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

e-mail: baselcommittee@bis.org

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EAPB comments on the Basel Committee's consultation on "Countercyclical capital buffer proposal"

The EAPB appreciates the opportunity to comment on the consultation papers "Countercyclical capital buffer proposal" (CP 172). We would like to provide our response in the following.

The Basel Committee provides with this consultation a detailed proposal for the introduction of a countercyclical capital buffer as already announced in the consultation paper of December 2009 "Strengthening the resilience of the banking sector".

General remarks

The specifications on a countercyclical buffer proposal as set out in the consultation paper can be a suitable tool to dampen the procyclicality of Basel II. However, some questions remain to be discussed.

We would like to notice that we strongly reject the idea of a capital conservation buffer. The envisaged constraints on distribution of earnings impose a considerable interference with the contractual arrangements between credit institutions and investors which could pose legal uncertainties. Furthermore, we do not consider the capital conservation buffer capable to dampen the procyclical effects of the current framework. Especially in times of recession it is not very likely that banks will be able to reduce their capital reserves.

Regarding the level of the capital buffer and interdependencies with other measurements the consultation paper does not give any specific indications about the level of the countercyclical capital add-on. The level of the capital add-on is important, given the correlation with the capital conservation buffer and the future developments of minimum capital requirements in general. It must be ensured that the same risks are not covered by multiple capital requirements. If risks stemming mainly from the economic cycle and

Avenue de la Joyeuse Entrée 1 - 5, B-1040 Brussels ● Phone :+32 /2 / 286 90 62 ● Fax : +32 /2 / 231 03 47
Website : www.eapb.eu

extraordinary credit growth are covered by capital add-ons, minimum capital requirements need to be increased by a lesser amount.

We would like to stress that the Basel III reform package has already taken on board several measures to dampen procyclicality which have a similar effect to capital buffers. Just to name a few, the increase of capital requirements for the credit counterparty risk with OTC derivatives or the introduction of a leverage ratio. Also, the introduction of contingent capital as a capital instrument can be considered as a form of a capital buffer. This will help the credit institutions to counteract negative economic development when the contingent capital is converted into equity capital.

A sound forward looking provisioning system as envisaged by the International Accounting Standards Board (IASB) could be another effective measure to mitigate the bulk of the undesirable procyclicality observed in the recent crisis. If the provisioning system proves to be effective in removing the excessive cyclicality, additional rules-based systems should only apply to those institutions not covered by the provisioning system.

The calibration of a countercyclical capital add-on cannot be isolated from the rest of the Basel revision. We therefore urge the Basel Committee to split the forthcoming revision of the Basel II accord into several packages and introduce them partially, with at least one year in between. By doing so, the actual impacts can be observed and remedy can be introduced quickly if necessary. Due to the fact that the countercyclical buffer is a new measure and several questions still remain to be resolved, the introduction of the countercyclical buffer should take place at a later stage.

The proposed methodology to dampen procyclicality discriminates economic convergence of emerging markets due to higher volatility in both parameters (credit and GDP) used in the model. The growth of emerging economies depends heavily on credit growth. Implementing a strict Credit-to-GDP-ratio as a buffer trigger would in fact make it very difficult for emerging markets to develop.

From a technical point of view, it might be problematic for a number of emerging markets to construct a credit-to-GDP gap variable of sufficient quality, either because of unavailability of a broad-enough measure of credit or because of lack of a sufficiently long data series. With short series, the HP filter of the historical data would not necessarily represent a trend value and the gap may misrepresent the build-up of imbalances.

National buffer decisions and jurisdictional reciprocity

We support the idea to have the national authorities determining the analysis of the economic cycle, the calculation method for credit growth and the definition of capital

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buffers. To raise the acceptance of decisions of the supervisory authorities and to avoid market distortions, it is necessary to disclose all decisions of the supervisory authorities. This will help to identify whether the chosen indicators are suitable to capture systemic risks. In those cases where a deviation from the 'credit-to-GDP ratio' is noticeable, a justification should be required.

If capital add-ons are decided nationally, it bears the risk that this might lead to market distortions between different countries affecting the competition of enterprises. A countercyclical capital buffer could be an incentive for enterprises to decide for a particular location. We therefore reject the discretion for the home supervisor to impose higher capital add-ons on domestic institutions for loans contracted abroad than the host supervisor would request. These credit institutions would suffer from higher capital cost than their foreign competitors.

Calculating bank specific buffers

Regarding the calculation of countercyclical capital buffers, the credit institutions would need data on the geographical distribution of their outstanding credits. In general these data should be available but it might involve considerable cost for internationally active credit institutions to calculate their buffer. We suggest that a materiality threshold is introduced to avoid unnecessary excess burden associated with data collection.

When the countercyclical buffer is dissolved the surplus capital is distributed. However, according to the provision laid out by the Basel Committee, the national supervisor should be entitled to deny the distribution if specific circumstances justify such a decision. This restraint on distribution could hamper the already difficult recapitalisation of the banking industry. We urge to refrain from introducing a veto right for supervisors here.

It is not fully comprehensible from the consultation paper when a countercyclical buffer can be used to cover losses. A decision on this delicate issue by the national supervisor seems to be difficult because the individual portfolio of a credit institution is decisive for the use of the buffer. The composition of the portfolio is the trigger for the buffer because it reflects which part of the economy is affected by the economic downturn.

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Should you have any questions, please do not hesitate to contact us.

Kind regards,

Henning Schoppmann
EAPB

Sandra Hafner
EAPB

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