European Association of Co-operative Banks
Groupement Européen des Banques Coopératives
Europäische Vereinigung der Genossenschaftsbanken

Secretariat of the BCBS
Bank for International Settlements
CH-4002 Basel, Switzerland

Brussels, 10 September 2010
HG/VH/B2/10-160

baselcommittee@bis.org

Consultation paper: Countercyclical capital buffer proposal

Dear Sir/Madam,

The European Association of Co-operative Banks (EACB) welcomes the opportunity to comment on the Consultation paper " Countercyclical capital buffer proposal".

Please find our remarks on the following pages. Do not hesitate to contact us should you have any questions.

Yours sincerely,

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1. General remarks

Addressing procyclicality in the financial system is an essential component to strengthen the macroprudential orientation of regulatory and supervisory frameworks.The EACB supports in general the Basel Committee overall goal of targeting the dynamic interactions between the financial sector and other sectors of the economy. However, the fairness of the proposal can also be discussed as the banks with a conservative business model and who their even take cyclical issues into account in their risk management will be subject to a countercyclical buffer in the same way than banks with a high appetite for risk.

The additional capital buffer add-ons requirement of countercyclical capital buffers is worrying for banks, particularly for decentralized banking sectors. They hamper the capital raising of banks (in particular on the capital market) and disadvantage banks to other branches. It must not be forgotten, that local/regional banks in decentralized banking sectors often generate substantial parts of their profits from dividends paid out by their central institutions. Moreover in some jurisdictions, payouts are limited by law or statutes. In these cases, restrictions of dividends would sit on top of the limitations of payouts established by law/statutes.

Whilst the consultation paper addresses the necessity to provide appropriate tools to prevent that such interaction amplify the business cycle fluctuations that might cause financial instability; there are many questions that remain open. Moreover, the EACB has strong reservations about the design of a countercyclical buffer as a compulsory measure. Furthemore the Committee acknowledges, countercyclical buffers are not intended to be used on a regular basis (maybe only once every ten or twenty years).

Before commenting on the proposal to set up countercyclical buffers, we would like to reiterate our doubts concerning the appropriateness of the overall purpose of the capital conservation buffers and their interactions with the countercyclical capital buffer as we already commented in our response to the Basel consultation "strengthening the resilience of the banking sector".

It is crucial that the specific amount of the capital buffer is further clarified as it is connected to the capital conservation buffer and to the minimum capital requirements. Therefore more certainty is required on the overall capital charge.

In that context a proper calibration of the minimum capital requirements and the capital buffers is necessary to avoid capital charges in excess.

Indeed, we doubt that the capital buffer mechanism can provide the desired flexibility in capital management that it seeks to achieve. On the contrary, due to the way markets operate, capital buffers might be perceived as a new minimum capital requirement to be respected at all times. As a result, such a measure might rather cause the effect of reducing the amount of credit and thus impinge the real economy.

Moreover, buffers only restrict the credit market, as opposed to the capital market; thus, large companies will seek financing from the capital market, which thwarts the proposal's goal to limit excessive growth through credit restrictions.

Thus, the EACB is concerned that the proposal might contribute to create incentives to move borrowing outside the highly regulated banking sector.

For the above mentioned reasons, the EACB has serious doubts about the effectiveness of a countercyclical capital buffer. In our view, there are more appropriate tools to reduce procyclicality (i.e. forward looking provisions). In addition, The Basel Committee already suggested a number of measures that lead to the reduction of cyclical effects (e.g. reduction of counterparty credit risk, introduction of leverage ratio).

The calibration of an anticyclical capital buffer has to be done consistently with the context of the whole Basel package. To that regard, the EACB would like to outline that the measures envisaged in the Basel reform should be introduced in different phases to allow the industry to fully assimilate the new standards.

It has to be noted that the pricing of the customer business will be more difficult as a result of the permanent variation of capital buffers. A business which is in one year EVA positive can become EVA negative the next year without fault of the customer. Hedging is hardly possible due to the responsibility of the respective supervisory authorities which possibly apply different criteria.

Finally, a global asymmetric situation could arise if such a measure is not implemented in the United States. This would create an uncompetitive level playing field at the global level which will most likely curb the economic growth in the European Union.

<u>Section 1- Objective and operation of the proposal</u>

1.1. National buffer decisions and jurisdictional reciprocity

The consultation paper states that the institutions would have 12 months to build the capital buffer. However, it has to be considered that the capital planning of an institution it is much longer than 12 months.

Institutions would not be able to consider it in their regular capital planning. Thus, in times of negative market, normal conditions could not be obtained. In addition, the management of capital might become more difficult for cross border groups, because increased capital requirements will apply on a short notice for a wide range of jurisdictions.

It has to be underlined that the suggested introduction of anticyclical capital buffers might have an impact on credit prices. It has to be ensured that anticyclical capital buffers are not used as a measure of regional economic policy.

Furthermore, the EACB fears that different capital buffers could lead to competitive distortions between lenders in different countries, since the conditions of financing may differ significantly depending on the country of origin.

In order to avoid distortions of competition, the EACB has strong reservations on the options of home supervisors to require higher capital buffers to home institutions' exposures located in the host country. If that were the case, national institutions would have to bear higher cost than local competitors.

Section 2-Further details on key elements of the proposal

2.1. Principles underpinning the role of judgement

The EACB considers necessary the use of judgment in order to introduce some flexibility to the measure; however it would be essential to create confidence in such a process.

In that context, the EACB appreciates the powers that are to be given to National Authorities to analyze the economic cycle, to capture the credit growth, and thus to determine the capital buffer for the exposures in their jurisdiction.

However, In order to avoid competitive distortions we consider appropriate that Authority decisions are revealed and that is proven that the indicators suggested by the Authority are appropriate to measure systemic risk.

In addition, reasons should be given to justify why the Authority deviates from the preferred credit/GDP guide. We encourage the Basel Committee to consider this aspect more explicitly under principle 3.

It has also to be considered that within one jurisdiction, economic development and levels of credit growth may differ significantly from the average rate at national level. The EACB believes that any future macro-prudential model should be flexible enough to consider the situation of local banks which only operate in specific regions where the credit/GDP rate might be much lower than the one at national level. It should be avoided the situation where signals of excessive credit growth penalize local banks to build up buffers whereas at local level there might not be any signal of excessive credit growth.

2.2. Calculating bank specific buffers

2.2.1. Calculation methodology

According to the proposal, the capital buffers shall be defined based on the deviation of the credit/GDP ratio from a long term trend.

The capital buffer would have to be created if the factor exceeds the trend to a certain degree. As the table in page 25 (UK) shows this can lead to a capital buffer even when the volume of credit/GDP guide is declining.

A buffer should be created if the relation between credit volume and GDP is increasing by a certain factor above the trend. If however the trend is increasing more that the credit/GDP guide, then the buffer would melt down.

The EACB has serious concerns on the complexity of the measure. Further attention should be given on how to reduce the cost of calculation of such a measure at firms' level.

Further clarification would be required on the definition of “exposures” as several definitions for this term may lead to misinterpretations.

In addition, the credit/GDP ratio is not an appropriate parameter for all economies. In the case of emerging markets, the ratio is not representative, as it will differ significantly from the trend values. The implementation of this parameter would be a disadvantage for those banks which are active in these markets. Therefore, other ratios should be applied in such cases.

2.2.2. Data availability

For internationally active institutions the calculation of the buffer can be very costly. We therefore suggest the introduction of a de minimis limit in order to keep the expenses low for very small assets without substantial importance for the whole portfolio.

Equally the suggested look through for structured products as well as for investments funds will require considerable expenses which are not related to its usefulness.

Furthermore, in some cases, the location of risks can be very complex. As for some exposures the location is clear (i.e. real strate exposures) in other cases it might be more difficult to determine it (i.e revolving credit facility or standby facility).

2.2.3. Interaction with Pillar I and II

It is not clear yet whether the conceptual distinction put forth in the proposal between the new buffer and Pillar II, will work in practice.

The Basel II accord already addresses under pillar II, some of the same issues as the new countercyclical buffers (e.g. business cycle effects). In our view, tailored additional capital requirements for each bank under Pillar 2 are not only fairer but also more effective than a fixed countercyclical buffer applied without differentiation to all banks.

With the introduction a countercyclical buffer, the EACB has doubts on how this measure will interact with Pillar II requirement. It is crucial to prevent double counting of environmental and cyclical issues under both pillars.

In addition, bank stress tests and capital planning already take account of macro and cyclical issues, arising the risk again to over counting cyclical risks.

The banks with a more conservative business model are likely to be penalized by the new buffer unless a proper balance between Pillar II and the new buffer is achieved.

Considering the above the EACB believes that it is too hasty the introduction of a countercyclical buffer under pillar I. A period of analysis and experimentation is needed in order to assess its usefulness. Until then, such a measure should fall under Pillar II.

2.3. Publishing the jurisdictional buffers and the bank specific buffers

The consultation paper states that banks will need to disclose a distribution of geographical exposures. However, as stated above, such a disclosure would require more certainty on the concept of “location” of the exposures, in particular in the context of credit exposures.

2.4. Treatment of surplus when buffer returns to zero

When the capital buffer is released, unused funds may be distributed as dividends. However, according to the consultation document, National Authorities can prohibit such payout if they consider it inappropriate with regard the specific situation of the institution.

This right to prohibit payouts will make recapitalization of the banking industry even more difficult. We therefore suggest deleting this right of veto.

Furthermore, it remains unclear when the capital buffer can be used to cover losses. A central decision by National Authorities seems inappropriate. Instead, for the use of the buffer, primarily credit portfolio of individual banks should be relevant.

For example, a credit institution which predominantly has loans to suppliers of a specific industry in its portfolio may be affected by the cyclical developments later than an institution having mainly exposures to service provider in its portfolio.

2.5. Selecting the authority to operate the buffer

A question that remains open is to determine the authority that will operate the buffer. Such an authority will need to focus on the macroprudential goals set by the Basel Committee and will need be to take decisions with independence to other national policies but at the same time with information enough from other authorities to take the right decisions.