COMMENTS TO THE CONSULTATIVE DOCUMENT “COUNTERCYCLICAL CAPITAL BUFFER PROPOSAL” ISSUED BY BASEL COMMITTEE ON BANKING SUPERVISION

CONFEDERACIÓN ESPAÑOLA CAJAS DE AHORRO (C.E.C.A.)

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1 INTRODUCTION

C.E.C.A. is the Spanish Confederation of savings banks and is also a credit institution with no specific limitation which provides the savings banks products and services within the technological and financial area. CECA plays an important role in the Spanish savings bank sector and one of its main objectives is to represent its members, **with the aim of strengthening the competitive advantage of this important sector of Spain´s financial system, which accounts for half of the Spanish market (loans and deposits).**

The following document provides **the views of the working group that CECA has created with a group of Spanish savings banks**. The aim of the group is to analyze the possible consequences and impacts that the new proposals might cause to the Spanish savings banks. This group sent its comments to the Basel consultative document "Strengthening the resilience of the banking sector" on April 16th, 2010 and this document is the result of the position of the group related to the document ”***Countercyclical capital buffer proposal***” issued by the Basel Committee (BSBS) on July, 2010. This document is open for comments until September 10th, 2010.

2. GENERAL COMMENTS

Given that the financial crisis has demonstrated the excesses in credit developments in the past, it is necessary to identify a new and sustainable equilibrium regarding prudential capital requirements. **CECA supports the international efforts to repair the financial regulatory framework** with a view to render it safer and more resilient, as we responded in our comments sent to the Basel Committee in April 2010. Most of the regulatory repair measures put forward by policy makers in response to the crisis have a rationale when looked at individually. However it is essential that **their effects be considered in the broader context of the overall regulatory reforms that are envisaged**.

There is also a real risk of moving to over-regulation. This involves enormous costs and burdens, not only for financial institutions but also for the economy as a whole. So, we wish to emphasize that regulatory proposals should be always the outcome of in-depth analysis as to their suitability, justification, impact and cost-benefit analysis.

From a conceptual perspective, **we agree with the proposed framework whose main idea consists in linking equity requirements with economic cycles.** In fact the issue of excessive procyclicality in the financial system needs to be addressed. Macro-prudential rules need to be introduced to protect both the financial system and the economy from financial systemic risks and we welcome the efforts of the Committee in this area. Increasing capital buffers in normal times and drawing them down during low economic cycles should consolidate capital requirements and make credit supply to main-street economy less cyclical**. However, we have concerns about the capacity of the proposed buffers to avoid the fire-selling of assets and the reduction of exposures to keep the capital ratio adequacy in periods of economic distress .**

In addition the proposal might excessively increase the cost of funding of banks in normal times. History has proven that increasing capital requirements encourages banks to develop activities that

demand less capital. It is therefore important to take into account the specificities of the different business models of banks and accept that different models requirements may require different level of capital buffers.

MAIN PROBLEMS IDENTIFIED:

- TIMEFRAME OF CONSULTATION AND INTERACTION BETWEEN CONSERVATION BUFFER AND COUNTERCYCLICAL BUFFER:

In the consultative document of December 2009 a buffer range was established above the regulatory minimum TIER I capital requirement and capital distribution constraints were to be imposed on the bank when capital levels fell within this range. The constraints **only related to distributions**, not to the core operations of the bank. However, the present consultation focuses on countercyclical capital buffers and leaves aside the latter, an issue which was raised by various stakeholders.

Introduction of capital buffers on top of a minimum capital requirement and the corresponding reduction of dividend payments could from our point of view **hamper the competitiveness of retail banks vis-à-vis other financial companies**. Banks should be granted sufficient latitude to distribute their earnings in order to attract investors and avoid facing competition distortions.

Therefore, **we have serious concerns with additional regulatory rules which restrict paying dividends to shareholders and investors**. This proposal, on top of a higher minimum capital requirement, would limit the attractiveness of banking shares vis-à-vis other industries. Likewise, capital buffers will intensify the pressure on banks because they have to attract investors to raise capital to comply with the increased capital requirements. Regulators should bear in mind that banks have to compete not only among the group of financial institutions but with all participants on the global capital markets in respect to raising fresh capital.

- **COMPLEXITY OF THE SUM OF COUNTERCYCLICAL MEASURES**:

The Basel Committee should ensure that the sum of all the proposals **will not increase too much the complexity of the framework applicable to banks.** We stress that the proposed solutions should not be applied simultaneously as the combined effect of all the envisaged measures are at this stage extremely difficult to foresee (as many of the changes would add up and reinforce each others). One of the main concerns of CECA is related to the idea of **simultaneously handling a unique problem (excessive procyclicality) through various angles**: by the introduction of countercyclical capital buffers, capital conservation buffers, forward looking provisioning, a leverage ratio, by emphasizing a “through the cycle” as opposed to a “point in time” approach, by amending accounting standards. **It is in our view necessary to limit the number of ways to address the issue of excessive procyclicalit**y and to introduce only targeted changes, after a carefully conducted impact assessment. It is also of particular importance for the accounting and regulatory communities to work together in order to come to solutions which are appropriate from the two perspectives – notably as regards the definition/treatment of provisions.

The proposals of setting up a new minimum capital requirement and the forward looking provisioning are in an early stage. They are only mentioned in the document issued in July 2010, so we have many concerns about to the way they will be included in the calibration process. In the case of the forward looking provisioning, the IASB and FASB are under pressure from the European Commission to deliver conclusions by the end of 2011 but a key element of potential procyclicality will come into play after finalisation of the Basel Reform package. **Hence, we envisage there be significant operational issues in the implementation of these changes**.

CECA would like to avoid that the measures taken on both the accounting and the prudential/regulatory sides overlap. Any lack of coordination between accounting standard setters and prudential supervisors could mean that entities end up with an undesired excess of requirements.

- IMPACT ASSESMENT AND CALIBRATION

Regulators should appropriatety calibrate the proposals according to the results of the Quantitative Impact Study (QIS). An appropriate calibration is **key to the success of the proposed regulatory reforms and the overall analysis can only be done on the basis of the results of the trustworthy impact study.** Calibration is critical for getting the new rules right and making them capable of addressing the current failures; if the new rules are not properly drafted they have the potential to result in a massive negative impact not only on banks but also on all other economic sectors. Conducting an in-depth calibration exercise is of utmost importance as the right balance has to be found between the cost of capital and protecting financial stability.

The proposal imposes economic constraints on the intermediation business model during normal periods in order to offset the risk of insolvency in the whole banking industry in periods of stress. **However, in case of inadequate calibration the growth of the demand for credit might exceed the speed at which banks can rebuild their capital buffers.**

- MARKET EXPECTATIONS OF CAPITAL IN TIME OF CRISIS:

Systemic financial crisis are rare and capital is costly and the recent experience in the last crisis has shown that market expectations (and also regulators' demands at that time) do not allow banks to reduce their capital base. On the contrary, they are expected to boost it immediately. Based on this experience, we wonder if the fact that capital markets generally expect higher capital requirements in time of crisis renders the BIS approach on capital buffers ineffective.

The introduction of capital buffers will impose significant capital constraints on an every day basis for banks. An inappropriate level of regulatory requirements (via either too low or too high capital buffers) might prove to be either inefficient or excessively expensive. **We remain highly sceptical of the fact that banks would be allowed, by the market, the rating agencies or even their supervisors, to actually use their buffer when the economic situation deteriorates.**

- PERMANENT ADD-ON:

The consultation paper envisages that each country will determine whether credit markets are over-heating, and an add-on expressed as a percentage of RWA will be applied rarely (every 10 to 20 years). From an economical point of view it will be very difficult to release the buffers so it looks inevitable that they will inevitably become another layer of capital requirement above the minimum capital requirement set by the regulators. **We have concerns about the possibility that buffers become permanent add-ons. It is likely that the conservation capital buffer and the countercyclical capital are added as a new minimum .** we are opposed to constraints on management's and shareholders' rights in respect of earnings distribution as they are against basic rights of shareholders in our legal framework and would also put some banks in a difficult situation when competing to raise capital.

- EXCESIVE CAPITAL BUFFERS:

Additionally, the Basel Committee should also ensure that the sum of all the measures **will not result in banks dealing with excessive capital buffers** beyond what is necessary to maintain a resilient banking

sector. The consequences of the whole measures will impact in terms, not only of possible excess of capital, but also of high operational and administrative costs to implement them.

- SPECIFITIES OF THE DIFFERENT BUSINESS MODELS:

CECA stresses that it is of utmost importance to take into account the specificities of the different bank business models and accept that different models require different capital buffers. **The calibration and impact assessment should assess the difference between the different systemic risks that retail banks entail when compared to investment banks.** It should not be forgotten that retail banks are liquidity providers to the economy and that they are not at the origin of the financial crisis.

These additional buffers aim not only at protecting banks from bankruptcy but also at aligning the behaviour of the whole banking industry with the concerns of supervisory and prudential authorities As such, the issue of excessive procyclicality has to be addressed by taking into account the specificities of the banking sector and particularly of retail banking activities**.**

The retail business model entails the built/up of capital banking buffers. Countercyclical buffers could ultimately appear redundant with such business model in case of inadequate calibration. The retail banking activity requires holding a sound capital base to perform a lending activity. This is indeed necessary as retail banks have to cover the internal risk correlation between illiquid portfolios for which there is little possibility to hedge the risks through either capital markets, securitisation or insurance coverage. **In our opinion that regulatory capital overestimates economic capital when it comes to retail activity.** Numerous empirical experiences show that the internal rating parameters used in assessing the risk of retail portfolios, (in particular when correlation between different assets is considered) leads to economic capital needs lower than the regulatory requirements of Basel II.

- FUNDING TO SMEs:

A particular concern relates to the availability of funding to SMEs. Any extension of the difference between regulatory capital and economic capital could heighten the credit limitations that SMEs face when it comes to their short-term and treasury issues. Indeed, while credit allocation to SMEs is individually risky, diversification, along with an in-depth client relationship mitigates it to a great extent. This is the reason why retail banks' economic capital, when measured with internal models, is generally lower than the capital measured by regulatory formulas. Too high capital buffers will affect the lending activity and dramatically increase the price of the loans.

- UNIQUE LEVEL OF COUNTERCYCLICAL CAPITAL BUFFER FOR ALL BANKS IN EACH JURISDICTION:

The countercyclical capital buffer should not be used with the aim of reducing excessive credit growth (although this might be a by-product), since it is not the appropriate mechanism to achieve this goal. **We believe that a countercyclical capital buffer with a unique level for all banks in a jurisdiction would do little to prevent excessive credit growth**. Although the cost of granting a loan would increase, it could easily be passed-through to consumers if all banks in the jurisdiction had a similar cost of capital, with little effect on loan demand. Other regulatory measures (such as countercyclical provisioning, tighter supervision of shadow banking system, caps on LTVs, incentive schemes, etc.) as well as monetary and fiscal policy appear to be more adequate tools to prevent the creation of excessive credit cycles.

- **DELAY IN THE MATERIALIZATION OF THE LOSSES**:

Excessive credit growth is often the result of the perverse incentives that arise due to the delay in the materialization of the true costs (in the form of credit losses of bad loans) of an aggressive commercial strategy. **Hence, a comprehensive approach to prociclycality should include bank specific features so that those banks that contribute largely to the credit boom are penalized**. In this sense, we believe that a well calibrated system of countercyclical provisions may help correct the underestimation of these costs. By construction, this system of provisions would mostly affect those banks whose behavior contributes most to a credit boom.

Time inconsistency could then be a major problem. The period established by the Committee to meet the additional buffer, twelve months, is not tested and it is difficult to know the market reaction to this effect.

- INTERACTION BETWEEN PILLAR I AND PILLAR II:

The countercyclical capital buffer mechanism would neither be a Pillar 2 nor a Pillar 1 approach. First of all, the consultation says that the Pillar 2 approach will need to adapt to accommodate this new instrument but the Basel Committee provides little guidance as to how this accommodation would be done. We are also concerned by the statement that the capital used to meet Pillar 2 requirements should not be used to satisfy the countercyclical capital buffer requirement. Additionally, the **local discretion in setting the overload makes it difficult to consider this proposal as an extension of Pillar I, but neither is within Pillar II because:**

- The add-on is only applied to the capital base yielded only by Pillar I.

- The minimum capital requirements must be met including the add-on.

We fear this may lead to double counting of capital as stress-testing in Pillar 2 already leads to defining capital buffers so we expect some sort of collusion between the countercyclical buffer and the conservation buffer with Pillar II.

One possibility to set up the appropriate and necessary buffers avoiding the collusion could be by covering them by the capital stress-testing carried out under Pillar II, **resulting in a single institution specific buffer** that includes all the risk factors and business model/mix of the institution calculated at a consolidated level and, particularly, supplements a series of statistical predeterminated formula with the judgement of experienced local supervisors that know the characteristics of their own jurisdictions, reinforcing its power. The specific concerns about the built up of credit excessive growth and bubbles could be handled in the form of specific guidance as to the additional scenarios to be included in capital stress—testing, instead of a separate, standalone capital buffer.

The results of the stress-test should be taken into consideration in the decision making process of the financial institution and the actions should be credible. Supervisors could consider recommending scenarios to institutions and undertaking their own stress tests on an individual institution. Each supervisor would adapt these guidelines to their country specificities in such a way to keep a level playing field.

The approach of each supervisor could be similar to existing capital requirements for concentration risk in Spain, in which the Spanish Supervisor has calibrated a number of range (or capital ratios), which allows an individual treatment by state according to their position and business model. Thus, the calculation of the capital buffer would take into account the business model of each financial institution. This formula also could solve the problem of complexity of calculation of capital buffers.

It is important to find a simple measurement system suitable for small financial institutions that do not have a model for calculating economic capital based on the macroeconomic situation (economic capital include not only regulatory but also buffers excess that are targeted by each financial institution in its management process).

- INTERACTION BETWEEN BUFFERS AND LEVERAGE RATIO:

Another aspect that is not mentioned in the document is the **interaction of this buffer and the new leverage ratio** that was introduced in the document of December 2009. In fact, the leverage ratio can act as a brake on credit growth, regardless of the quality of risk.

- DISCLOSURE OF THE BUFFERS AND FREQUENCY OF CALCULATION:

Capital buffers do not need to be disclosed to the market. If they were disclosed, market could treat them as additional capital requirements to Pilar I, losing the countercyclical effect.

The calibration process has to take into account that the market might charge individual banks an additional buffer. Market demands may be only a consequence of a perceived lack of transparency of banking financial statements. In this respect, **detailed disclosure of banks' credit exposure and regulatory requirements (by jurisdiction, economic sector, etc) could improve the market discipline** and make an indiscriminate additional buffer on top of regulatory requirements unnecessary.

As regards to the frequency of calculation if the supervisors decide to include the conservative buffer, it would be more appropriate to set the schedule for an annual calculation (December) to be consistent with the distribution of results (which usually have annual distribution though some entities distribute interim dividends).

- BANKS VESUS OTHER FINANCIAL INSTITUTIONS/ DIFFERENCES BETWEEN CONTINENTS:

CECA highlights that the proposals could hamper banks with respect to all other financial companies. In order to avoid competitive distortions, the Basel Committee has to follow a more flexible approach, such as, for instance, when it comes to controlling the latitude banks can have in order to distribute their earnings.

Finally, the proposal might trigger competitive distortion as Basel III might not have the same impact in different continents. Some banks might appear artificially highly capitalized while in reality a significant part of the risk lies in an unregulated sector of financial system.

3. COUNTERCYCLICAL CAPITAL BUFFER: DETAILS AND METHODOLOGY

- CONSULTATIVE DOCUMENT:

The countercyclical buffer proposal is designed to ensure that banking sector capital requirements take into account the macro-financial environment in which banks operate.

In this document, the Committee presents a proposal to mitigate the procyclicality of capital by setting an add-on applicable to credit risk as a function of the relationship between the volume of credit to GDP: In periods when this ratio is above its "long-term trend" an overload in the capital base given by the Pillar I would be activated, while if the ratio is below a certain threshold, the add-on would be disabled, taking zero value. Thus, the objective pursued is to increase capital cushions in situations where there is an excessive credit growth that can often jeopardize the system as a whole. To do so, the Committee proposes a common methodology, however, remains open to local supervisors, that are responsible for setting the appropriate value for the add-on at all times, using all the information that they deem to be appropriate.

- COMMENTS:

The idea of protecting the banking sector from excess credit growth is in itself interesting. **However, CECA suggests that the Basel Committee should be very cautious**. We are not sure about the possibility of measuring the dynamics of macro-level risks across banking sector activities. We believe that the proposal tries to introduce a general discipline of a higher capital requirement in situations of excessive credit growth, as a potential future systemic risk, leaving a fairly wide margin of discretion to national supervisors. It is unlikely that any authority could know or have the right tools to assess the right level of growth for the - or some part of the financial sector. **This raises numerous questions as the banking industry is a risk taking business by definition and as cyclicality is inherent to its activities.**

On the other hand, the Committee has opted for a "macro" solution that relates the excess credit growth with an underestimation of risk. We agree that **an internationally identical, hard-rule framework is not appropriat**e given that there is not a single universal indicator of how risks are built during the cycle. However, we consider that the deviation of the **credit to GDP ratio from its long term trend should be seen as the main reference** rule given its good track record in preceding financial crisis. National supervisors should stick to that rule as much as possible and any deviation would need to be carefully and clearly justified. In particular, national discretion should by no means override the need of a level playing field within groups of homogeneous countries i.e. OECD members, emerging markets….

Therefore, this proposal rejects to face the procyclicality approach from a bottom-up perspective**, not taking into account the structure of portfolios and their one by one risk assessment of them, which is, actually, where the problem is located.**

We agree with the idea of an asymmetric treatment of buffer increases and decreases in normal times. However, we believe national supervisors **should develop and communicate a clear and binding rule regarding the reduction of the buffer level in times of stress** in order to convince markets and financial institutions that the buffer will be made available by supervisors. This might need to come in combination with restrictions on the use of the buffer in order to avoid undesired effects such as its distribution as dividend or the incentive for continued excessive risk taking that might carry out an immediate increase in the Credit&GDP ratio.

DRAWBACKS OF THE BOTTOM-UP APPROACH:

1. **Origin of pro-cyclicality of capital under the IRB approach**:

- The own procyclicality of the PDs: to the extent that these PDs are not properly adjusted to a full cycle, tend to increase in periods of recession.
- The migration of many portfolios to lower qualified levels.

It is known that the criteria for determining the regulatory **PDs have not been the same by the different supervisors in each jurisdiction**. For example, in Spain, the procyclicality of the PDs had a moderate impact because they should be anchored to a period of time that should pick up the crisis of the early '90s, which showed rates of very high delinquencies. Therefore, perhaps the first step should be to define more precisely the criteria for the determination of the PDs, as well as the necessary adjustments, depending on the nature of the models used (PIT or TTC) to adequately cover the risk of migration. In this sense, the experience of a global crisis greatly expanded the determination of properly adjusted to cycle risk parameters.

2. **The add-on will be common to the whole system**, **so that**:

- Do not discriminate specific segments in which the main growth of the portfolio takes place.
- The proposal recognizes the benefits of the geographical diversification so it seems that it is not going to take into account the fact that some institutions are exposed to local or regional markets whose evolution may be different from the domestic market. **We suggest that a wider definition which encompasses industry and regional diversification within a country** as well would be desirable to avoid competitive disadvantages for domestic.
- These specific issues have their treatment through Pillar II or even through the Pillar I by adjusting the parameters of risk for certain portfolios under the IRB approach (eg LGD for mortgage portfolios.). The supervisor should adequately solve this problem to avoid producing an excess of capital requirements whose distribution among the different entities might be unfair.

3. **The methodology itself introduces some arbitrary elements**:

- It recognizes that there is a growing relationship between credit and GDP, meaning that as time goes on more credit is needed per unit produced.
- Even though, this relationship seems to be governed by a deterministic trend, it seems rather stochastic. Therefore, a filter is applied “ad-hoc” as the Hodrick-Prescott filter, with which is built up the "trend." However, either the appropriate choice of the value of the parameters of this filter or the application of another type of filter could lead to a different trend. **This means that, in practice, each supervisor will determine their own path of credit growth target and adjust the add-on in accordance with the deviations from this objective.**

4. CONCLUSIONS

Differences in capital requirements across jurisdictions are unavoidable once the existence of credit cycles is taken into account in their definition. Taking this into account, **the need to resolve procyclicality must be very cautious** and the way of it is resolved by regulators raises numerous questions as the banking industry is a risk taking business by definition and as cyclicality is inherent to its activities, as the signs of excessive growth.

Nowadays, there are many details of the countercyclical approach that are not finished yet but it seems as **the Committee maintains its “buffer-on-a buffer (on-a-buffer) approach**. In our view, it is and insufficient response to the problem of procyclicality of capital:

MAIN REASONS:

- We consider crucial that the proposals to address the procyclicality must be finished before an overall analysis can be carried out. **The sum of all the measures to address procyclicity will increase the complexity to the institutions and there will be significant operational costs to implement them.** Adopting an inadequate calibration would per se penalize retail banks and by extension an important part of the world economy. It would achieve the contrary to what is intended: it would not automatically address the insolvency issue while penalizing part of the industry which did not cause the financial crisis.
- There are many concerns that the buffers will be difficult to release because **the market can see them as another capital minimum requirement losing their countercyclical effectiveness** and increasing the cost of capital for the institutions, making them inefficient and expensive.
- **The specific business model of retail banks has also to be taken into account** in order to avoid the risk of a credit crunch. The business model of retail banks consists in building capital buffers.
- **The proposal faces the procyclicality approach from a top-down perspective**, not taking into account the structure of portfolios and their one by one risk assessment. It does not make differences among institutions, business models and specific segments (it could be redundant for the retail banks).
- The local discretion in setting the overload makes **it difficult to consider this proposal as an extension of Pillar I**, but neither is within Pillar II because the add-on is applied to the capital base given only by Pilar I and the minimum capital requirements must be met including the add-on.
- In some jurisdictions a simple rule based approach may be necessary, but we **believe a more judgemental approach is central to strengthening micro supervision** and risk management in banks.
- One way to avoid the collusion between Pillar I and Pillar II could be **covering them by the capital stress-testing carried out under Pillar II**, resulting in a single institution specific buffer.
- Given the appropriate calibration, t**he framework should ensure that each bank is charged differently according to its particular contribution to the credit boom** and also that the global size of the buffers in a jurisdiction attains the level desired by the Committee. It also should diminish the incentive for financial institutions to increase leverage in periods of economic growth.
- Alternatively, the Committee **could set a specific buffer zone for a specific capital ratio that would trigger a supervisory review** as to whether capital needs to be conserved and, if so, by how much. The replacement of the specific regulatory buffer with a bank-by-bank specific buffer (established in Pilar II), would allow the supervisor to be more strict as regards to particular financial institution market. If the risk-taking of the bank is a concern to supervisors, the institution might meet a specific capital ratio above the minimum capital requirement.