The Clearing House

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

Re: Countercyclical Capital Buffer Proposal

Ladies and Gentlemen:

The Clearing House Association L.L.C. ("The Clearing House"), an association of major commercial banks,[1] is pleased to comment on the Basel Committee on Banking Supervision's (the "BCBS") July 2010 consultative document, *Countercyclical capital buffer proposal* (the "CCB Proposal"). The CCB Proposal outlines the proposed framework for a countercyclical buffer to Tier 1 capital requirements to be imposed when, in the reasoned view of applicable national authorities, excess aggregate credit growth in the broader economy is judged to be associated with and precede a build-up of systemic risk in the banking sector (the "Countercyclical Buffer"). We agree that periods of excess credit growth can pose risks to the banking system and the economy more generally. However, we have a number of concerns with the CCB Proposal as a tool to address these risks, summarized below under "Executive Summary," and addressed in more detail under "Detailed Comments."

EXECUTIVE SUMMARY

Our foremost concern, should the BCBS adopt the CCB Proposal, is that the Countercyclical Buffer would, when combined with the Conservation Buffer, effectively institutionalize a *de facto* minimum capital level for banks at a level considerably above the

[1] Established in 1853, The Clearing House is the United States' oldest banking association and payments company. It is owned by the world's largest commercial banks, which collectively employ 1.4 million people in the United States and hold more than half of all U.S. deposits. The Clearing House Association is a nonpartisan advocacy organization representing through regulatory comment letters, amicus briefs, and white papers the interests of its member banks on a variety of systemically important banking issues. Its affiliate, The Clearing House Payments Company L.L.C., provides payment, clearing, and settlement services to its member banks and other financial institutions, clearing almost $2 trillion daily and representing nearly half of the automated clearing-house, funds-transfer, and check-image payments made in the U.S. See The Clearing House's web page at www.theclearinghouse.org

minimum standards assumed by the BCBS's December 2009 capital proposals. The *de facto* minimum capital levels would raise the bar even higher as banks, their investors and creditors aim to stay above "buffered" levels, even as the cost of capital increases incrementally.

In addition to the *de facto* minimum capital requirement implications, a number of other aspects of the CCB Proposal raise concerns, including:

- the uncertainties inherent in the implementation of the Countercyclical Buffer and banks' ability to appropriately manage their capital levels in practice;
- the effective imposition on the banking industry of the burden to counter the systemic risk of the entire financial system;
- the application of the proposed Countercyclical Buffer on a global reciprocity basis;
- the proposed aggregate private-sector credit-to-GDP ratio gap measurement being too blunt an instrument; and
- the interconnection and interdependency among the December 2009 Proposal's four key objectives to address procyclicality.

DETAILED COMMENTS

1. The Countercyclical Buffer Further Raises *De Facto* Minimum Tier 1 Capital Levels that are Significantly Above the Standards Assumed by the December 2009 Basel Proposals.

The BCBS's December 2009 Consultative Document, *Strengthening the resilience of the banking sector* (the "December 2009 Proposal"), included a proposed buffer range—the "Conservation Buffer"—above the regulatory minimum capital requirement that would, if a bank's capital falls within the range, trigger capital distribution constraints (e.g., on dividends, share buy-backs, and discretionary bonus payments) based on a defined band of capital conservation ratios.[2] The CCB Proposal indicates that the Conservation Buffer and the Countercyclical Buffer described in the CCB Proposal will work in tandem. We believe that there is a substantial risk that the Conservation Buffer and the Countercyclical Buffer, if implemented, will create a *de facto* minimum Tier 1 capital requirement above the BCBS's intended calibrated minimum, which has not yet been determined.

This phenomenon occurred in the United States under the Prompt Corrective Action ("PCA") regime—instituted in 1991 by the U.S. Federal Deposit Insurance Corporation Improvement Act.[3] A major concept within the PCA regime is that banks must have capital

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2 See pp. 28–30 of The Clearing House's Comment Letter, dated April 16, 2010, to the BCBS concerning the December 2009 Proposal, which included comments on the Conservation Buffer, available at http://www.theclearinghouse.org/reference/comment_letters/commentLetterDocs/070463.pdf.

3 Pub. L. No. 102-242, 105 Stat. 2236 (1991).

levels that are significantly above regulatory minimums in order to be considered "well capitalized,"[4] and it has become the industry norm for banks to treat the well-capitalized criteria as their minimum capital ratios. Subsequent legislation has significantly bolstered the PCA requirement; for example, section 103 of the Gramm-Leach Bliley Act[5] provided that a bank holding company may not acquire or retain shares of any financial company unless "all of the depository institutions subsidiaries of the bank holding company are well capitalized," and section 606 of the recently enacted Dodd-Frank Wall Street Reform and Consumer Protection Act[6] extends this well-capitalized requirement to financial holding companies. Bank management, investors, and creditors, and even bank supervisors, expect a bank's capital levels to be well above these well-capitalized ratios.

Under the CCB Proposal, the size and timing of the Countercyclical Buffer would not generally be known ahead of time; but, whatever its size, when applied, the Countercyclical Buffer would be added to the then already existing Conservation Buffer. We believe it is likely that analysts and investors may very well address such uncertainties when evaluating capital adequacy by assuming a component for the Countercyclical Buffer in establishing minimum or targeted capital levels irrespective of whether the Countercyclical Buffer has been officially applied. As such, the combined effect of the *de facto* minimum capital requirement established by the Conservation Buffer—and additional potential capital requirements in the CCB Proposal—may very well lead to an overall impact on capital that is significantly greater than "official" minimum capital requirements, regardless of the calibration and implementation of the buffers under consideration by the BCBS.

In addition, the Countercyclical Buffer's impact on this *de facto* minimum capital requirement is likely to remain in place even after regulators determine to enter into the "release phase" contemplated by the CCB Proposal. Even if the economy is in the recovery phase and the Countercyclical Buffer is released, banks may very well be highly circumspect in decreasing their capital levels in practice. As such, it is far from clear that once the Countercyclical Buffer is released, the intended increase in aggregate credit would necessarily occur. Banks, in the face of uncertainty concerning where they are in terms of the business cycle and market pressures, are likely to operate with capital levels above the minimums required even where the Countercyclical Buffer has already been released. As a result, contrary to the intention of the CCB Proposal, the Countercyclical Buffer's impact on minimum capital requirements is likely to apply throughout the economic cycle.

The experience in the United States with the PCA and the aftermath of the current crisis provides ample evidence that our concern regarding *de facto* minimums is far from theoretical.

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4 For example, an "adequately capitalized" bank may have Tier 1 and Total Risk-Based Capital ratios of 4 and 8 percent, respectively. To be "well capitalized," a bank must have Tier 1 and Total Risk-Based Capital ratios of at least 6 and 10 percent, respectively. Less than "well capitalized" banks may be subject to restrictions on capital distributions, additional capital requirements, greater supervisory scrutiny, and limitations on business expansion.

5 Pub. L. No. 106-102, 113 Stat. 1338, 1346 (1999).

6 Pub. L. No. 111-203, — Stat. — (2010).

If the BCBS takes the approach of a combined Conservation Buffer and Countercyclical Buffer, we respectfully urge that it carefully consider and reflect this reality not only in its calibration of the buffer thresholds relative to the required minimum ratios, but also in its calibration of the minimum ratios themselves.

2. The Uncertainties Inherent in the Implementation of the Countercyclical Buffer Will Make it Challenging for Banks to Appropriately Manage their Capital Levels in Practice.

The Countercyclical Buffer would be invoked by applicable national authorities based on macroeconomic evaluations of excessive credit growth. The CCB Proposal develops a methodology to determine when this has occurred based on the gap between the historical and actual ratio of aggregate private-sector credit to gross domestic product ("GDP"). The BCBS recognizes that the credit/GDP ratio gap is not a perfect tool, and the CCB Proposal stresses that, in practice, applicable national authorities will need to apply a great degree of judgment in determining the right additional Tier 1 capital buffers, based on, among other variables, asset prices, funding and credit default swap rates, credit condition surveys, and real GDP growth. While this need to use deliberative judgment is indeed quite prudent when dealing with highly complex macroeconomic variables, it creates a great degree of uncertainty for banks in their capital planning. Banks will face a great degree of uncertainty as to when applicable national authorities will determine that a Countercyclical Buffer needs to be applied because the very need to use deliberative judgment in making such decision makes the process rather opaque and difficult to predict. This uncertainty is compounded because the CCB Proposal acknowledges that the Countercyclical Buffer is only one of "a suite of macroprudential tools at the disposal of the authorities," including loan-to-value limits, interest rate qualification tests, or specific capital buffers for particular sectors that could be deployed in specific situations. Simply put, it will be challenging for banks to appropriately manage their capital when there is considerable uncertainty as to the very drivers that applicable national authorities will use to determine what capital requirements will be in place at any time 12 months in the future. This is even more true for internationally active banks that will be subject to Countercyclical Buffer decisions being made by several different applicable national authorities, each applying its own judgment as to when excessive credit growth is occurring.

The CCB Proposal's 12-month phase-in period only partially mitigates this capital management problem because the very application of a Countercyclical Buffer could, as discussed further below, very well have negative market effects and therefore make it harder to raise capital in advance of the implementation of a Countercyclical Buffer. This would give banks a further reason to maintain a capital cushion that is significantly greater than "official" minimum capital requirements regardless of the calibration and implementation of the buffers and therefore amplifying the *de facto* minimum capital expectations described above.

If the BCBS determines to move forward with the CCB Proposal, we respectfully submit that the BCBS should consider implementing firmer and more transparent guidelines for determining when a Countercyclical Buffer is to be applied so that banks can employ reasonable forward-looking expectations concerning Countercyclical Buffers in their capital-management processes.

3. The CCB Proposal Imposes on Banks the Burden of Countering the Systemic Risk of the Entire Financial System, Including Non-Bank Financial Companies Not Subject to the Same Standards.

The CCB Proposal uses a broad definition of credit when describing the aggregate credit-to-GDP ratio gap that captures all sources of credit for the private sector. The proposal states that "[t]his should not be viewed as penalizing the banking sector for credit that has been supplied via the non-bank financial sector. Rather it simply recognizes the reality that banks can suffer the consequences of a period of excess credit, even if they have not directly driven its growth." We do not, however, believe it is either appropriate or effective to obligate banks to counter the systemic risk of the entire financial system. Individual banks should not be required to consider the risks originated by other institutions (both banks and non-bank financial companies) when implementing their own strategies, except to the extent such risks create threats for the individual bank. Additionally, we believe this strategy does not take into account the effects of steps taken by the G-20 and in various national authorities to regulate large institutions more heavily. In the recently passed Dodd-Frank Act in the U.S., for example, the Board of Governors of the Federal Reserve System (the "Federal Reserve") will be required to set capital, liquidity, and other risk-management standards for "systemically important" financial institutions that are necessarily more stringent than those for non-systemically important institutions.[7] With banks becoming even more regulated in the U.S. and other large markets, there is some likelihood that capital will seep out of the banking system and land in unregulated portions of the economy exacerbating the inequities referred to above.

We respectfully urge further consideration of credit originating from the non-bank financial sector when analyzing credit growth and Countercyclical Buffer decisions.

4. Application of the Proposed Countercyclical Buffer Rules on a Global Reciprocity Basis Requires Further Consideration.

Under the CCB Proposal, the Countercyclical Buffer will function by providing each jurisdiction with the ability to use its judgment to extend the size of the minimum buffer range established by the Conservation Buffer. Although the CCB Proposal contemplates reciprocity, there are a number of political and logistical issues that may hinder and otherwise affect the global implementation of such agreements. Where reciprocity agreements do not exist or have not been finalized, differences in home-host requirements for internationally active banks may create the unintended consequence of competitive imbalances. For example, a home country regulator could declare an excess of credit growth in its jurisdiction while a host country disagrees. In this situation, the rule would be binding only on home-country firms and not on the firms supervised in the host country. We recommend further clarification with respect to the assignment of geographic exposure. Specifically, such rules should cover instances in which an internationally active bank makes credit available to its multinational customers in multiple jurisdictions. Multinationals, hypothetically, could "re-source" credit from one subsidiary or branch to another if lending in one country were subject to the countercyclical buffers because of the supervisor's excess growth determination.

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[7] Bank holding companies with over $50B in assets are automatically considered "systemically important."

Furthermore, the jurisdictional reciprocity approach set forth in the CCB Proposals presents inherent challenges to sovereign decisions concerning monetary policy—an area that heretofore traditionally has been viewed as a prerogative of national or certain supra-national institutions (e.g., the Federal Reserve and the European Central Bank). Monetary policy in any applicable jurisdiction often reflects that jurisdiction's customs, standards, and policy preferences and trade-off decisions (e.g., between stimulating demand and employment, on the one hand, and taming inflationary pressures, on the other hand). The CCB Proposal is predicated on jurisdiction A giving effect to the monetary policy preferences of jurisdictions B and C, perhaps to the commercial disadvantage of jurisdiction A's banks. In addition, jurisdiction A runs the risk that even if it cooperates with jurisdictions B and C concerning Countercyclical Buffers, jurisdiction D "defects"—to borrow game theory terminology—in order to advantage its own monetary policy preferences or banks. As such, the voluntary jurisdictional reciprocity approach of the CCB Proposal, when applied to monetary policy which oftentimes reflect particular policy choices of each jurisdiction, has the potential of being only as strong as it weakest national link.

At a minimum, we respectfully recommend further consideration of approaches designed to deal with home-host jurisdictional reciprocity and competitive balance related issues.

5. The Proposed Aggregate Private-Sector Credit to GDP Ratio Gap Measurement May Be Too Blunt an Instrument.

The CCB Proposal's methodology transforms the aggregate private-sector credit to GDP ratio gap into a suggested buffer add-on. In their paper *Calibrating Macroprudential Policy*[8], Barrell, *et al* suggested that other variables, such as real estate residential prices, are better predictors of a crisis, but emphasized that it is poor quality lending that is the primary cause of such crises. Likewise, the CCB Proposal recognizes that pure statistical economic measures, such as credit-to-GDP ratio gap, are insufficient and would have to be heavily supplemented by judgment and analysis of other macroeconomic variables.

Nevertheless, even if a perfect set of macroeconomic variables were to be identified and perfect judgment were to applied in determining when a Countercyclical Buffer should be implemented, we are concerned that the broad application of such a buffer across an entire economy may penalize some sectors that are performing within normal parameters while falling short of curing the "irrational exuberance" of another, more volatile sector. In light of these considerations, we respectfully suggest the further consideration of the use of a credit-to-GDP measure that is risk adjusted to give more weight to higher-risk-weighted (or lower quality) assets and lower (or in some cases, no weight) to lower-risk-weighted assets maintained on banking organizations' balance sheets. This measure may be more reflective of excess credit growth rather the use of nominal credit measures. In addition, we recommend that the BCBS pursue an assessment of how the use of these measures and the subsequent changes in capital requirements would interact with other concurrent monetary policy measures.

8 Barrell, R., Davis, E.P., Karim, D. and Liadze, I.1, NIESR and Brunel University. *Calibrating Macroprudential Policy*: April 15, 2010.

6. The Interconnection and Interdependency Among the December 2009 Proposal's Four Key Objectives to Address Procyclicality Require Further Study.

In the December 2009 Proposal, four key objectives to address procyclicality were established by the BCBS:

(1) Dampen any excess cyclicality of the minimum capital requirement;

(2) Promote more forward looking provisions;

(3) Conserve capital to build buffers at individual banks and the banking sector that can be used in stress; and

(4) Achieve the broader macroprudential goal of protecting the banking sector from periods of excess credit growth.

While the CCB Proposal addresses the fourth objective, the remaining three have not yet been fully developed. For example, several significant Conservation Buffer elements, such as calibration and application to the consolidated group versus an individual business within the group, are not yet clarified. In addition, the BCBS's forward-looking provisioning proposal to the International Accounting Standards Board has not been finalized. Most importantly, the calibration process for the various components of the 2009 Basel Proposal is not yet complete.

We believe that there are other concepts and exercises, such as contingent capital and ICAAP-related stress testing, which may mitigate excess credit growth effects in lieu of the Countercyclical Buffer. Since all four prongs of the December 2009 Proposals are supposed to work together to "strengthen the resilience of the banking sector," it is difficult at this point in time to fully analyze how all such the various components will interact with each other and how they may be interdependent upon each other given the lack of clarity with respect to some of these prongs, or portions thereof, and until the final calibration of such proposals is complete.

While we are fully cognizant of the fact that such lack of clarity at this point in time is indeed unavoidable given the magnitude and complexity of the project being undertaken by the BCBS, we nevertheless respectfully request that BCBS present opportunities for a holistic analysis of the interconnections and interdependencies among all four countercyclical prongs set forth in the December 2009 Proposals once such proposals are more fully developed and calibrated in both concept and detail.

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The Clearing House appreciates your consideration of the views expressed in this letter. If you have any questions, or if the members of The Clearing House can assist you in any way, please contact me or Joseph R. Alexander, Senior Vice President and Deputy General Counsel of The Clearing House, at (212) 612-9234 or joe.alexander@theclearinghouse.org.

Sincerely yours,

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