European Bank
for Reconstruction and Development

Mr Nout Wellink, Chairman of the Basel Committee
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Comments on the Basel Committee on Banking Supervision's proposals to strengthen global capital and liquidity regulations

Dear Mr. Chairman,

On behalf of the European Bank for Reconstruction and Development (EBRD), we are pleased to provide you with our comments on these proposals. As you know, the EBRD is a publicly owned development bank tasked with supporting the transition to the market economy of the 29 countries of Central and Eastern Europe, Central Asia and Turkey. Developing deep and resilient banking systems and local financial markets is a key aspect of this mandate.

In our comments we focus on Central and Eastern Europe – a region in which financial sectors have undergone profound changes during the past twenty years and which has also been deeply affected by the global financial crisis. The consequences of the shortcomings in regulation that your proposal is trying to address have also been visible in our region, and have as such contributed to the problems the region has faced during the crisis. We therefore strongly welcome the greater capital backing and resilience in liquidity that your proposals will mandate for supervision, as well as the application of counter-cyclical buffers. We take this opportunity to bring to your attention certain concerns regarding the potential impact of the proposals on the Central and Eastern European region, where economic recovery remains fragile, as well as the potential impact on the development of the region's banking sector. These concerns pertain to:

- the nature of some of the capital eligibility proposals;
- the unintended consequence of capital charges on counterparty risks in the form of penalizing cross-border parent bank funding of subsidiaries – a proven source of support during the global financial crisis;
- the consequences of some of the liquidity proposals on the development of local capital markets; and
- the need to address elements of the liquidity risks relating to bank lending in foreign currency.

The consultative process, quantitative impact studies and calibration exercise should help shape the final design of the proposed measures and our institution stands ready to support the Committee's efforts in this area.

Best regards,

Manfred Schepers
Vice President Finance

Erik Berglöf
Chief Economist

Basel Committee proposals to strengthen global capital and liquidity regulations: Comments by EBRD staff[1]

Overall assessment

We welcome the financial market regulation measures proposed by the Basel committee. These proposals would underpin the much needed strengthening of financial sector resilience to external and domestic shocks in both advanced and emerging market countries.

We support the principle of comprehensive reforms and note that it will be important to avoid pushing credit provision into the 'shadow banking' sector. The perimeter of regulation ought to be sufficiently broadly defined and in this respect further work by the Committee will be important, as already set out in the 'Review of the Differentiated Nature and Scope of Financial Regulation'.

We support a careful impact assessment of *all* planned regulatory changes. There is currently not sufficient regard for the systemic consequences of implementing the entire package of regulatory reforms. We welcome ongoing impact assessment exercises and suggest that these pay due attention to regional issues, including those specific to emerging markets in Central and Eastern Europe (CEE).

We believe that the unique and specific characteristics of financial systems in emerging markets would need to be explicitly considered. The financial systems in CEE are still in the early and intermediate stages of development towards the depth and scope that would be in line with countries' respective economic development. Financial systems and institutions should therefore be allowed to go through their development stages and to grow at a faster rate than those in advanced economies. Local capital markets are on the whole underdeveloped and offer only short maturities in debt contracts. New regulations, in particular on liquidity standards and on macro-prudential buffers, should be appropriately calibrated to address this greater volatility in asset quality, variation in underlying liquidity and capital adequacy.

In Central and Eastern Europe the benefits from financial integration should be safeguarded. The region is characterised by deep and interconnected ownership linkages between banks in Western Europe and those in CEE. With few exceptions, foreign ownership shares of the banking systems are in excess of 70 per cent in these countries. In recent EBRD research we have demonstrated that this type of financial integration has been overall beneficial to economic growth in the emerging Europe region. While foreign banks have contributed to the build up of a number of financial vulnerabilities – such as the pervasive unhedged foreign currency exposures and vulnerable funding practices – these banks have been instrumental in developing post-communist local financial systems with know-how and capital, and they have proven to be deeply committed to the region throughout the financial crisis.[2] We are concerned that some of the proposals, as currently tabled, could substantially increase the capital requirements for parental support and reduce this key source of support for the development of further financial intermediation in CEE. It will be important to allow for sufficient national discretion to accommodate regionally specific circumstances.

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[1] These comments address the consultative documents "Strengthening the resilience of the banking sector" and "International framework for liquidity risk measurement, standards and monitoring".

[2] EBRD (2009): Transition Report.

We recommend introducing appropriate transitional arrangements to avoid abrupt negative economic consequences. Many of the proposed measures - including the redefinition of Tier 1 and Tier 2 capital, together with the taxing of counterparty risks - will abruptly affect emerging Europe's banks, which are currently still experiencing a very fragile recovery. In the introduction of liquidity standards there is of course less scope for transitional arrangements.

Specific comments

With regard to the proposed capital calculations within "Strengthening the resilience of the banking sector"

- Bank subsidiaries in several countries of our region are capitalised with significant minority stakes. This is a result of the history of privatisation and mergers in the region and in some countries of regulations limiting the ownership shares of strategic investors. Deducting such minority stakes from Tier 1 capital at the group level makes sense in as much as capital is not freely fungible across the group. However, this is likely to result in a considerable capital shortfall for important European bank groups, and could be destabilizing for the banking system in CEE. Moreover, the buyout of minority investors could hamper the important development of local equity markets.
- Exclusion of minority interests from core Tier 1 capital appears unbalanced as assets in subsidiaries are included in the calculation of capital ratios. We recommend that this exclusion be mitigated, for instance by reducing risk assets commensurately at the group level.
- New capital charges on counter-party risks may reduce parent bank funding of subsidiaries – a form of funding support that has proven critical during the crisis and in general has been a very stable form of external financing.

With regard to the proposed "International framework for liquidity risk measurement, standards and monitoring"

In our view the framework constitutes a welcome overhaul of liquidity risk management standards. Liquidity practices have not been in line with the underlying liquidity risks, including in the EBRD's countries of operation. However, conditional on calibration, we believe that the implementation of these regulations could have significant consequences on bank business models and it is essential that this is evaluated closely, considering the interaction with other aspects of the regulatory overhaul.

Any new regulation on liquidity ratios will need to accommodate the need for emerging financial markets to deepen and grow at a faster pace. Whilst restricting liquidity risk (and hence maturity transformation) in developed financial markets might be perfectly appropriate, the proposed measures could have a negative impact on less-developed financial systems with generally shorter maturities in debt contracts.

Our main concerns are as follows:

- In CEE countries, especially those with less-developed financial markets, the enforcement of the proposed liquidity standards could entrench current real economy fragilities stemming from the generally short-term maturity of debt contracts. Typically, banks do not have access to long term local currency liabilities and cannot issue bonds; therefore, they lend in shorter tenors of less than 2 years: i.e. there is currently not enough maturity transformation. This is especially the case as deposits cannot be relied upon as a stable source of funding to allow banks to provide long term loans. Our concern is that imposing in its present form the Net Stable Funding Ratio (NSFR) would stunt the development of longer term debt contracts. The risks inherent in allowing more maturity transformation out of short term funding (for example by imposing a less onerous NSFR) could be mitigated by imposing a more onerous Liquidity Coverage Ratio (LCR).

- The recommended liquidity regulations could hinder the development of liquid local currency bond markets in CEE. Banks are the largest participants in CEE corporate bond markets; therefore, measures which restrict banks' ability to finance bond holdings could have a detrimental effect on market development.

  In particular, the NSFR could require banks to issue long dated senior unsecured bonds in order to finance existing and new longer-term assets, whilst also penalising banks' holdings of most financial sector assets by giving these assets zero long-term liquidity value in the stable funding requirement calculation. The resulting imbalance between demand and supply could lead to disruptions in this important market sector of the nascent CEE capital markets. In jurisdictions where covered bond legislation and investor bases exist, the relatively favourable treatment of covered bonds for liquidity purposes acts a mitigating factor; however this is mostly not the case in CEE.

  Further, NSFR (coupled with increased capital charges on trading books) could also impact banks' willingness to become active market-makers in local currency bonds, by making the funding of trading books significantly more expensive. This would hinder the deepening of liquidity in CEE corporate bond markets, in turn discouraging non-bank participants from becoming active investors in corporate bonds.

- An important issue which the proposals need to address is whether the liquidity regulations will be assessed at group level or on a subsidiary by subsidiary basis. This is a crucial distinction in light of the legal structure of banking markets in many CEE countries. In particular, in certain cases banking groups may comply with the liquidity regulations on an aggregate basis but not on a subsidiary-by-subsidiary basis. Especially for those banks with subsidiaries outside the euro area, the liquidity regulations should apply on a subsidiary basis, unless legally binding parent bank commitments exist for liquidity support to subsidiaries.

- Also important in considering the impact of the liquidity regulations on CEE countries is whether the liquidity regulations will be applied per currency. Currency mismatches on bank balance sheets have proven to be a major vulnerability in many CEE countries, and requiring banks (including

subsidiaries of foreign banks) to comply with the liquidity regulations per currency would likely encourage the development of local currency intermediation and maturity transformation, contributing to financial and economic stability.

However, applying the liquidity regulations (in their present form) per currency could in some cases require large balance sheet adjustments and severely impair some banks' ongoing ability to provide foreign currency credit to CEE customers. Many banks in CEE hold foreign currency assets, which prior to the crisis were funded using a combination of short term unsecured credit, foreign exchange derivatives and parent bank credit lines. Replacing these types of liabilities with longer-term stable foreign currency funding will present a very significant challenge; indeed, the effects of market participants simultaneously attempting to lengthen foreign currency liability profiles can be readily observed in the volatility exhibited by cross-currency basis swap spreads.

In calibrating the liquidity ratios, the important trade-off between fostering development of local currency debt markets and allowing for an orderly transition from the current state should be carefully considered. A possible reconciliation could be to require the LCR to be met per currency whilst allowing greater scope for currency mismatches within the NSFR.