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**Joint trade associations' response to the Basel Committee on Banking Supervision
Consultative proposals to strengthen global capital and liquidity regulations, BCBS
164 and 165 issued on 17 December 2009**

Dear Governor Wellink

The Global Financial Markets Association ("GFMA"), the British Bankers' Association ("BBA") and the International Swaps and Derivatives Association ("ISDA") are pleased to respond to the Consultations BCBS 164 *Strengthening the resilience of the banking sector* and BCBS 165 *International framework for liquidity risk measurement, standards and monitoring*.

Introduction

Our members share the Basel Committee's goal of enhancing the regulatory framework, in the context of rebuilding a strong global economy, and commend it on the significant progress that it has made to date. A robust regulatory framework that supports market confidence is as important to industry practitioners as it is to the regulatory community. We believe the Basel Committee has correctly identified a number of key areas for improvement, in line with the regulatory mandate agreed by the G20 Leaders in September 2009. The Pittsburgh Declaration rightly focused on the need for action and set challenging deadlines both for development of revised standards to improve the quality and quantity of bank capital

and to discourage excessive leverage (by the end of 2010) and for their implementation (phased by the end of 2012). These goals were set against a backdrop of ensuring economic recovery and delivering balanced and sustainable global growth. We agree that it is important for the Basel Committee to deliver against these commitments.

In addition, the range and extent of these proposals, combined with the significant changes already implemented, or in train, have potentially far reaching consequences for the real economy. In this context, it is important to reflect on the significant progress made to date, by both regulators and industry, to improve institutional resilience, risk management practice and market discipline. These improvements, while not addressing all the issues arising from the crisis, have already made a fundamental difference to market practice. Before finalisation of these proposals, their consequences must be fully understood. A holistic approach needs to be taken, so this assessment should take account of the broader initiatives to reform the financial system. It should also take into consideration the lessons learned in respect of supervisory approaches, as well as fiscal and monetary policies, which along with issues arising in banks, all contributed to the crisis.

We therefore recommend that, in meeting the G20 commitment, the focus should be on agreeing the structure of the framework by the end of this year and that the detail and calibration should be finalised over a longer time horizon. To this end we urge the Basel Committee to engage in a further round of consultation with the industry, following the QIS and the assessment of broader economic impacts. This review is essential to ensure that unintended consequences are identified and addressed; the goals for economic recovery and growth are met and that banks are allowed to continue to facilitate maturity transformation, support international trade, support risk management services and to provide funding and working capital to meet the continuing needs of consumers and corporates. In this regard, we strongly believe that there is need for refinement and, in some areas, significant amendment of the details of the Basel Committee's proposals if the goals are to be achieved. As part of this iterative process there should be a clear articulation of the detailed objectives that underpin the high level G20 objective of enhancing standards. The consultation recognises the need for phased implementation, which we support. However, given the potential impacts and our views on the need for refinement and amendment, we think that, for some elements, the implementation timetable should extend beyond 2012.

Overarching key issues

Calibration and impact assessment

We are strongly supportive of the Basel Committee's approach to determining the calibration of the proposals through the Quantitative Impact Study (QIS) currently underway, which takes account of these proposals and also other changes in train. Review should also build on experience of the crisis, where the loss attribution exercise will be important in ensuring that the proposals are focused on the areas that need attention, and are implemented in a proportionate manner. However, these studies do not, and cannot, address the effect on the real economy of the changes proposed and the commercial impact they will have on the capacity of the banks to provide financial services and on the price of those services. Therefore the broader analysis that is being undertaken by the Financial Stability Board in conjunction with the Basel Committee, is vital to understand the potential impacts of the range of proposals, both prudential and those addressing wider financial reform, on the services that the banks will be able to provide and the commercial impact this will have on the wider economy. We cannot emphasise too strongly that premature imposition of significantly higher capital and liquidity requirements on banks will result in lower lending volumes at a higher cost to customers, both individual and corporate, with a resultant impact on economic recovery and expectations for growth.

It is still too early for our members to be able to make recommendations on the calibration. However, initial indications have revealed that the consequences of the proposals could be

very significant. For example, the capital required to support the counterparty credit risk proposals for credit valuation adjustments alone may be a significant multiple of the total current trading book capital requirement. As a result we think that it is inappropriate to move from this consultation, and associated impact study, straight to final rules. As members will only submit their QIS data this month, we may wish to provide additional comments in light of the results. These proposals are likely to shape the financial landscape for years to come and, in our view, it is more important to get the proposal right than to finalise all the details by the end of 2010. We therefore recommend that the Basel Committee agree the structure of the proposals by the end of the year, but finalise the detail and calibration over a longer timeframe. We are keen to continue our engagement with the Basel Committee on the finalisation of the calibration and the further consultation that we think should be undertaken.

As this process evolves and the impacts become clearer we think that it is important that the Basel Committee and other key authorities articulate:

- their vision for the regulatory destination;
- the target, in terms of overall capital and liquidity in the system, of the revised framework;
- their view of what financial stability should mean; in that context we also look forward to discussing the framework for balanced and sustainable growth.

It is in the interests of governments, citizens, customers and banks that there is clarity and consistency on the reform agenda and that it is implemented, at the right time and in the right way, in the major economies around the world.

Timing and sequencing

We recognise the political imperative regarding implementation by the end of 2012. However, we think that careful consideration needs to be given to the timing and sequencing of introduction. For some elements, we think that a longer timeframe than 2012 should be agreed to ensure that economic activity is supported. The QIS and broader economic analysis should inform not only the most appropriate timetable, but also sequencing of the changes and any necessary grandfathering measures. In our view the potential consequences clearly support the need to avoid hasty changes.

Additionally, as the Basel Committee acknowledges, some elements of the package, such as systemically important firms and measures to address procyclicality, are at an early stage of design and require considerable thought. Other areas, where the proposals are more detailed, such as the Net Stable Funding Ratio and the leverage ratio, are very new, and require substantial 'road-testing' and discussion before they can be finalised. Further, some aspects of the proposals are inter-dependent with other parts of the package, such as the leverage ratio, and the Basel Committee will therefore need to bear in mind the sequencing of the underlying components. It is also important to recognise that the announcement of final proposals, combined with a short implementation date, will cause many banks to attempt to access the markets at the same time.

In summary, given the need to enhance financial stability, promote economic growth, iterate the design through consultation and impact assessment and to sequence the introduction of these measures appropriately, it is important in our view, to consider a longer time horizon for some elements. Additionally a phased implementation timetable is essential.

Consistent implementation

Many of our members operate globally and therefore strongly support a fully harmonised prudential capital and liquidity regime. This is essential in terms of reducing risk in the financial system globally, whilst also reducing the burden on banks of regulatory compliance; indeed divergence may lead to increased risks in the system. Harmonisation also contributes to streamlining supervisory processes, facilitating a common understanding amongst members of supervisory colleges.

Further, harmonisation of implementation should also create a level playing field across markets, thereby supporting market confidence. Local and regional regulators should be discouraged from gold-plating, or diverging, from internationally agreed measures

We therefore think that the new regulatory regime should be implemented by all members of the Basel Committee, in the same way and at the same time according to a common transition timetable. A lack of convergence on timing will result in competitive and regulatory distortions, which could undermine financial stability and market confidence.

However we acknowledge that the Basel Accord is not legally binding, but would note that the Pittsburgh Declaration also indicated that all major G20 financial centres commit to adopting the Basel II framework by 2011. From this commitment, we expect supervisors to fully implement all three pillars of the Accord, which should include ensuring that they have the necessary tools. This is particularly important for the convergence of Pillar 2 processes and for the effective functioning of supervisory colleges. Our internationally active members are particularly keen to continue to play their part in ensuring that colleges of supervisors deliver a coherent and harmonised approach to supervision, based on a robust Pillar 2 process which is informed by a comprehensive understanding of their activities and based on a common reporting framework applied at the group level.

In some areas of the response we have recommended that a Pillar 2 approach be adopted, either initially, or on an ongoing basis, and we think that the implementation of the commitment to adopt Basel II will facilitate these recommendations. We suggest that the Standards Implementation Group would be an appropriate forum for the review of implementation by Basel Committee members.

Key issues - BCBS 164 and 165

We would also like to bring the Basel Committee's attention to a number of particularly significant issues identified by Members. These issues, and other more detailed comments, are covered our individual responses to BCBS 164 and 165, which are attached as annexes to this letter. The significant issues are ordered in line with their location in the consultation rather than importance.

BCBS 164

Capital and deductions

There are two issues:

Grandfathering: It is essential that there is grandfathering of existing capital instruments and that its scope is articulated quickly. The results of the QIS must be used to determine the calibration and sequencing of the increased capital requirements, particularly in view of the current position in the economic cycle and other measures that are being proposed, along with an appreciation of what can realistically be achieved by banks in the capital markets.

Deductions: The Basel Committee's proposals introduce procyclical effects, for example by deducting deferred tax assets, Expected Loss (EL) provisions and pension scheme deficits from Core Tier 1. We would instead argue that the tier of capital from which deductions are made, as well as the mechanism for doing so, should be reconsidered, based on an understanding of the way in which they could exacerbate the economic cycle, reducing the overall benefits of the reforms.

Counterparty credit risk

Our members believe that the Basel Committee has unduly focused on changes to a counterparty risk capital framework. The proposals in this area are significant and we have a number of concerns we wish to raise regarding the methodologies proposed and the disproportionate impact thereof.

We understand the motivation for the Basel Committee to focus on the credit valuation adjustment (CVA) as an area requiring reform. The credit valuation adjustment (CVA) charge, among the many overlapping counterparty risk measures, raises the most questions, and we note the following key points. The charge:

- a) appears to be highly disproportionate, requiring multiples of extra capital for counterparty risk;
- b) is, via the 'bond equivalent', risk-insensitive and fails to recognise hedging practice;
- c) does not reflect the current variety in the impact on banks' financial statements, under diverse accounting regimes;
- d) could, in principle, reflect the modelling of CVA together with other trading book risks; or be based on Probability of Default (PD)/ Loss Given Default (LGD).

Our response on CVA is built on the premise that (demonstrably prudent) hedging of counterparty risk should lead to a lower capital charge. This should include some recognition of hedging of the systematic component of credit spread risk. The proposal should address any potential inconsistencies between the existing treatment of 'maturity' in the Basel IRB framework and the ultra-conservative treatment of maturity within the bond equivalent treatment. We have suggested two different approaches to the CVA calculation and look forward to working with the Basel Committee on developing them further.

Leverage Ratio

We acknowledge that the level of leverage was a factor in the crisis, as it may have amplified the downward pressure on prices. We therefore agree that it is an appropriate area for regulatory review and support the introduction of some form of leverage ratio as a supplementary measure, provided it is properly calibrated and designed to include fundamental risk management techniques. However, we have some serious concerns over its potential design, particularly around its ability to address differing business models. We would highlight that the role of market makers in risk intermediation (whereby risk is taken on in client servicing transactions and hedged with other counterparties) is not specifically considered by the proposals and is severely penalised because hedging is ignored/disallowed. Interrelated to this issue is our concern that it does not support good management practice more generally by not recognising other forms of credit risk mitigation. As we perceive the leverage ratio to be a going concern measure, we think that total Tier 1 should be the capital input and see no reason to restrict it to Core Tier 1.

Although some of the issues we identify could potentially be addressed by calibration, there remain fundamental concerns with respect to the methodology. While calibration and design must be addressed, we believe the leverage ratio will need to form part of the Pillar 2 framework. We recognise the political dimension of the debate on the leverage ratio, but Pillar 2 not only allows sufficient flexibility to assess a firm's leverage in the context of its business model, structure, governance and risk management, but also provides a forum for robust dialogue between bank and its supervisor to address the methodological and calibration issues that will be specific to banks' business models. In addition, to facilitate this process, we think that the introduction of a leverage ratio range, rather than a single number, should go part way to addressing the issue. Furthermore we would note the improvements that are being made to the regulatory architecture and the existence of the college of supervisors for certain large international banks, which have undoubtedly facilitated the

handling of the financial crisis, and the enhancement of the college process should be further pursued. We think that the Standards Implementation Group could be an appropriate forum for ensuring that convergent practices are adopted.

Procyclicality

The consultation addresses procyclicality with a number of overlapping proposals, the impacts of which need to be understood. Where possible we believe that existing regulatory tools should be used to avoid unnecessary regulatory duplication or double counting. In our view Pillar 2 already gives supervisors extensive tools to address the issues identified, such as preventing dividend distribution and requiring firms to maintain capital buffers to reflect their risks. Indeed, over the past year there have been several occasions where supervisors have constrained the distributions of capital. We therefore believe that the tools to conserve capital already exist within Pillar 2.

We believe that consistent application of Pillar 2 should be a focus of the Basel Committee through its Standards Implementation Group. We support the Basel Committee's proposal to update the guidance on sound provisioning practices rather than introduce proposals for 'dynamic provisioning'.

Where jurisdictions already operate equivalent measures to those proposed, and which are proven techniques, we would urge the Committee to align its proposals with existing supervisory practice, rather than introduce new duplicative or inconsistent requirements which we would not support. This is of particular concern as regards the preliminary capital buffers proposal.

BCBS 165

Calibration of the liquidity proposals and supervisory factors

We are very concerned by the calibration of the Liquidity Coverage Ratio (LCR) and Net Stable Funding ratio (NSFR). This concern derives from two inter-related sources:

- the severity of the assumptions underpinning the factors - e.g. a three-notch downgrade in the institution's public credit rating;
- the use of standardised factors applied to broad asset and liability classes.

This means that firm specific factors (such as business model) and/or changes in a bank's behaviour made over the ratio horizons can not be taken into account.

On an individual firm basis, the proposed ratios will likely result in a complicated set of calculations that overstate the liquidity risk. It is important to bear in mind the aggregate impact on the industry of this conservatism in terms of the objective being set for liquidity risk management and achievability given the availability of funding in the market.

In summary, if the calibration of the LCR and particularly the NSFR are not substantially altered then they will result in a large reduction in the availability of finance to individuals and corporates and will have an early and sustained adverse impact on the wider economy.

Net Stable Funding Ratio

We support the Basel Committee's objective of encouraging more medium and long term funding. However, we have serious concerns that, in its proposed form, the NSFR will distort markets and impede economic growth. We have a number of concerns over its calibration,

complexity and the lack of risk sensitivity which produces perverse risk incentives. As a result we believe further consideration should be given to its design. We appreciate the need for a measure that addresses the structure of funding, and suggest that the Basel Committee's develop an appropriately calibrated and sophisticated risk sensitive measure that could better reflect firm specific factors.

In short, we recommend an approach that recognises that the NSFR is only one measure among many that needs to be used by supervisors in the evaluation of a firm's liquidity profile. Thus the NSFR (and indeed the LCR) should be used by supervisors along side firm's internal measures in the evaluation of liquidity. This will allow some comparability between firms while encouraging the continued development of firms' internal metrics and models and providing supervisors with a more complete picture of firms' liquidity position and processes.

Conclusion

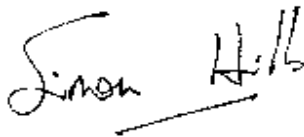
We are supportive of the initiatives that the G20 Member States are taking to reform regulation and strengthen the stability of the financial system. More capital and liquidity are only part of the solution, which should also include a combination of the identification of systemic/macro-prudential risks and strengthened supervision of individual banks. In our view the Basel Committee's primary aim should be to agree the structure of the framework by the end of 2010. Building on the results of the QIS, the details should be finalised over a longer time horizon, based on a holistic assessment of the broader economic impacts, in order to determine the most appropriate timing and sequencing of their harmonised introduction.

If you have any comments or questions regarding this response please contact either, Diane Hilleard (diane.hilleard@afme.eu on behalf of GFMA), Simon Hills, (simon.hills@bba.org.uk), and Richard Metcalfe (rmetcalfe@isda.org) should you require further information.

Yours sincerely,



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Enc: Responses to BCBS 164 & 165

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GFMA joins together the common interests of hundreds of financial institutions across the globe. GFMA's mission is to develop policies and strategies for global policy issues in the financial markets, thereby promoting coordinated advocacy efforts across its partner associations. GFMA is a partnership of the Association for Financial Markets in Europe (AFME), the Asia Securities and Financial Markets Association (ASIFMA), and, in the United States, the Securities Industry and Financial Markets Association (SIFMA).

The BBA is the leading association for the UK banking and financial services sector, speaking for over 200 banking members from 60 countries on the full range of UK or international banking issues and engaging with 35 associated professional firms. Collectively providing the full range of services, our member banks make up the world's largest international banking centre, operating some 150 million accounts and contributing £40 billion annually to the UK economy.

ISDA represents participants in the privately negotiated derivatives industry, and has over 810 member institutions from 57 countries on six continents. These members include most of the world's major institutions that deal in privately negotiated derivatives, as well as many of the businesses, governmental entities and other end users that rely on over-the-counter derivatives to manage efficiently the financial market risks inherent in their core economic activities.

Annex 1: Capital: BCBS 164 Strengthening the resilience of the banking sector.

The Global Financial Markets Association (“GFMA”), the British Bankers’ Association (“BBA”) and the International Swaps and Derivatives Association (“ISDA”) are pleased to respond to the consultation BCBS 164 Strengthening the resilience of the banking sector.

Annex 1 provides a detailed response to the five Committee proposals outlined in the consultation BCBS 164 Strengthening the resilience of the banking sector. Our response should be read in conjunction with the points raised in our covering letter dated 16 April 2010 and Annex 2.

The order of topics in Annex 1 follows the order of proposals as set out in the Basel consultation.

Section 1 Raising the quality, consistency and transparency of the capital base

Section 2 Enhancing risk coverage

Section 3 Supplementing the risk-based capital requirement with a leverage ratio

Section 4 Reducing procyclicality and promoting countercyclical buffers

Section 5 Addressing systemic risk and interconnectedness

1 Raising the quality, consistency and transparency of the capital base

We welcome the proposed approach to the redefinition of bank capital and support the reduction and simplification of its categorisation as well as the removal of the current complex limits structure. We strongly support such harmonisation.

Whilst describing the features of going and gone concern capital – the two future categories of capital – the paper does not explicitly describe the relative purposes of these two types of capital. The Committee's current reformulation of capital provides a good opportunity for it to communicate and debate with a wider audience the different types of risk – for instance unexpected, expected, unrealised and deferred losses faced by the banking community and how capital can be properly held against them.

We believe that *going concern* capital enables a firm to continue trading even during a period of financial stress or where it has suffered severe losses or no longer has the confidence of the market or its creditors. Of course it is difficult to identify the point at which a firm loses the confidence of the market/its creditors. In this respect we believe that the relevant test in times of severe stress should be the lead supervisor's view of the solvency situation of the bank, established and discussed bilaterally based on heightened dialogue with the firm. The outcome of such discussions will be a key determinant of the actions the firm takes to implement its recovery plan and restore its *going concern* capital position to above its regulatory minima, using where necessary the features of Tier 1 and Additional Going Concern Capital.

We view the purpose of *gone concern* capital as being to absorb losses in liquidation, in order to minimise calls on the deposit guarantee scheme, which is funded by the banking industry generally and minimise losses to senior unsecured creditors and depositors not covered by the deposit guarantee scheme.

We observe however that an array of different regulatory initiatives is currently under consideration, many of which are proposed in this Consultation, and all of which have the objective of reducing the probability of an individual bank's failure. The proper application of an appropriate range of these other measures, combined with more robust going concern capital should help to maintain the solvency of the firm. As such there is no need to over-engineer Tier 2 capital over and above what is necessary to protect depositors and other creditors in liquidation by for instance requiring coupon deferral mechanisms or lock-ins. Tier 2 capital should not be seen as providing going concern support in any way, shape or form. Making it more equity-like will reduce the range of investors able to invest in it, unhelpfully reducing banks' diversification of funding sources.

1.1 Key messages

We wish to make the following comments in relation to the capital and deductions section of the consultation paper:

1.1.1 Going concern capital – what is predominant?

We agree that the predominant form of going concern capital should be common shares and retained earnings. However the extent of 'predominant' has yet to be defined – the commonly accepted view is that it should be no more than 50% plus one share although we are aware that regulators may be targeting a much higher number. The ongoing QIS exercise will be used to calibrate 'predominant' and in arriving at a decision we encourage regulators to be cognisant of the current composition of bank capital and investor appetite to supply additional

amounts of going concern capital in the future. For instance we note that innovative capital currently comprises about 25% of all Tier 1 capital and it is proposed that this should be phased out over an indeterminate period. Replacing 25% of the banking industry's capital base will not be possible overnight and we expect regulators to take this into account as they calibrate their proposals and plan the transition to the new regulatory capital regime.

1.1.2 Tax deductibility doesn't matter

In paragraph 76 the Committee is considering the treatment of instruments with tax deductible coupons in Additional Going Concern Capital. In contrast, we are of the opinion that capital recognition should be independent of tax treatment. So long as all of the relevant criteria in relation to loss-absorbency, permanence are met, there is no justification in imposing additional restrictions about tax treatment in relation to capital recognition. Doing so would create an unlevel playing field while providing no additional capital support.

Furthermore, harmonisation of the global taxation rules for capital instruments will be virtually impossible – and any forced regulation through the Committee's proposals will result in an unfair advantage for some issuers over others. There should also be no restrictions imposed on the structure of on-loan instruments as we do not believe these affect capital quality. This view has also been reflected in the recent European CRD 4 proposals which make clear that tax should not be a factor when assessing the quality of hybrid instruments.

1.1.3 Hybrids with innovative features remain useful instruments for regulatory capital purposes

We note the Committee's view that innovative features have eroded the quality of Tier 1 capital and should be phased out. It is not clear which innovative features it has determined to be objectionable – it has particularly identified step-ups meaning that the scope of the possible prohibition is unclear. But we do not consider hybrids pose a threat, particularly when coupled with a regulatory lock-in. Alternatively, they provide our members with the opportunity to structure a range of different instruments to appeal to different components of the investor base promoting funding diversification.

1.1.4 Grandfathering of instruments prior to the consultation paper's release does matter

It is essential that the results of the QIS are used to examine the impact on banks of the limitation on the use existing capital instruments and to work with industry to come up with appropriate grandfathering arrangements and phase-in periods. Not to do so would require banks to raise additional Core Tier 1 capital (or more likely reduce risk weighted assets) at a time when the world's economies have not returned to full health and the investor appetite for bank capital remains muted. This creates the risk of further damage to banks, their customers and the financial system.

Whilst investors now have an appetite to buy new capital instruments and banks want to issue them the Committee's lack of clarity about grandfathering of instruments issued prior to the finalisation of the rules at the end of 2010 means that very little issuance has actually taken place. More clarity on the Committee's proposed approach with respect to grandfathering of instruments before the end of the year would be every welcome including a clear signal as to the effect date from when grandfathering will commence. We are of the opinion that this date should not be earlier than the date on which the proposals are implemented.

1.1.5 Deductions

It is not necessary in our view that all of the regulatory adjustments applied to regulatory capital should be made from Core Tier 1 capital. A number of the deductions considered in the consultation paper do have value on a going concern basis but arguably less so on a gone concern basis. So we believe the Committee should re-consider the tier of capital from which deductions are made.

1.2 Detailed proposal

In addition to these key messages we have the following comments to make on the consultation paper's detailed proposals:

1.2.1 Common equity component

We generally agree with the proposed classification criteria governing the common equity component of Tier 1 capital and itemised under paragraph 87. Our comments on specific criterion are as follows:

5. We note the requirement to pay distributions from distributable items. However the legal definition of distributable reserves varies from jurisdiction to jurisdiction and there may be a need to harmonise these, or alternatively provide discretion in relation to the application of this criterion to ensure it is globally workable.

7. At present, partly as a result of government support for the banking industry some banks have different classes of common equity which have differential dividend rights. These should be accommodated in criterion 7.

10. We suggest the deletion of criterion 10, which links the definition of equity to accounting approaches, which are not yet harmonised. Furthermore future changes to accounting treatments could induce swings in capital ratios which did not reflect a change in a bank's robustness.

14. We suggest that the disclosure requirement be explicitly stated in terms of Pillar 3. This would avoid any suggestion that the disclosure has to happen physically on the face of the bank's balance sheet.

Additional going concern capital

In principal we support the introduction of minimum criteria for Additional going concern capital (AGCC). In reference to the proposed set of criteria identified under paragraph 89 we offer the following comments:

4. Rather than requiring an instrument to be perpetual we believe that there is room for including dated instruments with a lock-in in additional going concern capital. The lock-in would ensure that capital does not disappear just at the time when it is needed but the extra flexibility dated instruments bring would enable finer management of bank capital. We would propose a minimum maturity of 30 years. Furthermore we do

not believe that modest incentives to redeem should be prohibited. Doing so will unhelpfully narrow the investor base for bank capital instruments and regulators can be re-assured that the requirements in criterion 5 will enable them to veto redemption where they deem it necessary. These features could be accommodated by making redemption, as well as the exercise of a call option, subject to prior regulatory approval by amendment of criterion 5.

5. We suggest that points c i) and ii) be moved to the beginning of this criterion – the more natural place we believe for this clause which sets the fundamental premise that a call may not be exercised option but then goes on to establish circumstances under which a call option can be exercised.

We suggest that clause c i) be amended to remove the rather vague reference to ensuring that the conditions upon which it is issued are sustainable given the income capacity of the bank.

We suggest that c ii) be amended to remove again the imprecise ‘well above’ from the wording replacing it with:

‘The bank demonstrates that it will continue to meet its minimum capital requirements.’

So the two clauses of 5 c could be merged to read:

A bank must not exercise a call or redeem an instrument unless they replace it with capital of the same or better quality and it demonstrates that its capital position remains well above the minimum capital requirements.

An exemption (cross-referenced to the deductions proposals, where we are seeking a similar exemption) should be included to allow banks to buy and sell their own additional going concern capital as part of their market making activities.

7. a) We presume that dividend pushers will still be permitted as they are necessary to preserve the relative rankings of AGCC capital instruments with Core Tier 1 and would appreciate the Committee’s confirmation of this
 - d) Use of traditional ACSM mechanisms for the settlement of deferred coupon payments through either i) the issuance of new equity or Core Tier 1 instruments to holders or ii) paying holders the cash proceeds raised by the sale of shares into the market, does not reduce the net capital position of the issuer but are needed to maintain the relative positions of hybrid holders vis-à-vis holders of common equity. As such we see no reason why these mechanisms should be restricted and are concerned that this particular sentence could have that effect we recommend it be clarified.
8. A wide interpretation of dividends/coupons should be taken in order to accommodate partnership allocations/profits.
 9. We support the prohibition of features that require a dividend/coupon to be reset upon a change in the issuing bank’s credit standing. We note however that some structures include fixed/floating or floating/fixed resets which we would not view as being credit sensitive and would appreciate the Committee’s confirmation that this is its view too.

11. This criterion refers to instruments classified as liabilities, whilst remaining silent on whether the accounting or legal definitions of liabilities should be used. In the absence of a harmonised definition approach we suggest that the reference should be to the instruments' classification under national insolvency law as we believe that the Committee's key objective is to ensure that AGCC holders should not be able to petition for the insolvency of the issuer. This interpretation is supported by the CRD 4 consultation paper (see Annex VI criteria 10 and 11). If our interpretation is correct, we believe criterion 10 could be combined with criterion 11 in such a way that would imply that only those AGCC must have principal loss absorption which are: (i) treated as liability for national insolvency law purposes AND (ii) contribute to any tests for the purposes of determination whether institution is insolvent under the national insolvency law.

In addition, for instruments that would be subject to a principal write-down requirement following the above analysis, the national regulator should be allowed additional discretion to permit exceptions to this requirement where such a requirement would otherwise have an adverse impact with respect to the instruments' treatment under national tax and accounting rules. Not having such discretion would put issuers in such jurisdictions at a competitive disadvantage to other issuers in jurisdictions where principal write-downs are either supported by national tax and accounting rules, or not required

a. criterion a) is silent as to whether the write down should be permanent or temporary. We strongly believe it should be temporary and capable of being written back up upon liquidation. A permanent write down would mean that the AGCC was subordinate to Common equity and that holders could not share in the recovery of the bank or any liquidation proceeds. Without this it is unlikely that there will be any significant investor appetite for such instruments.

12. We agree that if a bank directly funds a customer's purchase of the bank's own capital that capital should not be recognised by the bank. Our concern with this criterion is that the normal provision of financing by the bank to its customer, perhaps through collateralised lending secured over a portfolio of instruments, including some AGCC capital issued by the bank, could be caught by this prohibition which we do not believe is the intention – the bank's intention in providing the finance should be taken into account.

14. We suggest moving the last part of this criterion to follow 'immediately available' such that it would read:

... immediately available *in a form which meets these AGCC criteria*, without limitation.....

Our point here is that the up streaming of the capital need not be in identical form to the instrument issued by the SPV but should, nonetheless, meet the AGCC requirements. So where capital instruments are issued indirectly through an SPV they may be included as part of capital where an on-lending agreement for the transference of the capital to the parent company complies with the conditions for qualification as AGCC.

Additional requirements

- We suggest adding the clarification that the instruments being referred to are AGCC instruments

- The proposed deduction should be on a like-for-like basis

Gone concern - Tier 2 capital

Our only significant concerns with the criteria for inclusion in Tier 2 capital relate to the straight-line amortisation of Tier capital in the final 5 years. This could in itself be viewed as an incentive to redeem as the regulatory capital credit diminishes. We believe the cost of amortisation could be mitigated by the introduction of a lock-in feature which provides issuers with full capital benefit for the term of the instrument but also provides regulatory discretion to prevent the capital instrument from being redeemed under a period of stress. For the capital instrument to be marketable to investors the trigger for 'lock-in' should be transparent and reflective of the 'gone concern' nature of the capital security. The amortisation treatment or 'lock-in' feature for Tier 2 instruments should be used independently i.e. not simultaneously and issuers should have the flexibility to structure Tier 2 securities with either feature when assessing their capital raising opportunities.

Our only other concerns mirror the comments above in relation to AGCC, which are that the ordering of subsections in criterion 5 should be reversed and that a market making exemption should be included in criterion 8.

Transparency

We support greater transparency and expect to deliver this through annual Pillar 3 mechanism and agree that disclosure of the parameters and features of capital proposed in paragraph 80 are appropriate.

We assume that disclosure of the term and conditions of a transaction as usually detailed in a public prospectus would satisfy the Committee's disclosure requirements.

We note that separate disclosure of all regulatory adjustments is required, but request that this be limited to material adjustments only to avoid lengthy and unnecessary disclosure.

We note that paragraph 81 requires 'full' disclosure of all regulatory capital instruments, including, we presume, privately placed structures. This raises concerns about whether public disclosure of private placements on the bank's website could constitute a public offer which would lead to enforcement action.

Grandfathering and transitional provisions

We understand and support the authorities desire to move to the new capital framework in a measured way that permits grandfathering of existing instruments. The QIS process now being undertaken will inform the authorities and banks of the optimum parameters of grandfathering and transitional provisions. Adjusting our capital ratios will take some while and we trust that the authorities will recognise this, taking into account the possible negative impact on the wider economy that early imposition of higher, tighter ratios could cause.

Additional Committee work – contingent capital

We look forward to being able to comment on the Committee's additional work on contingent capital, convertible instruments and instruments with write down features. Our members are keenly assessing the benefits of structures, but have not reached a conclusion. There is certainly a concern that contingent capital instruments, which will effectively require a bank to

hold a buffer over and above the trigger point, could hasten a bank's demise as that buffer is eaten into and holders of such instruments seek to sell their holdings in the market.

Lock-ins for Tier 2 instruments

Lock-ins for Tier 2 instruments are not appropriate. Tier 2 capital is designed to support depositors and other creditors on the event of insolvency. As long as the bank is not insolvent at the point at which the Tier 2 instrument matures, redemption should be permitted. To introduce lock-ins would make Tier 2 capital more loss absorbing on a going concern basis and therefore more equity like, which would reduce its attraction to its current investor base that are invariably not permitted by their investment criteria to invest in such instruments.

1.2.2 Regulatory adjustments applied to regulatory capital

We support the Committee's proposals aimed at harmonising the treatment of certain items from capital but are unsure whether it has thought sufficiently about the potential impact of these deductions and the level at which they should be made. For example the Committee's proposals include deductions made from the Common Equity Tier 1 level regardless of whether these deductions appear on the asset or liability side of the balance sheet or whether cyclical or structural in nature. Each of these elements gives rise to different considerations in terms of how and when they should be financed.

A number of the planned capital deductions (e.g. AFS adjustments, Deferred Tax positions and Pension Fund positions) are, by their nature, volatile with changing economic conditions. In good times they are likely to be broadly capital positive and in bad times capital negative. By proposing their deduction from the Core Tier 1 requirement, procyclicality is being introduced into the Core capital requirement, which is at odds with stated intention of the proposed changes in seeking to eliminate pro-cyclicality from the capital requirements framework.

We believe that the natural volatility of such items during business-as-usual means that they would be more appropriately dealt with by "gone concern" capital, which would be available to absorb the relevant loss when a liquidation actually crystallised, without permanently weighing down the banks performance simply to deal with an effect that will ebb and flow naturally during performance or economic cycles.

1.2.3 Stock Surplus

Stock surpluses, once created, can be used by the bank in an unfettered way, regardless of the Tier of capital giving rise to the premium. The Committee's proposal that a surplus should only be included in Core Tier 1 to the extent that it was generated by Core Tier 1 capital is wrong and reviewed.

1.2.4 Minority Interests

We do not think the proposed approach, removing the eligibility of minorities for inclusion in the common equity component of Tier 1 is appropriate.

Third-party investment in a subsidiary provides loss absorbing capital to that subsidiary and would be recognised as such on a solo basis or by the local regulator: the proposed treatment does not recognise this on consolidation. If such a deduction from capital is made then the risk weighted assets should also be reduced by the proportion of the subsidiary owned by minorities on a consolidated view.

Not to do so would interrupt the gradualist business model that our members use as they plan to increase their exposure to a particular economy, by first working with a local partner

with the necessary local knowledge before possibly buying that partner out if the venture succeeds.

Similarly in some countries national law prevents the ownership of a local bank by an overseas firm, meaning that a joint venture with a local partner is a prerequisite to doing business there. Such business arrangements should not be penalised.

We therefore recommend only deducting excess minority capital above the local regulatory capital required to support local RWAs from the group core Tier 1 but adding it back to total Tier 1.

1.2.5 Unrealised gains/losses on instruments

We support the Committee's objective of eliminating inconsistencies across jurisdictions in the treatment of these items and agree with the Committee's proposal to free up common equity to be fully available to absorb banks' losses as they become realised. In our view, movements in unrealised gains and losses on instruments should be adjusted through Tier 1/Tier 2 capital rather than specifically through common equity and therefore establishing that only at the point the loss is recognised is there a hit to equity.

Furthermore, we recommend that the Committee clarifies its proposal to specifically refer to unrealised gains/losses on AFS reserves.

1.2.6 Goodwill and other intangibles

We agree with the proposed approach in relation to goodwill but believe that there are other types of intangible assets that can be a source of value, for instance software and mortgage servicing rights, and which thus should be excluded from the deduction requirement.

1.2.7 Deferred Tax assets

We agree with the Committee's assertion that firms should not place undue reliance of deferred tax assets (DTAs) for prudential purposes and welcome its recognition that where a DTA relates only to a temporary timing difference on different types of assets such exposures should be risk weighted according to the relevant sovereign weighting. We note that such DTA will typically be balanced by similar timing differences which create an offsetting deferred tax liability (DTL). Concerns about a firm's capital adequacy would not affect the DTA and DTL relating to such timing differences.

However we do not support the proposal that DTAs which arise from Tax Loss Carry Forwards because a bank has incurred a loss of financial reporting/accounting purposes but not for tax purposes should be deducted from Core Tier 1 capital. Deduction from going concern capital cannot be justified when auditors will only agree to their inclusion in the expectation that the bank will remain a going concern so a harmonised approach which permits their inclusion in capital should be permitted as DTAs:

- Are verified by the bank's auditors
- Have value even in insolvency as companies containing DTAs be sold on to third parties for whom such assets would be beneficial
- Barring their inclusion for capital purposes will also be procyclical as firms would be deducting the assets when they were not profitable – at just the time when additional capital is likely to be needed.
- The approach may also discourage banks to make provision for tax timing differences which would not be prudent.

- We therefore suggest that DTAs (adjusted where necessary for minority interest holdings) be permitted up to a threshold percentage of core Tier 1 capital or failing that deducted in their entirety from Tier 2 capital.

1.2.8 Investments in own shares (treasury stock)

Long positions – hedging deferred compensation scheme exposures

Other than for market making purposes banks do not typically hold positions in their own common shares. The main instance in which they do relates to long holdings of common stock acquired to hedge the deferred compensation schemes which regulators are requiring banks to use to a much greater extent than in the past. We therefore believe that long holdings of shares should be netted off against such long term liabilities.

Netting of gross long positions against shorts only if no counterparty risk

We note that the Committee is planning to prevent the netting of long and short positions unless there is no counterparty risk. This runs against existing industry practice and would discourage good risk management practices.

We acknowledge that this proposal may be seeking to avoid wrong-way risk but consider these risks are already dealt with adequately in other areas of the proposed amendments - added conservatism should not be introduced as is proposed in this element of BCBS 164.

Index securities

We do not agree that when a firm has an exposure to an index containing its own shares it should look through to the underlying components of that index in order to deduct them. It is unlikely that the proportion of a bank's own shares in the index will be significant.

The exposure a holding of an index security creates is to the issuer of the indexed securities, not to the underlyings, so is more in the nature of a counterparty risk which is captured by other elements of the Basel framework. When the indexed security is traded on an exchange this risk disappears. The component of an index security that comprises the firm's own common shares should therefore not be deducted from the bank's capital.

Market making exemption

Many of our members make markets in a range of different securities, usually including their own shares, which beneficially promotes market liquidity facilitating the price discovery process that is essential to a thriving market economy. At certain times too they may decide to undertake share buy-backs.

Such market making and buy-back activities should be exempt from the deduction from capital requirement below a certain threshold. We suggest that the CEBS guidelines, which are being implemented in Europe, are used as a model for this exemption. These permit instruments to be held for market making or market smoothing purposes provided that they do not account for more than 10% of the relevant issue or 3% of a firm's total capital. We further suggest that holdings in excess of these levels should be subject to a class by class by deduction rather than entirely from Core Tier 1.

1.2.9 Investments in capital of financial entities outside the scope of regulatory consolidation.

We are unclear of the intentions behind this element of the consultation paper which is likely to affect some firms more than others and are not risk based. Our view of this proposed amendment is that it is designed to achieve a macro-prudential goal – discouraging cross-shareholdings between financial institutions – and that mechanisms are currently being developed to avoid double counting of capital in the banking sector – for instance through the

Financial Conglomerates Directive in the EU. So the use of a micro-prudential tool – deduction of such shareholdings from capital - is not appropriate.

Investments in insurance companies

Insurance companies are already under a regulatory regime that requires them to hold sufficient capital to protect the interests of policy holders. They can also be a source of value in stressed conditions

Deducting the full amount of any investment in an insurance business from the Core Tier 1 capital of a bank is too extreme and implies that the insurance business would have no value in a stressed situation. This is not the case and indeed such investments may have counter-cyclical value to the extent that the risks to which they are exposed are not highly correlated with the risk types to which banks take on.

We therefore reject the proposal that investments in insurance companies should be subject to a deduction and call upon the Committee to recognise the Joint Forum's work on conglomerate regulation and include it in the proposed capital regime.

In addition there should also be a market making and buy-back exemption available as we noted above. Market making in capital instruments should not result in a breach of the limits.

1.2.10 Shortfall of stock of provisions of expected losses

Whilst we agree that the shortfall of provisions to expected losses should be deducted from Core Tier 1 we argue for a symmetrical approach. Where a bank has over-provided, compared to expected losses, any excess should be included in Core Tier 1. Not to do so would penalise prudence.

1.2.11 Cash flow hedge reserve

We agree with the approach suggested by the BCBS.

1.2.12 Cumulative gains and losses due to changes in own credit risk on fair valued liabilities

We agree with the approach suggested by the Committee with regard to the existing deduction (liabilities fair valued under the Fair Value Option). However, we question whether the proposal to make such deductions on all fair-valued financial liabilities is appropriate. This requires further thought which we expect will further evolve through the QIS exercise.

1.2.13 Defined benefit pension fund assets and liabilities

We do not agree that defined pension fund liabilities should be deducted from the common Equity component, but do agree that the two questions of the *quantum* and *level* of any deduction in respect of such liabilities should be addressed.

However in answering these two questions it should be borne in mind that different countries and banks have different approaches to pension provision for their citizens and staff. In some countries the predominant form of pension provision is via a state provided pay-as-you-go unfunded scheme. In other countries employer-provided defined contribution or defined benefit pension plans are more common. The impact of the BCBS proposals will vary from country to country and from bank to bank, depending on the pension model adopted.

A number of jurisdictions explicitly or implicitly require banks to hold capital for this element of pension risk via their Pillar 2 assessment. We would suggest that this be the route by which they continue to approach this matter rather than via this Pillar 1 deduction being proposed.

So we propose that the treatment of deficits arising from defined benefit pension scheme liabilities be subject to a national discretion allowing the local regulator to make adjustments to a bank's capital which reflects the specificities of pension fund arrangements in the country in question. [We should emphasise however that we do not generally support national discretion but think in this case that it can be justified.]

Quantum of Adjustment

There are a number of different methodologies that could be employed to assess the quantum of any deficit, including:

- Accounting approach based on IAS19
- Trustee's valuation
- Pension Fund Regulator's valuation
- Buy-out valuation
- Any deficit recovery agreement (DRA) that has been agreed with the trustees

Whilst we would normally support regulatory capital quantification based on accounting approaches, we believe that an accounting approach is not appropriate for pension valuation from a regulatory capital perspective as it potentially creates unwelcome volatility, based as it is calculated on point in time assessments of market prices. Furthermore changes in the accounting approach in the future – for instance in relation to the risk-free rate used – could impact regulatory capital arbitrarily. It is important to note too that unlike the DRA the accounting approach is not based on contractually agreed amounts.

We believe the DRA, derived from a statutory Recovery Plan that has been contractually agreed by the bank sponsor with the pension fund trustees is the best assessment of quantum that should be used to adjust regulatory capital. Currently the DRA is the sum of five years additional funding under the Recovery Plan, and were the DRA to be extended, to cover say, ten years additional funding, then we would suggest that this be based on the net present value of the additional payments.

Level of Deduction

We do not believe that the deduction of the NPV of the deficit reduction amount should be made from common equity and reserves.

As the pension fund trustees have a claim alongside other creditors in insolvency and this is the point at which any under-funding would crystallise we believe that the default should be deduction from gone concern capital, not going concern capital and recommend that the Committee adopts this approach.

Disclosure

We acknowledge that the treatment by banks of pension funds for reporting purposes can be opaque and would be pleased to consider ways in which the reporting of the details of a banks' pension fund could be improved in Pillar 3, providing the NPV based DRA is adopted and deducted from gone concern capital.

1.2.14 Remaining 50:50 deductions

We agree with the approach suggested by the BCBS but note that this agreement is dependent of the ultimate level at which 'predominant' is set.

2 Enhancing risk coverage

The members agree it is appropriate to review the treatment of counterparty risk, together with its measurement and management, in light of experiences in the period from 2007 on. It seems clear from these experiences that a regime that encourages more accurate and realistic assessments of the level, variability and drivers of counterparty risk is desirable, including such crucial factors as wrong-way risk. At the same time, the regime can usefully recognise where firms hedge counterparty exposures and their variability.

To put the issue of counterparty risk in perspective, we believe it is vital to bear in mind that:

- losses realised because of outright defaults were very effectively contained and mitigated by the operation of netting and collateralisation;
- losses were also realised because of declines in the value of marketable securities, notably because liquidity dropped across the system as a whole, as a result of concerns about creditworthiness more generally – not counterparty risk exclusively.

We note the Committee's desire to see greater and better aggregation of exposure at counterparty level and agree that this is a *sine qua non*.

A closer analysis of the 2007-09 experiences reveals some important aspects of how an improved regime could, in industry's view, best operate. This would not only set the overall level of capital appropriately, but also allocate that capital proportionately to the various components of risk, while avoiding:

1. double-counting (whether with existing measures or as between the current set of new proposals); and
2. arbitrary increases (i.e., ones that are not risk-sensitive and which therefore incentivise behaviour that is at odds with the stated aims of the Consultation).

CVA

We focus particularly on CVA, where we believe that the 'Bond Equivalent' approach violates both these principles in certain ways. As a general principle, we feel that there should be due recognition where firms hedge risk in a demonstrably prudent fashion; and that the proposed approach does not satisfactorily mesh, either with the factors that drive exposure (or, therefore, ways of hedging that exposure) or with credit-risk hedging practice. To formally state the key principle, therefore:

"A firm that reduces its economic risk to the default of a counterparty should post less capital than another firm with the same economic exposure that chooses not to hedge. The reduction in capital should be commensurate with the reduction in risk; and there should never be a capital dis-incentive to reduce economic risk."

We also note in regard to this issue the consultation's observation (in para 120) that "*over time, CCR should...be treated in an integrated manner with market risk*" – something that the Bond Equivalent approach does not achieve.

At the same time, it is clear that 1) different firms (or parts of firms) experience different degrees of balance-sheet impact from CVA changes and that (as we set out in some detail in our response) different approaches to a CVA charge could be adopted accordingly; 2) that the CVA charge will only work effectively to influence behaviour if analysed jointly with other elements of the capital regime, notably charges for jump-to-default and expected loss.

Put another way, important as it is to set the *overall* level of capital that banks hold, it is vital also to get the right *allocation* of that capital between risk classes, relative to their nature and size. This appears particularly relevant in the case of a CVA charge. If the capital rule is

simplistic and risk-insensitive, it will distort relative prices and will create uneconomic incentives that will lead capital-optimizing banks to pursue strategies that are sub-optimal (and could ultimately result in large costs to society). It is better to have risk-sensitive models, whose results are scaled appropriately to reach the desired level of capital, than blunt rules that assess capital on an idiosyncratic basis to each activity and arbitrarily fix the relative amount of capital, irrespective of the actual underlying economic risks.

Firms' analysis clearly shows already that the impact of the CVA charge, as set out in the December 2009 proposal, will be non-trivial. While we recognise that the full, detailed QIS will be important in validating this, we believe it important to make it clear now that, on its own, the CVA charge will demand that significant new capital be raised, with even the most modest impact assessments representing a whole-number multiple of current counterparty-risk charges, *after* hedging.

Business with end-users will attract the largest CVA charge (since portfolios with end-users are those most likely to entail significant open positions). Assisting corporate customers in managing risk is a basic banking function. The impact of the current proposals on the costs and availability of hedging services is likely to be economically significant. Moreover, these increased costs will affect firms whose main business does *not* consist of taking interest rate, foreign exchange or other financial market risks, and the effect will be proportionally larger for smaller end users. These are factors that should be considered when the Committee decides on revisions to its proposals.

We further note i) the double counting with the existing treatment of maturity in Basel II and ii) the ultra-conservative nature of the bond equivalent.

Industry firmly believes that the deficiencies of the bond equivalent approach run much deeper than questions as to how it is calibrated. Merely adjusting the scaling factors, for example, would not address its shortcomings, because it would remain misaligned with both risk and the hedges of that risk. It might, of course, be possible in theory to re-engineer the bond equivalent approach, taking due account of the ways in which it is deficient and addressing each of them in turn. In practice, though, this would constitute no more than a modest step in the direction of the risk-sensitivity that we advocate in this response.

In summary, among the many overlapping counterparty risk measures, the CVA charge raises the most questions. We note that the charge:

- a) appears to have a disproportionate, multiplier impact on charges for counterparty risk;
- b) is, via the 'bond equivalent', risk-insensitive and so does not mesh well with hedging practice;
- c) does not reflect the current variety in impact on bank's financial statements, under diverse accounting regimes;
- d) could, in principle, reflect the modelling of CVA together with other trading book risks.

Our response on CVA is built on the premise that (demonstrably prudent) hedging of counterparty risk should lead to a lower capital charge. This would include some recognition of hedging of the systematic component of credit spread risk.

Stressed EEPE

On Stressed EEPE, while we recognise the overall objective, we believe greater clarity is needed as to the role that could be played by a) back-testing and b) the Pillar II stress charge.

Asset Value Correlation

As regards Asset Value Correlation, we believe that the incentives for looking at this, as well as the calibration merit further careful consideration. The measure allows for no distinction between quality of financial counterparty; and appears to ignore the changes in practice as regards collateral and central clearing, which mitigate and reduce the 'interconnectedness' the charge is presumably targeting. It is hard to comment more fully, without access to the data on which the Committee has based its proposal. We do, however question the inclusion of a strong *disincentive* for financial firms to face each other, particularly when the liquidity regime already strengthens firms' resources, let alone the further measures that are contemplated in relation to systemically important banks (paragraph 47).

On all of these items, more detail follows. We also take this opportunity to mention briefly some points on some other issues.

Overall

Overall, we would note that the Consultation contains a very large number of measures, each of which may have some merit in its own right but whose integrated, cumulative effect is not yet clear. If, taken piecemeal, the effect is to put a strain on the economy (because of a need for increased capital raising, *whatever* the stage of the economic cycle) and to damage the effectiveness of risk-transfer markets, we do not believe either outcome to be desirable.

Clearly, there is scope within the QIS exercise to take stock of relative allocations, as well as overall levels of capital (taking into account the changes to the Trading Book treatment, published in July 2009). We assume that will take into account the incentive issues we mention in this response.

CCPs

For CCPs, we believe that there has been a clear and demonstrably strong move towards central clearing, which was accelerated by but not fundamentally driven by the crisis. We fully accept that there should be a relative incentive to face a CCP (provided, of course, that the CCP adheres to reasonable international standards set by CPSS-IOSCO and, in particular, does not undertake the clearing of contracts that would be inherently unsafe to clear centrally). We would, however, caution against penalising contracts that are not centrally cleared, since by definition this would include the very tailored contracts that are most valued by end-customers.

With regard to CCPs, we would note that paragraph 121 switches terminology from 'zero EAD' to 'zero percent risk weight' part way through, and would suggest that 'zero EAD' captures the desired intent.

Margin period of risk

Increasing the margin period of risk makes sense for portfolios that include illiquid transactions (or collateral). We suggest, however, that the introduction of materiality thresholds and note that a large portfolio is not necessarily synonymous with difficulty in valuing contracts or replacing them (particularly on a net basis, using risk-factor assessments). Moreover, industry has made significant progress in implementing both portfolio reconciliation (obviating disputes about trade *population*) and dispute resolution (addressing disputes about trade *value*)¹

¹ viz: www.isda.org/c_and_a/pdf/ISDA-Collateral-Committee-Dispute-Resolution-Proposal-Briefing.pdf.

Securitisation in repos

We further note that penalties for using securitisations in repos will slow the access of firms to alternative sources of funding, which in some cases may prolong the burden on the taxpayer. This is particularly important since repo of securitisation tranches can work well, as has been the case in 2010; in other words, while it is important to reflect experiences from stressed situations, it is right to recognise these as extreme rather than the norm.

2.1 CVA

Capitalizing for Unexpected Loss Arising from Variation in CVA

*BCBS 164, page 5, paragraph 21, "Banks will be subject to a capital charge for mark-to-market losses associated with a deterioration in the creditworthiness of a counterparty. While the current Basel II standard covers the risk of counterparty default, it does not address such CVA risk, which has been a **greater source of losses than those arising from outright defaults.**"*

BCBS 164, page 28, paragraph 114, "Mark-to-market losses due to credit valuation adjustments were not directly capitalised. Roughly two-thirds of CCR losses were due to CVA losses and only about one-third were due to actual defaults."

BCBS 164 correctly references the large losses faced by (numerically) a small proportion of the overall industry. It attempts to characterise these risks with a single approach, that will (per paragraph 20, page 5) "provide incentives to strengthen the risk management of counterparty credit exposures." The industry concurs with this goal, with particular emphasis on recognising demonstrably effective hedges of such exposures. However, it is already clear the impact of the charge as currently drafted will be disproportionate. Moreover, capital requirements should assess the propensity for the unhedged portion of a trading or banking book risk to generate unexpected losses. The capital requirements themselves should not introduce new risks, and firms should certainly not be penalised for hedging. Without recognising the differentiating factors within the industry that drive management of, and practices around CVA, the consultative paper both introduces new risks (through an unhedgeable, procyclical, spread-sensitive capital charge); and fails to incentivise prudential risk management and hedging where appropriate. Depending on the exact impact, it may also reduce the availability of hedging services to the real economy. Industry analysis already suggests that, as currently proposed, the CVA charge *on its own* will be likely to require firms to raise new capital.

The intended goals of the industry, as reflected in this response, are:

- Recognise that a firm which hedges against changes in credit should face a lower charge than one that does not.
- Ensure a charge that is proportionate to the risk.
- Recognise the progress made by the industry during, and since the crisis to address the proper characterisation and measurement of the risks faced.
- Recognise the need for demarcation of trading book and banking book treatments for CCR.
- Recognise that where firms assign positions differentially to trading and banking book, different capital treatments may be necessary.
- Progress towards a capital framework across trading and banking book that does not penalise hedging.
- Progress towards a capital framework where the sum total of capital components is reflective of the overall balance-sheet risk faced by firms over a one-year horizon.

Preliminary estimates from the industry suggest that the proposals could result in a very large increase in counterparty credit risk capital, even where largely hedged. This is

disproportionate to the risk. The bond equivalent CVA defined by the Consultation is also disjointed from the real balance-sheet risks faced by firms, and represents a blunt tool with which to increase capital requirements. The industry clearly recognises, and fully accepts the requirement to appropriately capitalise for *unexpected* variation in P/L arising from movements in the CVA. We also note, however, that since the crisis, tens of millions of dollars have been spent increasing the risk management capabilities at all firms.

Central to the industry's argument is the recognition that, where *marked-to-market*, counterparty credit risk is a *trading book* risk; where the risk is accounted for using non-market based approaches, it is a *banking book* risk. Firms should not be penalised for hedging in the capital constructs and, when comparing the same portfolio with the same counterparty across two firms, the firm that has existing hedges should hold less capital than the firm that does not. However, care must also be taken when comparing different firms on different treatments (trading book or banking book).

On the Validity of "Same Counterparty, Same Portfolio = Same Risk = Same Capital"

It is clear that the loss distribution arising from default at some future date T is theoretically dependent only on the counterparty credit and the portfolio of derivatives. However, the moment we introduce a risk horizon $t < T$ and ask ourselves, "What is the capital required to buffer the firm against unexpected variation in P&L until t?", then the balance-sheet risk (and hence capital requirement) faced by the firm depends directly on its choice of market-value adjustment. The more volatile the measure, the greater the need to hedge the measure, in order to avoid bankruptcy between today and time t. Of two firms opting for different treatments (trading/banking book), if one firm cannot survive to time t, it is irrelevant that ultimately the loss distribution is the same for both upon default of the counterparty.

This undermines the quoted principle above: It is therefore precisely the difference in chosen approach that led to the mark-to-market losses referenced by the Consultation; it is also why a single approach may not truly be able to 'look through the accounting' and describe the potential for unexpected variation in P&L over the next year.

Globally, firms opt for one (or more) of four approaches to the problem of provisioning for expected counterparty default loss.

1. No adjustment.
2. A through-the-cycle adjustment, based on expected exposure and a historic loss-norm, calibrated from firms' histories of PD and LGD experience.
3. A market-implied adjustment to the mark-to-market of the derivative contracts in question.
4. A model-based, forward-looking EL adjustment, calibrated to estimates of PD that use both CDS spreads and historic values as input to the model.

Within each firm, different treatments are applied. These treatments are reflective of the relevant accounting standards that apply; these broadly follow IFRS outside the US, or FAS within. Rarely is a single approach ubiquitously applied across a group; the Committee, in applying the proposal across the board, fails to recognise that potential balance-sheet losses, arising from unhedged variability in CVA, are limited to the scope of application of each method. Firms simply will not register the impact that the proposal, as a broad measure, intimates. Moreover, in creating a third (yet another) valuation of expected loss² through the bond-equivalent CVA, the proposal creates fictitious risks that are not present in the way risk is valued or hedged in firms today.

One area of particular focus must be the maturity adjustment in the existing Basel II framework. As detailed in the BIS publication, *An Explanatory Note on the Basel II IRB Risk*

² Besides the actual accounting definition and the regulatory expected loss.

Weight Functions, the maturity adjustment was calibrated to incorporate the 'mark-to-market valuation of credits'. In particular, it relates to 'potential down-grades and loss of market value of loans'. To some extent, therefore, this already captures some of the sensitivity of the CVA. The consultative paper goes further in trying to isolate the spread sensitivity, and to some extent, the cross-sensitivity of CVA to both market and credit movements, but fails to address the maturity adjustment.

The remainder of this CVA-focused comment is as follows: We look first at the Consultation's proposal against these goals through the bond-equivalent CVA. We then discuss, in turn, the banking book and trading book. We look at how the sum of capital components must make sense, and then consider the nature of fallback approaches. All approaches are dependent on the recognition of the reduction in jump-to-default risk from single-name credit hedges (and equivalents). Therefore, we follow the main proposals with a discussion of single-name default swaps. Whatever the chosen approach, we recognise the need for a framework where the underlying assumptions of diversification behind the EPE measure are well-founded, and specific wrong-way risks are addressed more fully.

The Bond-Equivalent CVA

A new standalone, credit sensitive capital charge creates multiple undesirable consequences and, contrary to the stated intention of the Consultation, *reduces* the incentive for firms to prudentially manage and/or hedge their risk. We consider a few of the implications here.

For firms with no CVA, the proposal to capitalise CVA in this way bears few similarities with the real risk. Indeed, the proposal actually creates new risks for these firms, and will spur the need to hedge regulatory capital in markets that simply may not support the necessary credit instruments (which will drive 'skew' in credit indices). These firms treat CCR as a banking book risk, and the EAD framework and maturity adjustment provide adequate accounting in the capital calculations.

For firms applying a through-the-cycle adjustment, it is clear that they do not have this spread risk either; rather, it is the risk of rating transition or downgrade in the loss-norm that largely drives an adjustment through net income. The stability of their PD and LGD estimates drives the potential for loss associated with deterioration in creditworthiness of their counterparty. Again, the fictitious risks created here will skew credit markets.

Moreover, it is important to recall that the through-the-cycle approach to CCR is conceptually identical to the standard approach of the wholesale loan portfolio. It is also the underlying assumption of the current IMM rules for CCR. Of course, the one material difference between a loan portfolio and a CCR portfolio is the dynamic and stochastic nature of CCR exposure. That is already captured and modelled in the IMM via ($\alpha \times \text{EEPE}$) and the effective maturity M .

If the proposal was adopted verbatim, a firm with no CVA, or one opting for a through-the-cycle methodology, would quickly find itself running a large, potentially unhedgeable, *procyclical* CS01 risk in its capital charge. The very reason the firm opted for the approach in question is likely the lack of a deep market for single-name hedge instruments for the counterparty risk in question; one might extrapolate that the firm would be forced to hedge the new charge with index positions if available — however, the index hedge (being excluded from the bond-equivalent CVA calculation) would, itself, become an unbalanced market risk in the firm's trading book charge (either VaR or SMM), requiring additional capital!

For firms applying a market-implied CVA, the Consultation ignores the fact that spread sensitivities are, by definition, already available from the calculation of CVA. The proposal in the Consultation also creates a bond position which materially differs from the economic risk faced (see Appendix 1). In particular, the Consultation approximates the credit sensitivity as a function of exposure only (EAD and effective maturity), when in reality, the spread sensitivity is a function of exposure *and* prevailing spread. As outlined in Appendix 1, it is

also clear that the sensitivity of the CVA to changes in market rates is equally important as the spread sensitivity. A firm with a market-implied CVA would therefore see every hedged position become unhedged for capital purposes, due to the difference between the real CS01, and the fictitious risk of the bond equivalent.

Critically, all market vectors and many credit sensitivities would also become unbalanced in the market risk VaR, suggesting a potential for trading loss that is not reflective of the real risk. In stable, low-spread environments, the principal sensitivity of the market-implied CVA is to market vectors and the vega-risk represented by the exposure profile; in volatile, high-spread environments, the sensitivity is geared more to the joint movement of credit and market vectors (with the market sensitivities converging to that of the underlying derivative in the limit). Carving out the single-name hedges from VaR leaves behind a significantly misrepresented, unbalanced risk in the trading book VaR.

In general, the rationale for a standalone VaR is flawed; there are a multitude of instruments that provide economic offset to CVA movements, in particular when the idiosyncratic risk of jump-to-default is carved out, as it is with the banking book treatment of EAD. Furthermore, the bond-equivalent prescription misstates, and potentially understates, the market-sensitivity of the CVA.

All standalone VaR approaches create opportunities for arbitrage, and in marked contrast to the Consultation, the focal point should not be so much the perception that VaR of CVA conceals risk, but rather the assessment of the jump-to-default measure against:

- The implicit diversification assumptions and the potential for concentrated risks.
- The potential for wrong-way risk.
- The correct calibration of the maturity adjustment to capture market sensitivity of the CVA.

Furthermore, the annualisation (5x) and scaling (3x) embedded in the proposal are not consistent with the trading book regime, with which the Consultation seeks to attain alignment. The rationale for the scaling in the trading book VaR equates to a 99.9%, one-year principle, with which the industry agrees. However, the two scaling factors put this approach well beyond that tail estimate. For a normal distribution, the 99.9%, 250-day VaR is circa 6.6 times the 99%, 10-day VaR; *not* (5x3 =) 15 times. Taking into account the addition of Stressed VaR, and the reality of fat tail effects, this is an extreme measure.

In summary, therefore, the bond equivalent CVA:

- assumes that spread risk hedges are most important, whereas industry analysis (see *Appendix 1, Example B, Table 1*) suggests that rates and volatility hedges together are generally larger in magnitude than spread hedges;
- entails double counting with the maturity adjustment in the existing Basel II framework;
- does not recognise the difference between trading and banking book approaches to the management of risk;
- further penalises hedging by isolating the single name hedges; and,
- with no corresponding adjustment of jump-to-default risk for the benefit of hedges in the banking book construct, is strictly additive to the capital.

Industry therefore firmly believes that the deficiencies of the bond equivalent approach run much deeper than questions as to how it is calibrated. Merely adjusting the scaling factors, for example, would not address its shortcomings, because it would remain misaligned with both risk and the hedges of that risk.

It might, of course, be possible in theory to re-engineer the bond equivalent approach, taking due account of the ways in which it is deficient and addressing each of them in turn (as illustrated below). Once one goes down this route, however, it logically and rapidly leads one towards the market-implied approach we outline in this response, or its banking-book equivalent.

1. The additional capital charge could be calculated based on the actual CS01 of the firm wherever possible:
 - a. For firms that calculate a market-implied CVA, use the actual CS01.
 - b. For firms that calculate a through-the-cycle CVA, the CS01 should be scaled accordingly.
 - c. For firms that do not calculate a CVA, but do have an IMM permission, this can be inferred from their EPE profile.
2. For firms with a VaR approval for general and specific market risk, subject to national supervisory permission, the charge should be based on a suitably conservative integration with the existing VaR, or on a standalone basis otherwise.
3. The charge could be based on 10-day VaR and Stressed VaR, but not IRC.
4. The 10-day VaR and Stressed VaR could be scaled by 3, to be consistent with the market risk standard, and to avoid arbitrage of the rules.
5. For those firms with an IMM permission under the IRB framework, and for whom the integrated VaR is permitted, the effective maturity should be set to 1 in the calculation of the jump-to-default, EPE-based capital component, since the market sensitivity of the CVA is captured in the VaR.
6. For those firms with an IMM permission under the IRB framework, and for whom the integrated VaR is not permitted, the effective maturity could be recalibrated to isolate only the market sensitivity of the CVA.
7. Any such approach could work at the level of netting set, rather than counterparty. This mirrors the calculation of counterparty credit risk capital and ensures greater sensitivity to amounts that would actually be realised through netting. Moreover, the maturity of the 'bond' could be the capped effective maturity, as 5 years is a reasonably long forecasting horizon and the CDS market is not necessarily so liquid for transactions with a maturity significantly longer than 5 years.

For Firms Opting for a Banking Book treatment for CCR

Firms that apply banking book treatment to CCR are not necessarily subject to the same balance-sheet risks over a one-year horizon as those applying an unhedged trading book treatment.

Ubiquitously, firms should defend the assumption of diversification underpinning the EPE framework if they choose to apply it, or look to alternative measures to capture concentrations of, or specific wrong-way risk; the CEM approach naturally errs towards a higher measure of EAD, whilst the EPE framework has the alpha multiplier. The fragmented and piecemeal approach, taken by the Consultation to addressing these fundamental issues, clouds the overall assessment of whether the risks are adequately capitalised.

Firms with no reserve methodology are not subject to the same volatility arising from a variation in reserve, but are exposed to the full jump-to-default distribution. Under paragraph 43 of International Convergence of Capital Measurement and Capital Standards, the addition of regulatory expected loss to Tier 1 and Tier 2 capital requirements provides the basis for an adequate capital measure, when combined with the EAD-based measure of jump-to-default risk, and the full maturity adjustment M. However, the industry does accept that the overall

incentives of this approach are not yet aligned with the stated aim of strengthening risk management practice.

Firms with a through-the-cycle approach are subject to variation arising from changes in exposure, PD and LGD. The industry has developed the CVA Variability Charge (CVC) proposal to address this. The stated aims of this proposal are, in addition to those above:

- Model to capture the unexpected loss of potential variability in CVA due to changes in quality of counterparty.
- In keeping with the bond-equivalent CVA, the expected exposure profile remains constant.
- Soundness standard of 99.9 percentile 1-year, in line with the banking book treatment under Basel II.
- Aim for a stable capital charge, in line with the through-the-cycle approach.
- Incorporate credit correlations explicitly in the model. Stress testing can then help identify the impact of wrong-way risks.
- The single name hedges can be directly modelled in the exposure calculation leaving only the residual exposure for the CVA calculation.

The CVC approach involves defining a discrete set of credit states that counterparties can migrate between. The 'defaulted' state is excluded, since this is accommodated by the EPE charge. The CVC approach focuses solely on the credit worthiness and how a change impacts the CVA. It is therefore predicated on the existing maturity adjustment being appropriately calibrated to capture the market sensitivity of the CVA. In the case where CVA charges are calculated using a historical probability based transition matrix, the credit states are already well defined and correspond to either internal or external ratings.

For all counterparties, the change in CVA caused by counterparty migration across credit states (i.e. moving from one rating category to another) must be calculated. The CVA will increase as the credit state worsens, and vice versa when credit states improve, with no change in CVA as long as the counterparty remains in the same credit state. For each counterparty, one would generate a set of numbers representing the change in CVA corresponding to the pre-defined credit states.

Where there is a single counterparty in the portfolio, the change in CVA relating to the worst credit state represents the CVC because of the extreme choice of confidence interval. However, in a larger portfolio, the diversification among the counterparties will be a key driver in assessing the CVC as the change in CVA in a given scenario could be different for each counterparty within the portfolio.

To account for this correlation, a Monte-Carlo approach might be adopted where, in each trial, we draw the credit states for all counterparties in a correlated fashion. The banking book IRB approach uses a single factor with correlation calibration in the range of 12%-24% depending on rating. More granular correlations could be defined, involving grouping counterparties by, for example, sector, rating, region, country and then determining the correlations between groupings. Internal models for credit correlation should be subject to the same standards of validation and integrity as for other IRB models.

At the end of each trial the sum of change in CVA due to the migration of credit states for all counterparties is calculated. The process is then repeated until we have performed enough trials to obtain a stable distribution from which we can extract losses for a required confidence interval as the CVC measure.

For Firms Opting for a Trading Book Treatment to CCR

Over the last fifteen years, large banks have spent substantial resources to enhance their capabilities to measure, price and manage counterparty credit risks. During the same period, an expanding credit derivative market (especially for vanilla index and single-name CDS) has created opportunities for the risk management of counterparty credit risk as a trading book operation with active hedging.

Most large derivatives dealers have built sophisticated risk management systems and have established trading desks that are dedicated to the pricing and management of their counterparty risks. Those desks have executed large amounts of hedges against the CVAs, to the tune of tens of billion of dollars in CDS notional amounts.

The banks that marked to market their CVAs experienced severe CVA volatility during the 2007-8 financial crisis, especially during the fourth quarter of 2008. The variability of their CVAs reflected the turbulence in the markets and, to the extent that their CVAs were unhedged, the banks' P&Ls were affected, in some cases quite negatively and severely.

We recommend that the regulatory capital treatment of portfolios of counterparty risks that are marked to market and managed within a trading book regime be consistent with other similar trading risks.

Our proposal has the following stated aims, above and beyond those stated above:

- To be consistent with the actual risk measurement and management practices of the banks.
- To align the risk measurement and stress testing capabilities to what drives capital charge.
- To set proper economic incentives for active hedging and mitigation of counterparty credit risks.
- To provide a platform for identification, and stress testing of specific wrong-way risks.

Specifically, we recommend that the regulatory capital on counterparty risks should be assessed by including the CVA (and all its single-name, credit index and other hedges) in the trading VaR, stressed VaR, and IRC frameworks. The adoption of the trading book regime comprising these three elements is now considered robust. In this way, the CVA risks and hedges would be treated as integral parts of the full trading book and would be measured within the full trading book context. Currently, the hedges of the CVA reside in the trading book but the CVA does not. This creates a very material split-hedge problem that will in practice penalise banks that do hedge the CVA.

The IRC framework is analogous to the IRB Asymptotic Single Risk Factor (ASRF) model that is used to calculate the Risk Weights in the banking book but it has the advantage that it captures the concentrations (granularity) of the portfolio of exposures. We recognise the importance of setting the liquidity horizons of the various CVA risks correctly and the dependencies between market prices and counterparty credit need to be modelled appropriately to capture the right and wrong-way risk effects.

The IRC framework has the following stated aims:

- Capture the jump-to-default risk, based on the appropriate liquidity horizon.
- Be consistent with the wider trading book regime; assume no further hedging over the liquidity horizon.
- Integrate the effect of both market and credit vectors on the jump-to-default calculation.
- Integrate the effect of both market and credit vectors into the VaR component.
- Address concentration risks.

- Address specific wrong-way risks.

The industry feels that this is a practical goal: The modelling of CVA within the trading book frameworks is not more complex than the modelling of other hybrid credit risks that exist in the trading book. In that sense, VaR and IRC of CVA are not more complex than the current applications of those models to other derivative products in the trading book. Indeed, some banks already include CVA and its hedges in their VaR models (both internally, and in some cases, for regulatory purposes, to prevent mis-statement of their market risk). Furthermore, the full integration of the market sensitivities into VaR and IRC correctly removes the need for the maturity adjustment and the requirement to approximate the cross-gamma of risk to joint credit and market movements.

In addition, when a firm marks-to-market CVA and captures both the credit and market-risk deltas in VaR, there is a strong argument to also include DVA market-risk sensitivities in VaR. These provide an effective partial hedge to the market sensitivities of the CVA. Large banks measure and manage CVA risks as integral parts of their overall trading risks. At times, long credit positions in the CVA book are used to offset short credit positions in other portions of the trading book, as part of the overall risk management strategy.

A further advantage of an integrated approach is that stress tests bind the capital impact more closely to with the potential economic risk to the firm, strengthening the alignment of senior management's risk appetite to the day-to-day management of counterparty risk within the firm's risk culture.

On the Double-Counting Issues, and the Sum Total of Capital Components

With regard to the role of CVA as a dynamic provision, the consultative paper clarifies and removes the perceived incentive to provision at low levels, by deducting any shortfall of provisions against expected loss under the IRB approach 100% from the common equity component of Tier 1 capital. Where the provision is in excess of the regulatory expected loss, however, the current framework allows for a deduction of the excess only from Tier 2 requirements, and subject to a cap. Given the new explicit charge for the variability in CVA proposed even where CVA is not measured today, it seems prudent to re-evaluate the role of CVA vis-à-vis a Tier 1 or Tier 2 deduction, and in particular the caps.

Tier 2, as an expression of gone-concern capital, is not the correct place to account for a forward-looking dynamic provision. If a default occurs, the CVA is available to offset in whole, or part, the loss when a claim needs to be provisioned. In that respect, for the part of the loss where a bank holds an amount of CVA, it is unnecessary to have a capital charge, as the CVA is already reserved for that loss. As CVAs are fully dedicated for well-identified counterparties, the industry proposes that the excess of CVA over regulatory expected loss be incorporated as a direct deduction from CCR capital charge rather than being made eligible to Tier 2 capital; this provides stronger incentives to provision and adhere to the governance and validation standards that underpin the forward-looking modelling of exposure. The knock-on effect is stronger risk management practices across the industry.

It is clear to the industry that additionally capitalising against unexpected variation in CVA introduces a further concern, namely that losses cannot arise from both a change in CVA and a default at the same time:

- The fully integrated trading book approach deals with this through the IRC component in fully assessing the jump-to-default risk net of hedges.
- For other approaches, there would be a double counting between, on the one hand, the base amount of CVA plus the new capital charge to reflect the potential increase of CVA; and, on the other hand, the regulatory expected loss and unexpected loss for counterparty risk. In no real scenario would a bank make a loss due to the CVA in addition to a jump-to-default loss. Industry urges regulators to take this double-counting effect into account.

Recognition of Vanilla CDS Hedges to CCR

An important step towards more effective management of counterparty credit risk, irrespective of trading or banking book treatment, would be to recognise designated CDS hedges as also offsetting the EAD of counterparty credit risk calculated under Annex 4 of the existing Basel II text (BCBS128). While paragraph 7 of Annex 4 allows CDS hedges in principle, the recognition requirements do not generally permit any regulatory effectiveness of hedges, even though there are valid economic arguments that CDS are an effective cover of CCR and thus should be prudentially recognised.

The CDS market has simplified and further standardised default swaps, in response to the needs of the financial markets to provide effective transfer of risk. This is illustrated inter alia by the presence of central counterparties in this marketplace. The following points illustrate the economic validity of CDS as hedges of CCR:

1. Case where there is a public credit event (Bankruptcy or Failure to Pay):
 - Straightforward. The Master cross-accelerates and will be closed out. The termination value is a claim that is pari passu with other unsubordinated claims of the defaulted counterparty.
 - The CDS then makes use of the Determinations Committee and the established protocol to ascribe a value to unsubordinated assets. This is the same situation as for bank loans.
2. Case where there is a public credit event (Restructuring):
 - For a bond or syndicated loan, the meaning of Restructuring has a clear inference. Restructuring relies on observable tests in the public domain, such as principal deferral or reduction in interest rates for example.
 - This logic is unclear for a Master. To highlight this ambiguity, consider a few situations:
 - i. A reduction in interest rates may be a feature of a derivative contract.
 - ii. Contractual terms involving interest rates could be changed, but the net present value of the payment streams may be unaffected.
 - iii. A derivative contract does not have a notional principal value and so the idea of an actual principal deferral has no meaning.
 - Requiring a CDS to cover Restructuring for a bilateral obligation implies that the holder of the bilateral obligation is able to trigger the Restructuring event. However, leaving this assertion to the holder of the bilateral contract would subject the CDS seller to an abusive triggering that may not objectively be related to a credit event.
 - More importantly, assuming that a counterparty to a derivative contract is 'credit challenged', then a change in the timing of derivative payments, for example, is a choice and not an obligation of the stronger party. In effect the stronger party has, of its own accord, given up its right to early terminate and require immediate payment (which, if not made, which would constitute a failure to pay).
3. Case where there is no public credit event but we face a close-out under a Master:
 - Where a genuine credit event has arisen, if the claim is unpaid, the unpaid party has the ability to go to court and petition for bankruptcy of the counterparty. That event cannot stay private and it will become a public credit event.

- In recognising that there can be a timing delay between petitioning the courts and when the credit event information becomes public, we would propose that in the case of bilateral exposures that the maturity of a standard CDS used for hedging purposes be considered 6 months shorter than its scheduled maturity.
4. Case where there is a credit event but the claim cannot be delivered into a CDS contract:
- Not relevant. Standardisation of CDS, notably through the Big Bang protocol and use of the Determinations Committee and the growth of the CDS market mean that cash settlement has largely supplanted physical settlement as the method for valuing defaulted obligations.

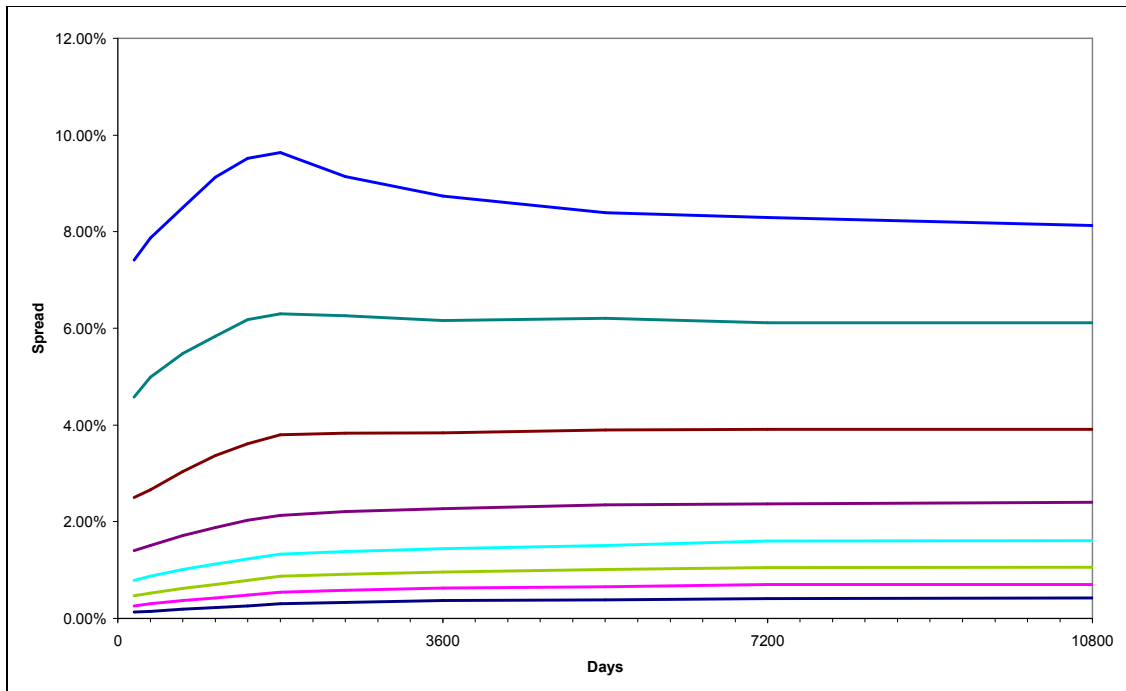
2.1.1 CVA / Appendix 1: Observations on the Bond Equivalent CVA

A Zero-Coupon Bond Is a Poor Approximation of CVA Risk

The purpose of the following examples A, B, C and D is to show how various aspects of the bond-equivalent CVA lead to a crude and erroneous picture of the market implied CVA. We believe that the QIS comprehensive results will confirm this point quite strongly.

Example A

Here we take a \$100MM, 10yr pay fixed swap at-the-money, settling annually, with rates modelled lognormally with a volatility of 20% and drifting to forward rates. We look at the spread sensitivity of the CVA to a 1bp parallel shift of the par CDS spread, a 1bp parallel shift of interest rates, and a 1% absolute increase in volatility. We define eight levels of starting spreads (from Level 1 being the lowest to Level 8 being the highest), stratifying the market place:



The CS01 for the CVA with each of these spreads is then compared to that of the bond-equivalent. EAD, CVA and sensitivities are expressed in \$.

In the table below we compare the sensitivities of the CVA with the Bond-Equivalent. EAD is \$2.082MM.

Level	CVA	CS01	DV01	VEGA	BE CS01
L1	155,749	3,957	920	1,504	1,512
L2	261,120	3,800	1,607	2,601	1,396
L3	390,813	3,606	2,496	3,998	1,262
L4	563,871	3,343	3,724	5,917	1,080
L5	834,948	2,926	5,750	9,036	866
L6	1,272,264	2,249	9,249	14,358	560
L7	1,718,218	1,497	13,736	20,882	299
L8	2,037,644	896	18,081	26,851	168

From the table, it is clear that the Bond-Equivalent fails to capture the nature of the risks faced.

Example B

In this example, we assume that the bank is receiving fixed in a plain vanilla USD interest rate swap. We choose a trade in which the bank is receiving fixed since exposure to the counterparty will rise at the same time the counterparty's credit quality is worsening (assuming that official rates will be lowered in such an environment). We assume paths of interest rates, volatility, and spreads over a hypothetical 2 year period consistent with the recent financial crisis. We assume that the 10-year swap rate is 4.6% at the inception of the trade and that implied volatility is 20%. The counterparty's initial credit spread is 100 basis points. Although CVA is in reality hedged very frequently, such as daily, we calculate the CVA and the sensitivities to the risk factors, i.e., interest rates, volatility, and credit spreads on a monthly basis for simplicity. We then calculate hedges to those risk factors and compare to mark-to-market changes in the CVA. The Table below reports the results.

Notional of Swap (\$MM)	100
Tenor of Swap (yrs)	10
Forward Swap Rate	4.60%
Fixed Swap Rate	4.60%
Current Swap Rate	4.60%
Swap Rate Volatility	20%
Spread (bps)	100.00%

Year	Market Data			Sensitivities			CVA	Hedges				CVA Change
	Swap Rate	Swap Vol	Spread	Rate dv01	Spread sv01	Vol dv01		Rates	Spread	Vol	Total	
0	4.60%	20%	100	-1608	1917	101	205,279	0	0	0	0	0
0.08	4.43%	23%	125	-2184	2343	120	318,157	27,336	47,925	30,300	105,561	112,878
0.17	4.27%	26%	150	-2776	2748	135	454,055	34,944	58,575	36,000	129,519	135,898
0.25	4.10%	29%	175	-3375	3129	148	611,236	47,192	68,700	40,500	156,392	157,181
0.33	3.93%	32%	200	-3976	3486	157	788,296	57,375	78,225	44,400	180,000	177,060
0.42	3.77%	35%	225	-4577	3816	165	983,202	63,616	87,150	47,100	197,866	194,906
0.50	3.60%	38%	250	-5173	4121	169	1,194,222	77,809	95,400	49,500	222,709	211,020
0.58	3.43%	40%	275	-5767	4403	172	1,420,363	87,941	103,025	33,800	224,766	226,141
0.67	3.27%	43%	300	-6355	4662	173	1,659,560	92,272	110,075	51,600	253,947	239,197
0.75	3.10%	46%	325	-6938	4899	173	1,910,327	108,035	116,550	51,900	276,485	250,767
0.83	2.89%	49%	350	-7518	5117	170	2,172,223	143,617	122,475	51,900	317,992	261,896
0.92	2.77%	52%	375	-8092	5315	167	2,443,174	92,471	127,925	51,000	271,396	270,951
1.00	2.60%	55%	400	-8662	5496	162	2,721,962	137,564	132,875	50,100	320,539	278,788
1.08	2.68%	52%	375	-8050	5307	155	2,427,120	-69,296	-137,400	-48,600	-255,296	-294,842
1.17	2.77%	49%	350	-7448	5109	147	2,148,239	-72,450	-132,675	-46,500	-251,625	-278,881
1.25	2.85%	46%	325	-6858	4902	139	1,885,582	-59,584	-127,725	-44,100	-231,409	-262,657
1.33	2.93%	43%	300	-6280	4687	130	1,640,244	-54,864	-122,550	-41,700	-219,114	-245,338
1.42	3.02%	40%	275	-5712	4463	120	1,411,411	-56,520	-117,175	-39,000	-212,695	-228,833
1.50	3.10%	38%	250	-5155	4231	110	1,199,264	-45,696	-111,575	-24,000	-181,271	-212,147
1.58	3.18%	35%	225	-4609	3992	100	1,004,540	-41,240	-105,775	-33,000	-180,015	-194,724
1.67	3.27%	32%	200	-4072	3746	89	826,572	-41,481	-99,800	-30,000	-171,281	-177,968
1.75	3.35%	29%	175	-3545	3493	77	665,420	-32,576	-93,650	-26,700	-152,926	-161,152
1.83	3.43%	26%	150	-3027	3235	66	521,442	-28,360	-87,325	-23,100	-138,785	-143,978
1.92	3.52%	23%	125	-2517	2972	54	394,088	-27,243	-80,875	-19,800	-127,918	-127,354
2.00	3.60%	20%	100	-2014	2704	42	283,260	-20,136	-74,300	-16,200	-110,636	-110,828

As can be seen in the above table, we assume that interest rates, volatilities, and spreads follow a pattern similar to their dynamics over 2008 and 2009. At the beginning of each month, we calculate the rates, spread, and volatility sensitivity of the CVA. These sensitivities are defined to be the dollar change in the value of the CVA given a 1 basis point increase in the underlying risk factor. We also calculate the CVA at the beginning each month. We then assume that we put on trades for each risk factor equal to the CVA sensitivities to be hedged. We then calculate the change in value of these hedges as well as the change in value of the CVA.

Although the bond-equivalent approach makes the assumption that spread risk hedges are most important, a glance at the results in Table 1 suggests that rates and volatility hedges together are generally larger in magnitude than spread hedges.

Example C

To get a sense of the magnitude of the potential double counting between the CVA charge and the existing IRB treatment of maturity, we consider a simple portfolio comprised of 1000 BBB-rated counterparties, all of whom have a single trade in their portfolio – a 10-year USD \$100 million interest rate swap. We assume that interest rate volatility is 20% in order to compute EEPE and that there are no CVA hedges. We use 18 basis points for the probability of default, the 1983-2008 1-year Moody's average for a BBB-rated counterparty. We also assume that LGD is 65%. The table below shows the regulatory capital calculations using the five year maturity cap.

Capital with M = 1	86,759,696
Adjustment to M = 5	110,866,872
Total Capital	197,626,568

Total credit regulatory capital for this portfolio would be \$198 million. Using a one year maturity, total capital would have been \$87 million, implying a mark-to-market add-on of \$111 million for maturity implicit in the current Basel II capital formula.

To compare this add on to the proposed bond-equivalent VaR add on, we use a simple linear VaR model in which we specify a bond-equivalent notional equal to EEPE of the trade with a

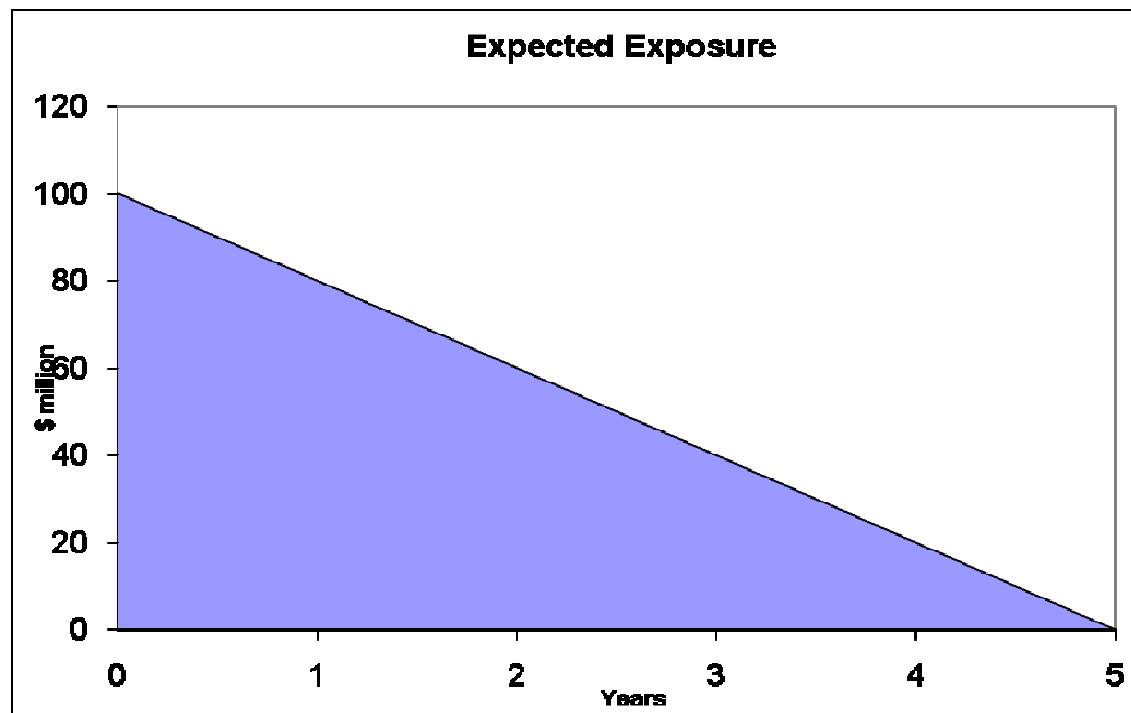
5-year maturity. We assume spread correlation is 40% and calculate VaR for a range of typical BBB credit spreads between 50 and 100 basis points. The table below reports the results.

Spread (bps)	50	60	70	80	90	100
Spread Correlation	40%	40%	40%	40%	40%	40%
Spread Volatility	32%	32%	32%	32%	32%	32%
99.9% 1-year VaR	68,361,905	82,034,286	95,706,667	109,379,048	123,051,429	136,723,810

The results in the above table suggest that under ordinary circumstances the mark-to-market adjustment already built into the Basel II IRB formula covers the proposed bond-equivalent risk fairly well. These results are not surprising given the calibration done by the regulatory community to ensure that the maturity adjustment is quantitatively reasonable. But, the results do serve as a reminder that CVA mark-to-market risk can be accounted for in the current framework. Of course, during a stressed environment in which the level of spreads or volatilities is larger, particularly for firms that are using risk-neutral exposure models, the bond-equivalent add on could be larger than the mark-to-market maturity adjustment add on in the Basel II formula.

Example D

Consider the expected exposure profile of the bank’s exposure to counterparty XYZ. The shape of the exposure profile below is typical of counterparties with large portfolios of trades. As time evolves, the expected exposure declines because the in-the-money cash flows roll off. The exposure forms one part of a group of netting-sets with differing effective maturities.



For this profile:

- CE = \$100 M
- EAD = \$140 M
- M = 5 years (set exogenously by the longest netting set of the counterparty)

Assuming:

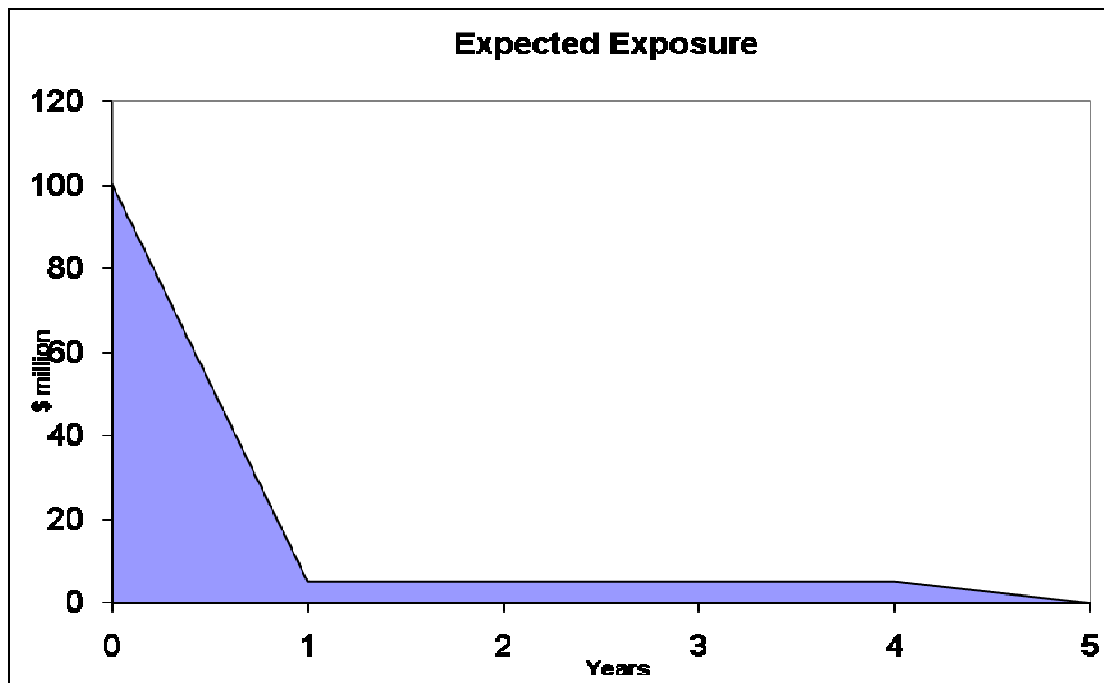
- Interest rate = 4% flat
- Credit spread of the counterparty = 2% flat

We calculate:

- CVA = \$4.49 M
- The CS01 of the CVA is \$0.0215 M per bp.
- The CS01 of the zero coupon bond equivalent is \$0.0511 M per bp.

Thus, the bond equivalent CS01 is 2.4 times the correct CVA CS01.

Consider the following expected exposure profile of the bank's exposure for another netting-set with XYZ. This profile is typical of counterparties with whom we have many short-term trades and a small number of long-term ones.



For this profile:

- CE = \$100 M
- EAD = \$140 M
- M = 5 years (set exogenously by the longest netting set of the counterparty)

Assuming:

- Interest rate = 4% flat
- Credit spread of the counterparty = 2% flat

We calculate:

- CVA = \$1.30 M
- The CS01 of the CVA is \$0.0063 M per bp.
- The CS01 of the zero coupon bond equivalent is \$0.0511 M per bp.

Thus, the bond equivalent CS01 is 8.1 times the correct CVA CS01.

In summary, the use of the longest maturity for any netting-set significantly overstates the CVA spread risk.

2.2 Effective EPE with stressed parameters to address general wrong-way risk

The Consultation sets out suggested changes, to address problems seen in respect of general wrong-way risk (WWR – paragraphs 118 – 122). The concern in respect of this risk is shared by the industry, even though it has been notably difficult to quantify WWR historically. The opportunity to work with the regulators in ways to assess and capitalise this type of residual risk is welcomed.

The proposal to take the higher of current market factors and stressed market factors is clearly appealing, as it is simple in concept and prevents a benign market environment from unjustifiably and increasingly impacting results, as historic spikes fall out of the time series used.

It is, however, noteworthy that the Pillar 2 stress test charge should already take potential wrong-way risks into account through the stress scenarios envisaged and there is, therefore, a risk that a stressed EPE charge – which would be computationally highly intensive – is duplicative.

For a number of reasons, we believe that EPE based on stressed inputs may not produce the intended benefits and may even increase overall risk.

- Where the stressed charge dominates, the use test may be weakened, as it is unlikely to be adopted for credit sanctioning purposes. Credit risk management already considers tail values on a client by client basis.
- It will become harder for firms to manage exposures; undertaking additional trades to offset risk based on current market factors could potentially increase the exposure of a stressed EPE basis due to differences in correlations. Furthermore, clients are unlikely to be willing to post initial margin against stress volatility instead of current or market implied volatilities.

Industry would add that the main (and most credible) tool to demonstrate EPE validity is back-testing, on which a regulatory approach is of course still in development. We consider that materiality of the use of a stressed EPE should be reviewed, once a) results of the QIS are known and b) a back-testing framework is published.

2.3 AVC for Financial Institutions

Our members have shown considerable interest in the proposal to increase AVCs for categories of financial institutions. The Consultation suggests that empirical work has been performed, yet more is required. The Consultation suggests that the definitions of 'large' and 'systemically important' require further thought and consultation, itself suggesting that the interpretation of the empirical work has been inconclusive in this regard.

The Consultation also suggests uncertainty remains in areas such as the inverse relationship between low PD and high correlation. In the absence of a published, detailed study, it is hard for the industry members to arrive at any conclusion with regard the assertion of the Consultation. Noting the lead time to integrating the new capital constructs, the members feel that the details of a full and comprehensive study should be agreed with the industry prior to the analysis being performed, and then published for comment by the Committee.

It is not clear to the industry members how a snapshot of the impact within the QIS can better inform the outstanding decisions.

At the same time we note the rapidly increasing use of central counterparties, reducing the apparent 'interconnectedness' of financial institutions that is presumably one target for the AVC charge in the first place. We also observe the possibility of increased incentives *not* to face financial firms, which could reduce the 'network efficiency' of the market while increasing relative exposures elsewhere.

We include some specific observations related to the Consultation.

BCBS 164, pg 6, para 21, "Moreover, to address the systemic risk within the financial sector, the Committee also is proposing to raise the risk weights on exposures to financial institutions relative to the non-financial corporate sector, as financial exposures are more highly correlated than non-financial ones. It is conducting further analysis of the appropriate calibration as part of the impact assessment."

BCBS 164, pg 10, para 48, "In addition, refinements to the Basel II risk weighting functions can be made to directly address the risks created by systemically important banks (see for example the proposal in Section II.2 to increase the asset value correlation for exposures to large financial institutions relative to those for non-financial corporate exposures...)"

The industry is keen to learn further how the Committee performed an analysis of AVCs, given the opacity of many accounting approaches across the markets, and the greater or lesser degrees to which exposures are hedged and managed by financial institutions. The industry is also keen to understand how financial and non-financial institutions have been brought together comparatively.

BCBS 164, pg 28, para 114, "Large financial institutions were more interconnected than currently reflected in the capital framework. As a result, when markets entered the downturn, banks' counterparty exposure to other financial firms also increased. The evidence suggests that the asset values of financial firms are, on a relative basis, more correlated than those of non-financial firms. As such, this higher degree of correlation with the market needs to be reflected in the asset value correlations. The Committee, based on its empirical work, found evidence that asset value correlations were at least 25% higher for financial firms than for non-financial firms."

A large proportion of exposures between financial institutions are collateralised. The increase of these exposures is a function of market volatility, and the relationship between market volatility and exposure is attributed to general wrong way risk by the Consultation (pg 28, para 114), not asset-value correlation or interconnectedness. The alpha multiplier in the existing IMM framework, intended to capture general wrong way risk, is untouched by the Consultation. The industry members can only speculate on the approach used by the Committee to arrive at the Consultation's conclusion. However, recalling the RMMG Survey

Information from July 2009, it is hard to conceive how market driven exposure measures lead to an AVC conclusion that spans both trading and banking book positions. Considering further the many methods that can be used to derive AVCs from equity prices, the data is inherently flawed by other market influences at the height of the crisis, namely speculation, market rumour and fear. The dislocation in traded availability of credit derivatives and equity prices through the crisis can also mislead in determining the level of underlying interconnectedness across financial institutions.

BCBS 164, pg 30, para 116, "Apply a multiplier of 1.25 to the asset value correlation of exposures to regulated financial firms (with assets of at least \$25 billion) and to all exposures to unregulated financial firms (regardless of size). The Committee continues to conduct analysis to assess the appropriate calibration of the proposed multiplier and asset size threshold."

BCBS 164, pg 36, para 135, "During the crisis, financial institutions' credit quality deteriorated in a highly correlated manner and they proved to be relatively more sensitive to systemic risk than non-financial firms. As a result, financial institutions were more correlated than reflected in the current Basel II IRB framework. The work conducted by the Committee indicates that asset value correlations for financial firms were, in relative terms, 25% or more higher than for non-financial firms, and the Committee is of the view that this higher degree of correlation with the market needs to be reflected in the IRB capital framework. For this reason, the Committee is proposing that a multiplier of 1.25 be applied to the AVC of financial firms. Under this proposal, the AVCs between financial firms would range from 15% to 30%, as opposed to the 12-to-24% range currently set forth in the Basel II framework. The Committee is conducting further analysis on the appropriate calibration of this proposed multiplier."

BCBS 164, pg 37, para 136, "The definition of financial firms would be broadly defined to include banks, broker-dealers, insurance companies, and highly leveraged entities, such as hedge funds and financial guarantors, since all of these firms exhibited heightened sensitivity during the crisis. Exposures to smaller banks, broker-dealers and insurance companies did not exhibit this sensitivity to the same extent. As a result, the Committee is proposing to limit the application of the multiplier to exposures to banks, broker-dealers and insurance companies with assets of \$25 billion or more. It is conducting additional analysis to verify the appropriate calibration of the proposed threshold. Under this proposal, exposures to unregulated financial intermediaries, including highly leveraged entities that derive the majority of their revenues from financial activities, such as hedge funds and financial guarantors, would always be subject to higher AVCs, regardless of asset size. The Committee is seeking comments from the industry and other stakeholders on the appropriate definitions for regulated and unregulated financial institutions, and will seek to capture consistent data using possible definitions during the 2010 impact assessment."

The industry members are willing to work with the Committee to help categorise the definitions of regulated and unregulated financial institutions, noting the differences in accounting treatment across the many markets around the world.

BCBS 164, pg 37, para 137, "While the higher AVC was evident in counterparty exposures, the effect was not limited to such exposures, but extended to other exposures between financial institutions such as interbank lending, which also experienced system wide stress. Furthermore, default on any of these financial exposures leads to default on all other such exposures. For this reason, the Committee proposes that the multiplier on the AVC parameter be applied to all financial exposures under the IRB approach, subject to the above \$25 billion limit."

The Consultation again alludes to the conclusion of a higher AVC driven by counterparty exposure. The relationship between counterparty exposure and market volatility is not evidenced by other forms of near-term risk such as interbank lending, settlement and

clearing lines. The conclusion that an AVC multiplier should be broadly applied across credit and counterparty exposures is not wholly supported by the language used in the Consultation.

BCBS 164, pg 37, para 138, "The Committee is aware that the proposed 25% increase in AVC could result in a percentage increase in capital requirements that is actually higher due to the nonlinear relation between capital and AVC. The effect is more pronounced for the low PD and high AVC counterparties for whom capital could increase by approximately 35%"

BCBS 164, pg 38, para 140, "The Committee welcomes comments on the definition of unregulated financial institutions. The Committee believes that further work on the absolute level of AVCs and on the assumption of an inverse relation between PDs and AVCs is required."

The industry members are keen to engage with the Committee on both aspects.

2.4 Collateral

In recent years, firms have heavily invested in their collateral management units, processes and systems, and have worked with industry and regulators to strengthen collateral management throughout the industry. Examples are the dispute resolution protocol, standardized electronic messaging for margin calls and reconciliation requirements imposed by regulators (Fed reconciliation).

With this in mind, industry welcomes the proposed rules to strengthen collateral management units, as the majority of the proposed changes have already been implemented by industry.

However, industry does not agree with all circumstances where the margin period of risk is to be increased.

Large netting sets

Counterparties with big portfolios are usually counterparties with large credit lines, i.e. counterparties with good credit quality. Firms would not have as many trades with them if they were not comfortable with having such large portfolios with these counterparties. Also, since the credit crisis, regulators have imposed reconciliation requirements on the "Fed 14" counterparties: daily reconciliation for all Fed 14 counterparties with more than 500 transactions and monthly reconciliation for all counterparties with more than 1000 trades. This is complemented by extensive regular reporting. These reconciliation requirements improve data quality, significantly reduce the risk of disputes, make sure that the portfolios are tightly managed and would support a quick closing out of such positions. Note here that every transaction within a netting set does not have to be closed out separately; rather, the position is closed out on a net-market-risk basis. For large netting sets this typically requires orders of magnitude fewer transactions.

An arbitrary threshold defining a large netting set will only lead to an incentive for firms to split these netting sets into smaller ones, actually reducing the netting effect and increasing risk. Industry therefore suggests not to introduce increased margin periods of risk for large netting sets.

Disputes

Industry has already been active and is – led by ISDA – currently implementing the Dispute Resolution Protocol. Using this protocol should considerably reduce the time for resolution of a dispute, i.e. there should be fewer instances where a doubled margin period of risk needs to be triggered.

We would however suggest introducing a materiality threshold, so that the margin period of risk is not doubled because of a few minor disputes in the past. Industry will be proposing a

consistent framework for dispute reporting to regulators by May 31st, which will include such thresholds. We suggest using these thresholds when determining whether the margin period of risk should be doubled or not.

Illiquid contracts or collateral

Industry accepts that there is a possibility that these positions cannot be closed out quickly and accepts that the margin period of risk will double in these cases. However, similar to netting sets with disputes industry suggests introducing a materiality threshold

3 Supplementing the risk based capital requirement with a leverage ratio

We acknowledge that the level of leverage that increased risk within firms was certainly a factor in the crisis and amplified the downward pressure on prices and we agree that leverage should be an area for regulatory review. However, leverage was not the primary cause of the crisis, nor did it affect all firms equally.

We therefore consider that the leverage ratio should be carefully designed to address the role it played in the crisis, appropriately calibrated and sensibly interpreted for it to be a useful tool for supervisors. Provided that this is the case, we support the introduction of a leverage ratio, as a supplementary measure to complement the main focus for supervisors, which is the risk based measure for capital adequacy. It is vitally important that all regulatory measures, including the leverage ratio, continue to include incentives for improved risk management. We would caution against regarding the leverage ratio as a panacea to all ills; strong corporate governance and risk management practices have a very important part to play.

Our comments therefore focus on the issues we perceive around the current proposals, absent information on the calibration, and our recommendations for a way forward.

3.1 Key messages

3.1.1 Supplementary measure

We support the Committee's view, in paragraphs 204 and 205, that a leverage ratio should be regarded as a supplementary 'backstop' measure. It is important to consider both the risk that a firm is facing as well as its degree of leverage to get an accurate picture. Used on its own, as contemplated in the current proposal and without full understanding of the firm's risk profile and management practices the leverage ratio will be a very blunt tool that could cause users to come to inappropriate conclusions about a firm and how it compares to its peers. A firm that uses its capital to invest in high grade corporate securities is quite different to one that invests in low grade assets, yet they both could have the same leverage ratio. Further, it is necessary to take account of the different business models and structures adopted by firms. For example firms that have extensive trading activities are likely to be more significantly affected, particularly if there is no netting, because of the volatility in gross exposures. Therefore the leverage ratio risks introducing procyclicality into the regulatory framework.

Inverting the notion of a regulatory supplementary 'backstop' measure, we essentially see the leverage ratio as akin to an internal risk management limit arising from a very severe, but still plausible, stress test. The severe stresses in this regard relate to a broader range of market and operating assumptions breaking down. However, for the stress test to remain plausible it is inappropriate to assume all operating assumptions breakdown simultaneously and a number of our comments below address this issue.

3.1.2 Integration into the supervisory framework

The Committee has articulated that it has designed the leverage ratio with a view to it migrating to a Pillar 1 treatment. We would encourage the Committee to reconsider the appropriateness of this decision because of its shortcomings as a simplistic tool, as a result of our very significant concerns about some aspects of the design (see below). A Pillar 2 approach, however, would facilitate a better dialogue with supervisors, which can take account of the firm's individual risk appetite, business model, structure, governance and risk management practices. A hard limit in Pillar 1, if inappropriately calibrated, has the potential to create perverse incentives by encouraging firms to invest in more risky assets to gain returns or to exacerbate problems by encouraging forced sales.

We think that a Pillar 1 ratio potentially has significant implications for trading activities and firms carrying out market-making and market intermediation activities. In this regard we are also concerned by the volatility of exposures values that result from some of the proposals – notably the lack of recognition of netting and an appropriate treatment for hedging. With a Pillar 1 measure these firms would need to manage to a much lower level of leverage (i.e. operate with a significant buffer) to ensure that they do not breach.

We recognise that there are concerns amongst some authorities that Pillar 2 potentially creates an unlevel playing field because it may not operate the same way in all jurisdictions and because it might result in 'similar' firms getting different leverage ratios. We are therefore recommending that the leverage ratio be expressed as a range rather than a single number, to introduce a bound on supervisory discretion. We would also note the commitment in the Pittsburgh Declaration that all major financial centres would adopt the Basel II framework by the end of 2011. We take this to mean that supervisors will implement all three Pillars of the Accord fully. Although we recognise that the Basel Accord is not binding, we would suggest that the Supervisory Implementation Group would be an appropriate forum for delivering greater supervisory convergence. At a more granular level much is already being done to deliver supervisory convergence through the college process and peer reviews of supervisory implementation. As a result we believe that this concern will be addressed. Supervisory disclosure, at an aggregate level across jurisdictions, could also be used to help drive convergence.

3.1.3 Interrelationship of initiatives

It is important to take into consideration the other changes being proposed or introduced, or proposed, to the prudential regulatory framework that also address the causes of the leverage that increased risk in firms. In particular, we note some of the possible causes of leverage to be: the availability of cheap money over a sustained period of time, risk mispricing in certain sectors and an over-reliance on short term funding. It has also been suggested that firms expanded their balance sheets by increasing their exposures to assets where the risk was underestimated to take advantage of lower capital charges³. A concerted effort has been made by the regulatory community to address the failings of the Basel Accord. In particular capital requirements are being increased significantly in the trading book and a number of measures have been introduced in respect of securitisation (removal

³ Bank of England Financial Stability Review, December 2009, page 48

of the reduced credit conversion factors for liquidity facilities, increases to the risk weights for certain securitisation positions).

The cumulative impact of the proposed measures, in this consultation package, also need to be taken into account, not only the specific improvements to the quality of capital and increase in the quantity of capital, but the introduction of quantitative standards for liquidity. We therefore welcome the Committee's decision to undertake a comprehensive impact assessment of the combined effects of these measures on banks in advance of the proposed implementation date of the end 2012. Although these measures do not provide an absolute cap on leverage they go towards reducing incentives to increase leverage.

The accounting framework is also undergoing significant changes, including classification and measurement of financial instruments, impairment, de-recognition and consolidation. As regards de-recognition, the IASB is moving away from the current risk and rewards based model and converging towards the FASB's control based model. As such the accounting balance sheet will not necessarily be a good indicator of a firm's risk. As a result it is necessary to take these changes into consideration if financial accounts are to be the starting point for calculation

3.1.4 Timing of introduction

Although we acknowledge the political imperative behind the timetable, we believe that the leverage ratio should be one of the last of the regulatory changes in this package to be implemented, and consideration should be given to a longer timeframe than end 2012. We have some serious concerns over the design of the leverage ratio, which we strongly believe require further consideration and consultation. It is also important for industry and regulators to achieve a common understanding of the factors (such as the components of capital) feeding into the ratio. In our view, it is more important to take sufficient time to ensure that the design and calibration of the leverage is appropriate than to implement a measure that has undesirable and unforeseen consequences.

Design and impact of the proposal

In the absence of a suggested calibration it is very difficult for us to comment on the impact of the proposal outlined. Appropriate calibration is essential if the desirable characteristics of a leverage ratio are to be achieved and we consider that further consultation will be needed with the industry post the QIS analysis. A ratio that has not been carefully calibrated has the potential to create perverse incentives when it starts to bite by encouraging firms to invest in more risky assets to gain returns or to exacerbate problems by encouraging forced sales, and will send an inappropriate and potentially inaccurate signals about firms and their risk management frameworks.

However, we would highlight a few areas where we believe that material issues will arise:

Netting: The failure to recognise netting for derivatives and repo and securities financing transactions will grossly inflate balance sheets out of all proportion to the risks that institutions are running and give a false impression of the levels of leverage. It will also introduce significant volatility into the exposure values and therefore potentially introduce

procyclicality. Gross figures also have the potential to disproportionately impact some business models and create perverse incentives. This could result in these activities migrating to less regulated markets to the extent that the leverage ratio is binding. In addition netting is assumed in contracts with central counterparties. Although we note that the position of such exposures is unclear in the proposal, if netting is not recognised this would seem to be at odds with the initiatives to encourage more extensive use of central counterparties. Legally enforceable netting has been proven to work during the crisis and we strongly urge the Committee to recognise its benefits in the design of the leverage ratio. We propose that regulatory operational criteria should be used.

Market making/market intermediation: By not recognising any hedging benefits, a misleading picture of leverage will be created which would not be reflective of the firm's position. Furthermore, the proposal results in double counting because both the exposure as well as its hedge/mitigant will feed into the leverage calculation. As a result good risk management practice is not recognised, and risk intermediation roles, such as those performed by market-makers would be disproportionately affected.

Other forms of credit risk mitigation: The failure to recognise financial collateral will also create a misleading view of leverage in individual firms and the system and provide a disincentive to good risk management. We therefore believe that financial collateral should be recognised, as it can be realised reasonably quickly in stressed conditions, albeit at a reduced price. We note that the consultation is not seeking to change the operational criteria for recognising financial collateral (although we note that the consultation seeks to improve collateral practices for IMM). As regards haircuts we note there is only a change proposed in respect of securitisation exposures. We therefore assume that regulators are generally content with the robustness of the existing requirements and recommend that financial collateral be recognised if the operational criteria are met. There are a number of methods for recognising collateral in the capital framework; we suggest that the comprehensive method be made available for the purposes of calculating leverage in situations with financial collateral. We accept that physical collateral is a more complex proposition, in light of the breadth of assets covered and the time that might be needed to realise some asset classes.. However, we do regard it as a useful risk mitigant and it should be encouraged. We also think this is another reason to support a Pillar 2 approach.

Securitisation: The proposal indicates that accounting will be followed, but that the Committee is also considering recording all securitised exposures on balance sheet. While the industry acknowledges that there have been issues in certain sectors of the securitisation market, securitisation is a very important funding tool and there have been significant strides made by the both the market and regulators in addressing shortcomings. Not recognising the transfer of risk through securitisation will create a misleading picture. We recommend using the regulatory operational criteria in the securitisation framework. Further detail on securitisation is included below.

Other off balance sheet exposures: It is important that the leverage ratio does not unduly curtail the intermediary function provided by banks in funding/liquidity provision to real economy market participants. Assumptions about the extent to which these exposures can be fully drawn and full losses taken require further consideration. The use of a 100% conversion factor for all contingent exposures is not in line with firms' experiences of draws

or losses, which are in nearly all cases substantially less. Unconditionally cancellable commitments are an invaluable tool for corporates to manage contingent liquidity requirements. This traditional and very important, banking service proves a vital function for the real economy. Trade finance, is also a key concern; as it is an essential part of global trade and economic recovery. We would note that it is a G20 priority. In order to facilitate business commitments and trade finance, we strongly recommend that lower conversion factors are permitted. If regulators are concerned about arbitrage possibilities, we suggest that the higher of the standard conversion factors, or firms' IRB estimates be used.

Credit derivatives: The consultation proposes an asymmetric of approach for bought and sold protection through credit derivatives. The approach is punitive on the sold protection side because it does not even recognise that notional may overstate the maximum possible loss, even without recognising any hedges. In addition by not recognising any hedging benefits, a misleading picture of leverage will be created, which is not reflective of the firm's position. Furthermore the proposal results in double counting because a credit derivative hedge purchased will also feed into the exposure calculation. The treatment should recognise the economic substance of firms' activities. Therefore in the trading book we think that the standard rules for market risk provide a template to recognise the risk position; these require the notional of the credit protection sold to be reflected but also recognise the offset of exactly matching protection bought.

It is also important to avoid conflicts arising between the various parts of the prudential framework; therefore we agree that it is important to consider excluding highly liquidity assets as defined in the proposed liquidity standards. In our view, inclusion of such assets within the exposure calculation, while theoretically pure, risks creating perverse incentives to take on riskier exposures if the leverage ratio becomes a binding constraint, so we support scoping them out.

Recommendation

In summary our position is as follows:

Desirable characteristics of the leverage ratio

In our view the desirable characteristics of a leverage ratio would be as follows:

- Capable of addressing a variety of business models.
- Comparable across jurisdictions with different accounting regimes.
- Binding only in periods of credit exuberance, not a main driver of firms' activities.
- Complementary to other risk, and non risk-based measures.
- Encourage good risk management practices and not create perverse incentives.
- Differentiate between firms on based on the risks that they are running.

Framework for the leverage ratio

Design: The leverage ratio should be expressed as a range, rather than a single number. Such an approach would allow the leverage ratio to take account of differing business models and firm specific factors. While the leverage ratio is a supplementary measure, it is still important that it take account of the nature and scope of a firm's business model otherwise it is too blunt an instrument to be really useful. This approach allows intelligent use of the leverage ratio through robust dialogue between the firm and its supervisor about the appropriate level of leverage for its particular business. It is also important to build in incentives to continually improve risk management.

Integration into the supervisory framework: We firmly believe that the leverage ratio, as a supplementary measure, should be incorporated into Pillar 2.

Timing of introduction: As a result of its interdependence with other aspects of the framework and as a result of the need to address certain design and calibration issues, it should be one of the last parts of the package to be implemented.

Capital inputs: As a preventative measure it is appropriate that a going concern measure of capital is used and therefore Tier 1 after deductions should be used.

Exposure inputs: In line with our view that a leverage ratio is essentially a limit imposed as a result of a very severe but plausible stress test, it should continue to provide positive incentives for good risk management. It should work with, not in conflict with, other elements of the prudential framework a number of exposure value. As a result:

- Legally enforceable netting that meets the operational requirements in the regulatory regime should be taken into account.
- Financial collateral should be recognised where the regulatory operational requirements have been met. For this purpose comprehensive approach should be available. We do not propose that physical collateral should be recognised.
- For other off-balance-sheet exposures, we propose the higher of the standard conversion factors and firms' IRB estimates should be used.
- For credit derivatives in the trading book, we propose the standard rules for market risk whereby the notional of the credit protection sold would be reflected, and exactly matching protection bought would be offset.
- The risk transfer benefits of securitisation should also be reflected and as such we would recommend the use of the regulatory risk transfer requirements.
- Highly liquid instruments, that are required to be held as part of the liquidity requirements should be scoped out to avoid creating conflicts between different parts of the framework and to avoid perverse incentives to take on risk.

3.2 Additional comments on the proposal

The numbering in this section relates to the sections of the consultation document

3.2.1 Level of application

In keeping with the rest of the Basel Accord, the consultation indicates that the leverage ratio should be applied at the group rather than solo, or any intermediate consolidation level. We agree that this is appropriate.

Given the changes that are currently being considered in the accounting framework, which will change the scope of consolidation for financial statements (including some special purpose entities and funds) and the exclusion of others it would seem appropriate to use the regulatory consolidation.

(A) Capital measure

As a preventative measure, we agree that a going concern definition of capital, i.e. Tier 1, should be used. We do not see any reason for tightening the definition still further, by focussing on core Tier 1. Deductions from capital should be taken where these items reduce the loss absorbency of capital, subject to our comments in Section 1 (Raising the quality, consistency and transparency of the capital base) of this Annex.

(B) Exposure measure

1 General measurement principles

a. Relationship with accounting

We agree that it is inappropriate to take account of risk based capital requirements, as this would not meet the objectives of a limit resulting from a very severe but plausible stress test. However, we can see arguments for starting from the accounting or regulatory balance sheet, as both would require adjustment to form a base for the calculation. The accounting balance sheet provides an independently verifiable starting point for calculation that is not risk adjusted. However, it does not necessarily capture exposures on the basis of risk and reward. The regulatory balance sheet addresses some of these issues, but presents its own challenges in terms of the various options available to firms and the need to address the treatment of modelled approaches.

If using the accounting balance sheet we agree that the leverage ratio should operate in a neutral manner between accounting regimes and over time. The issues identified by the Basel Committee for adjusting the accounting balance sheet are the correct ones, although our views differ in some areas as to the nature of any adjustments made.

We agree that exposure value should be reduced by provisions and value adjustments.

b. Netting

See above.

2 On balance sheet items

a. High quality liquid instruments

See above.

b. Repurchase agreements and securities finance

While we accept that reliance on repos and securities funding as a form of financing may have caused regulatory concern. Falling asset prices resulted in margin calls and consequent further sales and further depressed asset prices. However, an over-reliance on short term sources of funding is more appropriately addressed through liquidity requirements than the leverage ratio.

c. Securitisation

Securitisation has been an important source of financing for the real economy and the scope of its inclusion in the leverage ratio should be carefully considered. The securitisation market is currently very fragile, for example public issuance in the EU has fallen from €450bn in 2007 (90% of which funded real economy assets) to a few billion in 2008 and 2009. The majority of issuance in 2008 and 2009 has been retained by firms to use as eligible collateral to use with the ECB and other central banks. Regulatory uncertainty is one of the factors contributing to the lack of return of the market. The FSB report on enhancing market and institutional resilience recognised that when accompanied by adequate risk management and incentives, securitisation can offer a number of benefits to loan originators, investors and borrowers. 'Originators can benefit from greater capital efficiency, enhanced funding availability and lower earnings volatility. Investors can benefit from a greater choice of investments, allowing them to diversify and to match their investment profile more closely their risk preferences. Borrowers can benefit from expanded credit availability and product choice, as well as lower borrowing costs.' Given, the acceptance by the authorities of the usefulness of securitisation, and the likely withdrawal of central bank liquidity over the coming year, it is important not to provide unnecessary disincentives to this form of financing.

The industry acknowledges that there have been issues in certain sectors of the securitisation market and that there have been cases where banks took assets back for relationship rather than legal reasons. However, significant strides have been made by the industry and regulators to address shortcomings. The industry has undertaken a significant amount of work to address disclosure levels to ensure that investors understand the risks inherent in the position under consideration. In Europe the 5% retention requirement is intended to ensure that originators and sponsors have a vested interest in the risks of the underlying pools after issuance, similar measures are proposed in the US. Further, the understatement of risks in liquidity facilities has been directly addressed through the removal of preferential conversion factors. The recognition of higher risks contained in re-securitisation positions will also provide a disincentive to more complex structures such as CDO², CDO of ABS and other similarly highly leveraged structures. As a result, securitisation going forward is likely to be simpler, more transparent, with a clearer trail of responsibilities. As a result it would seem appropriate, particularly given the recognition of

the need to restart securitisation markets to provide funding to the real economy, to de-recognise securitisation transactions.

However, we admit that de-recognising securitisation transactions is not without its difficulties. We would note that accounting standard setters are currently revisiting the rules for both consolidation and de-recognition, which will change the basis of the accounting balance sheet for securitisation. The Basel framework provides a set of tests for de-recognition of securitised exposures, which are based on the transfer of significant risk. However, these criteria are not applied uniformly across all jurisdictions – in Europe additional criteria have been developed.

In our view, the changes made to the framework will deliver a more robust and appropriately managed securitisation market, where responsibilities and risks are clearer. On balance therefore, and in line with the approach taken to credit risk mitigation more generally, we think that the regulatory operational requirements should be the basis for de-recognition of securitisation transactions.

3. Derivatives

In terms of the basis for recording derivatives, we think that mark to market, without add-on for potential future exposure (PFE) is appropriate because there is no time horizon implicit within the leverage ratio. The PFE assumes market moves over a one year time horizon.

We also seek clarity on how centrally cleared derivatives will be treated.

a. Credit derivatives

See above.

3.2.2 Off balance sheet items (excluding derivatives)

See above.

3.2.3 Disclosure

The industry is very supportive of disclosure as a mechanism for delivering market discipline and recognises that it has a role to play even with leverage. However, although no potential disclosures have been consulted upon in this proposal, we would like to register some initial thinking around Pillar 3 in this area. We are concerned by the potential for misinterpretation of leverage numbers presented. The leverage ratio proposed is a very simplistic measure and without a full understanding of the risk profile and risk management practices of the firm, erroneous comparisons may be drawn between institutions, particularly if some of the issues that we have identified have not been addressed. On the current proposals allow levels of leverage would not correspond to low levels of risk nor would high levels of exposure correspond to high levels of risk. Careful thought will need to be given to the disclosures required in this area so that they balance the need to provide information with the risk of overburdening with data to explain very simplistic requirements. If a Pillar 2 approach is pursued, then confidentiality considerations will also need to be reviewed. Thought should

also be given to whether aggregate leverage statistics, disclosed by supervisors, may serve to better inform market participants rather than individual firm disclosure.

3.2.4 Calibration

See above.

4 Reducing procyclicality and promoting countercyclical buffers

4.1 Key messages

We note the Committee's concern that the interaction of the capital and accounting regimes proved to be excessively procyclical and the prominence the G20 has given the consideration of changes to the existing frameworks to reduce this effect going forward.

As is made clear in the consultation document, however, procyclicality has a number of sources and there are many interrelated proposals for how it could be addressed. Care must be taken to understand the full impact of each proposal and time taken to develop a package which works as a whole. This consideration should include a review of existing regulatory tools, some of which already achieve the desired aims, to avoid duplication and double counting. Analysis must include the trade-offs which the adoption of each would imply in terms of the impact on the real economy, financial institutions and financial stability. It is also important to recognise that some measures considered in the Consultation, such as the elimination from capital of deferred tax, pension fund deficits, counterparty risk changes etc. if adopted, could potentially increase procyclicality.

The industry believes there should be two core parts to the regime to address procyclicality and that it is necessary to keep a clear distinction between the accounting and regulatory capital frameworks. It should not be forgotten that accounting and regulatory loan loss provisions are calculated and used for different purposes. The first part to the regime to address procyclicality should concern the earlier recognition of *expected* losses and should be achieved by moving the accounting framework from an incurred to an expected loss basis, amending supervisory guidance on provisioning and unwinding disincentives to provision in the Basel II framework. The second should provide for a buffer to mitigate *unexpected* losses which arise through the economic cycle. This should, as the Committee indicates, be a regulatory counter-cyclical capital buffer outside the financial reporting framework, sitting in the Pillar 2 framework.

In our view Pillar 2 already gives supervisors extensive tools to address issues identified, such as prohibiting distributions and requiring firms to maintain capital buffers to reflect their risks. We believe that consistent application of Pillar 2 should be a focus of the Committee through its Standards Implementation Group.

Where markets already have equivalent measures we strongly oppose a further buffer process being introduced which will merely serve to duplicate existing proven techniques and measures. We also suggest that where firms already maintain a substantial buffer and have sound risk management and corporate governance practices, this should be taken into account rather than requiring a further buffer.

We do not support proposals for 'dynamic provisioning' which inter-alia conflate the recognition of losses for accounting purposes with the need to provide a buffer against losses which may arise in future over the economic cycle from business which has yet to be written. We believe such measures amongst other issues reduce transparency and have the potential to seriously damage market confidence in financial institutions.

4.2 Detailed comments on the proposal

4.2.1 Cyclicalities of the minimum requirement

The industry agrees that the Basel II framework has increased the risk sensitivity of the regulatory capital requirement. We recognise that there is a trade off between increasing risk capture and sensitivity at a given point in time and the degree to which the minimum capital requirement is cyclical over time. As the Consultation notes, credit losses in the banking book are only now moving to their peak level. We therefore support the Committee moving, once further evidence has been gathered, to assess what additional measures to dampen cyclicalities could be developed, over and above the flexibility already afforded to banks and their supervisors in the framework, to dampen cyclicalities via the more general application of downturn or through the cycle PDs.

In developing proposals, it is important that the fundamental link between Basel II processes being used for management and regulatory purposes is not broken by the use of overly conservative regulatory PDs. The introduction of overly conservative PDs would also increase the capital with the perverse effect of incentivising institutions to increase their exposure to 'riskier' business lines.

We strongly support the decision to conduct an impact study on the proposals in this area, and look forward to evaluating the outcome through a further consultation process.

4.2.2 Forward looking provisioning

We welcome the progress which is being made towards the G20's recommendation that standard setters should strengthen provisioning practices. As the Committee notes, this work has been disaggregated into three distinct streams:

- the revision of the IAS 39 impairment methodology to move it from an incurred to an expected loss basis;
- a consequential amendment to the supervisory guidance on provisioning; and
- moves to address disincentives to provisioning under the capital framework.

The banking industry supports the IASB's objective to move to an expected loss regime and the idea of ensuring that provisions raised incorporate a broader range of credit information than may currently be the case, and believes that it is important that this be achieved within the context of the objectives of financial reporting, which are different in certain ways to the objectives of prudential regulation. We agree that it should be possible to achieve more forward looking provisioning in financial statements by using a broader range of credit information, but are concerned that the introduction of excessive subjectivity into provisioning methodology, or approaches that seek to accumulate a prudential 'buffer' during benign periods in order to stabilise reported earnings during times of stress, will reduce the objectivity of financial reports and damage market confidence.

That being said, we do not agree with the expected cash flow approach based on an EIR (Expected Interest Rate) methodology as currently proposed by the IASB. This is an overly complex model both in terms of its design and ongoing application. We estimate the cost of implementation for the UK banking industry alone to be in the region of 50 to 75 per cent of first time adoption of IFRS or between £150 to £225 million in aggregate. That being so we strongly recommend the Committee does not pursue an EIR methodology.

In our view, the IASB can meet the G20's objectives via the adoption of a simpler model which aligns with risk management practices makes greater use of existing systems

developed for Basel II purposes. We agree with the Committee that the methodology adopted should reflect expected credit losses in loan portfolios over the life of the portfolio as at the balance sheet date.

As regards the treatment of the difference between provisions and regulatory expected loss, where accounting and regulation does not align we are not convinced that the approach proposed (i.e. to deduct the shortfall from core Tier 1, as opposed to 50:50 from Tiers 1 and 2) will deliver the desired objective of removing disincentives to sound provisioning. If accounting and regulation align, which the industry supports, then such provisions will be unnecessary. However if they do not align then other tools should be considered. We would note that the deduction of the shortfall represents another tightening of the requirements for which the impact requires assessment. While we understand the rationale for the current approach, to address the focus of the capital framework on unexpected rather than expected loss, the industry would emphasise that firms displaying sound provisioning practices should have recognition for their prudence, which could, for example, be reflected in the assessment of the need for capital buffers; the removal of any 'cap' on expected provisions over expected losses.

We note that the Committee is still considering its approach to any excess and look forward to continued dialogue in this area.

We look forward to the publication of proposals to update the supervisory guidance on sound provisioning practices and welcome the recognition of the importance of the new guidance utilising approaches that draw from relevant information in banks' internal risk management and capital adequacy systems wherever possible. The Committee should continue to work with the standard setters to achieve a satisfactory, globally applicable solution and continue to consult with the industry as these further develop.

4.2.3 Building buffers through capital conservation

As is acknowledged above, we believe that there may well be a case for capital buffers to be built over and above the minimum capital requirement but strongly oppose measures such as 'dynamic provisioning' which distort the financial reporting framework. We therefore are supportive that the proposal set out in the consultation document is focused on regulatory capital. We observe that a number of the institutions which weathered the financial turmoil well had discretionary buffers in place over their minimum capital requirements, supported by effective utilisation of the Pillar 2 process and sound risk management and corporate governance practices. In fact, a number of countries, including the UK and Canada, already operate a capital planning buffer measure as part of the existing regulatory Pillar 2 framework, which is closely monitored as part of the ICAAP protocols and stress testing framework. It should also not be forgotten that under the existing Pillar 1 parameters there already exists a number of stressed parameters (e.g. downturn LGD and the soon to be introduced stressed VAR), which already therefore form part of the capital plan and provide buffer for counter cyclical situations. The Pillar 1 credit risk framework also includes a stress test, which can potentially result in a buffer to cater for an economic downturn. On top of this in Pillar 2 many countries operate on a more severe stress scenario which further informs the buffer level to be held.

It should also be noted that the starting point for any capital buffer framework should be an explicit recognition that the buffer should be designed to be drawn down at the appropriate point in the economic cycle and in adverse external circumstances. It would be inappropriate if constraints were placed on the use of the buffer which resulted in it being viewed by either supervisors or the market as establishing a new minimum capital requirement or in breach of a regulatory requirement when drawn down.

We emphasise that it would be inappropriate to create a situation where buffers sit upon buffers trapping capital from its efficient use in the real economy. Firms which maintain a strong capital base which already has a buffer to offset cyclical capital depletions and stress situations should not be required to hold additional capital buffers as a result of these measures. The impact assessment currently underway needs to assess the extent to which there is double counting before determining any calibration to optimise efficiency.

In terms of the design of a capital buffer framework, it is always important to ensure the following principles apply to the buffer review process:

- be risk-based, recognising the individual firm's existing capital strength and robustness of its corporate governance and risk management practices. This should include taking account of the robustness of the firm's recovery and resolution plans, and management prudence. These qualitative measurements should all act as a mitigant to the resultant quantitative buffer sum.
- be established at the group consolidated level. There should be no room for national discretion, which could lead to an international firm having capital buffers in multiple locations; thereby tying up capital in an inefficient manner and not necessarily optimising its usage throughout the group both on a 'business as usual' basis or indeed in an economic downturn. Rather the consolidated supervisor should, working closely with the firm and its college of supervisors, lead the review of what the appropriate buffer at a consolidated level should be.
- remain a private matter between the firm and its consolidated supervisor/ college of supervisors to avoid the serious and potentially significant impact of any market or public knowledge, which could have serious and significant impacts. It should therefore remain part of the Pillar 2 supervisory process. As such the buffer should not be a 'hard' target but rather is 'soft' recommended target, which will form part of the ongoing dialogue between firms and their supervisors in relation to the firm's specific business activity.
- the use of the buffer should not trigger either corporate governance obligations and / or result in action that would alert the investor and/or public domain. Such an outcome could have far reaching consequences. Careful thought needs to be given to disclosure obligations that capital conversion standards could potentially trigger, with the ensuing serious risk of reputational damage to the institution.
- managed at the discretion of the individual firm.

As regards capital conservation, we would also note that the Principle 4 of the Pillar 2 framework also suggests a range of actions that supervisors might take to prevent capital falling below minimum levels, including the right to prevent firms from distributing dividends. We think that these tools can be used rather than creating additional capital conservation buffers which result in double counting. We therefore recommend that the Committee through its Standards Implementation Group focus on ensuring the uniformity of application of the Pillar 2 both as regards distributions and counter-cyclical buffers as well as strengthening stress testing parameters globally. This could be augmented through specific rules for college of supervisors to follow in the implementation of such measures on a firm specific basis.

We further note that capital constraints should only be imposed if capital levels fell within the buffer range and that the constraints would be proportionate to the level of incursion into the range but at all times not affecting the operation of the bank. However, we are unclear as to

how the Committee envisages the approach working, nor do we understand the methodology and we would appreciate further clarity in this area. Discretion should rest with the management of the firm over the way in which the buffer should be rebuilt. The balance between the various options should be for management to decide, in discussion with the consolidated supervisor.

We do not comment on the numbers provided in the table as we note these are for illustrative purposes only. However, this is not a simple subject and it has overlap with existing tools and therefore the industry welcomes further consultation with the Committee as it evolves its thinking and approach.

In summary, we do not believe that the Committee should pursue the establishment of a new regime of capital buffers or capital conservation, but should focus its efforts on the consistent application of existing tools and processes globally and recommend that the Standards Implementation Group is the appropriate forum through which to achieve that. That said, if the Committee pursues the model proposed, it will be vital that the calibration of the appropriate range for the capital buffer be considered alongside the exercise to recalibrate the capital framework and in light of the recommendations reached on forward looking provisioning. This exercise should include the review of existing national buffer processes to align processes, minimise double counting, and take account of the wider consequences for lending capacity and the real economy, as well as the impact that restrictions on the payment of dividends might have on the attractiveness to the market of an institutions' common equity. Full consideration would also need to be given to appropriate implementation and transition provisions, including further industry consultation

We also suggest that where firms that already have a substantial buffer and are seen to be well run with adequate systems and controls, this should be taken into account rather than requiring a further buffer. For such firms it would be sufficient to require the firm to notify its lead supervisor if its Pillar 2 stress testing indicates that its own buffer would be fully utilised in the recent of an economic downturn or other severe stress scenario to maintain minimum capital requirements.

4.2.4 Excessive credit growth

We agree that one of the lessons of the financial turmoil is the need for macro-prudential regulation to link the macroeconomic stewardship of the economy with the supervision of individual firms. We believe that a macro-prudential regime could go some way towards increasing the resilience of individual firms and better protecting the economy against the consequences of financial instability so as to maintain the essential services banks provide to the real economy. However, the outline proposal suggested is just one possible tool and it can not be considered in isolation. We are therefore not proposing to comment on the suggestion that the capital buffer could be used for this purpose, but have included more general comment on macro-prudential supervision.

We believe a macro-prudential supervisory framework must sit outside the micro-prudential regulator. The macro-prudential framework would use relevant indicators to detect 'bubbles' at a national level with input as relevant from regional bodies such as the European Systemic Risk Board and international bodies such as the Financial Stability Board. The macro-prudential body would be accountable for detecting areas of over-heating where problems may arise and laying these out for the micro-prudential supervisor. The micro-prudential supervisor would then assess the firms operating within the market over which it has supervisory authority to identify, as to which individual institutions it considers to be most exposed to the risk(s). Determination of any specific actions necessary to manage risk(s) should be assessed and determined through Pillar 2 supervisory review and discussion with the individual firm whether any specific action is necessary by that institution to manage the

risk(s). Macro-prudential supervision supervisors would therefore link to the micro supervisor in providing information, or recommendations that action should be taken, but should not have direct control of the remedial actions at institutional firm level. Determination of the precise actions required should be made by the micro-prudential supervisor on a case by case basis, with specific discussion with the individual firm.

It is also worth stressing that we do not believe macro-prudential regulation is sufficient by itself to address excessive credit growth. In particular, it should not be allowed to disguise from the need for reform in other areas, such as monetary policy, where the financial crisis has exposed weaknesses. Without a holistic approach (i.e. one that also recognises issues which address monetary policy, the need for a sustainable fiscal policy, and structural issues, such as in the housing market), macro-prudential regulation - however well designed - is unlikely to prevent another crisis. Prudential regulation (macro or micro) should not be looked upon as the panacea for a wide range of issues. The focus on prudential initiatives to address the supply side can divert attention from more uncomfortable questions about the role of monetary policy authorities in managing the demand side. Given the build-up of public sector deficits and sovereign rating concerns, the next crisis (and systemic risk) could conceivably be on the fiscal/demand side rather than originating in the banking sector.

The tools to implement a macro-prudential regime will be dependant upon its objectives. The decision on which to adopt should be based upon thorough analysis and an understanding of the trade-offs involved in terms of the impact on the real economy, financial institutions and the international competitiveness. A number of papers have been prepared on this, for example in response to the Bank of England's recent paper – "The role of macro-prudential paper policy" - and at the international level by affiliated associations, outlining the key principles the international banking arena believes will be necessary for such a macro-prudential regime to operate effectively.

5 Addressing systemic risk and interconnectedness

We acknowledge the role and consequences systemically important financial institutions can have on the real economy. We recognise that the Committee has not outlined policy proposals in this area as yet, but look forward to reviewing the details of these approaches in due course. However, we would like to make some high level comments at this stage on systemically important financial institutions because of the comments in paragraph 47 regarding the possibility of introducing capital and liquidity surcharges.

We recognise that for some firms, or categories of firms, maintaining the confidence in the financial system is a more important supervisory objective than for others. However, we urge the Committee to consider a holistic assessment of the approach to systemic risk and interconnectedness, taking account of the broader range of regulatory initiatives that serve to mitigate some of the risks. In particular we would note the importance of the development of resolution tools and an effective framework for cross border resolution. The proposed enhancements, already in progress or in development, will also serve to enhance these firms' ability to absorb losses and the cumulative impact of these proposals must be taken in to account. As the consultation document notes, the proposal to increase the asset correlation among financial institutions will directly address this issue, but other changes will also be important for example the proposals to dampen cyclicality, i.e. the link between macro and micro prudential regulation. Measures introduced to improve risk management practices will help to reinforce the importance of risk identification, measurement, monitoring and action. The international efforts to increase the use of central counterparties will serve to reduce interconnectedness between financial firms. Standards for central counterparties being developed will also serve to protect payment systems and improve resilience. Early intervention measures, supervisory and crisis colleges and recovery and resolution plans are other measures that should serve to mitigate the risk of failure as well as the potential impact if failure should occur. Existing competition tools in national jurisdictions and regions can continue to ensure that market dominance is addressed.

In designing any framework for systemically important firms, as well as taking account of the other initiatives, it is also important to establish a balance between enhancing the regulatory framework and economic recovery, sustainable and balanced growth, to meet common objectives in line with the G20's commitment in the Pittsburgh Summit Declaration. It is vital to recognise that large and complex firms bring social, economic and market benefits, as well as risks, through their capacity to intermediate between borrowers and investors across a range of markets. These firms perform a risk taking function that is necessary for economic vitality. Large firms can deliver economies of scale, scope diversification, improve market efficiency and support global trade. Any measures introduced should be carefully considered so as to avoid eroding these benefits and ensure that measures do not overcompensate for any perceived competitive advantages created by systemically important financial institutions.

As practical approaches are developed to assist supervisors measure the systemic importance of banks to the financial system, we urge the Committee to recognise that a number of factors are relevant to determine systemic importance and these should be taken into consideration. There is no one 'silver bullet' for the measurement and management of systemically important financial institutions and an element of judgement will be required. In particular we think that the following factors should be taken into account:

Financial stability: An assessment of the systemic importance and the implications for supervision of a firm, group, or collection of firms, will depend, at least in part, on how financial stability objectives are defined. Agreement of financial stability objectives is therefore a necessary preliminary step.

Objectives: It is important to be clear as to the objectives of a regime for systemically significant firms. We are pleased to note the Committee is not recommending a system that aims to limit size or complexity.

Definition: It is challenging to define systemic importance and it is important not to come to the conclusion that it can easily be equated with size. Systemic significance could be measured in terms of a combination of factors, such as size, connectedness, group/solo sectoral significance or market dominance. However, we think it would be difficult and potentially counter-productive to base this determination on a single objective test or in relation to a single factor. The boundaries of the categories may be very difficult to maintain as markets and the participants in them develop and continue to evolve. In a crisis, contagion risk may well make those boundaries meaningless. Furthermore, the assessment of what is or is not systemically significant may differ at national, regional, and global levels. A scorecard approach that can weight differing factors and involve supervisory judgement is a more appropriate way forward. Determination should therefore be made of where a firm sits on the scale of systemic risk, rather than having a single hard boundary. A hard boundary could distort competition and firms' ability to plan ahead.

Risk migration: It needs to be recognised that further requirements placed on systemically important firms creates the possibility of risk migration. Any framework needs to ensure that systemic risk does not migrate to unregulated or less well-regulated sectors or jurisdictions, where risks will be less visible and may accumulate to systemic levels.

Global dimension: Given the global nature of financial markets it is essential that any initiatives in this area are fully supported internationally, in terms of consistency of definition, treatment and implementation (substance and timing).

Better regulation and impact assessment: The assessment of any additional requirements for systemically important firms needs to be made with full knowledge of the cumulative effect on such firms of other requirements introduced in response to the market turmoil (see above). In addition, it is vital that the other process disciplines of good policy formulation are followed. While we appreciate the desire to maintain momentum, we urge the Committee to ensure that sufficient time is given to properly consider the full range of policy options to deliver the desired outcome.

Forward looking: It is important not to design a system specifically to cater for past failures, but take account of possible future stresses as well.

Tools of regulation: It is important to consider all available tools of regulation when determining an appropriate regime. In particular, Pillar 2 and the intensity of the supervisory relationship should be considered. The Pillar 2 process allows supervisors to take a holistic view of the impact of a firm's failure (taking account of risk mitigants) as well as its probability of default.

Risk management incentives: It is important to retain, and not undermine, the incentives to improve risk management currently provided by the Basel framework.

Disclosure: We do not think that it is appropriate for systemically important financial institution status to be disclosed because of the potential market distortions that could result. In addition, the introduction of other measures that will allow institutions to fail, such as resolution tools will mean that an absence of disclosure is not inappropriate. This would be consistent with our view that recovery and resolution plans remain confidential.

In summary, as the Committee develops its thinking in this area, we would stress that supervisory tools, changes to the capital framework, the introduction of a liquidity framework,

as well as broader regulatory developments, such as central counterparties, will contribute significantly to reducing the risks systemically important firms pose to the financial system and the economy. We do not believe that capital or liquidity surcharges should be considered until the QIS has been completed and reviewed, conclusions have been reached on the calibration design, timing and sequencing of the proposals in this consultation and the full range of options (particularly existing regulatory tools) have been assessed). The industry looks forward to working further with the Committee in developing its thoughts in this area and responding the forthcoming consultation.

Annex 2: Response to the Committee's Banking Supervision Proposals to strengthen Global Capital and Liquidity regulations (BCBS 165)

1 Introduction

The Basel Committee for Banking Supervision (BCBS) proposal for an *International framework for liquidity risk measurement, standards and monitoring* (BCBS 165) is welcome by our members including those of the Association of Foreign Banks. The recent crisis underlines the need for a common approach to liquidity risk standards which, compared to the framework for capital, are relatively underdeveloped. As such we view the Committee's proposal as the first stage in an on-going discussion to develop liquidity standards.

In principle we support the introduction of a short term measure that focuses on the adequacy of a financial institution's liquidity buffer in times of stress and a long term measure that focuses on the structure of its funding. The adoption of such standards will help to promote a more balanced approach to funding in the industry and ensure a globally consistent framework.

Nevertheless, we caution the Committee against the introduction of an overly prescriptive one-size-fits-all framework that assumes that all firms are equally affected by the liquidity crisis specified and, in the case of the NSFR, do not make adjustments to their balance sheets or strategy over the year that the stress is assumed to occur. The requirements do not appear to reflect minimum standards but rather a maximum stress based on an aggregation of recently experienced stress events. In Section 2, we highlight some of the potential consequences of such a framework and offer possible alternative solutions for the Committee's consideration.

We also welcome the Committee's proposals for common monitoring tools and the Committee's implicit recognition that firms deploy a variety of monitoring metrics in their day-to-day management of liquidity risk. To support the proposed international liquidity rules and their consistent application, we provide further recommendations on further harmonising reporting standards and urge the Committee to encourage a cross-border liquidity framework.

We are very concerned by the calibration of the LCR and NSFR. On an individual firm basis, the proposed ratios will likely result in a complicated set of calculations that overstate the liquidity risks being managed. So we support the QIS and suggest that a further calibration exercises will be required.

BCBS 165 generated a discussion among our Members from which emerged suggestions to improve the framework in addition to a number of detailed comments. We hope all our comments will be of interest to the Committee. Key messages and recommendations on BCBS 165 are presented in Section 2 while our detailed comments on aspects of the proposals are presented in Section 3.

2 Key Messages and Recommendations

2.1 *Timing of Implementation*

We recognise and welcome the Committee's 17 December 2009 statement⁴ that a fully developed set of standards should be in place by the end of 2010 with the aim of phasing them in, subject to economic and financial market conditions, for implementation by end-2012. Nevertheless, the calibration of the proposed liquidity measures depends on the outcome of the QIS. Currently, the full impact of the liquidity proposals is still unknown so it is difficult to fully evaluate the appropriateness of the current timetable for implementation. Thus, we urge the Committee to be generous in its implementation targets and suggest that the Committee's liquidity proposals be considered more carefully over a longer timeframe, with implementation starting, rather than finishing at the end of 2012. This would allow for an improved understanding of the likely impact on the global economy, give markets sufficient time to stabilise and let some form of 'new normality' establish itself before the new liquidity standards are fully implemented, at some point after 2012.

Furthermore, the Committee must not underestimate the workload that the proposals require. Complying with the new requirements – liquidity coverage ratio (LCR), net stable funding ratio (NSFR) and the suite of monitoring tools – is not dissimilar to a Basel II implementation project for which a minimum of 12 months was accepted by most regulators as a reasonable lead time once rules had been agreed at the national level.

Moreover, the exclusion of central bank funding from the NSFR, in paragraph 84 means that this funding will need to be replaced with funding by the market. However, given current market conditions, in the near term, we suggest that it would be unrealistic to have firms replace this funding with funding from the market without disrupting the economic recovery, so grandfathering arrangements also need to be explored.

Recommendation i: Agree international transitional and grandfathering arrangements for implementation of the BCBS liquidity framework after 2012.

2.2 *International Alignment*

We support the Committee's strong lead in the introduction of an international agreement on quantitative liquidity risk standards and monitoring tools. However, international consensus building requires time, so we urge the Committee not to rush implementation at the expense of a coordinated implementation process. Only a globally consistent framework will guarantee a level playing field and discourage regulatory arbitrage.

Recommendation ii: We urge further international discussion policy discussion on all aspects of the liquidity proposals and agree an internationally coordinated implementation timetable.

2.3 *Calibration of the proposals and supervisory factors*

We are very concerned by the calibration of the LCR and NSFR. This concern derives from two inter-related sources:

⁴ <http://www.bis.org/press/p091217.htm>

- The severity of the assumptions underpinning the factors - e.g. a three-notch downgrade in the institution's public credit rating.
- The use of standardised factors applied to limited broad asset and liability classes.

This means that firms specific factors (such as business model, product types, funding types and varying counterparty behaviour) and or changes in firm strategy made over the ratio horizons can not be taken into account.

On an individual firm basis, the proposed ratios will likely result in a complicated set of calculations that overstate the liquidity risks being managed. It is important to bear in mind the aggregate impact of this conservatism in terms of the objective being set for liquidity risk management and achievability given the availability of funding in the market. From a macro economic perspective, this would have the impact of significantly dampening the provision of credit to the system and / or have the consequence of transferring activities to less regulated sectors of the financial system.

A related concern is the lack of discussion of how the Committee arrived at these standardised factors. We suggest that some of the factors appear to be arbitrary and we ask the Committee to explain how the percentages for the outflows and inflows were derived – they do seem somewhat ad-hoc. In many cases they appear even more severe than experienced during the recent crisis.

Recommendation iii: Reconsider the severity of stress test assumptions which in their current form can not reflect firm specific factors/behaviours and would therefore, on aggregate, be considered severe but implausible.

Recommendation iv: Disclose the methodologies used to derive the LCR and NSFR factors.

2.4 Unintended consequences of the proposals

A. Incentives for good risk management overlooked

On a point related to the severity and standardisation of the stress assumptions being applied to the LCR and NSFR, there is a concern that these assumptions could come to dominate firms' efforts to assess the impact of less severe but more plausible scenarios. Over time this could effectively discourage firms from developing and analysing their own liquidity stress test models taking account of firm specific liquidity risks, stress scenarios and mitigating actions.

Especially, in the case of the LCR, the conservative run-off assumptions driving the LCR computations threaten to overshadow firms' own assessment of run-off rates with the effect of undermining the further development of firms' liquidity risk management frameworks.

We also note the difficulty in defining concepts such as stable and non stable sources of funds. We urge the Committee to remember that there is a multi-dimensional liquidity spectrum that spans across different types of depositors and types of products. Drawing hard lines within the spectrum, to create arbitrary buckets, and applying behavioural overlays to each of these buckets will result in risk insensitive measures which will then get reflected in the pricing of liquidity across the liquidity spectrum.

In terms of the NSFR, the prescription being introduced appears to be unaligned to the risks that the NSFR is attempting to capture. For instance, it is not intuitive that an unsecured

three month loan to a hedge fund requires less support than a blue chip security. This puts the proposed framework at odd with firms' own risk management efforts.

We recognise that the Committee's proposal for a liquidity risk framework is at an earlier stage of development than the Committee's standards for credit, market and operational risk, but we are concerned that the proposed liquidity framework stands in stark contrast to the Basel II requirements as well as the CEBS's December 2009 *Guidelines on Liquidity Buffers*⁵ and the UK FSA's liquidity framework⁶. Basel II and alike, actively encourage firms to use internal models to improve risk measurement and management and to better understand firm specific risks. We continue to support the use of internal models and measures, but caution the Committee against being overly prescriptive in setting behavioural overlays that should apply to contractual outflows and inflows or sources and uses of funding.

Recommendation v: Refine the proposed framework to allow firms, with the capability to estimate behavioural factors (funding factors), to apply their own behavioural (or funding estimates) to contractual inflows and outflows (sources and uses of funding) associated with the LCR (NSFR)

B. Macro - economic impacts: lending to consumers and business

It is important to remember that the strength of a liquidity buffer derives not just from the quality of the assets held alone, but also the nature of the liabilities funding the buffer - the longer the maturity profile of these liabilities, the longer the survival period. Recent reports from UK clearers indicate that the five major British high street banks together could hold approximately £ 550 billion in liquid assets to meet the 100% funding of the LCR, all of which would have to be funded for a significant period reducing the ability of banks to lend to the wider economy. This locked-up liquidity equates to 25% of the estimated total of deposits from UK residents of £ 2.3 trillion.⁷

Moreover, the construction of the NSFR needs to consider the delicate balance of providing greater financial stability and draining long term liquidity as the pool of investors providing long term liquidity is expected to shrink considerably (e.g. in respect of money market funds). The current formulation of the NSFR will translate into an increased demand for long term funding (i.e. most non government assets require 100% funding) and will no doubt increase funding costs, which again will be passed on to customers as margins are compressed.

Additionally, the creation of long term funding by banks will be heavily curtailed by the exclusion of bank CD's and FRN issues by financial institutions from the LCR. Liquidatum Ltd has calculated that the top 100 banks in the world will have to raise €3.3 trillion in long term funding to reach the 100% coverage mark based on 2008 figures (see Figure 1).⁸ There are concerns that this will result in significant deleveraging as firms are likely to adapt their business model rather than raise more expensive long term funding. The economic impact will potentially be reduced access to finance for consumers.

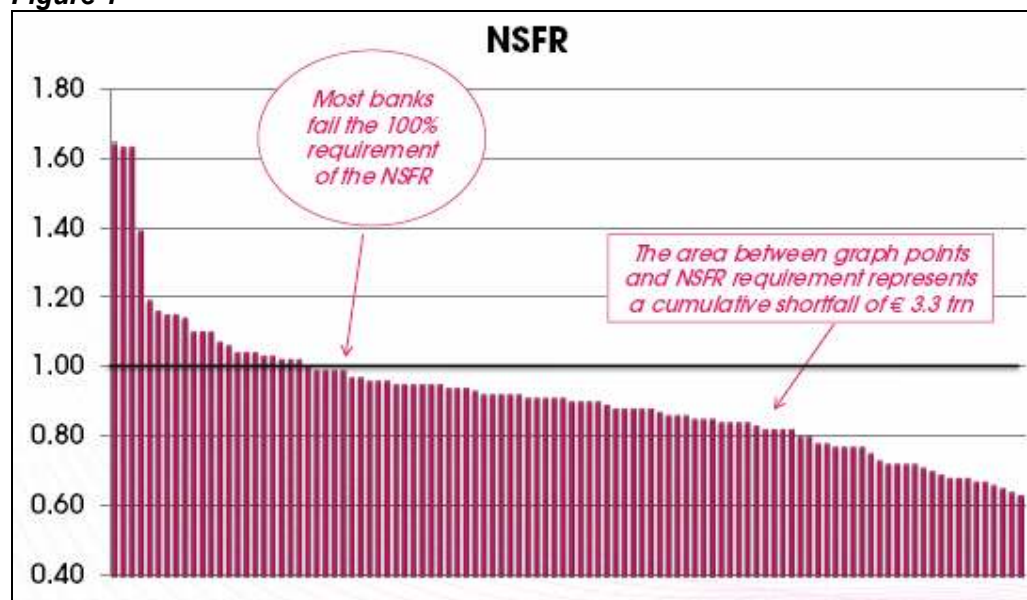
⁵ <http://www.c-eps.org/documents/Publications/Standards---Guidelines/2009/Liquidity-Buffers/Guidelines-on-Liquidity-Buffers.aspx>

⁶ http://www.fsa.gov.uk/pubs/policy/ps09_16.pdf

⁷ These numbers are source from - <http://blogs.telegraph.co.uk/finance/jeremywarner/100001873/banks-forced-to-hold-punishingly-large-liquidity-buffers/> and <http://www.bankofengland.co.uk/statistics/ms/2010/feb/tab1.1.xls>

⁸ Liquidatum Ltd: The corresponding chart provides an analysis of the effect of implementing the NSFR using the coefficients in Appendix 2 of the BIS Consultation Paper published in December 2009. This data comprises approximately 100 banks from Australia, China, SE Asia, Continental Europe, Scandinavia, UK and North America. The data set represents their year - end 2008 data. We have excluded data on Japan as the granularity of their report we believe is insufficient to carry out meaningful analysis.

Figure 1



Our concerns about the macro-economic impact of the Committee's proposals are heightened when we consider the potential impact of the Committee's liquidity proposals in conjunction with the new capital requirements agreed by the Committee in 2009 and the capital proposals contained in the BCBS Consultation Document 164 *Strengthening the resilience of the banking sector* (BCBS 164).⁹

Recommendation vi: We invite the BCBS to evaluate and discuss the proposals along with QIS results in terms of macro-economic consequences and more specifically the impacts on consumers and businesses.

C. Impact on markets: Inter-bank market and government

We also note that the proposals appear to favour retail over wholesale deposits (i.e. the LCR run-off factors for wholesale funding assume that elements of wholesale funding are less sticky than retail deposits, and under the NSFR value of retail deposits < 1year is 85% versus 50% for wholesale funding < 1year) giving little recognition to the fact that retail deposits are finite, and, taking Northern Rock as an example, not necessarily more sticky. Furthermore, for the purposes of the liquidity buffer, no recognition is given to assets issued by financial firms, effectively penalising transactions with banks in comparisons to transactions with unregulated entities. This is a paradox and, moreover, likely to increase systemic risk.

Financial institutions which specialise in providing the market with assets which are now intended to be excluded from eligible liquid assets will see their business model disappear. The issuance of securities provided by financial institutions has developed into a significant market in Europe more so than in other locations and would therefore be more seriously affected than in other jurisdictions. Ultimately, more banks will have to issue 1 year liabilities, while their counterparties would be penalised. Implementing the proposed requirements will imply a huge burden for smaller banks that are often reliant on deposit business and investment products from larger firms.

⁹ <http://www.bis.org/publ/bcbs164.pdf?noframes=1>

We recognise the concern that holding assets issued by financial services firms can create artificially inflated liquidity in the system and wrong-way-risk where two or more banks issue assets to one another. However, we believe that there is an argument for smaller banks, at least, to be given value for holding the paper of larger banks. It is true that during the recent crisis such paper became difficult to sell, but for idiosyncratic stress scenarios smaller bank holdings of larger bank paper have proved beneficial over a longer time horizon. Furthermore, the effort to strengthen bigger bank liquidity and capital positions make it less likely that their paper will not be marketable in a crisis. In Europe these measures are being complimented by large exposure rules that will mitigate concentration risk in inter-bank funding.

Finally, an additional point to consider is the distinction between inter-bank deposits (which are illiquid) and inter-bank bonds, as a case can be made for bonds still being tradable even during an idiosyncratic stress.

Recommendation vii: Give value to smaller firms holding larger firm bank paper for idiosyncratic stress in a 2 nd tier buffer.
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D. Impact on markets: Government bonds

The narrow range of assets eligible for inclusion in the liquidity buffer will introduce distortions in markets for those assets. The focus on government bonds potentially props up markets for some government bonds that may not otherwise be demanded by investors. Furthermore, it is likely that there will be increased concentration risk in 'cheapest to deliver' assets of certain government bonds.

E. Impact on European and US mortgage markets

One of the criteria set for liquid assets requires that marketable securities guaranteed by non-central government entities be zero risk weighted. This excludes mortgage securities such as Freddie and Fannie Mac and sets their treatment apart from covered bonds, which are in the liquidity buffer. The potential impact of this exclusion on mortgage market needs to be considered.

Recommendation viii: We invite the Committee to discuss the potential economic consequence of the proposals in terms of the market volatility they may introduce and the economic impact it may have on the markets for some instruments.
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2.5 LCR and NSFR – objective and use

A. Using long and short term buffers

The Committee has not discussed the buffer and usage in terms of whether the firm is a going or gone concern. This lack of discussion obscures the objectives being set for the buffer. Paragraph 20 states that the LCR “should enable the bank to survive until day 30 of the proposed stress scenario, by which time it is assumed that appropriate actions can be taken by management and/or supervisors, and/or the bank can be resolved in an orderly way.” Furthermore, no reference is made that the liquidity buffer is expected to be used in times of stress to alleviate funding pressures leaving the reader with the impression that the LCR is there to ensure funding for the gone concern, implying a requirement for a “buffer on top of a buffer”.

We maintain that liquidity buffers are there to be used in stressed times to ensure that a firm remains a going concern, even if this means they may need to temporarily be run below the levels set by supervisors. We concede that there needs to be an appropriate governance structure and day-to-day oversight for the use of the buffer (and for its level to be considered

in the light of other liquidity measures and metrics). If there is a crisis - which may be measured by the firm triggering certain liquidity or other metric hurdles - then the institution's Contingency Funding Plan (CFP) would be activated, and if necessary, its supervisors advised. Such plans would, of course, include the plan for the subsequent rebuilding of the buffer after the regulatory level has been breached, once the institution's crisis has passed.

We agree that supervisors should be able to challenge the level of the buffer at any time and that they should be able to satisfy themselves that the appropriate governance processes to control the buffer are in place.

Recommendation ix: Allow for use of buffers in stressed times and, utilise Principle 11 of the BCBS's *Principles for Sound Liquidity Risk Management and supervision* which sets out that banks should have CFPs that address shortfalls in emergency situations and require clear lines of responsibility.¹⁰

B. LCR

While we support the concept of holding a liquidity buffer, we are perturbed by the narrow definition of eligible liquid assets and the stress assumptions applying over 30 days. In part, our concern relates to outcomes such as the distortion of the government bond market, reduction of inter-bank funding, and increased concentration risk in 'cheapest to deliver' assets of certain government bonds. Other concerns relate to the lack of alignment between the horizon suggested by the Committee and that suggested by CEBS's in its *Guidelines on Liquidity buffers and survival periods*.

So we urge the Committee to widen the list of qualifying liquid assets by adopting a tiered approach to the buffer that is aligned to two phases of stress occurring within the 30 day time horizon. Underpinning this approach is an understanding that following two weeks of stress marketable assets can be realised with less forced sale risk. Also, given the availability of special resolution regimes and possible recovery and resolution planning requirements an initial 15 day severe stress period is quite sufficient.

Recommendation x: Split the 30-day horizon into two phases and allow a wider range of assets in the buffer over the second phase. The narrow definition of the buffer would apply over the first 15 day period when the institution is experiencing a combined idiosyncratic and market related stress, and the wider definition of the buffer (including the second tier of assets) would apply over the next 15 days when the firm is subject to a moderate market wide stress.

If the Committee does not support the idea of broadening the definition of the liquidity buffer, we then ask it to consider recognising less severe net-outflows while also counting some of the excluded assets in the stock of liquid assets (i.e. what we refer to as the second tier) under the LCR's denominator.

Recommendation xi: If the Committee rejects recommendation x, as an alternative, include in the denominator some of the assets excluded from numerator (i.e. stock of liquid assets) in the LCR's denominator and review the conservativeness of the factors being applied to outflows and inflows.

C. NSFR

We support the Committee's objective of encouraging more medium and long term funding. However, we have serious concerns that, in its proposed form, the NSFR will distort markets and impede economic growth. We have a number of concerns over its calibration,

¹⁰ <http://www.bis.org/publ/bcbs144.pdf?noframes=1>

complexity and lack of risk sensitivity which produces perverse risk incentives. As a result we believe further consideration should be given to its design. We appreciate the need for a measure that addresses the structure of funding, and suggest that the Committee develop an appropriately calibrated and sophisticated risk sensitive measure that could better reflect firm specific factors.

In short, we recommend an approach that recognises that the NSFR is only one measure among many that needs to be used by supervisors in the evaluation of a firm's liquidity profile. Thus the NSFR (and indeed the LCR) should be used by supervisors along side firm's internal measures in the evaluation of liquidity. This will allow some comparability between firms while encouraging the continued development of firms' internal metrics and models and providing supervisors with a more complete picture of firms' liquidity position and processes.

Recommendation xiii: Develop an appropriately calibrated and sophisticated measure of the structure of funding that could better reflect firm specific factors.
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D. Asymmetries

There appear to be a number of asymmetries, for example, intra-group flows and commitments and derivatives. These should be addressed.

Recommendation xiii: Resolve all asymmetric treatments.
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2.6 Need for cross-border liquidity framework and convergence

The Consultation leaves the quantitative standards and monitoring tools open to "...apply at group and/or entity level and to foreign bank branches (para. 130)." Without coordination between national supervisors then there is a real danger of multiple liquidity buffers and reporting requirements being implemented which would create inefficient duplication of liquidity reserves, i.e. trapped pools of liquidity, and reporting efforts (para 133 does nothing to guard against this).

The ability to manage liquidity centrally for some banking groups promotes the efficient use of funds in order to reduce the overall funding liquidity risk, minimise cost and earnings risk, decrease consolidated capital, credit and balance sheet usage, and optimise liquidity and exposure to third party funding across the group. The recent financial turmoil has shown that global markets can fragment, becoming a collection of separated domestic markets in times of stress. This is due to internationally uncoordinated responses by national authorities within their own jurisdictions to the pressures facing the banking system.

With no coordination between national supervisors there is a real risk that the prescribed strengthening of liquidity buffers in some host entities of a group will result in the weakening of the group, which will by default affect its various entities. We thus urge the Committee to develop and encourage an international framework for the management of cross-border liquidity risk and supervision. We see colleges of supervisors and a framework for the delegation of supervisory task i.e. Global Liquidity Concessions (GLCs) as a viable option for cross-border liquidity management. In turn we see colleges of supervisors as instrumental in identifying early warning signs and effectively coordinating supervisory action. We recognise that the sharing of group wide liquidity information is a paramount first step for cross-border supervision.

Recommendation xiv: Encourage a cross border framework for liquidity management via colleges of supervisors and delegation of supervisory tasks.

2.7 Need for harmonised reporting

We believe that the first step towards advancing a cross-border supervision framework for liquidity risk is the development of an internationally harmonised liquidity reporting framework. Such a framework should ideally take account of banks' individual liquidity risk profiles to ensure that the appropriate metrics are monitored.

A common reporting standard will also do much to facilitate the monitoring requirement of frequent and granular data requests. Agreeing on one globally acceptable format will eliminate duplication of reporting and keep down costs for firms, while also enabling supervisors to better understand liquidity data for cross-border groups.

In turn we see colleges of supervisors as offering a platform for developing these reporting standards and sharing key liquidity information for individual banks efficiently between supervisors. We thus urge the Committee to address these issues in its final paper and call on national and regional supervisory bodies to develop a common reporting language and format. We note that the current QIS work stream or the existing CEBS Liquidity Identity Card¹¹ would be good starting points in developing a comprehensive list of monitoring tools, i.e. building on metrics already identified in the QIS template and Liquidity ID.

Recommendation xv: Develop a harmonised and comprehensive list of monitoring tools and common reporting language and templates.

2.8 The public disclosure requirements and exposure to reputational risk

While, we generally support the principle of transparency, the Committee's proposal imposes far-reaching public disclosure requirements on the standards and monitoring metrics. Obviously, disclosing detailed quantitative information on changes in the firm's liquidity positions could have negative consequences for the firm, and potentially the financial services sector. If, for example, firms are required to disclose a fall in the buffer, this drop could be misunderstood by the market, trigger a run on the firm and undermine its efforts to rebuild its buffer. The European Central Bank in its discussion paper *EU Banks' Liquidity Stress Testing and Contingency Funding Plans (2008)* has rightfully pointed out:

...public disclosure could have negative repercussions on the liquidity situation of some banks under certain circumstances. While more disclosure, in particular on banks' liquidity risk management, is generally to be encouraged, the BSC considers that, in the case of liquidity stress test results, the detrimental effects of mandatory public disclosure are likely to outweigh the benefits.¹²

Furthermore, disclosures made on a routine basis under normal conditions tend to limit the possible actions firms can take in the face of stressed market conditions.

Therefore, we do not recommend disclosure of liquidity metrics to the public. If it is viewed as essential to the Committee, we suggest that these metrics be disclosed in arrears and be based on rolling averages computed over an extended time period rather than point in time

¹¹ <http://www.c-eps.org/getdoc/747246f8-2236-4f25-816f-3985b7f24cee/Liquidity-Identity-Card.aspx>

¹² <http://www.ecb.int/pub/pdf/other/eubankliquiditystresstesting200811en.pdf>

metrics. This would remove contextual information from market makers who are likely to act on and escalate certain disclosure events which, allows firms the flexibility to act without raising undue market concern.

Recommendation xvi: Public disclosure requirements should be avoided or at least be delayed and based on rolling averages computed over an extended time period.

2.9 Treatment of repos and derivatives

While the Committee's liquidity proposal appears to include treatments for repos, reverse repos and derivatives, it is not entirely clear this is achieved and lacks any explicit discussion of the logic underpinning the proposal. Clarity of treatment and the rationale is important for both supervisors and firms, particularly as these instruments have been the focus of much debate as a result of the crisis.

It is our understanding that in the case of the LCR, repos and reverses are treated on a transaction basis and derivatives on a contract basis. However, in the case of the NSFR it appears that the legs of such transactions are considered separately but we have questions in relation to:

- the scope and treatment of 'repo-like' transactions excluded by paragraph 88;
- the rationale for the apparent lack of value given to secured borrowing (0% ASF and 100% RSF);
- the rationale for the 100% support and 0% value attributed to derivatives;
- the rationale for the lack of differentiation between types of derivative transactions (e.g. FX products versus interest rate products); and,
- whether netting is permitted, we assume that this would be the case from brief instructions provided under the BCBS QIS FAQs document.

We urge the Committee to engage with firms to clarify its intended treatment of these instruments.

Recommendation xvii: Clarify the treatment of repos, reverse repos and derivatives in both the LCR and NSFR ensuring they are conceptually aligned and symmetric.
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Recommendation xviii: Provide examples of how the LCR and NSFR tables apply.

3 Detailed Comments

3.1 Comments on Liquidity Coverage Ratio (LCR)

Purpose of LCR

The Committee has not discussed the buffer and usage in terms of whether the firm is a going or gone concern. This lack of discussion obscures the objectives being set for the buffer. Paragraph 20 states that the LCR “should enable the bank to survive until day 30 of the proposed stress scenario, by which time it is assumed that appropriate actions can be taken by management and/or supervisors, and/or the bank can be resolved in an orderly way.” Furthermore, no reference is made that the liquidity buffer can be used in times of stress to alleviate funding pressures leaving the reader with the impression that the LCR is there to ensure funding for the gone concern, and implying a need for a “buffer on top of a buffer”.

Also, we caution against applying adjustment factors that reflect severe stress results in the computation of the LCR. This approach creates the impression that a quantum of liquidity must be held against all possible stress events and ignores the fact that liquid assets will be used up over the course of the stress event. We are also concerned that by setting a minimum stress based LCR, regulators create a self defeating ratio, whatever the definition of the liquidity buffer. If a firm is not permitted to fall below the minimum ratio, it cannot use the assets in the buffer in just the circumstances that it needs to. So by inference, the assets are no longer liquid.

Liquidity buffers

We maintain that liquidity buffers (i.e. the LCR’s numerator) as above are there to be used in stressed times to ensure a firm remains a going concern, even if this means the buffer will need to temporarily be run below the levels set by supervisors. We understand that there needs to be an appropriate governance structure and day-to-day oversight for the use of the buffer (and for its level to be considered in the light of other liquidity measures and metrics). If there is a crisis - which may be measured by the firm triggering certain liquidity or other metric hurdles - then the Contingency Funding Plan (CFP) will be activated internally and, if necessary, supervisors will be advised. Such plans will, of course, include the subsequent rebuilding of the buffer, once the firm’s crisis has passed.

We agree that supervisors should be able to challenge the level of the buffer at any one time and that they should be able to satisfy themselves that the appropriate governance processes to control the buffer are in place.

Term of Funding

Some of our membership would also like to highlight that the funding requirements of the liquidity buffer should have a tenure that is conservatively longer than the survival period so as to provide sufficient coverage. We agree with the Committee that the LCR buffer and supporting funding should be separated from other activities. However, to ensure liquidity, the buffer needs stable funding and under the Committee proposals elements of the liquidity buffer (i.e. qualifying marketable securities from sovereigns, central banks, public sector entities, and multi-lateral development banks) only require 5% stable funding (Table 2 of BCBS 165). By implication, 95% of these could be funded at 1 month and 1 day thereby

exposing the LCR to a potential cliff effect with funding of the buffer running out in 1 month. Conservative funding of the LCR, therefore could be regarded as out to 90 days.

Qualitative Variables in LCR

It would appear that paragraph 19 imposes “more stringent standards or parameters” on the supervisory assessment of a firm’s compliance with Committee Sound Liquidity Principles, however the proposed framework is silent on benefits or incentives for good liquidity risk management practices. We would encourage the Committee to consider how the qualitative and quantitative elements of its proposed framework, in connection with its *Sound Liquidity Principles*, could be used to encourage firms to improve their modelling techniques.

Prescription of LCR Assumptions

We are of the view that the Committee is overly prescriptive in setting behavioural overlays applying to outflows and inflows particularly given the difficulty in defining stable vs. non stable sources of funds. We urge the Committee to remember that there is a multi-dimensional liquidity spectrum across different types of depositors and types of products. So to draw hard lines within that spectrum and apply behavioural overlays to each segment may create dysfunctional behaviour in the evaluation of the liquidity risk and hence, ultimately, pricing.

It would be helpful for the Committee to explain how the percentages for the outflows and inflows were derived – they do seem a bit ad-hoc. In many cases they appear even more severe than experienced during the recent crisis. In particular we believe some of the percentages relating to undrawn facilities are completely unrealistic while also being asymmetric, depending on whether the facility is being given or received, and fail to take account of the nature of the facilities. By publishing prescribed outflows the Committee takes away from an institution the ability to set its own liquidity risk appetite and dictates the way in which the industry will value different types of funding. We are concerned that regulatory arbitrage will occur and dysfunctional pricing will follow.

We propose that firms use their own behavioural assumptions. Where a supervisor disagrees with a firm’s assumptions or risk management practices, or the institution lacks the requisite modelling ability the Committee’s outflow and inflow factors would then apply.

Definition of the metric (para 21-25)

In principle we agree with the formula set for the LCR but we are concerned by the narrow range of assets eligible for the liquidity buffer, and the stress scenarios being applied both in terms of their severity and formulation.

We would therefore recommend at least one of the following alternatives:

- a) Widen the list of qualifying liquid assets in numerator.
- b) Split the 30 day time horizon into two phases and adopt a tiered approach to the buffer aligned to these phases with a wider list of qualifying liquid assets available in the second tier.
- c) Create two tiers of qualifying liquid assets with a wider list of qualifying liquid assets available in the second tier.
- d) Recognise a wider range of assets in the denominator
- e) Reduce the severity of the net outflow assumptions

We recognise the Committee's concerns about a) so we wish to signal our preference to b) and c). An alternative compromise is d) and e). With regard to option b) we believe that a 30 day time horizon under an acute liquidity stress scenario is overly excessive and recommend a split of this period into a 15 day period combined stress scenario followed by another 15 day period with a moderate market wide stress. In this split the first 15 day period would require a narrow range of liquid assets as currently proposed while the second 15 day period could include a wider range of assets for the numerator as discussed below under definition of liquid assets.

With regard to option a), b) and c) we suggest that the following assets should be included as qualifying liquid assets in the liquidity buffer:

- Precious Metals
- Commodities
- Bank Paper
- Corporate Bonds
- Covered Bonds
- Equities
- Government sponsored paper

Recognising that the Committee may not have the appetite to widen the range of assets for inclusion in the liquidity buffer, we also offer option d) and suggest that the above list of assets be recognised in the denominator to count towards the net inflows.

In this approach a narrow definition of the liquidity buffer remains for the numerator. However, a firm would be allowed to bring forward the haircut value of unencumbered less liquid securities in the mismatch ladder in accordance with the time taken to sell/repo them at a value consistent with the stressed environment.

In terms of option e), we make this recommendation independently of the view that firms should be using their own estimates and suggest that the Committee's severity assumptions (paragraph 22 of BCBS 165) are overly draconian. For example regarding paragraph 22.a) we agree that 100% of the additional collateral should be included although we would argue that this should be considered against a 2 notch downgrade for the purposes of the published measure. We do, however, recognise that banks must be able to identify downgrade levels where any significant additional liquidity is required and that this should be shared with the bank's regulator (and, of course, through its own risk management governance). For this purpose firms should identify factors such as the proximity of its current credit rating to the non-investment grade level. We expand further below under **Net Cash Outflows** on option e).

Characteristics of high quality liquid assets (para 28-33)

We agree with the Committee on the characteristics of a liquid asset, but we would point out that a large firm must be seen by the market to be trading the asset for it to be liquid. This will reduce the risk that the sudden sale or repo of a new asset class by the firm will result in reputation risk which will only exacerbate the liquidity problem.

For smaller firms we stress the need for a proportional approach as trading in the markets is costly and resource intensive. Smaller banks are concerned about not having repo capabilities for government bonds to test their CFP. Thus we urge that some allowances be made for smaller firms to test their CFPs without executing costly transactions. In practice these concerns could be alleviated by allowing smaller banks access to central bank reserve

accounts and permitting the use of money market funds for liquidity purposes if they invest in government bonds.

Central bank eligibility criteria: We note that the Committee is of the view that high quality assets should also ideally be eligible at central banks, and although some allowance is made for a wider definition of acceptable liquid assets in jurisdictions where central bank eligibility is limited to an extremely narrow list of assets, we urge the Committee to include those assets that central banks accept during normal times as counting towards the stock of liquid assets. Being accepted by central banks during normal times is an appropriate indicator of liquidity and one that will reinforce their acceptability in the open marketplace.

We understand the Committee's proposed criteria, that liquid assets be central bank eligible, is intrinsically linked to a broader debate, i.e. the role of central banks in resolving financial crises. We fully agree that central banks should not be considered as lenders of *first* resort and that the liquidity buffers should, therefore, be populated by suitable assets that can be liquefied directly into the markets. We also understand that central banks would wish banks to restrain from relying on emergency facilities to obtain liquidity, although banks are none-the-less encouraged to test the central banks' effectiveness in providing liquidity against eligible assets on a regular basis. One of the main issues to be addressed within the framework of such a discussion is if prudential measures in the area of risk liquidity management would indeed be an appropriate instrument to achieve central banks' objectives.

We are strongly convinced that the liquidity of an asset does not only depend on its quality but also on the market infrastructure. This view is supported by experience drawn from the recent crisis: markets in certain assets, which probably did not meet the requirements which are being proposed in the Consultation, nevertheless remained liquid because the infrastructures through which they were traded ensured anonymity and had established links with central banks. On this ground, we believe that the Committee should adopt a more balanced view: instead of relying on the proposed distinction between highly liquid and less liquid instruments, more emphasis should be put on funding channels and exchanges which remained available to counterparties during the crisis and through which firms were able to obtain a high liquidity value for their collateral.

We strongly agree with the observation made by the Committee of European Banking Supervisors (CEBS) that "(B)anks should periodically test whether central banks will effectively provide funding against (assets eligible as collateral) and should apply appropriate haircuts to reflect the amount of funding that central banks might actually provide in stressed scenarios (for the assets in question and for the banks themselves). Furthermore, banks will have to demonstrate adequate diversification in the total composition of the buffer so as to guarantee to supervisors that they are not relying too heavily on access to central bank facilities as their main source of liquidity." This would also indicate that a narrow definition of assets considered liquid should not be too narrow.

Definition of liquid assets (para 34-37)

Our comments on the definition of the buffer can be divided into three sets. The first set focuses on cash and government guaranteed paper already recognised in BCBS 165. The second set concerns the case for widening the buffer and the third looks at recognising the marketability of other assets.

Cash: A number of regulators have argued that cash balances are held for the reason that they are necessary to enable payments over the counter and through ATMs etc. In this respect, these holdings have been compared with intraday collateral required for settlement

purposes. We would agree, with the Committee, however, these cash levels move up and down according to a firm's assessment of its liquidity needs and, in times of stress, these are likely to be increased.

Government guaranteed paper: We welcome the recognition that government guaranteed paper and non central government public sector entities can be included (subject to conditions) and also that the Committee recognises the value of paper issued by lower credit rated governments to support liquidity risk in the local currency of that government. We note, however, that in terms of claims guaranteed by sovereigns there has been no attempt to differentiate between the credit worthiness of different sovereigns or the concentration risk associated with the tendency of nationally based financial institutions to hold the government paper of the jurisdiction they operate in. A recent example is Greek sovereign debt which has recently been downgraded. For most firms who may look to raise liquidity through repo, the risk-weighting is not particularly relevant. Therefore linking liquidity value to risk-weighting does not appear to make sense in practice.

We also welcome the recognition in paragraphs 34d and 134 that firms must meet their liquidity needs in each significant currency. That is, liquid assets match foreign currency liabilities. This could imply that the framework allows local liquidity buffers in countries whose government issued paper's credit rating is not high enough to qualify in the liquidity buffer. For example, a net outflow in Indian rupees matched by Indian government securities with a market value greater than the stress net outflow, should count as part of the liquidity buffer. However, India's sovereign credit rating does not meet the criteria as set out in 34c (i) of a 0% risk weight for credit risk under the standardised approach, so the Committee's proposed intent is unclear.

We encourage the Committee to allow the highest corresponding government bonds to qualify in the liquidity buffers so they can match respective foreign currency exposures which are appropriate to where a bank operates. This is especially important for firms active in emerging markets.

Furthermore, we note that it is not uncommon for local liquidity regulation to require banks to hold a stock of local liquid assets and/or deposits with central banks to meet local liquidity requirements.

Widening the buffer

Taken together with the treatment of debt securities, the liquidity buffer is too narrow. This has a number of consequences:

- Firms will not be able to diversify their liquidity risk against a market wide stress event thereby creating concentration risk. There is a scenario where all banks are trying to sell or repo the same type of assets at the same time. (We appreciate that, at least at present, there is no shortage of government securities but that could change.)
- Where securities of a particular government become ineligible e.g. due to a downgrade, there will be significant market disruption as banks seek to rebalance their portfolios.
- Assets not in the buffer become less marketable making it harder to fund certain markets (e.g. the mortgage market)

Our comments on the narrowness of the buffer and the inclusion of a wider set of assets are, in part, referenced to the experience that during a crisis there may be a wide range of assets which continue to trade but with wider spreads. So the issue should not be their blanket exclusion, but their liquidity potential demonstrated by the haircuts, where the haircut

represents the level of the market's acceptance of the liquidity of the asset, and perceived credit risk of the counterparty. Other factors to consider for the calculation of the haircut should include:

- The period over which the asset might be sold. On one hand the longer the period to offer for sale the less forced-sale risk, on the other, however, the greater the risk that the underlying market price moves against the seller.
- The periodicity that the firm marks the asset to market. It cannot be assumed all firms will necessarily mark to market each and every asset daily.

As pointed out above we also believe that more consideration needs to be given to diversification. For example, under the current formulation of the buffer, concentration risk will likely arise from institutions looking for the same 'cheapest to deliver' assets. A broader range of assets will help to ensure that the buffer operates across different liquidity scenarios and avoids concentrations in particular government instruments and also does not risk creating incentives for the behavioural patterns that might intensify a liquidity squeeze.

Also we argue that over a longer survival period (i.e. beyond 15 days of stress) the pool of marketable assets that are saleable is wider. We suggest that assets that should be considered for inclusion in the buffer beyond 15 days are:

Corporate and Covered Bonds: In response to Committee's consideration of corporate and covered bonds (para 35), we are of the view that a broader definition of the buffer should include these instruments.

We argue that any haircuts applied should reflect observed price volatility, particularly during the crisis. With regard to the proposed haircuts in (para 36 and 37) we ask how these have been calculated. Moreover the requirement that these instruments have 10 years of history to prove their reliability excludes a large proportion. For some corporate and covered bonds, a 3-5 year data history would be sufficient, although a haircut of 25% would likely apply.

We suggest that a better way to look at the eligibility of covered and corporate bonds would be to require firms to assess them by instrument type subject to the firm being able to demonstrate that it regularly trades the asset by sale and/or repo. Firms not able to undertake these assessments but regularly trading the asset would then be subject to standardised haircuts.

Government sponsored paper: We urge the Committee to expand the buffer so that government agency paper, such as FNMA (i.e. Fannie Mae) and FNLMC (i.e. Freddie Mac) corporate debt and mortgage-back securities, are included. These securities represent a very large, liquid and important international market, with well-developed repo and financing frameworks (consider that they are eligible central bank collateral in the US) and generally proved to be extremely liquid in times of stress.

Recognising the marketability of other assets

Equities: We encourage further supervisory dialogue on the inclusion of equities, above a suitable quality threshold and with a suitable haircut. Our members are concerned that Committee's proposal will greatly hamper equity markets liquidity and efficiency, with consequent impacts to the global economy. Additionally, our members believe that the Committee's exclusion of equities seems particularly harsh and more consideration should be given to the liquidity of these markets and their resiliency. Consider, for instance, that during the recent crisis:

- a) Trading volumes for major indexes remained considerable, showing the equities could be disposed of and monetised.
- b) Secured financing/ E4E (equity for equity) trades in primary index equities continued on these assets (and although some haircuts were eventually applied the market did not lock up)

Moreover, in the aftermath of Lehman's demise equity markets primary equity markets continued to function and facilitated a significant de-leveraging that occurred across the hedge fund and banking sectors; this resiliency is somewhat explained by the significant level of shorts that were outstanding and also closed out during this period, aiding price discovery and providing market liquidity.

Exhibit 1: V2X - Stoxx Volatility Index (2 June 2008 – 4 Dec 2008)



As shown above, market volatility clearly spiked in the aftermath, although it did take several weeks to peak.

The extent of the market de-leveraging that occurred is best illustrated by the SBL market data sourced from Dataexplorers which valued the total equity securities lending market in August 2008 at \$3.34trillion. By October 2008 this figure was \$2.3trillion and by Jan 2009 \$1.8trillion, which has remained roughly the total to date. Widespread de-leveraging, especially by hedge funds, explains the reduction seen, although the market remains substantial.

Exhibit 2: Euro Stoxx 50 Price Index (2 June 2008- 4 Dec 2008)¹³



The size and depth of the equity securities lending market supports asset funding (collateral deployment). Whilst we clearly acknowledge that lower quality assets and certain secured funding transactions (such as triparty repo and upgrade trades) are unlikely to be resilient during a stress or crisis, we do believe that high quality (primary index) equities deployed to stock loan counterparties (equity-for-equity or “E4E”) are resilient, even though the market standard contractual maturity is “open”.

Daily mark-to-market collateral implicit in these stock loan transactions assures counterparties that haircut protection is maintained. Risk management practices within the stock loan community held up well during the market crisis and have continued to evolve with lenders more inclined to accept positively correlated collateral, increasing the opportunity for resilient equities funding.

Precious Metals and Commodities: Gold is included in the NSFR ratio with a risk weight of 50%, but is excluded in the LCR as a liquid asset. We suggest including gold and other precious metals as well as commodities in a wider definition of the liquidity buffers, subject to the application of an appropriate haircut. We would further argue that gold has a rich tradition in banking and that in times crisis there is normally a flight to gold, so we also question how the Committee arrived at the 50% treatment of gold under the NSFR.¹⁴

¹³ Similar pictures exist for FTSE100, CAC40, DAX and Nikkei225.

¹⁴ We note that the World Council in its response to BCBS 165 provides a wealth of empirical evidence showing that gold “...not only fits comfortably into this category, but that it would contribute to the counter-cyclicality of the new liquidity measures and that the application of a 50% RSF is wholly inappropriate and punitive in comparison to the historical treatment of gold in EU and US regulatory legislation.”

Bank Paper: Currently corporate bonds issued by banks, investment and insurance firms are excluded from the buffer. We appreciate that this exclusion is motivated by concerns that this could be a source of artificially inflated liquidity in the system and wrong way risk (where two or more banks issue assets to each other). Nevertheless, we believe there is an argument for smaller banks, at least, to be given value for holding the paper of larger banks. It is true that during the recent crisis such paper became difficult to sell, but for idiosyncratic stress scenarios smaller banks' holdings of larger banks paper have proved beneficial over a longer time horizon. Moreover, current efforts to strengthen the liquidity and capital positions of larger firms make it more likely that their paper will be marketable in a crisis. In Europe, the position of firms will be further strengthened by large exposure rules, being implemented as part of CRD 2, that will mitigate concentration risk arising from inter-bank funding. A similar logic can be applied to the use of bank bonds to collateralise the payment systems, as the LCR determines the survivability of the banks issuing these bonds.

Net Cash Outflows (38-40)

We are concerned with the level of prescription embedded in the standardised net cash outflow assumption and question whether these present realistic levels of severity and segmentation of retail and wholesale funding flows. In particular we are concerned that pricing will follow the segmentation and that flexibility to design products with a risk/reward payoff reflecting liquidity risk will be reduced. Re-pricing of asset classes may result in some products no longer being offered, notwithstanding that they are useful to companies and retail clients. A further impact to consider is the effect on funding of the mortgage market as haircuts will also drive markets for Mortgage Backed Securities (MBS).

So, especially if the liquidity buffer i.e. stock of high quality of liquid assets, cannot be widened we strongly urge the Committee to dampen the assumptions applied to the LCR's denominator for a standardised approach.

Severity of Assumptions

With regard to the severity of the flows we ask how the percentages were derived as these seem to surpass the experienced net outflows of the recent crisis. In particular, we question how the Committee derived the behavioural assumptions for the run off percentages and urge further assessment of past data that demonstrates how various types of deposits and wholesale funding actually behaved during the crisis to establish more realistic ratios. If the percentages are to be used as an industry standard then it is vital they reflect the recent experience and potential liquidity risks. The first question to be asked is: what is the threshold between a survivable stress scenario and test to destruction. Then firms need to assess what their liquidity risk appetite is.

Segregation of Funding

In terms of the segregation of funding there is no simple split that gives justice to the diverse behaviour and liquidity risk of deposits and wholesale funding. While any greater granularity increase prescription, any less granular segregation ignores varying degrees of liquidity risk and thereby limits pricing and the design of products to fewer categories.

More appropriately, we suggest that firms be required to justify to regulators their behavioural assumptions for their net cash outflows to their respective supervisors. Firms themselves are best placed to set out the basis on which they segment their liquidity categories. We do accept however that supervisors have the right to challenge, and to apply standardised

factors if a firm is unable to justify its own behavioural overlays, appears to be clearly out of line with industry benchmarks and/or is unable to estimate their own behaviour overlays.

Retail deposit run-off (para 41-44)

We are concerned with the prescriptive minimum outflow levels being suggested. We appreciate that the Committee is looking to provide a simple way of calculating this metric but suggest that 7.5% and 15% form a starting point for a discussion on behavioural assumptions. Again we urge further assessment of realistic run-off levels based on past data. The assumptions with respect to deposit run-offs are unrepresentative of any major market and all the more unrealistic and damaging in markets where banks are still able to rely to a substantial degree on retail deposits.

We suggest that supervisors and firms be left to agree how best to break up their categories of retail deposits according to varying degrees of stickiness. We recommend that the Committee should not set the minimum for each class of deposit but leave that to be agreed between supervisor and firm. International consistency should then be achieved in the process and review criteria of an individual firms' approach.

We appreciate that not all firms may have the capability to produce their own behavioural estimates, and a simple option is needed. Such an option would be useful as a benchmark against a firm specific analysis.

We note that paragraph 42 appears to conflict with the statement in paragraph 41 that an effective insurance scheme is not sufficient to consider a deposit "stable", as it suggests that a bank should be able to determine which deposits are covered by insurance in order to identify stable deposits. We agree with the Committee that deposit insurance is neither necessary nor sufficient to represent stability and we would welcome the clarity here.

With regard to paragraph 43 on time deposits we argue that 15 days is sufficiently material as a minimum stress. Any further add-on should be to the supervisory discretion and individual bank's stress testing.

With regard to paragraph 44 on foreign currency deposits we argue that firms should use their own behavioural assessments rather than a supervisor's metric.

Unsecured wholesale funding provided by small business customers: 7.5%, 15% and higher (para 48-50)

Here we make the same arguments about splitting the deposits (between stable and less stable) as we did for retail. But we are further concerned that the Committee have included an aggregate limit (less than € 1 million – see para. 49). Quite often customers will use different products for different purposes and may not therefore move all funds at the same time; particularly they may not move transmission or nostro accounts.

Unsecured wholesale funding provided by non-financial corporate customers, sovereigns, central banks and public sector entities with operational relationships (para 51-53)

We note the recognition that operational (transmission or nostro) accounts should be treated differently from other types of accounts for these types of customers. The fact that the Committee has identified this type of product separately demonstrates the complexity of dividing up funding streams into categories.

Specifically here we disagree with the run-off factor of 25% as it does not at all reflect the average behaviour of non-financial customers. We argue that more professional counterparties are likely to run down their balances quickly as they will have options to use alternative accounts for their operational accounts. On the other hand SMEs will be more reluctant to move such business elsewhere as they are less likely to be multi-banked. Further it is worth noting that more sophisticated corporates will run their operational accounts at minimum levels using cash management systems which need related non-operational accounts which are less likely to be moved.

Again we caution against supervisory prescription and guidance on the segmentation of the liquidity categories as this will impact the liquidity value firms' ascribe to these types of funding and also to their pricing.

Unsecured wholesale funding provided by non-financial corporate customers (para 54)

We caution that by grouping together all these funding types the Committee is in danger of ignoring a wide variety of different behaviours. Firms themselves are best placed to set out the basis on which they segment their liquidity categories. Furthermore, we are of the view that the Committee should not set the minimum for each class of deposit but leave that to be agreed between supervisor and firm dependent upon the way in which the degrees of run-off are broken down and in line with a firm's behavioural assumptions and judgements made by business managers on client relationships.

This approach would avoid any unnecessary granularity and allow firms and regulators the maximum flexibility to reflect true liquidity risk.

Unsecured wholesale funding provided by other legal entity customers (para 55-56)

This category covers a wide variety of counterparties. We agree that 100% is a reasonable factor for some in the group but we suggest that further consideration needs to be given to this group and in particular the treatment of sovereigns and central banks. A framework that allows firms to use internal estimates would provide the flexibility needed. If this route is not adopted we suggest that this category be refined and the run-off factors reviewed.

Secured funding run-off (para 57-59)

As currently drafted under the proposals, it is our understanding that repurchase, reverse repurchase and secured lending are treated on a transaction basis. If the transaction is backed with illiquid assets, it is assumed that both the cash and the security are lost and the transaction attracts an outflow factor of 100%. However, if backed by liquid assets, it is assumed that the transaction gets rolled over and attracts an outflow factor of 0%.

We strongly recommend that the rules for these transactions be reformulated to recognise both legs of these transactions, separating the flow of cash from the flow of the underlying security. We suggest that at the maturity, a repo of high quality assets should be treated as an outflow of cash and an inflow of the security (similarly a reverse repo would show the outflow of a security and an inflow of cash). The cash outflow can then be treated as an unsecured outflow whilst the return of the collateral can be reviewed dependent upon the nature of that collateral. Similarly we would suggest that, at maturity, reverse repo transactions be split between the return of cash and the delivery of collateral. By netting the cash positions and collateral positions and separating them, firms and supervisors would obtain a more comprehensive view of the firm's changing liquidity risk patterns.

We also suggest that the cash be split out by security and the securities be split out by issuer. This would introduce greater risk sensitivity into the framework.

We also note that a long position in a security would need to be split between the cash returned at maturity in the cash ladder and the surrender of the bond in the security ladder.

Additional requirements (para 60-70)

Downgrade triggers: With regards to **'Increased liquidity needs related to downgrade triggers embedded in short term financing transactions, derivatives and other contracts'**, we suggest that the framework needs to shape the rules to reflect the actual triggers in the contracts, to avoid the outcome of rules applying to contracts where a trigger has not been activated. We recognise that banks must be able to identify downgrade levels where any significant additional liquidity is required and that this information should be shared with the bank's supervisor (and, of course, through its risk management governance). For this purpose firms should identify factors such as locality of markets and its current credit rating as impacts will differ.

Increased liquidity needs related to market valuation changes on derivative transactions. It is not clear why there should be national discretion on this potential outflow when other overlays have been prescribed by the Committee.

Increased liquidity needs related to the potential for valuation changes on posted collateral securing derivative transactions. We ask the Committee how the 20% figure was calculated given that collateral could be anything from cash to commercial paper. The Committee appears to be treating derivatives, under the LCR, on a contract basis. We suggest that derivatives need to be treated on a mark-to-market and margin posted and received basis.

Draws on committed credit and liquidity facilities. We accept that a firm should consider the possibility that at least some of their undrawn committed facilities will be drawn down in normal circumstances and that the pattern of drawdown may change in differing stress scenarios. As the possibility to raise funds in the markets dries up in the stress scenario then a bank will need to be able to liquidate a proportion of its liquidity buffer if it is to meet those commitments.

Whilst we therefore agree that liquidity facilities (which we take to be facilities of a revolving nature) may not be repaid during the course of a scenario of the type envisaged, we do not, however, agree that there will necessarily be an additional draw on such facilities of the magnitude envisaged. The experience for use of such facilities by non financial corporate customers has been that drawings were well short of the proposed 100% level. Non-financial organisations use such facilities as working capital and the stress scenario does not lead to increased drawdown of such facilities to any great extent.

On the other hand, for credit facilities, a higher level of drawdown may be expected as they represent drawings for specific purposes. In normal (let alone stress scenarios) it is plausible that at least some of these draw in full over defined periods. For example, where the facilities relate to pipeline risk firms would expect a higher level of drawdown as illustrated by mortgage pipelines which tend to be drawn over a 3-6 month period. We therefore question the basis on which the percentages suggested by the Committee have been calculated.

Turning to facilities granted to finance companies we would make a distinction between those relating to banks (or bank SPVs) and those relating to other financial businesses. We agree that those relating to banks should carry a 100% draw. The scenario is clear that

there is stress in the market and all banks are likely to fully draw their lines. Of course, the corollary to this is that writing of such lines is likely to be unattractive to banks. For other financial firms a similar argument can be made as for facilities to corporate clients.

Finally, we note inconsistencies in paragraph 66 a) to d) which has weightings of 10 -100% for the expected outflow of various credit and liquidity facilities. But paragraph 76 states that the inflows from similar facilities held with other banks are taken as 0%, as it is assumed the other bank may not be in a position to honour credit lines.

As above, we recommend that assumptions should be set by firms based on their own experience and subject to supervisory approval. There is also a need to clearly distinguish between credit and liquidity facilities.

Cash Inflows

Retail inflows (para 73)

We believe there is a need to make adjustment to contractual flows particularly in respect of products offering revolving credit. For example overdrafts in the UK are contractually repayable on demand but in practice are not demanded. Credit card receivables have contractual minimum repayments but some customers pay more than this. We suggest that the answer is to allow some national discretion.

Wholesale inflows (para 74)

See below under reverse repos and secured lending.

Reverse repos and secured lending (para 75)

As per our comments on paragraphs 57 - 59, we suggest that reverse repos and secured lending be considered in terms of their separate legs rather than on a transaction basis. This would allow credit to be given for cash coming into the firm at the maturity date of the reverse repo or securities lending agreement and avoid the following counter intuitive result implied by the proposal, i.e. that a loan maturing in one month and secured with government debt will not be treated as an inflow, whereas an unsecured loan due to mature within a month will be treated as an inflow.

Lines of credit (para 76)

We note that the treatment of undrawn liquidity facilities is asymmetric. If a firm is a drawer of a liquidity facility it cannot include this as an inflow. We argue a firm should be able to include undrawn liquidity facilities with risk weights and net positions based on their own assessments and subject to supervisory approval.

Other cashflows (para 77)

Note in reference to paragraph 63 the Committee appears to be treating derivatives, under the LCR, on a contract basis. We suggest that that derivatives need to be treated on a mark-to-market and margin posted and received basis.

3.2 Comments on Net Stable Funding Ratio (NSFR)

Objective (para. 78-79)

We support the Committee's overall aim to encourage more medium and long term funding and we welcome a measure that considers stable funding and liabilities. However, the current formulation of the NSFR (ratio of available stable funding over required stable funding) presents a number of outcomes that we question. To this end, we draw the Committee's attention to the below examples recognising that the final example maybe be an intended result. These examples are based on our interpretation of the available stability (ASF) and required stable funding (RSF) tables appearing in Annexes 2 and 3 and Tables 1 and 2 (pages 21 and 23) of the document.

- According to Annex 3 and paragraph 88 a corporate bond rated AA and financed with three month commercial paper sold to a non-financial corporate has an NSFR of 250% (50% available stable funding (ASF) for commercial paper/ 20% RSF for the corporate bond), while the same asset financed with nine month repo has an NSFR of 0% (0% as per paragraph 88/20% RSF for the corporate bond). So, the NSFR makes it more advantageous for a bank to finance an AA-rated corporate bond with the sale of three month commercial paper than nine month securities repo, while the commercial paper can be sold back and the repo cannot be unwound early. It is counter intuitive that locked in funding is treated more harshly.
- In reference to Annex 2, a blue chip equity security requires more stable funding (50% or 100% depending on whether the criteria laid out for the 50% bucket is met) than an equivalently sized unsecured nine month loan to a hedge fund (0%). This result is counter intuitive as the treatment appears unaligned to the risks associated with these assets.
- Under Annex 3, a renewable nine month unsecured loan to a hedge fund (which the bank has an irrevocable right to call) is assigned a 0% RSF while an identically termed loan secured with blue chip equities attracts either a 50% RSF or 100% RSF (depending on whether the criteria outlined in Annex 2 for the 50% RSF are met). As a consequence of the treatment of collateral, a financial services firm may find that it prefers to extend the loan to the hedge fund over the secured loan although a secured loan is more prudent from a credit and financing risk management perspective.
- Under Annex 3, it would appear that secured borrowings are penalised attracting an ASF of 0% (for the cash borrowed by the firm) and an RSF ranging from 5% (for governments) to 100% (for most non-government assets) for the securities lent to finance the borrowing. This treatment could mean the end of secured borrowing as it ignores the true stability of funding offered by certain types of secured borrowing and overstates the stickiness of many assets that are regularly liquidated in the normal course of business.
- Under Annex 2, unencumbered marketable securities (representing claims or governments or alike) with residual maturity of 1 year or greater attracts a required stability factor (RSF) of 5% factor whereas a mortgage with say 7 years left on it would attract a 100% RSF (as it would fall into the 'all other assets category'). So, it appears that the securities dealing business is favoured over straight retail lending which requires more stable funding. The result is the same for commercial lending

where the securities dealing business also appears to be favoured. This indicates to us that precise calibration is important and required.

The above examples point to a number of possible outcomes. Namely, funding will be available from fewer sources/counterparties; less prudent credit activity will be incentivised; and secured borrowing could disappear; and, in some instances investment banking will be encouraged over retail or commercial banking although retail deposits are favoured from a stability of funding perspective (i.e. under Annex 2, we can also see that retail deposits of < 1 year are treated more favourably than wholesale funding);

We may have misunderstood the NSFR Tables and Annexes. However, we would suggest that this points to a need for the Committee to engage with the industry on the NSFR in terms of its formulation and calibration.

The definition of the metric (para. 80-86)

In addition to the odd outcomes intended or unintended by the Committee, the proposed NSFR is overly complex and spuriously inaccurate. In regard to the Available Stable Funding (ASF) factors, why have 5 categories and not 10, why 85% for retail deposits and not 80%? Similar comments could be made about the Required Stable Funding (RSF) factors.

To assess the NSFR with regard to individual business models and stable funding needs, we suggest that Committee develop an appropriately calibrated and sophisticated risk sensitive measure that could better reflect firm specific factors. In setting its liquidity risk appetite an institution is balancing between prudence on the one hand and the level of maturity transformation on the other. We see this measure adding value in incentivising firms to better understand their long term liquidity risk and innovate and update their liquidity risk management practices.

We note that paragraph 83 suggest that the NSFR "...is to ensure stable funding on an ongoing, viable entity basis, over one year in an extended firm-specific stress scenario..." Thus, we argue it is necessary to subject the NSFR to different and varying scenarios to show how maturity transformation changes under institution specific stress. We also stress that the scenario needs to allow for mitigating actions (e.g. phase out of non-core businesses and the use of normal central bank facilities) and be appropriately calibrated

Definition of available stable funding/Table 1 Components of Available Stable Funding and Associated ASF Factors (para.82-86)

As implied above, with regard to paragraph 83, we believe that the stress assumptions (e.g. a potential downgrade in a debt, counterparty credit or deposit rating) are misplaced because they distort the snapshot of the funding relationship.

Also we note that paragraph 84 states that term central bank crisis funding should be excluded from this measure. We agree that reliance on central bank funding is to be discouraged, outside the regular market operations undertaken by the central banks in normal times; however, with the market as it is, we believe it would be unrealistic for institutions to replace such crisis funding in the near term by funding from the market. We therefore suggest some form of grandfathering. Also, we note again that paragraph 83 suggests that the NSFR "...is to ensure stable funding on an ongoing, viable entity basis, over one year in an extended firm-specific stress scenario..." Thus we would argue that normal central bank funding should be assumed.

Turning to the proposed ratios for ASF in Table 1 Components of Available Stable Funding and Associated ASF Factors we again question the Committee on how they derived the factors.

We also note following points:

- On the application of the factors, we assume that they are applied before the LCR run-off factors. It would be helpful for the Committee to confirm.
- On category 2 (ASF 85%), we note that:
 - This is just double the 7.5% used for such deposits in the LCR.
 - We would welcome an explanation of the basis for the weighting which implies 7.5% of such deposits might run off in the 1 month to 1 year period after 7.5% ran off in the 1 month period.
 - Would it not be simpler to recognise these are stable deposits and not introduce stress test assumptions at all?
- On category 3 (ASF factor 70%) we would again make the point that introducing stress test percentages for this relatively sticky funding gives the ratio a possibly misleading degree of accuracy.
- On category 4, non financial corporate clients cover a large range of entities covering small corporate businesses with less sophisticated treasury functions and larger corporates with advanced cash management functions. Indeed many large corporate companies operate professional treasuries and this form of funding would better be treated as volatile. The exact nature of non-financial corporates would be better assessed with the help of historical data and judgement of senior account managers.
- On category 5, see our discussion of repos and reverse repos and derivatives.

Definition of required stable funding for assets and off-balance sheet exposures/Table 3 (para. 87-91)

As stated above we suggest that the RSF in the denominator needs to consist of the unstressed amounts of balance sheet assets which require term funding.

With regard to paragraph 87, where it states that the "...RSF factor applied to the reported values of each asset or OBS exposure is the amount of that item that supervisors believe should be supported with stable funding," we are concerned about potential divergence of RSF factors and national discretions. It would be useful if the Committee could clarify how they intend to progress harmonised definitions of RSF factors.

In Table 2 we question where the Committee has drawn their figures from. With regard to the RSF factors and their respective composition of asset categories we make the following points:

On the 0% RSF factor line we note that clearing and settlement accounts should be included.

On the 20% RSF factor as under the LCR with regard to covered and corporate bonds, we urge the Committee to re-assess criteria of stable funding for these categories. The treatment should be consistent with their treatment under the LCR.

On the 50% RSF factors we are not clear why loans to non-financial clients require 50% stable funding. We assume this may be based on the assumption that some loans represent

working capital and are of a non maturity nature, some will roll at maturity and some will be non-performing. We would welcome details on how the 50% figure has been calculated.

Also we see, as mentioned under the LCR, that there is a case for other precious metals, commodities, equities (i.e. part of a major index) and precious metals as well as reverse repos with non-financial corporates to be included, with a suitable weighting.

We would welcome an explanation on how the 85% figure for retail loans has been derived.

The treatment of repos and reverses

A more explicit discussion of the proposed treatment of repos and reverse repos is required. Paragraph 88 appears to state that 'repo-like' transactions are excluded from the NSFR's encumbrance definition. We ask that the full scope of 'repo-like' needs clarification including whether the exemption applies to reverse repos.

The scope of these exemptions is important particularly given our current understanding of how secured borrowing and lending are treated under the NSFR tables. As already stated, it would appear that secured borrowings are penalised attracting an ASF of 0% (for the cash borrowed by the firm) and a RSF ranging from 5% (for governments) to 100% (for most non-government assets) for the securities lent to finance the borrowing. Similarly, consider that secured lending to financials for a period less than a year appears to attract a 0% RSF for the loan plus and RSF percentage for the collateral (which is held by the firm as 'unencumbered marketable securities' available to the firm for financing requiring an RSF) which is 100% for most non-government assets.

The treatment of derivatives

The proposed framework lacks an explicit discussion of derivatives and we suggest that a full discussion is needed. It would appear that under the NSFR derivatives fall into the 'all other liabilities and equities' 0% ASF bucket and 'all other assets' 100% RSF bucket implying that they have no value as source of stable funding and require 100% support. We suggest that this treatment needs to differentiate between types of derivative transactions (e.g. interest rate products and FX products). The framework is also silent on whether netting is permitted, although it would seem from the BCBS QIS FAQs document that netting on a counterparty basis is allowed.

Similar to our comments on the treatment of derivatives for the purposes of the LCR, we think it would be sensible if the RSF applies to the derivative receivables on a netted basis (by counterparty) and net of any rehypable collateral received (i.e. collateral to which a firm has rehypothecation rights).

Off balance sheet activities

In regard to Table 3 and the treatment of off balance sheet (OBS) activities, we note that (paragraph 87) that the RSF factors to be applied are to be determined by national supervisors. This is in stark contrast to the treatment of other instruments in the proposals. Moreover (paragraph 90) suggests that an extra reserve is being required for these activities.

3.3 Comments on Monitoring Tools

We welcome the Committee's proposal for a consistent set of monitoring metrics. This will assist colleges of supervisors in looking at the liquidity risk in global banks and create a common language, reducing the risk of misinterpretation of information by boards and senior management, commentators and supervisors. It will also have the added advantage of reducing systems costs in reporting liquidity risk being run by such entities.

Against this backdrop, we particularly welcome the initiative taken by the CEBS Task Force on Liquidity Risk Management to develop a "Liquidity Identity Card" which is meant to help supervisory colleges to develop a common language and consistent processes in this area. This will improve mutual communication amongst the members of supervisory colleges and contribute to a more efficient treatment of cross-border firms. The final version of the Committee's paper should draw inspiration from this initiative and expand its use on a global level.

We urge national regulators and the Committee to develop and agree a standard reporting template from which supervisors can request individual firm relevant information. This would help to guard against an outcome whereby firms are faced with different reporting requirements across jurisdictions and are faced with building multiple reporting platforms. It would also encourage transparency and support supervisors and senior management awareness of the liquidity position of a firm.

Thus, we welcome the Committee's recognition that the monitoring, management and control of liquidity requires institutions and regulators to look at a number of metrics, to review the trends within those metrics and to review the inter-relationship of the differing metrics.

When considering a list of common liquidity indicators we acknowledge that there is a wide array of liquidity metrics to choose from. However, some metrics will be more or less relevant for each individual firm. Thus, we propose that a starting point would be to develop a maximum harmonised list of liquidity measures that would serve as a menu for regulators to choose from when considering a cross border group. The first discussion of a college of supervisors then could be to focus on identifying relevant liquidity metrics for the cross-border bank in question. We envisage that a harmonised liquidity reporting menu would cover:

- (i) Loan-to-Deposit ratio
- (ii) Liquidity risk factor (also known as maturity transformation) average tenor of assets to average tenor of liabilities
- (iii) Inter-entity funding report for Group and consolidated banking entities
- (iv) Pricing data
- (v) Currency analysis
- (vi) Funding Concentration Report, indicating extent of reliance on single sources of funds (e.g., top 5 biggest single sources, by sector and individual firm/customer, and if within limits if the firm had set a limit of no more than (say) 10% of funds from one single source)
- (vii) Report on the amount of funding capacity that exists after taking into account the headroom required to survive a stress event (whether firm-specific or market-wide), the extent that existing liabilities and assets will be rolled over and the amount of new business put on, over a given period of time. We call this metric the "Surplus Funding Capacity" for a bank
- (viii) Weekly Qualitative Report – A descriptive summary of any material detrimental changes to the above metrics (e.g. significant changes in: 1-week and 1-month

liquidity ratios; cash and liquidity gap in Cumulative Liquidity model; the Liquidity Risk Factor; intergroup borrowing/lending position.

We suggest that the BCBS's QIS would be a particular good starting point in the development of a comprehensive list of monitoring tools.

We accept that the development of granular data items is useful for harmonised reporting, but remind the Committee that there is no single approach to assigning any metric or limit to one firm. Supervisors need to be flexible in considering specific metrics on a case by case basis to take account of specific firm liquidity risk. Therefore any harmonised list should only be a starting point for a discussion between a firm and its supervisor.

However, we remain concerned that BCBS 165 includes no discussion of harmonised reporting formats. It is suggested (Paragraph 100) that banks will provide raw data to supervisors but it can not be assumed that banks will provide data in the same way (see Application issues for standards and monitoring tools section).

Concentration of Funding (para 104—116)

With regard to concentration of funding we note that it would be more useful to measure liquidity risk exposures relative to funding of liquidity rather than to the total balance sheet. Also, we note that there is no metric to measure the concentrations of liquid assets in the LCR. We propose a measure as above under the alternative metrics for NSFR which suggests the following:

Unsecured wholesale funding < 1 year

Total deposits + debt securities in issue + capital

With regard to significant counterparties (paragraph 106), we suggest that it would be better to segregate secured vs. unsecured borrowings.

With regard to significant currencies in paragraph 111 we note that significant currencies as defined by 1% of the banks total liabilities would easily qualify all currencies for firms. 15% would be a far more relevant ratio to consider currencies as significant.

Application Issues for standards and monitoring tools

Scope of application

The application of the new framework – i.e. on a consolidated and, potentially, on a legal entity basis as well – is a cause of concern, particularly to cross-border banks which do not tend to organise their management of liquidity risk beyond a legal entity basis.

As outlined in Section 2 of this document, we urge the Committee to develop a harmonised reporting language and format. This would enable cross border firms to provide one single consolidated report that can be shared among supervisors.

In any case we would welcome further clarification on the intended level of reporting. In particular, more clarification would be welcomed on (i) the possibility to off-set liquidity excesses across convertible currency jurisdictions and (ii) how intra-group transactions need to be treated. The Committee should ensure the following:

- Within a single country, the requirements need to be met at a consolidated level only;

- Double counting needs to be avoided across countries, particularly where third-party deposits are concerned.

We recognise that governments will need time to agree on arrangements which foster an optimal flow of liquidity within cross-border banking groups and which would, in particular, lift restrictions to intra-group exposures which are an obstacle to organising liquidity transfers within a banking group in conformity with banks' best practices. Regulators should be aware that the absence of such arrangements may encourage banks that are active across borders to provide services by means of branches instead of subsidiaries.

However, introducing harmonised reporting would be a first step in providing a cross-border supervision framework that could aid the coordination or delegation of task in between supervisors.

Frequency of calculation and reporting

The cost and systems implications of the requirement that metrics should be reported monthly with the flexibility to scale up to weekly or even daily in stressed situations should not be underestimated. Harmonisation in reporting standards and baseline metrics is important for firms. Without harmonised standards, firms are faced with reporting similar information in multiple formats and potentially having to upgrade and / or replace reporting systems as jurisdictions change their requirements. We would encourage the Committee to consider the extent that CEBS's work on Liquidity Identity Cards or the Basel QIS (see monitoring tools) might be used to standardise reporting. Most cross border firms will agree that it would be preferable to have granular and frequent reporting to one format at a group wide level rather than submitting similar data in multiple reporting formats.

Public disclosure (para 135)

As already mentioned, Basel public disclosure requirements are far-reaching. Obviously, disclosing detailed quantitative information on liquidity positions could have negative consequences for the firm, and potentially the financial services sector. The European Central Bank in its discussion paper *EU Banks' Liquidity Stress Testing and Contingency Funding Plans (2008)* has rightfully pointed out:

...public disclosure could have negative repercussions on the liquidity situation of some banks under certain circumstances. While more disclosure, in particular on banks' liquidity risk management, is generally to be encouraged, the BSC considers that, in the case of liquidity stress test results, the detrimental effects of mandatory public disclosure are likely to outweigh the benefits.¹⁵

For example, consider a rumour circulating in the market about a bank which has discovered a "rogue trader". There will be a period when the bank needs to marshal all its liquidity resources whilst it investigates the rumour, confirms or otherwise its truth, quantifies the level of loss and communicates to the market what it means for the firm. During that period the buffer may well be used. A variation on that might be that the rumour has identified the wrong bank.

Furthermore normal flows of cash through the firm due to seasonal and other factors may well see fluctuations in the LCR. Publication of the LCR at specific dates could well show a decrease between one date and another (whilst still showing levels above the minimum) which merely reflect those normal movements but could create unnecessary concern among

¹⁵ <http://www.ecb.int/pub/pdf/other/eubankliquiditystress-testing200811en.pdf>

the uninformed. Moreover, disclosures made on a routine basis under normal conditions provide institutions with less flexibility once the market is under stressed conditions.

For these reasons we believe that the liquidity information (and in particular information relating to the LCR and a firm's use of its liquidity buffer) should only be shared with the regulator and not made public to the wider community. If it is viewed as essential to the Committee, we suggest that these metrics be disclosed in arrears and based on rolling averages computed over an extended time period rather than point-in-time metrics. This would remove contextual information from users of the disclosure and would provide firms with flexibility to use the buffer without raising undue market concern.

4 Other comments

Glossary of terms

The final version of the BCBS 165 paper should include a comprehensive glossary which provides clarity on the terminology used throughout the Paper. This is essential. Items that could be included are:

- Liquidity facilities
- Credit facilities
- Retail notes –are they included as retail deposits
- Marketable assets
- Difference between normal and transferable loans
- Inflows
- Outflows
- NSFR
- Repos
- Reverse Repos
- Derivatives
- Off Balance Sheet