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Secretariat of the Basel Committee on Banking Supervision
Bank for International Settlements
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Basel
SWITZERLAND

Subject: Comments on the consultative proposals "Strengthening the resilience of the banking sector" and "International Framework for liquidity risk measurement, standards and monitoring" released on 19 December 2009

The World Bank appreciates the opportunity to comment on the consultative documents "Strengthening the resilience of the banking sector" and "International Framework for liquidity risk measurement, standards and monitoring."

The World Bank provides assistance to its client countries in ensuring soundness, stability and development of their financial systems, which are central to sustainable development and efficient allocation of resources to foster growth. The Financial Sector Assessment Program (FSAP) and financial sector Report of Observance of Standards and Codes (ROSC) assessments, jointly managed with the IMF, anchor the World Bank's engagement in financial sector development and support client countries in identifying risks and vulnerabilities and assessing their adherence to international standards.

In addition, the World Bank provides technical assistance to financial sector authorities in middle and low income countries as a follow-up to FSAP and ROSC recommendations or in response to other demands of client country authorities. This technical assistance involves strengthening the core elements of regulation and supervision as well as the integrity of the financial sector to build strong financial systems and ensure compliance with international financial standards.

The World Bank broadly supports the consultative documents' proposed measures to strengthen the regulation, supervision and risk management of the banking sector. We believe these proposals are likely to result in more appropriate capital and liquidity requirements, and lower leverage levels, provided they are adequately implemented. This should, in turn, result in sounder and more stable banking and financial systems.

We have the following specific comments based on our FSAP, ROSC, technical assistance and other work in our client countries.

1. Scope of application

The recent expansion of the Basel Committee on Banking Supervision (the Committee) has made the international decision making process more inclusive and legitimate, and that will help enhance the global reach and acceptance of the Committee's standards. Nonetheless, many countries and regions with relatively smaller banking systems are still not represented. We also note that some Committee member jurisdictions are not home supervisors to internationally active banks, which has been the traditional focus of the Committee.

Perhaps reflecting this situation, there is uncertainty among non-Committee member countries regarding the scope of application of the consultative documents. Both consultative documents explicitly point to internationally active banks in some instances, and in others they refer to the banking sector in general. We encourage the Committee to provide greater clarity as to its intentions on the scope of application of the current and future consultations. This is particularly important for our client countries in light of the Financial Stability Board's broader initiative to encourage adherence of all countries and jurisdictions to international financial standards.

More broadly, the World Bank advocates fair representation and an equal voice for its client countries to the Committee since a greater diversity of views will ensure more effective outcomes. Furthermore, it will allow the concerns of low and middle income countries to be reflected in the debates and in international regulatory and supervisory guidelines.

2. Calibration

We have a number of concerns arising from the fact that the Committee apparently intends to perform an assessment of the impact of the proposed capital and liquidity standards among its members only. It is based on this assessment that the regulatory minimum level of capital and the reforms proposed in the consultative documents will be reviewed to arrive at an appropriately calibrated total level of capital.

First, the vast majority of the World Bank client countries are not members of the Committee and their jurisdictions and banks, therefore, will be excluded from this important impact assessment. As a result, capital standards may be calibrated without taking into account the effects on domestic banks in non-Committee member countries. This may result in suboptimal calibration outcomes and reduced effectiveness in supporting global and national financial stability.

Second, many implementation issues are only identified when banks actually complete the impact study spreadsheets and/or supervisors analyze the trends and outcomes. Limiting the impact assessment to Committee members gives rise to the risk that some country or region specific implementation issues will not be identified before the proposals are finalized.

Third, many non-Committee member countries are host countries to internationally active banks. They may experience direct and indirect impacts of stricter capital and liquidity requirements on internationally active banks. For example, stricter liquidity requirements could affect local branches of internationally active banks, which may react by withdrawing loans from domestic banks and selling assets to repatriate funds. This can result in local banks encountering funding problems as well as in increased market volatility. Increased funding costs may lead to reductions in lending to firms, especially SMEs, and to households.

Although we appreciate that the intention of the calibration exercise is not to assess the impacts of tighter capital and liquidity standards on the economy of a particular home or host jurisdiction,

impact assessment participation would ensure prompter identification of potential flow-on effects on particular non-member jurisdictions. This would allow non-member countries to start considering mitigating policy options to help ensure sustained levels of local banks' funding and/or financial inclusion.

Finally, we commend the Committee's intention to introduce the proposed measures in a manner that raises the resilience of the banking sector over the longer term while avoiding negative effects on bank lending activity that could impair economic recovery. It remains unexplained, however, how this objective can be attained in the case of non-member countries. We remain concerned that the interests of all countries, including the smaller and poorer ones, will not be taken into account when setting the implementation timetable. In this respect, we urge the Committee to at least consider the outcomes of the calibration in the context of non-member jurisdictions before the proposals are finalized. This could give rise to the inclusion of appropriate national discretions in the proposals or the introduction of more flexible transition timelines.

3. <u>The role of micro prudential supervision</u>

Following on FSAP findings, the World Bank frequently provides technical assistance to client countries to strengthen supervision practices and cultures. Our experience is that, whereas many supervisors place great reliance on regulation and on high level monitoring of compliance, the actual resilience of the banking sector is dependent on more than strengthening capital and liquidity rules, and requires in addition close supervision of their actual application.

Indeed, the effectiveness of regulation can only be assured if adequately resourced and competent supervisors can determine whether banks are actually observing the new requirements. Supervisory authorities must also be endowed with sufficient authority to impose corrective measures if needed.

We recognize the work the Committee has done in terms of promoting sound supervision, particularly the strengthening of the supervisory guidance and the links to the Pillar 2 review process. Although the financial crisis has identified the need to strengthen and clarify supervisory mandates and improve supervisory culture, it may be that too little attention has been given to the detected failings in micro prudential supervision in developed as well as in emerging economies.

Unless significant improvements are made to the way micro prudential supervision is performed, efforts to improve global financial stability by enhanced regulation will be thwarted. We encourage the Committee to continue to strengthen the standards and codes to ensure a more challenging and less trusting approach by supervisors. This will probably be best materialized by an update of the Core Principles on Banking Supervision to integrate the new regulations as well as stricter requirements for sound micro prudential supervision, such as a proactive and intrusive supervisory culture with a strong onsite component.

The World Bank stands ready to contribute to this effort and to any requirement for further elaboration or clarification of our general findings on supervision practices and cultures during the FSAP process.

4. <u>Distribution of capital within international banking groups</u>

The World Bank commends the Committee for its proposals for raising the capital base of banking institutions, as well as the quality, consistency and transparency of their components. In

the vast majority of the World Bank's client countries, domestic banks have levels of capital that would be considered conservative compared to their international peers, and also have very rarely issued nontraditional instruments of capital.

On the other hand, it is important to note that in addition to the supervision of domestic banks, most of our client countries also have the responsibility to act as host supervisors of the local subsidiaries of large international banking groups. While host supervisory authorities are expected to have the legal authority and the ability to require local subsidiaries of these international groups to hold capital levels that adequately match the risks taken locally, we have observed that in practice only in a limited number of host countries the local supervisor has the power to call for additional capital injections in the subsidiaries operating in their jurisdictions.

Therefore, we suggest to the Committee to explicitly emphasize the importance of an adequate distribution of capital within the different subsidiaries of internationally active banking groups so as to ensure that risks taken locally are supported by capital that is legally located in the subsidiaries in question. We consider that it would result not only in more resilient subsidiaries, but also in better risk management practices at the local level.

5. Liquidity

Some of our client countries are deeply concerned with the proposals in the area of funding liquidity requirements. Many of these economies have not experienced significant direct effects of the global financial crisis on banks' liquidity and funding. This is mainly the result of structural differences between these emerging and lower income economies and developed economies.

These structural differences are many. As examples, the absence of a large middle class in many countries can result in lower savings rates and relatively smaller pools of stable retail deposits. The small and less liquid nature of local capital markets will commonly limit banks' ability to bolster liquidity buffers and/or lengthen liquid asset maturity profiles. Exchange controls can result in more "sticky" wholesale deposits than in open economies. And dollarization is a common feature in a number of developing and transition economies.

The Committee should give specific consideration to these and other structural features of emerging and lower income economies when finalizing the rules set out in the consultative document. For example, the narrow definition of liquid assets in paragraph 34 will pose challenges client countries with underdeveloped capital and government bond markets and in dollarized economies.

Furthermore, many countries do not have explicit deposit insurance, either as a matter of public policy or as a result of religious legal arrangements, such as *Shariah* law. Although most countries have some form of implicit insurance and in fact would not let their important banks fail, the Committee's proposals to treat explicitly insured deposits as more stable may not give sufficient recognition to these factors.

We encourage the Committee to consider taking these structural differences into account when designing the final liquidity requirements, either by introducing supervisory discretion so as to account for structural differences, or by lengthening the implementation periods. The Committee will wish to avoid a situation whereby jurisdictions that performed well during the financial crisis would be excessively constrained by liquidity requirements only because these were not tailored to their particular circumstances.

6. Provisioning

The World Bank supports sound provisioning practices and therefore explicitly backs the proposals of the Committee to address the disincentives to stronger provisioning inherent to the current regulatory capital framework. We particularly appreciate the Committee's resolve in advocating robust loan loss provisions that are based on sound methodologies reflecting expected credit losses in banks' existing loan portfolios over the life of the portfolio.

The recently issued exposure draft "IFRS 9: Financial Instruments" illustrates, however, the complexity of provisioning approaches based on expected loss. While a number of our client countries have moved to International Financial Accounting Standards (IFRS) and some are dealing with significant implementation challenges, others have not yet decided to adopt IFRS. The inherent complexity of accounting frameworks has motivated many countries to implement or maintain bank specific regulatory provisioning frameworks that are simple and transparent, and layered on top of existing accounting standards.

The development of a simplified minimum loan provisioning standard for banks by the Committee, for example based past-due status, and on Loan to Valuation ratios for mortgage lending, would be applauded by many of our client countries as it would set an internationally accepted, simple, and transparent benchmark that would be independent of any further development in accounting standards.

7. The leverage ratio

The World Bank supports the proposals by the Committee to introduce an internationally harmonized leverage ratio. The combination of a leverage ratio with risk based capital requirements can reduce the risk of excessive leverage building up in individual entities and in the system as a whole.

Despite our reservations on the limited scope of the impact assessment referred to above, we also appreciate the upcoming efforts of the Committee to ensure adequate calibration of the leverage ratio and appropriate testing of its interaction with the risk based measure.

For many World Bank client countries and particularly for emerging markets, access to affordable trade finance has been constrained since the start of the global financial crisis. Hence, we urge the Committee to review the appropriateness of a 100% credit conversion factor for off balance sheet trade finance items with a maturity less than a year. This review would ideally take into account the largely self-liquidating, low risk and shorter maturity of many trade finance products.

The Committee has indicated that the leverage ratio will be migrated to a Pillar 1 treatment based on appropriate review and calibration. From our reading of the consultative document, it remains unclear how the leverage ratio will be used, and the extent to which it is intended to be binding. The leverage ratio is versatile enough to be used as a macro and micro prudential policy tool and as a countercyclical instrument. We encourage the Committee to carefully specify the objectives of the leverage ratio and to provide greater clarity as to its intentions in this area.

8. Other minor comments

Paragraph 87 should clarify the treatment of "retained earnings". Footnote 17 states that this account is included as common equity but it does not meet the criteria of paragraph 87. The current presentation can cause confusion for some readers.

Should you have any questions relating to this letter, please do not hesitate to contact Katia D'Hulster at kdhulster@worldbank.org or David Scott at dscott@worldbank.org.

Sincerely,

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