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Dr. Nout Wellink
Chairman
Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002 Basel
Switzerland

Dear Dr. Wellink,

Response to Basel Committee on Banking Supervision (BCBS) Consultative Documents:

General comments

The proposals set out in the consultative document are wide-ranging, with an ambitious implementation timeline. It is of the greatest importance that the cumulative impact of implementing all proposals at the same time be evaluated carefully to ensure that their impact on the macro economy and the functioning of capital and credit markets are fully understood. While the proposals as outlined may have merit unilaterally, the likelihood of unintended consequences and secondary effects being precipitated, if they are implemented as a collective package, is very high.

To comply with the proposed regulations, banks will have to grapple with a higher cost of capital, and potentially reduced capital supply as investors reassess the reduced attraction of investment returns from the banking sector. At the same time, the new liquidity requirements could trigger a surge in demand for liquid assets, the supply of which may be inadequate. The ramifications are likely to extend beyond the banking sector: availability of credit to the wider economy could be curtailed, and increased disintermediation could adversely affect economic activity, as consumers and businesses are impacted with increased costs.

It is also of critical importance that the final package of rules be introduced on a globally coordinated basis and be uniformly applied. Consistency in requirements and the permitted timeframe for compliance is necessary to ensure that there is a level playing field. Otherwise, there is a risk that the entire process of global reform will be undermined as a result of regulatory arbitrage; moreover, in the absence of a coordinated and uniform approach, some risk-taking activities may shift to more opaque and less comprehensively regulated parts of the banking system, which would have an impact on systemic stability.

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Document: Strengthening the resilience of the banking sector

Quality, consistency and transparency of the capital base

While we support the broad policy intent underpinning the changes proposed, we note that grandfathering rules are presently not aligned across jurisdictions; this will favour banks which are given more scope to issue under existing structures and grandfather them, while penalising others.

Across the industry, there appears to be different interpretations of the grandfathering language outlined in the consultative document: some are of the view that instruments issued prior to the new rules becoming legally effective will be grandfathered, while others expect all issues executed after the release of the consultative documents to be consistent with the new proposals. To achieve a level playing field, and for better comparability across banks, grandfathering rules should be aligned across jurisdictions.

A transition period that allows too little room for manoeuvre could result in a sudden spike in the cost of capital, arising from a combination of two developments: (a) a sudden slew of new issues beyond what the market can absorb could materialise once the rules are clarified; and (b) qualifying instruments under the proposed rules are likely to be more costly and, in some jurisdictions, also lose their tax-deduction benefit. This could trigger unintended procyclicality effects. The focus on going concern capital may also result in a smaller investor base being targeted, with fixed income investors featuring less prominently as capital providers.

In order to be consistent with the grandfathering rules, banks should be required to comply with the revised permitted limits for the various instruments constituting the capital structure after an appropriate transition period. The calibrated limits must be consistently applied across jurisdictions. National discretion could also be granted for temporary departures if deemed necessary e.g. allowing for the limits to be varied in order to counter pro-cyclicality forces and allow greater flexibility in recapitalisation.

Enhancing risk coverage of the capital framework

One of the proposals put forth to strengthen the capital requirements for counterparty credit exposures arising from banks' derivatives, repo and securities financing activities is the introduction of a capital charge for credit valuation adjustment (CVA) risk. We note that various methodologies are being proposed as part of the accompanying QIS. One method is to proxy the capital charge by a "bond-equivalent of the counterparty exposure" approach, using market risk computation methodologies (standardized or internal models) and a 1-year liquidity horizon. As part of the QIS results review, it would be useful if the BCBS could evaluate the appropriateness of including the general market risk capital charge component as part of the overall CVA risk.

Banks could have also taken a charge for unearned credit spreads through P&L; the BCBS should review if this could be used to reduce the CVA risk charge.

Supplementing the risk-based capital requirement with a leverage ratio

Instituting non-risk sensitive measures to complement risk-based ones have limited value. The proposed methodology to compute the leverage ratio appears to have elevated the quest for simplicity (netting of derivatives, repo style transactions etc being disallowed; written credit protection being included at notional value; direct flow-through of AFS reserves to capital) above all other prudential objectives. As far as possible, risk-based measures which are not inconsistent with broad accounting principles should be admitted as components constituting the leverage ratio.

Reducing procyclicality and promoting countercyclical buffers

The various issues covered under this broad topic are methodologically challenging to standardise. It is also difficult to build consensus among many important constituents, including accountants and regulators. In particular, the proposed framework to build capital buffers through capital conservation is at risk of becoming too rigid, such that there is no room for management discretion. For example, the inability to pay dividends may hinder recapitalisation plans, thereby curtailing the pursuit of intended remedial measures. There could be implications on the structuring of, and investor reception to, capital instruments as well.

The capital management process, in general, is dynamic and needs to satisfy the demands of many different parties. As such, it is best undertaken through a consultative process, and accommodated within Pillar 2. Capital buffers are highly susceptible to misinterpretation by the markets and it may not be advisable for any capital conservation ranges to be made public.

Document: International framework for liquidity risk measurement, standards and monitoring

Definition of high quality liquid assets

If financial corporate bonds were to be completely disallowed as part of banks' liquid assets, banks' ability to raise long-term debt as part of its stable funding base would be compromised by the reduced market demand for such instruments.

The proposed requirements on what would constitute "liquid assets" may put banks operating in emerging markets at a disadvantage since there might not be a sufficient supply of qualifying debt securities in their markets. As a consequence, entities operating in locations where there are insufficient local currency-denominated liquid assets/securities and have to resort to purchasing foreign currency-denominated ones, such as US Treasuries, to maintain ratios, thereby incurring additional foreign exchange and country risks as a result.

Taken together, these recommendations may result in a substantial increase in funding and liquidity costs. In particular, the "reserve" cost for the banks could increase significantly if liquid assets are narrowly defined to exclude other non-government securities and bonds issued by financial institutions

Net Stable Funding Ratio (NSFR) assumptions and multiplier calibration

The current NSFR assumptions can be a challenge even to banks with strong liquidity positions and healthy loan-to-deposit ratios. Under the proposed assumptions, banks with strong balance sheets may still have to raise substantial long term funding from long term debt issues. From the supply angle, retail and corporate customers, in general, do not have a preference or the risk appetite to place long dated deposits. Together with the earlier point made on disqualifying bonds issued by financial institutions as liquid assets, the imbalance in the supply and demand for long term funding will become pronounced, impacting both compliance costs and timelines.

We would propose that, apart from adjusting the risk factors and/or the qualifying benchmark, BCBS could also consider applying different sets of NSFR factors for financial institutions of different size ratings, strength and countries of operation. This can be achieved through permitting a greater scope for national discretion to be exercised in applying these factors – national regulators can take into account different country demographics, business environment, sovereign ratings, and the specific credit ratings of each financial institution in calibrating the appropriate NSFRs.

Conclusion

We are in the midst of a major overhaul of the global banking and financial system. Besides the BCBS proposals, changes are also taking place in accounting standards, as well as the legal framework governing banks. The various constituent elements of the jigsaw have to be pieced together before full clarity can emerge, and the final impact ascertained: we urge the Basel Committee to start this process when they meet in May.

Yours sincerely,

Piyush Gupta.