

UK Response to the Commission Services Staff Working Document on further possible changes to the Capital Requirements Directive

1 April 2010

Executive summary

Introduction

This document sets out the UK response to the Commission Services Staff Working Document on further possible changes to 2006/48/EC and 2006/49/EC (the 'Capital Requirements Directive', 'CRD'). This response has been produced by Her Majesty's Treasury in consultation with the Bank of England and the Financial Services Authority.

The foundation of reforms to the global financial system must be a strengthened, internationally consistent regime for capital and liquidity. To this end, the UK fully supports the objective, set out in the Commission Services Staff Working Document, of introducing a package of reforms to the CRD that are closely aligned with the changes to international capital and liquidity standards that the Basel Committee is currently consulting on. Consistent global implementation of reforms to financial regulation agreed by the G20 will be essential to avoid regulatory arbitrage and the fragmentation of international financial markets.

It will be essential to ensure that the aggregate impact of the full package of regulatory reforms agreed by the G20 is assessed, and that this assessment is taken into account when calibrating and implementing CRD IV. We must ensure that regulation strikes a balance between enhancing financial stability, while supporting strong and sustainable economic growth.

G20 Leaders have agreed that internationally agreed rules to improve both the quantity and quality of bank capital and to discourage excessive leverage will be phased in as financial conditions improve and economic recovery is assured, with the aim of implementation by end-2012. The UK is encouraged that the European process is on course to meet this schedule. Implementation of reforms to European capital and liquidity standards will need to be carefully managed so as to avoid constraining prudent lending by banks and impeding the pace of recovery. However, concerns about the timing of implementation should not be used as a reason to weaken the ambition of the reforms; where necessary a longer transitional period can facilitate implementation of the fundamental reforms that are needed.

Within the overall package of proposed reforms to the CRD set out in the Commission Services Staff Working Document, we have identified several key priorities. In the order that they occur in the Working Document, our key issues are:

Liquidity

The UK fully supports the introduction of an internationally agreed liquidity standard throughout the EEA. The liquidity coverage requirement will greatly enhance the stability of the banking system, as well as giving countries more time to implement resolutions if necessary. It is important that the EU framework contributes to a robust private sector market in liquidity, including under conditions of stress. To this end, those assets eligible for the liquidity buffer

must remain liquid precisely when bank funding becomes illiquid. In practice this will mean agreeing a narrow, prudent definition of liquid assets such as high quality government bonds.

Capital

The UK agrees with the Commission's proposals to simplify the current capital structure, and to ensure that, within this structure, capital instruments are fully effective in absorbing losses. As G20 Leaders have emphasised, both the quality and quantity of regulatory capital should be enhanced. In practice, this means that all Tier 1 capital must be capable of providing going concern loss absorbency (both on principal and coupon payments). Tier 2 capital has also largely failed to absorb losses during the crisis. Going forward it would be important to ensure that Tier 2 instruments are loss absorbent for all firms if they are to continue to remain in the capital structure. The UK also supports the work being conducted by the Basel Committee to assess the merits of contingent capital. Finally, it will be important to develop concrete policy options to implement the principle set out in the Commission's consultation paper, and agreed by G20 Leaders in Pittsburgh in 2009, that "our prudential standards for systemically important institutions should be commensurate with the costs of their failure".

Leverage ratio

In the run up to the financial crisis, many banks were able to increase their absolute leverage while retaining a high and consistent risk weighted capital ratio. The UK supports the international consensus that, to address this risk, a binding leverage ratio is needed as a complement to risk based capital requirements. A leverage ratio would act as an important regulatory backstop to mitigate against both over-reliance on an individual bank's modelling and measurement of risk, and excessive, unsustainable growth in absolute balance sheet size that might risk diluting capital standards over time. By its very nature, any "back-stop" must have the assurance that comes from a binding, automatic measure. The leverage ratio should therefore be a mandatory element in Pillar I of the CRD.

Mitigating pro-cyclicality

A package of policy measures is likely to be needed to address different aspects of the pro-cyclicality of financial markets. Accordingly the UK believes that the Commission should, consistent with the approach being taken by the Basel Committee, take forward work on four potential policy tools:

- forward looking provisioning to reduce the cyclicality of expected losses;
- steps to reduce the cyclicality of minimum capital requirements;
- a counter-cyclical capital buffer; and
- a capital conservation buffer.

In designing and calibrating the final package, it will be important to recognise the interdependencies between these tools. However, whilst they have a potential to overlap, as long as they are correctly calibrated they will prove complementary rather than duplicative. For example, it is important to recognise that, taken on its own, the capital conservation buffer will not have a counter-cyclical effect as neither the size of the buffer nor the restrictions associated with breaching it will vary over the economic cycle and that additional measures will be needed to ensure that capital requirements act to mitigate financial market pro-cyclicality.

Regarding provisioning, the UK supports work at EU level and internationally to explore options to introduce more forward looking provisioning. It is sensible that, where possible, banks provision for losses they can reasonably expect to make, and that capital distributions are not

made on the basis of unreasonable profit expectations. The UK welcomes the Basel Committee's engagement with the IASB in this process.

There are a range of options under consideration, including the "expected cash flow (ECF) model" being considered by the IASB, "above the line" dynamic provisioning as proposed by the Commission and "below the line" through-the-cycle reserving, which could be presented in a regulatory income statement. All of these options require further work and consideration. It is critical that any EU approach to provisioning is fully consistent with international accounting standards.

1

Liquidity

Liquidity Coverage Requirement

1.1 The UK fully supports the implementation of an internationally agreed liquidity standard throughout the EEA. A correctly calibrated Liquidity Coverage Requirement (LCR) will help to ensure that all banks within the EEA can survive for one month without the need for official sector intervention.

1.2 The effectiveness of the LCR will depend on the appropriate definition of what banks can consider liquid for the quantitative buffer. The EU framework must contribute to a robust private sector market in liquidity, in 'peacetime' but also under conditions of stress. This means that the stock of eligible liquid assets should comprise high quality liquid assets that a bank can sell, repo or otherwise convert into cash under all plausible conditions without accepting large 'fire sale' discounts or haircuts. The UK therefore strongly supports a narrow, prudent definition of liquid assets as government bonds and central bank reserves.

1.3 Through their market facilities, central banks set monetary policy and provide a range of types of liquidity insurance to the banking system. The collateral accepted by the central bank in those facilities depends on the nature of the specific operation, bearing in mind the risks to its own balance sheet. This is a separate issue to the eligibility of assets in commercial banks' own liquid asset buffers and the two should not be conflated.

1.4 An appropriately designed buffer will allow banks to self-insure through holding assets that remain liquid in times of stress without reliance on public support. Government bonds represent the most resilient form of liquidity in the market, and have been reliably liquid and stable in value over the past two years. This is particularly the case for high-quality government debt of credit rating AA- and above. When hit by a liquidity shock, banks tend to move to secured funding markets, where the majority of collateral passing through private repo markets is government debt. For example, government collateral dominates the European repo markets, consistently representing more than 85% of collateral posted according to the ICMA Repo Market Surveys.

1.5 In addition, a simple single-tier definition of liquid assets mitigates the risk of an erosion of standards over time. By agreeing to a multiple-tier buffer supervisors are at a greater risk of succumbing to pressure by firms to relax the criteria of the different tiers over time. This has been the case with the composition of capital buffers, whereby relatively less loss-absorbing capital was gradually included in both Tier 1 and Tier 2 capital over time. This risk is even higher if the definition is overly reliant on a number of subjective assessments.

1.6 A simple and transparent definition also aids international harmonisation, which the UK understands is a key Commission objective. In effect, the potential for significant differences to emerge across national supervisors and banks is limited. There is no need for complex rules setting out the extent to which different assets are eligible or the possible haircuts that can be applied.

1.7 One criticism of a narrow definition is that it does not recognise the liquidity value of other assets and may lead to a fall in demand or market liquidity for those assets. This is a flawed argument. A narrow definition of liquid assets does not prevent banks from holding and trading

other assets on their balance sheet. The LCR is only one part of the regime (the Net Stable Funding Ratio and contingency funding plans will recognise other assets). In addition, the aim of the LCR is not to increase demand or market liquidity for certain assets – it is to ensure that banks are holding a portfolio of genuinely resiliently liquid assets. That is the primary objective and all assets included in the LCR must meet that criteria;

1.8 Another criticism of a narrow definition that has been made recently is that heightened concerns over sovereign risk mean authorities must be mindful of concentration risks. However, replacing sovereign debt with other debt issued in the same jurisdiction will provide no relief against this. First, the pricing and liquidity of private sector debt securities are likely to be closely correlated to their benchmark government bonds. Second, even if certain categories of private sector securities proved to be resiliently liquid in a crisis, it would be very difficult to single them out *ex-ante* before the onset of the crisis.

1.9 Ultimately, the primary consideration in designing a liquid assets definition for banks is whether banks can reliably sell or discount the assets for cash in a crisis without the need for official intervention. Only such assets can offer a stressed institution reliable insurance against the scenarios of losing access to funding markets.

1.10 To emphasise the point further, this is already common best practice in the industry. Banks *themselves* almost exclusively accept cash and government bonds to collateralise their own counterparty derivative credit exposures in the knowledge that these assets are most reliably liquid in the stressed circumstances of a financial firm failing.¹

1.11 Some of the proposals to include specific asset classes also merit specific responses:

- assets such as corporate bonds and covered bonds are far more susceptible than government bonds to illiquidity and price volatility during periods of banking sector stress. Such periods are typically correlated with periods of stress in the real economy. Therefore, assets originated in the real economy (e.g. corporate debt or mortgage assets) are liable to become illiquid because of credit risk concerns. Because of this, investors tend to sell these assets in times of stress, accentuating any price volatility. If an institution attempts to sell these assets at 'fire sale' prices, the institution, and other financial institutions holding the same asset, will suffer mark-to-market losses. The application of haircuts cannot prevent this;
- covered bonds are not acceptable forms of prudential liquidity. If permitted in the buffer, banks will issue covered bonds to one another, and a bank's liquidity will be contingent on the solvency position of another bank. This can be illustrated by an example where banks are assumed to be allowed to place covered bonds in the LCR and have placed such assets in the buffer. Should the banking system be hit by a wholesale funding market shock, covered bonds would be of little use in helping the system to raise outside liquidity as the buffers would comprise broadly of the same assets that have just suffered a shock – in other words covered bonds are 'inside' liquidity. Allowing covered bonds in the buffer clearly reduces the effectiveness of the LCR and does not support a prudent outcome;
- the crisis has demonstrated that covered bonds are not resiliently liquid instruments. As a 2008 ECB report points out², the uncertainty surrounding covered bonds led market-makers to reduce the level of market liquidity they provide to

¹ As noted earlier, the ICMA repo market survey of European banks consistently shows that more than 85% of all repo activity is secured on government bonds. More generally, it is government debt that other commercial banks are willing to accept as collateral which they expect to liquidate in a crisis. For example, more than 90% of collateral posted pursuant to ISDA Master Agreements is either cash or government bonds.

² The report can be found by following this link: http://www.ecb.eu/pub/pdf/other/coverbondsintheeufinancialsystem200812en_en.pdf

these instruments. This had led to wider bid-ask spreads, smaller trade sizes and periods of suspension in market-making. During this period, a bank would have found it extremely difficult to obtain sufficient liquidity by repoing or selling its portfolio of covered bonds; and

- while the Commission Services Staff Working Document does not suggest inclusion of equities in the liquidity coverage ratio, there have been suggestions that equities should be included. The UK strongly opposes such a proposal. Equities are not an acceptable form of regulatory liquidity. Equity market prices are highly sensitive to large liquidations and the repo markets for equities are shallow. Large scale liquidation of equities by a number of banks will have significant impact on the value of equities leading to knock on effects for insurance companies and pension funding. At the same time, banks may also face a hit on capital from selling equities. This is not a credible proposition.

1.12 Annex A sets out in explains in more detail the rationale for setting a narrow definition of assets eligible for inclusion in the liquid assets buffer.

Net Stable Funding Ratio

1.13 The UK's preferred policy outcome is to have an appropriately calibrated net stable funding ratio (NSFR) in place in Pillar 1, supplemented by a core funding ratio (CFR) in Pillar 2. While the UK agrees with the Commission that the NSFR is conceptually attractive, the UK notes the importance and difficulty in achieving the appropriate calibration.

1.14 The purpose of both the NSFR and the CFR should be to ensure banks maintain prudent funding structures in relation to their asset base. Such ratios are particularly relevant during the economic upswing, when banks may engage in rapid balance sheet expansion funded by short-term wholesale funding. The ratios are conceptually different from the LCR, where the intention is for banks to hold sufficient liquid assets, which can be liquidated in times of need. Both the NSFR and CFR should be calibrated clearly with this purpose in mind.

1.15 The UK is concerned that a flawed calibration of the NSFR can create the wrong incentives for banks. The UK therefore strongly supports a review of the calibration of the NSFR to ensure that it does not have the following adverse unintended consequences:

- the primary purpose of a structural funding measure should be to ensure that the bank has good quality funding. Care needs to be taken to ensure that banks are not simply encouraged to change the asset side of their balance sheet (e.g. exchanging corporate loans for corporate bonds) increasing significantly the level of quasi-liquid assets they hold for little financial stability benefit. Related, any structural funding measure should help to ensure that there is an appropriate balance between trading book and banking book activity. The proposed design of the NSFR might favours the broker/dealer model while penalising the universal banking model might need reviewing depending on the results of the quantitative impact study; and
- the ratio must not be calibrated in a way that encourages the banking system to constrain credit availability through loans regarded as illiquid. As currently calibrated the ratio could significantly disadvantage SME and retail loans relative to lending to large highly-rated corporates.

Completeness of legislative approach

1.16 The UK notes that there are a number of key liquidity risks that are not covered by the new ratios (e.g. intra-day liquidity risk, a key factor in the Lehman failure). Further, the new approach

needs to provide some flexibility to place funding limits on individual banks, and to implement the standards on an individual currency basis if appropriate. This is important given the significant euro and US dollar exposures of some UK banks.

Scope of application

1.17 The UK supports the application of liquidity standards on a legal entity level. (The treatment of branches is discussed below.) Creditors have contractual obligations with legal entities, not groups. Subject to appropriate safeguards, the UK is willing to consider the idea of deviating from this approach through a waiver model. To be able to support such a framework the UK would need to be satisfied that (1) waivers will allow for partial dis-application, not an all or nothing approach; (2) the decision to grant a waiver should be at the sole discretion of the Host Authority; and (3) in addition to the conditions set out in the consultation, the additional conditions set out in Annex A are met.

1.18 In addition, the UK would encourage the Commission to be more specific over the issue of third country entities. There are two generic situations: EEA groups with third country sub-groups and third country groups with EEA sub-groups. In the case of the former the UK believes that the Commission is proposing that at the very minimum the liquidity standards must apply to the consolidation of all EEA legal entities excluding the third country sub-groups. In the latter case the Commission is proposing that the liquidity standards will always apply at a minimum to the EEA sub-group, meaning liquid assets are always held within the EEA.

1.19 In this context the UK believes that the Commission needs to consider how branches are addressed. Most third country groups active in the EEA operate through both branches and subsidiaries. This potentially will allow banking groups to avoid the intent of the CRD IV proposals, both through a change to booking activities and intra-group transactions. The treatment of branches is discussed in more detail below.

1.20 The UK supports the inclusion of certain investment firms within the scope of the liquidity standards. The failure of Lehman Brothers International Europe Ltd demonstrated the impact investment firms can have on European financial stability. The UK believes that the most appropriate threshold is a maximum level of leverage as measured by the leverage ratio proposal set out in the consultation. Leverage is a measure of equity to total assets and so is a good proxy for the degree of liquidity risk such institutions take, and could thus usefully determine which investment firms should fall within scope of the liquidity standards. This should, of course, be consistent with the introduction of a binding leverage ratio.

Intra-group transactions

1.21 The Commission Services Staff Working Document proposes three alternatives for intra-group transactions and commitments: two symmetrical approaches which treat inflows and outflows the same (a “zero percent” treatment and a “100%” treatment) as well as an asymmetric approach which treats outflows at 100% and inflows at 0%.

1.22 The UK believes that it is important that the Commission considers the interaction between the treatment of intra-group transactions and its approach to scope of application; prudent assumptions should lead to the asymmetric treatment in the final standard.

1.23 The 100% treatment of inflows and outflows will allow, at a sub-group level, firms to meet the new standard with intra-group committed facilities or short-term loans from their parent. This will undermine the Commission's proposals for applying the ratio on a legal entity basis.

1.24 While the 0% symmetrical treatment for intra-group transactions would ensure that entities are not able to rely on intra-group liquidity lines to satisfy the LCR, the UK believes that such an approach fails to consider other important risks.

1.25 Firstly in the case of intra-group commitments, while it ensures that each entity is holding a local pool of assets to meet its LCR, the entity may still prefer to call on the intra-group liquidity line when faced with a stress as an alternative to depleting its liquid assets buffer. This is particularly likely to be the case where using its own buffer would cause it to breach the LCR. In this case, a parent entity could suffer an outflow to a subsidiary, depleting its liquidity reserves. But in the 0% symmetric approach, the parent entity does not have to hold liquid assets as insurance against such a possibility.

1.26 Secondly, in the case of intra-group loans and deposits the 0% symmetrical treatment assumes that intra-group transactions roll-over during times of stress. This is not a prudent assumption. Short-term intra-group assets and liabilities proved to be a source of instability during periods of stress.

1.27 For these reasons, the UK believes that an asymmetrical treatment of intra-group transactions is the appropriate approach to take. This approach assumes that in a stress intra-group deposits will not roll over and that intra-group loans should be treated as evergreen, irrespective of their contractual maturity and that commitments are drawn upon by the lender, but that the borrower may not rely on them for meeting the ratio.

1.28 Although on the face of it this will result in increased liquid asset buffer requirements for firms, the simple behavioural change of lengthening the term of their funding such that loans and deposits mature outside the stress period would eliminate any additional requirements.

1.29 The UK recognises that an asymmetrical intra-group treatment for commitments may result in an increase in the level of liquidity a group is holding, but believe that such an approach ensures that all-important intra-group risks are considered.

Branch responsibility

1.30 We do not believe the case has been made for the transfer of responsibilities for branch liquidity supervision. Prior to proposing a change in the existing allocation of any responsibilities it is essential that full consideration is given to the potentially significant adverse consequences and to risk mitigation strategies, including taking in to account Member States' resolution capabilities. Furthermore, even if these are believed to be manageable, it is only prudent to introduce a package of rigorous safeguards to provide the necessary assurance for all parties concerned, especially local consumers. The revision of the Deposit Guarantee Schemes Directive will be important in this regard. Consideration could be given, for example to a "waiver" framework similar to that set out above for groups.

1.31 In addition, the UK does not believe that it is possible to address the issue of EEA Branches without harmonising the treatment of third country branches. The CRD should set out clear obligations on the host supervisors of non-EEA branches. Should such obligations not be implemented, the third country group would be able to evade effective EEA level liquidity supervision and undermine the Commission's position on "waivers". Given the €1.4tr of assets held in the London branches of non-EEA groups, the UK considers this a material issue.

1.32 Finally, the UK would like to highlight an issue that is not addressed in the consultation. Many EEA banks branch into non-EEA countries, which will impose liquidity requirements on those branches backed up by depositor preference. The UK is of the view that this issue needs to be addressed.

2

Definition of capital

Introduction

2.1 G20 Leaders committed in Pittsburgh in September 2009 to "...developing by end-2010 internationally agreed rules to improve both the quantity and quality of bank capital...". The UK strongly supports this objective and support the Commission's proposals to simplify the current capital structure and to ensure that, within this structure, capital instruments are fully effective at absorbing losses. In practice this means that all Tier 1 capital must be capable of providing going concern loss absorbency (both on principal and coupon payments). Tier 2 capital has also largely failed to absorb losses during the crisis. Going forward it would be important to ensure that Tier 2 instruments are loss absorbent for all firms if they are to continue to remain in the capital structure.

2.2 As with the other reforms to the CRD, implementation of measures to strengthen capital quality will need to be carefully managed so as to avoid constraining prudent lending by banks and impeding the pace of recovery. However, transitional issues should not be allowed to undermine the overall long-term goal of substantially improving the quality of capital.

Simplifying capital structure

2.3 The UK supports the proposal to simplify the capital structure. The classification of Tier 2 into upper and lower Tier 2 has not improved the quality of banks' capital. The UK's view is that the main issue for prudential capital resources is ensuring each class of instrument is capable of absorbing losses.

2.4 The UK also agrees that there is no justification for different risks to be met by different capital resources (i.e. market risk) and therefore supports the proposal that Tier 3 should be eliminated. However, the UK would also flag that as generally reflected in CRD 'Limited Licence Investment firms' may need a separate treatment where their capital requirement is the fixed overheads requirement.¹

Enhancing capital quality

2.5 To a significant extent, non-core Tier 1 and Tier 2 capital failed to absorb losses as expected in the recent crisis. Non-core tier Tier 1 included a number of elements which proved not to be genuinely loss-absorbing on a going concern basis, specifically non-core Tier 1 failed to deliver principal loss absorption. It also did not bear losses via coupon cancellation or deferral. This reflected an inability to avoid exercising call dates in fear of punitive reaction from investors and fear of being stigmatised as a weak bank. Similarly the necessary intervention of governments to avoid the failure of systemic firms meant that Tier 2 capital often did not bear losses (except through ad hoc buy-backs or liability management).

¹ Firms subject to the capital requirement outlined in CAD Article 20(2) where their effective capital requirement is the 'fixed overheads requirement' under CAD Article 21 (i.e. where their fixed overheads requirement is more than the sum of their market and credit risk requirements).

2.6 The UK therefore strongly supports the overall aim in CRD IV to tighten significantly the definition of capital to avoid such failures in the future, and the proposals that the Commission Services Staff Working Document sets out to achieve this.

Criteria proposed for Core Tier 1, non-Core Tier 1 and Tier 2

2.7 The UK agrees with the proposed Core Tier 1 criteria. Non-Joint Stock (NJS) companies should also be required to meet these criteria in full. However, the UK also believes that the criteria need to work for NJS companies. Consideration will need to be given to how this can be achieved in light of the specific constitutions of different types of mutuals.

2.8 The UK notes that during the recent crisis Tier 2 capital failed to absorb losses as intended for a number of firms, not just those seen to be systemically important. This was due to governments being forced to prevent the wider systemic impact of a firm failure, with the result that this capital has largely not ended up in a gone-concern situation. Going forward, it will be important to ensure that Tier 2 instruments are loss absorbent for all firms if they are to continue to remain within the capital structure.

2.9 Work is underway in the Basel Committee to assess the merits of proposals to make gone-concern capital loss absorbent for all internationally-active firms, via either conversion or write-down, when a bank is unable to recapitalise in the private market and the public sector decides to provide support. The UK supports this work and would urge the Commission to ensure that the CRD can mirror Basel's progress.

Conversion or principal write-down features in non-Core Tier 1 capital

2.10 The UK believes that all non-core Tier 1 instruments (referred to as 'additional going concern capital' in Basel) should be capable of providing going-concern principal loss absorbency (i.e. not just cancellation or deferral of coupon payments). During the crisis non-core Tier 1 capital instruments, including innovative hybrids and preference shares, largely failed to absorb losses.

2.11 Given this, the UK believes that non-core Tier 1 capital should include a conversion or write-down feature to achieve going-concern principal loss absorbency. CRD IV should therefore follow the directive amendments made in CRD II. (The UK notes that the CEBS guidance on hybrid capital under CRD II discussed some of the features of such mechanisms, as the requirement for principal loss absorbency was introduced in Article 63a(4) of the BCD as part of CRD II).

2.12 In terms of the trigger for conversion/write-down, the UK notes that there is a specific workstream in Basel that is discussing contingent capital, which includes the discussion on the trigger and how it might work. Contingent capital has emerged as a key issue in policy discussions amongst a broad range of interested parties including supervisors, regulators, academics, finance professionals and other market participants. The basic setup of a contingent capital proposal is that non-core tier one capital, for example, converts into common equity on a trigger event. The choice of trigger event, along with other design aspects depends very much on the policy objective. Different forms of contingent capital instruments have been issued in the market over the last year.

2.13 There are a number of potential policy objectives, including: increasing common equity in times of stress when new equity is scarce; ensuring going concern loss absorbency of non-equity capital; improving incentives for managers and investors; improving the gone-concern loss absorbency of capital; reducing moral hazard; and lowering the cost of capital relative to common equity in benign times. Some of these objectives are not mutually exclusive, and each

involves different design considerations. The UK believes that contingent capital may well prove to be a very useful component of the regulatory capital structure.

2.14 The UK is supportive of on-going efforts by the Basel Committee to develop policy options and strongly encourage the Commission to act to ensure that CRD IV approval and implementation plans remain flexible enough to ensure that should future international agreement on contingent capital emerge this can be delivered in the EU context. We await the outcome of the work underway in Basel - it would not be meaningful to comment on design features before the potential objective of contingent capital is firmly established.

Prudential adjustments

2.15 The UK supports the proposal in the Basel Committee's consultation, reflected in the Commission Services Staff Working Document, that prudential filters and deductions should generally be made in respect of core Tier 1 capital. The UK also broadly supports the proposed regulatory adjustments to regulatory capital set out in the Basel and CRD consultations. In particular, we do not consider that deferred tax assets, where they rely on the future profitability of the bank, can provide capital relief for going concern losses at the point in time when it is needed.

2.16 It will be necessary to await the outcome of the quantitative impact study (QIS) to fully understand the impact of the proposed reforms to prudential adjustments. The UK notes that some adjustments may have significant system-wide impacts, but be less significant at the level of individual firms/groups, whilst others may have a bigger impact on individual firms. The UK may provide further evidence on issues around prudential adjustments at a later date.

Calls for non-Core Tier 1 and Tier 2 and buy-backs

2.17 The UK is of the view that the case has not been made for the inclusion of calls in regulatory capital. The governance arrangements around calls included in banks' regulatory capital proved inadequate during the crisis. As a result, the inclusion of call-dates for Tier 1 and Tier 2 debt led to unintended consequences, weakening the quality of capital in the past crisis. The inclusion of call dates undermines the permanence of undated capital and exacerbates roll-over risk for dated instruments. More importantly, during the crisis issuers felt forced to continue to call capital even though calling capital and refinancing increased the cost of debt at a time when capital positions were weak.

Unrealised gains

2.18 The UK agrees that a further review of the treatment of unrealised gains is likely to be appropriate, particularly regarding the reliance that can be placed upon different types of valuations within the accounting framework. In the first instance, it may be appropriate for the Basel Trading Book Group to consider the reliance that can be placed on 'level 2' (where inputs can be verified) and 'level 3' (models where inputs cannot be verified) valuations within the accounting framework.

Large exposures

2.19 The UK note that the Large Exposures regime was examined recently as part of the CRD II reforms. This exercise benefited from extensive advice (including impact assessment) provided by CEBS to the Commission. It is suggested that the Commission might again wish to request CEBS to provide advice on whether any further changes to large exposures may or may not be appropriate in the light of any changes to the definition of capital.

Disclosures

2.20 The UK fully supports the enhanced disclosures proposed in the Commission Services Staff Working Document (which go further than those agreed in CRD II) and agree that regulatory capital should be reconciled back to the balance sheet values of capital instruments in the audited financial statements. It is essential that investors have adequate information to properly assert their shareholder rights. Transparency must be at the heart of future reforms to regulatory capital requirements.

Transition and Grandfathering

2.21 The UK believes that the implementation of a newly strengthened regulatory framework will need to be carefully managed, reflecting the G20 commitment that internationally agreed reforms to strengthen capital quality be phased in as financial conditions improve and the economic recovery is assured. However, while implementation needs to be appropriately phased, transitional issues should not be allowed to undermine the overall long-term goal of substantially improving the quality of capital.

2.22 The UK agrees with the Commission on the factors that need to be considered in arriving at appropriate grandfathering (paragraph 76 (a) to (c)), namely: the appropriate interaction between CRD II and CRD IV; the economic recovery; and the results of the QIS. The UK would encourage the Commission to consider grandfathering for all capital instruments as part of the CRD IV process, which will involve reconsidering the appropriate treatment for those instruments that will be grandfathered under CRD II. Lessons learnt over the last year suggest that 30 years is not a reasonable period for conclusion of these reforms and should be revisited.

3

Leverage ratio

Introduction

3.1 G20 Leaders in Pittsburgh in 2009 agreed that:

“We support the introduction of a leverage ratio as a supplementary measure to the Basel II risk-based framework with a view to migrating to a Pillar 1 treatment based on appropriate review and calibration”.

3.2 The UK strongly supports this commitment. A binding leverage ratio would act as an important regulatory back-stop discipline, serving as a mitigant against both over-reliance on an individual bank's modelling and measurement of risk, and also excessive, unsustainable growth in absolute balance sheet size, which otherwise risks diluting capital standards over time.

3.3 By its very nature, any "back-stop" must have the assurance that comes from a binding, automatic measure. The leverage ratio implemented through the CRD IV reforms should therefore be a mandatory element in Pillar I of the CRD.

Objective of the leverage ratio

3.4 Some of the institutions that suffered the largest losses in the current crisis were, on a risk-weighted capital measure, among the best-capitalised large international banks in the world. However, looking at a simple leverage measure, these institutions were among the worst-capitalised banks¹. In the run up to the crisis, many banks' leverage increased significantly even though they continued to meet their risk based capital requirements. When leverage is very high, smaller movements in the value of assets can quickly wipe out capital.

Chart 1: Major European banks' tier 1 capital ratios

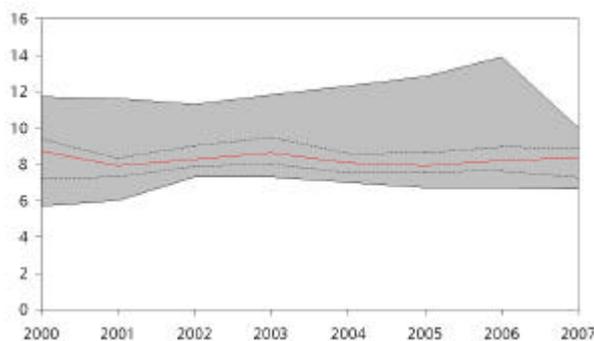
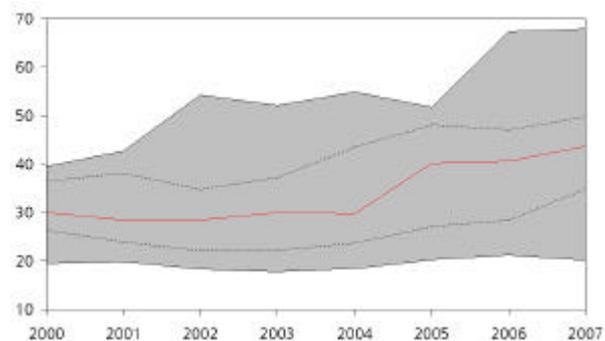


Chart 2: Major European banks' leverage ratios



Note: quantiles (min, Q2, median, Q3 and max) of the distribution of tier 1 capital and of the leverage ratio (total assets / tier 1 capital) of a panel of 15 major European banks.

Source: HM Treasury calculations based on published accounts.

¹ See, for example, comments by Philip Hildebrand, Chairman of the Swiss National Bank, in his speech *Is Basel II Enough? The Benefits of a Leverage Ratio*, Financial Markets Group Lecture, London School of Economics, 15 December 2008 (http://fmg.lse.ac.uk/upload_file/1147_Hildebrand.pdf)

3.5 If regulatory risk weights were perfectly designed and calibrated, a risk-based capital requirement would be sufficient to constrain the riskiness of banks' balance sheets. In practice, regulatory risk weights are subject to measurement and model error. For example, during the recent crisis, risk models tended to underestimate the risk of trading portfolios, providing banks with an incentive to expand their trading activities.²

3.6 In such circumstances, a properly designed and calibrated leverage ratio (total assets and off balance sheet exposures to Tier 1 capital) provides an important complement to risk based capital requirements. The purpose of such a requirement is to provide a backstop constraint to ensure that some minimum level of capital is maintained in good times. This would serve as a mitigant against the risks of inaccurate modelling and/or mismeasurement in setting risk weights, and also against excessive, unsustainable growth in absolute balance sheet size, which otherwise risks diluting capital standards over time. It can therefore be a useful complementary tool at the micro-prudential level and for the banking sector as a whole.

3.7 Introducing another requirement makes it more difficult for banks to "game" capital requirements (either actively taking advantage of inconsistencies or through engaging in activities the riskiness of which is underestimated). A dual approach (as implemented by the Canadian authorities, for example) ensures that the incentive to leverage up created by the risk-based approach is countered by the leverage ratio, while the incentive to hold riskier assets (which is created by the leverage ratio) is countered by the risk-based capital requirement.

3.8 To be effective, the leverage ratio should:

- be simple and transparent so that it is comparable across banks and can be easily understood by stakeholders, thus enhancing market discipline;
- be comprehensive, by including both on and off balance sheet items;
- be a mandatory element in Pillar I of the CRD; and
- only bite for well-managed institutions when in a period of excess credit growth, as the purpose of such requirement is to complement rather than undermine the risk-based approach.

Definition of the leverage ratio

Capital

3.9 Consistent with the overall emphasis on enhancing the quality of capital, Tier 1 capital (or a higher quality definition of capital) should be used to determine the leverage ratio.

3.10 The leverage ratio is one of the tools aimed at increasing the resilience of financial institutions, and so it is appropriate that the capital measure used to determine the ratio only encompasses going concern loss-absorbing capital. A high quality definition of capital also encourages banks to issue high quality loss absorbing capital in good times, and helps to create consistency across regimes.

3.11 Complying with such a requirement should be made easier by the proposed increase of higher quality capital under the risk based capital requirement. As part of an overall package, the introduction of a leverage ratio, if properly calibrated, will efficiently complement other evolutions with limited cumulative impact on capital requirements.

² See Box 6 in the December 2009 version of the Bank of England Financial Stability Report.

Assets

3.12 The overriding principle should be to design a simple, transparent and comprehensive measure of assets.

3.13 This principle can guide most design issues. For example, the exposure measure should consolidate off-balance sheet special purpose vehicles. In addition, since providing credit protection through writing a credit derivative is economically equivalent to providing a guarantee, it is appropriate that these exposures are treated identically, with the exposure under a written credit derivative measured at its notional value, i.e. the amount that the institution could be liable to pay under the terms of the protection.

3.14 Although concerns have been raised regarding the impact of accounting rules³, the UK believes that these issues can be resolved. Technical solutions can be (and in some cases already have been) designed to overcome differences in accounting practices.

3.15 Regarding the treatment of derivatives exposures, a case can be made for requiring derivatives to be measured on a gross basis, in order to remove incentives for institutions to manipulate leverage ratios by creating netting positions. This would also incentivise the standardisation of products and the trading through exchanges and clearing houses.

3.16 On the other hand, preventing netting and imposing the same leverage ratio on banks that undertake significant investment banking activities as on those that do not (as the preference for a simple, transparent and comprehensive measure would suggest) would either require a curtailment of those investment banking activities or implementing a leverage ratio that is unlikely to ever have an impact on banks that predominantly undertake commercial / retail banking activities.

3.17 Overall, further analysis appears necessary on this issue and the results of the QIS will be critical in determining the effect of different approaches to netting.

Nature of the requirement

3.18 The leverage ratio should be a mandatory element in Pillar I of the CRD for the following reasons:

- by its very nature, any "back-stop" must have the assurance that comes from a binding or automatic measure;
- a Pillar II tool is open to level playing field considerations especially regarding regulatory arbitrage; and
- the risk arising from being over leveraged is easily quantifiable using a rules-based approach and as the crisis has shown, constitutes a major source of risk to the financial sector. This means it is appropriate to be treated under Pillar I rather than under a discretionary Pillar II.

Calibration

3.19 The results of the QIS will provide critical information to help inform design decisions and calibration.

3.20 More generally, concerns have been raised that a leverage ratio may undermine the effectiveness of risk based capital requirements. For example, there is a risk that if the leverage

³ For example regarding the treatment of SPEs under US GAAP and IFRS.

ratio, rather than risk weighted capital requirements, becomes the binding constraint on banks, this could penalise those holding low risk assets and encourage them to boost their holdings of risky assets.

3.21 The UK believes that these are primarily issues of calibration. As discussed above, the leverage ratio should be seen as a backstop constraint in good times, as opposed to a constraint that binds most of the time. The purpose of the leverage ratio is to complement the risk-based approach, so it should be calibrated so it only bites on well-managed institutions when in a period of excess credit growth.

3.22 Choosing the highest quality capital and the broader definition of assets to calculate the ratio will help to ensure that the leverage ratio binds in benign economic conditions. Whether or not such a definition would cause a problem in a downturn needs to be explored. Broadly, however, the UK would expect firms to operate at a lower level of leverage (higher leverage ratio) than that imposed under the regulatory requirements, just as they hold capital above the current risk-based capital requirements.

4

Counterparty credit risk

Introduction

4.1 The UK supports the approach set out in the Commission Services Staff Working Document to tackling weaknesses in the risk capture and calibration of the counterparty credit risk framework that were exposed during the financial crisis. In particular, the UK:

- agrees that capital should be held against volatility of Credit Value Adjustments (CVA), and that “wrong way risk” should be accounted for through calibrating the Expected Positive Exposure to include a period of stress;
- supports the proposed approach to strengthen the use of collateral;
- is broadly in favour of increasing the Asset Value Correlations for large financial institutions.

4.2 While generally supporting the proposals in the Commission Services Staff Working Document, the UK does not support a zero capital charge for central counterparties, and would caution against allowing firms to use their own estimates of Alpha.

Requiring a stressed measure of Expected Positive Exposure

4.3 The UK fully supports the proposed changes to the exposure metric to ensure it includes a period of stress. Stressed Expected Positive Exposure (EPE) is a loan-equivalent measure that retains the desired sensitivities of EPE to the factors that drive exposure at default such as initial margin and the non-normality of the exposure distribution. The stressed calibration acknowledges that defaults tend to cluster in periods of market stress and is therefore more effective than the current EPE measure at capturing generalised wrong way risk (which was recognised as a notable weakness of the existing framework during the recent crisis).

Loan-equivalent Credit Valuation Adjustment (CVA) charge

4.4 The UK supports the introduction of an explicit capital charge against the volatility of CVA. Fair value losses on OTC derivatives attributable to a relative deterioration in the credit quality of an institution’s counterparty have proved to be a significant source of P&L volatility, and thus counterparty credit risk, over the crisis. That there is currently no capital held against the risk of CVA volatility is a considerable weakness of the current framework.

4.5 The extent to which using a bond is appropriate to proxy CVA risk is less clear. The UK believes that a relatively simple CVA requirement, which is sensitive to volatility in credit spreads, should be appropriate as an interim solution. However the bond-equivalent approach may not be particularly well aligned with the way some firms calculate and hedge their CVA in practice. There is no universally defined methodology by which CVA is calculated, and indeed firms adopt widely different practices. Consequently the risk of CVA volatility is likely to be interpreted very differently by individual firms.

4.6 No standardised requirement could accommodate this heterogeneity and there is a risk in creating a 'one-size fits no-one' approach, whereby some firms are effectively required to calculate, hedge and hold capital against a risk that they do not recognise. That said, the UK does not recognise the concerns of firms who oppose a CVA capital charge on the grounds that they do not calculate CVA. It is best practice for firms to calculate CVA; for those that do not, we should not be concerned about this misalignment between the 'risk' and the capital charge.

4.7 Due consideration must also be given to the types of hedges that are allowed to offset any CVA capital charge. A balance needs to be struck between widening eligible hedges to include those instruments which we observe firms are currently using to hedge CVA for which there is a deep and liquid market, and between minimising the resulting basis risk (i.e. the mismatch between the counterparty and the reference entity/index underlying the hedge) which cannot be captured under the bond-equivalent method.

4.8 Many of these problems arise due to the simple and standardised nature of the capital charge. To some extent, these problems could be avoided under a more advanced modelling based approach whereby firms could identify the sensitivities relevant to their own CVA and calculate the risk accordingly. While the UK would not go as far as to suggest firms should be necessarily permitted to develop their own VaR of CVA methodologies for regulatory capital purposes, depending on industry feedback to the consultation, there is a case for exploring a more practical measure for sophisticated firms to adopt in the interim.

4.9 The UK also notes the apparent contradiction that arises due to the fact that firms are permitted to use CVA as an offset to regulatory expected loss. It may be seen as somewhat contradictory to require capital to be held against CVA volatility, when CVA losses, once incurred, are reversed out for the purposes of the regulatory capital calculation. The UK believes that the Commission should give further consideration to whether these two policies can coexist in a coherent prudential framework.

Use of own estimates of Alpha

4.10 While in theory, it would seem unnecessary to prohibit firms from modelling Alpha given that the use of their own estimates is subject to supervisory approval; our concern is that modelling Alpha is a technically demanding exercise and one which, to-date, no firm has successfully managed to achieve. In view of Alpha's complexity and the likely difficulties in developing a comprehensive and exhaustive framework for its approval, there is a risk of inconsistency in the approval process, particularly across different jurisdictions.

4.11 The potential for such jurisdictional arbitrage can often precipitate a 'race to the bottom' in terms of modelling standards. The UK believes that almost all firms are some way from developing compliant internal models of Alpha. Therefore, the risks in permitting own-estimates seem firmly weighted to the downside and there are strong reasons to prohibit them.

4.12 Similarly, if Alpha is seen as a tool for recalibration – as suggested in the consultation – then it is necessary to prohibit own estimates. Currently Alpha is not an element of the calibration (it is simply the ratio of economic to regulatory capital, and is therefore unique to each firm). If Alpha is simultaneously used to alter the calibration then it is no longer unique to the firm and therefore can no longer be modelled.

Multiplier for asset value correlation for large financial institutions

4.13 The UK is broadly in favour of increasing the asset value correlations for large financial institutions and fully agrees that further work is desirable in calibrating the size and scope of any adjustment. There are difficulties in measuring asset value correlations, and the results are sensitive to the method employed. The UK therefore believes that any further quantitative

analysis should be more top-down in nature and focus on the capital implications of the proposals following the QIS exercise. It should also take into account the work that the Commission plans, and the work already underway by the Basel Committee, on assessing the degree to which firms are systemic.

Collateralised counterparties and margin period of risk

4.14 The UK is wholly supportive of the Commission's strategy on strengthening the utilisation of collateral. Financial collateral is one of the key mechanisms for reducing counterparty credit risk and thus capital requirements held for OTC derivatives, securities financing transactions and long settlement. The proposals address gaps that have been identified in the current framework, but it will be necessary to rely on the results of the forthcoming QIS to affirm the adequacy of the increased supervisory floors.

4.15 Volatility adjustments applied to securitisations need to be adequate. The UK believes that further analysis is needed to assess whether the new adjustments for securitised collateral should be double the adjustments currently applied to corporate debt. Furthermore, the UK would encourage the Commission to review the continuing suitability of the volatility adjustments applied to all eligible collateral to ensure that they capture the observed volatility and illiquidity, especially over the last 18 months.

Central counterparties

Risk weights on CCP exposures

4.16 In allowing firms to assign a zero Exposure at Default (EAD) to mark-to-market and collateral exposures to a central counterparty, there is no requirement to hold capital against the resulting counterparty risk, and thus an implicit suggestion that central counterparties cannot default.

4.17 However, no exposure is risk-free, and the UK is concerned that a zero-percent risk weight represents a systematic understatement of the risk, and will also disincentivise the risk management and monitoring of CCP exposures. The UK would caution against imposing a 0% risk weight against any exposure, particularly exposures to highly-systemic counterparties such as CCPs. Furthermore, in prescribing a zero capital charge, there is a moral hazard risk that authorities are viewed as effectively pre-committing to support the CCP in the event of default.

4.18 The UK does acknowledge, however, that the 'true' risk weight on these exposures may well be very small. Replacing 0% with something positive, but small should not (materially) prejudice any capital incentive but has a valuable signalling benefit in that it makes it clear that CCPs are not perceived to be free of default risk.

Risk management elements in CCP standards

4.19 The UK believes that the priority must be to achieve global consistency in CCP standards for both banking and central counterparty regulation. CPSS-IOSCO is beginning to undertake the detailed quantitative analysis and review work that should inform the more technical areas of the standards, i.e. margining and default fund requirements. Until this is completed, the UK would caution against trying to pre-empt the conclusions of this work by recommending detailed and prescriptive changes to the current ECB-CESR standards.

4.20 At this stage, the UK would simply note that it is essential that ECB-CESR closely reflect the recommendations of CPSS-IOSCO. Given the misalignment in timescales, the UK believes the Commission should, in designing the legislation, focus on high-level principles in the Level 1 text and supplement that as necessary at Level 2 to harmonise with the work of CPSS-IOSCO.

Enhanced counterparty credit risk management requirements

4.21 The proposed review of the Counterparty Risk framework has been designed to address most of the areas of weakness identified in the measurement and management of counterparty risk. The areas covered are distributed across the spectrum of risk management: the exposure calculation, collateral management and practices, stress testing, backtesting, validation, specific and general wrong way risk and the calculation of CVA for bilateral counterparty risk. The higher correlation between financial institutions has also been addressed. Further requirements relating to the confidence level for minimum margin requirements and liquidation periods are also suggested for CCPs.

4.22 Whilst the UK view these changes as an important step forward, it has been recognized that the review has only addressed a number of specific topics in isolation, leaving the wider framework untouched. Therefore while the proposed set of changes will serve to enhance and strengthen the overall counterparty credit risk framework, as it currently stands, they do not address the entire suite of risk measurement and management requirements for bilateral counterparty risk and CCPs.

4.23 Among the areas not included in the current review and which may need to be subject to further work, either in the form of new requirements or as guidelines, are: data integrity and data quality, review of the Mark to Market method and of the Standardized method, collateral eligibility, the appropriateness of collateral haircuts, and senior management awareness and involvement. On the subject of collateral haircuts, the Commission may also wish to take into account the comprehensive report published recently by the CGFS: 'The role of margin requirements and haircuts in pro-cyclicality'.¹

¹ *The role of margin requirements and haircuts in procyclicality*, CGFS Publications No 36, March 2010 (<http://www.bis.org/publ/cgfs36.htm>)

5

Countercyclical measures

5.1 A package of policy measures is likely to be needed to address different aspects of the pro-cyclicality of financial markets. Accordingly the UK supports taking forward all the following measures identified in the Commission Services Staff Working Document (and also discussed in the Basel consultation paper of December 2009):

- forward looking provisioning - to reduce the cyclicity of expected losses;
- cyclicity of minimum capital requirements - to reduce the cyclicity of capital requirements;
- counter-cyclical capital buffer – a variable buffer to restrict discretionary distributions of banks’ earnings during the upswing of the economic cycle so as to increase the resilience of banks to subsequent economic shocks. This is also likely to contribute to broader macroeconomic stability by leaning against excess credit growth; and
- capital conservation buffer – a buffer to be used by banks to absorb losses when hit by an idiosyncratic or market-wide shock. Banks will be expected to pay a penalty for breaching the buffer by conserving capital in terms of restrictions in their dividend distributions.

5.2 Whilst these various measures do have the potential to overlap, as long as they are correctly calibrated they will prove complementary rather than duplicative; all of them are important regulatory tools. Note in particular that taken on its own the capital conservation buffer will not have a counter-cyclical effect as neither the size of the buffer nor the restrictions associated with breaching it will change over the economic cycle. Taken in isolation, this measure would not, therefore, address the G20’s requirement for regulatory reform to address pro-cyclicality.

Forward looking provisioning

5.3 As discussed above, the UK believes that a package of tools is needed to address the pro-cyclicality of financial markets. The UK supports work at EU level and internationally to explore options to introduce more forward looking provisioning. It is sensible that, where possible, banks provision for losses they can reasonably expect to make, and that capital distributions are not made on the basis of unreasonable profit expectations. The UK welcomes the IASB’s work to explore options to introduce more forward looking provisioning, and the Basel Committee’s engagement in this process.

5.4 There are a range of options under consideration, including the “expected cash flow (ECF) model” being considered by the IASB, “above the line” dynamic provisioning as proposed by the Commission and “below the line” through the cycle reserving, which could be presented in a regulatory income statement.

5.5 The EU has committed through the 2002 regulation that all listed European companies must apply International Financial Reporting Standards. To introduce, at a European level only, an above the line through the cycle measure would necessarily imply a divergence from international accounting standards. Convergence, particularly with Asian economies, enhances

European firms' access to international capital markets. Such an approach also risks undermining the EU's commitment to the independence of accounting standard setters.

5.6 Regarding the Commission's suggested approach to calculating a potential through the cycle provision if it were deemed desirable, the UK considers that a methodology based on IRB estimates, as opposed to common supervisory estimates at a country level, might be sensible. However, the UK would welcome clarity on whether the Commission intends institutions to:

- convert IRB estimates into proper through the cycle measures – which is conceptually correct but carries implementation challenges; or
- use the IRB estimates, or at least the PDs, without adjustment -which would be more simple to operationalise but would not have the same counter-cyclical impact - in some cases proving little different from the existing incurred loss approach.

Capital buffers

5.7 In the absence of regulatory requirements, many banks did not choose to hold a large enough buffer at the top of the last cycle, nor were they compelled by market discipline to do so.

5.8 By definition, banks cannot use capital that is part of the regulatory minimum to absorb losses. Therefore, if the purpose of increasing capital requirements is to enhance the resilience of banks to shocks to the economy or financial markets, there is a case for requiring banks to hold an additional buffer or buffers that can be drawn down in times of stress, but the use of which during the upswing of an economic cycle carries sanctions in the form of restrictions on discretionary distributions of earnings. (Comparisons can be made to the prompt corrective action approach employed in the US, which places mandatory restrictions on bank's activities depending on capital ratios.)

5.9 There are a number of ways in which a counter-cyclical capital buffer and a capital conservation buffer could be implemented. The UK supports an approach where the counter-cyclical buffer should apply as a scalar to the fixed capital conservation buffer. The scalar should depend on an assessment of whether excess credit growth is leading to a build up of aggregate risk in the economy.

5.10 A number of specific issues relating to capital buffers are addressed below.

Counter-cyclical capital buffers

Objectives and design

5.11 A counter-cyclical capital buffer should aim to increase the resilience of the financial sector to economic shock, and make it less likely that credit constraints will amplify an economic downturn. It could also help to lean against excessive credit conditions and risk taking in the financial system, which can act to amplify an economic upturn.

5.12 Overall, the effectiveness of the buffer in enhancing the resilience of banks going into a downturn will depend on its size and how it is combined with other counter-cyclical measures such as through-the-cycle provisioning. In order to ensure the flow of bank credit to the real economy in a downturn, the authorities will need to be ready to release the counter-cyclical buffer proactively in a credit crunch, either to absorb current losses or to support further lending. In order to convince bank investors and creditors that this buffer is designed to be released, it is essential that the overall capital regime is communicated clearly to the market and is credible.

5.13 It is also worth considering whether counter-cyclical buffers could be implemented with reference to particular sectors that are judged to be to have built up excessive risks, for example, commercial real estate lending in the recent crisis. In this case, additional capital would be required to be held against assets that represent exposures to an over-exuberant sector.

Calibrating the counter-cyclical buffer

5.14 In order to calibrate the appropriate counter-cyclical capital buffer, an assessment would need to be made on the degree to which excess credit growth was leading to a build up of aggregate risk in the banking system. In an ideal world, it would be possible to identify a fixed rule that made use of one or more indicators to determine what the appropriate buffer should be at any point. As proposed by the relevant BCBS taskforce and the BIS, the credit-to-GDP ratio compared to its trend is likely to be an informative variable in assessing this risk, but it is unlikely that this variable – or any other combination of one or more statistical indicators – will be sufficiently robust in all circumstances according to a pre-determined rule. Among concerns are, that:

- particularly in relation to the release of the buffer, a simple rule is unlikely to be able to distinguish between demand-side and supply-side shocks to the economy – arguably the timing of the release of the capital buffer warranted by these two shocks might be different; and
- measuring the trend of credit/GDP is likely to be difficult, particularly as financial deepening reaches its limits in an economy; and the credit/GDP measure will vary cyclically with GDP, which may sometimes cause it to move for the ‘wrong’ reasons.

5.15 These limitations of a rules-based regulatory tool suggest that some discretion would be appropriate in setting the requisite counter-cyclical buffer. However, there are also concerns around the use of regulatory discretion, including:

- authorities are not necessarily more immune to “risk illusion” / “disaster myopia” than the markets they regulate;
- in an upswing, authorities are likely to come under pressure when raising counter-cyclical buffers – pressure that is easier to divert when policy is driven off rules rather than discretion; and
- increased discretion makes it harder to establish an international level playing field for financial services, and hinders comparability across jurisdictions.

5.16 In light of the above, it is likely that some combination of rules- and discretion-based policies would be most appropriate¹. As discussed in the Commission Services Staff Working Document, the authorities might exercise their discretion in increasing or decreasing the buffer as appropriate taking into account the broader range of information which supervisors and central banks will be able to consider in the context of the circumstances which prevail at the time. Constraints on the exercise of regulatory discretion could be considered in order to mitigate against the problems associated with a discretion-based regime (as above), for example:

- setting the relevant authorities clear and transparent objectives;
- an internationally-agreed ‘guide’ variable to which the authorities should make reference when setting the buffer eg credit/GDP compared to its trend; and
- requiring authorities to provide a published justification for their decisions.

¹ See Bank of England (2009), ‘The role of macroprudential policy’, for a more detailed discussion of rules and discretion.

Capital conservation buffer

Objectives

5.17 The purpose of the capital conservation buffer is to encourage banks to hold an additional buffer of capital to enhance their resilience to economic shocks. Moreover, there are clear advantages to rules based approaches in addressing time consistency problems. A Pillar 1 conservation buffer could act to increase bank resilience in a predictable and 'rules-based' manner.

5.18 However, it is important to recognise that a fixed capital conservation buffer on its own will not have a counter-cyclical effect; to have such an effect, it will need to be implemented alongside a counter-cyclical capital buffer.

Restrictions on distributions

5.19 The main discretionary distributions which could be subject to restrictions include the following:

- dividends on common equity;
- discretionary bonuses;
- share buy-backs; and
- discretionary dividends / coupons on some classes of shares and/or debt.

5.20 The UK does not believe it is necessary or appropriate to prioritise some distribution restrictions over others. Accordingly, when restrictions are required they should be imposed on the aggregate earnings pool, rather than on particular categories of discretionary distribution. An affected bank can then determine the way in which it distributes that portion of earnings that are not subject to restrictions.

5.21 It could be argued, for example, that restrictions on the payment of large discretionary bonuses should be prioritised given the link between discretionary bonuses and increased risk-taking. However, this risks confusing the purpose of the buffer - concerns over the link between risk-taking and remuneration are more appropriately addressed within the broader regulation of remuneration, where the UK continues to support the FSB principles. Accordingly, the UK sees no reason to prioritise distribution restrictions.

5.22 The UK supports the Commission's proposal that the restrictions on distributions should become progressively more severe as the bank draws down on the buffer and approaches the regulatory minimum capital requirement. It is appropriate that a bank that is closer to its minimum capital requirement should retain more earnings in order to shore up its capital levels.

5.23 From an operational perspective, a key concern is that the buffer level could become the new minimum if the sanctions for drawing on the buffer are too severe. Banks are likely to hold an additional precautionary buffer above the regulatory requirement. The more stringent the sanctions the larger the precautionary buffer is likely to be. Conversely, if the sanctions are too lenient banks may choose to operate within the buffer even in good times. In practice, striking the right balance will be very difficult. The Commission's suggested approach attempts to address this policy design challenge by making the severity of the capital conservation requirements on a bank a function of its distance from the regulatory minimum. In other words the share of earnings required to be retained by banks for the purpose of rebuilding their capital buffers increases the nearer their capital levels are to the minimum capital requirement (i.e. the more the buffer has been depleted).

5.24 Note that there may also be a case for considering other sanctions – for example, restrictions on acquisitions.

5.25 It also needs to be considered whether sanctions should escalate if a bank remains within a buffer for a prolonged period of time and whether the timing of this escalation process should be lengthened in times of stress.

Cyclicality of the minimum capital requirement

5.26 The UK welcomes the inclusion of this policy area in the Commission Services Staff Working Document. The UK agrees that it is too early to fully assess the cyclicality of the minimum capital requirement, as the first reports produced by the Basel Committee's capital monitoring group do not provide conclusive evidence about the cyclicality of the minimum or the potential pro-cyclicality of Basel II; these initial reports do in fact show relatively stable credit risk parameters (PDs, LGDs) since the implementation of Basel II in January 2008. However, the UK believes that the cyclicality of the minimum capital requirement should continue to be monitored and assessed going forward.

5.27 However, given this, the UK sees challenges in implementing through-the-cycle PDs in calculating through-the-cycle provisions (for those firms on IRB approaches), as suggested by the Commission Services. In addition, if through-the-cycle PDs are used for calculation of the through the cycle provision, whilst still allowing for the use of point-in-time PDs for regulatory capital expected loss calculations, the stock surplus/shortfall (expected loss minus provisions) could have pro-cyclical effects.

6

Systemically Important Financial Institutions

Addressing systemic importance

6.1 As the financial crisis has shown, large and interconnected institutions, particularly those that operate on a cross border basis, pose significant risks to financial stability and their failure or distress can impose huge costs on the rest of the financial sector and the wider economy. To mitigate these costs, governments chose to support some of the largest, systemically important financial institutions (SIFIs) to maintain financial stability, reflecting an expectation that some institutions are now too big to be allowed to fail (or partially fail) given the costs that such a failure would impose.

6.2 Efforts underway to strengthen capital and liquidity requirements will enhance the resilience of all banks, but the UK believes that additional measures are needed to address the risks posed by SIFIs. The objectives of these policies should be to: reduce the probability of their failure; mitigate the disruption caused in the event they become severely distressed or reach a point of failure; and to address moral hazard arising from an expectation that they will benefit from government support if they get into difficulty.

6.3 A range of policy options have been put forward to address the risks posed by SIFIs, including: recovery and resolution plans (RRPs) to facilitate their resolution; strengthening market infrastructures to reduce contagion risks; systemic levies aimed at discouraging activities that generate systemic risk; and structural changes. The UK agrees with the Commission that a package of policies is needed to address the risks posed by SIFIs, including enhanced national resolution regimes and the implementation of RRPs, which would require that firms themselves must plan for effective resolution and organise themselves internally so that they can be easily resolved. The UK is supportive of efforts by the FSB and its member bodies to develop by the end of October 2010 possible measures to address the “too big to fail” (TBTF) problems associated with SIFIs.

Prudential standards for SIFIs

6.4 The focus of the CRD consultation is on proposals to introduce strengthened prudential regulatory standards for SIFIs. The UK supports the principle, set out in the Commission Services Staff Working Document and agreed by G20 Leaders in Pittsburgh, that “our prudential standards for systemically important institutions should be commensurate with the costs of their failure”. To this end the UK believes that systemically significant firms should, consistent with risk based regulatory approaches, be subject to tougher regulation. This could involve, for example, enhanced governance arrangements, and making capital requirements on a firm dependent not only on the riskiness of its activities (and therefore the probability of the firm’s failure) but also on the degree of damage to the wider financial system that its distress or failure would cause. Other policy tools should also be considered, including liquidity requirements and tighter restrictions on exposures to other institutions under the large exposure regime. The relative merits of and complements between the full range of policy options should be assessed.

Measurement of systemic importance

6.5 A key challenge in designing and implementing policy instruments that are targeted at systemically important financial institutions is measuring ex ante the degree to which the failure of a particular firm poses a systemic risk. Systemic risk is dependent not only on the firm's size but also on other factors such as the degree of interconnectedness with the rest of the financial system, the quality of market infrastructure supporting the financial system as a whole and the prevailing circumstances at the time.

6.6 The IMF/BIS/FSB paper defines systemic risk as the risk of disruption to financial services imposing significant external costs on other parts of the financial system and on the real economy. It outlines three main principles they consider to be useful in identifying the systemic importance of a market and institution:

- size (this can be a function of the firm's absolute size or in relation to a specific financial market or product in which a firm is particularly dominant);
- substitutability (the extent to which other parts of the financial system can provide the same services in the event of a failure of a firm or financial market); and
- interconnectedness (this can include, inter alia, inter-bank lending, cross holdings of bank capital instruments, and being a significant counterparty in a crucial market).

6.7 The complexity of a firm's structure and other factors relevant to the ease with which a firm can be resolved by the authorities, including the quality of a firm's recovery and resolution plan, will also need to be taken into account. The UK supports efforts by the Basel Committee's Macroprudential Supervision Group to develop an indicator-based approach reflecting three aspects of systemic importance: size, inter-connectedness and substitutability.

6.8 Implementation of tougher prudential standards for SIFIs may require supervisory judgement, given the complexities of assessing a bank's systemic importance. But there is a significant risk that under a partly discretionary approach not all countries will impose tougher standards. A more rule-based approach may be necessary to ensure a consistent application of tougher prudential standards on SIFIs and so explicit measures or surcharges under Pillar 1 should not be ruled out at this stage pending completion of the work of the Basel Committee on SIFIs.

6.9 A key question is whether to categorise firms in a binary way (either systemic or non-systemic) or through using a more granular sliding scale based on the degree to which a firm is systemic. The Swiss Government has taken the former approach, imposing significantly tougher prudential regulatory requirements on its two largest banks. However, the UK believes that there are in principle strong arguments for the latter approach. Identifying firms as either systemic or not might increase the dangers of moral hazard and may provide SIFIs with an incentive to increase their systemic importance once they are in the SIFI category. Similarly, a more granular sliding scale provides sharper incentives for banks to take steps to reduce their systemic importance.

Systemic importance across financial markets

6.10 The UK believes that the scope of regulation is a key issue and welcomes the steps that are being taken to implement the commitment made by the G20 in London in April 2009 that all systemically important financial institutions, markets, and instruments should be subject to an appropriate degree of regulation and oversight.

6.11 For the purposes of CRD IV, the UK believes that it is appropriate to concentrate on addressing the risks posed by systemically important banks, which played a central role in the recent financial crisis.

6.12 However, the UK recognises that other firms and infrastructure providers (both regulated and unregulated) can potentially be systemic, even though the risks they pose can be very different. The UK believes it would be appropriate, for example, to consider how to mitigate the risks associated with systemically important financial institutions with large insurance practices in the forthcoming fundamental review of the Financial Conglomerates Directive.

7

Single rule book

Areas where more stringent requirements are more necessary

7.1 As the UK outlined in our September 2009 response to the Commission Services Staff Working Document on further possible changes to the CRD, the UK is supportive of a reduction in the number of national options and discretions within the CRD. This was subject to two overriding principles:

- where there is a choice between "levelling up" and "levelling down" it is important that the more prudent treatment is applied to avoid a general reduction in regulatory standards across the EU; and
- as set out in Recommendation 10 of the Larosiere report, Member States need to retain the ability to impose stricter capital requirements and/or adopt more stringent national regulatory measures considered to be domestically appropriate for safeguarding financial stability. We also believe that this should include liquidity standards.

7.2 With regard to the latter point, our interpretation of the CRD is that, while Pillar 2 can deal with specific negative circumstances at individual credit institutions, it is not necessarily a 'substitute' for appropriate Pillar 1 requirements where there is a need for clear, transparent standards to be maintained by all institutions subject to supervision by the competent authority.

7.3 The UK noted in our response several areas where it would be appropriate that national discretion remain. These were on:

- standard rule risk weights for residential and commercial mortgages;
- use of the country assessment method instead of the credit assessment method for bank exposures;
- specific risk charge for covered bonds (where the UK did not support 'levelling down'); and
- [a single definition of default set at 90 days (where the UK believes this would not in practice achieve a consistent definition of default and where this would, in most cases, act to reduce capital requirements in the UK).]

7.4 The UK also note in particular, in the advice given to the Commission by CEBS, the explicit recognition that there will still be a very small number of national discretions that remain justified on the basis of genuine differences in local market characteristics.

7.5 The UK recognise and support the change in approach taken to national options and discretions in the current consultation. As the UK understand, it is now being proposed that a discretion can be formulated around a specific circumstance, thereby obviating the need to identify these circumstances as 'national'. This is a sensible approach.

7.6 However, the UK see difficulties with this general approach where assets are similar, but their markets are different, and different in many ways that will, in practice, prove impossible to 'specify' with sufficient clarity. In particular, this will apply to real estate and other forms of

collateral (e.g. physical collateral such as say farm machinery). Here, different national markets have widely different underlying mechanisms of supply and demand, which lead to wide differences in pricing and liquidity.

7.7 The UK is concerned that the proposed approach would not be able to deal with these genuine national circumstances, leading to the imposition of imprudent asset weightings and thereby restricting growth or causing asset price bubbles in national markets.

7.8 The UK proposes that the Commission request CEBS to conduct a review of where individual markets have characteristics defined by their nationality and for national discretion to be allowed to apply appropriately in these markets.

Treatment of real estate lending

7.9 The UK welcomes that the proposal to fully harmonise the preferential treatment of exposures secured by real estate property based on very tight LTV requirements has been withdrawn. The UK believes this would have negatively impacted the prime UK residential mortgage market by increasing prices where there is no evidence of risks warranting higher capital requirements than those applied under the current UK implementation of the standardised approach for residential mortgage exposures. It would also negatively impacted the UK commercial mortgage market by reducing prices in a market which has been prone to volatility.

Suggested prudential treatment for exposures secured by mortgages on residential property

7.10 As discussed above, the UK believes real estate markets are not harmonised across the EU and believe this is an area where a national, rather than specific, discretion is warranted.

7.11 The owner occupation rate in the UK differs greatly from many member states. In addition to further demographic differences, the UK also has housing supply constraints that entail a unique market environment. The UK mortgage market differs significantly from that of many other European countries. In the UK, most mortgages are variable and linked to the bank base rate, whereas in other countries mortgages are fixed for durations of up to 25 years.

7.12 In the UK an 80% LTV is applied for preferential treatment of residential mortgages under the standardised approach. The UK does not think that a lower level would be appropriate as according to our evidence, mortgages with LTVs under 80% have not suffered significant rates of default. Losses in 2008 on UK exposures with an LTV below 75% were zero and increased to 0.4% for exposures where the LTV is between 75% and 95%.¹

¹ Source: FSA estimates based on survey of UK lenders

A Liquid assets buffer and liquidity waiver

A.1 This Annex:

- explains in detail the rationale for setting a narrow definition of assets eligible for the enhanced liquidity buffer proposed in the CRD IV consultation document; and
- describes a set of conditions which would need to be met for the UK to be willing to consider a waiver model to disapply the application of liquidity standards on a legal entity level.

Rationale for a narrow, single-tier definition of liquid assets

A.2 The definition of assets eligible for the enhanced liquidity buffer proposed in the CRD4 consultation document should provide a simple and robust definition that will meet the test of time. This means that only those assets most likely to enable the bank to generate liquidity within a period of severe stress should be eligible, and that a multiple-tier buffer should be avoided to minimise the risk of standards erosion over time. The paragraphs below set out these arguments.

Government bonds¹ are the assets most likely to remain liquid in times of banking sector stress

A.3 The December BCBS paper 'International framework for liquidity risk measurement, standards and reporting' recommended that the stock of eligible liquid assets should comprise high quality liquid assets that a bank can sell, repo or otherwise convert into cash irrespective of the bank's own conditions and the market dislocations assumed in the specified scenario (short of a complete loss of confidence in the bank that jeopardises all private counterparty relationships) without accepting large 'fire sale' discounts or haircuts.²

A.4 Apart from cash and central bank reserves, it is government bonds that most readily and obviously meet these requirements. In times of stress, investors systematically buy government bonds, i.e. government bonds benefit from a flight to quality. This means that, far from the possibility of losing value in a crisis, government bonds actually increase in price.³ This is particularly the case for high quality government debt of credit rating AA- and above. In addition, when hit by a liquidity shock, banks tend to move to secured funding markets. And most collateral passing through private repo markets is government debt.⁴

¹ And central bank reserves, which are liquid by definition.

² It is important to note that the LCR scenario falls short of describing an *aggregate* liquidity shock, where a number of institutions (or the sector as a whole) are subject to a large withdrawal of funding sources. In this scenario, only one institution suffers a large withdrawal of funding sources, and hence only one institution is liquidating its stock of assets.

³ For example in the recent crisis the yield on US Treasury Bills turned negative during the most acute phase of the crisis reflecting the demand for them. More generally, across government bond markets (of countries whose banking system was under severe stress) bid-ask spreads and credit spreads remained low.

⁴ The ICMA repo market survey of European banks consistently shows that more than 70% of all repo activity is secured on government bonds. More generally, it is government debt that other commercial banks are willing to accept as collateral in a crisis. For example, more than 90% of collateral posted pursuant to ISDA master agreements is either cash or government bonds.

A.5 A liquidity coverage ratio based on holdings of cash, central bank reserves and government bonds also creates a strong financial incentive for firms to manage excessive liquidity risk and to price liquidity risk adequately because government bonds impose a significant opportunity cost on banks. This incentive structure is much weaker and possibly non-existent where there are wider definitions of liquid assets such that firms would be able to profit from their holdings of liquid assets.⁵

A.6 Other assets are far more susceptible to illiquidity and price volatility during periods of banking sector stress. Such periods are typically correlated with periods of stress in the real economy. Therefore, assets originated in the real economy (e.g. corporate debt or mortgage assets) are liable to become illiquid because of credit risk concerns. Because of this, investors tend to sell these assets in times of stress, accentuating any price volatility.

A.7 This is particularly the case for banking sector liabilities. In times of banking sector stress, banking sector liabilities are highly likely to become illiquid. Covered bonds, in particular, should not be an acceptable form of prudential liquidity. If permitted in the buffer, banks will be likely to issue covered bonds to one another, and a bank's liquidity will be contingent on the solvency position of another bank. As such, the financial incentives for the banking sector as a whole to constrain liquidity risk disappear. This clearly reduces the effectiveness of the LCR and does not support a prudent outcome. The experience during the recent crisis has confirmed that covered bonds are not resiliently liquid instruments. As a 2008 ECB report points out⁶, the uncertainty surrounding covered bonds led market-makers to reduce the level of market liquidity they provided to these instruments. This led to wider bid-ask spreads, smaller trade sizes and periods of suspension in market-making. During this period, a bank would have found it extremely difficult to obtain sufficient liquidity by repoing or selling its portfolio of covered bonds.

A.8 Equities are also inadequate form of regulatory liquidity. Equity market prices are highly sensitive to large liquidations and the repo markets for equities are shallow. Large scale liquidation of equities by a number of banks will have significant impact on the value of equities leading to knock on effects for insurance companies and pension funding. This is not a credible proposition.

A.9 If an institution attempts to sell any of these assets at 'fire sale' prices, the institution, and other financial institutions holding the same asset, will suffer mark-to-market losses. The application of haircuts cannot prevent this. The alternative to sale is repo. But as seen during the recent crisis, counterparties are unlikely to accept assets as collateral (even with a haircut) if there is significant uncertainty over the future price of the asset. Even if repo markets do stay open, there is a real risk that counterparties require a larger haircut than was assumed under the regulation in normal times. It is also a risk that haircut standards get eroded over time (e.g. many people thought that structured products were liquid pre-2007).

A.10 It has been noted that governments are exposed to credit risk too, and therefore their debt is susceptible to falls in liquidity. This is true of course. But the government (either domestic or of the home regulator) is ultimately the provider of capital and liquidity support if the banking sector is in trouble.⁷ In this situation, the liquidity even of central bank money may be called into question. Protecting against the possibility of that government defaulting is beyond what prudential regulation can protect against.

⁵ For example, many firms, as they expanded their internal definition of liquid assets prior to 2007, were able to profit both from taking additional liquidity risk and increasing the buffer of assets held to insure against a stress.

⁶ http://www.ecb.eu/pub/pdf/other/coverbondsintheeufinancialsystem200812en_en.pdf

⁷ In this respect it is notable that governments are, almost without exception, a lower credit risk (as measured by ratings) than all banks in their respective economy (i.e. the credit rating of the domestic government tends to provide an upper bound on the credit rating of the domestic banking sector).

The case for a single tier of liquid assets

A.11 In addition, there are strong arguments in favour of having a single-tier buffer. In particular, it mitigates the risk of an erosion of standards over time.⁸ By agreeing to a multiple-tier buffer, supervisors are at a greater risk of succumbing to pressure by firms to relax the criteria of the different tiers over time. For example, supervisors may come under pressure to accept second-tier assets as part of the first-tier buffer. This has been the case with the composition of capital buffers, whereby relatively less loss-absorbing capital was gradually included in both Tier 1 and Tier 2 capital over time. This risk is higher if the definition is reliant on a number of subjective assessments.

A.12 A simple and transparent definition such as that set out above ensures international harmonisation (as far as is possible, given the caveats set out in paragraph 3). The potential for significant differences to emerge across national supervisors and banks is limited. There is no need for complex rules setting out the extent to which different assets are eligible or the possible haircuts that can be applied. Hence, a definition such as that outlined above is the surest way of ensuring an international level-playing field.

A.13 One criticism of a restrictive definition that has been highlighted is that it does not recognise the liquidity value of other assets on the balance sheet. This is not a valid criticism. The liquidity coverage ratio is only one part of the regime and will represent a relatively small part of the balance sheet.⁹ Other parts of the regime – the Net Stable Funding Ratio and contingency funding plans – will recognise the liquidity value of other assets. The point of a regulatory stock of liquid assets is to make sure that banks are holding a core of highly liquid assets. It is not appropriate to include assets in the stock whose liquidity value is uncertain. But where they clearly have some liquidity value, that value should be fairly reflected in coming to an overall view of the liquidity of their balance sheet.

A.14 Another concern raised about the unintended effects of a narrow liquidity definition is the impact upon the demand of assets excluded from the definition. While potential market disruptions need to be taken into account when sequencing reforms, it is clear that the definition of regulatory requirements (for liquidity) should not be used to increase the attractiveness of certain assets at the expense of a more resilient European liquidity regime.

Liquidity waiver

A.15 The UK fully supports the application of liquidity standards on a legal entity level. Subject to appropriate safeguards, we are willing to consider the idea of deviating from this approach through a waiver model. However, in addition to the general considerations set out in the chapter, the additional conditions set out in the table below would have to be met:

⁸ A simple definition such as this also means that consistency can be applied across the LCR and the NSFR.

⁹ And indeed, a stock composed solely of government bonds will be smaller (as a proportion of the balance sheet) than a stock composed of a wider range of assets, because with a narrow definition firms will have greater incentives to reduce the size of the stock requirement.

Upfront arrangements between home and host supervisors	Upfront arrangements between host supervisor and parental undertaking of firm seeking waiver
<p>Written agreement from the home competent authority that:</p> <p>(1) it will notify the host supervisor of any material or persistent breaches by that undertaking of the home competent authority's liquidity rules, or of risks that such breaches are imminent;</p> <p>(2) it is satisfied with the adequacy of the parent undertaking's arrangements for liquidity risk management;</p> <p>(3) it is satisfied as to the adequacy of the parent undertaking's liquidity resources including:</p> <p>(a) the size and quality of its liquid assets buffer; and</p> <p>(b) the size and quality of any liquidity resources that are held in the host state for the purpose of meeting the liabilities of an applicant firm as they fall due;</p> <p>(4) it does not object to any undertakings given by that parent undertaking in respect of an applicant firm to ensure that the firm has adequate liquidity resources; and</p> <p>(5) it will have due regard to the views of the host supervisor in its supervision of the liquidity position of that parent undertaking.</p>	<p>Written agreement from the parental undertaking of the firm seeking liquidity waiver that:</p> <p>(1) it will make available liquidity resources at all times to that applicant firm if needed;</p> <p>(2) it will enter into an undertaking in a suitable form with an applicant firm committing it to provide liquidity support to that firm on the occurrence of certain defined events;</p> <p>(3) it will ensure that the applicant firm maintains liquidity resources of appropriate size and quality in the host state for the purposes of meeting the liquidity needs of that firm;</p> <p>(4) it will maintain arrangements, including having adequate liquidity resources, to ensure that it, the applicant firm and any other entities in its group to which it provides liquidity support are able to wind down their businesses in an orderly and controlled manner in circumstances where its, or their, businesses cease to be viable;</p> <p>(5) it will make available to the host supervisor regulatory data</p> <p>(6) it will provide 12 months notice to the host regulator of any intent to withdraw from the undertaking.</p>

B

Impact of CRD IV reforms

Introduction

B.1 The policy proposals outlined in the consultation are likely to have a substantial impact on banks' balance sheets, costs and business models, as well as consequential implications for market structure. At the same time, and by increasing financial stability and reducing economic volatility, these changes will also deliver significant economic benefits to the wider economy.

B.2 However, at present, the lack of detailed information on the overall mix and calibration of the proposed policies renders it difficult to provide a detailed and exhaustive response to the Commission's request for information on the benefits and costs of the proposals.

B.3 The UK therefore requests that the Commission services have regard to the following considerations in assessing the impact of the proposals:

- The impact assessment must go beyond assessing the micro impact on firms' current balance sheets, and analyse also the macroeconomic costs and benefits of the policies in order to achieve the optimal calibration of policy.
- Cross-sectional data analysis, along the lines of a QIS analysis, is valuable but has important limitations. Detailed analysis of firms' current balance sheets provide a static picture and will reveal little detail on the likely behavioural responses by firms, including unintended consequences, which are key to understanding the costs and benefits of the proposals; and
- The impact assessment should consider the effects of the different proposals as a package. Policies may interact with important implications for costs and benefits, and the proportionality of the whole package is unlikely to be equivalent to the sum of the proposals considered individually.

Macroeconomic costs and benefits of prudential regulation

B.4 It is essential that the impact assessment of the proposals contained in the Commission's consultation document goes beyond compliance and capital/liquidity costs to consider the macroeconomic costs and benefits of the proposals. It is critical to understand the impact of the package of policies on the volume of financial services, such as credit supply, and hence reduction in lending and outputs. It is equally important to have a measure of the benefits of the policies in terms of the reduced likelihood of distress in the financial sector, and the resulting losses in real output.

B.5 Only when policymakers have this information can they make a decision about the design and calibration of capital requirements, which is optimal for society as a whole, including judgements on the appropriate level of capital and liquidity (among other key parameters of the prudential framework). By contrast, the QIS exercise primarily yields information on the current *micro* impact of specific measures on banks' current balance sheets without any response function and therefore mostly informs short-term decisions such as the design of transitional arrangements.

B.6 The FSA have worked with the National Institute of Economic and Social Research to produce a version of their well-respected model of the UK economy (“NiGEM”) which incorporates a banking sector and therefore can be used to assess the costs and benefits of changes in capital and liquidity requirements. We provide details of this model, should the Commission consider adopting a similar approach.

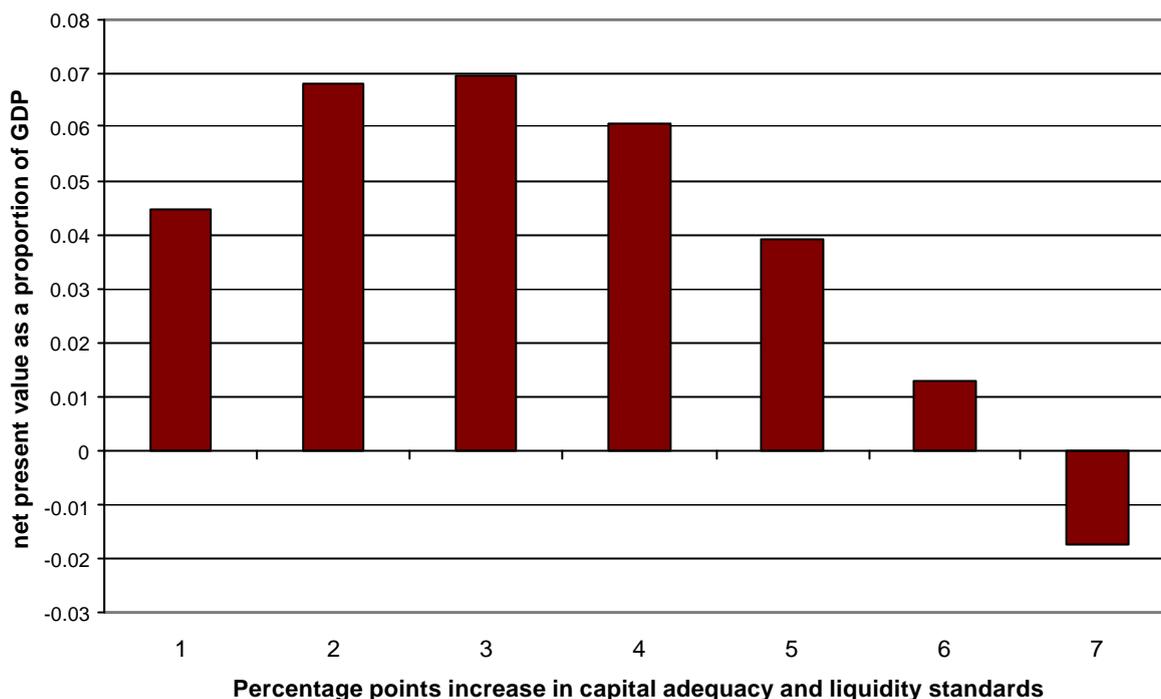
B.7 NIESR’s approach to calculating a “macro-economic cost-benefit analysis” proceeds as follows. Financial crises raise risk premia in the economy. This restricts the future formation of capital as the suppliers of capital demand higher returns. Consequently, financial crises can reduce long-run economic output by lowering the level of GDP for a sustained period, in addition to the immediate short-term loss of output. Higher prudential standards can reduce the probability and impact of financial crises. Benefits therefore arise by avoiding this loss of output as well as the immediate costs of any crisis. It is also possible to model the benefits of reduced volatility, which raises society’s level of welfare, although this is an issue that would require further work. Offsetting this benefit is the impact of tougher regulatory requirements on the availability and price of credit in the economy. Increases in the amount of capital and liquid assets that banks hold can be expected to increase the costs that banks face in providing credit to the economy¹. Thus tougher regulation is expected to increase the price of credit supplied by banks to firms and consumers. This increase in capital and liquidity requirements for banks will tend to suppress macroeconomic activity during the upswing of the business cycle and reduce the level of GDP from the level achievable without the increased cost of regulation (other things equal).

B.8 Preliminary results of the work done by the FSA and NIESR are shown in Figure 1 below, which is reproduced from FSA Discussion Paper no. 09/04². These are subject to significant caveats and should not serve to base policy decisions on them. On the horizontal axis is the percentage point increase in both capital and liquidity standards (i.e. “1” is a one percentage point increase in both capital and liquidity standards from the actual levels of capital and liquidity held in 2007 by major UK banks). The vertical axis shows the net present value of net benefits expressed as a proportion of current GDP. These figures are indicative only, since they do not include a number of improvements which have been made to the methodology since the publication of the paper, and as discussed above there are important caveats associated with this type of analysis as described in the DP referenced above. However it is clear that substantial increases in prudential standards generate net benefits even relative to the actual levels of capital and liquidity held by UK banks prior to the financial crisis. The implication is that a large increase in minimum standards of capital and liquidity can be achieved without net macroeconomic costs.

¹ FSA research has shown that, in responding to higher capital requirements, banks tend to shrink their lending and other risk-weighted assets, implying a withdrawal of credit supply from the economy. See FSA Occasional Paper no. 36, <http://www.fsa.gov.uk/pubs/occpapers/op36.pdf>.

² A more detailed description of the modelling process is included in <http://www.fsa.gov.uk/pubs/occpapers/op38.pdf>.

Chart 7.A: Macroeconomic cost benefit analysis of capital and liquidity standards - preliminary results



Limitations of cross-sectional data analysis

B.9 We note that a European Quantitative Impact Study (QIS) is to be conducted by the Committee of the European Banking Supervisors, which is substantially the same as the Basel Committee QIS. This type of analysis can provide very useful analysis about the extent to which policy proposals would be binding on firms at a particular point in time, or over a short time horizon. This information can be used to calibrate policies so as to achieve the desired changes. However, there are two major limitations to the usefulness of a QIS exercise:

- since the QIS only tells us the potential impact of policies at one point in time, it does not tell us the extent to which policies may be binding given changes in firms' balance sheets and business models. For example, capital constraints may become relatively more binding in an economic upturn such as the one experienced in 2000-07, since risks of lending in such a period may be under-estimated³. In contrast, during and in the aftermath of a crisis, capital ratios tend to be at relatively high levels due to declining loan demand and a re-appraisal of risk by investors and regulators. Similar fluctuations are observed for liquidity, which tends to fall during upturns and rise during downturns⁴; and
- a QIS exercise provides limited information on how bank-specific behavioural responses may translate into sector-wide changes, which may have implications for financial stability and macroeconomic outcomes. For example, a firm will have a deficit of capital, but it will not tell us whether the bank will choose to raise the new capital, or whether it will seek to meet the new requirement partly by reducing its risk weighted assets instead, for example by reducing lending. Equally, if a firm

³ The research literature indicates that capital ratios tend to move against cycles, i.e. in period of high economic growth capital ratios tend to rise, and that capital requirements tend to be binding in a period of sustained economic growth (see FSA Occasional Paper no 31 for a review of this literature: <http://www.fsa.gov.uk/pubs/occpapers/op31.pdf>).

⁴ The cost of capital and liquidity, calculated as the spread between capital and debt, and liquid and non-liquid assets respectively, tend to be highly cyclical, i.e. they fall during an upturn, partly due to misperceptions of risk and strong investor demand. This may affect firms' likely responses to change in policy.

does choose to raise capital, we need to know what instruments prove to be the most attractive vehicle, since in the upturn period it would have been possible to raise capital levels using relatively low quality tier 2 capital which did not prove to be loss-absorbing during the crisis.

B.10 It is also important to consider possible unintended consequences of new policy, such as the implications for banks' risk-taking incentives. Imposing constraints on banks' liquidity or capital adequacy may cause them to increase the level of risk, for example by lowering lending standards or investing in risky trading assets. While FSA research has shown that firms responding to increases in risk-weighted capital requirements tend to reduce risk as measured by regulatory risk-weights⁵, firms may also seek to increase risk in ways that are not captured in the regulatory risk-weighting process. For example, the growth in securitisation and build up of structured credit products in the trading book prior to the recent crisis was arguably due to regulatory risk-weights that had been set too low to capture the full systemic risks posed by these products.

B.11 Therefore, as well as measuring the impact of policies on banks' current balance sheets using the OIS, the impact assessment should include analysis of how the policies are likely to affect banks over the economic or financial cycle. In particular, it should consider potential behavioural responses from banks which may affect the benefits or costs. These behavioural responses can be identified through discussions with market participants, through empirical research of responses to past policy changes, or from simulation of banks' balance sheets using assumptions about how they maximise profit given their risk preferences.

The importance of considering the joint-impact of policies

B.12 An additional risk in the impact assessment exercise is to consider the costs and benefits of each of the proposed policies in isolation. This could lead to a decision to proceed with a package of several policies without considering the joint impact of those policies. There are two reasons why the joint impact may be different from the sum of individual impacts of the policies:

B.13 The first reason for considering the impact of the policies as a package is that there may be important interactions between them, which have implications for costs and benefits. We list some important examples here, although there will be many more:

- if changes in liquidity policy or how firms provision for losses reduce firms' profitability, then they may raise the cost of raising capital to meet changes such as the revised definition of capital;
- a firm's substitution from non-liquid to liquid assets may reduce the firm's risk-weighted assets, which reduces capital requirements and hence also reduces the incremental cost of complying with capital policies such as the definition of capital and counter-cyclical buffers;
- the interaction of the leverage ratio with counter-cyclical capital buffers may affect the extent to which the buffers maintain their capacity to absorb losses in a period of stress;
- the introduction of through-the-cycle loss provisioning is likely to help assuage swings in capital over the cycle, by preventing firms from paying out profits

⁵ See reference in note 1 above. The literature has mixed conclusions on the theoretical impact of tighter capital standards on risk-taking, and this seems to depend crucially on the calibration of risk-weights.

resulting from short term discrepancies between incurred and through-the-cycle losses; and

- the changes in definition of capital are likely to reinforce banks' incentives to manage the assets side in response to changes in capital requirements, since the cost of changing higher quality capital such as equity is higher than the cost of lower quality instruments which may have been used to meet requirements during the upturn period.

B.14 The second reason for considering the policies as a package is that the incremental costs and benefits of a specific policy depends on how one defines the baseline, i.e. in terms of which policies have already been implemented. On the benefits side, the incremental benefits of further tightening of standards tends to fall as successive policy changes mean the financial system reaches a low probability of financial instability. On the costs side, as firms adjust their balance sheets to comply with new rules, they will make the least costly adjustments first (e.g. dropping business lines which are only marginally profitable), so that the marginal cost of further tightening of requirements will tend to increase. The declining incremental benefits and increasing marginal costs would tend to result in an optimal level of policy which can be indicated using macroeconomic cost-benefit analysis as described above.