EUROPEAN SHADOW FINANCIAL REGULATORY COMMITTEE

www.esfrc.eu

BASEL III: THE NEED FOR SIMPLICITY IN CAPITAL AND LIQUIDITY REQUIREMENTS

Statement No. 33

London, January 24, 2011

In this statement the European Shadow Financial Regulatory Committee (ESFRC) recommends that:

(i) *capital regulation should focus on simple ratios of capital to non-risk weighted assets;*

(ii) *contingent capital should be assigned an expanded role in required capital;*

(iii) *simple liquidity requirements should be introduced to complement capital requirements;*

(iv) *supervisors should monitor metrics for changes in liquidity to obtain early warning signals of systemic problems.*

Background

The proposed Basel III framework, of which the last version was presented in December 2010, broadens the current risk-weighted capital ratio framework in Basel II to include 1) a minimum ratio of common equity employing a stricter definition of equity capital, 2) a capital conservation buffer 3) a countercyclical provision, and 4) enhanced risk coverage that includes counterparty credit risk and derivatives. Furthermore, Basel III complements the risk-weighted ratios with a simple leverage ratio and adds minimum liquidity coverage and funding ratios.

There are a number of problems with the Basel approach: banks will be assessed using up to seven different ratios to be introduced over a long period of time. Instead of contributing to financial stability, the net result may turn out to be an increase in regulatory uncertainty and risk arbitrage. Some of the drawbacks of the current Basel II framework have not been appropriately addressed: first, procedures specifying predictable consequences for banks violating existing regulation ("Structured Early Intervention and Restructuring" or "Prompt Corrective Action") are still in the making. As a result, incentives of banks to keep a high capital buffer relative to minimum ratios remain ambiguous. Second, incentive effects and competitive distortions introduced by some banks being "Too Big to Fail" have not yet been adequately addressed. Thereby, market discipline on the risk-taking of these banks remains weak. Third, enforcement of market discipline through the use of contingent capital has been given a too narrow a role in the proposed Basel III framework.

In the following we focus on the specification of liquidity requirements and the potential for an expanded use of contingent capital as instruments for reducing the likelihood of systemic crises.

Liquidity requirements

Although solvency problems generally are at the core of financial crises the recent crisis demonstrates that illiquidity can magnify the depth of crises. Banks face potential illiquidity of two kinds: "Market illiquidity" occurs when banks cannot sell assets without realizing large losses, and "Funding illiquidity" occurs when banks that rely on short-term funding cannot refinance long maturity assets.

If banks hold enough highly liquid assets and do not rely too much on short-term funding, the contagious effects of a capital shortfall in a part of the banking system will be mitigated. Market discipline cannot be relied upon to resolve this externality. It could be addressed by substantially increasing capital requirements. However, the costs to the banking system would be reduced by employing liquidity requirements along with less stringent capital requirements.

The Basel Committee has produced two requirements in the form of ratios that must be satisfied by banks involved in maturity transformation. The Liquidity Coverage Ratio (LCR) refers to the stock of high-quality liquid assets relative to the net cash outflow that would happen in a stress scenario. A high ratio enables the bank to escape selling assets at depressed prices if funding is withdrawn or not renewed. The Net Stable Funding Ratio (NSFR) refers to a ratio between availability of stable funding relative to the need created by long-term assets. NSFR limits the degree of maturity transformation of banks and, therefore, enhances "funding liquidity". Both ratios are based on a complex set of weighting factors that appear somewhat arbitrary.

The ESFRC welcomes the increased emphasis on liquidity in bank regulation and supervision. We consider the proposed regulation excessively complicated, however, when potential costs in terms of regulatory burden, efficiency losses, incentives for evasion of regulation and costs of enforcement are taken into account.

The ESFRC recommends that liquidity requirements should be specified in simple terms in the form a minimum ratio of cash and other highly liquid, riskless assets to total assets instead of the LCR, and a simple measure of maturity mismatch instead of the NSFR with its menu of weighting factors. These requirements should apply under normal conditions and be relaxed in times of stress on the financial system.

The liquidity requirements should be implemented uniformly across Europe. In addition, national supervisors should have the obligation to assess liquidity positions as part of Pillar 2, and investigate rapid and large changes in these positions as potential warning signals for impending systemic problems. The Basel III proposal contains useful metrics for liquidity assessment.

A degree of substitutability between capital and liquidity requirements should be taken into account when setting levels for the two kinds of ratios. The ESFRC has previously recommended that a simple non-risk weighted capital ratio (leverage ratio) becomes the main focus of capital regulation. The Canadian experience during the recent crisis illustrates that a relatively high simple capital ratio enables banks to avoid severe consequences of illiquidity in the markets.

Contingent capital

In our view, the Basel Committee is overly conservative in limiting the potential use of contingent capital instruments while being too timid in increasing capital requirements**.** Contingent capital has to a great extent the same potential as common equity to absorb losses. It has the advantages of carrying tax-deductible interest costs while reducing the need for bail-outs of all creditors in case of distress.

The fact that many banks' capital buffers were rapidly depleted in the recent financial crisis indicates that the required levels before the crisis were inadequate. The ESFRC recommends that the required non-risk weighted ratio of equity to total assets (the so-called "leverage ratio") should be increased substantially above the ratio envisioned in Basel III. The minimum ratio can be raised gradually once the world economy has recovered sufficiently from the financial crisis.

In order to reduce the burden for banks to substantially increase their capital base, we support existing proposals to make it possible for banks to increase their regulatory capital to the new higher level without having to resort fully to equity markets. One promising instrument is long-term bank debt which mandatorily converts to common shares when the capital ratio reaches a pre-determined low level (also known as "contingent convertibles" or CoCos). The ratio of equity capital relative to total assets (in terms of market values) that triggers conversion should be high enough so that common shareholders risk dilution in response to a substantial shock to the financial system. The exchange ratio between contingent debt and equity also affects dilution as well as the attractiveness of the contingent capital instrument.

Another proposed form of contingent capital is to include long-term bank debt containing a write-down mechanism which allocates losses to the debt holders at a pre-specified trigger point. Both this hybrid debt capital instrument and CoCos have the ability to absorb losses like common equity while the bank remains a going concern.

Apart from making it easier for banks to increase their capital base, contingent capital instruments have important incentive effects. Given the fact that the holders of these debt instruments have their investment truly at risk, they are likely to have powerful incentives to strengthen the risk monitoring of the bank, and if necessary, to discipline the bank by requiring more capital and/or a higher risk on the debt.

The potential use of contingent capital is currently being studied by the Basel Committee and the Financial Stability Board. In the proposed Basel III framework contingent capital instruments could count as part of Tier 1 capital but the scope for these instruments is limited by the statement that the predominant form of Tier 1 capital must be common equity, primarily consisting of common shares and retained earnings.

We urge the Basel Committee to acknowledge the important and attractive characteristics of contingent capital instruments and to allow these instruments to be a more substantial part of Tier 1 capital. Not only would such instruments make it less costly for banks to increase their capital ratios but they would have significant effects on market discipline as well.

Contingent capital instruments would not substitute completely for “Structured Early Intervention and Restructuring” (SEIR) and insolvency procedures that determine the costs of violation of capital requirements and the allocation of losses to banks’ creditors in case of insolvency. However, the instruments represent a step in the direction of creating greater predictability for the allocation of losses to shareholders and creditors of banks. Thereby, they strengthen market incentives. As mentioned in previous statements, the ESFRC considers the predictability of SEIR and insolvency procedures a cornerstone of a regulatory framework for financial institutions.