Summary of the discussion

The session focused upon several issues raised by Mr Anand Sinha in the context of both advanced and emerging market economies (EMEs). Keeping in view, broader interlinkages between the financial sector and the real sector, the need for better coordination between financial regulation and macroeconomic policies for sustaining growth was emphasized. Given the nature and origin of the recent crisis, the particular attention was on the banking regulation.

Mr Zanota's presentation on Basel III Liquidity Framework

Preceding discussions, Mr Zanota from the BCBS Secretariat had the opportunity of presenting an overview of the key elements of the Basel III liquidity framework. This framework is new and since there is no long track record, a longer implementation period has been envisaged. The primary objective of this new framework is to increase resilience of the banking system to liquidity shocks and sensitize banking system to liquidity risks by ensuring appropriate funding – both of short term and long term – thus minimizing dependence upon public sector in times of stress.

The framework has standards defined in terms of two ratios, namely, one a short term, Liquidity Coverage Ratio (LCR) to be implemented by 2015 and the other a long term, Net Stable Funding Ratio (NSFR) to be implemented by 2018. The LCR would ensure that high quality liquid assets adequately cover net liquidity outflows; and the NSFR would ensure stable funding including equity to cover illiquid part of assets.

A few areas are currently under review to avoid unintended consequences, including the definition of highly liquid assets. This will try and address the problem of jurisdictions which have no significant fiscal deficits and hence are not issuing substantial amounts of sovereign paper.

Before concluding, Mr Zanota observed that financial stability is a broader question including the well-functioning markets, infrastructure and institutions and therefore, banking regulation alone would be insufficient to address broader policy objectives. Developments in areas such as insurance, accounting and markets would be equally important.

Discussion

Impact on Growth

During the discussions that followed, while sharing the various country experiences, the consensus was that while the new regulatory requirements would have some impact on growth the medium and long term benefits would outweigh these costs. In particular, with a common agreement for global minimum standards, it is expected that the dimension and frequency of the crisis cycles would be reduced.

Comparing the differing results of the IIF and BIS studies on the impact of the Basel III regulations on growth, it was noted that the IIF study assumed that higher capital would result in demand for a higher ROE by shareholders. This however is surprising since Basel III norms would make banks less risky, not more. The IIF study used a simplistic model as against the BIS model, which was based on the data provided by central banks using their own models. Other reasons for the differences in the results were on account of the sample of banks used by IIF being dominated by large systemically important banks. The assumption of more than 300 bps increase in cost of lending was also unrealistic. The study also assumes that credit and growth are proportionately related and did not take into account the non-linearity of the reaction function. Another view was that when the impact of Basel III is studied, what was relevant were the global net benefits.

It was further noted that the impact of the new capital requirements is not very significant for the smaller and traditional banking systems – an assessment borne out by the BIS impact studies. The large banks especially those with aggressive trading desks were the ones most severely impacted. In their case, growth was driven by credit and leverage which became unsustainable. Another reason why the smaller non-trading banks were less affected was on account of the quality of capital which in their case was closer to what is required under Basel norms while in the case of the large trading banks, the share of core equity was very low.

As most developed countries are facing close to or at the lower zero bound interest rate, there is little scope for monetary policy to mitigate adverse conditions and hence the impact on growth especially in the near term cannot be underestimated. Other issues raised were the need to still make some calibrations to the risk weighting system, especially for smaller retail banks to provide for greater harmonization.

Macro prudential measures

With regard to dynamic provisioning, the Spanish experience was said to be positive but it had obvious limitations in taming the lending cycle without other macro-economic policies acting in conjunction. In contrast, in the Indian case, where counter cyclical additional risk weights and provisions for certain sectors were taken in conjunction with monetary policy and fiscal measures could have the desired effect of taming the lending cycle to certain asset classes.

On countercyclical buffers, a view was expressed that in a rule based system there is a clear and simple formula for building up of the buffer, but there is no formula that applies to release the buffer. The release of the buffer is very important for counter cyclical instruments because otherwise the credit crunch will be more severe.

In the context of cross border flow, it was noted that trade credit seized up in the wake of the crisis and this disrupted growth for many EMEs. Further cross border lending by large banks either directly or through subsidiaries was also severely affected and EMEs dependent on such funding /credits had to face severe liquidity crunch. The need for active management of the capital account in a manner integrated with prudential regulation especially macro prudential measures for ensuring sustainable growth especially in EMEs is now being recognized explicitly by the IMF. India is a good example in this regard. Merely dealing with flows is not enough as very often the capital controls are rendered less effective because operations shift to derivatives. It will therefore be necessary to look at the examples of Brazil or South Korea in terms of exerting equivalent regulation on derivative products which often mimic capital flows.

In the context of high build-up of short term external liabilities creating structural liquidity problems in countries like South Africa and South Korea, it was clarified that such issues are being considered while evolving norms for high quality liquid assets.

Directed credit and credit enhancements /guarantees

It was noted that Basel capital regulations allow capital relief for the SME sector. It was observed that credit allocation at the macro level alone would not be sufficient and this should be supplemented by micro level intervention for the credit flow to be effective. Ways to ensure credit flow to the SME sector which usually faces constraints in a crisis and post crisis situation were discussed. Some countries have a priority sector fund. A suggestion put forward by Ghana was to provide tax incentives for lending to this sector. In India, the priority sector lending targets do not carry any discriminatory or relaxed prudential standards and nor they have any interest rate caps. To deal with the problem of high NPAs in the SME sector, credit guarantee schemes have been adopted in several jurisdictions. But, to be efficient, guarantee schemes have to be based on understanding of the risk at the ground level. Credit risk in cases where guarantee is supported by the State is treated as zero under the Basel framework. It was urged that credit guarantee systems need to have some element of risk based premia – even if supported by the State. In case of infrastructure finance, sovereign credit enhancements could solve some of the constraints faced in both risk weights and exposure norms. If a non-government credit enhancer brought into the picture, the risk weight for the exposure actually does not alter very much as the risk weight of the guarantor is substituted for the risk weight of the underlying exposure. In some cases the exposure is also not altered. It was clarified that exposure norms are risk neutral; they do not really factor in risk of the counter party. The basic reason is that it takes a view of what is the maximum loss that a bank will suffer if the counter party failed with due factoring in of the risk mitigants.

Subsidiary vs branch banking model

There was a discussion on the issue of Subsidiary vs Branch banking model. After the crisis, most countries have preferred to adopt the subsidiary model as they are seen to be ring fenced and more amenable to the host country regulations.

Concluding observations

The new regulations are expected to lead to a more resilient banking sector particularly in the advanced markets. EMEs are expected to gain through spillover effects. While concluding, the chair attempted to provide responses to questions raised in the paper, based on the discussion:

- *Will the new regulatory approaches and measures impinge and run counter to the growth objective?*

  The broad objective answer is no. There is no doubt some cost; but this is acceptable. It also needs to be viewed in the right context – the global crisis costing between 3 to 15 per cent loss in output, in comparison to giving up growth by 0.6 to 2 percentage points.

- *Has the overall post crisis regulation alter the balance in favour of stability rather than growth to the disadvantage of SMEs?*

  The answer is not clear; but, it is the quality of growth, the quality of capital and the quality of supervision which matter.

- *How will the increased capital leverage and liquidity impact the flow of credit to the commercial sector in general and trade, SME and infrastructure in particular?*

  This is country specific. It depends on how a particular country implements regulation to facilitate growth of certain specific sectors.

- *What can the EMEs expect to gain from Basel III?*

  Implementation of Basel III is yet to begin. EMEs need to focus on key Basel III issues to further strengthen the soundness and stability of their financial systems. Tightening supervision will also yield important benefits. However, certain aspects of Basel III can be difficult to implement because limited regulatory resources. Therefore, there will be a need to prioritise and to focus on the most important issues.

- *What is the relevance of Basel III and other post crisis regulation for EMEs?*

  The spirit of Basel III is convergence amongst regulators to improve the quality of banks and the quality of supervisors to serve the real sector better. It is also about understanding the systemic risk better and strengthening global cooperation. The system should be more resilient to withstand the next shock when it comes.