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The voice of banking & financial services

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Dear Governor Wellink

British Bankers Association (BBA) response to the Basel Committee on Banking Supervision Consultative proposal upon a Countercyclical capital buffer

The BBA acknowledges the proactive stance taken by the Basel Committee to provide further consultation in the area of a countercyclical buffer in response to feedback given in April to the BCBS 164 consultation. We recognise the work undertaken by the Macro Variable Task Force in developing a more detailed framework over a complex subject.

As stated in our April response, the industry recognises that there may be a role for a capital buffer to be built over time to address cyclicality, and periods of economic downturn and stress. We view a capital buffer framework to be a part of the macro-prudential tool set and believe the evolving Systemic Risk Boards and Macro Prudential Authorities have an important part to play in this area with the monitoring of risk in the global system, the facilitation of the development of global stress tests and the monitoring and signalling of buffer levels in conjunction with the Basel Committee.

We would however always stress that capital is only one aspect to addressing risk within the system. A capital buffer is a blunt and limited instrument tackling mainly the supply side of credit growth. It does not directly impact the behaviour of businesses or households where other tools will be needed to manage demand. The importance of sustainable monetary, fiscal and regulatory policy in engendering financial stability should also not be overlooked.

A general reservation the industry has is that the proposed system of buffers is becoming increasingly complex as to how the various buffers and countercyclical measures interact with each other and with existing Pillar 2 measures. There is a danger that the system as proposed could be widely misinterpreted or misapplied. We would strongly recommend therefore a simpler approach utilising a single regulatory buffer system the size and dynamic of which could still reflect the various objectives identified by the Committee.

It is also essential that the design and calibration of the buffer is considered within the wider design and calibration of the Basel III reform package. We firmly believe that the appropriate calibration of the regulatory minimum requirements combined with a well defined single capital buffer can effectively manage credit expansion. These will then automatically give rise to higher capital requirements reflecting increased RWAs arising from increased volumes of loan assets and other risk exposures. This approach targets those banks that are contributing most to the credit expansion.

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Recognising this is a nascent process, the industry fully supports the Basel Committee's suggestion for a sub-committee to be formed to develop further the buffer principles and operating model. The industry recommends the inclusion of a representative group of banks to that sub-committee, so that as the principles and guidance is developed practitioners can facilitate the review similar to the RMMG model.

We develop these themes further below in our detailed response to the consultation and highlight the general principles by which we believe a buffer framework should operate:

1. <u>Objective</u>

Whilst recognisng the objective to address cyclicality and in particular excessive credit growth, the use of a buffer to affect this cannot be reviewed in isolation to the other reform initiatives which are also seeking to address such matters and other related issues. In addition, due recognition must be given to the fact that the banking industry is not the sole generator of credit growth and authorities will need to consider other measures outside of the industry that may be necessary to introduce to support that aim.

From an industry standpoint we reiterate the view that there are several key parts to the regime to address cyclicality and that it is necessary to keep a clear distinction between the accounting and regulatory capital frameworks.

Currently the series of initiatives already in place or being developed to help manage, and dampen cyclicality are broadly encompassed by the following regimes:

i) The presence of the Basel II framework and the general application of downturn or through the cycle PDs and scalars upon which further work can be undertaken to ensure their consistent application

ii) Introduction of forward looking provisioning with the intended

- revision of the IAS 39 impairment methodology to move it from an incurred to an expected loss basis;
- consequential amendment to the supervisory guidance on provisioning; and
- moves to address disincentives to provisioning under the capital framework.

The banking industry supports the IASB's objective to move to an expected loss regime (but holds serious reservations over the workability of the IASB's proposed model) and the idea of ensuring that provisions raised incorporate a broader range of credit information than may currently be the case and believes that it is important that this be achieved within the context of the objectives of financial reporting, which are different in certain ways to the objectives of prudential regulation.

iii) Pillar 1 regulatory parameters e.g. downturn LGD and the soon to be introduced stressed VAR, which already therefore form part of the capital plan and provide buffer for counter cyclical situations.

iv) The use of the Pillar 2 supervisory framework, whereby in a number of jurisdictions a capital planning buffer regime operates informed by stress and reverse stress processes which includes review of economic downturns.

v) The changes to the Trading Book capital allocations which will reduce procyclicality.

The first part to the regime to address procyclicality should therefore concern the earlier recognition of *expected* losses and should be achieved by moving the accounting framework from an incurred to an expected loss basis, amending supervisory guidance on provisioning and unwinding disincentives to provision in the Basel II framework.

The second element is where the buffer operates in mitigating *unexpected* losses which arise through the economic cycle and that should be the key objective of the buffer. Stress tests will therefore play their part in the determination of elements of the buffer level. Other elements as highlighted above that will facilitate management of cyclicality are the development of through-the-cycle PDs and scalars.

It will be imperative as the Committee, regulatory authorities and industry evolve their thoughts upon a buffer regime that critical attention is paid to the manner in which each of these measures interact and inter-relate to avoid double counting and the unintended consequence of trapping capital to an extent that hinders lending and support to the real economy. The calibration of the combined reforms will be essential to consider as a whole, rather than in isolation, if the optimum balance is to be achieved. No buffer framework should be set in isolation.

A single buffer framework: Avoidance of double counting is an imperative

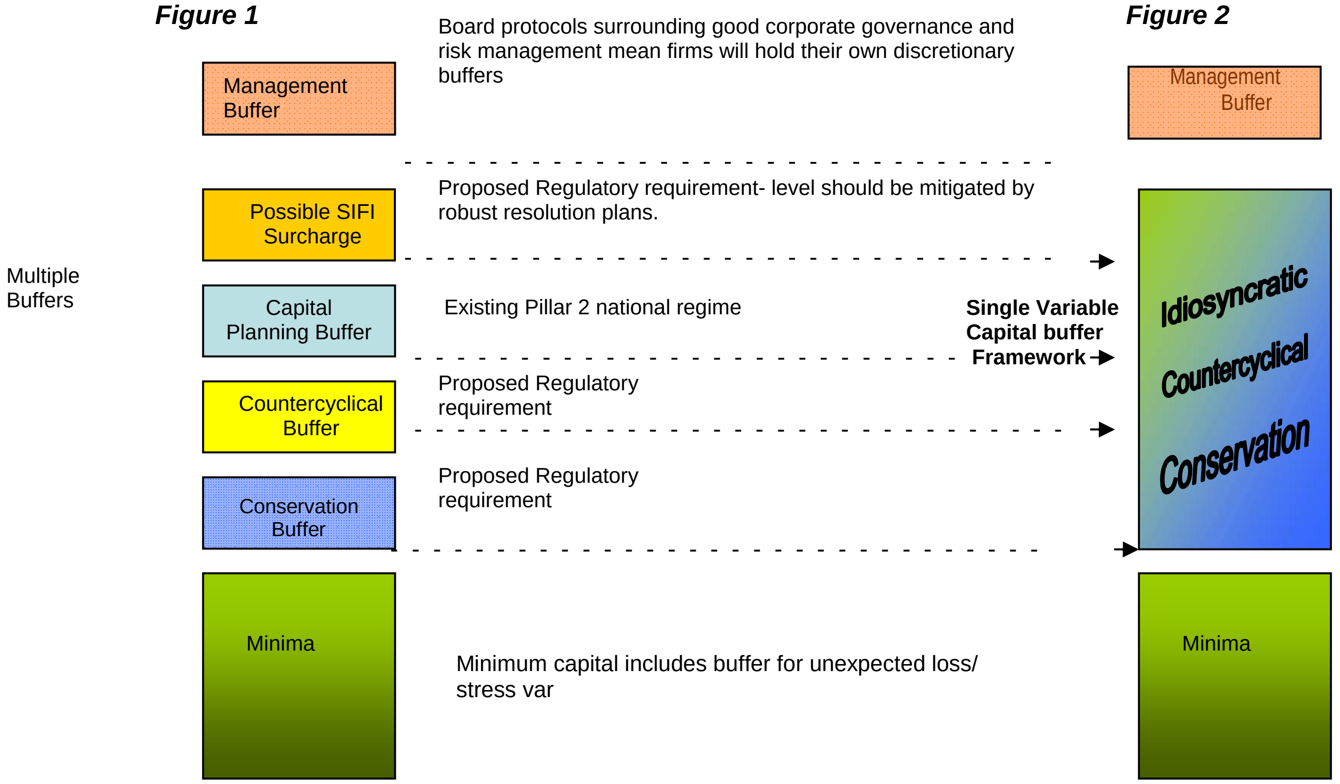
Whilst supportive of the overall benefit of the development and adoption of a consistent global buffer framework the industry remains highly concerned by the double counting to which the proposal would give rise and the wider consequences for lending capacity and the real economy.

It would be entirely inappropriate to create a situation where buffers sit upon buffers trapping capital from its efficient use in the real economy. Yet, as depicted in figure 1 below, it seems that there is a real danger that this will be the exact resultant consequence of the proposed counter-cyclical and conservation buffer regimes. On the face of it, these sit on top of existing national regimes rather than, as should be the case, fully integrating with a national regime to, in effect, create one buffer framework – what might be called a Single Variable Capital Buffer Framework - the level of which has been derived by reviewing the following components i) conservation; ii) countercyclical environment and iii) idiosyncratic related provision.

Recognising the complexities involved in the setting of a capital buffer while avoiding layers of buffers and double-counting the UK industry has worked closely together in reviewing the suggested Basel proposal and has developed this Single Variable Buffer Framework, with the components listed above and depicted in figure 2 below as a means to simplify implementation and facilitate market understanding. It is this Single Variable Buffer Framework that we recommend be adopted internationally as part of the Basel framework and in section 3 below we outline the guiding principles that we believe should be set to govern the framework and to thereby create a global standard and methodology.

It should also be noted that the starting point for any capital buffer framework should be an explicit recognition that the buffer should be designed to be drawn down at the appropriate point in the economic cycle and in adverse external circumstances. It would be inappropriate if constraints were placed on the use of the buffer which resulted in it being viewed by either supervisors or the market as establishing a new minimum capital requirement or in breach of a regulatory requirement when drawn down: some of our members have concerns that this will be challenging to achieve in practice, particularly without careful explanation to the market.

Figure 1 *Figure 2*



2. National buffer decisions and jurisdictional reciprocity

It is critical that the interplay between the buffer framework proposed by the Basel Committee interacts effectively with any national buffer regime. The global Basel framework should therefore fully integrate with a national regime to, in effect, create the one Variable Capital Buffer Framework as described above. This transition of the old national regimes to the new global standard will be critical and will need suitable lead in time. In terms of the formulation of the buffer range, whilst the industry understands the manner in which the Basel Committee is proposing for these to be calculated for domestic institutions, refinement is needed to the manner in which this is achieved for an international cross border firm as follows:

For an international cross border firm it should be the responsibility of the lead consolidated supervisor to determine the overall setting of the appropriate aggregate buffer level for the group, which would be maintained at the **consolidated group level**. There should be no national capital buffer holdings for an international firm, rather there should be national buffer parameters and recommendations submitted to the lead consolidated supervisor with the final agreement being reached on overall buffer level, held at the consolidated level, through the consolidated supervisor with support from colleges as necessary.

It needs to be recognised that for a consolidated group, the most efficient use of capital is by holding surplus capital at consolidated level, minimising the capital surpluses held within subsidiaries. That enables the free transfer of capital around the group as and when it is most needed and avoids capital becoming 'trapped'. For this reason where it is necessary to set regulatory capital buffers, the buffers should be set at consolidated group level only. Application to individual legal subsidiary entities within a consolidated group should be avoided to facilitate maximum flexibility of the group's capital resources to be deployed efficiently.

The industry views colleges as being critical to making this home/host process work. The Basel guidance should build out the process and principles on which the group buffer should be developed endorsing a

consolidated level application and engage members of the Industry in the working group tasked with drafting these. We would envisage this group being of similar composition and terms of reference as the RMMG. We suggest that the reference to this issue should be included in the recently published good practice guidelines for the operation of colleges.

3. Common reference guide and principles to promote sound decision making

We support the Basel Committee determining a common methodology and starting reference point for setting buffer ranges and taking buffer decisions. This is essential to ensure consistency and robustness of approach. We believe the methodology suggested by the Basel Committee based on the aggregate private sector/ GDP gap to be a useful start point.

We also strongly recommend the Basel Committee's Standards Implementation Group be charged with setting global standards for the capital buffer methodology. In developing this guidance we view the adoption by the Basel Committee of the key principles outlined below to be critical. Embedding these into formal guidance will ensure the right framework for buffer development is created which drives the right behaviours and achieves the end objective.

The Guiding Principles to the Single Variable Capital Buffer Framework - which we recommend be adopted by the Basel Committee:

i) Regulatory capital buffers should be expressed for each institution as a single "Variable Capital Buffer" derived by the supervisor based on its review of the quality of the institution's governance and risk management practices, capital plans (including under stress) and associated management actions.

ii) The methodology for deriving the Variable Capital Buffer should incorporate the following four principles which align to the Basel Committee's objectives:

I. Firm specific (idiosyncratic) – each firm's forward-looking plans should be stressed to assess the implications of stress events for its particular risk profile and capital needs.

II. Counter cyclicality – the size of the capital planning buffer should vary, building up in times of excess credit growth and being drawn down in adverse circumstances.

III. Conservation – designed to allow capital conservation measures to be taken as firms draw down the buffer under stressed conditions after management actions.

IV. Avoid double-counting - supervisors must ensure that double-counting is eliminated in determining the buffer.

iii) The level of buffer should be determined:

- Through the Pillar 2 process for individual firms with no fixed amounts and according to international standards set by the Basel Committee;

- Using a combination of institution-specific stress tests and supervisor-defined scenarios which capture macro-economic and system-wide stresses (see global methodology below);

- Taking into account the impact of macro-prudential and other supervisory tools (such as loan-to-value limits) which are designed to reduce risks undertaken by banks and hence their capital requirements;

- At Tier 1 level (on the basis that under the new definition of Tier 1 capital, it will be loss absorbing);

- In addition to capital for specific Pillar 2 risks (such as interest rate risk in the banking book);

- As an absolute amount which can, for presentation purposes, then be expressed as a Tier 1 percentage of Pillar 1 RWA.

iv) Identifiable criteria should be defined to determine when the buffer may be used, explicitly recognising that the buffer is designed to be drawn down at the appropriate point in the economic cycle or in otherwise adverse external circumstances. That is, the size of the buffer should vary as macro-economic stress assumptions take into account the economic cycle. It could be expected, in theory, to be nil in extreme stress circumstances.

v) In setting the idiosyncratic element of the Variable Capital Buffer, supervisors will consider the strength of an institution's corporate governance, risk management practices, going–concern recovery plans and the implications of resolution for the institution. These qualitative assessments inform measurement of institution-specific risk and should influence the resultant quantitative buffer amount. Existing RWA calculation practices should also be taken into account when setting the buffer (for example, with regard to the extent of through-the-cycle volatility of the Pillar 1 methodology).

It is important to focus on a specific institution's profile as banks adopt a range of modelling methodologies from "point-in-time" to "through-the-cycle" which needs to be understood when sizing the quantum of any particular capital buffer.

vi) The methodology and standards for setting the Variable Capital Buffer should be internationally aligned.

- o The Standards Implementation Group should be charged with setting global standards for the capital buffer methodology. While firm-specific buffers should remain confidential, the methodology used by supervisors should be internationally agreed, made public and, be applied consistently across jurisdictions.

- o International supervisors should work on improving standards and coordination of stress testing across markets.

- o The macro-economic component should be based on internationally consistent tools, frameworks and processes.

- o The determination and review of stress scenarios and the process of stress testing should be coordinated internationally through supervisory colleges. The nature of stress scenarios should be published to signal to the market the level of counter cyclicality built in and to create confidence in the methodology.

- o The methodology should specify the approaches that supervisors should use to prevent supervisors from requiring growth of capital buffers in stressed circumstances.

vii) The Variable Capital Buffer should be established at the group consolidated level as determined by the consolidated lead supervisor in liaison with the national supervisors in of the countries which the institution operates. Global standards should be developed to govern how home and host supervisors should collaborate to set the buffer for the group; ensure that there is no double counting within a group, and resolve differences of view. The consolidated supervisor should manage the overall process

viii) National supervisors should comply with the agreed framework and avoid weakening or strengthening the local capital buffer methodology and capital buffer levels. This is to avoid creating market distortions and arbitrage opportunities.

ix) Trigger ratio principles (particularly, in relation to capital conservation actions) should be made public. Specific trigger levels above the minimum Tier 1 ratio should be set bilaterally between supervisors and firms and remain confidential as part of the Pillar 2 supervisory framework.

x) If a firm's Tier 1 capital falls below pre-determined firm-specific trigger levels, this should initiate a supervisory review through a Pillar 2 process to determine if and how capital levels need to be rebuilt:

- Actions for consideration should be set out in advance within a confidential recovery plan, with specific types of actions attributed to each trigger point.

- The range of actions should include reductions in the distribution of retained earnings, particularly: dividends, share buybacks and discretionary payments on Tier 1 instruments.

The use of the buffer should not activate any additional supervisory disclosure or corporate governance obligations in addition to those covered by, for example, existing listing requirements.

4. Communicating buffer decisions

If regulators set public buffers above the regulatory minima, the general perception of what is adequate capital is then likely to be set at a step above that. Consequently, banks will be unable to utilise regulatory buffers to the same extent as they would use internal management buffers. They will need to hold additional management buffers on top of the regulatory buffers. As a result banks will be forced to capitalise to levels well in excess of those envisaged by the Committee, and in excess of the levels justified by the risk.

This unintended pressure upon capital levels would, to an extent, be alleviated if the regulatory buffer is set through bilateral and confidential discussions between the bank and its regulator. The key here is that the buffer would be bank specific and not disclosed. We touch upon this further in the following sections.

In addition, as previously stated, the industry believes that the Basel Committee, FSB and National Macro-prudential Authorities (MPAs) have a key role to play on the communication and signalling of buffer levels and a methodology for this must be developed. This will be essential in ensuring the buffer is not seen by the market as a new capital minima and in ensuring appropriate market behaviours occur when buffer ranges decrease or are drawn-down.

We also firmly believe the Basel Committee working with the FSB should act as a 'clearing house' for national authority's determination of and the countercyclical element of a buffer and should be the global source of information on these levels. These institutions should be tasked with the monitoring of baseline buffer levels and the FSB should assess overall risk in the system to help inform the establishment of the buffer levels and timing of drawdown vs build up.

Identifiable criteria should be defined to determine when the buffer may be used, explicitly recognising that the buffer is designed to be drawn down at the appropriate point in the economic cycle or in otherwise adverse external circumstances. That is, the size of the buffer should vary as macro-economic stress assumptions take into account the economic cycle. It could be expected, in theory, to be nil in extreme stress circumstances

The Basel Committee subgroup referred to should be formed not only of national regulators but also key global industry banks, and FSB/IMF counterparts to ensure the regime develops in a consistent and appropriate manner. The construct of this group would be similar to that of the RMMG subgroup.

This group should be formed quickly and part of its initial role should be to assess the extent to which there is double counting before determining any calibration to the buffer level. It will be vital that the calibration of the appropriate range for the capital buffer be considered alongside the exercise to recalibrate the capital framework and in light of the recommendations reached on forward looking provisioning. This exercise should include the review of existing national buffer processes to ensure the ability for the existing national regimes to be subsumed/ transitioned into the new global framework thereby ensuring double counting is minimized, and the wider consequences for lending capacity and the real economy are minimized. An appropriate implementation and transition timeline will be required.

We will be happy to discuss this further with the Basel Committee and propose institutions that could play a role in it.

5. Further comments upon the key elements of the proposal:

i) Principles underlying the role of judgment:

Principle 1:

Whilst accepting the theory of Principle 1 the industry has a number of concerns over the practical manner in which it will operate.

A capital buffer is a blunt instrument and limited to tackling the supply side of credit growth it does not directly impact buyer behaviour which can only be influenced via other tools. In addition it is not just banks that create credit and authorities will need to be alert to what potential tools will be needed for other sectors in order for them to manage excessive credit. It would be inequitable – and perhaps ineffectual - for credit to be dampened within the banking sector only for an issue to arise elsewhere.

Equally as highlighted by the Committee fiscal, monetary and other public policy will have its role to play.

As stated above the manner in which the buffer is built and then released is critical. The FSB, Basel Committee and Macro-prudential Authorities (MPAs) have an important part to play here in managing expectation and in signalling

i) the base line buffer framework, approach and levels;

ii) alterations over time of buffer ranges and

iii) reduction in buffer ranges/ drawdown

This signalling role of the FSB, Basel Committee and MPAs will be crucial in ensuring the Single Variable Buffer is not seen by the market as a new capital minima and in ensuring appropriate market behaviours occur when buffer ranges decrease or are drawn-down.

In addition the use of the buffer should not activate any additional supervisory disclosure or corporate governance obligations in addition to those covered by, for example, existing listing requirements.

Formal board guidelines/ enhancement to corporate governance guidelines, education of board members on uses of the buffer are likely to be necessary to develop. This will need to include, inter alia, formal legal opinion of disclosure of obligations and listing rules.

Principles 2 and 3:

We support the Basel Committee determining a common methodology and starting reference point for setting buffer ranges and taking buffer decisions. The macro-economic component should be based on internationally consistent tools, frameworks and processes. This is essential to ensure consistency and robustness of approach. The principles outlined in Section 3 above should be a guiding factor.

We believe the methodology suggested by the Basel Committee based on the aggregate private sector/ GDP gap to be a useful starting point albeit, as noted above, acknowledging its limitations is also important to recognise.

We therefore agree that authorities should use this measure as a reference guide coupled with the best information available to gauge the build-up of systemic risk.

We further recommend the Basel Committee working with the FSB should act as a ‘clearing house’ for national authorities’ determination of the macro-economic component (countercyclical) component and should be the

global source of information on these levels. These institutions should be tasked with the monitoring of baseline buffer levels and the FSB should assess overall risk in the system to help inform the establishment of the buffer levels and timing of drawdown vs. build up.

Care must be taken to avoid arbitrage.

The Basel Committee subgroup referred to earlier working with the Standards Implementation Group can play a key role in the development of these principles and we would recommend its formation in the short term including members of industry to take these principles and guidance further forward.

Once the countercyclical picture has been formed through this methodology at the Basel Committee level it should then be incorporated as relevant at the firm specific level under following guidance principles:

- Through the Pillar 2 process for individual firms with no fixed amounts
- Taking account of existing RWA calculation practices should also be taken into account when setting the buffer (for example, with regard to the extent of through-the-cycle volatility of the Pillar 1 methodology).
- At Tier 1 level (on the basis that under the new definition of Tier 1 capital, it will be loss absorbing);
- As an absolute amount which can, for presentation purposes, then be expressed as a Tier 1 percentage of Pillar 1 RWA.

In setting this supervisors should consider the strength of an institution's corporate governance, risk management practices, going–concern recovery plans and the implications of resolution for the institution. These qualitative assessments inform measurement of institution-specific risk and should influence the resultant quantitative buffer sum. In terms of the calculation of buffers being aligned to credit exposure positions – careful thought needs to go into the determinant of the level applied recognising the fact that for those institutions subject to IRB modelling an element of procyclicality is already catered for within their RWA calculation.

Principle 4: Release

Identifiable criteria should be defined to determine when the buffer may be used, explicitly recognising that the buffer is designed to be drawn down at the appropriate point in the economic cycle or in otherwise adverse external circumstances. That is, the size of the buffer should vary as macro-economic stress assumptions take into account the economic cycle. It could be expected, in theory, to be nil in extreme stress circumstances

Disclosure of the buffer would make it difficult to implement effectively a reduction in the buffer when the excessive credit growth is judged to have reduced to acceptable levels. Market expectations are likely to work against a bank being able to reduce the buffer it holds even after the regulator has withdrawn the requirement.

Impact when the buffer is breached

The holding of capital buffers over regulatory minimum levels is a necessary and standard practice of well run banks. Moreover, it is recognised that there will be occasions when it is appropriate for a regulator to enter into a dialogue with a bank concerning the ways the bank intends to improve or conserve the level of capital buffer it holds. That is a normal part of the relationship between supervisor and firm. Importantly, though, we suggest that the most appropriate manner for that discussion to take place is on a bilateral confidential basis, not subject to public disclosure.

If a firm's capital falls below the firm-specific buffer levels, this should initiate a supervisory review through a Pillar 2 process to determine if and how capital levels need to be rebuilt:

- Actions for consideration should be set out in advance within a confidential recovery plan, with specific types of actions attributed to each trigger point.

- The range of actions should include reductions in the distribution of retained earnings, particularly: dividends, share buybacks and discretionary payments on Tier 1 instruments.

We absolutely support the principle that a bank should generally look to reduce its profit distribution as the buffer is utilised. The most appropriate way for that to work, however, is likely to be different depending upon the individual bank's circumstances including the reasons for the buffer utilisation and its forecasts for recovery. The bank itself should, therefore, initially construct a distribution proposal and should, as required, discuss that with its regulator. Only if it fails to satisfy its regulator that this it has an appropriate distribution strategy should the regulator then consider imposing restrictions, tailored to the individual bank.

Principle 5 Part of suite of tools

We support this principle. Capital is only part of the equation. Other tools will need to be developed if the regime is to have an impact on credit growth. As set out in the attached paper, we fully support the development of a macro-prudential framework seeing it as a necessary complement to existing macroeconomic management and micro-prudential regulation.

<u>ii) Calculation</u>

Whilst acknowledging the methodology outlined by the Basel Committee we stress the following points:

The Variable Capital Buffer as previously stated should be established at the group consolidated level as determined by the consolidated lead supervisor in liaison with the national supervisors in which the institution operates. Global standards should be developed to govern how home and host supervisors should collaborate to set the buffer for a group and how to resolve differences of view.

National supervisors should comply with the agreed framework and avoid weakening or strengthening the local capital buffer methodology and capital buffer levels. This is to avoid creating market distortions and arbitrage opportunities.

Trigger ratio principles (particularly, in relation to capital conservation actions) should be made public. Specific trigger levels above the minimum Tier 1 ratio should be set bilaterally between supervisors and firms and remain confidential as part of the Pillar 2 supervisory framework.

The Industry views it to be critical to refine the home / host process and it to be essential that the Basel Committee embed an overarching principle for an international group that the resultant aggregate buffer be held at the consolidated level. These principles should be built out in the Basel guidance which should be developed in a working group including members of the Industry. This should crucially avoid the multiplicity of national buffers and opportunities for arbitrage that the suggested Basel mechanism promotes.

In addition, in setting the overall Variable Capital Buffer, supervisors should also consider the strength of an institution's corporate governance, risk management practices, going–concern recovery plans and the implications of resolution for the institution. These qualitative assessments inform measurement of institution-specific risk and should influence the resultant quantitative buffer sum. Existing RWA calculation practices should also be taken into account when setting the buffer (for example, with regard to the extent of through-the-cycle volatility of the Pillar 1 methodology).

It is also important to reflect here the reference point against which the buffer is calculated. As authorities will recognise many bank corporate customers have global limits designed to facilitate the booking of activity across lending trade finance and global markets as efficiently as possible to support their underlying business. Great care must be taken by the Basel Committee and regulators in developing a methodology for the calculation and management of the single variable capital buffer not to encourage corporate arbitrage or market distortions. For example, a client may determine where booking is effected based on where they know the level of buffer calculation and hence the costs of capital and borrowing will be lower; or where, given the public notification of the country specific cycle view, one market captures greater business opportunities over

another purely by the differentiation in buffer calibration, This would be an inappropriate unintended consequence that would not support/ endanger financial stability

This potential for arbitrage and market distortion is another reason why it would be inappropriate for a firm's buffer to be disclosed and for a Pillar 2 approach to be adopted,

The weighted averaging of national buffers reflecting a bank's national exposures should be undertaken by reference to the bank's published balance sheet, excluding its Trading Book, for which the geographical distribution can be subject to a high level of volatility. The resulting average buffer amount would then be applied to the whole of the bank's assets including the Trading Book.

iii) Data Availability

Whilst acknowledging there are a number of sources of data care must be taken as regards its confidentiality and access. Information that a bank is required to provide in order to inform the buffer level should leverage information readily available from a financial institution's own systems and should not add an unnecessary additional administrative burden.

In terms of the calculation of buffers being aligned to credit exposure positions – careful thought needs to go into the determinant of the level applied recognising the fact that for those institutions subject to AIRB an element of cyclicality is already likely to exist within their RWA calculation and double counting must be avoided.

iv) Location of buffer

As commented previously for cross border firms we do not agree with this approach which could lead to a multiplicity of buffers across multiple jurisdictions thereby tying up capital in an inefficient manner and not necessarily optimising its usage throughout the group both on a 'business as usual' basis or indeed in an economic downturn.

We therefore recommend the principle be established that for international firms the buffer will be located at the consolidated group level. The level derived will be formed from the input of the national authorities in the jurisdictions in which the institution operates. This will then be reviewed by the consolidated supervisor to derive the consolidated aggregate buffer level for the group. Global standards should be developed to govern how home and host supervisors should collaborate and how to resolve differences of view.

National supervisors should comply with the agreed framework and avoid weakening or strengthening the local capital buffer methodology.

v) Frequency

The manner in which the consultation currently reads suggests that a firm's buffer amount would need to be calculated on a daily basis. This is entirely unnecessary and inappropriate. A bank's buffer requirement should be set normally once a year in line with existing ICG/ICAAP processes.

vi) Interaction between Pillar 1 and 2

The Variable Capital Buffer should be established at the group consolidated level as determined by the consolidated lead supervisor in liaison with the national supervisors in which the institution operates.

The level of buffer should be determined through the Pillar 2 process for individual firms with no fixed amounts and according to international standards set by the Basel Committee. Whilst methodology of calculation should be published, the firm specific buffer level should be set bilaterally between supervisors and firms and remain confidential as part of the Pillar 2 supervisory framework. This is also important from both a market as well as client perspective to avoid arbitrage and unintended consequence.

vii) Publication

We have already highlighted that the public disclosure of a regulatory buffer is likely, through market expectations, to lead to the buffer being viewed more as a regulatory minimum. The impact would be to force banks to hold management buffers over and above the regulatory buffer and driving up capital levels beyond what is intended. The consequences of that are additional costs which would either be passed through to borrowers or would serve to reduce the returns on equity achieved by banks and thereby depressing new investment in the sector. From a macroeconomic viewpoint neither of these outcomes is desirable.

We are also concerned that disclosure would generate greater volatility when the market reacts to a bank's surplus capital over the regulatory minimum approaching the buffer range. This is more likely to occur if a bank does not hold a management buffer over the regulatory buffer as described above, and would generally act to de-stabilize the bank's financial position.

Disclosure of the buffer would also make it difficult to implement effectively a reduction in the buffer when the excessive credit growth is judged to have reduced to acceptable levels. Market expectations are likely to work against a bank being able to reduce the buffer it holds even after the regulator has withdrawn the requirement.

Furthermore, if the proposed inflexible scale of distribution restrictions is published then this may act as an additional major disincentive to investors. This would particularly be a barrier to recapitalisation during a time of stress when buffers are depleted.

It is essential that the use of the buffer should not activate any additional supervisory disclosure or corporate governance obligations in addition to those covered by, for example, existing listing requirements.

viii) Treatment of surplus when buffer returned to zero

The industry notes and agrees this approach. The manner of communication needs developing including how this is achieved through for example macro-prudential authorities and careful consideration to market reaction will be crucial.

ix) The authority to operate the buffer

The industry duly notes this approach and as stated earlier sees an important role for the FSB and Basel Committee in policing this process working with other Systemic Risk Boards such as the ERSB and other macroprudential agencies, and acting as a consolidator of information. However, from a firm specific viewpoint it is the consolidated lead supervisor that has the overall determination of the right level of buffer for that institution in liaison with the national authorities in which the firm operates

National supervisors should comply with the agreed framework and avoid weakening or strengthening the local capital buffer methodology and capital buffer levels. This is to avoid creating market distortions and arbitrage opportunities.

x) International comparisons and exchanges of views

The industry fully agrees with this and urges the inclusion of the FSB/IMF within this body. At establishment the industry also recommends the inclusion of a selective group of banks so that as the principles and guidance is developed practitioners can facilitate the review similar to the RMMG model.

Conclusion

Whist the industry recognises that there may be a role for a capital buffer to be built over time to address cyclicality, and periods of economic downturn and stress there is still much work to be conducted in developing the manner in which this operates and interacts with both existing and evolving regulatory initiatives. We firmly believe in the concept of a Single Variable Capital buffer that meets the objectives laid out by the Basel Committee but in a manner that is more simplistic for the market and industry. In considering the buffer framework great care needs to be taken to avoid double counting issues and arbitrage opportunities. A capital buffer is a blunt and limited instrument tackling mainly the supply side of credit growth - sustainable monetary, fiscal and regulatory policy in engendering financial stability are also key factors as are other tools to dampen demand. Recognising the evolving nature of this proposal the industry fully supports the Basel Committee's

suggestion for a sub-committee to be formed to further develop the buffer operating model and would welcome being able to participate in such a forum.

We look forward to a continuing, engaged dialogue on this topic with the Basel Committee and my colleagues and I would be delighted to discuss our thoughts on the above in more detail with you when convenient.

Yours sincerely,

Irene Graham

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