Comments on Issues paper: Review of the Capital Adequacy Framework for locally incorporated banks.

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Q1. For each of the three sections (numerator, denominator, ratio), are there any important topics relating to capital adequacy that we have left out entirely?

Q2. For each of the three sections (numerator, denominator, ratio), have any important and relevant issues been omitted from the topics that have been discussed?

The issues paper is comprehensive. It covers many relevant topics. Nevertheless, the following areas may deserve more attention:

1. Stress testing. Some important supervisors have adopted stress testing as a tool that compliments capital requirements. The European Banking Authority (EBA) in particular is transparent about its stress tests: it publishes the methodology of the tests, the results, and all relevant data. This to promote transparency. This approach fits the Reserve Bank's reliance on market discipline.

2. Phase-in of changes in capital requirements. Banks tend to respond positively to higher capital requirements once they are announced and accompanied by set phase-in periods, say five years. Such announcements often prompt a race to the top (of sorts), with strong banks making an effort to meet higher requirements in an expedited fashion.

3. Procedures addressing the disqualification of capital instruments. Capital instruments are complex. There is always a risk that interpretations of the eligibility of capital instruments change. This calls for a procedure to be followed in case of disqualification.

4. The risks of mis-selling of capital instruments as savings products. See the picture below of a brochure of a convertible capital instrument issued by an Australian bank.

Q3. Do you have any information (e.g. empirical data) that is relevant to the issues discussed in the paper?

On bail-in and convertible instruments

This week has shown a successful bail-in of capital instruments under European bank resolution rules.

Though not an admirer of convertible capital myself (because of practical problems, the supervisory resources they claim, and important unforeseen consequences) this week's win of EU bank regulation is significant, see Martin Sandbu's comments in the Financial Times (Sandbu, 2017). This development is also significant given comments of ECB's Danièle Nouy (2017), who had become more skeptical about convertible instruments recently:

> ..., we have experienced significant supervisory issues with Additional Tier 1 instruments, more fit for gone concern purposes.

Note that, under Basel III rules, conversion at a pre-specified trigger is not a requirement. The rules offer the supervisor the ability to write off or convert before the bank touches a pre-specified trigger, see point (2) of the BCBS non-viability press release of 13 January 2011:

> The trigger event is the earlier of: (1) a decision that a write-off, without which the firm would become non-viable, is necessary, as determined by the relevant authority; and (2) the decision to make a public sector injection of capital, or equivalent support, without which the firm would have become non-viable, as determined by the relevant authority.

Note that part of the disciplining effect of convertible instruments may be lost when bank executives and managers are allowed to hold them.

Lastly, not all academics agree with Professor Admati. Joseph Sommer (Federal Reserve Bank of New York), for example is much more optimistic about capital levels (Sommer, 2014). He argues:

> Bail-in transforms the meaning of capital. In bail-in, parental debt does exactly the same thing as equity: it protects financial liabilities from a degradation of value. If this is the function of capital, we may conclude that *with bail-in, all non-financial liabilities are capital!* It also means that in a bail-in regime, megabanks currently hold much more capital than we thought they did. But with poor insolvency law, there is no access to it.

The calibration of capital

Recent empirical evidence of the Federal Reserve Board shows that risk-based Tier 1 capital ratios between 13 and 26 percent are optimal, albeit that these results apply to the U.S. (Firestone et al., 2017).

The approval process

The EBA is moving toward pre-approval, see Section 3.2 of EBA's Report on the Monitoring of CET1 Instruments Issued by EU Institutions (EBA, 2017). Given the importance of capital instruments, perhaps pre-approval, or extensive coordination between issuer and supervisor before issuance could be beneficial in that it may avoid ex-post misunderstandings.

Regulatory Adjustments

Regarding the deduction of unrealised gains and losses that have resulted from changes in the fair value of liabilities due to the changes in the creditworthiness of a member of the banking group (e.g. subsection7(3)(i) of Document BS2A), see the attached paper co-authored with Annelies Renders on the unintended consequences of this deduction (Lubberink and Renders, 2016).

In addition, the effects of regulatory adjustments applied to bank capital may be limited, see the attached paper co-authored with Roger Willett (Lubberink and Willett, 2016).

Q4. Are there particular areas of the review that should be prioritised?

References

Danièle Nouy (2017). Public hearing on “Updating CRR, CRD, BRRD and SRMR: the new banking legislation package” in the ECON Committee of the European Parliament.

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