POSITION PAPER

WSBI-ESBG Position for the Basel consultation on an "strengthening the resilience of the banking sector" (BCBS 164)

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The World Savings Banks Institute (WSBI) and the European Savings Banks Group (ESBG) appreciate the call for contributions in the Basel Committee's consultation on "strengthening the resilience of the banking sector". Before entering into the discussion of the Basel Committee's concrete proposals, WSBI-ESBG would like to comment on some important aspects of the methodology followed and the approach taken.

I. GENERAL REMARKS

a) Concern about the volume and pace of regulatory change

WSBI-ESBG supports the international and European efforts to repair the financial regulatory framework with a view to render it safer and more resilient. Most of the regulatory repair measures put forward by policy makers in response to the crisis appear to have a sound motivation when looked at individually, however it is essential that their effects be considered in the broader context of the overall regulatory reforms that are envisaged.

There are some serious concerns as regards the pace and volume of the envisaged regulatory changes:

- There is a very high degree of **uncertainty** in the financial markets given the unpredictable outcome of the regulatory reforms. The banking industry is currently faced with multiple regulatory proposals stemming from different sources. Each of the envisaged regulatory changes will most probably entail a significant increase in the level of capital required for banks or otherwise the deployment of significant resources by institutions. The cumulative impact of the measures put forward since the financial crisis is at present assessed and most of the proposals currently on the table will be subject to further details and calibration once the results of the quantitative impact analysis will become available. The banking industry is actively involved in such ongoing impact analysis, whilst having to cope with major uncertainties as regards the final regulatory output. Such uncertainties impinge to a large extent on the way day-to-day banking business is carried out and on the planning of activities.

- The **speed** by which the new measures are devised and adopted is unprecedented. This confirms that the regulatory framework allows for swift adaptation in case of need. However, there are strong concerns that quicker decision-making occurs at the expense of the quality of the regulatory output. Too often during the past two years, regulatory proposals were not accompanied by thorough studies as to their suitability, justification, impact and cost-benefit analysis. Consultation processes, if any, were reduced to minimum periods, and stakeholders have been overwhelmed with questions from various sources. Now is the time to ensure that this pattern will not repeat itself.

- There is a real risk of moving towards **over-regulation**. Such an outcome would result in a significant misallocation of resources, entail enormous costs and create a burden not only for financial institutions but also for the whole economy.

- This large amount of regulatory reforms paradoxically puts a **heavier burden on the retail banking sector**, which was the most resilient during the crisis. Investment banking might be hit hard by the proposed regulatory package, yet this business model has a clear advantage: a capacity to react and adjust the business mix more quickly. Instead retail banks will find it more difficult to mitigate the impact, as they have much lower flexibility in adapting their business model and their restricted capability of passing regulatory costs because they operate in a highly competitive environment. Also, it should be reminded that retail banks are driven by the business-needs of their customers, which renders cost optimisation through redesign of the business model and reconfiguration of operations more difficult.

b) Consultation Procedure

WSBI-ESBG notes that the consultation documents issued by the Basel Committee do not contain some key elements and figures that would give substance to the concepts developed in the papers. Without clarity on calibration no full feed-back can be given. Therefore, WSBI-ESBG warns that this response is only a preliminary assessment of proposals, which have not been substantially fleshed-out. A final assessment hinges on a final complete and concrete proposal.
In this context the current consultation has to be seen only as a pre-consultation. WSBI-ESBG looks forward to a future consultation on the actual proposals, which should be based on the results of the properly conducted QIS.

c) Need for clarification

Apart from the missing details of some of the concrete proposals that are expected to be disclosed once the results of the impact assessment will be available, WSBI-ESBG considers that it is imperative that the Basel Committee clarifies two more fundamental aspects of the proposal.

First, WSBI-ESBG observes that there is no clear objective of the proposals as regards the expected overall amount of capital in the system. The proposals only generically refer to the intention to raise the quality, consistency and transparency of the capital base. By contrast, when discussing Basel 2, it was clear from the outset that the overall aim was to maintain the existing amount of capital in the system, but to redistribute it so that it was held in accordance with risk. In the absence of such stated objective during the present consultation exercise, it is impossible to assess the internal coherence of the current proposals. Hence, we invite the Basel Committee to make public its intentions.

Second, WSBI-ESBG takes the view that it should be explicit, which concrete proposals fit into Pillar 1 (CVA, asset correlation) and which should come under Pillar 2 (any form of capital add-on). This is particularly important in view of consistent implementation, and especially for ensuring that all regulators have access to the same regulatory toolkit.

d) Risk-sensitivity

As mentioned above, WSBI-ESBG generally welcomes the ongoing review of the Basel II capital framework, in view of correcting the weaknesses made apparent by the crisis. At the same time, it is

important to recognize that not all aspects of Basel II should be questioned; Basel II has represented a significant step forward as compared to Basel I, which has helped many firms to improve their risk management practices.
A particularly positive aspect of Basel II is the risk-sensitive approach it takes; risk-sensitivity should continue to form the basis of any future prudential regulation applicable to the financial sector. Actually, what is needed is not less risk-sensitivity, but rather *more* of it.

e) Impact assessment and calibration

As already indicated above, conducting an overall cumulative impact assessment is crucial. WSBI-ESBG is confident that regulators will very seriously analyse the results of the ongoing Quantitative Impact Study (QIS) and appropriately calibrate the proposed measures.

WSBI-ESBG would like to highlight that it is important that the impact assessment incorporates a macro-economic assessment of the effects on the whole economy, as well as on specific sectors. This should necessarily include also a thorough analysis of the effects of the proposals on smaller banks. It should appropriately acknowledge as well structural differences and specificities in the national financial markets all over the world. Furthermore, it has to duly consider the differences between good banking practices and bad banking practices and between different business models.

Appropriate calibration is key to the success of the proposed regulatory reforms. It can be done only on the basis of the results of a trustworthy impact study. Calibration is critical for getting the new rules right and making them capable of addressing the current failures; if the new rules are not properly drafted they have the potential to result in a massive negative impact on not only on banks but also on all other economic sectors.

f) Grandfathering and transitional arrangements

In view of the far-reaching consequences that the envisaged measures will have on the financial sector and as a consequence on the financing of the economy, WSBI-ESBG urges the Basel Committee to introduce appropriate transitional, phase-in and grandfathering arrangements. We wish to highlight in particular the following points:

- The phase-in, grandfathering and transitional arrangements envisaged by the Basel Committee, which are vital in order not to disrupt the markets and the economy, are so far not known. We urge the Basel Committee to clarify its intentions in this respect. Such arrangements have to pay due account to the fact that the crisis affected differently different types of financial institutions and manifested itself in different ways and to a different extent in the various countries.
- The transitional arrangements should be defined in function of cumulative impact assessments to be conducted by the Basel Committee, aiming at establishing acceptable transition periods in view of avoiding massive disruptions in the markets.
- In order to ensure a convergence of approaches internationally, we suggest basing the transitional arrangements on those agreed upon in Europe last year, at the time of adoption of the revised Capital Requirements Directive ('CRD II').
- Finally, it is key to ensure that the new rules are not applied retroactively, for instance as of the date at which proposals were made by the Basel Committee. It is not acceptable that

grandfathering should only apply for instruments issued before 17 December 2009. Capital, which complies with the currently applicable legal requirements should continue to be attributable to the relevant capital categories as long as it is issued before the new regime enters into force.

II. <u>Specific comments on the proposals contained in Consultative Documents (BCBS 164)</u>

1. Comments on the proposals for raising the quality, consistency and transparency of the capital base

a) General comments

1. <u>Introduction</u>

WSBI-ESBG supports as a matter of principle the efforts undertaken by international banking regulators to improve the quality, consistency and transparency of banks' capital base. The financial crisis has clearly demonstrated that there were some flaws in the existing capital adequacy framework, which unquestionably need to be addressed. Yet, WSBI-ESBG warns that an erroneous message is given through these proposals, namely that the crisis could have been prevented merely by requirements for higher capital of a better quality to all market participants, whatever their business models or risk profiles.

WSBI-ESBG is generally supportive of the Basel Committee's approach and would like to welcome as positive especially the proposals' very likely contribution to simplifying the structure of own funds, fostering convergence and thereby reducing competitive distortions. In light of such broad support for the proposals on capital and of our general reservations as regards the current consultation document expressed in the introductory remarks, WSBI-ESBG would also like to underline some specific aspects that raise concerns.

2. <u>Principles-oriented approach for defining capital</u>

WSBI-ESBG is supportive of a principles-based approach to the definition of capital as a means to achieve international harmonisation. We believe that a principles-based definition of capital is the right way forward and is reflected in the proposed approach consisting of a catalogue of criteria for the eligibility of capital instruments for regulatory purposes. The main focus in the assessment process of an instrument should be on the fulfilment of the three principles of permanence, loss absorption and flexibility of payments. The very purpose of developing criteria governing inclusion in the capital base is meant to support such a principles-based approach, where emphasis is on the substance.

Yet, the wording used in the consultation paper seems to add also a formal criterion, requiring that in the case of joint stock companies the "criteria [governing inclusion in the Common Equity component of Tier 1] must be met solely with common shares" (§ 87) . WSBI-ESBG considers that the legal form of an instrument does not have any relevance as long as the criteria are fulfilled in substance. Therefore, it needs to be avoided that a specific form is required that would actually exclude - merely because of formal aspects - instruments that substantially comply with the required criteria. Hence, we argue that – also in the case of joint-stock companies – other instruments than common shares be eligible for the common equity component of Tier 1 Capital. We would invite the Basel Committee to accordingly change the text in § 87. In support of this approach we would like to point also to the definition of common equity given in footnote 17 (§ 85), where it is considered inclusive of not only common shares plus retained earnings, but also of "other comprehensive income net of the associated regulatory adjustments".

3. Specificity of non-joint stock companies and inappropriateness of designating common shares as the benchmark (§ 87 – footnote 19)

WSBI-ESBG wishes to firmly recall that a functional and balanced banking environment is characterised by pluralism and the participation of a variety of financial actors. Such variety of actors implies a variety of corporate structures that regulators need to properly consider when proposing new regulatory measures. We welcome the acknowledgement in footnote 19 of the specificity of mutuals, cooperatives, or savings institutions and the need for prudential rules to take into account their specific constitution and legal structure. However, given that these institutions constitute a substantial proportion of the banking market, WSBI-ESBG urges the Basel Committee to acknowledge such specificity not merely in a footnote, but instead in the core text. All financial institutions need to be treated equally, and it would be discriminatory and unjustified to refer to non-joint stock companies only in a footnote.

Furthermore, the approach taken by the Basel Committee implies the consideration of common shares as the benchmark for assessing the features of instruments issued by joint stock and non joint stock companies. This entails the risk of completely diverting regulators' attention from the specificities of non-joint-stock companies. Therefore, WSBI-ESBG strongly calls for the references to common shares to be consistently accompanied throughout the text with an explicit reference to "the equivalent for non-joint stock companies".

4. Differentiating between going concern and gone concern capital (§ 85)

The Basel Committee proposes to introduce this new distinction, indicating Tier 1 Capital as "going concern capital", and Tier 2 capital as "gone concern capital". This differentiation needs to be better explained and the underlying rationale clarified. Our interpretation would be that "going concern capital" helps keeping a bank running, whereas "gone concern capital" should be seen mainly as a capital cushion for safeguarding deposits.

5. Limits and minima (§ 82, 85)

The Basel Committee proposes to delete the current system of limits that makes the level of Tier 2 capital a function of how much Tier 1 capital the bank has issued. Instead, separate explicit minima will be established for common equity, Tier 1 Capital and Total Capital. Concrete figures have not been proposed yet and in their absence it is practically impossible to give a final assessment of the proposed new system of limits. Yet, at this stage, WSBI-ESBG would like to underline that any increase of the existing limits and minima (4% Tier 1 Capital and 8% solvency ratio) would have an impact on both the earning and lending capacity of banks.

Furthermore, the Basel Committee requires that the predominant form of Tier 1 must be its Common Equity component (after the application of regulatory adjustments). In the accompanying letter to the G20, FSB mentioned a range between 50-85%. Yet, in the light of the new qualitative requirements for core capital and hybrid instruments, which ensure the equivalence of the two capital instruments in terms of regulatory quality, as well as their common purpose as "going concern capital", a predominance of core Tier 1 capital beyond 50% would not be justified. This is moreover the case when considering that the Basel Committee's proposals are likely to make hybrid Tier 1 Capital more equity-like and homogeneous, with a higher likelihood of coupons on future

hybrids being cancelled in periods of stress. Consequently, WSBI-ESBG assumes that predominance will mean above, but strictly near 50%.

The BCBS draft does not deal with the issue of the possible eligibility of excess Tier 1 capital as Tier 2 capital. However, WSBI-ESBG assumes that – in line with previous regulatory practice – eligible higher-value capital instruments will be taken into account in the next capital category if the ratio-based restriction does not permit eligibility in its original capital category. This is mainly due to the fact that going concern capital by definition is also available in gone concern situations. This issue is of utmost significance particularly since under the present proposal, minority interest would no longer be eligible as core Tier 1 capital, but only as other Tier 1 capital. We therefore suggest explicitly providing for excess Tier 1 capital to be eligible as Tier 2 capital

6. Different classes of shares

Corporate law has always permitted and supported the existence of different classes of shares. Different rights and privileges counterbalance certain specific features of particular shares (e.g. the privileged payment of dividends compensates for the lack of voting rights). Such rights and privileges do not interfere with the substance of the criteria for the definition of capital, and especially they do not impinge on the loss absorbency capacity of the instrument. Therefore, WSBI-ESBG welcomes that the Basel Committee explicitly allows for both voting and non-voting common shares to be included in common equity.

Yet observing proposed criterion 7, WSBI-ESBG does not see why shares with non-cumulative preferential distributions would be of less quality than common shares because of their preferential distribution right in respect of other share holders. In light of the Basel Committee's proposals to strengthen the loss absorption capacity of Tier 1 Capital, in our opinion there is no difference in quality between common shares and shares with non-cumulative preferential distributions to absorb losses in a going concern. A preferential distribution right, exercised after decision – and with full discretion – of the general assembly, does not change the quality of the instrument as such. On the contrary our belief is that during the financial crisis such instruments have proven to absorb losses to the same extent as ordinary shares. Consequently, given that shares with a preference in dividend fully comply with the criteria of Common Equity they should be explicitly included in the Common Equity component of Tier 1 capital.

To us it seems irrelevant if different classes of equity capital have different precedence in dividends and/or ranking in the event of liquidation. The important factor is that the shareholders collectively are subordinated to all other claim holders, and thus jointly represent the most subordinated class or "the last line of defence" both during going concern and in liquidation. It must be up to the shareholders to decide differences between the different types of classes of equities, which are done at a shareholders' general meeting. Any such agreement amongst the shareholders leaves their joint relationship toward the rest of the claim holders unaffected, which should be the only concern of the regulators.

To be able to attract equity capital in the event of a financial turmoil it is of greatest importance that different ways to have access to the capital market are available. To offer investors shares with precedence in dividends and/or prior ranking to ordinary shares in liquidation might be one way to ease the supply of equity share capital in a crisis situation. If this type of equity capital is excluded from Core Tier 1 Capital it will affect banks access to capital markets, particularly in stressed situations which will be contrary to the aim to create financial stability.According to § 87 criterion 2

any instrument eligible for inclusion in Core Tier 1 capital must be entitled to a claim of the residual assets that is proportional with its share of issued capital, after all senior claims have been repaid in liquidation. In case there are different classes of equity capital with different ranking in liquidation it is not obvious if the current wording of Criterion 2 would allow all equity classes irrespective of the ranking. We believe a more adequate wording would be: "Entitled to a claim on any residual amount only after all other claims are satisfied in liquidation. In case the institution has more than one category of capital instruments (i.e. ordinary shares and other capital instruments) with different ranking in liquidation, on a break-up basis the proceeds from the realisation of the credit institution's assets are applied firstly to satisfy all prior claims (e.g. depositors, creditors, holders of subordinated instruments) and any residual amount is distributed between the ordinary shareholders and the holders of such other capital instruments in accordance with the articles of association, or equivalent, of the institution."

To conclude we are of the opinion that non-cumulative shares including a preference in dividend should henceforth be eligible for inclusion in Core Tier 1 capital. Any dividend paid on such equity capital is decided on – and with full discretion – by the General Assembly. Such equity capital has thus the same loss absorbing capacity in a going concern as ordinary shares. We are also of the opinion that if different classes of equity capital have different ranking in liquidation this is not a valid reason for excluding them from being eligible for inclusion in Core Tier 1 capital, as the only relevant distinction in a liquidation situation is between claim holders in general on one hand and the shareholders collectively on the other. This distinction is inherent in the type of claim each of these categories represent.

7. <u>Scope of application of the harmonised definition</u> (footnote 16, § 85)

WSBI-ESBG welcomes the clarification in footnote 16 to § 85 that the harmonised definition of capital applies to banks on a solo basis, as well as to consolidated banking groups including bank holding companies. This would definitely contribute to minimising competitive distortions. Yet, we deem that it is not sufficient to harmonise the scope of application of the new capital structure, but especially as regards bank holding companies, it is necessary to ensure a uniform application of the consolidation provisions.

b) Regulatory adjustments applied to regulatory capital

1. <u>Introduction</u>

WSBI-ESBG believes that international harmonization of regulatory adjustments applied to regulatory capital has the capacity to foster comparability of banks' capitalization, and is therefore a welcome endeavour. This being said, regulators should keep in mind when pursuing the objective of comparability that differences will inevitably remain, as a result of differences in national company, tax and insolvency law.

As a general comment, WSBI-ESBG considers that the sum of all the proposals appears far too extensive and is likely to lead to an unnecessarily stricter regulatory environment for the banking industry. In particular, the proposed deduction regime and regulatory adjustments represent a significant tightening of regulatory capital requirements. This tightening will not only arise from the extension of the deductions' catalogue (by adding deferred tax assets and minority interests) but

also from the mandatory rule to apply these adjustments to the Common Equity element of Tier 1 capital.

In the following sections, we will present in some details the regulatory adjustment we recommend changes as compared to the current deduction proposals. We wish to already stress now that it is highly important to achieve consistency and coherence between prudential and accounting rules. In addition, we wish to emphasize a specific concern related to the timing of the introduction of the changes, which needs to be handled very carefully in light of the fragility of the emerging economic recovery worldwide. Due to the cumulative effect of the tightening of the capital criteria, the increase of capital ratios and the extension of the deduction regime, many banks may have to increase their capital base at the same time; this might prove extremely costly for banks and investors may in fact not be able to provide the needed amount.

2. Stock surplus (§94)

The Basel Committee considers that the predominant form of Tier 1 capital must be common shares and retained earnings. In addition, the criterion 6 governing the inclusion in the Common Equity component of Tier 1 states that under no circumstances distributions should be obligatory. The decision over the distribution of profits is left to be taken by shareholders after all legal and contractual obligations have been met and payments on more senior capital instruments have also been made.

Against this background, WSBI-ESBG considers that the proposal is too strict. It is not adequate to deduct stock surplus from the Common Equity component of Tier 1 capital if (1) these revenues are as retained earnings and (2) banks meet criteria 6 regarding distributions.

In addition and as already explained above, WSBI-ESBG believes preference shares with non cumulative preferential rights in relation to other parts of common equity should be explicitly included in the Common Equity component of Tier 1 capital. Therefore, stock surplus relating to such shares should be granted a similar treatment.

3. Minority interest (§95)

3.1 General comments on minority interests

The Basel Committee proposal on minority interests excludes minority interests from the Common Equity component of Tier 1 (although it is not explicit, we assume that minority interests will continue to be fully included in Tier 1).

The exclusion of minority interests may be reasonable to the extent that there are no doubts on the liability of minority interests on the risks of the entire consolidated group. But as drafted, the proposal is methodologically inconsistent, as it treats assets and liabilities of subsidiaries asymmetrically. This imbalance would reduce the Common Equity on the one hand (deductions of minority interests) while the risks of the subsidiaries would have to be consolidated on the other hand (full inclusion of RWA which are included in the calculation of capital ratios).

In this context we understand that the goal is also to prevent the misuse of corporate structures to increase the group's capital base by consolidating special and not supervised Special Purpose Vehicles (SPVs) structures where the capital base is accompanied by little or no risk. However, we

consider that supervisors should distinguish between abusive consolidation constructions and the consolidation of financial/banking subsidiaries, which are the subject of on-going supervision. As a consequence, minority interests of at least financial/banking supervised subsidiaries should continue to count as eligible Common Equity in the future.

Finally, we stress that we are uncomfortable with any difference between the proposals aiming at strengthening the Tier 1 capital base and the current consolidation rules of capital. In our understanding minority interests cover the losses related to their proportional share in the consolidated RWA.

Against this background, we do not support the current proposal as it ignores the capital of subsidiaries at group level while the risks exposures of the same subsidiaries would be fully recognized in the consolidated accounts.

3.2 ESBG's main proposals on minority interests

- Symmetry of liabilities and assets has to be restored by deducting from the consolidated capital the RWA covered by the minority interests.
- Minority interests of at least financial/banking supervised subsidiaries should continue to count as eligible Common Equity in the future.
- Alternatively, minority interests should be eligible for Tier 1 up to the necessary level to cover the assets of the subsidiary. If excess capital within the subsidiary is so significant that it would influence the capital ratio of the consolidated Group and lead of overcapitalization, the excess should be eligible for additional Tier 1 or Tier 2.

3.3 Joint liability schemes

WSBI-ESBG highlights that the Basel Committee has to take into account the specific issue of control agreements with joint liability schemes. Joint liability schemes generally increase recoverable assets on a going concern basis by making it mandatory for banks that are members of such a scheme to guarantee coverage in case of losses from any other member of the same scheme. The coverage is performed through payments and aim at avoiding insolvency or liquidity issues. Hence, the potential liability basis is as strong and potentially stronger compared to other group structures which do not possess this obligation to provide assistance.

As liability agreements call on the members of a scheme to take their share in the scheme; their capital would also be used to cover losses. As a consequence, it is secondary to wonder if schemes imply coverage through members' own shares or through minority interests in the controlled company.

WSBI-ESBG is concerned that these structures, which have proven their resilience during the crisis, might be put at risk. The non-eligibility of minority interest could imply that the current joint liability schemes would no longer be allowed. Any regulation excluding minority interests from the Common Equity capital base should therefore take into account the specificity of joint liability schemes and therefore not be applied to any contractual groups based on them.

3.4 Minority interest: more specific comments

- *Coherence between prudential rules and accounting standards is needed*

WSBI-ESBG considers that there is a need of consistency between prudential and accounting rules. In this particular context, we are uncomfortable with any difference between the proposal aiming at strengthening of the Tier 1 capital base and the current consolidation rules of capital. In our understanding, the mandatory consolidation rules set up that all companies are to be considered as one single company. The capital base of a company is by definition responsible to absorb the risk and losses with respect to the stated Risk Weighted Assets (RWA) of this firm. At the level of the subsidiary, the capital base of the individual subsidiaries stands for their own risk. At group level, the minority interests support their own risk and stand for their own portion of risk, while benefiting the whole group.

- *A distinction between abusive consolidation constructions and the consolidation of financial/banking subsidiaries is necessary*

The Committee does not fully fulfil its goal as the exclusion rule is also applied to subsidiaries which are credit or financial institutions or securities firms. From our point of view, and in order to achieve their objective of introducing a reasonable capital framework for banks, another balance has to be found. Supervisors should distinguish between abusive consolidation constructions and the consolidation of financial/banking subsidiaries when talking about the exclusion of minority interests from the Common Equity component of Tier 1. Therefore, minority interests of at least financial/banking supervised subsidiaries should continue to count as eligible Common Equity in the future.

- *Some banking groups will be unintentionally penalized*

The complete exclusion of minority interests would penalize the business model of a number of banking organisations; especially for those groups with minority interests in listed subsidiaries. The asymmetry between full deduction of the minority interest and full inclusion of the RWA creates particularly disparate impacts and unnecessarily unfair results.

- *A disincentive to investment is to be expected*

The proposed deduction creates a disincentive to investment that would be detrimental both to the banks and to the markets in which they might wish to invest. It will penalize banks in their external growth strategy and/or will change their behaviour in relation to the capitalisation of their subsidiaries. We specifically highlight the case of developing countries where there are cases in which national entities have to have a participation in financial institutions made up by foreign banks.

- *An unintended weakening of crisis management can be foreseen*

It would also limit private sector solutions for rescuing ailing banks: if minority interests had not been considered by regulators as part of the Common Equity component of Tier 1, some operations would have probably never happened. This is contradictory with the objective to build a stronger framework of crisis management with a more balanced burden-sharing between private and public sectors.

4. <u>Unrealised gains and losses on debt instruments, loans and receivables, equities, own use properties and investment properties</u> (§96)

Introducing a waiver of filters is not useful as this would amplify pro-cyclicality. Filters on gains and losses should be maintained. In addition, and as far as IFRS are concerned, such a provision will no

longer be needed as the relevant category "available for sale" will be eliminated in IAS 39 - this raises again the procyclicality problem. ESBG insists that on no account it seems appropriate to filter only gains because this would be one sided.

5. <u>Deferred tax assets</u> (§98 & §99)

5.1 General comments on deferred tax assets

We support the Basel Committee's goal to set clear and transparent rules at international level to avoid undue reliance on deferred tax assets in regulatory capital. We recognise that a certain degree of prudence may be required for allowing deferred tax assets in regulatory capital as their value can be affected in periods of economic stress. However, we see little justification for the proposal made in the document, i.e. that deferred tax assets that rely on future profitability to be realised should be deducted from the Common Equity component of Tier 1 (the Predominant Core Tier 1). In our view this fails to take into proper consideration the various categories of deferred tax assets and the real value of deferred tax assets on a going concern basis.

5.2 WSBI-ESBG position on deferred tax assets

- WSBI-ESBG considers that the full allowance in Core Tier 1 should be maintained for deferred tax assets for which there is no doubt about their future realization, i.e. for those assets resulting from discretionary forward looking provisions or from pension plans.
- In addition, WSBI-ESBG recommends considering a more balanced approach for deferred tax assets such as the partial deduction rule already applied in some countries. Some banking regulators partially deduct deferred tax assets for the portion exceeding a specified maximum proportion of capital. In some jurisdictions, where banks have booked significant losses and taken some credit for tax recoverable on these, the deduction of deferred tax assets could have a very significant impact. As a consequence, we support partial deduction for deferred tax assets for which the realization is dependant on future profits.

5.3 Deferred tax assets: more specific comments

- *The necessity to take auditors into account*

According to most accounting standards (e.g. IFRS - IAS 12 for instance -, US GAAP, UK GAAP etc.), the objective of accounting for income taxes in the Profit & Loss statement is to recognise not only the amount of taxes payable or refundable for the current period but also deferred tax reflecting the future tax consequences of events recorded in the financial statements during that period.

Most deferred tax assets dependent upon future profitability arise both from tax loss carried forward and timing differences between the recognition of gains and losses in financial statement and their recognition for tax computation. Such timing differences commonly derive from the numerous discrepancies between tax and accounting rules, which vary greatly depending on tax laws and jurisdictions.

In reporting net deferred tax assets, companies are required by accounting standards to make an assessment of recoverability based on assumptions and estimates of future taxable profits. WSBI-ESBG stresses that this assessment is subject to scrutiny from external auditors, an elements which has to be taken into account. Deferred tax assets will not be recognised (or will be written off in whole or in part if they have been previously recognised) in case there is not enough certainty that

taxable profits will be available to support the utilisation of deferred tax assets in future years. Such write down will decrease the net profit reported for the period.

- *Inconsistency with the going concern approach*

The logic underlying the proposed deduction (which is that deferred tax assets are dependent on future profitability and should hold no value at all whatever the circumstances), does not appear coherent with the "going concern" approach adopted by the Basel Committee for Tier 1 Capital. As explained earlier, deferred tax assets are already subject to an economic value test conducted by external auditors to confirm their recoverability. The time limit set by tax authorities to utilise deferred tax assets is usually very long or unlimited and therefore deferred tax assets may retain value over the long term as long as the bank is in operation and even if they have been temporarily written down. Deferred tax assets on tax losses carried forward also contribute substantially to the value of the business or the subsidiary in case it is sold or transferred.

- *Increase of pro-cyclicality*

We consider that the deferred tax assets deduction can be a pro-cyclical measure which will further deplete capital during economic crises. A significant driver of deferred tax assets for banks is the fact that many tax systems only permit a deduction for loan loss provisions upon actual realization of those losses, whereas the deduction for accounting arises at the time the provision is made. Requiring an Equity Tier 1 deduction for deferred tax assets resulting from tax losses, loan loss reserves (not always tax deductible) and from unrealised investment losses will have pro-cyclical effects: the deduction will increase during downturns and will be reversed when results improve. As a consequence, the proposed deduction will further deplete capital in periods of economic stress.

- *Forward looking provisioning might increase the amount of deferred tax assets*

There is the risk that the forward-looking provisioning scheme, as promoted by the Basel Committee, will generate deferred tax assets that must be excluded from deductions altogether. This will substantially increase the amount of deferred tax assets. Deducting such artificially created deferred tax assets from the Common Equity component of Tier 1 would in part annihilate the benefit of this countercyclical measure and may even discourage conservative accounting.

- *No level playing field*

The proposed deduction is in part contradictory with the stated objective to maintain a level playing field. The proportion of deferred tax assets resulting from temporary differences varies widely between countries depending upon local tax laws. Deducting such deferred tax assets penalise banks operating in tax jurisdiction where certain asset value adjustments (e.g. loan loss reserves, impairment, write down) are not tax deductible and this will translate into undesirable distortions based on the localisation of a bank's activities.

6. <u>Investments in own shares (treasury stock)</u>(§100)

WSBI-ESBG disagrees with the "look through" requirement of the Basel Committee requiring to deduct the exposures of index securities to own shares. Banks usually hold inventory of index securities for market making purposes. Investments in own shares and holdings of index securities are different activities. The identification, measurement and separation of the own share component in the index is in our opinion artificial. A capital deduction of indirect holding of own shares via index securities would put stock listed banks at a disadvantage to non-listed banks.

Banks already have an incentive to limit the size of inventory in order to limit the associated funding costs. Finally it is questionable whether the benefit for the banking industry from deducting indirectly held own shares will outweigh the costs. Consequently, instead of focusing on indirectly held own shares, WSBI-ESBG urges the Basel Committee to concentrate on the deduction of directly held own shares.

7. Investments in the capital of certain banking, financial and insurance entities which are outside the regulatory scope of consolidation (§101)

All comments on this proposal are in line with those made on paragraph 100. We have similar concerns as regards the "look through" requirement for holdings of index securities to deduct exposures to financial institutions which exceed the threshold limit. We stress again that investments in financial institutions and holdings of index securities have no common grounds. Not only is the identification of financial institutions and the assessment of the holding value through the index a complex operating process, but also the deduction of those items is totally artificial and unjustified as there is no double gearing through index. Banks usually hold inventory of index funds for market making purposes. Thus, a capital deduction of indirect investments held via index funds would increase the costs of market making. In line with the comments made above, it is highly questionable whether the benefits to the banking system resulting from deducting indirectly held investments will outweigh the costs.

In addition, we have difficulties to understand to what kind of capital the threshold that will trigger the deduction of holdings of common stock in (a) financial institution(s) will be applied. We propose that it should be applied to gross capital, i.e. to Tier 1, Tier 2 and before any deduction. Otherwise, the common stock of financial institutions will quickly be exhausted. The proposal could reduce the incentive for banks to diminish the risk of their investments by taking a mitigating short position. We propose to allow the netting of long and short positions.

8. Shortfall of the stock of provisions to expected losses (§102 & §103)

By principle, expected losses are covered by provisions under an IRB approach and unexpected losses are covered by capital. The Tier 1 capital base should be fully available to absorb losses on a going concern basis. In this proposal, the Basel Committee aims at avoiding any incentive for banks to provision at low levels. It proposes to deduct a shortfall of the stock of provisions on capital.

WSBI-ESBG does not fully agree with the Basel Committee proposal. We believe that the deduction of a shortfall of the stock of provisions should impact not only core capital but also the whole Tier one, including additional capital as it is part of the going-concern criteria.

9. Defined benefit pension fund assets and liabilities (§106 & §107)

From our point of view, the proposal appears very general. A deduction would provide an incentive for banks to minimize the over funding of pension funds but it could also encourage them to accept under funding, putting pensions at risk. It is important to know that in numerous cases prudential filters have already been defined to mitigate actuarial deviations. This results from the adoption of IFRS.

First of all, WSBI-ESBG suggests that the Basel Committee takes into account the most recent work of the IASB on this topic. Indeed, an "Exposure Draft" on employees benefits is expected to be issued (comprising benefits associated with pensions funds) for the first quarter of 2010, which will enter into force in the first of half 2010, and foresees a review of the actuarial deviations.

We propose to waive the deduction until the IASB publishes its final standard. The Basel Committee should continue to monitor pensions in Pillar II. Should the Committee still feel the need of a deduction, we would propose deduction from Tier 2 capital because the pension surplus would only need to be realized in a gone-concern scenario.

10. Remaining 50:50 deductions (§108)

The planned change to replace the deductions of certain assets in the numerator of the ratio by weights of 1250% in the denominator is not neutral and produces very significant effect on the coefficient level without having technical grounds. We believe that the best way to picture our concerns is to use a numerical example.

Example:

A financial institution has a capital of € 1,200 and risk-weighted assets (RWA) of € 10.000. Its capital adequacy ratio would be: 1200/10000 = 12%. The same bank invests in an asset that involves deduction of own resources:
a) With the current rules its capital adequacy ratio would be the same (12%)
b) With the new rules, the coefficient will be as follows: 1200 +400 / 10000 + (400 * 12.5) = 1600/15000 = 10.7%. The solvency ratio decreases.

A weighting of 1250% is intended to be equivalent to requiring coverage with capital of 100% of the assets concerned. However the proposal does not achieve this target. By including the new capital in the numerator and by including in the denominator the assets weighted at 1250%, the solvency ratio decreases. As a result the Basel Committee obtains an unintended consequence: the ratio obtained is not equivalent to the current 50:50 proposal, it is more stringent.

In addition, it is important to see that the impact of the reduction is greater as the current solvency ratio level of the institution is larger. This results in punishing the more capitalized entities:
a) If the previous rate is 15%, capital would be reduced to 12.7%
b) If the previous rate is 20%, would drop to 16%

More examples can be constructed with different combinations and structures that give other results but in all cases the impact is significant.
a) The impact is neutral only if the entity has prior solvency ratio of 8%
b) If the bank was failing and had a solvency ratio below 8%, the new regulation would improve the new ratio. Example: From a previous rate of 6%, the result is:

- Current Regulation: 600/10000 = 6%
- Future regulation: (600 + 400) / 15,000 = 6.7%

Therefore, the weighting of assets at 1250% produces a perverse effect on the solvency ratio. Overall it will render appropriate comparisons in the system more difficult, distort the perception

that the market has of the actual creditworthiness, and might also affect the calculation of capital buffers.

2. **Risk coverage**

c) Credit rating agencies

We would like to specifically comment on the Basel Committee's proposal to revise paragraph 733 (see § 194), as this is particularly relevant to WSBI-ESBG Members.

As a general remark, we support the view that external ratings should be looked at critically. However, we do not agree that this should result in a requirement for banks to develop their own 'shadow rating', as it is not possible for individual banks to conduct their own detailed research for each exposure. In addition, the well-established Credit Rating Agencies possess internal information on issuers which is not always accessible to individual financial institutions for their own research or assessment (such as information on business strategy, auditing reports, Research & Development). Finally, it has to be kept in mind that the criticisms towards Credit Rating Agencies relate mainly to some specific segments (such as securitization). The use of external ratings should therefore not be questioned altogether.

Referring more concretely to the proposals of paragraph 194, WSBI-ESBG wishes to point out that requiring banks applying the Standardised Approach to construct a risk assessment which would be equivalent to an own rating would go against the proportionality principle inherent in Pillar 2 and would cause significant extra work load, for little benefit. In this context, it should be kept in mind that SA banks have already to include own information into the assessment of the adequacy of their capital coverage. This approach provides a safeguard that such banks do not rely exclusively on ratings by third parties.

Against this background, WSBI-ESBG rejects the proposed changes to Paragraph 733, stipulating that the adequacy of rating and risk weight needs to be assessed for *all* claims.

3. Leverage ratio

a) *Introduction*

WSBI-ESBG strongly opposes the introduction of a mandatory leverage ratio, as a supplementary measure to the Basel II risk-based framework with a view to migrating to a Pillar 1 treatment. Furthermore, given the conceptual and structural flaws of the leverage ratio discussed below and the complete uncertainty as regards the conditions of a migration from Pillar 1 to Pillar 2, WSBI-ESBG also dissents with the introduction of a mandatory leverage requirement under Pillar 2. WSBI-ESBG could only support the establishment of a non-binding leverage indicator under Pillar 2, to be used during the supervisory review process, but without any hard figures or automatic regulatory sanctions attached to it. Furthermore, the decision to use a leverage ratio under Pillar 2 as a non-binding indicator should be left to the national competent authorities, who should decide on the appropriateness of such an indicator and on its appropriate use depending on the structure of the banking market they are in charge of.

In the sections below, WSBI-ESBG challenges first of all the conceptual underpinning of the Basel Committee's proposals. First, the proposed rules on introducing a leverage ratio are inappropriate for attaining the two declared objectives of the Basel Committee's proposals, namely limiting the build-up of leverage in the banking sector and reinforcing the risk-based requirements (§ 204). Also, we will highlight its discriminatory impact on different business models. Furthermore, WSBI-ESBG would like to underline structural flaws of the proposed leverage ratio in light of the accounting framework, as well as the foreseen liquidity rules. Last some specific comments on the proposals will be made.

b) *A non-risk based leverage ratio cannot address systemic risk concerns*

The first objective listed in § 204 shows clearly that the Basel Committee's intention is to address systemic risk caused by excessive leverage through the imposition of a "backstop" measure on all banks. Yet, such a one-size-fits-all approach is in WSBI-ESBG's view unreasonable as it simply stigmatises leverage altogether, without identifying and addressing those aspects of leverage that are actually problematic from a systemic risk perspective. Such a broad-brush approach simplifies reality in a way that cannot sensibly address genuine problems related to leverage.

WSBI-ESBG understands that high leverage can result in excessive risk-taking and henceforth the interest of regulators in addressing this issue. However, WSBI-ESBG calls for the Basel Committee to acknowledge the complexity of addressing such difficulties and the importance of identifying those instances where leverage becomes problematic. Such instances are not necessarily linked to the degree of leverage as such (irrespective of how it is measured), but rather and foremost to the quality and riskiness of assets and the hereto-linked maturity mismatches. Ignoring this renders the whole proposals irrelevant for addressing systemic risk concerns and makes them an additional box-ticking measure for supervisors. This is likely to trigger drastic undesired consequences especially for the banks conducting high volume, low-risk business.

Also, if systemic risk concerns are at the heart of regulators' worries, the impact of the leverage ratio should be looked at in a broader macro-economic context. Consequently, pros and cons and possible trade-offs should be considered between the introduction of a leverage ratio and banks' lending capacity, the cost of capital, etc.

c) *Whilst contradicting the Basel II risk-sensitive approach the leverage ratio cannot possibly reinforce risk-based requirements*

The second declared objective behind the Basel Committee's proposals (§ 204) is to reinforce risk-based requirements. It is however inconsistent to pursue such ambition through an additional non-risk based measure in a context where the risk-based requirements are substantially under review in order for them to be strengthened. The introduction of a non-risk based leverage ratio would not only question the very purpose and effectiveness of ongoing prudential reforms, but ultimately appears to override completely risk-based capital requirements. The leverage ratio would indicate the quantitative threshold to which the risk-based capital requirements will have to indirectly adjust. This would be particularly problematic if the limit of the leverage ratio will be set higher than the currently foreseen own fund requirements, as it would then definitely restrain substantially banks' lending capacity.

A leverage ratio could possibly reinforce the risk-based prudential requirements only in as far as it would constitute a reference indicator under Pillar 2 to guide the supervisory review process. Within this process, supervisors could monitor the amount of leverage and its evolution and, in a situation where a bank would exceed the supervisory defined thresholds, the competent authority could initiate a dialogue with the supervised institution and eventually apply relevant sanctions.

d) *The proposed leverage ratio discriminates between business models*

As already critically assessed, the Basel Committee's proposals on the leverage ratio take an unacceptable one-size fits all approach. Banks with different business models have typically different refinancing structures. The amount of regulatory capital usually depends on various factors such as the risk-sensitivity and volume of a bank's business, the various access possibilities to external financing on financial markets. In this context retail banks, whose portfolio mainly consists of well collateralised retail exposures carrying low risks have usually been subject to a more lenient capital treatment as compared to banks that are involved on a large scale in risky investment activities.

Yet, such common sense is not taken into account within the leverage proposals and, paradoxically, the proposed measures appear to punish those banks that are the least risky, especially from a systemic perspective. De facto, the Basel Committee's proposal on the leverage ratio results in penalising strongly those banks whose business model relies on the holding of high amounts of customers' credit on the asset side and of customer deposits on the liabilities side – typical for retail banking. Yet, these banks proved to be amongst the most resilient throughout the crisis, and were the ones who consistently provided credit to the real economy thus preventing an overall credit crunch.

A single leverage figure applied to all institutions irrespective of their business model could not possibly account for the specificities of these institutions, and independently of their risk situation would either privilege or disadvantage certain business models. This actually transforms the leverage ratio into a policy instrument that could determine the structure of the banking market. This is in WSBI-ESBG's view unacceptable. Regulatory requirements have to remain neutral as regards the business model of the regulated entities.

e) The strong reliance of the proposed ratio on the accounting treatment creates important competitive distortions

The Basel Committee has declared the accounting measure of disclosure as the generally preferred measure of exposure, although it recognises that differences in accounting treatments may have a significant impact on the measurement of a leverage ratio at an international level. WSBI-ESBG considers that such major differences actually preclude the international harmonisation of a leverage ratio. The competitive distortions linked to the reliance on different accounting measures is unacceptable and prove the existence of non-negligible flaws in the concept of a leverage ratio. Therefore, WSBI-ESBG strongly calls for the accounting issue to be seriously discussed and not to be minimised, as currently done by the Basel Committee when merely proposing some adjustments on netting to deal with differences.

WSBI-ESBG recalls that differences appear not only between IFRS and US-GAAP, but also between these two and national accounting standards, which are used by a number of small retail banks worldwide. The same business activities would be valued differently according to each of these standards. Whereas the proposed netting adjustments address one of the important causes in accounting differences, there are further accounting differences that influence the amount of own funds and the measure of exposure for balance sheet and off-balance sheet items. Given that the amount of own funds actually constitutes a residual measure following from the valuation of items on the assets and liabilities side, accounting differences cannot be dealt away by providing netting adjustments for derivatives and REPOs.

The only way to address the competitive distortions stemming from accounting differences would be to achieve a far-reaching harmonisation of accounting standards, especially of IFRS and US-GAAP, but also of national accounting frameworks. Such harmonisation will not be achieved in the short run. Yet it is a condition sine-qua-non for ensuring a sufficient degree of comparability and for introducing at international level a leverage measure.

f) Correlation with proposed liquidity requirements

WSBI-ESBG would like to draw attention to the interactions between the proposed leverage ratio and the Basel Committee's proposals for an international liquidity risk framework. Given the narrow definition of "high quality liquid assets" proposed in the liquidity framework, it appears that a large part of the leverage ratio will be already used by simply complying with the new liquidity rules. Therefore, the liquidity buffers necessary for compliance with the requirements on "high quality liquid assets", should not be considered for the purposes of a leverage ratio (even for a leverage indicator under Pillar 2).

g) Specific comments

As explained above, WSBI-ESBG is of the opinion that a leverage ratio could bring value only if used as a non-binding leverage indicator under Pillar 2, during the Supervisory Review Process. With this in mind, we would like to make the following specific comments to some of the concrete proposals by the Basel Committee.

§ 208: Only the total amount of Tier 1 capital should be taken into account as a basis for the capital measure of the leverage ratio, as all of the Tier 1 capital is available as "going concern" capital.

§ 218-19: The Basel Committee proposes to include all assets (together with high quality liquid assets) in the measure of exposure. It considers only as an alternative the possibility of excluding high quality liquid assets, given the interaction of the leverage ratio with the liquidity framework requirements. WSBI-ESBG takes the view that it is indispensable that cash-like, highly liquid assets are excluded from the capital measure and made subject to zero-weighting. High quality liquid assets are - by definition - low-risk, and therefore it does not make sense that they are accounted for within the regulatory limits established for purposes of the leverage ratio.

§ 227: The Basel Committee discusses two distinct approaches without netting for the treatment of derivatives. Derivatives are regularly assessed at their value for balance sheet purposes, as well as for various business-related aspects. The evaluation does not follow the nominal value of the underlying transaction, but the actual value of the derivative. Such value is also the one relevant in case the derivative is closed or realised earlier. For these reasons WSBI-ESBG supports the second option: "(ii) use the current exposure method to measure potential exposure but with no netting".

§ 233: The Basel Committee proposes to include in the measure of exposure also all off-balance sheet (OBS) items at a conversion factor of 100%. This means that all OBS items will be considered along actual credits for the purposes of the leverage ratio. This is not acceptable from a risk-perspective. It would only make sense to use for OBS items the same conversion factors as used for own funds purposes.

4. Procyclicality

a) Introduction

WSBI-ESBG generally agrees that the issue of excessive procyclicality in the financial system needs to be addressed. At the same time it should be kept in mind that cyclicality is inherent to banking activities. As such, the issue of excessive procyclicality has to be addressed by taking into account the specificities of the banking sector and particularly of retail banking activities.

Referring to the Basel Committee's proposed approach, the main concern of WSBI-ESBG is related to the idea of simultaneously handling a unique problem (excessive procyclicality) through various angles: by the introduction of countercyclical capital buffers, by the introduction of forward looking provisioning, by the introduction of a leverage ratio, by emphasizing a "through the cycle" as opposed to a "point in time" approach, by amending accounting standards.

It is in our view necessary to limit the number of ways to address the issue of excessive procyclicality and to introduce only targeted changes, after a carefully conducted impact assessment. It is also of particular importance for the accounting and regulatory communities to work together in order to come to solutions which are appropriate from the two perspectives – notably as regards the definition/treatment of provisions.

Overall, WSBI-ESBG lists four main reasons why the Basel Committee should pay particular attention to the effects of all the proposed changes on banks' capital requirements.

1. First of all, the Basel Committee should ensure that the sum of all the measured will not increase too much the complexity of the framework applicable to banks. We stress that the proposed solutions should not be applied simultaneously as the combined effect of all the envisaged measures are at this stage extremely difficult to foresee (as many of the changes would add up and reinforce each others). The Basel Committee should limit the number of proposals to address excessive procyclicality to one or two proposal(s) maximum after carefully assessing their impact.
2. Additionally, the Basel Committee should also ensure that the sum of all the measures will not result in banks holding excessive capital buffers beyond what is necessary to maintain a resilient banking sector. WSBI-ESBG warms that the devil in the details. Conducting an in-depth calibration exercise is of utmost importance.
3. The specific business model of retail banks has also to be taken into account in order to avoid the risk of a credit crunch. The proposal could excessively increase the cost of funding of banks in normal times, which would incite banks to limit their credit allocation. History has proven that increasing capital requirements encourages banks to develop activities that demand less capital. Overall it is possible that increasing capital requirements will reduce banking intermediation in Europe. Paradoxically, the proposal could ultimately favor an originate-to-distribute model financial system (disintermediation and securitisation) rather than the classical originate-and-hold business model. It is therefore important to take into account the specificities of the different business models of banks and accept that different models requirements may require different level of capital buffers.
4. Finally, WSBI-ESBG highlights that the proposals could hamper retail banks with respect to all other financial companies. In order to avoid competition distortions, the Basel Committee has to follow a more flexible approach, such as, for instance, when it comes to control the latitude banks can have to distribute their earnings.

b) *Forward looking provisioning* (§243-246)

The Basel Committee is promoting more forward looking provisioning based on expected losses, which captures actual losses more transparently and could be less pro-cyclical than the current "incurred loss" provisioning model. The Committee strongly supports the initiative of the IASB to move to an expected loss approach.

As regards the IASB's proposals to address procyclicality through forward looking provisioning, WSBI-ESBG is still in the process of assessing whether an expected cash flow method to provisioning could efficiently solve the procyclicality issue, although any methodology based on the "expected losses of the portfolios over their life" will certainly reduce it to some extent.

However, a number of critical points have already been made by WSBI-ESBG on the concrete effects that the proposals could have. For all the three following reasons that we will develop hereunder, WSBI-ESBG believes that forward looking provisioning is at a too early stage to be considered a possible solution.

1. First of all, while we think that the IASB's Exposure Draft (ED) *"Financial Instruments: Amortised Cost and Impairment"* moves towards the right direction as it is based on "expected losses" and is clearly principles based, it has some drawbacks. The most important of them is its complexity. It would also require significant developments in the systems of banks, presumably making it expensive to implement to attain little benefit. Additionally, given the methodology proposed by the ED, the definition of "amortised cost" could change, resulting in additional uncertainty.
2. In addition, while WSBI-ESBG is in line with most of the BIS six points plan to achieve a sound "expected loss provisioning approach" established in the paper "Guiding Principles for Replacement of IAS 39"[1] (published 27 August 2009) it wonders if the IASB will be able to address all these guidelines. Some of our concerns are best summarized in EFRAG's assessment of the IASB's proposal. EFRAG - which was set up in 2001 to assist the European Commission in the endorsement of IFRS by providing expert advice on the technical quality of IFRS - is cautiously supportive of the proposals from a conceptual perspective (regarding the general objective as well as with the decision not to proceed with the alternative impairment models - such as fair value and through-the-cycle approach) but has some significant concerns on their operational implications[2]. Some of these concerns are:
   - Subjectivity: management judgment is central when calculating expected cash flows, including credit losses, therefore this subjectivity has to be sustained by comprehensible disclosures.

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1 The six points consisted in:

1. addressing the deficiencies of the incurred loss approach without introducing an expansion of fair value accounting,
2. promoting adequate and more forward looking provisioning through early identification and recognition of credit losses in a consistent and robust manner,
3. addressing concerns about pro-cyclicality under the current incurred loss provisioning model,
4. incorporating a broader range of credit information, both quantitative and qualitative,
5. drawing from banks' risk management and capital adequacy systems and
6. being transparent and subject to appropriate internal and external validation by auditors, supervisors and other constituents

[2] http://www.efrag.org/news/detail.asp?id=485

- Uncertainty on the future content of the proposals: the content of the ED is likely to change significantly prior to the issuance of the final standard as a result of input from the Expert Advisory Panel and stakeholders on operational issues.
- Necessity for further guidance: input from the Expert Advisory Panel is urgently needed to avoid a wide range of interpretations which would impair comparability.

3. Thirdly, and as a consequence of our second concern, WSBI-ESBG members would like to avoid that the measures taken on both the accounting and the prudential/regulatory sides overlap. Any lack of coordination between accounting standard setters and prudential supervisors could mean that entities end up with an excess of requirements that are not desirable.

For all these reasons, WSBI-ESBG believes that forward looking provisioning is at a too early stage to be considered a possible solution. A more detailed response will depend chiefly on the outcome of the second-step approach to review IAS 39 which is expected by July 2010.

c) ***Building buffers though capital conservation*** (§247-§259)

From a conceptual perspective, WSBI-ESBG agrees with the proposed framework whose main idea consists in linking capital requirements with economic cycles. Capital buffers should cancel out the propensity banks have, when facing an economic crisis, to decrease their exposures and fire-sell their assets in order to maintain an adequate capital ratio. Increasing capital buffers in normal times and drawing them down during low economic cycles should consolidate capital requirements and make credit supply to main-street economy less cyclical. It should also diminish the incentive banks have to increase leverage in periods of economic growth. Given that the financial crisis has demonstrated the excesses in credit developments in the past, it is necessary to identify a new and sustainable equilibrium regarding prudential capital requirements.

However, WSBI-ESBG has also some concerns with the proposed framework. These additional buffers not only aim at protecting banks from bankruptcy but also at aligning the behavior of the whole banking industry with the concerns of supervisory and prudential authorities. Our contribution will therefore focus on the efficiency of the BIS proposal. Additionally, and as the Basel Committee acknowledges, calibration, which is foreseen only by the end of 2010, will be a key aspect of the proposals. Against the background of these two issues, we have four main concerns:

1. Can capital buffers offer an adequate protection against systemic risks (i.e. protecting financial stability)?

Systemic financial crisis are rare and capital is costly. The introduction of capital buffers will impose significant capital constraints on an every day basis for banks. An inappropriate level of regulatory requirements (via either too low or too high capital buffers) might prove to be either inefficient or excessively expensive.

We recall the recent experience in the latest crisis when market expectations (and also regulators' demands at that time) forbid banks to reduce their capital base. On the contrary, they had to boost it immediately. Based on this experience, we wonder if the fact that capital markets generally expect higher capital requirements in time of crisis renders the BIS approach on capital buffers ineffective. We conclude that conducting an in-depth calibration exercise is of utmost importance as the right balance has to be found between the cost of capital and protecting financial stability.

2. Can they play a role in maintaining credit supply in case of a downturn of the economy?

Concerning the issue of credit availability, WSBI-ESBG is concerned that the Basel proposal might trigger some negative effects and even lead to a credit crunch if the business model of retail banks is not taken into account.

The proposal imposes economic constraints on the intermediation business model during normal periods in order to offset the risk of insolvency in the whole banking industry in periods of stress. One of our concerns is that in case of inadequate calibration the growth of the demand for credit could exceed the speed at which banks can rebuild their capital buffers. Time inconsistency could then be a major problem. Secondly, we consider that regulatory capital tends to overestimate economic capital when it comes to retail activity. Numerous empirical experiences show that the internal rating parameters used in assessing the risk of retail portfolios (and especially when taking into account the correlation between different assets) leads to lower economic capital than the regulatory requirements of Basel II.

A particular concern relates to the availability of funding to SMEs. The crisis clearly made banks more risk adverse. Credit rates have a natural tendency to increase in periods of stress. We highlight that the Basel Committee should take into account the business model of retail banks so as to avoid the risk of a credit crunch. Any extension of the difference between regulatory capital and economic capital could heighten the credit limitations that SMEs face when it comes to their short-term and treasury issues. Indeed, while credit allocation to SMEs is individually risky, diversification, along with an in-depth client relationship mitigate it to a great extent. This is the reason why retail banks' economic capital, when measured with internal models, is generally inferior to the capital measured by regulatory formulas. It is therefore essential to calibrate the proposed measures by taking into account the specificities of the business model of retail banks. Too high capital buffers will affect the lending activity and dramatically increase the prices of the loans.

3. Is there a risk to introduce competitive distortions with other financial institutions or other competitive continents?

While we generally challenge the capacity of buffers to reduce procyclicality and improve the stress resilience of banks, the introduction of capital buffers on top of a minimum capital requirement and the corresponding reduction of dividend payments could from our point of view hamper the competitiveness of retail banks with all other financial companies.

Banks should be granted sufficient latitude to distribute their earnings in order to attract investors and avoid facing competition distortions. Therefore, we have serious concerns with additional regulatory rules which restrict paying dividends to shareholders and investors. This proposal, on top of a higher minimum capital requirement, would limit the attractiveness of banking shares vis-à-vis other industries. Likewise, capital buffers will intensify the pressure on banks because they have to attract investors to raise capital to comply with the increased capital requirements. Regulators should bear in mind that banks have to compete not only among the group of financial institutions but with all participants on the global capital markets in respect to raising fresh capital.

This worldwide competition to raise capital is also a reason why shares with preferential distributions rights should still be considered as equity and part of Predominant Core Tier 1. Features that differentiate common shares from regular voting common shares are needed to compensate investors for missing voting rights or for convincing new investors to recapitalize a bank during stressed situations. There is no difference in quality between common shares and

preference shares when it comes to absorb losses (preference shares are subordinated to all debt instruments). On the contrary, preference shares will be needed, first of all, to maintain the competitiveness of banks vis-à-vis other financial institutions and, more importantly, to ensure that banks will be able to raise the necessary amount of capital when they will all face a systemic crisis.

Finally, there is the general concern that the proposal might trigger competitive distortion as Basel III might not have the same impact in different continents. Some banks might appear artificially highly capitalized while in reality a significant part of the risk lies in an unregulated sector of financial system.

4. Could capital buffers be redundant with the business model of retail banks?

The business model of retail banks consists in building capital buffers. Countercyclical buffers could ultimately appear redundant with such business model in case of inadequate calibration.

The retail banking activity requires holding a sound capital base to perform a lending activity. Retail banking therefore imposes naturally high capital buffers. This is indeed necessary as retail banks have to cover the internal risk correlation between illiquid portfolios for which there is little possibility to hedge the risks though either capital markets, securitisation or insurance coverage. It is therefore possible that countercyclical buffers ultimately appear redundant with the business model of retail banks if they do not take into account the specificity of their business models. This would appear counter productive as retail banks' business models have proven to be extremely resilient during the crisis.

Against this background, WSBI-ESBG stresses that it is of utmost importance to take into account the specificities of the different business models of banks and accept that different models requirements require different capital buffers. The calibration and impact assessment should at least make the difference between the different systemic risks that retail banks entail when compared to investment banks. It should not be forgotten that retail banks are liquidity providers to the economy and that they are not at the origin of the financial crisis.

Adopting an inadequate calibration would per se penalize retail banks and by extension an important part of the world economy. It would achieve the contrary to what is intended: it would not automatically address the insolvency issue while penalizing part of the industry which did not cause the financial crisis.

d) *Excessive credit growth* (§260-§262)

The idea of protecting the banking sector from excess credit growth is in itself interesting. However, WSBI-ESBG urges the Basel Committee to be very cautious. When assessing the BIS very preliminary views, WSBI-ESBG wonders if it is possible or even desirable to measure the dynamic of macro-level risks across banking sector activities. It is unlikely that any authority could know or have the right tools to assess the right level of growth for the - or some part of the financial sector. This raises numerous questions as the banking industry is a risk taking business by definition and as cyclicality is inherent to its activities. Therefore we wonder:

- What will be the signs of excessive credit growth? Which macro-economic tools are going to be used?
- What about the competitiveness of EU countries and companies against Asia or US?

For these reasons WSBI-ESBG is skeptical on this proposal and suggests that the Basel Committee does not implement a rules-based regime. Should this approach be given further, then the Basel Committee should rather opt for general guidelines leaving sufficient room to national authorities.

About WSBI-ESBG (World Savings Banks Institute – European Savings Banks Group)

WSBI-ESBG – The Global Voice of Savings and Retail Banking

WSBI (World Savings Banks Institute) is one of the largest international banking associations and the only global representative of savings and retail banking. Founded in 1924, it represents savings and retail banks and associations thereof in 90 countries of the world (Asia-Pacific, the Americas, Africa and Europe – via ESBG, the European Savings Banks Group). It works closely with international financial institutions and donor agencies and promotes access to financial services worldwide – be it in developing or developed regions. At the start of 2009, assets of member banks amounted to more than €9,000 billion, with operations through more than 180,000 branches and outlets.

ESBG (European Savings Banks Group) is an international banking association that represents one of the largest European retail banking networks, comprising about one third of the retail banking market in Europe, with total assets of more than € 6,000 billion (1 January 2009). It represents the interests of its members vis-à-vis the EU Institutions and generates, facilitates and manages high quality cross-border banking projects.

WSBI and ESBG members are typically savings and retail banks or associations thereof. They are often organised in decentralised networks and offer their services throughout their region. WSBI and ESBG member banks have reinvested responsibly in their region for many decades and are a distinct benchmark for corporate social responsibility activities throughout Europe and the world.

WSBI-ESBG – Association internationale sans but lucratif/Internationale vereniging zonder winstoogmerk/International not-for-profit association

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