BNP PARIBAS

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BNP PARIBAS RESPONSE TO THE BCBS CONSULTATIVE PAPER N°172 ON COUNTERCYCLICAL CAPITAL BUFFERS

Executive Summary

BCBS has conducted a thorough analysis with the objective of softening the cyclicality of the current regulatory framework and creating a disincentive for banks to contribute to an excessive indebtedness growth.

Whilst we support the need for all banks to hold sufficient capital in order to withstand unexpected losses and to behave wisely we would like to bring forward some fundamental concerns about the proposal that we believe are serious enough to justify abandoning the concept itself.

The countercyclical buffer, designed as a macro policy tool, is not appropriate

This is not an appropriate tool for managing the responsibility of banks in the economic cycles.

Slowing down the excessive expansion of debt would be better achieved through the usual policy instruments and particularly the monetary one, which implies consistent and conscious arbitrage between conflicting objectives by decision makers. The concept that underlies the proposed mechanism is bright but ineffective.

Its actual effect is partial and will slow down the credit distribution too late while the stimulatory effect of credit supply sought by the release of the countercyclical buffer is purely academic. We have never seen that a supervisor or the market relax the constraints in the midst of the crisis.

The forward-looking provisioning is much more efficient to keep control of the excessive and risky banking behavior.

The forward looking provisioning as formulated in the proposal of the European Banking Federation on the basis of Spanish scheme (which has already proven its effectiveness) seems much more efficient.

It takes into account the specific behavior of the banks and impacts directly and immediately its earnings according to the volume and quality of its risk taking.

Earnings have much more influence on management and development than capital.

This macro policy tool is unfair and favors disintermediation.

The proposal made by the committee does not make any difference between banks have they a reasonable or a careless credit distribution policy. It weighs only on intermediating banks even when they are not responsible of the indebtedness growth. It clearly encourages disintermediation.

Finally, this tool will be an additional factor of uneven playing field

Not only does it favor financial systems where markets are predominant but it is also a factor of complexity and divergences in its implementation.

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Detailed comments

1. Consistency of the aim assigned to the countercyclical capital buffer measure with the objectives formulated by the G20

The commitments taken by G20[1] aim to lower the procyclicality of the regulatory framework (commitment 52) and to prevent the build-up of a systemic risk (commitment 49):

- o *"The FSB, BCBS, and Committee on the Global Financial System working with accounting standard setters should take forward implementation of the recommendations published to mitigate procyclicality, by the end of 2009, including a requirement for banks to build buffers of resources in good times that they can draw down when conditions deteriorate"* (commitment 52),

- o *"The national implementation of higher level and better quality capital requirements, counter-cyclical buffers, high capital requirements for risky products and off balance sheet activities, as elements of the Basel II capital framework, together with strengthened liquidity risk requirements and forward-looking provisioning, will reduce incentives for banks to take excessive risks and create a financial system better prepared to withstand adverse shocks"* (commitment 49).

We consider that the objectives which are contemplated in the BCBS's proposal are slightly different from the objectives set forth by the G20 as it consists in the following:

- o preserving the ability of banks to maintain the flow of credit in the economy during a crisis resulting from a too rapid credit growth (page 2 of the proposal)[2];
- o protecting the banking sector in addition to ensuring the solvency of individual banks;

The potential moderating effect on the build-up of the credit cycle is then only viewed as a beneficial effect, rather than the primary aim of the proposal.

We therefore understand that the final objective of the proposal is not to curb the distribution of credit by banks, but rather to force them to preventively build-up a "cushion of safety" in the event of financial crisis. The approach is not to effect on the causes of the crisis, but rather to weigh on its consequences, by considering the risk as an exogenous variable.

We consider that this is an unorthodox way of understanding the term "macro-prudential" since this term usually refers to the regulation of the overall level of risk appetite in the financial system, by changing the incentives and the rewards of the risk taking. However, the proposed mechanism does not have this incentive, since the consequences in terms of capital requirements of individual bank behaviour (distribution of uncontrolled or excessive

[1] Progress Report on the economic and financial actions of the previous G20 Summits, July 20, 2010
[2] BCBS Consultative Paper 172, p.2

credit) are shared between different credit institutions, regardless of their respective contributions to the gap between the ratio debt / GDP and its trend. By exerting a marginal influence on the bank behaviour, such a mechanism would be costly to implement in practice, without offering the benefits expected by the G20 in terms of reducing the pro-cyclicality across the financial system.

Moreover, the partial mitigation of pro cyclicality of minimum capital requirement is not even mentioned in the consultation document. If the proposal was at work, this corrective action would intervene too late, since its implementation is at the discretion of the national regulator (with an additional one-year lag between the decision and implementation).

We do not raise objections on the argument that a broader definition of credit is a better leading indicator of banking financial stress than a narrower one. However, restricting bank lending when the significant increase of the stock of private debt is not due to banks seems unfair, not only for virtuous banks but also for clients whose only financing channel is credit (SMEs, individual entrepreneurs, households). The effectiveness of the proposal is questionable since it is not encouraging slowing the progression of lending whose growth is excessive, but only bank lending. This raises the question of the scope of prudential regulation. It should be recalled here one of the commitments of the G20:

"We will amend our regulatory system to ensure authorities are able to identify and take account of macro-prudential risks across the financial system including in the case of regulated banks, shadows banks and private pools of capital to limit the build up of systemic risk."

Indeed, the current scope of regulation is too narrow. The Heads of States and Governments of the G20 have defined a straightforward principle on the matter: all markets, products and financial players have to be subject to appropriate regulation or supervision. We deplore that the countercyclical buffer proposal will apply only to the regulated sector, thus aggravating the level playing fields issues between regulated and non-regulated sectors which finance the economy due to the difference of requirements and capital constraints. Therefore, we consider that the proposed buffer will create a counterproductive incentive by providing a competitive advantage to the non-regulated financial sector and strengthening a "shadow banking system" which is conflicting with the G20 objectives.

2. Unclear interaction between the set of proposals to reduce procyclicality

The consultative document identified four factors to dampen procyclicality of the financial system and to promote countercyclical buffers that aim to stabilise the system. Only one of them (protect banking sector from period of excess credit growth) is considered by the proposal. However, other factors (such as reduce cyclicality of minimum requirements primarily through Through-the-cycle (TTC) PDs or downturn PDs, promote forward-looking provisioning) are omitted from the paper. Therefore, we notice that the procyclicality is addressed by a number of overlapping proposals without having a clear understanding of the potential interplay between measures or an assessment of the cumulative and incremental impacts.

There is serious concern that the building-block approach to capital requirements (the countercyclical buffer is the forth building block) which is currently underway can operate with the efficiency anticipated. In effect, what is missing from the discussion is the importance of avoiding double or triple counting through the layered capital requirements that would be harmful to the consultative document's objectives.

Furthermore, a similar danger of double-counting cyclical risks arises with regard to the TTC rating systems under Pillar 1. The TTC parameters (notably PDs) already include a component reflecting the economic cycle and their use is a stronger incentive to smooth the credit cycle should they be included in the loan pricing of credit.

Finally, it is important to note that the interaction of the buffer with the forward-looking provisioning is ambiguous. While the loan-loss framework is conceptually distinct from the countercyclical buffer, in practice and according to its objectives the forward-looking provisioning should be considered a better tool for mitigating the countercyclicality of the capital requirements.

3. Lack of clarity regarding the interaction of the countercyclical capital buffer mechanism with ICAAP

While the paper states that the countercyclical capital buffer proposal is not a Pillar 2 approach, it does not explain how the proposal would interact with ICAAP requirements. Moreover, the expectation that the conceptual distinction between the countercyclical capital buffer and ICAAP will work in practice as foretold is debatable.

According to the ICAAP process functioning regulators and banks should already be considering macroeconomic and cyclical aspects in making the assessments of the capital requirement. Prudently run banks that have included macro cyclical issues in their ICAAP process would be particularly affected by the proposal in ways that might undermine their capital strategies. Furthermore buffer constrain would penalize conservative business model (i.e. those banks that have no or less exposure in the overheating sector(s) and also create incentives to disintermediation in cases where credit demand is strong. To avoid this drawback (i.e. undergoing an additional countercyclical buffer requirements for risks already taken into account by its ICAAP) the bank would have to exclude from the scope of ICAAP discussion with the supervisor the macro cyclical impacts. Moreover, the proposal contemplates the further introduction of “sectoral capital buffers” without providing additional guidance.

Stress tests requirements raise similar concerns. Stress tests aim is to provide an indication of how much capital might be needed to absorb losses should large shocks occur. In order to reach this capital objective, a stress test should contemplate severe cyclical downturns, possibly as a result of excess credit growth. The countercyclical capital buffer shares the same objective which raises once again the danger of double-counting cyclical risks.

Therefore, we consider that the macro prudential’s objectives of the proposal are already covered by the micro prudential rules.

4. The interaction with the macroeconomic policy decisions is poorly addressed

The proposal sets forth under Principle 1 that the countercyclical buffer is not meant to be used as an instrument to manage economic cycles or asset prices. It is important to distinguish macro prudential goals from macroeconomic policy decisions. Whilst the objective of the buffer is to protect banking system against potential future losses when excess credit growth is associated with an increase in system-wide risk, the transmission mechanism between required capital buffers and the impact on the price and demand for credit is not fully demonstrated. It is of outmost importance to evaluate whether it is possible in practice to address the macro prudential dimension singly. Moreover, the identification of the true roots of the crisis is always very debatable and highly complex.

If the authorities contemplate to smooth economic fluctuations, they should use appropriate instruments, such as monetary and fiscal policies, without interfering with the prudential regulation or supervision of financial intermediaries.

In the context of low and stable inflation, the monetary policy regimes that do not inhibit the accumulation of financial imbalances resulting in an exceptionally rapid increase in credit flow and asset prices may intensify unwillingly the financial imbalances.
In this regard the implementation of a formal coordination between central bankers and bank regulators is highly desirable.

5. Foreseeable negative consequences of the countercyclical buffer proposal application

Countercyclical buffer, as proposed, will encourage the massive disintermediation of the financing the economy and the transfer of risk outside the regulated area

Even if the buffer will have a small dampening effect on the broad credit aggregate volume (intermediated and disintermediated debt), however its application will lead to the substitution of market financing or granted by other financial players than banks to bank credit, as a consequence of the higher prices on intermediated financing inherent to the additional regulatory capital required by the regulator. Thus, the distortion of competition resulting between regulated and unregulated players would be likely to encourage the development of risk outside the regulated area. This unintended consequence will go against the objectives set by the G20.

This asymmetric scope of the countercyclical buffer application should be recognised and reviewed.

We would like to underscore that the effectiveness of the buffer depends on the level of intermediation of the economy. The countercyclical capital buffer has a self-regulatory feature which is more significant in countries where the rate of intermediation is high. Conversely, the probability that the excessive growth of debt is not attributable to the regulated sector is even greater when the rate of intermediation is low. In countries characterized by relatively low intermediation rate (U.S., UK, France), the proposal will fundamentally lead to unintended consequences by strengthen the disintermediation of funding. Thus, the buffer constraint could create incentives to disintermediate the banks in cases where credit demand is strong. This would also create incentives to move from country to country.

Moreover, the concentration of risks in the financial market beyond the absorptive capacity of the banking system (which acts as a buffer between players in need of funding and traditional lending players when the former are experiencing repayment difficulties) would accentuate the vulnerability of the real economy to a possible financial crisis.

The "originate and distribute" business model, whose responsibility in the crisis is not arguable, will be largely strengthen by the countercyclical capital buffer application

Banks whose model is to grant credits and then to transfer the risk to third party would be encouraged to persist in this strategy. The impact of the proposal on these institutions would be limited given that the burden of an additional layer of capital due to excessive credit growth will be shared by all banks, irrespective of their business model. Moreover, the lower “originate and distribute” financial institutions total net worth compared with more virtuous “originate and hold” credit institutions, the more limited their contributions to the overall additional layer of capital will be.

The countercyclical capital buffer will translate into a permanent increase of the minimum requirement

Buffer release

The discretionary decision to release the requirement belongs to the national regulator. In the absence of pre-established rule, this decision may be perceived by the market as a signal indicative of the regulator's concerns about the situation of banks. Moreover, the recent history has shown that factors such as increased uncertainty and risk aversion forced banks to increase their capital cushion, so it is very likely that an implicit market requirement will substitute to the requirement of the regulator. Accordingly, we believe that the consequences of the proposal are equivalent to a perennial increase of regulatory minimum capital requirement.

We think there is a paradox. In adopting the principle of the buffer release, the regulator admits that a higher level of regulatory capital requirements may restrict the lending capacity of the banking system. At the same time, the proposed mechanism involves *de facto* a permanent increase of capital requirements for banks, the strengthening of the implicit requirement of the market will offset more or less, the impact of the buffer release on banking behaviour.

It seems difficult to anticipate the likely market (both borrowers and investors) and the credit rating agencies behaviour with regard to the buffer decision and the need for banks to raise additional capital. We remain highly sceptical on the fact that banks would be allowed by the market, the rating agencies or even the supervisors to use the buffer when the economic situation deteriorates as it would be expected from banks to hold additional capital to withstand the financial turmoil. Most likely this will lead to consider the buffer as a part of the new minimum capital requirement.

Constraints on earnings distribution

The constraints on earnings distributions set forth by the proposal represent a serious breach of the shareholder rights to define the distribution policy of the company. Moreover, the distribution policy is not the only instrument available to the company to maintain its solvency ratio. Indeed, there are indeed many other means (capital increase, portfolio reallocation, transfers of assets).

From a more economic standpoint, putting aside a part of results by building capital reserves is not usually enough to improve the solvency ratios. Symmetrically, the restrictions on dividends would probably have modest efficacy to limit or prevent the resultants erosion. On the other hand, dividend distribution constraints may restrict the ability of banks to raise capital on the market, which constitutes an essential instrument to preserve its solvency. Indeed, experience suggests that the distribution policies are not without influence on the share value, contradicting the second theorem of Modigliani-Miller.

5. Countercyclical buffer proposal – a critique

In addition to the concerns formulated above we consider that the proposal displays several flaws which are presented hereunder.

The relevance of the indicator

We consider that is deeply unfair to calculate the countercyclical capital buffer based on the evolution of a credit aggregate apprehended in a broad sense, covering all debt instruments from the resident private sector, including funds raised from non-residents. For the Basel Committee, this principle is simply based on the fact that banks may suffer from the consequences of an excessive credit growth period, even though they would not be the direct cause.

It is said in the proposal that the long-term trend of the credit/ GDP ratio is purely a statistical measure that does not capture economic cycle's turning points well as recognised in the proposal. We consider there is a significant error risk for authorities in estimating the sustainable level of credit in the economy, not to mention the time lag which is inherent to a statistical approach.

Home-host supervisor issues

The Committee acknowledges that the calibration of the countercyclical buffer will be based mostly on a judgemental approach which is a rather delicate exercise requiring a lot of judgement from the regulators. Moreover, it is said in the paper that "judgement coupled with proper communications is an integral part of the proposal". This would suppose that a timely sharing of information among the authorities in charge for the conduct of monetary and fiscal policies as well as banking supervision should be set.

Regarding buffer decision, we can foresee an important concern in cases where contradictions will crop up between macro prudential and macroeconomic objectives (especially monetary policy). Whilst this aspect is crucial, the proposal does not clarify what authority will be entitled to operate the buffer decision in such cases.

As previously exposed, the interaction between home and host supervisors is an important concern. Indeed, in the proposal the Committee states that will continue to further develop this issue and anticipates the need for international coordination and jurisdictional reciprocity.

We consider that the proposal gives room for differences of opinion, judgment or analysis between supervisors on different topics such as the buffer decision, the buffer release and the calibration of the buffer. This aspect raises serious concern regarding inconsistent countercyclical buffer implementation across jurisdictions. As a result, different jurisdictional decisions would create incentives to borrowers to arbitrage borrowing conditions by moving from country to country.

Moreover, we fear that in some situations the national discretions may prevail that could create undesirable competitive imbalances.

Location of the buffer

The proposal is confusing and lacks clarity with regard to the location of the buffer. Indeed, according to the proposal host authorities can request that the countercyclical buffer be held at its level without clarifying the buffer functioning for cases where the credit exposure to this jurisdiction is booked in another country.

6. Conclusion

In the light of the above we do not support the Basel Committee proposal to introduce countercyclical buffers and we strongly favour the forward-looking provisioning measure as proposed by the EBF.

The proposal of the Basel Committee with respect to forward-looking provisioning should alleviate the necessity of implementing countercyclical capital buffers.

Limit the pro-cyclicality of the financial system is a laudable concern but countercyclical capital buffer does not seem to be the most effective instrument among the various options to achieve the goal. Thus, the forward-looking provisioning encompasses the following features:

- Given that the provisions directly affect the outcome, the bank behaviour will be more sensitive to a stressed economic environment, making the forward-looking provisioning a more effective instrument in terms of incentives.

- The provision for losses expected to help curb the volume of loans when it is growing rapidly, by penalizing institutions that would release their eligibility criteria. Indeed, any subsequent crisis draws at least as much rooted in the growth of bad risks induced by the intensification of competition in the credit volume growth, regardless of risk. However, unlike the countercyclical capital buffer, a dynamic provisioning system can discriminate the treatment of new financing by level of risk.

- Like the countercyclical capital buffer, a system of forward-looking provisioning takes into account the geographical allocation of the portfolio.

The EBF proposal which draws inspiration from the Spanish scheme of dynamic provisioning, (which has already proved its effectiveness), differs fundamentally from countercyclical buffer. Indeed, it makes the provisioning requirements ex-ante dependent of the individual behaviour of the credit institution since the calculation of the provisioning requirements is based on institution specific criteria rather than a macroeconomic variable. However, it has an undeniable macroprudential interest acting effectively in fine on the overall incentive to take risks in the financial system. It works also like an automatic stabilizer and is not dependent on a discretionary decision of the regulator.

Therefore we urge the Basel Committee to make sure that these objectives are shared by the accounting standard setters.