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June 17, 2015

Mr. William Coen
Secretary General
Basel Committee on Banking Supervision
Bank for International Settlements
Centralbahnplatz 2, CH-4002 Basel
Switzerland

Re: Coherence and Calibration

Dear Mr. Coen,

The IIF and its member firms commend the Basel Committee on Banking Supervision for establishing the Task Force on Coherence and Calibration. The calibration and interplay of the various new regulatory reforms can have significant downstream consequences, both in banks' risk management practices and in market reactions, and we welcome the BCBS's initiative in focusing on these issues.

The IIF has mobilized a Working Group to identify and explore the most significant items in the revised regulatory framework where there are coherence and calibration issues. The IIF will be undertaking detailed analysis of these areas over the coming months, and it is our desire to foster a dialogue with the Task Force, particularly so that we can supply our analysis in a timely fashion to support the Task Force in its deliberations.

More immediately, we are pleased to share our initial thinking, in terms of the key items we have identified, and where we intend to concentrate our efforts to develop detailed analytical examples. We will be most grateful for any feedback and guidance you can offer, to ensure our analysis is of the most value for the Task Force.

Broadly, we have assembled our identified issues around three major themes:

- Market liquidity
- Risk and banks' balance sheets
- Banks' funding bases

A possible fourth theme relates to Sovereigns, whilst acknowledging that this is an upcoming item on the BCBS workplan, and that some specific issues relate more to national treatments.

Some of the more pertinent issues identified under these themes are summarized as follows:

Market Liquidity

We are concerned that the trend of reduced market liquidity could emerge as a new source of systemic risk, and that the conflux of new and proposed regulations could inadvertently contribute to this. We acknowledge that each of the various regulatory initiatives that have a bearing on this issue (e.g. trading risk capital, the leverage ratio and the NSFR) are valid when taken in isolation, but we feel that the accumulation of multiple reforms has led to much greater impacts than was perhaps intended. This affects not only banks' traditional role as market-makers, but also the ability to hedge and manage risk and the efficiency and robustness of the financial system.

Particular regulatory initiatives in this area include the higher capital requirements for trading books, the fact that repos and initial margins on derivatives are not netted under the Leverage Ratio's calculations, and NSFR asymmetries that discourage market-making activities.

We also note the potential for these impacts to be compounded should the standardized approach within the Fundamental Review of the Trading Book emerge as the binding constraint for market risk, whilst fully acknowledging that the BCBS is still to finalize the design and calibration of this initiative.

There have been measurable reductions in trading volumes and banks' inventories of various asset classes; for instance, corporate bond inventories have fallen by 75% in the US and 50% in Europe since 2007, making it more difficult for credit market investors to quickly buy or sell a security without moving its price. While some of the reduction in banks' inventories has been prompted by other drivers, such as banks unwinding large credit books post-crisis, we believe that new regulations have accelerated this trend.

Consequently, we are concerned that banks will be constrained in their ability to act as shock-absorbers in times of volatility, with the loss of liquidity (and increased concentration) potentially introducing a new source of systemic risk. Instability in secondary markets can also translate to a higher cost of issuance for corporates, with downstream economic impacts.

We stress that discussion and analysis in this area needs to take account of the current low interest-rate environment and extraordinary monetary policy settings. We are concerned that some of these downstream market impacts have been partially masked or under-stated to date because of the environment, but that they could pose significant new threats to system stability when rates rise in the future.

This market liquidity theme is one where the IIF already has analysis underway. Together with GFMA and ISDA, we have engaged PWC to further examine market conditions and possible frictions between regulations, as well as the impacts borne by buy-side firms and corporate issuers. We anticipate this report will be launched in late-June, and we will look forward to sharing its insights with the Task Force.

Risk and Banks' Balance Sheets

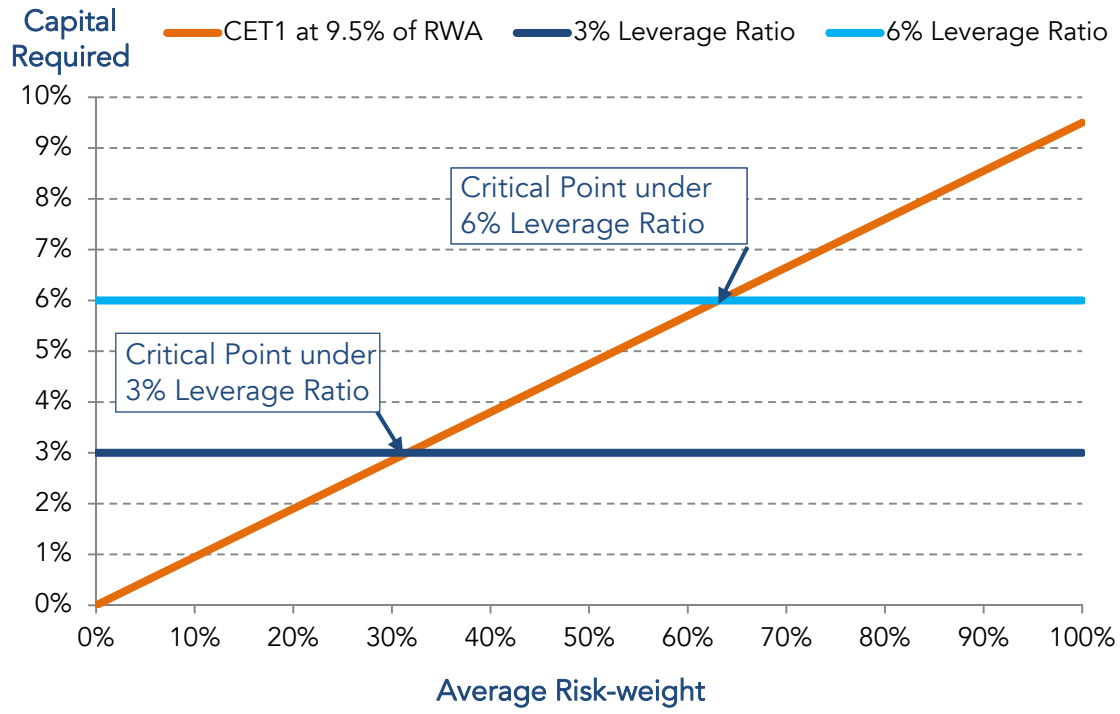
The IIF continues to emphasize the criticality of risk-sensitivity for effective portfolio construction and capital allocation, whilst acknowledging that banks need to continue improve and harmonize key elements of their risk modeling practices.

The nature in which the various instruments within the Basel capital framework (RWA, the proposed new Capital Floor and the Leverage Ratio) interact is then pivotal, and we are concerned that some possible calibration scenarios could introduce new risks, as well as generating economic and behavioral mis-incentives.

Whilst the calibration of the Capital Floor and the Leverage Ratio are still to be finalized, we see a risk that if these are calibrated at high levels, they will cease to provide complementary "backstop" measures and instead over-ride and overwhelm the risk-based measures, particularly for banks with strong credit portfolios. It is a concern where the Floor or Leverage-based measure ceases to be a "backstop", and instead becomes the binding constraint.

This was well articulated by the Bank of England in their July 2014 Leverage Ratio discussion paper.[1] Under a moderate Leverage Ratio, the Critical Point (intersection between risk-based and Leverage measures) would mean that the Leverage Ratio would primarily become the binding constraint for outliers with the more aggressive modeling approaches, though it could also unduly constrain custody banks with large levels of central bank deposits and other low-risk assets.

In contrast, a higher Leverage Ratio generates a higher Critical Point, becoming the binding constraint for the majority of the system.

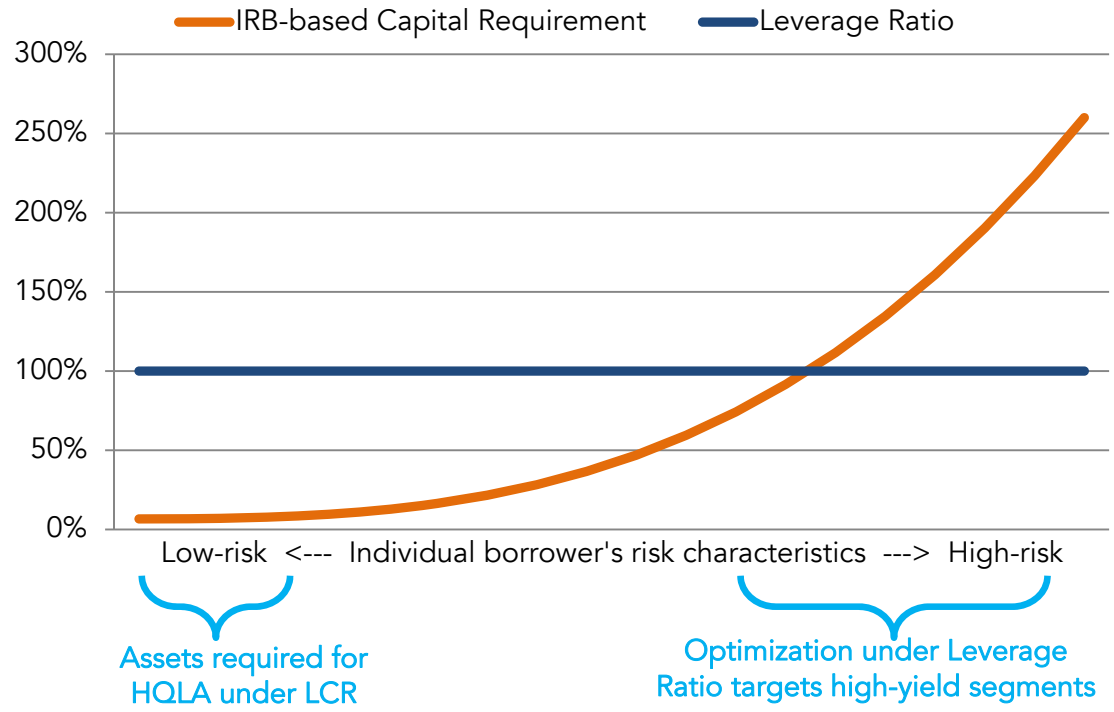


[1] Bank of England, *The Financial Policy Committee's Review of the Leverage Ratio: A Consultation Paper*, July 2014.

Such a scenario would see risk-return metrics being overshadowed, with prevailing capital metrics that mask the true level of risk and undermine efforts to embed a risk culture throughout institutions. Banks would be incentivized towards pursuing riskier transactions, and the internal business case for further investment in risk models would be weakened.

This is potentially compounded by the interaction between the LCR and Leverage Ratio. Whereas the LCR requires banks to hold an expanded portfolio of low-risk (and low-yielding) assets, those assets are then extended at their full nominal value under the Leverage Ratio, as are central bank placements.

Whilst some contend that this merely reflects the Leverage Ratio's status as a non-risk-based measure, this becomes significant in cases where the Leverage Ratio is a bank's prevailing capital measure (binding constraint). With the LCR's HQLA requirements providing a hard constraint, a bank that then seeks to optimize its returns under the Leverage Ratio would logically look to pursue high-yield/high-risk assets to offset this, as per the following illustration:



This could drive banks towards barbell-shaped portfolios (concentrated at either end of the credit spectrum), and away from assets in the middle-range, such as Investment-grade corporates. Apart from pushing strong credits out of the regulated sector, this phenomenon has impacts for the efficient allocation of capital throughout the economy, and is especially pertinent in economies that lack domestic capital markets as alternative source of finance for the local corporate sector.

Banks' Funding Bases

We share the BCBS's belief that banks should be encouraged to maintain a diversified funding base. Whilst initiatives such as the LCR and NSFR have helped to emphasize greater stability of funding profiles and larger liquidity buffers, we are concerned that the intersection of these

with other initiatives could instead encourage a limited type of funding model which would increase concentration risk and decrease the funding options open to corporates.

For instance, a potential conflict emerges between the stable funding imperatives of the LCR and NSFR and the FSB's TLAC proposals. Whereas the LCR and NSFR emphasize the stable value of retail and operational deposits as a funding source, TLAC will require banks to issue other wholesale debt instruments, even in the case of banks that are fully funded with stable deposits and equity.

Where a fully-funded bank is required to issue subordinated debt (or similar instruments) that it might otherwise have no need for, this may then compel that bank to expand its balance sheet, and find assets where its surplus subordinated-debt funding can be deployed. To offset the higher funding cost and maximize returns (particularly if the Leverage Ratio is the binding constraint), these new assets could logically be from the high-yield end of the credit spectrum.

Alternatively, banks may use this subordinated debt funding to replace other (traditionally stable) sources of funding, not only increasing cost, but leaving banks with a reduced appetite to take retail deposits. Potentially large volumes of TLAC issuance could also crowd out non-financials from raising funds from institutional markets.

Concurrently, we note that some of the suggested structural reforms could impact stable funding, particularly if banks were required to segregate or ring-fence the part of their business with a stable retail deposit base away from other business lines. This would firstly lead to a loss of diversification in funding-bases.

Furthermore, such segregation would require Institutional banking operations to be funded from long-term wholesale debt (for LCR/NSFR compliance), moving out along the funding curve and most likely causing an increase in costs for borrowers. This segregation would likely also lead to lower yields for depositors.

We acknowledge that these issues are not uniquely within the BCBS's domain, for instance where BCBS initiatives might intersect with those of the FSB. We nevertheless believe these are highly relevant within the scope of Coherence and Calibration, taking a holistic view.

As well as embarking on new analysis on this topic, the IIF has already examined some aspects of the NSFR's impacts on equities and derivatives with Oliver Wyman, which we will be happy to share with the Task Force.

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We understand that the Task Force is at an early stage of its endeavors, and it is our desire to engage and assist the Task Force in alleviating the issues that we have raised. We consider the effort to ensure stability without generating undue externalities to be a shared objective, and also a shared responsibility.

To this end, the above describes a sub-set of our initial identification of key issues, with further candidate items listed in the Appendix. Our intent is to numerically analyze some priority items

from within this set, beyond sharing the outcomes from the upcoming PWC Market Liquidity report.

We reiterate that we understand and acknowledge that the BCBS is still reviewing treatments for a number of these issues, including sovereign exposures, and that some of these concerns are forward-looking and pre-emptive on rules that are yet to be finalized. Recognizing that context, we feel these issues are worth considering, and hope that we can contribute worthy analysis in support of the BCBS's deliberations on some of those matters.

We would be most grateful for your feedback on the issues we have identified, and your views on prioritization and on the Task Force's envisaged timelines. We are very keen to ensure that we focus and sequence our endeavors where they can most support your Task Force's activities, and will appreciate any guidance you can offer on this.

Once again, congratulations on launching the Coherence and Calibration initiative. The IIF is pleased to support the BCBS in this important undertaking, and we stand ready to assist wherever possible.

Sincerely,

Appendix

The following lists the initial coherence and calibration issues identified by the IIF Working Group:

1. Market Liquidity:

Market liquidity across a range of asset classes is being reduced by the conflux of multiple regulatory initiatives, including:

- Capital –eg. higher capital requirements for trading books; the anticipated changes under the Fundamental Review of the Trading Book; repos and initial margin on derivatives that aren't netted under the Leverage Ratio's calculations; increased buffers that have driven deleveraging, especially on corporate bonds
- Liquidity – where banks are required to hold large stocks of High Quality Liquid Assets (HQLA) such as sovereigns, this encourages holding (rather than trading) such assets, and a preference for sovereigns over other assets
- Funding – NSFR asymmetries on matched-book repos, inventories of securities and derivatives, which deter market-making activities and discourage securities lending transactions
- Structural Reform (eg. Volcker Rule) – a previous PWC study found that 90% of universal banks had either stopped or substantially reduced their proprietary trading
- Proposed post-trade transparency requirements

The individual validity of each of these initiatives is acknowledged. It is the interaction and compounding effects of these that have affected liquidity, and which warrant consideration.

These will each be explored in more detail as part of the Market Liquidity report, currently being undertaken by PWC.

2. Risk and Banks' Balance Sheets

Specific instances of where the coherence of multiple regulatory reforms could lead to increase in banks' risk profiles are as follows:

Issue Description	Potential implications for banks' risk management	Potential market implications
Interaction of RWA (under IRB models), Capital Floors and Leverage Ratio: whilst calibration of the Leverage Ratio and proposed Capital Floors are still to be finalized, there is a risk that if these calibrated at high levels, they will cease to provide complementary "backstop" measures and instead over-ride the risk-based measures	Risk-return metrics overshadowed, such that prevailing capital metrics mask the true level of risk, undermining efforts to embed a risk culture throughout institutions; banks are incentivized towards riskier transactions, creating a scenario of adverse selection on credit portfolios; business case for further investment in risk models weakened	Capital allocation is distorted, favoring weaker credits and with pricing anomalies; Better disclosures could help to mitigate the RWA variance issues, whereas Capital Floors and the Standardized Approach may actually create misleading comparisons between banks

Issue Description	Potential implications for banks' risk management	Potential market implications
Interaction between the LCR (HQLA requirements) and Leverage Ratio: the LCR requires banks to hold a portfolio of low-risk (and low-yielding) assets (and central bank placements), which are then extended at their full nominal value under the Leverage Ratio	With LCR/HQLA providing a hard constraint, optimizing under the Leverage Ratio requires pursuing high-yield/high-risk assets	Banks are driven towards barbell-shaped portfolios, and away from assets such as Investment-grade corporates in the middle range; shrinking balance sheets will also impacts banks' behaviors for lending to SMEs
LCR HQLA and Derivatives: collateral requirements are both exacerbating a scarcity of the same assets. Concurrently, the NSFR discourages securities lending transactions that could otherwise provide liquidity and reduce transaction costs in these securities.	Inability to secure high-grade collateral; possible need to loosen liquidity policies or widen asset eligibility; greater use of lower-grade collateral with higher levels of over-collateralization required; banks hold more sovereign risk (concentration) in their balance sheets	Implications for other participants who may be crowded out of HQLA; higher cost of hedging due to use of weaker collateral with larger haircuts; reduced capacity of sovereign debts that authorities can utilize for policy measures
Leverage Ratio and Trading Books: collateral and margin are not considered by the Leverage Ratio	A distorted view of in trading activities is created, not representing the true risk of the business	Distortions to the economics of trading activities could increase the cost of hedging
IRRBB & Derivatives: increased costs of regulatory requirements in hedging interest rate risk, against an increased IRRBB capital requirement if unhedged	The increased cost of hedging may encourage banks to take greater interest rate risk; however, increased IRRBB capital requirements may drive the other way	Increased costs associated with funding; note: national consistency element, given that some nations already have IRRBB capital requirements
IRRBB & FRTB: alignment of potential new regulations	As the proposed approaches for IRRBB and FRTB are refined and calibrated, it is important that these reflect the true underlying risks, and are not over-ridden by standardized approaches that could present a distorted picture	If a standardized approach to IRRBB over-rides modeling of behavioral elements, increased capital requirements could deter the provision of credit

3. Banks' Funding Bases

Issue Description	Potential implications for banks' risk management	Potential market implications
Potential structural reform and stable funding: the potential for banks to be segregated/ring-fenced with stable retail deposit funding separated from other business lines	Loss of diversification in funding-bases	Institutional banking operations required to fund from long-term wholesale debt (for LCR/NSFR compliance), causing an increase in funding costs; possible lower yields for retail depositors
LCR/NSFR funding imperatives and TLAC: whereas the LCR & NSFR emphasize the stable value of retail and operational deposits as a funding source, the FSB's TLAC proposals require banks to increase issuance of subordinated debt-type instruments, even for banks that are fully funded with stable deposits and equity	Where banks are compelled to issue subordinated debt that they otherwise have no need for, they may then have to expand their balance sheet, and find assets where their surplus sub-debt funding can be deployed – to offset the cost and maximize returns under the Leverage Ratio, these may be riskier assets	Higher funding costs, potentially reflected in borrowing costs; banks' reduced incentive to take retail deposit funding (perhaps lower margins paid for deposits); could crowd out non-financials from raising funds from the debt markets note: need to consider TLAC single counterparty limits also
NSFR & Derivatives: whilst the NSFR requires longer funding tenors, there are higher CVA capital requirements for longer-dated hedging; CVA sensitivities are greatest for hedges that are longer-dated and involve a principal exchange, such as Cross-Currency Swaps	These have a compounding impact on banks that raise funding offshore, such as in economies that lack sufficient pools of domestic savings. The deterring costs of long-dated cross-currency swaps may encourage banks to either (i) take greater FX risk (go unhedged), or (ii) pursue more local funding where possible (increase funding concentration risk)	Higher cost of funding, for those banks that rely on sourcing from offshore, such as in many Emerging Markets; Also higher hedging costs for corporates that raise funding offshore

We also note that there are interdependencies between the NSFR and RWA requirements (for instance, the application of RSF values according to a 35% threshold of mortgages risk-weighs), which may need to be reviewed depending on the eventual outcome of current RWA consultations.

4. Other Topics

Beyond those three major themes, some additional items identified are as follows:

4.1 Sovereigns

- LCR-HQLA requirements and capital requirements: potential increases in risk-weights on sovereign exposures may encourage banks to shift their liquidity portfolios towards other assets, perhaps weakening the quality of those portfolios; potential Pillar 1 requirements for Interest Rate Risk could add to such impetus
- Increased capital requirements for sovereign exposures may add to the impetus for banks to balance their overall credit portfolio (and optimize return metrics) with greater high-risk/high-yield assets
- Potential concentration caps: where there have been suggestions to introduce concentration caps on banks' exposure to a particular sovereign, this could contradict HQLA requirements, particularly in markets that lack markets of alternate (private) liquid securities
- Home-host aggregation treatments, where multi-national firms are required to hold local sovereign assets in each of their subsidiaries' liquidity portfolios; this can sometimes see low (or zero) risk-weights apply at the subsidiary level, but not when aggregated at the group-level. This issue extends beyond sovereigns in some jurisdictions, to also include Level 2 liquid assets and potentially cumulative levels of additional buffers.

4.2 National-level Calibration Issues

Whilst the following examples of calibration issues at national-level are perhaps best reviewed within the BCBS's process for Regulatory Consistency Assessment Programme, we feel it is appropriate to reference these:

- Required Reserve Ratios and the Leverage Ratio: different national reserve requirements can generate different Leverage Ratio values for banks, even where they have identical equity and balance sheet positions
- LCR-HQLA portfolios and revaluation reserves: if interest rates rise on the assets held as HQLA, revaluation reserves will be reduced, thereby reducing banks' capital levels, even as the economy improves; some national regulators currently apply prudential filters to address this, and we would support a more consistent application of this approach