case of pension assets, banks would be incented to minimize the annual level of contributions, such that pension plans may only be adequately funded. As governments look to move the cost burden of retirees to the private sector, it would be prudent to eliminate any obstacles to overfunding pensions for the benefit of bank employees.

The deductions for Deferred Tax Assets ("DTA") and for holding of own shares may also conflict with regulatory objectives of reducing the complexity of banks and increasing the stock component of compensation packages. The requirement to fully deduct DTA may cause some banks to look at aggressive tax planning strategies to decrease the size of the asset, which may result in more complex bank corporate structures. As mentioned before, banks that are forced to hold more capital against holdings of other financial institutions' or their own shares, will be less inclined

to offer employees long-term, stock-based compensation if they are unable to hedge movements in the price of their stock from the date of grant to the payment date.

5. Trading Risk Amendments and Credit Valuation Adjustment

We are cognizant of the new market risk rules that will come into effect at the end of this calendar year. We believe these rules are an important step in fixing the deficiencies in banks' risk frameworks which facilitated the excessive risk taking and leverage that led to the financial crisis. Consequently, we believe the global implementation of the market risk rule changes should not be delayed.

We also agree that there needs to be more consideration of counterparty credit risk in the capital framework. However, we share the industry view that the proposed credit valuation adjustment calculation and calibration is not practical. We encourage the Committee to correct this design flaw.

Closing

We would like to thank the Committee for the opportunity to provide our comments on the consultative document. We support the Committee's goal of strengthening the resilience of the banking sector and the overall need for reform. That being said, we believe that any changes need to be implemented in a manner which does not cause economic instability, and should be prioritized to address the root causes of the financial crisis first. Significant progress has already been made with the pending introduction of the new market risk rules, and the Committee has also identified some additional areas of improvement. While there are a number of voices calling for massive overhaul of bank regulation, we believe that all stakeholders – banks, consumers, businesses, and governments – will emerge stronger from the aftermath of the crisis by concentrating on the handful of the shortfalls which caused the unprecedented instability in the banking system.

Yours sincerely,

Ed Clark

cc: OSFI (Gilbert Ménard, Richard Gresser)