Submission on BCBS Consultative Document Countercyclical capital buffer proposal

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Table of Contents

Submission to BCBS on Counter-cyclical buffers

1. Introduction

The ABA appreciates the Basel Committee on Banking Supervision's (Basel Committee's) concerns that excessive growth can be a precursor to large banking system losses and, in turn, to losses in the real economy. In principle, and when considered in isolation of other tools, a countercyclical capital buffer that promotes the build up of system-wide capital to absorb potential downturn losses can be a useful macro-prudential tool.

The ABA also recognises that the buffer could help to stabilise economic cycles. Increasing bank capital requirements when economic and financial conditions are buoyant may have the secondary effect of moderating excessive credit growth. Similarly, reducing bank capital requirements when the economy is in a downturn may help avoid constraints in the supply of credit - although we note later in this submission that the market may prevent banks from releasing capital in times of stress.

The ratio of credit to GDP will be an important guideline in making this determination but the consultation paper appropriately recognises that relying upon one figure is not sufficient and that regulators will need to form a judgement based upon a wider range of variables. Regulators have yet to determine this framework, and it is likely that the framework will differ between jurisdictions. This potentially variance in application creates a risk that the overall objective will not be achieved.

There are a number of compositional consequences of the proposal. One is that bank capital buffers may be increased regardless of how much of the credit growth is funded by banks. Another is that an individual bank will have its capital buffer increased regardless of its contribution to credit growth or its lending practices.

Notwithstanding the usefulness of the buffer, we emphasise that careful consideration will need to be given to the interactions between monetary policy and prudential regulation, particularly in jurisdictions where the responsibilities for monetary policy and prudential regulation are held by separate authorities.

We also note that, as is the case with most of the Committee's reforms, application of the buffer to the banking sector has the potential to transfer risk to other sectors. While possibly beyond the responsibility of the Committee, the ABA regards this issue as a significant concern that does not appear to have been addressed by regulatory authorities thus far in the body of reform proposals under consideration.

Finally, credit growth to all sectors will be subdued by the proposal regardless of the credit growth that sector has received. If the rapid growth in lending is concentrated in a high growth sector, the imposition of the buffer may result in lending activity being constrained in other areas to continue feeding the growth sector, thereby having a perverse and unintended impact, which may be addressed only in part by bank risk management practices.

2. Support for the proposal

ABA supports the principle of a counter cyclical capital buffer as a standalone concept. Building up capital buffers in the good times as protection against the bad times is a sound concept.

Currently there might be a disincentive for an individual bank to raise capital in the "good" times (unless for merger and acquisition purposes), as this may place that bank at a competitive disadvantage to their peer banks who are not raising capital (i.e. capital raising is EPS dilutive and compresses ROE). A mandated counter cyclical buffer requirement therefore appears to remove one of the impediments to banks raising or retaining additional capital in anticipation of losses arising.

The ABA also recognises that the proposal could be an important instrument in a suite of macroprudential tools, and that it could help to stabilise the economic and financial system cycles. Increasing bank capital requirements via imposition of the countercyclical buffer may have the secondary effect of reducing bank lending, thereby helping to take some of the heat out of economic growth; and having banks that can still lend in the "bad" times will help keep monetary policy effective. Careful consideration will need to be given to assess potential consequences in jurisdictions where monetary policy and prudential regulation are administered by independent authorities.

While the proposal clearly has the potential to bring something new and valuable to this long standing problem of banking cyclicality, it does also raise a number of significant implementation issues that must be addressed for the principal objective to be realised. The remainder of this submission documents these practical issues and offers suggestions for addressing them.

To the extent that it would be helpful, the ABA would be very willing to organise a meeting with industry experts to discuss ways to address the issues identified in this submission. The psychology of how markets react to the introduction and release of the buffer will likely be just as important as the technical specification of the proposal. Failure to adequately address these "soft" issues may risk the buffer becoming a permanent de facto extension of the capital conservation buffer, which is clearly inconsistent with its stated purpose.

3. Market responses and the need for a clear communication strategy

The psychology of how markets react to the introduction and release of the buffer will likely be just as important as the technical specification of the proposal. Failure to adequately address the likely market response may risk the buffer becoming a permanent de facto extension of the capital conservation buffer. This would be inconsistent with the Committee's intentions for the buffer.

To assist in addressing some of these issues, regulators' communications of buffer decisions and their expectation of macro prudential risks will be important in managing the response of markets to changes in bank buffer levels and the cost of capital funding.

More detailed comments on these considerations are outlined in the remainder of this section.

3.1 Signalling issues

The proposal seems to assume that benign market conditions will persist beyond the announcement of the buffer requirement and that 12 months is a sufficient time for a buffer to be built. It seems doubtful that the market would shrug off a signal from the prudential supervisor that they believe the probability of a systemic increase in bank loan losses has just increased. Even if the market did remain generally upbeat in the face of this adverse signal, the idea of asking shareholders to subscribe more equity to absorb near term, relatively higher probability losses would be challenging (although it would be open to banks to reduce dividends and discretionary payments, these reductions would most likely not be enough to meet the proposed buffer).

As noted in our April submission to the Committee, the ABA also has reservations as to whether market behaviour will allow the proposed capital buffers to work as intended. As illustrated during the GFC, the market generally expects banks to increase capital, and even "over-capitalise" in periods of stress, in order to provide an additional margin of safety. These considerations do not appear to have been addressed in the Committee's proposal.

3.2 Permanence of the countercyclical buffer

Market reaction to the buffer coupled with the natural desire of banks to preserve flexibility on dividend payout could also result in the buffer becoming semi-permanent. Depending on the confidence that banks have in anticipating both the announcement of buffer requirements and the likely behaviour of peer banks in raising or retaining additional capital, banks may be inclined to 'pre-fund' their buffer requirements before notice is formally issued by the regulator. For example, many institutions' capacity to raise capital may be affected if there are a number of smaller or regional banks who have to queue up behind the major banks, or if the local capital markets are impacted by timing issues, such as market holiday periods.

As a result, the countercyclical capital buffer could become a semi-permanent extension of the capital conservation buffer – an outcome that runs counter to the intention of the buffer being applied only infrequently.

3.3 Notice period

Confirmation is needed on the operation of the notice period. The ABA believes there is some ambiguity in the paper about how the notice period will operate. The paper initially states that buffer add-on decisions would be pre-announced by 12 months but also states that "If a bank's capital level **falls** into the extended buffer range they would be given 12 months to get their capital level above the top of this range before restrictions... come into effect." (Page 4, emphasis added). One interpretation of this latter reference is that a bank could fall back into the buffer range after it has already been put in place and then have another 12 months to build up capital to an adequate level before restrictions come into effect.

This means that it could be a total of 24 months before the restrictions impact distributions, in either a continuous 24 month period (if a buffer is put in place and then a bank immediately falls below) or two discrete 12 month periods (if the

buffer is in place for several years and then the bank falls below the buffer). The mechanics of how the notice period would operate should be clarified.

3.4 Communication strategy

The discussion paper suggests that regular updates of the macro financial position should be published, and how economic conditions might impact potential buffer actions. It is suggested that these updates should be published at least annually, but that there should be no expectation of quarterly statements.

We agree with BCBS that regular updates are necessary for banks, shareholders and the wider financial markets to facilitate understanding of the views of regulators on the macro prudential outlook. Regular information will be necessary to ensure that financial market views of the outlook for macro prudential risks are anchored closely to that of regulators. This is particularly important at potential turning points (ie, when the buffer might either be switched "on" or "off").

If communication strategies are not well developed and not transparent, then investors may put a risk premium on bank share prices due to the uncertainty associated with future bank capital plans. This in turn would make it more expensive, and potentially more difficult, to raise funds when the buffer is turned on.

The ABA therefore agrees with the Committee's approach to developing best practice guidance for regulatory authorities to develop a communication strategy that promotes accountability and transparency regarding buffer decisions. As financial market views can change significantly over the course of a year, the ABA recommends that regular information updates of the macro prudential outlook (and how they may impact buffer actions), be published by regulators on a more frequent basis than annually.

4. Interaction with other proposals

While the concept of a counter cyclical buffer makes sense in isolation, there is a concern over how it will interact with the suite of other reforms already proposed by regulators. These proposals are significant, and are already likely to provide banks with substantial protection against all periods of heightened systemic risk, not only those potentially caused by excess credit growth. ABA members believe there needs to be more analysis of how the reforms will work with the wide range of other proposals under development at present.

Globally, there has been a heightened level of supervision and scrutiny from regulators, whether as a consequence of legislative/regulatory change, or from a change in philosophy. ABA supports the change in focus by regulators, as some of the countries that did well through the crisis (e.g., Canada, Australia) did so by virtue of strong supervision. The new focus of regulators is not only on the risk of what banks do (e.g., proprietary trading) but how they do it.

The greater use of stress tests by banks, and the more intense focus they are receiving by regulators, should ensure that banks are more likely to hold capital for the "bad" times. Additionally, the proposals to improve the quality of capital that banks hold will provide a greater cushion by the banks for the "bad" times.

Regulators have yet to release their suggested calibration of the new capital ratios. But the combination of the minimum capital and the capital conservation

buffers will mean that banks will already have a greater cushion against the losses than previously. The concept of the counter cyclical buffer may create an environment of banks holding buffers on buffers.

Clarification is also needed on the interaction between the system level countercyclical buffer and bank-specific forward loan loss provisions, and their impact on Tier 1 capital.

4.1 Calibration of buffer

We note that the Committee has acknowledged the challenges in recalibrating the capital framework to provide for cyclical buffers, particularly given that the aim of the buffer is to ensure that banks have enough capital to maintain the flow of credit in the economy. By definition, credit growth tends to be weak following periods of excess credit growth. This reflects constraints on the supply side, as banks rebuild their balance sheets, but also lower demand for credit as the wider economy seeks to deleverage. In this respect, it would be useful to understand the severity of loss that the countercyclical buffer is intended to absorb.

ABA would expect that the size of the buffer would be calibrated in some way to the average level of expected loan write-offs, adjusted for the average level of loan loss provisions. Any setting of the buffer must take into account the interaction with both local accounting and regulatory arrangements for the setting of provisions at both an individual account and portfolio level. That is, it must take into account provisioning for loss events that have occurred, future loss events that are expected to impact the prudential position, plus existing capital levels for unexpected loss events.

Further information is needed on:

(1) How BCBS is calibrating the size of the buffer, on both a gross basis and also on a net basis, after having regard to the range of capital management responses that can be employed to mitigate the size of the size of the losses; and

(2) What severity of loss the counter-cyclical buffer is intended to absorb.

4.2 Release of the buffer

The document correctly identifies the two principles behind releasing the buffer. The first is that it can be used to offset sizeable losses in the banking system. Second, capital could be released if there ended up being problems elsewhere in the financial system that could cause a disruption in the supply of credit to the economy.

There is very little discussion of the process as to how the buffer will be released. The proposal (correctly) states that the release of the buffer should be prompt. The document makes some suggestions as to which indicators could be used (non-performing loans, asset prices such as house prices and financial market indicators such as credit spreads). But, as noted, every suggested indicator also has its shortcomings.

Before a counter-cyclical buffer can be put in place, a strong understanding of the drivers for release of the buffer needs to be well understood to allow banks to

better plan capital management activities when the buffer is put in place. Otherwise banks may feel the need to hold additional capital on top of the buffer, diluting the benefit of releasing of the buffer during the "bad" times. Communication will be crucial here. Explanation by the regulator on why and when the buffer is to be released will make it easier for the market to understand the movements in capital and the underlying reasons.

4.3 National discretion on key variables

There are also concerns as to whether there can be international consistency in the application of the buffer. Different regulators may have different response functions as they currently do with monetary policy. This has the potential to create an uneven playing field.

The potential for differences between regulators may also reflect the wide variety of indicators that are likely to be needed when setting the buffer.

5. Implementation issues

While the countercyclical buffer proposal brings a new and potentially valuable response to the long standing problem of bank cyclicality, a number of practical implementation issues require addressing and/or clarification. These are set out below.

5.1 Implementation with an observation period

In light of current uncertainties relating to the calibration and operation of the countercyclical buffer, the ABA recommends that its implementation proceed by way of "observation" only until such time as these aspects of the buffer, together with the likely market response, have been fully assessed. Implementation will also need to have regard to the timeframes for implementation of other Basel regulatory reform proposals.

This will assist in providing confirmation that the buffer will work as intended and not simply as an additional regulatory minimum or permanent extension of the capital conservation buffer. It will also allow time for regulators, particularly those that have less experience in publicly commenting on macro financial conditions, to gain experience in its operation, and for regulators, industry and other stakeholders to continue to discuss the detail of the buffer to ensure that is objectives and operation are fully understood.

5.2 Loan location

Practically it might be difficult to determine the jurisdiction of the ultimate beneficiary of the credit. The proposal may also lead to capital arbitrage across large multinational borrowers, with loans originated in countries not impacted at any given point in time by the counter cyclical buffer and on-lent internally. This may affect retail/small business adversely as they cannot avoid the impact of the overlay, whereas multi-nationals can, leading to distortions in pricing/credit supply.

Clarification is requested on the impact of parent guarantees, where the corporate borrower is guaranteed by the parent. Is the relevant jurisdiction the country of the borrower or the country of the parent guaranteeing the subsidiary?

If the objective is to protect against credit losses then it should be country of the guarantee, but if it is about credit supply, then should be the country of the borrowing subsidiary.

5.3 Application of Buffer

The proposal makes mention of the buffer being applied either at an individual legal entity or consolidated level.

ABA members believe that the buffer should be applied to Tier 1 capital, at the consolidated bank level. It is the consolidated bank that will effectively bear any losses.

The paper states that the proposal implies there would be jurisdictional reciprocity but also states that it will leave the power to set and enforce buffers with the home authority and not embed a requirement of reciprocity with any host jurisdictions. Depending on approach of the home regulator in relation to adoption of a buffer in a host jurisdiction, there is the possibility that an inequality may be created which could favour either local banks or international banks.

The paper notes that the home-host aspects of the proposal are one of the particular areas that remain under consideration at the Basel Committee, and the ABA urges the committee to discuss options that reduce the risk of an inequality being created.

5.4 Credit/GDP

Comparing the trend between countries might be difficult, particularly for emerging markets, where strong periods of growth can take place during periods of capital deepening in the economy. But it also might be difficult for some developed countries.

For example, countries like Australia are currently experiencing very strong terms of trade. This extended period of strong national income growth may coincide with stronger than usual credit growth. This may be understandable not only in terms of strong income growth to pay back debt, but also in that this period of growth will lead to profitable investment opportunities.

If the credit/GDP trend is to be the measure used, it must be applied carefully, having regard to possible circumstances that might lead to apparent "anomalies" in the trend data – which may not in fact warrant the application of a buffer. It is also recommended that the approach be confirmed only after a substantive trial, and re-calibration as required.

6. Interaction with monetary policy

As the Committee notes, the counter cyclical buffer is a macroprudential instrument that would be available to authorities, its introduction might make the monetary policy setting process more difficult, especially in jurisdictions like Australia, where monetary policy and prudential regulation are administered by independent authorities. For example, during periods of extremely weak economic growth, central banks might set interest rates at very low levels to encourage substantial borrowing by households and businesses. This might lead to credit growing very strongly for a period relative to GDP growth, but this would be a

desired outcome of the monetary policy. A simple reading could be that the counter cyclical buffer should come into play, which could reduce lending, thereby offsetting the goal of expansionary monetary policy.

Given the potential macroeconomic impact of the countercyclical buffer, there are good arguments that authority responsible for monetary policy should have the responsibility for setting the counter cyclical buffer. However there are also good arguments that the authority that has responsibility for setting the micro prudential regulation should also have the macro prudential responsibility. It is recommended that the committee recognise the difficulties that might arise in jurisdictions (like Australia) where responsibility for monetary policy and prudential supervision reside with independent authorities.

While this separation of responsibilities can be addressed by formal agreements between the agencies, the determination of policy differs from that in jurisdictions where there is a single regulatory authority for both monetary policy and prudential regulation.

7. Conclusion

A counter-cyclical buffer is conceptually sound, although there appear to be a number of practical implementation issues. Given the range of other proposals to be introduced, it is important that the development of the countercyclical buffer has regard to the other capital proposals under development.

If a counter-cyclical buffer is to be introduced, then there will need to be an extended period of observation, similar to that proposed for the NSFR and the Leverage Ratio. Even then it might be difficult to model the full implications of the counter-cyclical buffer given the complexity of the announcement impacts.

It will take time for individual jurisdictions to develop and communicate a framework that banks and the wider financial sector can understand. The practical difficulties in developing a credible counter cyclical buffer communication and application strategy also suggests that policy implementation should be some way off.