Executive summary

AFME has analysed and formally commented on both the Basel Committee’s December 2009 Package on capital and liquidity reforms and the European Commission’s consultation on CRD 4, which considers how the Basel proposals could be applied in Europe. The reform, while broadly welcome, presents a number of risks concerning timing of implementation, particularly in relation to the studies being undertaken into the likely impact of the proposed reforms, the sequencing of their implementation and the need for supervisory convergence. AFME has identified a number of issues vital to ensuring that these risks are addressed and the objectives of the reforms – ensuring that banks to hold increased capital and funding resources – are achieved.

Overview

At the instigation of the G20, in December 2009 the Basel Committee published a package of reforms (BCBS 164: Strengthening of the resilience of the banking system and BCBS 165: International framework for liquidity risk measurement, standards and monitoring. In parallel the Commission issued its own consultation (Possible further changes to the capital requirements, otherwise known as CRD 4). In broad terms, the proposals aim to:

- improve the quality, consistency and transparency of the bank capital base;
- strengthen the risk coverage of the framework with new standards for counterparty credit risk exposures arising from derivatives, repos and securities;
- introduce a leverage ratio to contain the build up of excessive leverage in the banking system and provide an extra layer of protection against model risk and measurement error;
- improve measures to address procyclicality; and,
- introduce two minimum liquidity risk standards – 30-day liquidity coverage ratio (LCR) and a 1-year Net Stable Funding Ratio (NSFR) – along with a set of common monitoring metrics and application standards to allow supervisors to analyse liquidity risk trends at a bank and system wide level.

The Basel Committee also highlighted systemically important financial firms (‘SIFI’) and discussed Central Counterparties (CCPs). We are expecting detailed proposals on possible additional measures for SIFIs from the Committee in 2010; the Committee is also working with the Committee on Payment and Settlement Systems (CPSS) and International Organisation of Securities Commissions (IOSCO) to update current CPSS/IOSCO recommendations on CCPs.

The Commission’s proposals (CRD 4) bring to the forefront issues that are specific to the EU, such as the introduction of liquidity waivers for firms with EU
parents and the role the proposed European Banking Authority (EBA) may play in the implementation of the reforms.

The G20 has set a challenging timeline for these reforms. The standards are to be developed by the end of 2010 (for the G20 meeting in November 2010). The G20 has stated that the rules ‘will be phased in as financial conditions improve and economic recovery is assured, with the aim of implementation by end-2012.’

The Basel December Package and CRD4 were preceded by the Basel July 2009 Package / CRD 3 (and part of CRD 2), which introduced changes to the trading book (introducing high capital requirements to capture the credit risk of complex trading strategies) and strengthened the capital treatment for certain securitisations. These Basel reforms were published as Revisions to the Basel II market risk framework – final version and Enhancement to the Basel II framework. CRD 3 is currently under consideration by the European Parliament (as is part of CRD 2 which is to be implemented by member states by 1 January 2011).

Central to the development of all these reforms are the results of the Comprehensive quantitative impact studies (QIS) being undertaken concurrently by the Committee and European Commission. These studies are being used to:

- evaluate the impact of the Basel December (and CRD 4) proposals and changes already in progress on firms; and,
- determine the calibration of the proposals, i.e., the magnitude of the various factors / weights to be used and the overall level of capital and funding requirements that will result.

The results will be presented to the Basel Committee in July 2010 and may be published in Q4. There are also some private studies underway to evaluate the impact of the proposals.

The implications of the Committee’s capital proposals are likely to be very significant for the banking industry and the economy. Our concerns with capital proposals lie in: the detail of their design; or where we believe there is significant overlap with other proposals (already in place or which the Committee and Commission are seeking to introduce); or where the distinction between the accounting and regulatory frameworks might be confused.

A key characteristic of the recent financial crisis was the inaccurate and ineffective management of liquidity risk, so we welcome the introduction of an international standard that promotes stronger liquidity buffers and strengthens the structure of funding. However, we are concerned that in their current form the proposals will result in a complicated set of calculations that overstate the liquidity risks being managed by firms.

**Risks of the Package**

A chief risk of this package of reforms is the imposition of capital and liquidity requirements that will result in lower lending volumes at a higher cost at a time
when economic recovery is still fragile. This is both a question of scale of the charges, the timing of their introduction and transitional arrangements.

*Calibration and impact:*
We are concerned that the QIS cannot comprehensively address the effect of the proposed changes on: the real economy; the capacity of the banks to provide financial services; and the price of those services. Broader analysis being undertaken by the Financial Stability Board in conjunction with the Basel Committee is vital to understanding the potential impact of these capital and liquidity reforms, in the context of the wider financial reform, on the services banks will be able to provide as well as the commercial impact this will have on the wider economy.

Given the threat to economic recovery these reforms potentially pose, for the Committee or the Commission to move on the basis on the consultations issued in December and February straight to final rules agreed at the end of 2010 would be very risky. **Stakeholders must be given the opportunity to review the proposals in light of QIS results and any advances in design in order to avoid any unintended consequences.**

*Timing and sequencing:*
The success of these reforms will not only depend on phasing in their implementation over a timeframe beyond the currently proposed end 2012 but also on the sequencing of their introduction.

As acknowledged by both the Basel Committee and Commission some aspects of the proposals, such as measures to constrain credit growth or those additional measures directed at SIFIs, are at a very early stage of design and require further consideration. Other elements, while more fully populated, such as the Net Stable Funding Ratio and leverage ratio are very new, require substantial road-testing and further discussion before they can be finalised.

Furthermore elements of the proposals, *e.g.*, leverage ratio, potentially overlap with other areas of the package, so an overall view on impact is needed.

The announcement of final proposals, combined with a short implementation date, will cause many firms to attempt to access the capital markets at the same time. This is unrealistic.

*Convergence of supervisory approach:*
Although all the G20 states have committed to implementing the Basel Accord fully, the Accord is not legally binding. The CRD, on the other hand, is. This creates a risk of inconsistent implementation, causing regulatory and competitive distortions. It also brings challenges to international firms who may have to operate to inconsistent prudential requirements.

The key areas of the December 2009/CRD 4 package that AFME has identified that are of particular concern because of their potential impact are: deductions from capital; the proposed leverage ratio; the proposed credit valuation
adjustment (CVA); the definition and use of the liquidity buffer; and disclosure of liquidity standards and metrics.

**AFME’s position**

With the risks the package presents, the issues we have identified need to be addressed to ensure that the changes to the global capital framework and the introduction of a new liquidity framework yields a more resilient banking sector without stifling recovery. These issues are set out in a related document, *AFME’s Summary Position on the Basel Committee’s December 2009 Package and CRD4, June 2010*.

As regards the priority issues identified AFME is seeking:

- a reconsideration of both the tier of capital that deductions are made and the mechanism used;
- a reconsideration of the methodology for the leverage ratio and its placement in Pillar 2 rather than Pillar 1 as even a fixed ratio will be a blunt tool;
- a different approach to the computation of CVA risk that recognises hedging practices;
- a wider definition of the stock of high quality assets (liquidity buffer) and use of the liquidity buffer in times of stress; and
- no public disclosure of the proposed liquidity standards or monitoring metrics

The majority of our concerns are common to the Basel Committee’s proposal and EU Commission’s consultative document. The remainder are EU-specific.

**Further information**

The consultation period on both the Basel Committee’s December 2009 and the EU Commission’s February 2010 proposals have now closed. Both consultations attracted a wide audience and a considerable response

- Joint industry response position paper to the Committee's December 2009 Package
- Joint industry response position paper to the Commission’s February 2010 proposal
- Public responses to the Committee's December Package
- Public responses to the Commission’s February consultation paper
- BCBS consultation information page
- EU consultation page
AFME’s Summary Position on the Basel Committee’s December 2009 Package and CRD4, June 2010

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