Desjardins

Member of the International Co-operative Banking Association

Member of the International Confederation of Popular Banks

**Monique F. Leroux,** FCA, FCMA
Chair of the Board, President and CEO
Desjardins Group

Lévis, April 16th 2010

**Re: Consultative proposals to strengthen the resilience of the banking sector announced by the Basel Committee (issued for comments by April 16th, 2010)**

Dear Members of the Basel Committee on Banking Supervision ("the Committee"),

Desjardins Group (6th largest cooperative financial group worldwide) welcomes the opportunity to comment on the consultative proposals issued for comments by April 16th, 2010 ("the Document") and supports the efforts made by the Committee to strengthen the resilience of the financial sector.

Desjardins Group is an associate member of European Association of Co-operative Banks ("EACB"). In this quality, we are comfortable with and supportive of EACB's comments on the Document. We wish to submit additional comments and observations.

We generally agree with the principles and objectives of the proposed reform and do believe that complying with the spirit of the Document will benefit the global financial sector. We feel, however, that some adjustments should be made to the proposed guidelines prior to issuance in order to meet the Committee's objectives.

The attached document outlines our concerns and presents our insight on issues we consider of highest importance. In order not to dilute our message, we focused our comments on measures that are, in our view, overly restrictive, discriminating or impractical to implement.

In particular, we feel it is necessary to highlight that the Document appears to be written with joint stock company capital considerations in mind. It does not address the specific nature of financial cooperatives capital instruments. The legal constraints and constitution of cooperatives limit the ability of such instruments to fully meet the proposed eligibility criteria for inclusion in the predominant form of Tier 1 capital. In the absence of further guidance on how the proposals would apply to cooperatives, we believe that cooperatives would be placed at a competitive disadvantage.

Lévis (Head Office)
100 Des Commandeurs Street
6th Floor West
Lévis (Québec) G6V 7N5 Canada
418-835-2404
1-866-835-8444 ext. 2404
Fax: 418-833-4769

Montréal
1 Complexe Desjardins
South Tower, 40th Floor
P.O. Box 7, Desjardins Station
Montréal (Québec) H5B 1B2 Canada
514-281-7039
1-866-866-7000 ext. 7039
Fax: 514-282-9539

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A major component of Desjardins' capital base is comprised of "permanent shares" which fully meet the spirit of the Committee's proposals and, in our opinion, should be considered as capital of the highest quality. However, if applied as written, the proposed guidelines would exclude these shares from the predominant form of tier 1 Capital. Desjardins proposes to introduce flexibility in interpretation of the guidelines for cooperatives so that these instruments are legitimately recognized.

Moreover, we are concerned that the ultimate implementation of the final proposals could hinder economic recovery and possibly restrict credit access. Given the significant impact the proposals are expected to have on capital ratios and the fact that many institutions will consequently need to raise substantial capital, we strongly propose that a gradual implementation approach be developed, including certain grandfathering and phase-in mechanisms, as appropriate, in order to facilitate transition for the global financial sector.

We trust the Committee will find our comments useful in developing the final proposals.
Yours truly,

Monique Leroux, FCA, FCMA
Chair of the Board, President and Chief Executive Officer
Desjardins Group

cc.
Jean St-Gelais
President
Autorité des marchés financiers

# Section 1 – Introduction and key elements of the proposal

## 1.1. Introduction

In December 2009, the Basel Committee on Banking Supervision ("Committee") released two consultative papers, *"Strengthening the resilience of the banking sector"* which presents an enhanced capital framework and *"International framework for liquidity risk measurement, standards and monitoring"* which introduces a new liquidity standard.

These papers are the second part of the Committee's response to the financial crisis, following the July 2009 Basel II framework revisions that modified the approach for trading book and securitization exposures. A Quantitative Impact Study (QIS) is being undertaken in the first half of 2010 across both sets of guidance to review the impact of the proposals and calibrate the framework revisions.

## 1.2. Key elements of the proposal

Given the events of the past two years, the two papers represent the Committee's attempt to leverage the lessons learned during the financial crisis to strengthen global capital and liquidity regulation in an effort to create a more resilient banking sector. The Committee's goal is to improve the sector's ability to absorb shocks from financial and economic stress in order to mitigate the risk of spillover effects from the financial sector to the real economy. In order to achieve these objectives, the Committee is making the following five main recommendations which represent significant changes for many financial institutions:

1. Raising the quality, consistency and transparency of the capital base.
2. Strengthening the risk coverage of the capital framework.
3. Introducing a leverage ratio as a supplementary measure to the Basel II risk-based framework.
4. Introducing a series of measures to promote the build-up of capital buffers in good times that can be drawn upon in periods of stress.
5. Introducing a global minimum liquidity standard for internationally active banks that includes a 30-day liquidity coverage ratio requirement underpinned by a longer-term structural liquidity ratio.

Desjardins generally agrees with the principles and objectives of the proposed reform and believes that complying with the spirit of the Document will benefit the global financial sector. We feel, however, that some adjustments should be made to the proposed guidelines prior to issuance in order to meet the Committee's objectives.

Sections 2 and 3 outline our concerns and present our insight on issues we consider of highest importance. In order not to dilute our message, we focused our comments on measures that are, in our view, overly restrictive, discriminating or impractical to implement.

## Section 2 : Desjardins' specific proposals to the Committee

### 2.1. Instruments recognized as Predominant form of Tier 1 capital

We find that the existing text is more tailored to traditional banking institutions (joint stock companies), as evidenced by the fact that only a few paragraphs and footnotes refer to cooperative institutions (non joint stock companies). While the Committee focuses primarily on internationally active banks, many supervisors will apply the rules to all of the financial institutions they supervise. The text of proposals, therefore, must apply equitably to all financial institutions covered. Given the key role played by financial cooperatives in the economy, it would seem necessary and appropriate to us that the proposals be modified in order to fully acknowledge the specificities of this type of institution. In particular, the specific nature of their capital instruments must be recognized.

We propose, therefore, to delete the last sentence of paragraph 74:

> *« These entry criteria will also be used to identify instruments of equivalent quality which non joint stock companies, such as mutuals and cooperatives, can include in the predominant form of Tier 1 capital. »*

We also propose to delete footnote 19 (paragraph 87) and to bring its content into a new paragraph immediately after paragraph 74:

> *Credit institutions also take the form of non joint stock companies, such as mutuals, cooperatives and savings institutions. Such institutions play a vital role in the financial system and in many countries. However, due to legal constraints and their constitution, they are not able to issue common shares. Where non-joint stock companies' capital instrument is of the highest capital quality, it should be recognized as the predominant form of Tier 1 capital. Specific constitution and legal structure of mutuals, cooperative and similar institutions should be taken into account when applying the criteria set out in paragraph 87. The application of the criteria should preserve the quality of the instruments by requiring that they are deemed fully equivalent to common shares in terms of their capital quality as regards loss absorption and do not possess features which could cause the condition of the institution to be weakened as a going concern during periods of market stress. Supervisors will exchange information on how they apply the criteria to non joint stock companies in order to ensure consistent implementation across jurisdictions.*

In an effort to recognize the specificities of capital instruments issued by cooperatives, Desjardins also proposes to add the following footnotes to criteria 2, 3, 5 and 8 of Paragraph 87. These footnotes will guide supervisors in their assessment of the quality of non joint stock company capital instruments.

Proposed footnotes (*in italic*):

Criterion 2 - Access to residual assets

> *For non joint stock companies, distribution of net assets in case of liquidation sometimes gives the holder a right to receive only the nominal amount paid for the share as a maximum refund.*

*Such a cap relating to the amount paid in liquidation should be acceptable if it is applicable to all instruments considered as the predominant form of Tier 1, so that is does not create privileges.*

Rationale : cooperative shares entitle their owners to a claim of the residual assets that is proportional with their percentage of detention of issued capital, after all senior claims have been repaid in liquidation. Given the constitution and legal structure of cooperatives, the amount they are entitled to receive is variable, but capped to the notional amount of the shares. If any residual assets remain after claims have been fully paid up to the notional amount, those assets often become the property of a government, public sector or non-profit entity.

Criterion 3 - Redemption clauses

*For non joint stock companies, redemption clauses when resulting from a provision under national law are acceptable if the institution and the competent supervisory authorities have a unilateral right to refuse, notably for prudential reasons.*

Rationale : in a number of limited cases unrelated to economic conditions, members may be permitted by law to tender their shares for redemption. This redemption feature is however subject to discretionary review by the institution and its supervisor, both of which may at all times refuse the member's request without having to justify. In light of theses safeguards, this kind of redemption mechanism ought not to be viewed as impairing capital permanency. Please note that, during the recent economic crisis, there was no noticeable increase in redemption requests from members.

Criterion 5 - Cap on distributions

*For non joint stock companies, a cap on distribution is acceptable when resulting from a provision under national law and when it is applicable to all instruments considered as the predominant form of Tier 1, so that is does not create privileges.*

Rationale : cooperative institutions are subject to an array of legal requirements designed to provide member protection, such as a mandatory cap on distributions. This requirement provides benefits in that the resulting surpluses will directly increase reserves and strengthen the cooperative's capital base. These reserves cannot be subsequently distributed and are inalienable. This cap mechanism enhances the solvency of cooperative institutions and, accordingly, should in no circumstances prevent the full recognition of cooperative shares as the predominant form of Tier 1 capital.

Criterion 8 - Loss absorption

*For non joint stock companies, depending on the national law, the share holder may have limited access to the reserves since, in case of redemption or liquidation, the share holder receives only the nominal value of the shares. Such shares, if they have embedded loss absorbency characteristics, should be acceptable as the predominant form of Tier 1.*

Rationale : the fact that the share holder has limited access to the reserves does not necessarily mean that such share holder does not share the first losses. In practice, the reserves will first absorb the losses and, if losses exceed the available reserves, the shares will then take proportionally the additional losses.

### 2.2. Deduction of Insurance entities investments

Desjardins would like to emphasize the importance of the potential impacts on the economy of this proposal. We believe that raising the capital requirement to conduct insurance activities could destabilize the business, notably for profitability and risk adjusted return reasons.

The 100% deduction of equity invested in insurances entities is, in Desjardins' view, unjustified and overly punitive. Furthermore, this proposal appears to be inconsistent with the concept of going concern capital.

Firstly, deducting the full amount assumes a perfect correlation between banking assets and insurance assets in situations of market turmoil (going concern), which has not been observed in the recent financial crisis.

Secondly, it appears very unlikely to us that the going concern values of insurance entities would fall to zero. We believe that interests in insurance entities could be divested even in times of market stress and that potential buyers would find an interest in acquiring those assets. Such divestiture activities have been observed on a few occasions during the last crisis.

Desjardins therefore proposes to keep the already severe provision set forth in the *International Convergence of Capital Measurement and Capital Standards: A Revised Framework* issued in June 2006 (i.e. deduction at 50% from Tier 1 and 50% from Tier 2).

### 2.3. Deduction of Deferred tax assets

Desjardins understands the reasoning behind this proposal but believes that it is overly conservative to assume that none of the deferred tax assets would be realized as a going concern.

In addition, this proposal appears to be pro-cyclical as it will reduce the capital base of institutions as they realize losses (which should normally give rise to deferred tax assets).

In order to limit the negative impacts of the proposal, Desjardins proposes that a cap be set to the amount of deferred tax assets allowed to be recognized as predominant form of Tier 1 capital. This cap should be expressed as a percentage of predominant form of Tier 1 capital (e.g. 15%). We believe that this solution would be more effective than a deduction mechanism.

### 2.4. Deduction of Minority interests

Desjardins understands the reasoning behind this proposal but believes there is at least a requirement to consider that such minority interests partially support the risk (and absorb losses) of the corresponding entities.

Desjardins therefore proposes that, if minority interests are fully deducted from Tier 1 capital, there should also be a proportionate deduction (at the consolidated group level) of the corresponding entities' Risk Weighted Assets. This reasoning provides consistency between capital and risk treatment.

### 2.5. Leverage ratio

Desjardins agrees that a ratio constraining excessive leverage build-up and protecting from model risk could be beneficial to the financial sector.

The proposal, however, is overly complicated and conservative by not allowing the netting of derivatives and considering total commitments (off-balance sheet items) instead of a measure closer to Exposure at Default.

Desjardins would support a more simple leverage measure like the one currently used in Canada ("Autorité des marchés financiers" / "Office of the Superintendent of Financial Institutions" requirement) which addresses the above mentioned concerns.

In any case, the retained metric should be harmonized across all jurisdictions and accounting regimes to ensure comparability and an even playing field.

### 2.6. Pro-cyclicality

Desjardins agrees that it is necessary to implement measures to address pro-cyclicality issues. However, we question the approach proposed by the Committee.

Firstly, we do not understand the rationale for addressing pro-cyclicality outside of Pillar II. Basel II guidelines issued to date have generally position concepts such stress-testing and Internal Capital Adequacy Assessment Process (ICAAP) to address such issues. Desjardins, like many other financial institutions around the world, made significant investments in Pillar II efforts over the last few years. Transferring the solution from Pillar II to Pillar I would, in our view, undermine key objectives of Pillar II.

Secondly, every institution has a very specific risk profile that should be well understood in order to assess how much capital should be put aside in good times to support the institution in stressed markets. We believe this can be achieved only through close and continuous dialogue between an institution and its supervisor.

Desjardins therefore proposes that any pro-cyclical buffer estimation should be part of Pillar II (stress testing / ICAAP) processes and that national supervisors should pursue one-to-one discussion with every institution.

Should the Committee decide to address pro-cyclicality issues within Pillar I, it would be of paramount importance that modifications to Pillar I factor in the asset mix and risk profile specific to each institution.

### 2.7. Risk-weights of 1250%

Desjardins understands that the goal of a 1250% risk-weight is to capitalize 100% of the exposure at default of the corresponding assets. This is effectively the case if an institution presents a total capital ratio of exactly 8%. For well capitalized institutions, this 1250% risk-weight is very punitive as an amount superior to the Exposure at Default of the assets would need to be kept in capital in order to maintain the current capital ratio level.

To avoid such discrimination against well capitalized institutions, Desjardins proposes that an institution should be given the choice of (1) applying the regulatory risk-weight, or (2) deducting 100% of the asset (Exposure at Default) from the predominant form of Tier 1 capital.

### 2.8. Liquidity – High quality assets definition

Desjardins believes that the high quality assets definition is too narrow and could potentially have a negative impact on the liquid assets markets. We therefore propose that the Committee allows for some flexibility (at the national supervisors' discretion) to recognize the high liquidity value of some assets currently excluded from the proposed guidelines.

In particular, we believe that mortgages insured by a strong central government should be assigned a higher liquidity value in the proposed liquidity standards, especially when an established public securitization program exists and is available in the normal course of business. In Canada for instance, mortgages insured by the Government of Canada through the Canada Mortgage and Housing Corporation (CMHC) often represent a large portion of Canadian financial institutions' balance sheets and are considered low risk assets that can easily be sold or securitized.

We also believe that high quality debt from financial institutions (e.g. senior debt or equivalent) should be recognized as a source of asset liquidity to an extent at least equal to corporate bonds. Not recognizing such instruments as liquid assets will create an incentive for financial institutions to hold more corporate bonds, which bear a higher credit risk.

The failure to recognize the true liquidity profile of such assets may be discriminating for institutions in some jurisdictions (e.g. Canada) when compared to other countries where the market structure may be different.

## Section 3: Transition and grandfathering

While we did not comment on all of the Committee proposals, we believe that the combined substance of these proposals will be cumbersome to implement by the financial sector as a whole.

Irrespective of which proposals are retained following the consultation process, we are concerned that their immediate and direct implementation would result in large scale capital requirements or lead to credit contraction, which could be detrimental to the economy as a whole.

Given that economic conditions remain weak, transitional provisions should be carefully assessed and chosen to prevent the economy from falling back into recession.

It is therefore critical, in our view, that the new rules be implemented over several years and that grandfathering provisions apply to those proposals having the most significant impact. These grandfathering provisions should, for example, exempt all instruments issued prior to the finalization date of the final rules (expected in late 2010) in order to provide institutions with sufficient time to conform to the new capital requirements.

## Section 4 - About Desjardins

Desjardins Group is the largest cooperative financial group in Canada and the sixth largest in the world, with overall assets of CAD 157 billion. It comprises a network of financial service cooperatives – caisses and credit unions, and some twenty subsidiary companies in life and general insurance, securities brokerage, venture capital and asset management.

Because of our cooperative nature, we work for the economic and social well-being of our 5.8 million members, and not just for the enrichment of a select few investors. Because of our cooperative nature, we protect the interests of our members and clients by offering them profitable and secure financial products and services and always prioritize sustainable development. Furthermore, for 40 years now, we have been providing technical support and investment services in developing countries through our subsidiary, Développement international Desjardins (DID).

**Mission:** To contribute to improving the economic and social well-being of people and communities within the compatible limits of its field of activity by:

- continually developing an integrated cooperative network of secure and profitable financial services, owned and administered by the members, as well as a network of complementary financial organizations with competitive returns, controlled by the members;
- educating people, particularly members, officers and employees, about democracy, economics, solidarity, and individual and collective responsibility.

**Fundamental cooperative values:** Self-help, self-responsibility and responsibility for others; democracy; equality equity and solidarity. Cooperative members respect ethical values of honesty, openness, social responsibility and caring for others.

**Desjardins Group values:** Money serving human development, personal commitment, democracy in action, integrity and discipline in the cooperative enterprise, and community involvement.

**Desjardins Group figures**

*Information as at December 31, 2009*

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| ***Total assets*** | *CAD 157.2 billion* |
| ***Number of member caisses*** | *481* |
| ***Number of service centres*** | *903* |
| ***Membership*** | *5,806,001* |
| ***Number of elected officers*** | *6,258* |
| ***Number of employees*** | *42,273* |
| ***Number of automated teller machines*** | *2,728* |
| ***Surplus earnings after taxes and before member dividends*** | *CAD 1,077 million* |
| ***Returns to the community (sponsorships, donations and bursaries)*** | *CAD 72.3 million* |
| ***Tier 1 and Total Capital Ratio*** | *15.86%* |