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Secretariat of the Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002 Basel
Switzerland

Dear Sirs/Madams:

Re: CBA Comments on the Basel Committee's consultative document "*Countercyclical capital buffer proposal*"

The Canadian Bankers Association[1] would like to thank the Basel Committee for the opportunity to comment on the July 2010 consultation paper entitled *Countercyclical capital buffer proposal*, and for its ongoing willingness to discuss and respond to industry concerns.

In principle, we believe that there is merit in introducing measures to achieve the macroprudential goal of protecting the banking sector from periods of excess aggregate credit growth and the associated build-up of system-wide risk. However, while we support the Basel Committee's goal, we have fundamental concerns with this proposal, which are outlined below.

1. Macroprudential Goal

The primary aim of the proposal is to use a buffer of capital to protect the banking sector from periods of excess aggregate credit growth that have been associated with the build up of system-wide risks. While this is a laudable objective, the interaction of countercyclical capital buffers and macroeconomic policy has not been sufficiently studied to ensure the result will be greater rather than less financial stability.

It is possible that the proposed countercyclical capital buffer could undermine the effectiveness of monetary policy, particularly during periods of economic downturn. When credit is growing quickly, application of the buffer would have a similar impact to a tightening of monetary policy. Consequently, the transmission mechanism of monetary policy would be affected. Central banks would need to factor the likelihood and impact of increased capital requirements into their decisions regarding the timing and extent of any tightening of monetary policy.

[1] The Canadian Bankers Association works on behalf of 51 domestic banks, foreign bank subsidiaries and foreign bank branches operating in Canada and their 263,400 employees to advocate for effective public policies that contribute to a sound, successful banking system that benefits Canadians and Canada's economy. The Association also promotes financial literacy to help Canadians make informed financial decisions.

2. Effectively a Permanent/Fixed Capital Buffer

There is considerable uncertainty regarding the practical operation of the buffer and whether it will become more of a permanent fixed buffer rather than the infrequently deployed buffer envisioned by the committee.

Although the draft proposal allows for an immediate release of the countercyclical capital buffer, the practical challenge is whether it will be feasible and permissible to draw down the buffer when credit growth slows. Banks may be pressured to maintain elevated capital levels to meet the expectations of stakeholders, such as investors and rating agencies that may not accept declining ratios following a period of losses. Regulators may fear a double-dip recession and require banks to maintain the buffer until a clear and sustained recovery is demonstrated. The recent downturn presents an example whereby market expectations led banks to hold higher rather than lower levels of capital.

While the consultative document states that the buffers are not meant to act as de facto minimums, incentives to ensure that capital distributions are not restricted and market sensitivity to declining buffers will likely motivate banks to stay above the buffer. As such the buffers will essentially be treated as a minimum by banks as market participants will want assurance that capital distributions are not constrained. Consequently, the proposal effectively results in the creation of a permanent or fixed capital buffer, rather than a variable capital buffer, raising minimum capital requirements.

3. Layers of Conservatism

We are concerned that the proposed capital buffers are adding another compounding layer of conservatism in the regulatory capital requirements. We would also strongly recommend that the BIS eliminate the 6% AIRB scaling factor. We are now many years into the implementation of Basel II and do not believe that the 6% scaling factor is as relevant.

4. Importance of Calibration of Buffer and Ability to Use Capital Instruments other than Common Equity to Support Buffer

If the buffer is implemented, we recommend that the size of the buffer (i.e., percentage of RWA) and transition period be calibrated to the industry's ability, to both grow retained earnings and raise qualifying capital in a reasonable manner. The potential size of the buffer quoted in the document (i.e., 2% of RWA) is significant and likely exceeds the industry's capacity to grow retained earnings to meet the higher threshold within the allotted time period. If some banks are to access the primary markets to meet the buffer, this may either result in the buffer effectively serving as a permanent buffer, or require banks to either reduce existing dividends or reduce RWA significantly to meet the buffer. Reductions in RWA could potentially cause a slowdown in the economy that could over-shoot the desired policy goal and may be broad-based and not focused in those areas of the economy that may be over-extended. Similarly, it is important that the buffer be permitted to be supported by instruments other than common equity and that have broad appeal to the institutional investor base, to ensure the buffer does not serve as a permanent buffer and/or lead to unintended economic consequences.

5. Interaction with Pillar 2

We believe that a broader application of Pillar 2 capital adequacy principles, which consider both demand and supply side of capital, would achieve the same objectives as the proposed countercyclical capital buffer, while avoiding unnecessary complexity. A focus on Pillar 2 would ensure that buffers are sufficiently flexible and determined as the result of dialogue between institutions and authorities, and that they are reflective of risk profiles and operating circumstances of individual institutions.

An overly punitive countercyclical buffer could increase reliance on a very broad and imperfect measure of credit risk (i.e., the credit-to-GDP ratio). Excessive focus on capital adequacy with respect to the buffer could decrease banks' reliance on more accurate assessments of risk under Pillar 2 and fail to recognize responses individual banks may be taking during the period.

6. Home Host Issues

The proposal states that authorities in each jurisdiction would be responsible for setting the buffer add-on in their jurisdiction. This may result in capital arbitrage among international banks. For example, banks may seek to lend to the same borrower from jurisdictions with lower buffers.

Also, once a host regulator increases its countercyclical buffer, banks will be incented to decrease exposure to that jurisdiction by selling loans (where available) to unregulated institutions. This raises concerns about the effectiveness of the proposal, and whether it could result in actions that would potentially contribute to systemic instability as risk shifts to unregulated institutions.

7. Measurement of Excessive Credit Growth

The proposed capital buffer requires an evaluation of 'excess aggregate credit growth'. However, just as bubbles are hard to identify, so too is 'excess' credit growth. The proposal is to use the ratio of credit-to-GDP as a reference. However, this benchmark can provide misleading signals, as is clearly acknowledged by the Basel Committee. Consequently, the proposal allows authorities to apply judgment, which introduces an arbitrariness that could result in inconsistent application both within and between jurisdictions. It is likely that other factors (political or otherwise) could influence the decision to impose buffers.

We are very concerned that getting the indicators and the timing wrong will limit the effectiveness of achieving the goals and may even exacerbate a recovery. Experts have not demonstrated an ability to accurately predict turning points in the cycle, a critical prerequisite to making the proposal work.

Also noteworthy is that the proposal is limited to bank capital. While it is true that, in many jurisdictions including Canada, regulated banks dominate the credit market, changes to the buffer could still be triggered by the lending activities of non-bank lenders. The capital buffer could put regulated banks at a competitive disadvantage. The nature of the proposal does not ensure that the problematic types of lending will be curtailed.

The definition of private-sector credit varies amongst jurisdictions. For example, there are many banks which have the state as the controlling shareholder. Although they can be listed as commercial banks with shares floated on stock exchanges, their lending activities may be

directed. Should the credit provided by state-owned/controlled banks be included in private-sector credit? What about private mortgage loans guaranteed by the Government/Government-sponsored agencies? In addition, the use of credit exposures does not reflect variations in asset quality which, in turn, depends on probabilities of default or downgrade.

Our more detailed issues are addressed in the attached Appendix 1 (“CBA Member Bank Comments”).

Thank you for considering our comments and suggestions.

Yours truly,

Attachment

cc: Mark White, Gilbert Ménard, Richard Gresser, OSFI

CBA Member Bank Comments
The Basel Committee's *Countercyclical capital buffer proposal*
July 2010 Consultation Paper

Canadian Bankers Association Member Comments

I. Fundamental Comments

Lack of clarity

- On April 16, 2010, the Canadian Bankers' Association expressed concerns to the Basel Committee on the capital buffer proposals[1] in mitigating procyclicality. Although this Basel Committee draft proposal on a countercyclical capital buffer provides more details, it is still not sufficiently well developed. It acknowledges, on p. 12, that it overlaps with the capital requirements determined under Pillar 2. However, it has not addressed how to accommodate the overlap. Like other proposed buffer and capital charges, the countercyclical capital buffer appears to be one of a number of piecemeal approaches without taking into account the overall impact on the total capital requirements.

  The size of the countercyclical capital buffer add-on will be determined in a calibration process. In order to take into account the severe downturn impact, the calibration will likely be at the bottom of the economic cycle. This will result in high levels of capital surplus at the top of the cycle. As much of the capital tied up in both countercyclical and conservation buffers will be unusable, and in order to maintain a bank's risk-adjusted profitability, higher costs will be imposed on borrowers.

  There are many unknown variables that require calibration. Perhaps the most important being an indication of how big these countercyclical capital buffers should be. To further transparency, there should be public debate on this, as well as the other variables which include: a) the minimum, b) the conservation level, c) the maximum counter-cyclical add-on mentioned previously, d) the credit conditions that trigger this add-on, and e) the schedule of restrictions on earning distributions as a function of where your capital level is within the buffer.

  Furthermore, with regards to the market place in general, multiple buffers will result in dynamic and different requirements for each bank which could result in confusion regarding capital adequacy on an absolute basis and relative to peers.

  As the procyclical capital buffers are to be subject to national discretion, it is possible that the capital buffers may be introduced or reduced in an untimely and asymmetrical manner. It is possible that some jurisdictions may, subject to political and/or lobbying pressures, decide to delay the introduction and/or release of the buffers in order to meet short to medium-term social and economic objectives.

  Also, the proposal has some inherent contradictions in its stated intent. The proposal indicates that the purpose is to provide additional capital to protect the banking system from future losses, with the side benefit of leaning against excess credit in the first place – but, it also says that the buffer is not meant to be used as an instrument to manage economic cycles or asset prices. Clearly, the imposition of the

[1] BIS, Consultative Document "Strengthening the resilience of the banking sector"

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buffer would, in fact, be an effort to temper economic and asset cycles. Indeed, there is a statement that authorities should look at real GDP and asset prices in evaluating whether higher buffers are warranted.

Competitive advantage for foreign (or more internationally diversified) banks

- We need to give more thought to the statement "While banks with internationally diversified exposures are less likely to be subject to either a zero countercyclical buffer or the maximum, this should not give them a competitive advantage over pure domestic banks". It seems to mean that any financial institution that has to hold more capital than a competitor is at a competitive disadvantage and any that has to hold less is at a competitive advantage. The proposal suggests that internationally diversified banks will generally run a small positive buffer in most times. When the countercyclical capital buffer is deployed in a jurisdiction, the internationally diversified bank can exercise a competitive advantage over regionally concentrated competitors, by pricing their loans with respect to their average portfolio wide capital requirements.

  We accept, in theory, the Basel Committee's comments stating that bank pricing will likely be based on the marginal cost of credit, and therefore banks with higher weighted average buffers should not be at a competitive disadvantage with regards to pricing. However, it is quite possible that banks concentrated in a particular jurisdiction may need to restrict lending as they build up capital to meet an increased buffer, thereby losing market share and relationships (perhaps permanently) to banks with lower weighted average buffers. In such a scenario, this could result in further concentration (as large multi-nationals gain market share) and potentially increase instability of the financial sector.

Local regulator discretion creates potential for unlevel playing field

- The goal is to have a mechanistic approach for transparency, but there is considerable room and discretion for judgment in the proposal.

  In general, we question the ability of various regulators to measure "excess credit" on a consistent basis across jurisdictions and time. Credit seems to be a reasonable metric for the build-up phase and when measured by the deviation of the credit-to-GDP ratio from its long-term average, and it appears to be a good leading indicator for financial distress. However, it does not always work well in all jurisdictions at all times. Other metrics such as CDS and the TED spread, captured the warning signs over the recent crisis better (as noted in the paper), but may not work well for other historic periods of stress or in certain jurisdictions.

  Furthermore, host regulators will likely face varying degrees of political pressure to maintain the buffer as low as possible (in order not to increase costs to consumers and dampen economic growth), which could result in the buffer being applied differently across various jurisdictions. Providing the host authorities with the right to demand that the counter cyclical buffer be held at the individual legal entity level (p. 11) could result in fluctuating capital requirements, and therefore an increase in the transfer of capital, across international borders, which would not be desirable. At a minimum, the Basel Committee and local regulators should consider the impacts on solo capital.

  Also, home authorities will always be able to require higher buffers, but not lower buffers, than host regulators (p. 4) which could lead to further discrepancies across jurisdictions.

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In addition, letting home authorities set up their own buffer add-ons for exposures to jurisdictions that do not operate and publish buffers is inconsistent with the objective of preventing systemic risk on host country.

Additionally, the collection of the statistical information required to determine if there is "excess credit" in a jurisdiction will be subject local agencies, and therefore the quality of the data and the decision regarding application of a buffer could be different across regions.

It is acknowledged in the consultative document that some authorities may have little experience in making buffer decisions. The operational timeframe for the countercyclical capital buffer regime should be long enough to let authorities gain sufficient experience.

Lost peer comparability

- The proposal causes different institutions to have different capital limits. This creates a significant challenge for the market trying to compare the financial strength of peers. In all likelihood, a significant portion of the market will continue to compare the ratios without fully considering individual limits and consequently view higher ratios as an indication that institutions are stronger. Given the drivers behind the countercyclical capital buffer, this may not be true. The proposal also incents banks operating in lower limit jurisdictions to hold higher ratios.

Inadequate recognition for banks' planning & potential increase in moral hazard

- The proposal gives little or no recognition to banks' own capital planning activities. Responsible banks will manage their capital to provide a reasonable amount of capital above the minimum level to cushion against future losses. The proposal may provide a disincentive for prudent management actions or forward looking planning as the perception may be that the rules will change in a bank's favour (i.e. capital requires will be lowered) during a downturn.

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II. Macroeconomic Comments

Countercyclical capital buffer limitations

- While the idea of a countercyclical capital buffer is appealing, the need for a built-in monetary stabilizer is debateable given the role of the central bank and leverage ratios already in place. Also, the effectiveness of the stabilizer is virtually unknown (as admitted in the paper) as the demand elasticity of credit is not well understood.

  The credit-to-GDP ratio has the least noise-to-signal ratio[2] and has been successful in capturing more than two-thirds of the crises in sample. However, despite the high coverage, the draft proposal cautions on the possibility that a simple credit-to-GDP ratio can provide misleading signals.

  Our economic research does not support the predictive power of the credit-to-GDP ratio. Although there is evidence that the credit-to-GDP ratio is a leading indicator of crises in a few countries, detailed analysis shows that in many cases, the credit-to-GDP ratio rises in large part due to the recessionary impact on the GDP denominator. Academic research[3] shows that both current account deficits and asset price increases may be better leading indicators of procyclical risks leading to the development of a crisis. Basel's research[4] also supports the fact that property prices perform very well in capturing crises although it has not mentioned current account balances as an important macroeconomic variable, despite the fact that international trade is very important to both the developed and emerging market economies.

  The draft proposal suggests the need for both further investigation and expert judgement in using the credit-to-GDP ratio. The subjectivity proposed in the draft proposal raises the question on how this can work internationally without creating unfair playing fields. The effectiveness of macroeconomic variables as a guide depends on data definition, compilation, availability and timeliness. This could affect the quality of the credit-to-GDP ratio as a guide and necessitate subsequent analysis to confirm the validity of its results. The draft proposal acknowledges that credit data availability varies across jurisdictions and thus, it has complicated the introduction of a universal definition of 'credit'.

  Also, the proposal, although named 'counter-cyclical-capital-buffer', could in practice, amplify the procyclicality by further increasing capital requirements that are already rising with PDs as the economy moves into a down cycle. Although, this can be partially off-set by a reduction of exposure due to the 'reduction in demand', it is not known if this mechanism will work. As a result, increasing PDs, magnified by the counter-cyclical buffers, is likely to make capital requirements more procyclical.

  In addition, it is assumed that losses incurred in the banking sector can be extremely large when a downturn is preceded by a period of excess credit growth. Such a statement seems to ignore that excess loss will increase if excess growth is accompanied with bad risk management or loose underwriting practice. This type of measure is not appropriate for all banks.

[2] It is the ratio of Type 2 errors (a signal is issued but no crisis occurs) over 1 minus the fraction of type 1 errors (no signal is issued and a crisis occurs). Source: Monetary and Economic Department, BIS Working Papers No. 317, p.15.
[3] Barrell, R., Davis, E.P., Karim, D. and Liadze, I, "Calibrating Macroprudential Policy", 15 April 2010.
[4] BIS, Working Paper "Countercyclical capital buffers: exploring options", No. 317, p.16.

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Further, the consultative document is silent on the potential impact of the countercyclical buffer on the economy, as bank will be forced to deleverage (lower the offer of credit), and how regulators will assess that credit growth will be associated with systemic risk. Using a discretionary approach is problematic, as it depends on sound decision–making by a large number of national regulators, and could result in domestic political pressure on supervisors to adjust capital levels.

Availability of capital

- The size of the countercyclical capital buffer will be determined in a calibration process and will be in effect when there is evidence of excess credit growth and possible system-wide risk. Many, if not all, of the banks in the affected jurisdiction will tap the capital markets for additional capital. This may result in market congestion. Another concern is the possible limited appetite for such equity issues as equity investors prefer to invest in growth rather than safety objectives.

Importance of cost of credit

- Bank credit is one major source, but not the only source, of aggregate private credit in an economy. The proposed bank buffer suggests that banks alone must pay the price for credit or asset value bubbles. This may have the unintended consequence of pushing lending and borrowing to non-bank related financial entities and/or the capital markets.

  The Basel Committee acknowledges that the proposal will increase the cost of credit, and views increased costs as a potential side benefit (p. 3). We have two concerns - First, the cost of credit will likely be increasing as a result of the Basel Committee's December 2009 capital, leverage and liquidity proposal, and adding further costs that will result from an additional buffer could have significant economic impacts. Second, the buffer is a very broad tool that will increase the cost of all products in all regions of a particular jurisdiction. (For this reason, we believe that Pillar 2 is a more appropriate method for dealing with concerns of excess credit risk).

  The Basel Committee also acknowledges that the link between capital buffers and the impact on price and demand for credit is not yet well understood. Given this lack of knowledge, and the potential for significant economic impact, we question the prudence of proceeding with yet more regulation and higher capital requirements.

  Assuming the buffer increases costs of borrowing in an economy, how will changes in prevailing interest rates interact with monetary policy? How will central banks and financial regulators pursue coordinated agendas?

Why not address these concerns through Pillar 2?

- The use of jurisdictional judgement makes the buffer somewhat distinct from Pillar 1. The buffer makes the minimum Tier 1 ratio time-varying, increasing it when credit relative to GDP grows over prescribed ranges. Since it is defined in the narrow Pillar I framework, there is no connection to Pillar 2 / ICAAP and actual available capital. A broader application of Pillar 2, which utilizes both demand and supply side of capital should achieve the same objectives as the countercyclical capital buffer, while avoiding unnecessary complexity.

  We caution the use of mechanistic rules, even if tempered by judgment, as they could lead to unanticipated consequences and the notion of a permanent increase in minimum capital requirements. The use of Pillar 2 is designed to accomplish a similar objective and perhaps if

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applied more broadly, can achieve the same desired outcome, without the unanticipated consequences that further buffers (on top of a buffer) would result in.

III. Technical Comments

Definition of credit exposure

- The draft proposal has not defined credit exposure. Does it include unsecured credit, letters of credit, and trading book RWA? How are netting and mark-to-market exposures going to be treated?

Location of exposure

- The use of geographic location of credit exposures to calculate a buffer add-on may be inappropriate as a credit exposure to a legal entity is identified in one country while the loan is transmitted and dispersed in another country. For example, a U.S. multinational bank can borrow in Hong Kong and wire the loaned funds to its branch in the U.K. In this case, the geographic location of the credit exposure is Hong Kong, but the multiplier impact of the loan (which is now considered an internal transfer of funds) is in the U.K.

Possible double-counting

- The proposed countercyclical capital buffer will result in double-counting as bank capital planning, enterprise stress testing process and through-the-cycle (TTC) parameters have already taken into account the cyclical impact. The draft proposal suggests the adaptation of Pillar 2 and other parameters to accommodate this buffer. Exactly how and whether this would displace the need to stress test under Pillar 2 at all is unclear.

One-year notice before the countercyclical capital buffer is implemented

- A financial cycle tends to be asymmetrical; that is, the crash is sudden and the recovery gradual[5]. Central bankers and governments have had mixed results in adopting monetary and fiscal policies to predict and manage economic cycles. It will be difficult to assess whether the one-year notice will be adequate. A credit crunch may occur during the one-year notice period. Severe financial strains may be over by the time the additional capital buffer is in place. It may be preferable to have frequent official macro/systemic projections on trends so that banks can anticipate their own individual capital buffer needs.

  With the notice period impacting all banks in a jurisdiction simultaneously, there are practical considerations about whether there is sufficient market capacity/appetite for a surge in capital issued by banks. In this environment, clearly the pricing dynamics amongst issuers and investors shifts towards much higher costs.

[5] BIS, Working Paper "Countercyclical capital buffer : exploring options" No. 317, p.6

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Release of buffers

- It is difficult to predict how markets would react to the announcement of a countercyclical buffer given a 12-month compliance period for banks. Following the announcement, markets are likely to react negatively if some banks are not sufficiently capitalized under the new buffer. Although regulators may release the countercyclical buffer in times of stress, the expectations of rating agencies and analysts may pressure banks to continue to hold capital in excess of the buffer. Due to restrictions on dividend payments the upper end of the capital conservation buffer may effectively function as a minimum capital requirement for banks.

  With a more integrated economy, we questioned the effectiveness of predicting the bottom of a credit cycle 12 months in advance. As banks will start to restrain credit supply as soon as the preannouncement, failing to correctly predict the cycle could have a negative impact on the economy.

  Also, it may be naïve to think that the increased capital requirement will not become permanent, at least in the eyes of other constituents such as rating agencies and analysts. We would question their acceptance of a decrease in capital ratios during a downturn in the credit markets, regardless of what regulators say is required. Furthermore, bank management may choose a more prudent, risk-averse approach to capital management. Both of these would decrease the countercyclical benefits of the proposal (and any benefit could be lost if rating agencies retain the non-cyclical measures).

Additional Pillar 3 disclosure requirements

- With additional disclosures, analysts may opine that the countercyclical capital buffer should remain in place rather than be released. The draft proposal has not considered how public disclosure may constrain banks' actions in drawing down the buffers.

Calculation of the weighted average buffer - arbitrage and risk transference

- The proposal states that credit exposure to non-bank financials should be included in the weighted average buffer calculation (p. 9) and regulators/banks should look through structured product and risk-transfer vehicles to the geographic residency of the underlying assets or obligors (p. 11). However, we remain concerned that in practice it may be difficult to prevent regulatory arbitrage.

  Depending on precisely how the weighted average buffer is calculated, there may be methods available to banks to arbitrage regulations if instruments are selectively booked in one jurisdiction and hedged in another.

  Conversely, if true/legitimate risk transference has occurred, requiring banks to look through to the geographic location of the underlying assets, rather than the geographic location of their counterparty credit risk, this may be overly punitive.

  Banks managing their exposure level well with respect to the credit cycles will pay for the mistakes of others as the buffer will be triggered based on "total credit in the system".

  If the banks are forced to maintain excessive capital, it will decelerate the capital build up due to reduced income per unit of capital.

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The proposal is not neutral to the level of PITness of the rating systems (the paper says work is under way) but we do not believe a solution in this narrow framework is possible. Banks with more PIT rating systems (PDs are more cyclical) will be more severely impacted with the initiation of the counter cyclical capital buffer.

Depending on how banks' exposures react, the imposition of the capital buffer could increase volatility in minimum dollar Tier 1 capital requirements.

Duration and frequency of the buffer

- The document stats that jurisdictions are likely to only need to deploy the buffer on an infrequent basis, perhaps as infrequently as once every 10 to 20 years (p. 2). However, under principles underpinning the role of judgment (p. 8), the document suggests that authorities indicate "how long they expect the release to last". This choice of wording causes concern that the Basel Committee views the lack of a buffer as temporary, and that the buffer could begin to be built up again shortly. If the deployment of a buffer was truly expected to be a once in 10 to 20-year event, then one would expect the release to be indefinite.