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Sent by e-mail to: markt-h1@ec.europa.eu

Response to the *European Commission on CRD 4*

Commission Services Staff Working Document Possible further changes to the Capital Requirements Directive - February 2010

Dear Mario Nava,

The Association for Financial Markets in Europe[1] ("AFME"), the British Bankers' Association[2] ("BBA") and the International Swaps and Derivatives Association[3] ("ISDA") are pleased to respond to the Commission Services staff working document *Possible further changes to the Capital requirements Directive*, Our response should be read in conjunction with our response to the Basel Committee's consultations on *The international framework for liquidity risk measurement, standards and monitoring* and *Strengthening the resilience of the banking sector*.

Introduction

Our members share the Commission's goal of enhancing the Capital Requirements Directive (CRD), in the context of rebuilding a strong EU and global economy, and commend it on the significant progress that it has made to date, in conjunction with the Basel Committee. A robust regulatory framework that supports market confidence is as important to industry practitioners as it is to the regulatory community. We believe the Commission and the Basel Committee have correctly identified a number of key areas for improvement, in line with the

[1] EC register of interest representatives 84360841127-33

[2] EC register of interest representatives 5897733662-75

[3] EC register of interest representatives 4663241096-93

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. It is important for the Commission to work with the Basel Committee to deliver these commitments.

In addition, the range and extent of these proposals, combined with the significant changes already implemented, or are 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 the 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 support the Commission undertaking a European Quantitative Impact Study (QIS) considering the aggregate effect of the proposed revisions. Members also support the Commission engaging the industry in a further round of consultation, following the Basel QIS, EU 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 and the Commission'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 well beyond 2012.

Overarching key issues

Calibration and impact assessment

We are strongly supportive of the Commission's approach to determining the calibration of the proposals through the Quantitative Impact Studies that are currently underway, which take 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 Commission 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 unduly 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 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 result in 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 the 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 Commission 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 Commission 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 Commission 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 Commission 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 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 firms 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 the risk in the financial system globally whilst also reducing the burden on firms of regulatory compliance - 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, so we support the move towards a maximum harmonisation Directive.

While the CRD is legally binding, we recognise that the Basel Accord is not. The Pittsburgh Declaration indicated that all major G20 financial centres commit to adopting the Basel II framework by 2011 and we trust that the Commission will emphasise the importance of this, as it engages with the Basel Committee. 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 will facilitate these recommendations. We suggest that the Standards Implementation Group (SIG) would be an appropriate forum for the review of implementation by Basel Committee members with the European Banking Agency (EBA) mirroring the SIG's work.

Key issues

We would like to bring to the Commission's attention a number of particularly significant issues identified by Members. These issues, our response to the questions posed by the Commission and other comments are covered in more detail in the attached annexes to this letter. The significant issues are ordered in line with their location in the consultation rather than in order of importance.

Liquidity

Calibration of the liquidity proposals and supervisory factors

We are very concerned by the calibration of the Liquidity Coverage Requirement (LCR) and Net Stable Funding Requirement (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 firm's behaviour made over the ratio horizons cannot 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 corporate and will have an early and sustained adverse impact on the wider economy.

Net Stable Funding Ratio

We support the Commission'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 BCBS 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.

Scope

We welcome the Commission's recognition for the need for liquidity waivers, but we are concerned by the Commission's proposal not to make them available to firm with a non-EEA parent.

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 firms in the capital markets.

Deductions

The 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.

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 risk management techniques). In our view it should be applied at the consolidated level, with the regulatory consolidation for the overall consolidating supervisor being used whether or not the consolidating supervisor is outside the EU/EEA. However, we have some serious concerns over its potential design, particularly around its ability to address differing business models. We would highlight 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 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 that we identify could potentially be addressed by calibration, we believe that 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. However, we contend that 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 a firm and its supervisor and enable them to address the methodological and calibration issues that will be specific to firms' business models. In addition, to facilitate this process, we think that the introduction of a leverage ratio range, rather than a single number, would successfully address the aims and objectives of the regulators by providing an upper and lower bound with supervisory discretion. Furthermore, we want to highlight the improvements that are being carried out to the regulatory architecture and the existence of the college of supervisors for certain large international firms, which have undoubtedly facilitated the handling of the financial crisis together with the enhancement of the college process, which should be further pursued. We suggest that the SIG could be an appropriate forum to ensure that convergent practices are adopted by Basel members and that the EBA could ensure that they are adopted within the EU.

Counterparty credit risk

Our members believe that the Commission 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 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 Commission on developing them further.

Countercyclical measures

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 but should be uniformly applied.

We therefore recommend that consistent application of Pillar 2 should be a focus of the supervisors and we recommend that the EU work with the Basel Standards Implementation Group to review supervisory standards and convergence in this area. We also support the Basel Committee's proposal to update the guidance on sound provisioning practices, rather than introduce proposals for 'dynamic provisioning' and recommend that the EU align with this international agreement.

Where juristrictions already operate equivalent measures to those proposed and which are proven techniques, we would urge the Commission 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.

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 and the Commission's commitment to implement them through changes to the CRD. 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 firms. The Commission'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.

Comments and Questions

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

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Enc: 1 Response to CRD 4

2 Response to Basel Committee's consultations on *Strengthening the resilience of the banking sector* and *The international framework for liquidity risk measurement, standards and monitoring*.

The Association for Financial Markets in Europe (AFME) represents a broad array of European and global participants in the wholesale financial markets, and its 197 members comprise all pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. AFME was formed on 1st November 2009 by the merger of the London Investment Banking Association and the European operations of the Securities Industry and Financial Markets Association.

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.

Introduction and overview

This document is structured as follows:

Annex 1 provides a detailed response to each of the seven key proposals the Commission issued for consultation including:

1: Liquidity standards;

2: Definition of capital

3: Leverage ratio

4: Counterparty credit risk

5: Countercyclical measures

6: Systemically important financial institutions; and

7: Single rule book in banking

Annex 2 provides our detailed response to BCBS 164 Strengthening the resilience of the banking sector and BCBS 165 International framework for liquidity risk measurement, standards and monitoring.

Annex 1: Detailed response to each of the seven key proposals the Commission issued for consultation

1 Liquidity standards;

1.1 Key messages

Our members, including those of the Association of Foreign Banks, welcome the proposals for *Liquidity standards for credit institutions and investment firms* put forward by the European Commission (Commission) and its attempt to closely align with the proposals simultaneously put forward by the Basel Committee for Banking Supervision (Committee) for an *International framework for liquidity risk measurement, standards and monitoring* (BCBS 165*)*. The recent crisis underlines the need for a common approach to liquidity risk standards which, compared to the framework for capital, is relatively underdeveloped. As such we view the Commission's proposal as a first stage in an on-going discussion to develop global liquidity standards.

In terms of the proposed regulatory requirements, in principle we support the introduction of a short term ratio that focuses on the adequacy of a financial institution's liquidity buffer in times of stress and a long term ratio 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 facilitate the establishment of a globally consistent framework.

While we support the introduction of minimum quantitative measures, we caution the Commission against the introduction of an overly tight and prescriptive one-size-fits-all framework. Moreover, the proposed requirements do not appear to reflect minimum standards but rather a maximum stress test based on an aggregate of recently experienced stress scenarios.

In terms of addressing cross border liquidity management, we welcome the Commission's proposals for common monitoring tools and the inherent recognition for a need of a number of metrics to fully capture a bank's liquidity risk profile. We also welcome the suggestion that there could be a waiver (subject to conditions) to recognise the central management of liquidity risks within a group if the legal entities of the group are located within the Member States.

We are however, concerned that non EU based firms will be unable to apply for similar exceptions. Specifically, we are concerned about the non-equivalent treatment of firms whose parent is located outside the EEA where the Commission does not envisage making available a waiver for these firms' liquidity requirements.

Finally we note that the ability of the proposed Basel BCBS 165 and CRD 4 framework to facilitate effective liquidity risk management and supervision will depend on the Committee's use of the Quantitative Impact Study (QIS) results to calibrate the ratios and haircuts, as well as final decisions on the composition of the stock of liquid assets. We have serious concerns about the proposed calibration of the ratios and haircuts and the very limited definition of liquid assets. We encourage the Commission along with the Committee to consider very carefully the calibration of the new liquidity measures to avoid pro-cyclical metrics that could impede banks' ability to perform their traditional and important intermediation functions.

CRD 4 and BCBS 165 generated a great deal of discussion amongst Members. While we already provided some of our key messages on the calibration, NSFR design and scope in the covering letter, we would like to refer the Commission to our key messages and detailed comments in our attached response to the Basel consultation BCBS 165 which expands on our concerns relating to the LCR, NSFR and Monitoring tools. Below we provide detailed comments on the text and questions in Section I of CRD 4.

1.2 Detailed comments on text and question

Paragraph 2

Timing of implementation should await economic recovery and allow for sufficient time for firms to build up buffers, long term funding and adjust their business models.

Paragraph 3

We welcome the recognition that a buffer would be run down in stressed times and agree that restoration plans need to be in place to rebuild these buffers.

However, we note that for just this reason it would not be appropriate to share point in time information on liquidity buffers with the public as this could lead to loss of reputation of the firm and could exacerbate a firm's idiosyncratic liquidity stress. Thus, we recommend disclosure to the regulator only, but not to the public.

Liquidity Coverage Requirement

Paragraph 5

We are concerned about the appropriateness of a standardised scenario which presumes that all firms are affected in the same manner by idiosyncratic and systemic shocks based on the financial crisis that began in the middle of 2007. How firms were affected over that crisis, and any crisis going forward, is a function of the jurisdictions they operate in, the products and services being offered and their corporate and risk governance.

Another concern is how and when the proposed assumptions underpinning the scenarios and the factors used in the computation of the Liquidity Coverage Requirement (LCR) would be updated. As the LCR is largely copied over from the proposals contained in the BCBS 165, any update of these assumptions would need to reflect changes made at the Basel level. If the EU seeks, sometime in the future, to modify these assumptions independently of any international agreement, level playing field concerns would come into play.

Paragraph 6

We welcome the recognition that firms must meet their liquidity needs in each currency and that high quality liquid assets must match the foreign currency liability in the same currency. We note that this could mean holding local liquidity buffers in countries whose government issued paper's credit rating is not high enough to qualify for the liquidity buffer. For example, a net outflow in Indian rupees could be matched by Indian government securities with a market value greater than the stress net outflow, which should therefore count as part of the buffer. This is a much more sensible approach than, for example, holding US dollars for Indian rupee liabilities.

However, in this example consider the case where India's credit rating does not meet these criteria of a 0% risk weight for credit risk under the standardised approach (as set out in Annex I). This issue also presents itself in BCBS 165 – paragraphs 34d and 134 also indicate that local assets should be matched to local currency exposures while simultaneously requiring 0% risk weighting under the standardised approach for credit risk under paragraph 34c (i).

We encourage the Commission and the BCBS to allow the highest corresponding government bonds to qualify for respective foreign currency exposures which are appropriate to where a firm operates. This is particularly important for financial services firms that are in scope of the CRD and active in emerging markets. Furthermore, 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.

Paragraph 7

We agree that central bank eligibility is a useful criterion in liquidity benchmarking and welcome the recognition that firms will access central bank liquidity facilities under severe stress. However, we do not think that central bank eligibility should be a mandatory requirement for liquid assets. We would argue that assets can be liquid, in a crisis, but not central bank eligible and we note, as does the Commission, that there is some divergence in eligibility criteria between central banks.

We also agree that in a market wide stress central banks will have a role to play to support the market generally. In so doing central banks will look to use all types of qualifying collateral for its credit operations. This suggests that there is an argument to extend the assets which qualify for inclusion in the LCR beyond the very narrow definition of government paper.

As can be seen in our accompanying paper to the the Basel Committee, we support the suggestion that the buffer might have two tiers to allow firms to use liquid instruments such as covered bonds, corporate bonds and, for the purposes of US dollar liquidity risk, agency paper. This has the added advantage of a less deleterious impact on the credit markets and the mortgage market in particular.

We support the Commission's call to "develop technical standards specifying the list of eligible collateral for liquidity purposes which may differ from the list established by central banks". However, as the European Banking Authority (EBA) has yet to be formed, we do not offer any comments on the EBA's proposed role in setting these standards, except to encourage the Commission to engage internationally on such standards.

The question of central bank eligibility is intrinsically linked to the broader debate of the role of central banks in resolving financial crisis. It is a discussion that we encourage.

Paragraph 8

We agree with the fundamental and market-related characteristics being set for liquid assets. However, the criteria 'active and sizable market' is of concern to smaller firms. The implementation of these criteria requires a proportional approach. Trading in the markets is costly and resource intensive. Smaller banks are concerned that they do not have the repo capabilities for government bonds to test these criteria. We urge that some allowances be made for smaller firms to test these criteria 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.

1.3 Response to questions 1 to 15

Question 1: Comments are sought on the concept of the Liquidity Coverage Requirement and its likely impact on institutions' resilience to liquidity risk. Quantitative and qualitative evidence is also sought on the types and severity of liquidity stress experienced by institutions during the financial crisis and – in the light of that evidence – on the appropriateness of the tentative calibration in Annex I. In particular, we would be interested in learning how the pricing of banking products would be affected by this measure.

Concept

We support the concept of holding a liquidity buffer, but we are very concerned 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. We have a number of detailed comments to offer on the buffer and these are as follows:

a) Time horizon and tiered buffer

Concerns relate to the lack of alignment between the horizon suggested in CRD 4 and BCBS 165, and by the CEBS *Guidelines on Liquidity buffers and survival periods*. The CEBS guidelines divide the time horizon set for the buffer into two phases: the first phase is one of short acute stress and lasts for a period of one to two weeks; the second phase is less acute but more persistent. These phases in turn, support a two tiered construction of the buffer that reflects assets that can be liquidated under the assumed stresses in the sub-periods. We urge the Commission, as we have the BCBS, to consider splitting the 30 day horizon into two phases and consider expanding the adoption of a tiered approach to the buffer that would allow a wider range of assets in the second phase when a wider pool of assets could be sold.

b) Use of Buffer

We welcome the Commission's recognition in paragraph 3 that it is "…clear that under stress, for instance because of a sudden loss of deposits, credit institutions could fail to meet the requirements." 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.

c) Public Disclosure

While we generally support transparency, we warn that far-reaching public disclosure requirements regarding changes in the LCR and/or use of the liquidity buffer could have devastating 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 buffers.

Public disclosures made on a routine basis under normal conditions provide institutions with less flexibility once the market is under stressed conditions. Therefore, we advise the Commission to limit the sharing of liquidity ratios to regulators only.

If the Commission should decide that there is a need for public disclosure requirements, we urge the Commission not to mandate any current point-in time metrics but rather rolling averages computed over an extended period of time. Additionally we would suggest a significant time lag in the publication of quantitative information in order to give banks flexibility to use the buffer, if needed, without raising undue market concern. This removes contextual information from market makers who are likely to act on and escalate certain disclosure events, e.g. a breech of a firm's buffer. Of course, more extensive and closer to real-time information would be made available to regulators.

d) Prescriptive behavioural overlays

We suggest that the Commission's run-off assumptions are too conservative and will discourage institutions from assessing and understanding their own risk drivers. There are no incentives in the framework to undertake such an internal assessment. Furthermore, we note the difficulties in defining such concepts as stable and non stable sources of funds. We urge the Commission to remember that there is a multi-dimensional liquidity spectrum across different types of deposits, products and customers. So to draw hard lines within that spectrum and apply behavioural overlays to each segment may create dysfunctional risk insensitive behaviour in the evaluation of the liquidity risk and hence, ultimately, pricing of the liquidity spectrum.

In this respect it would be helpful for the Commission 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. By publishing prescribed outflows the Commission 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 result and dysfunctional pricing will follow.

Against this backdrop, we urge the Commission to continue to work with the Basel Committee in the development of an international approach that would encourage firms to develop adequate internal quantitative frameworks that measure the liquidity risks to which they are exposed. We recognise that use of such internal frameworks would need to be approved by supervisors; so we would support the development of approval criteria that aligns with the Basel Committee's "Principles for Sound Liquidity Risk Management and Supervision", that is shared with the industry and implemented in an proportionate manner. Supervisory standards, such as those proposed in CRD 4 would then only be used by those firms unable to meet supervisory approval requirements because they an appropriate internal quantitative framework.

Qualitative and quantitative evidence of stress experienced during recent crisis

The information being requested by the Commission is market sensitive information. Consequently, trade associations are not in the positions to provide such information and we suggest that national supervisory bodies might be in the best position to provide this information to the Commission.

Impact on product pricing

As already suggested prescriptive behavioural overlays have the effect of drawing hard lines within liquidity spectrum across different types of depositors and types of products. This may create dysfunctional behaviour in the evaluation of the liquidity risk and hence, ultimately, pricing.

Question 2: In particular, views would be welcome on whether certain corporate and covered bonds should also be eligible for the buffer (see Annex I) and whether central bank eligibility should be mandatory for the buffer assets?

Corporate and covered bonds

As in the response to BCBS's consideration of corporate and covered bonds (paragraph 35 BCBS 165), we are of the view that a broader definition of the buffer should include corporate and covered bonds as per Annex I. We generally urge the Commission to expand the definition to include assets that historically have been liquid even under stressed conditions subject to appropriate haircuts. As above, we suggest that the 30-day horizon set for the LCR be divided into two phases or sub-periods and a tiered approach to the buffer be adopted. Underpinning this approach is an understanding that following two weeks of stress marketable assets can be realised with less forced sale risk.

With regard to corporate and covered bonds, we argue that any haircuts applied should reflect observed price volatility, particularly during the crisis. We ask how the haircuts proposed in Annex I have been calculated. Moreover the requirement that these instruments have 10 years of history to prove their reliability excludes a very 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.

We would also suggest that agency paper be able to qualify to cover US dollar positions.

Central bank eligibility

We do not support the idea that central bank eligibility should be a mandatory requirement for liquid assets. We would argue that assets can be liquid, in a crisis, but not central bank eligible and we note, as does the Commission, that there is some divergence in eligibility criteria between central banks.

However, we consider that a market stress event – which is inherent in assessing the LCR – is a shared problem between firms and their respective central banks. It seems sensible, therefore, to include in the buffer, assets which the central banks are prepared to accept as collateral at least in their normal "open market" operations.

We support the Commission's call to "develop technical standards specifying the list of eligible collateral for liquidity purposes which may differ from the list established by central banks."

The question of central bank eligibility is intrinsically linked to the broader debate of the role of central banks in resolving financial crisis. It is a discussion that we encourage.

We note that Commission includes, for monitoring purposes, a metric of "available unencumbered assets" (Annex III). This includes not only assets that have liquidity value in the market but also assets which could be used as collateral at central banks. This is a useful additional metric whatever the content of the liquidity buffer.

Question 3: Views are also sought on the possible implications of including various financial instruments in the buffer and of their tentative factors (see Annex I) for the primary and secondary markets in which these products are traded and their participants.

On this question trade associations are not in the position to provide information on this question, but suggest further work on the economic impact of the proposals is needed.

Net Stable Funding Requirement

Question 4: Comments are sought on the concept of the Net Stable Funding Requirement and its likely impact on institutions' resilience to liquidity risk. Quantitative and qualitative evidence is also sought on the types and severity of liquidity stress experienced by institutions during the financial crisis and – in the light of that evidence – on the appropriateness of the tentative calibration in Annex II. In particular, we would be interested in learning how the pricing of banking products would be affected by this measure.

Concept

We agree with the stated objective of encouraging more medium and long term funding and welcome a metric that focuses on long term funding compared to shorter term liabilities. To this end a metric measuring stable funding and liabilities would be very useful. However, we are concerned that the current approach to constructing such a ratio will not achieve the objective and could have a detrimental impact on the economy by discouraging maturity transformation. We would expect the amount of credit in the market to diminish markedly if the NSFR were introduced as proposed. We would also expect the cost of that credit to rise.

Further we caution against applying a stress test that assumes that all firms are affected by the stress scenario in the same way. The current standardised scenario does not sufficiently take into account firm specific characteristics and factors such as business models, mitigating actions, products, markets and the jurisdictions firms may operate in. It also creates some outcomes that we question, e.g. less prudent credit activity will be encouraged given the treatment of secured lending. We ask that the Commission review our response to BCBS 165. It illustrates counter intuitive treatment of sources and uses of funding under the NSFR.

Given our concerns on the NSFR over the calibration, complexity and lack of risk sensitivity which produces perverse risk incentives, 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 Commission 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. 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.

Furthermore, Paragraph 11 of CRD 4 suggests that the *"The NSFR aims at ensuring a sound funding structure of an institution over one year in an extended **firm-specific** stress scenario…"* As such the factors used in the NSFR appear to be overly draconian. Thus we argue it is necessary to subject the NSFR to different and varying scenarios to show how maturity transformation changes under an **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.

For example, the factors assume that all firms would have the same risk appetite to roll over less than 1 year loans. However, this will be dependent on the type of firm. A mortgage bank would be more likely to continue lending for house purchase but might cut back on personal loans and or other categories of lending. (Mortgage banks generally experienced the roll over of mortgage loans but not corporate loans).

Furthermore, as the NSFR is subject to an idiosyncratic stress, we argue that marketable assets would be subject to normal market wide stress. Thus, firms are likely to have a greater choice of assets that they can sell or repo to raise cash at short notice if the markets are functioning normally. Haircuts on those assets should reflect this fact.

Qualitative and quantitative evidence of stress experienced during recent crisis

It is difficult for trade association to be a conduit for data supplied by members. However, members have indicated that they experienced different outcomes during the crisis. In broad terms, this is because they:

a) failed

b) received government support

c) observed the benefit of flight to quality (with increased deposits)

Impact on pricing

As noted above under the LCR we note that NSFR prescriptive proposals will lead to formulaic pricing.

Detailed comment

We note that BCBS 165 includes a 10% Required Stable Funding (RSF) factor in respect of undrawn committed credit and liquidity facilities. CRD 4 does not. Is this simply an omission?

Question 5: Comments are in particular sought on the merits of allowing less than 100% stable funding for commercial lending that has a contractual maturity of less than one year. Is it realistic to assume that lending is reduced under liquidity stress at the expense of risking established client relationships? Does such a differentiation between lending with more and with less than one year maturity set undesirable incentives that could discourage for instance long term funding of non-financial enterprises or encourage investment in marketable securities rather than loans?

As stated above we believe that credit institutions will protect, if they can, their core franchise. However, what that core franchise is, will vary by institution. Furthermore, contingency funding plans (CFPs) will have differing levels of response dependent upon the severity of the stress being experienced. In very severe stress events a CFP should consider reducing the protection afforded even to the core activities, especially if the alternative is to run out of cash.

Loans are by their nature illiquid. Indeed it could be argued that the creation of “the originate and sell model” was an attempt to produce more liquid balance sheets. In an idiosyncratic stress event selling portfolios of loans can take a considerable amount of time. However, if instead of originating its own loans a firm buys them in the form of covered bonds, agencies, MBS, corporate bonds etc – assuming the market is functioning properly, the instruments are well understood and they have undergone stringent credit assessment – then the firm’s liquidity position is improved.

If the regulators also set standards that require more term funding for loans than marketable instruments credit institutions are likely to be discouraged from holding their own loans and more likely to package them up for sale.

Question 6: Views are sought on possible implications of inclusion and tentative "availability factors" (see Annex II) pertaining to various sources of stable funding for respective markets and funding suppliers. Would there be any implications of the tentative required degree of coverage for various asset categories for respective bank clients?

The proposed granularity of deposit categories in Annex II will limit a firm’s ability to assign appropriate liquidity cost to a wider spectrum of products. This is likely to distort product pricing and eliminate incentives to offer customers diverse choices in products.

Moreover, in regard to the assignment of standardised varying availability factors, we are concerned that there may be perverse incentives to pursue potentially riskier business streams e.g. investment activities.

Completeness of legislative approach

Question 7: Do you agree that all parameters should be transparently set at European level, possibly in the form of Technical Standards by the EBA where parameters need to reflect specific sub-categories of retail deposits?

As per our response to BCBS 165 and below, we suggest that there be greater scope for a risk based approach with firms using their own parameters that is more risk sensitive and allows for more granularity if needed.

We appreciate that not all firms may have the capability to produce their own behavioural estimates, and a standardised type option is needed. Further, a standardised method would be useful as a benchmark against a firm specific analysis. For this option we agree that transparent and common standards are needed. In this case we agree that an international body is required to set and review the categories and levels. However, until such time as there is a true single financial market across the EU there will always be national differences that need to be considered.

Question 8: In your view, what are the categories of deposits that require a different treatment from that in Annexes I and II and why? Please provide evidence relating to the behaviour of such deposits under stress.

The current proposed granularity of deposit categories in Annex I and II does very much limit a firm's ability to assign appropriate liquidity cost factors to a wider spectrum of products. This is likely to distort product pricing and eliminate incentives to offer customers diverse choices in products.

As above, we suggest that there be greater scope for a risk based approach with firms using their own parameters that is more risk sensitive and allows for more granularity if needed.

Given differences in business models, type of customers, and products, e.g. between multinational investment firms and retail banks, we maintain that firms are best placed to set appropriate segmentation of funding types and respective risk factors. These should be based on a firm's senior management's assessment of contractual maturities in normal times taking into account not only historical data but also a firm's sensitivity assessment, risk appetite, economic and financial stability factors.

We appreciate that not all firms may have the capability to produce their own behavioural estimates, and a standardised type option is needed. Also a standardised approach would be useful as an indicative benchmark or starting point for discussions with regulators. For this we agree that transparent and common standards are needed.

For a standardised approach we would propose to further differentiate the following deposit categories:

- Debt instruments
- Wholesale Funding of entities

Scope of application (paragraphs 15-20)

Question 9: Comments are sought on the scope of application as set out above and in particular on the criteria referred to in paragraph 17 for both domestic entities and entities located in another Member State.

We are fully supportive of the CRD 4 proposal for EU institutions to align primary responsibility for liquidity oversight with that for capital oversight back to home rather than host. Transparency and information sharing could be achieved through colleges of supervisors. We also broadly support the criteria under paragraph 17.

However, we raise the issue under paragraph 19 where the Commission does not envisage making available a waiver for individual firms' liquidity requirements where a parent is outside the EEA. The premise for this appears to be the assumption that asset transferability (paragraph 17) could not be met. We would argue that meeting stringent legal requirements (multi-currency liquidity support agreement accompanied by 3rd party legal opinion in the EU and abroad as well as commitment agreements relating to provision of liquidity information between parent and subsidiary/branch regulators) can adequately address asset transferability.

One issue not addressed by the CRD 4 is the treatment of branches of non-EEA parents. As suggested by our discussion above, Paragraph 19 appears to refer to EU subsidiaries of third country groups. Also, Paragraph 25, as suggested by our discussion of it under question 13, appears to discuss the treatment of branches of EU credit institutions. We recognise that branches of non-EEA parents are not legal entities in their own right and non-EEA parents are not subject to the CRD 4, so it maybe that the CRD 4 does not apply to branches of non-EEA parents – we urge the Commission to clarify that this is the case.

As already suggested, we urge the Commission to make waivers available to non-EU parent firms. In particular, consideration should be given to the instance where the parent's home regulator works closely with European regulators and meets local deposit guarantee schemes requirements (e.g. through direct membership or topping up arrangements). In such cases, and in line to our response to question 13, we would suggest that branches of non-EEA banks should be regulated by the home regulator of the parent firm, and as a consequence there should also be a waiver/modification of the rules to allow liquidity reporting to the relevant EU regulators at the same parent or consolidated group level at which the non-EU home regulator supervises the parent/group.

With regard to paragraph 18 which refers to the need to establish EU framework for cross border crises management, we urge policy makers to under the need to consider the extension of this framework to cover institutions operating within EEA whose parent is located in a jurisdiction where regulation is deemed broadly equivalent.

Finally, we caution that the inconsistent treatment of subsidiaries where non-EEA subsidiaries would face tougher liquidity requirements due to further localisation of liquidity regulation would create an unlevel playing field and may deter firms from operating in Europe. Further this could be met by retaliatory treatment of EEA branches outside of the EU as overseas regulators may not be prepared to agree to European parents holding liquidity on behalf of subsidiaries in their jurisdiction.

Question 10: Should entities other than credit institutions and 730K investment firms be subject to stand-alone liquidity standards? Should other entities be included in the scope of consolidated liquidity requirements of a banking group even if not subject to stand-alone liquidity standards (i.e. financial institutions or 50K or 125K investment firms)?

Where material we believe that firms need appropriate measures to control their liquidity risk proportionate and commensurate to the risk they present.

Question 11: Should the standard apply in a modified form to investment firms? Should all 730K investment firms be included in the scope, or are there some that should be exempted?

Where material we believe that firms need appropriate measures to control their liquidity risk proportionate and commensurate to the risk they present.

Treatment of intra-group transactions and commitments

Question 12: Comments are sought on the different options and in particular for how they would operate for the treatment of intra-group loans and deposits and for intragroup commitments, respectively. Comments are also sought as to whether there should be a difference made between the liquidity coverage and the net stable funding ratio.

We welcome the Commission's efforts to address the asymmetric treatment of commitments in the context of intra-group transactions. The Commission has proposed three options outlined in paragraphs 22, 23 and 24 of the consultation paper. In general, we prefer the option outlined in paragraph 22 which we refer to as the first option which is identified by the Commission as the 'symmetric option'. The second option, referred to as the 'alternate symmetric option' (paragraph 23) and the third option 'alternate but non-symmetric' (paragraph 24) are not favoured.

Under the current proposals, when an entity within a group draws down a liquidity line held with another, the entity to which the line is committed can not assume a liquidity inflow while the entity providing the line has to assume an outflow. Under the proposed symmetric proposal outflows would be treated in the same manner as inflows – it would be assumed that neither would occur. This proposal is prudent as it does not create a false sense of liquidity.

A symmetric approach also helps to avoid putting groups in the position where against the same third party risk they double up on liquidity at both the parent and subsidiary level. (We provide examples for illustration at the end of this section).

Question 13: Do stakeholders agree with the conclusion that for credit institutions with significant branches or cross-border services in another Member State, liquidity supervision should be the responsibility of the home Member State, in close collaboration with the host member States? Do you agree that separate liquidity standards at the level of branches could be lifted based on a harmonised standard and uniform reorganisation and winding-up procedures?

Yes we do agree with the conclusion that for credit institutions with significant branches or cross-border services in another Member State, liquidity supervision should be the responsibility of the home Member State, in close collaboration with the host member States.

As per our comments made in response to question 9 on the issue of branch of non-EEA parents, we are not clear what is proposed for branches of firms that are not based in the EEA. If these are not allowed to rely on parental support they may choose to operate outside the EU. Further, EU firms operating branches outside the EU may find their branches unable to rely on support from their parents.

Question 14: Comments are sought on the merit of using harmonised Monitoring Tools, either in the context of Supervisory Review or as mandatory elements of a supervisory reporting framework for liquidity risk. Comments are also sought on the individual tools listed in Annex III, their quality and possible alternatives or complements.

We welcome the Commission'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 senior management, boards, commentators and regulators. It will also have the added advantage of reducing systems costs in reporting liquidity risk being run by such entities.

However, we note that the measurement is only one part of the management of liquidity risk and that firms need to monitor a number of metrics in combination looking at trends versus absolute value. Ideally firms should be able to choose from a menu of metrics measures that are relevant to a firm's business model to discuss these with their supervisors.

Against this backdrop, we particularly welcome the four proposed metrics in Annex III and 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 communication amongst the members of supervisory colleges and contribute to a more efficient treatment of cross-border firms.

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

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 could 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

VII. 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)

VIII. 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

IX. Weekly Qualitative Report. A descriptive summary of any material detrimental changes to the above metrics. E.g., explains significant changes in: 1-week and 1-month liquidity ratios; cash and liquidity gap in Cumulative Liquidity model; the Liquidity Risk Factor; inter-group borrowing/lending position.

We accept that the development of granular data items is useful for the harmonisation reporting, but underline that there is no one-size-fits-all 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. We therefore suggest that supervisors develop a list of harmonised data items from which a firms and supervisors can choose their relevant baseline metrics that are material to a firm's business model and risk profile.

Currently, we remain concerned, however, that there is no discussion of harmonised reporting formats. It is suggested that banks will provide raw data to supervisors but it can not be assumed that banks will provide data in the same way.

Concentration of Funding (Annex III)

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.

Disclosure

While we generally support transparency, we warn that far-reaching public disclosure requirements regarding changes in the LCR and/or use of the liquidity buffer could have devastating 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 buffers.

Public disclosures made on a routine basis under normal conditions provide institutions with less flexibility once the market is under stressed conditions. Therefore, we advise the Commission to limit the sharing of liquidity ratios to regulators only.

If the Commission should decide that there is a need for public disclosure requirements, we urge the Committee not to mandate any current point-in time metrics but rather rolling averages computed over an extended period of time. Additionally we would suggest a significant time lag in the publication of quantitative information in order to give banks flexibility to use the buffer, if needed, without raising undue market concern. This removes contextual information from market makers who are likely to act on and escalate certain disclosure events, e.g. a breech of a firm’s buffer. Of course, more extensive and closer to real-time information would be made available to regulators.

Question 15: What could be considered a meaningful approach for monitoring intraday liquidity risk?

Given fast moving nature of intraday reporting, it would be meaningless to employ any static reporting metric. Therefore, we suggest that the key focus for regulators should be to ensure that firms have systems and controls in place with which to manage their own and their customers’ intraday liquidity flows, and have processes in place to size the associated intraday liquidity buffers maintained to support their payment flows.

We do not believe that there should be a “standard EU wide” measurement on intra day risk. Instead institutions should be able to demonstrate that they are monitoring their risk.

For liquidity purposes the approach needs to recognise the difference between:

- Firms who are members of settlement systems
- Firms who use others to clear their payments
- Firms clearing on behalf of other firms

It is important that firms understand the levels of cash flowing through the settlement accounts during the day. However, the total quantum of this flow is not a true representation of the true intra-day liquidity requirement. There should be controls on the speed at which payments are made which smooth out payments and controls which prevent excessive daylight overdrafts building up. These should be picked up as part of the management of operation and credit risk.

Firms who are members of settlement systems will need to monitor their net intraday positions with the relevant clearing exchange (indeed the exchange itself may have those numbers) to determine their maximum positions during the course of the day. This should be compared to the amount of collateral set aside for the system.

For the second group, the issue becomes whether or not they already are required to collateralise their intraday settlement requirements (usually in the form of running their nostro account in credit). This will require firms to understand the intraday need compared to the balance maintained on the account. If they are granted daylight overdrafts they will need to consider how big those might be (this is not always known as the overdraft is likely to be an uncommitted facility) and how they would collateralise them in the event they suffered a stress and the clearing bank withdrew the facility.

For the third group the important thing is to review the way in which intraday overdrafts are monitored and to review the speed at which payments on behalf of a firm can be stopped if the limits are approached. This is more an operational risk than a liquidity one.

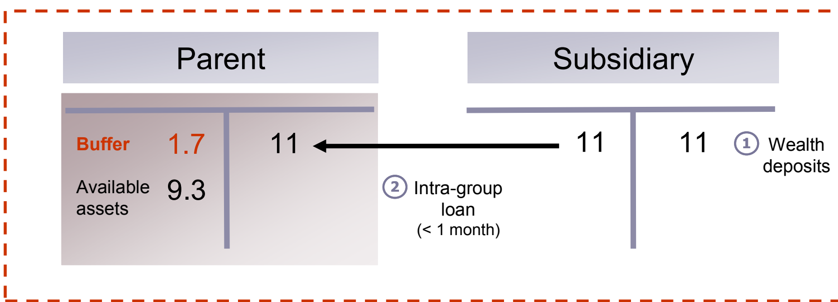
We would recommend that the principle of proportionality is applied here so that only the significant flows are considered.

1.4 Liquidity examples on symmetric versus asymmetric treatment (Question 12)

<u>Example 1: Liquidity Buffer – Symmetric treatment</u>

Assumptions

- Subsidiary has net surplus less stable retail deposits of £11bn, Intra-group loans have terms of < 1 month
- holds sufficient buffer determined by "looking through" intra-group flows to third party deposits, i.e. 15% of £11bn
- retains internal flow of funds thereby reducing external borrowing requirements



Buffer requirement

Parent treats intra group deposit as if it is a retail deposit. Buffer required for the Parent

= 15% x £11bn

= £ 1.7bn

Subsidiary treats intra group loans on same basis i.e. will receive back £1.7bn in crisis as parent holds liquid assets. The inflow nets with the third party withdrawal and the denominator of the subsidiary equals zero. Buffer required =0

Total buffer requirement = £1.7bn

Example 2:Liquidity Buffer – Asymmetric treatment

Assumptions

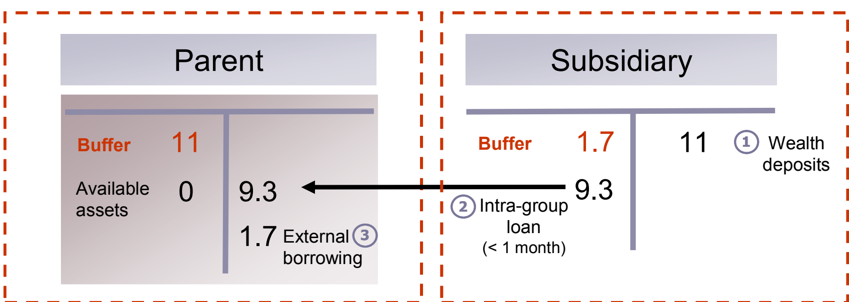
- Same as Scenario 1 (above) except assumes asymmetric treatment for intra-group loans to Parent (Sub treats loan as if evergreen, parent treats deposit as repayable in period and will not roll)

Subsidiary

- is required to hold its own buffer against its third party deposits
- lends surplus funds to Parent a < 1 month intra-group

Parent Company

- has partial benefit of intra-group loans with access to the funds only after Overseas Subsidiary has accounted for its own buffer requirement
- borrows the remaining funding from the external market (< 1 month)
- intra-group deposits and external borrowings generate a buffer requirement



Buffer requirement

① Overseas subsidiary is required to hold a buffer

= 15% x £11bn

= £1.7bn

② Parent is required to hold 100% of intra-group deposits

= 100% x £9.3bn

= £9.3bn

③ Parent is required to hold 100% of external borrowings

= 100% x £1.7bn

= £1.7bn

Total buffer requirement = £12.7bn

2 Definition of capital

2.1 Key messages

We welcome the Commission's 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 the Commission's promotion of such harmonisation. This response should be read in conjunction with our response to BCBS 164 *Strengthening the resilience of the banking sector, which* is attached in Annex 2.

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.

Tax deductibility doesn't matter

We note that in paragraph 57 the Commission is considering the treatment of instruments with tax deductible coupons in Non-Core Tier 1 capital. But we believe that capital recognition should be independent of tax treatment. So long as all of the relevant criteria in Annex VI 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.

Hybrids with innovative features remain useful instruments for regulatory capital purposes

We note the Commission'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 believe hybrids do 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.

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

It is essential that the results of the Basel and EU 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 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.

In our view it is important to establish a clear date such that non-Core Tier 1/Core Tier 1 capital instruments issued prior to this date are grandfathered. This date should not be earlier at least than the date of implementation of the new proposals. In addition it is important to provide for grandfathering of respective instruments in accordance with their current capital qualification (i.e. core capital as core (or Common Equity) (rather than hybrid) and hybrid capital as hybrid (or non-Core Tier 1) to provide for non-disruptive phasing-out for non-compliant instruments.

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, particularly bearing in mind the possibility that application of the proposed deductions could exacerbate cyclicality.

The remainder of this section addresses the specific questions posed by the Commission in Section II: Definition of Capital.

2.2 Response to consultation questions 16 – 24

Question 16: What are your views on the prudential appropriateness of eliminating the distinction between upper and lower Tier 2, and of eliminating Tier 3 capital?

We agree with the Commission's proposals to simplify the definition of capital with a greater emphasis on Going Concern capital and with upper and lower Tier 2, and Tier 3 being merged into Gone Concern capital.

We note that the purpose of Going and Gone Concern capital has not been spelt out. Our view is that *Going Concern* capital's role is to enable a firm to continue trading during a period of financial stress or when it has suffered severe losses. We view the purpose of Tier 2 G*one Concern* capital as to absorb losses in liquidation, in order to minimise calls on the deposit guarantee scheme, which is funded buy the banking industry generally and minimise losses to senior unsecured creditors and depositors not covered by the deposit guarantee scheme. To use the language of 'Living Wills' going concern capital supports the firm during the recovery phase whilst gone concern capital helps to minimise the cost to the tax payer in the event of resolution or insolvency.

A substantial portion of our members' capital currently comprises hybrid capital instruments that may or may not qualify as non-Core Tier 1 in the future. We emphasise very strongly the need to properly consider the implications of the rapid withdrawal of non-Core Tier 1 regulatory capital recognition from these instruments and our view that there will likely be a requirement for a period of grandfathering of such instruments after 2012.

Question 17: Are the criteria proposed for Core Tier 1, non-Core Tier 1 and Tier 2 sufficiently robust and how might they be improved?

We are supportive of the use of criteria to help determine an instrument's regulatory capital eligibility which are, we believe, still principles-based enough to encourage the development of the range of different capital instruments that is needed so that our members can access a necessarily wide investor base.

We are pleased that the Commission has determined that additional eligibility requirements in relation to tax deductibility are not required. We do not believe that the tax (or indeed accounting) status of an instrument should influence its eligibility for inclusion in regulatory capital.

We note the proposals to phase out innovative and dated hybrid instruments from non-Core Tier 1. It is not clear that dated instruments should be so eliminated or that incentives to redeem are inappropriate features in non-Core Tier 1 capital. Criterion 5 could be easily adapted to making redemption of the dated instruments, that we believe should be included in non-Core Tier 1 capital, conditional on prior supervisory approval. This would assist firms in their capital planning process, as we have argued on a number of occasions.

We also note that Criterion 9 of Annexe VI does not contemplate non-Core Tier 1 instrument with coupons, as the same Criterion in the Basel proposals in CP 164 do. We assume this is an oversight and that an instrument with a coupon would not be excluded from non-Core Tier 1 capital. The discussion in paragraphs 50 and 52 suggest that this is indeed a transcription error.

We do not believe that there is any need for a lock-in in respect of Tier 2 capital as its sole purpose is to provide gone concern support.

Question 18: In order to ensure the effective loss absorbency of non-Core Tier 1 capital, would it be appropriate under certain circumstances to require the write down of the principal amount of an instrument or its conversion to a Core Tier 1 instrument? To what extent should the trigger for write-down / conversion be determined objectively or at the discretion of an institution or its supervisor?

We generally support the use of temporary principal amount write-downs of non Core Tier 1 instruments to create Core Tier 1 capital treatment, but note that Tier 2 instruments could also contain such features. We strongly believe write-downs should be temporary and capable of being written back up upon liquidation. A permanent write down would mean that the non-Core Tier 1 capital was subordinate to Common equity and that holders could not share in the recovery of the bank or any liquidation proceeds.

The trigger mechanism should be activated by the firm in a way that provides clarity and transparency to investors in the non-Core Tier 1 capital securities based on objective triggers that are established at issuance. A firm should be able to set its own triggers, of course in consultation with its regulator, about what the proposed trigger level and the availability of any cure periods or mechanisms that may provide the firm with any flexibility in periods of stress. Whatever the trigger mechanisms are, they must be documented in the offering circular at issuance.

Should the loss absorbency trigger be activated by the firm it should have the discretion to enact the conversion or write-down feature, as the case may be, in light of other actions it may take that may be deemed more appropriate at the time and in consultation with its regulator.

Question 19: Which of the prudential adjustments proposed have the greatest impact? What alternative, robust treatments might be considered and what is their prudential rationale?

Our members are still completing their QIS submissions so it is too early to identify which are the most impactful proposals but we note that some of the deductions from Core Tier 1 introduce procyclical effects that could exacerbate the cycle and significantly reduce the benefits of the reforms.

We believe that the Leverage ratio and Net Stable Funding Requirement are two metrics that will have a significant impact on our members and may require some deleveraging by banks, with a consequent impact on economic activity. We strongly advise that these ratios should be ‘informational’ and thus addressed in Pillar 2 as trends rather than absolute binding levels are more relevant for the regulatory dialogue between supervisor and institution.

Question 20: Are the proposed requirements in respect of calls for non-Core Tier 1 and Tier 2 sufficiently robust? Would it appropriate to apply in the CRD the same requirements to buy-backs as would apply to the call of such instruments? What restrictions on buy-backs should apply in respect of Core Tier 1 instruments?

We believe that the requirements in respect of calls are sufficiently robust in that they require prior regulatory approval. As we note above we believe redemption of instruments as well as the inclusion of incentives to redeem, for instance by the inclusion of step ups, should also be permitted in non Core Tier 1 capital. We believe this can be justified if either the call or redemption of an instrument is made subject to prior regulatory approval.

We believe the same requirements should apply to buy-backs but note that an exemption should be included to allow banks to make markets in their own stock - an activity that provides liquidity to the market.

Question 21: What are your views on the need for further review of the treatment of unrealised gains? What would be the most appropriate treatment of such gains?

We agree that unrealised gains should be excluded from Core Tier 1 capital but believe that they should be included in total capital as they are not totally without value

Question 22: ***We would welcome comments on the appropriateness of reviewing the use of going concern Tier-1 capital for large exposures purposes. In this context, would it be necessary to review the basis of identification of large exposures (10% own funds) and the large exposures limit (25% own funds)?***

As noted in our previous submissions in respect of large exposures, we regard the objective of the regime to provide an appropriate degree of protection against firm failure arising from single name concentration risk in the credit portfolio. As a result the large exposure framework is a preventative measure and therefore it could be argued that the use of a going concern measure is appropriate. However, it is also important to note that the large exposures regime has recently been the subject of extensive review and firms are in the process of implementing the changes. As no regulatory failures can be identified at this stage, and given the extensive amount of change to the regulatory framework that firms are addressing, we do not think it is appropriate to make the definition of capital for large exposures a priority for change at this juncture and think that this should be reconsidered once the changes have been given time to bed down.

Question 23: ***What is your view of the purpose of contingent capital? What forms and triggers would be most appropriate?***

The purpose of contingent capital should be to provide additional Core Tier 1 capital in the event that a firm experiences a period of severe financial distress or unexpected loss so it can survive it by implementing its resolution plan, this avoiding costs to the deposit guarantee scheme, unsecured creditors or ultimately the tax payer.

It is likely that the most appropriate trigger would be one which required conversion at a point somewhat above the Core Tier 1 absolute minimum and that that trigger should be clear and unambiguous in order that investors in contingent capital instruments have a complete understanding of the risks to which they are exposing themselves.

We are concerned however that their extensive use could accelerate the failure of a firm as it is likely that investors would all rush for the door simultaneously as the trigger was approached.

Our members therefore are not yet convinced of the place for contingent capital instruments in their capital structure at anything above quite modest levels.

Question 24: ***How should the grandfathering requirements under CRD II interact with those for the new requirements? To what extent should the grandfathering provisions of CRD II be amended to bring them into line with those of the new capital requirements under CRD IV?***

We recognise that it is likely that CRD II grandfathering provisions will have to be amended to bring them into line with the Basel capital proposals as reflected in CRD IV, in order that the EU can lead the way in by example in promoting the harmonised, simultaneous and national discretion-free implementation of the Basel proposals on strengthening the resilience f the banking sector. Until we have more understanding of the results of the QIS' and the eventual calibration of the capital ratios and definitions it is difficult for our members to make recommendations about the nature of any grandfathering. Suffice it to say that this will be a key area of consideration as the authorities seek to increase global systemic stability whilst continuing to enable banks to play their part in promoting economic activity, at a time when there is only limited appetite for bank capital amongst investors. And it is one area in which our members would like to engage with the authorities at an early stage.

3 Leverage ratio

3.1 Key messages

Key messages

We acknowledge that leverage was a factor in the crisis, as it amplified the downward pressure on prices. We therefore agree that it is an appropriate area for regulatory review. Properly calibrated and suitably integrated into the regulatory toolkit it can be useful tool for supervisors to identify and prevent extreme behaviour. We believe that the following issues should be borne in mind in its development.

Supplementary measure in Pillar 2: It is important to consider both the risk that a firm is facing as well as its level of leverage to obtain an accurate picture of the firm. On its own, as contemplated in the current proposal, without an understanding of the risk profile, the business model and the risk management practices, the leverage ratio could lead to draw inappropriate conclusions about individual firms when compared to their 'peers'. Therefore, it should be regarded as a supplementary measure. In addition, as a Pillar 1 measure it could create perverse incentives if it is inappropriately designed or calibrated, by encouraging firms to take on more risky exposures. Such behaviour could then serve to create the problems of a downward pressure on asset prices and increase procyclicality should economic conditions deteriorate. Given these material shortcomings, we strongly believe that the leverage ratio should be a Pillar 2 measure and not part of Pillar 1.

A Pillar 2 approach would facilitate better dialogue with supervisors, thereby taking account of the factors that a Pillar 1 approach would ignore – risk appetite, business model, structure, governance and risk management practices. We recognise that there may be concerns amongst the Authorities that a Pillar 2 approach can create an unlevel playing field. As a result we suggest that the leverage ratio should be a range rather than a single number, which could put a bound on supervisory discretion, while taking account of firm specific factors. We also note the significant changes being made to the regulatory architecture, including ensuring that supervisors have access to the same supervisory toolkit, to the enhancement of the colleges of supervisors, and other measures to continue to enhance supervisory convergence such as peer review, which should serve to address these considerations.

Risk management incentives: It is important not to undermine the risk management incentives created by the CRD. As such, while we accept that the leverage ratio should be calculated on numbers unadjusted for risk based capital, we strongly believe that risk mitigants that have been proven to work, should continue to be recognised. In this regard, it is vital that netting is recognised. Recent experience has demonstrated that it works in the most adverse of conditions and therefore to record gross exposures will materially overinflate firms balance sheets, which has the potential for disproportionate effects on some business models. In this regard, we believe that the regulatory operational requirements provide a prudent basis for recognition, which avoids the problems associated with differing accounting regimes. In addition, we believe that the provision of financial collateral should be given adequate recognition and should be encouraged rather than discouraged. To this purpose, adequate weight should be given to this proposal by using the comprehensive approach, which adjusts exposure value.

Timing of introduction: We note and support the Commission's comments in paragraph 81 regarding the need to be watchful of the financial and economic recovery in determining the timing/phasing of the implementation of the leverage ratio proposals. Although we acknowledge the political imperative behind the timetable, we think that the leverage ratio should be implemented among the last elements of this package and that a longer timeframe for introduction then the end of 2012. We have serious concerns over some aspects of the design, 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 leverage ratio. In our view, it is more important to take sufficient time to ensure that the design and calibration is appropriate than to implement a measure that has undesirable and/or unforeseen circumstances.

Level of application: It is unclear from the consultation at what level the leverage ratio is to be applied – consolidated, sub consolidated, solo consolidated or individual entity. Applying at the individual entity level would ensure that no individual institution can build up significant exposures, but fails to take account of the fact that being part of a group can be a source of strength not just a source of weakness. In particular, it would limit firms' ability to centrally manage exposures, which allows concentration of expertise in a single location as well as minimisation of operational risks. As a result, we think that it is appropriate for the leverage ratio to be applied at the consolidated level, with the regulatory consolidation only. We would submit that this entails setting leverage ratios at the regulatory consolidated group level and not at the highest consolidated/sub-consolidated level within the EU/EEA. Further, the application of a leverage ratio at a subsidiary level would introduce double counting of exposures into the calculation, because of the inclusion of inter-company balances.

Risk management and supervisory review: We agree that, in principle, it is appropriate to amend Annex V and Annex XI of the CRD to accommodate the need for both institutions and supervisors and to consider the appropriateness of the level of leverage to the firm's business model, structure, governance and risk management practices.

Disclosure: We are supportive of disclosure as a means for delivering market discipline. Although the Commission has not yet consulted on the proposals we would like to register some initial thoughts on the Pillar 3 requirements in this area. Our members are very concerned about the potential for misinformed conclusions to be drawn. We believe that the leverage ratio proposed is a very simplistic measure, which requires a full understanding of the risk profile and risk management practices, or erroneous conclusion could be drawn from comparisons between institutions. Disclosures must be carefully considered and therefore appropriately balance the need to provide information with the risk of over-burdening users with extensive disclosure, which in fact could contain simplistic requirements. If a Pillar 2 approach is pursued, then the confidentiality considerations will also have to be reviewed. Furthermore, thought must be given to whether aggregate leverage statistics across jurisdictions, disclosed by supervisors, may possibly serve to better inform market participants.

3.2 Response to consultation questions 25 - 30

Question 25: What should be the objective of a leverage ratio?

Problem identification

Paragraph 79 of the CRD 4 consultation and paragraph 202 of the Basel Committee consultation on strengthening the resilience of the banking sector, would seem to indicate that the problem that is being addressed by the leverage ratio is the amplification of the crisis caused by leverage, which resulted in a downward pressure on asset prices and divestment, exacerbating the positive feedback loop between losses, declines in bank capital and credit contraction.

In considering this issue further, it is important to understand why leverage built up and where it was an issue. Leverage built up for a number of reasons, in particular:

- The availability of cheap money over a sustained period of time - Sustained cheap money encouraged the search for yield and helped to push up asset prices in certain sectors thereby creating an asset bubble.
- Risk mis-pricing in certain sectors – inadequate due diligence practices and an over-reliance on deficient risk measures (ratings) in certain sectors, caused some exposures taken on to be under-priced compared to their real risk. These practices further contributed to the creation of an asset bubble.
- Over-reliance on short term secured funding – cheap money, and the failure, by some market participants, to take full account of the possibility of a liquidity crisis, and the encouragement provided by the regulatory framework to collateralise in the absence of an internationally agreed liquidity framework, led to an over-reliance on short term secured funding.

Leverage then amplified the downward pressure on asset prices:

- Liquidity dried up, thereby puncturing the asset bubble.
- For mis-priced assets this effect was particularly severe, because the true nature of the risk also had to be priced in.
- In relation to secured funding, falls in asset prices led to an increase in margin calls, which in turn amplified the downward pressure on asset prices, as sales were required to meet margin calls and/or collateral had to be realised.

Relevant economic market(s)

The impact of the effects of downward asset price spiral were felt broadly and therefore it may be appropriate to define these as the markets for financial products and services, i.e. lending, wholesale markets (inter-bank being a particular issue for both lending and wholesale markets), follow on impacts to the fund management and insurance sectors.

Risks to regulatory objectives

Although the regulatory objectives were not explicitly set out in the consultation, they are generally assumed to be threefold:

- Financial stability,
- Market confidence, and
- Consumer protection.

As regards the consequences of leverage, all three objectives would appear to be relevant for consideration.

Market and regulatory failures

The market failures that are generally associated with these objectives are:

- Negative externality,
- Information asymmetry, and
- Market power.

Of these, market power, would appear not to be a relevant consideration. 'Market power is exercised when prices are changed solely by the decision of a few market players, prices are set by these firms with limited regard to customers or competitors, such that revenues above the marginal cost of all production inputs can persist rather than be eroded by competitive market pressures'[4] .

Negative externalities occur when decisions adopted do not take account of all the costs, which result from the firms actions, but which are not borne by the firm. In this case the possibility of market and funding liquidity drying up was not adequately taken into account and appropriate due diligence was not undertaken by some market participants in relation to certain exposure types. Market momentum considerations drove risk taking decisions without full deliberation of systemic consequences if underlying assumptions were incorrect. Therefore this would appear to be a relevant market failure.

Information asymmetry also played a part. Firms became wary of their counterparties because they did not have a full picture of their exposures to particular assets or understand the level of leverage a counterparty may be running. As a result the inter-bank market dried up. In addition deficiencies in disclosure in certain exposure classes contributed toward the mis-pricing of risk. Information asymmetry, therefore, would also appear to be a relevant market failure.

Regulatory failures exist where 'regulation has unforeseen and unintended effects arising from interaction with a specific characteristic of the market affected, or when a supervisor practice is no longer adapted to the realities of a rapidly evolving market'[5]. In this case it could be argued that the risk based framework for credit risk created incentives to take on apparently low risk exposures without requiring full due diligence to be undertaken, and the market risk framework (already acknowledged by regulators as requiring review) also failed to appropriately capitalise risks in the trading book. The prudential framework also encouraged the use of short term secured funding, without the presence of an internationally agreed framework for liquidity risk. Further, the framework focussed on the safety and soundness of individual firms, assuming that by doing so the system as a whole would be robust, thereby not addressing systemic issues across firms as they built up. Finally, the supervision of some firms did not adequately take account the true risk profile. The extent of procyclicality associated with the revised CRD is not yet fully understood, but it is obviously appropriate to assess the extent that a risk based framework has exacerbated the problems because of the increased capital charges associated with deteriorations in asset quality.

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[4] FSA – A guide to market failure analysis and high level cost benefit analysis, page 44, November 2006

[5] Impact assessment guidelines for EU Lamfalussy Level 3 Committees, page 22, April 2008

Although not a regulatory failure, per se, it is also important to recognise that the continued availability of cheap money, as a result of economic imbalances between jurisdictions with excess savings and those without, also had a role to play.

Existing regulatory/market mitigants

The crisis has changed the political and economic background and a huge effort has been made by both the regulatory community and the industry to address the issues arising. However, to determine the future course of action, it is important to take into account the mitigating effects of the initiatives already in place and to determine any remaining failures so that an appropriately targeted approach can be taken.

Big changes have been taken to improve the prudential framework already. However, the industry supports the need to make further changes to this framework to make it more robust. We believe that the following initiatives are relevant mitigants:

- Revised market risk framework, which significantly increases capital requirements in the trading book.
- Revised securitisation capital charges that take account of the increased risk in certain securitisation structures.
- Revised approach to liquidity facilities to securitisation structures, which essentially require full risk capital to be held against the entire amount of the facility.
- The introduction of stringent due diligence criteria for securitisation exposures, which have to be met before ratings can be used to determine capital requirements.
- Extensive stress testing requirements have been introduced
- The development of measurement and quantitative liquidity standards
- Proposals for addressing procyclicality in the capital framework
- Proposals for strengthening the quality and quantity of capital to absorb shocks

While we appreciate that increased capital requirements do not provide an absolute cap on leverage, they do significantly lessen the incentives to take on under-priced risks. It is also important to note that the Large Exposures framework has also been revised and the new requirements will be implemented at the end of the year. This also imposes limits on the exposures that firms can have to individual or groups of connected counterparties and therefore goes some way to controlling exposure levels

We also note that macro-prudential supervision is also under consideration by the regulatory community, which may use some of the tools outlined above. Revisions to the supervisory architecture have also been the subject of much debate; the creation/extension of global colleges of regulators and EU colleges of supervisors. The evolution of supervisory approach is probably also, although less publicly, under debate.

The industry, too, has not been idle. Much has been done in relation to information asymmetry issues: AFME/esf has created a series of guidelines on disclosure for securitisation products to ensure that investors have appropriate information to undertake due diligence. In terms of firm disclosure AFME, EBF, EACB, EAPB developed an industry guideline on the Pillar 3 securitisation disclosures in the CRD. In relation to derivatives, ISDA has worked with Members to reduce the volume of transactions outstanding by a portfolio compression exercise that have considerably reduced the number of contracts trading. ISDA has also been working closely with the regulators in Washington and Brussels on the proposals for the central clearing of some derivatives transactions.

Markets have obviously reacted to the changed world order and firms have been in a process of reducing their leverage, improving their risk management standards, reviewing the appropriateness of their structures and improving their non-regulatory disclosures. The regulatory changes outlined above obviously serve to support these initiatives.

Remaining risks to the regulatory objectives

As can be seen above, much has been done to address the issues that underpin the effects of leverage to address financial stability, market confidence and investor protection.

As a result, and as indicated by the consultation, it would appear that what is a sought is a backstop on total exposure that addresses a crisis scenario, such as recent events. Inverting the notion of a regulatory backstop, we essentially see the leverage ratio as akin to an internal risk management limit on arising from a very severe but plausible stress test. The severe stresses, in this regard, relate to a broader range of market and firm operating assumptions breaking down. However, for the stress test to remain plausible it is inappropriate to assume all operating assumptions break down simultaneously and a number of our comments on the proposals for a leverage ratio address this issue.

Question 26: Which element of going concern capital do you consider would be a more appropriate basis for the leverage ratio? What is your rationale for this view?

As the leverage ratio appears to be a preventative measure we strongly believe that total Tier 1, after deductions, should be the appropriate measure of capital. Tier 1 is supposed to represent a going concern measure of capital and as such we do not believe that it is appropriate to tighten the definition any further. With regard to the deductions from the capital base, our comments in Section II (Definition of capital) should be borne in mind.

Question 27: What is your view on the proposed options for capturing the overall extent of an institution's derivatives business in the denominator of the leverage ratio?

It is obviously appropriate to include derivatives and other off balance sheet exposures within the leverage ratio to ensure that a complete picture is created. However, we strongly believe that derivatives should be included after netting and credit risk mitigation has been taken into account. Netting has been proven to have worked in the most adverse of circumstances and therefore to ignore it will grossly overstate the degree of leverage to which an institution is subject.

As regards the basis on which derivatives should be recorded, we believe that it is appropriate to use positive fair value rather than the mark-to-market method contained in Annex III, Part 3 of the CRD. There is no implicit time horizon within the leverage ratio. The potential future exposure calculation envisages a one year time horizon for market moves.

Question 28: What is your view on the proposed approach to capturing leverage arising from credit derivatives?

We can understand the concern of regulators that the potential payout on protection sold through credit derivatives could be markedly different from the current market value in the accounts. However, credit derivatives, particularly single name are often traded and in the trading book firms aim to keep their books balanced so that they are not faced by such a risk. Therefore the treatment proposed, i.e. treating protection sold as a guarantee, with no recognition for offsetting positions, and in fact an additional exposure recorded for the value of the protection bought or any other short position created as a hedge, will provide an inaccurate picture of the leverage run by an institution. The treatment should recognise the economic substance of firms' activities and we think that the standard rules for market risk provide a means for recognising this; notional would be reflected and offset of exactly matching protection bought would be permitted.

We also seek clarity on how it is envisaged centrally cleared credit derivatives should be treated.

Question 29: How could the design of the leverage ratio ensure that it would act as an effective constraint only in benign economic conditions?

Design, calibration and position within the supervisory framework will all be crucial to delivering a leverage ratio that is only a constraint in benign economic conditions. Of these, position within the supervisory framework, i.e. Pillar 2 rather than Pillar 1, would , in our view, be the most appropriate way to ensure that it is only a constraint in benign economic conditions. However, in a Pillar 1 environment it may be necessary to relax/disapply the leverage ratio when the economic cycle warrants (determined by virtue of hard criteria or more subjective analysis), otherwise changes in exposure values could result in forced de-leveraging.

Design: A number of issues are relevant here:

- **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 give a false impression of the levels of leverage. Furthermore, it will also introduce significant volatility and 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, in absence of netting 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 Commission 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 impacted

- **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. We recognise that there are a number of methods for recognising collateral in the capital framework, as a result suggest that the comprehensive method be made available. We recognise 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 Commission 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 as it focuses on risk transfer. 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. We would note that the large exposures regime also allows for full or partial exemptions of low or medium risk items. 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 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.

- **Highly liquid assets** - It is also important to avoid conflicts arising between the various parts of the prudential framework, therefore we think that it is necessary 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. Therefore they should be scoped out. We would note that the Large Exposures framework also provides for exemptions for certain high quality exposures, e.g. governments and central banks that attract a 0% risk weight, and for certain exposures related to minimum reserve or statutory liquidity requirements.

Calibration: Calibration obviously needs to be credible to meet market confidence objectives. Therefore there are trade-offs to consider between design and calibration. Over-inflated exposure numbers will require a larger multiple/smaller ratio to be used if the leverage ratio is not to bite unduly.

Question 30: What would be the appropriate calibration of the leverage ratio?

We support the Commission's decision to determine calibration in light of the impact assessment exercise currently underway. Until that is complete, and the design of the leverage ratio is progressed, we do not think it is possible to suggest an appropriate calibration. In our view a further consultation and QIS will be necessary.

4 Counterparty credit risk

4.1 Key messages

The Section 2 of the attached Annex 2, our response to Basel Consultation BCBS 164, sets out the Associations' views on key elements of the counterparty risk regime. The remainder of this section addresses the specific questions posed by the Commission in Section IV: Counterparty Credit Risk.

4.2 Response to consultation questions 31- 37

Question 31: Views are sought on the suggested approach regarding the improved measurement or revised metric to better address counterparty credit risk. With respect to suggestion to incorporate - as an interim measure - a simple capital add-on by means of calculating the loan-equivalent CVA charge, views are sought on the implications of using VaR models for these purposes instead.

While the Loan Equivalent measure attempts to encourage hedging of counterparty exposures (by recognizing single-name CDS as a hedge of that 'loan'), it is deficient in significant respects. For one thing, it ignores the drivers of those exposures. In a low-credit-spread environment, these will predominantly be the market-risk factors driving the value of the portfolio. The 'loan' itself also has a 'maturity' that is much longer than the true effective maturity of the portfolio it is supposed to represent, leading to a material overstatement of the capital requirement.

The credit valuation adjustment (CVA) 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 impacts reflected in firms' financial statements as a result of diverse accounting regimes, under diverse accounting regimes;
d) could, in principle, reflect the modelling of CVA together with other trading book risks; *or* be based on historic 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 'effective maturity' in the Internal Ratings Based Approach and the ultra-conservative treatment of maturity within the bond equivalent treatment.

Question 32: Stakeholders are invited to express views on whether the use of own estimates of Alpha should continue to be permitted subject to supervisory approval and indicate any evidence in support of those views.

There are clear advantages to permitting firms' own estimates of alpha. The necessary analysis and modelling of market and credit risk factors give firms better visibility into concentration and correlation in their portfolios, and identifies general wrong-way risk and to an even greater extent specific wrong-way risk. Having an own-alpha estimate makes firms' capital more risk-sensitive and therefore provides the right incentives to firms.

Question 33: Views are sought on the suggested approach regarding the multiplier for the asset value correlation for large financial institutions, and in particular on the appropriate level of the proposed multiplier and the respective asset size threshold. In addition, comments are sought on the appropriate definitions for regulated and unregulated financial intermediaries.

It is hard to comment on the precise level of multiplier (if any) that is appropriate, without clarity as to the data used to come up with the proposal. What is clear is that close-out netting and collateralisation have performed well, where used, acting to contain and mitigate counterparty exposures, notably in the case of the Lehman Brothers default. (By the same token, in exceptional instances where these techniques were not used as intended[6], the system proved more vulnerable. In particular, collateralisation was *not* used in certain key counterparty relationships, where wrong-way risk was also present. Wrong-way risk, however, is the subject of other measures, both at the general and the specific level.) Levels of collateralisation are demonstrably high in the systemic, interbank context.

It is also clear that, since the crisis, industry has built on these techniques. Specifically, there have been significant advances in the range and number of contracts that are centrally cleared (where the same techniques of netting and collateralisation represent the principal shock absorber). To the extent that interconnectedness is an issue among financial firms, then moves to central clearing by definition reduce this, meaning that measures based on experiences in the crisis will not reflect this new reality.

Question 34: Views are sought on the suggested approach regarding collateralized counterparties and margin period of risk. Views are particularly sought on the appropriate level of the new haircuts to be applied to repo-style transactions of (eligible) securitisations. In this context, what types of securitisation positions can, in your view, be treated as eligible collateral for purposes of the calculation of the regulatory requirements? Any qualitative and/or quantitative evidence supporting your arguments would be greatly appreciated.

As regards bilateral relationships, it is worth noting that tighter procedures now apply in collateralisation, in terms of portfolio reconciliation and dispute resolution. We believe that these improvements are not sufficiently factored in to the proposed treatment of margin period of risk period, which indiscriminately sweeps contracts into the 20-day period, whether they merit it (as could be the case with complexity of trades or disputes) or not (as would be the case, simply based on size of portfolio). In any case materiality thresholds should be introduced.

We believe it is wrong to unduly hinder the use of securitisations in repo. The level of haircut should clearly be risk-based and reflect potential variations in liquidity, including the potential for such instruments to be affected by a flight to quality. However, there should be no further disincentive, to reflect a) the qualitative changes in the market as regards the level of information available about the underlying exposures and b) the enhanced supervisory scrutiny of the distribution of holdings.

[6] Notably in relation to monoline insurers.

It is worth noting that the access of troubled banks to funding is eased to the extent that the full range of securities holdings is capable of being used in the repo markets.

Question 35: Views are sought on the suggested approach regarding central counterparties and on the appropriate level of the risk weights to be applied to collateral and mark to market exposures to CCPs (on the assumptions that the CCP is run to defined strict standards) and to exposures arising from guarantee fund contributions.

The relative incentives for central clearing versus bilateral exposures are strong and have resulted in over $100 trillion (notional) of swaps being cleared, and over $7 trillion of CDS (from zero, twelve months ago). The incentives, whereby collateral and mark to market exposures to CCPs are zero, should continue, given the risk management and operational security provided by CCPs.

At the same time, it is evident that there are many contracts that either cannot safely be cleared or can usefully be kept in a bilateral portfolio, because they offset exposures incurred via other contracts that cannot be cleared.

The risk weighting of bilateral exposures should be strictly loss-based and should not be increased to address issues being targeted through other measures, such as the measures for wrong-way risk.

Question 36: Views are sought on the risk management elements that should be addressed in the strong standards for CCPs to be used for regulatory capital purposes discussed above. Furthermore, stakeholders are invited to express their views whether the respective strong standards for CCPs to be used for regulatory capital purposes should be the same as the enhanced CPSS-IOSCO standards.

The revised IOSCO rules have not yet been released, so it is difficult to answer the question. The concentration of risk in CCPs means that regulation should be intrusive and comprehensive, and operational connectivity and processes should in addition be sound. Firms whose capital backs a particular CCP should have governance rights relating to that CCP.

We believe the focus should be on

1. the investment criteria and management and regulation of the CCP - to ensure the security of collateral/margin;
2. the computational ability and capacity to appropriately determine market liquidity and margin levels plus default-fund backing for the products that are to be cleared;
3. the operational capacity and connectivity to manage the business in an automated fashion

Question 37: Views are sought on the suggested approach regarding enhanced counterparty credit risk management requirements. Do the above proposed changes to the counterparty credit risk framework (in general, i.e. not only related to stress testing and backtesting) address fully the observed weaknesses in the area of risk measurement and management of the counterparty credit risk exposures (both bilateral and exposures to CCPs)?

While we welcome the review of counterparty risk charges, we note the possible overlap between the many proposed measures, as well as possible double-counting with existing measures. Moreover, the current proposals follow on from significant changes to the Trading Book. We believe that the proposals require further testing against key principles, relating to risk-sensitivity and the recognition of hedging; not just because of the likely major impact of the ‘bond-equivalent’ approach for CVA. Our response highlights more than one possible approach to CVA, reflecting the varying ways this risk is already measured and capitalized by firms.

5 Countercyclical measures

5.1 Key messages

We share the view that the financial crisis has demonstrated that the interaction of the capital and accounting regimes proved to be excessively pro-cyclical. We therefore support the prominence that the G20 has given to the consideration of changes to the existing frameworks to reduce this effect going forward. Albeit that we note that some of the some measures considered in the consultation paper, such as the elimination from capital of deferred tax, pension fund deficits, counterparty risk changes, etc. if adopted, could potentially increase procyclicality.

The consultation paper identifies two possible counter-cyclical measures: through-the-cycle provisioning for expected credit losses; and capital buffers and the cyclicality of minimum capital requirements. It observes that the two are not necessarily cumulative.

Whilst we would agree with the Commission that there are fundamentally two sources of measures to be pursued in seeking a countercyclical effect: accounting provisions and capital requirements, we are concerned at the apparent shift in the dividing line between the two evidenced in the consultation paper in comparison to the approaches promoted by other interested parties, including the Basel Committee and the International Accounting Standards Board (IASB).

We disagree that the two proposals are not cumulative. They are cumulative, and regarding them as such provides a better starting point for ensuring the right distinction between what can be achieved through the accounting regime and what may in addition be needed in terms of a capital buffer. .

Where markets already operate measures such as those proposed we strongly oppose a further measure being introduced which will merely serve to duplicate existing proven techniques and measures. This is of particular concern as regards the suggested capital buffers proposed.

The Pillar 2 regulatory framework has the potential to address many of the issues identified such as giving the right to supervisors to prevent dividend distribution, to managing capital buffers by individual banks relevant to their risks.

We strongly oppose proposals for 'dynamic provisioning' which inter-alia conflates 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. Such measures will, amongst other issues, reduce transparency and also have the potential to seriously damage market confidence in financial institutions.

We strongly recommend the Commission focus its efforts on working with the Basel Committee's Standards Implementation Group to ensure the uniformity of application of the Pillar 2 processes, both as regards dividend and discretionary bonus distributions and Capital Planning buffers. Approaches to stress testing should be strengthened to ensure consistent standards are applied by supervisors.

Part 1 – Through-the-cycle provisioning for expected credit losses

The accounting element of the Basel Committee proposals for strengthening the resilience of the banking sector is described as promoting more forward looking provisions. Paragraph 35 of the Basel paper explains that the Committee is advocating a change in the accounting standards towards an expected loss approach that captures actual losses more transparently and is less procyclical than the current incurred loss approach. We support this, with the industry favouring an expected loss over the life of the portfolio approach.

In the meantime, the IASB has published its own proposals for revising the measures within IAS 39 governing impairment provisions. In this, the IASB has proposed an approach which sits conceptually within the expectations of the G20, the Basel Committee and the banking industry for impairment provisions to be more forward-looking and based on a broader range of credit information than may currently be the case. Whilst we are broadly supportive of this, we do not agree with the expected cash flow approach based on a proposed Expected Interest Rate (EIR) methodology as currently proposed by the IASB. Our practical concerns stem not least from the complexity of the model both in terms of its design and ongoing application.

The Commission's paper proposes making use of data available under banks' Internal Rating Based (IRB) approaches to credit risk and, while equivalents would need to be found where IRB data is not available, this would be welcome since it would remove the need to complete a whole new data set purely for IFRS – an exercise which we estimate could cost equivalent to 50 to 75 per cent of first time adoption of IFRS, which for a large institution would be in excess of £25 million. This has commonality with an approach proposed by the European banking industry to the IASB and many of our members were engaged in the development of that model.

Where we diverge from the Commission's, however, is when it comes to its belief that the G20's procyclicality concerns necessitate the imposition of EU measures on dynamic provisioning for financial reporting that potentially would over-layer any IFRS requirement with a requirement for a through-the cycle accounting provision. This to our minds – and notwithstanding the section title implying otherwise - would invariably take us beyond an approach based on expected loss provisioning and instead take us into the territory of *unexpected loss* which most see as sitting within the capital regime.

By blurring the two, the Commission's have consulted on an approach that in effect would require provisions to be made against business that has not yet been written. While this may be mitigated through the application of a 12 month PD, it nevertheless remains that the Commission's proposal would require an accounting provision other than for assets currently on the balance sheet. We do not believe this would be supported by the accounting standard setters. We also believe it to be unnecessary as the G20's counter-cyclical objectives can be met through an approach which reflects expected credit losses in existing loan portfolios over the life of the portfolio.

In summary the industry's preferred approach is that of expected loss over the life of the portfolio.

5.2 Response to consultation questions 38 - 45

Question 38: The Commission services invite stakeholders to perform a comparative assessment of the three different methods (ie ECF, incurred loss and IRB expected loss if it could be used for financial reporting) for credit loss provisioning from 2002 onwards based on their own data.

While we do not have the data to perform this exercise we would observe that it will not be an easy task and that small difference in assumptions will result in substantially different results. In terms of the three methods listed:

- ***ECF***

We support the parameters of the expected cash flow method in that it is firmly grounded in an institution's actual balance sheet. We dislike its complexity and believe that a better counter-cyclical outcome can be achieved through an approach that draws on data held by banks' for risk management purposes.

- ***Incurred loss***

We understand that a number of authorities remain convinced of the need for banks to be able to make impairment provisions on the basis of an approach other than incurred loss. This, however, is not to say that we should necessarily lose sight of incurred loss since it provides the means of anchoring expected loss to actual loss. This provides an evidence-based element to expected loss provisioning and ensures that the level and use of provisions is grounded in reality. It forms an essential part of the equation and has the potential of providing an objective trigger for the release of expected loss provisions in that expected loss provisions should begin to be drawn down when they are exceeded by incurred loss provisions. The alternative is to rely on judgements about the point at which we find ourselves in an economic cycle – something that few have proven well equipped to do.

- ***IRB expected loss***

If by an IRB expected loss approach the Commission services in fact mean an IRB approach encompassing expected and unexpected loss then we would disagree with its imposition within financial reporting for the reasons explained above.

We would however welcome Commission services support for the industry's preference for an expected loss over the life of the portfolio approach.

Question 39: Views are sought on the suggested IRB based approach with respect to the through-the-cycle provisioning for expected losses as outlined above.

We see benefit in proposing that the IASB consider a more flexible approach to expected loss provisioning that would permit, the use of IRB data – where available – as this would enable banks to base their accounting provisions on fundamentally the same data as used for their risk management purposes. This fuses together the accounting and the regulatory capital regimes in an appropriate way and constitutes a practical simplification providing useful synergy between the regulatory and audit processes.

We do not however agree with the proposal that the expected loss provision be on a through-the-cycle basis as this in effect must result in the inclusion of an unexpected loss element in circumstances where the life of the portfolio is shorter than the time horizon of the economic cycle. This would be unlikely to be supported by the IASB as it would involve the making of a provision based on a projection of assets that will exist between the maturity of existing assets and the nadir of the economic cycle. The industry is also not supportive of this as it resembles an unexpected loss approach and as such sits within the domain of the prudential capital regime and not expected loss accounting provision.

Capital buffers and the cyclicality of minimum requirements

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, already operate a capital planning buffer measure as part of the existing regulatory Pillar 2 framework, which is closely monitored as part of the ICCAP process 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.

Where jurisdictions already operate equivalent measures to those proposed, and which are proven techniques we would urge the Commission to align its proposals with existing supervisory practice rather than introduce new duplicative or inconsistent requirements.

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 that already maintain 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 assessments currently underway need to assess the extent to which there is double counting before determining any calibration to optimise efficiency.

We therefore strongly recommend that the Commission focus on working with the Basel Committee to ensure the uniformity of application of the Pillar 2 both as regards distributions and counter-cyclical buffers as well as strengthening stress testing parameters globally to ensure consistent standards are applied on a global scale.

Question 40: ***Do you agree with the proposed dual structure of capital buffers? In particular, we would welcome your views on the effectiveness of the conservation buffer and the counter-cyclical buffer, separately and taken together, in terms of enhancing the resilience of the banking sector going into economic downturn and ensuring the flow of bank credit to the "real economy" throughout the economic cycle.***

As highlighted above we believe there are exiting tools within the Pillar 1 and Pillar 2 regulatory frameworks that already cater for the provision of capital conservation buffers and countercyclical buffers. We also believe that where these frameworks exist and run alongside sound corporate governance and risk management they have worked very effectively.

It should 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.

There will need to be calibration of the multiple potential buffer scenarios in relation to what is envisaged here, as compared to those that already exist within the Pillar 2 process to ensure effective alignment; to avoid double counting and 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, lead the review of what the appropriate buffer at a consolidated level should be, liaising as relevant with the firm’s college of supervisors.

- 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 Pillar 2 framework also suggests a range of actions that supervisors might take to prevent capital falling below minimum levels, which include 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.

In addition in light of the expansion of impairment loss provisions to include expected loss we question the need for any further counter cyclical element, Should, for example, impairment loss provisioning be expanded to include expected loss over the full period of instruments on the balance sheet then this should go a considerable way to providing the cushion needed to ensure a ‘softer fall’ during the downturn of the economic cycle.

Capital buffers and expected loss provisioning need to be viewed together as they both provide the means of ensuring that belt tightening can be undertaken from a reserve above and beyond core capital built up over time. By definition, we need to ensure that the mechanics of both work in such a way that they can be released at an appropriate time – which should not be controversial as an objective given the envisaged increase in Core Tier 1 capital. In this way, banks should be placed in a position to maintain credit flows to the real economy in the downturn, though it would only be natural for there to be some contraction as a result of demand-side deceleration.

Question 41: ***Which elements should be the subject of distribution restrictions for both elements of the proposed capital buffers and why?***

We would consider that banking supervisors will want to enter into a dialogue with individual institutions about the way in which their distribution policy lines up against their plans for meeting their obligations both to build up a capital buffer and to make expected loss provisions. We would not, however, see a need for this to be expressed in some separate statutory provision unless the Commission can identify reasons why the supervisory process would not work. The existing Pillar 2 regulatory framework already has the power to address this issue and it should be this framework which should continue to be used to manage such matters ensuring it is therefore applied to individual banks relevant to their risks.

Question 42: ***What is the appropriate timing – following the breach of capital buffer targets – for the restrictions to capital distributions to start? Should the time limits for reaching capital buffer targets be determined by supervisors on a case-by-case basis or harmonised across the EU?***

We are concerned by the use of the word 'breach' in this context. As stated above, 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 on breach of a regulatory requirement when drawn-down. The supervisory dialogue should in the first instance be based on an firm demonstrating that it is projected to meet the enhanced standards expected to be phased in over time – the period of which is yet to be established. Once buffers have been drawn-down/used, the question will be the extent to which this should affect capital distribution. Whilst conservation may be an objective, the ability to raise new capital may also be a relevant factor and dividend policy is a relevant consideration.

On the building up of capital buffer targets, we believe the starting point of this should be to review the practice of countries that already operate a capital buffer process under the Pillar 2 framework with a view for this to be replicated uniformly, not just across Europe, but internationally, working with the Basel Committee's Standards Implementation Group. With this framework in place it should then rest with the consolidated supervisor of the individual firm to establish to the relevant buffer for that firm relative to its risk and governance profile i.e. on a case by case basis. A suitable timeframe based on reasonably wide time bands would need to be developed to allow firms to reach the expected levels.

Question 43: ***what is the most suitable macro variable (or group of variables) that may be used in the counter-cyclical buffer to measure the dynamics of macro-level risks pertinent to the banking sector activities?***

We believe it would be very difficult to identify a single variable, or even a group of variables, which could reliably assess the extent to which credit had gown to excessive levels. Moreover, it is unlikely that any indicator would provide a robust guidepost over time. In reality this is an area which requires the use of judgement. That being said, we believe there are indicators which could be used to inform this process. For example we point to the following list identified by the Bank of England in its recent discussion paper on the role of macroprudential regulation:

- Credit flows, stocks and spreads.*
- Income and capital gearing of households, corporates and other financial companies (OFCs).*
- Unemployment rate.*

- House price to earnings ratio, house price inflation.*
- Maximum loan to income and value ratios of first-time buyers.*
- Commercial property prices and rents.*
- Property pipelines and vacancy rates.*
- Credit conditions surveys.*
- Volumes/spreads data on LBO (leveraged buyout) and private equity deals.*
- Volumes/spreads data on syndicated loan activity.*
- Growth in assets under management at hedge funds and OFCs.*
- Contribution to growth in mortgage market from other specialist lenders.*
- Reliable data on leverage ratios of hedge funds/other OFCs.
- A granular geographical breakdown of banks' loan books.
- Richer data on the quality of institutions' loan portfolios — such as the loan to value breakdown of their mortgage and commercial real estate lending; a breakdown of their mortgage book between prime, adverse credit, self-certified and buy-to-let.
- A consistent breakdown of trading assets by class and quality.

Note: An asterisk (*) denotes that the data source is currently available.

Question 44: ***What are the relative merits and drawbacks of capital buffers versus through-the-cycle provisioning for expected losses with respect to minimising pro-cyclical effects of current EU banking regulation?***

The two need to be seen as complementary. Expected loss provisions have the benefit of ensuring that profits are not overstated in the early part of the life of a loan since they will overturn the current arrangement whereby the credit risk element of interest is booked as profit even if it is known that instruments tend to become impaired later in their life. This should be self evident since if it is that clear that an instrument will become non-performing in the near term then the arrangement should not be entered into in the first place. Expected loss provisions should also relate to business entered into and therefore their expression is rightly to be found within the primary financial statements.

Whether there is a need for a counter-cyclical capital buffer to fill gap perceived to exist, as a result of the term of portfolios for which expected loss provisions have been made being shorter than the projected period to the bottom of the economic cycle is the resulting question.

Whilst the industry supports expected loss over the life of the portfolio it does not support the need for additional counter cyclical capital buffers given that such measures exist both in the Pillar 1 regulatory framework and specifically in the Pillar 2 regulatory framework.

Question 45: ***Do you consider that it would be too early to fully assess the cyclicality of the minimum capital requirement?***

Yes. We agree that it is too early to fully assess the cyclicality of the minimum capital requirement. We particularly think this too early not only because the qualitative impact assessments are still being prepared and yet to be reviewed but in addition because, as highlighted a number of regulatory tools already exist to address procyclicality, so care must be taken to understand the full impact of each proposal and time taken to develop a package which works as a whole, without replicating existing tools.

Where jurisdictions already operate equivalent new measures to those proposed and which are proven techniques, we would urge the Commission to align its proposals with existing supervisory practice, rather than introduce new duplicative or inconsistent requirements.

In summary, we do not believe that the Commission should pursue the establishment of a new regime of capital buffers or capital conservation, but should focus working with the Basel Committee in the consistent application of existing tools and processes globally. That said, if the Commission continues to pursue 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 to lending capacity, and consequence to 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.

6 Systemically important financial institutions

6.1 Key messages

We note that the identification, measurement and monitoring of these 'Significantly Important Financial Institutions' (SIFIs) is being debated in global, European and national fora. We welcome the Commission's responsiveness to these discussions and its decision not to propose specific treatments at this stage. We look forward to reviewing the details of these approaches in due course, which we hope the Commission will align with Basel upon. At this stage we make some high level comments and identify some issues for consideration.

We recognise that for some firms maintaining the confidence in the financial system is a more important supervisory objective than for others. We agree that large and diverse firms, or those whose operations include a high degree of interconnectivity, require careful oversight, given their systemic importance. However, it is vital to recognise that large and diverse firms bring social, economic, and market benefits, through their capacity to intermediate between borrowers and investors across a range of markets. These firms perform a risk taking function, which is necessary for economic vitality. Large global firms can deliver economies of scale, scope, and improve market efficiency and support global trade. Diversification inherent in these institutions can also provide a buffer for absorbing shocks to any one jurisdiction or region, product or market. It is important that any framework for financial stability seeks to encourage diversity in the financial sector and not penalise firms who pursue it as a business strategy. In designing a framework for SIFIs it is therefore necessary to achieve a delicate balance between enhancing the regulatory framework and eroding these benefits given the potential implications for both economic recovery and future growth – a priority in the G20s commitment in the Pittsburgh Summit Declaration.

It is important to take account of initiatives that already go a long way to address the issues posed by SIFIs. We urge the Commission, working with the Basel Committee, to consider a holistic assessment of the approach to systemic risk and interconnectedness, taking account of the broad range of regulatory initiatives that serve to mitigate some of the risks. This includes for example supervisory and crisis colleges, and recovery and resolution plans. The current proposals contained in CRD 4 to increase the asset correlation for financial institutions and to dampen cyclicality, will play important parts in managing SIFIs. International efforts to increase the use of central counterparties will play an important part in managing the risks SIFIs could pose to the financial system. Standards for central counterparties being developed will also serve to protect payment systems and improve resilience. The existing competition tools in national jurisdictions and regions can continue to ensure that market dominance is managed. All of these initiatives which are already in development, or in place, will serve to enhance these firms' ability to absorb losses and the cumulative impact of the proposals must be taken in to account.

In summary, as the Commission 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 Commission in developing its thoughts in this area and responding the forthcoming consultation.

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6.2 Detailed response to questions 46 & 47

Question 46: What is your view of the most appropriate means of measuring and addressing systemic importance?

In determining the most appropriate means of measuring and addressing systemic importance we think that there are a number of steps and considerations to bear in mind, which are set out below. It is essential that this thinking is set against the backdrop of ensuring international alignment.

Financial stability

Systemic importance can only be measured in the context of the objectives for financial stability. Agreement of these objectives is a necessary first step and we look forward to further discussion taking into account on the framework for balanced and sustainable growth.

Objectives: It is important to be clear as to the objectives of a regime for SIFIS given the existing initiatives, applicable to all firms, underway that have an impact..

Risk migration: There needs to be recognition that further requirements placed on SIFIs creates the possibility of risk migration. Any framework needs to ensure that systemic risk does not migrate to unregulated or less well-regulated sectors/ markets, where risks will be less visible and may accumulate to systemic levels.

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. .

Disclosure: We do not think that it is appropriate for SIFI 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.

Measuring systemic importance

While complexity is often cited as an issue, it is inherent in banking and we do not believe that it is an indicator of systemic importance. Good governance and risk management ensure that risks cannot build up without being appropriately identified, measured, monitored and acted upon. We believe that collectively the following characteristics can be indicative of systemic importance, although individually we do not believe that any one is deterministic:

- **size:** This can be a function of absolute size or in relation to a specific financial market or product in which a firm is particularly dominant.
- **interconnectedness:** This can arise from inter-bank lending, cross-holdings of bank capital instruments, membership of payment systems, and being a significant counterparty in a crucial market

- **common risk factor:** This can arise from a group of firms conducting a similar business. While one firm engaged in high-risk conduct may present no systemic risk by itself, many firms engaging in the same activity may create such risk. This relates to interconnectedness and contagion

We do not believe that there is a single objective test that can determine systemic importance, certainly not one based on a single factor. For example it has been proven over the crisis that size is not a determining factor, relatively small firms, or groups of firms, by global standards have been shown to have quite significant impacts on financial stability. All firms, both regulated (within and beyond the banking sector) and unregulated can potentially be systemically important depending on the external environment, the size and nature of the jurisdiction they operate in and their exposure to global and local economic cycles. Therefore there will be no single line that defines systemic from non-systemic but assessments will need to be made of the degree to which firms pose risk to the system.

We suggest that a scorecard approach covering a range of factors, which can weight different factors and incorporate supervisory judgement, could be an appropriate way forward. In this regard we believe that the assessment will have to be made firm by firm and would see the consolidated supervisor, the college of supervisors, in discussion with the firm concerned, playing an important role in determining a view. Such assessment would also need to take account of macro-prudential supervisors view on the risks present to the system. It is therefore important to note that the degree of systemic risk will change over time and as markets and their participants evolve. Assessment will therefore need to be periodically reviewed.

Addressing systemic importance

There is 'no single silver bullet' for dealing with SIFIs, and a multifaceted but flexible and coherent approach is needed. There is potentially a trade-off between enhancing financial stability and stimulating economic growth so a thorough assessment of the cumulative impact of any proposed measures, in line with changes already in train, is required.

There are a range of prudential and regulatory tools currently being reviewed by, regulators around the globe. We provide our general comments on some of those being considered below. In considering these options we stress the importance in assessing the cumulative effect of existing regulatory proposals before concluding upon any further proposals.

Capital or liquidity surcharges for SIFIs: We do not believe that additional capital or liquidity surcharges should be the immediate choice of regulators. It is important to take account of the other initiatives in train and consider the full range of the regulatory toolkit. As noted in our key messages above, across the board prudential capital and liquidity changes in train will serve to protect against probability of failure. Many of these measures focus on stressed economic conditions and therefore go to the heart of financial stability. Therefore the impact of these proposals needs to be taken into account. However, we regard supervisory review under Pillar 2, particularly the intensity of the supervisory relationship as being a key component of any framework for systemically important firms.

Placing restrictions on activities: We do not support measures to restrict or split off aspects of firms' business, such as trading. In the recent crisis diversified firms were more resilient and in practice such a split would be extremely difficult to implement as there is no easy way to distinguish such activities. We would note that the majority of firms' trading activities is actually client driven either directly, or indirectly through hedges on exposures acquired. Treasury activities will also make this distinction difficult.

Absolute limits on size: We do not think that absolute limits on size are appropriate. As noted in our key messages, large internationally active firms provide benefits, social and economic, to the financial system, as well as pose risks. Economies of scale result in lower costs to consumers and broader product choice. The diversification that large internationally active firms achieve also helps those firms to absorb local, regional and market shocks and therefore contribute to global financial stability. It is important that any measures do not undermine those benefits. Size is also a very blunt tool. As we have discussed in the context of the leverage ratio, simple limits on balance sheets do not provide protection against risk. A small thinly capitalised firm that invests in complex, highly leveraged exposures that is interconnected with other market participants could have systemic implications, while falling within a "non-SIFI" size limit.

Early intervention measures and recovery and resolution plans: The Commission's Communication and Staff Working Paper on crisis management discussed early intervention tools and living wills. As outlined in other parts of this paper we agree that it is appropriate for supervisors to have a common regulatory toolkit and to continue to develop convergence of understanding and approach. Crisis management colleges and recovery and resolution plans can play an important role. Although it is important that the latter are developed in a proportional way and that they are not used as a mechanism for imposing arrangements on firms/ groups that regulators are seeking for other reasons.

Question 47: How could the Commission services ensure a consistent prudential treatment of systemic importance across financial sectors and markets?

We believe that the establishment of local and cross-border systemic risk oversight authorities and colleges of supervisors would be possible tools to ensure consistent treatment of SIFIs. While we currently are of the opinion that the creation of cross-border resolution mechanism for systemically significant financial firms will be very difficult, supervisors should continue to work towards_more consistent cross-border rules and procedures for the resolution of financial firms. Again this could be facilitated through colleges of supervisors and crisis management colleges, which would focus on greater coordination among national crisis intervention and resolution regimes. Cross-border systemic risk oversight authorities and colleges could be charged with monitoring exposures and risk concentrations across the full range of markets creating a forward look of the next potential crisis.

With regard to other financial sectors and markets, e.g. the insurance, pension and commodities sectors, we believe that there is need for consistent outcome but are not in a place to give specific advice. Looking beyond the boundary of regulated firms, ongoing review of markets should inform supervisors of the regulatory perimeter, to ensure that systemic risk does not migrate to areas or jurisdictions where oversight is weaker. The European Systemic Risk Board will have a role to play in making such assessments.

7 Single rule book in banking

7.1 Key messages

We welcome the creation of a single rulebook, which should help make supervisory arrangements for cross border financial institutions in the EU single market more efficient. We continue to support the proposal for maximum harmonisation of the Directive in the areas that are already fully harmonised. We think that the Commission's comments in paragraph 172, which emphasise the need to arrive at a convergent outcome, are helpful as they recognise that national and product circumstances should still be taken into account in arriving at that outcome. We also support the Commission's work towards convergence on options and discretions, albeit recognising that supervisory judgement is necessary and distinct from that process.

We have been closely engaged with the earlier High Level Group Report by Jacques de Larosière and the European Commission's consultation on improving regulatory cooperation and supervision across the EU. We have supported the development of the review of the supervisory framework and much of the content of the resulting proposals for the EBA and amendments to the CRD. The objective of such changes should be to improve the quality of supervision and co-ordination and convergence of supervisory practice.

As regards technical standards, the majority of our members think that there should be limitation on their application to avoid the possibility that they will introduce more stringent standards than those agreed internationally in Basel. In particular, in relation to Article 124, the majority believes that technical standards should be restricted to co-operation procedures to avoid limiting necessary supervisory judgement. However some members support a broader scope for technical standards and support the Commission proposal. Where technical standards are introduced they should be subject to appropriate consultation and impact assessments.

7.2 Response to consultation questions 48 – 52

Question 48: In which areas are more stringent general requirements needed given national or other circumstances? Is Pillar 2 a sufficient tool to address specific negative circumstances at credit institutions and if not, how could it be strengthened?

The current Basel and EU proposals on capital adequacy and liquidity, counter-cyclical buffers and the leverage ratio will further harmonise the prudential framework. We do not see other areas where the rules need to be tightened.

Pillar 2 is the right place to address firm-specific issues, including as noted in Section III, the leverage ratio., But the approach to Pillar 2 requires new thinking from supervisors. Improvements should be made in the Pillar 2 supervisory review and evaluation process with a greater focus on understanding banks' businesses models and the risks that they could create, individually and collectively, for the financial system. More engagement with our members in their stress testing and scenario analysis, augmented by peer group analysis would also be beneficial. However, as noted in the key messages, the majority of our members think that technical standards in relation to Pillar 2 should be restricted to cooperation procedures, so as not to impose more stringent standards than those internationally agreed in Basel. Some members do support the wider remit suggested by the Commission.

Question 49: What is your view of the suggested prudential treatment for exposures secured by mortgages on residential property outlined above? What indicators and their respective values do you consider appropriate as possible preconditions for the application of the preferential treatment of exposures secured by mortgages on residential property?

For questions 49, any qualitative and/or quantitative evidence supporting your arguments would be greatly appreciated.

We feel that an informed debate about the social and economic consequences of the proposed regime should take place. It is evident that the changes being contemplated for mortgages, such as loan-to–value (LTV) or loan-to–income (LTI) limits, have the potential to have a highly significant effect that may have wider social impacts. The consequences of the regulatory measures in hand are clearly of considerable public interest and it is important therefore that the authorities conduct impact analyses from this perspective.

As a starting point to the debate we would like to make the following points:

For a well developed market such as the UK an LTV in excess of 75% would be an appropriate threshold for lower risk weights. This is because of the peculiarities of the UK market, and the fact that credit risk data suggests that below this level, ratios of defaults are significantly reduced. As a result there is no justification in our view for making changes that would drastically change the nature of the UK housing market. Furthermore a lower threshold could potentially work against affordability, which is a major driver of lending decisions. We would be happy to share data with the European Commission showing the appropriateness of an LTV similar to the 80% suggested by the Commission.

We find it difficult to see how a hard test for LTI could be implemented in practice without resulting in adverse effects on customers. As already mentioned affordability is the key driver, nevertheless we feel that customers are too different to have a single hard test. For example, some customers have irregular income, and others have other assets which they will use to repay mortgages. Individuals have different spending habits from each other and, particularly for first-time-buyers, spending habits can be changed to accommodate mortgage payments. We are therefore worried that the proposals will unnecessarily reduce the availability of mortgages to those that are not in a regularly paid employment, such as construction or self-employed consultants.

Housing markets are, in part, influenced by culture and geography. Any EU regulation has to take this into account, and enable national governments and supervisors to address issues that are of particular concern.

Question 50: What is your view of the suggested prudential treatment for exposures secured by mortgages on commercial real estate outlined above? What indicators and their respective values do you consider appropriate as possible preconditions for the application of the preferential treatment of exposures secured by mortgages on commercial real estate? In particular, are additional preconditions needed to ensure the soundness of this treatment? Do you believe that the existing preferential risk weight applied to exposures secured by mortgages on commercial real estate should be increased?

For questions 50, any qualitative and/or quantitative evidence supporting your arguments would be greatly appreciated.

The comments made for Question 49 equally apply here.

Question 51: Should the prudential treatment for exposures secured by mortgages on residential property be different from the prudential treatment for exposures secured by mortgages on commercial real estate? If so, in which areas and why?

We refer to our answer to question 49. Nevertheless we accept that different thresholds may be relevant, as commercial real estate can have different characteristics to retail mortgage activities.

Commercial real estate markets are, in part, influenced by geography and government development plans. Any EU regulation has to take this into account, and enable national governments and supervisors to address issues that are of particular concern.

Question 52: What is your view of the merits of introducing measures that would help to address real lending throughout the economic cycle? Which measures could be used for such purposes? What is your view about the effectiveness of the possible measures outlined above?

The balance between the different objectives of macro-prudential policy (individual financial institution resilience versus dampening the credit cycle) will drive the extent to which any regime is focused on the whole market or individual institutions. If the objective is to simply make individual institutions more robust in the face of the economic cycle then it follows that tools should be designed to impact individual financial institutions' balance sheets. The greater the importance placed upon dampening the credit cycle and protecting the real economy from activities in the financial services sector then the greater is the need for the tools to be system wide. We would however caution against regulation of financial services being the only tool for dampening asset bubbles. Taxation and other government policies, and changes in social trends, can be just as important drivers and should not be incorporated into the debate. As a result we are of the view that the dampening of credit cycles is much more of a government policy issue that should not be left solely to regulators to determine.

If the objective is to stem credit growth on a system wide basis the issue of what is termed "leakage" by the Bank of England's Paul Tucker arises. That is for instance, if UK domestic authorities were to take steps to reduce the credit supply, these would only apply to UK headquartered firms and the subsidiaries of foreign owned banks. It would not impact branches of foreign-headquartered banks operating in the UK and would therefore have a lesser impact than it might otherwise do. That being said, the resilience of UK banks would still be strengthened, but it does point to the desirability of a coordinated EU or global approach.