March 31, 2010

Secretariat of the Basel Committee on Banking Supervision
Bank for International Settlements,
CH-4002 Basel, Switzerland.

Re: Consultative Document - Strengthening the resilience of the banking sector.

I am an economist specialized in macroeconomics. Additionally I have over 20 years of experience working in the banking industry, particularly the last 12 years in management of regulatory capital. I work in a well-known financial entity and I prefer to keep my name secret. That's why I chosen confidentiality. Nevertheless I expressly authorise you to publish this letter if you consider it convenient.

I welcome the opportunity to comment on the Basel Committee on Banking Supervision's Consultative Document: Strengthening the resilience of the banking sector. I strongly support this initiative, and specially the fact that proposals seem to be focused in restoring confidence in the effectiveness of the regulation. However I'm worried about the possibility that political interest could interfere in the process, bringing out an overregulation that could be visibly shown and being secretly nullified by using grandfathering clauses that would last until the next crisis.

I want to propose the inclusion of 2 additional points to the discussion. Both are related to the systemic risk, both takes into account the cost of capital and both are simple technical additions to enhance el benefits of the rest of the regulation.

1. **A capital charge related to the complexity of the banking group should be established.**
   There is a risk to the system that comes from the legal abilities to circumvent regulations. This is independent to the size of the banking group and will not be eliminated by limiting the activities of the bank. This capital charge should be calibrated to disincentive the abuse of special purpose vehicles.

2. **A floor should be established on sovereign risk so that capital required is always above zero.**
   That means to eliminate or reduce the existing national discretion that all governments use in its own benefit. This will reduce the procyclicality of the system. Also, this "capital cost" will disincentive the use of regulatory arbitrage structures and will eliminate the profitability of huge regulatory trading transactions. If this change is not made the new regulations could reduce the flow of credit available to the private sector.

Some reasons supporting my proposals are included in the Appendix attached

Sincerely,

Anonymous

Appendix

COMPLEXITY CAPITAL CHARGE

The past crisis was a regulatory crisis. The financial system based its interbank settlement procedures on the believing that the effective supervision reduces the risk. At a certain moment regulatory noncompliance was so evident that well managed banks lost its trust on supervision, and they increased its credit spreads above the past crisis ones.

This loss of confidence is part of the systemic risk, and we must search its origins on the supervision itself. The effectiveness of the supervision must be based in the clear definition of the supervision scope.

Please consider that If a bank wants to avoid regulation, then the best way is to isolate the activity to hide and take it out of the reach of the supervisor. One of the most used methods was the design of SPV that moves the activity just amid the difference between regulatory and financial consolidation perimeters.

This “regulatory avoidance activity” is not illegal, but is unfair and appears in transactions between banks and/or corporations. Entities involved share the savings in the cost of capital. It is very common in investment banking and wholesale financing and is almost impossible in retail banking.

As competition between banks moves away the regulated system, then the positive effect of the banking industry on the real sector of the economy disappears and the risk on the banking industry itself increases.

To keep bank activity within the regulated system is positive for the economy, would also reduce supervision difficulties and reduce credit spreads in interbank financing. Also, as a positive side-effect, it could improve financial transparency.

The easiest way to achieve this goal is to eliminate the savings in the cost of capital that encourages the abuse of SPVs. A capital charge calculated on the number of legal entities of a banking group could help. To avoid damaging fair business the capital charge should count the number of legal entities proportionately to the size of the entity or established as a minimum per legal entity.

This capital charge should be simple, direct and easy to calculate.

SOVEREIGN RISK FLOOR

If a national supervisor uses its discretionary clause then there is no regulatory capital required for sovereign exposures in local currency. This feature of sovereign exposures has 3 main side-effects:

1. **Procyclicality.**

Zero Sovereign risk is an incentive to procyclicality:

Usually banks need more capital when the lower part of the economic cycle comes. At that time banks has 3 options, to preserve capital (i.e. capital increases or reducing dividends), to reduce capital consumption or to significantly increase credit rates. The economic rationale will lead banks to reduce the capital consumption because it coincides with its objective of maximising profits (reducing credit risk to avoid excessive credit loss).

Even if banks are forced to build up capital buffers they will react in the same way if they want to maximise profits.

Appendix

In addition to this behaviour, banks have the economic incentive of reducing capital requirement by substituting private sector risk with sovereign risk, which increases its financing requirements just at the same time.

2. **Subsidies government financing.**

Zero Sovereign risk implies a subsidy from the rest of the economy:

When a national supervisor uses its discretionary clause then there is no regulatory capital required for its financing needs and no cost of capital is assigned to sovereign exposures in local currency. This is an economic incentive to redirect bank lending to the public sector, changing the optimal allocation of resources of the economy.

The negative effect of this distortion is proportional to the difference between zero and the real credit spread of the sovereign.

3. **Use in regulatory arbitrage transactions.**

Zero Sovereign risk is the optimal building block of regulatory arbitrage:

There is an asymmetry between measurements made by risk departments to assess the viability of transactions and the measurement that is performed to evaluate the regulatory capital.

This asymmetry is unavoidable and is due to the different target of each measurement. However, although such measurements are not identical they must maintain a certain similarity.

If the asymmetry is big enough then trade opportunities appear. The profitability of the transactions depends on the difference between the real valuation of the risk and the different marginal cost of the regulatory capital required. The banks can trade risks between them according to their capital strength.

If a national supervisor uses its discretionary clause then there is no regulatory capital required and no cost of capital assigned to sovereign exposures.

This no-regulatory-capital-cost asset is perfect to be used as the currency of regulatory capital transactions. This in turn, incentives regulatory arbitrage.

A capital floor implies the assignment of cost of capital to these exposures and could eliminate regulatory arbitrage transactions, eliminating the excessive leverage and reducing transactions to those necessary to reallocate risks among banks according to capital strength.

All of these 3 side effects already have negative influence on the economy. That influence will be increased proportionately to the increase of cost of regulatory capital.

Many of the regulatory changes (ie. the new “common equity” ratio, the exclusion of minority interest, the changes in deductions, the reinforced requirements of additional tier 1 or tier 2 capital and the capital buffers) will increase the cost of regulatory capital.

Consequently, from an economic point of view, we can anticipate that the establishment of the regulatory changes will lead to an increase of the negative side-effects of the government discretionary clause.