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Basel Committee on Banking Supervision

Consultation document: *Countercyclical capital buffer proposal*

Euroclear response

The Euroclear group is the world's leading provider of domestic and cross-border settlement and related services for bond, equity, fund and derivative transactions. User owned and user governed, the Euroclear group includes the International Central Securities Depositary (ICSD) Euroclear Bank, based in Brussels, as well as the national Central Securities Depositaries (CSDs) Euroclear Belgium, Euroclear Finland, Euroclear France, Euroclear Nederland, Euroclear Sweden and Euroclear UK & Ireland.

We are pleased to be given the opportunity to provide our view on the consultation issued by the Basel Committee on Banking Supervision, *Countercyclical capital buffer proposal.*

General comments

We support the Committee's aims, which we understand to be the following: ensuring that banks are well protected in times of excessive credit growth and preventing the build up of system-wide risk.

However, we consider the current proposal to be too crude, as it would treat all credit institutions alike, irrespectively of their core activities and thus irrespectively of the closeness of the relation between their exposures and the national economic conditions prevailing in the countries in which such exposures are incurred. This may affect credit institutions that are not directly providing loans to the economy inappropriately.

Specific comments

We understand that setting buffers at the national level aims to reflect differences in national credit cycles and would allow dampening excessive credit growth in relevant areas without disrupting credit provision where local economies are weak. However, we wonder whether the domestic level is appropriate in that respect: large economies may have asynchronous regional cycles and economic regions, sharing industries and business cycles, may span across national boundaries. In the Eurozone or other currency areas, different ratios may influence the convergence of economic cycles. In theory, this influence may be positive, if credit cycles are smoothed in all economies belonging to the currency area; but this would only be fully true if the ratios are applied at the appropriate regional level.

We note that the current proposal gives much discretion to domestic regulators. While it is understandable that assessing whether credit growth is excessive or not is a matter of judgement and cannot be based on an exhaustive list of objective factors, this is not without risks. First, it may induce an excessive reliance on regulatory judgement. Second, and more importantly, it goes against the principle of global banking standards and harmonisation of regulatory requirements. As a consequence, it may pave the way for a return to a pre-Basel II era, where regulatory competition would threaten the meaningfulness of the countercyclical buffer. This may also render regulators more vulnerable to political interference. An alternative would be to introduce a countercyclical component directly in Pillar I credit risk models. This would have the advantage of improving the models by reducing their pro-cyclicality, and would remain in the spirit of Basel II's risk-based approach.

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We note that the Committee has well identified potential interactions with fiscal and monetary policies and believe that these potential interactions would deserve deeper analysis, in order to avoid unforeseen (or inaccurately calibrated) impacts. Behavioural aspects would also need to be given further thoughts. In that respect, we are not convinced of the fact that releasing the buffer would trigger the desired behaviour, i.e. increasing the provision of credit to the economy, in all circumstances. In a severe stress situation, banks would be unlikely to step up their lending, even if the buffer were released.

We believe that one single buffer, applicable to all bank exposures in a given country, would not be fully appropriate. Not all banking activity is likely to add fuel to a credit boom. For example, Euroclear's exposures, which stem from the provision of payment, clearing and settlement services for clients, are not incurred to fund economic activity. It should also be noted that applying the buffer on top of capital held against exposures to banks would give rise to a multiplier effect in the buffer, as all banks in the lending chain would need to hold additional capital for exposures among themselves. The overall buffer, and therefore the overall brake on credit, might be excessive. Effects on interbank lending cannot be excluded either.

We would like to ask the Committee to clarify further how the buffer would relate to proposals with regard to dynamic provisioning and to the applicable accounting rules. Strong divergences between prudential and accounting rules are not desirable.

Please also clarify what is meant by "Capital used to meet Pillar 2 requirements should not be used to satisfy the countercyclical capital buffer requirement". Does it mean that banks need to hold capital for countercyclical purposes on top of their Pillar 2 requirements, if those Pillar 2 requirements are higher than the regulatory capital requirements? If that is the case, we believe that this is not appropriate. Indeed, the way Pillar 2 requirements are determined may be materially different from the way Pillar 1 requirements are set. This is the case of Euroclear's economic capital model for credit risk, which includes intraday exposures, and is thus much stricter than the applicable regulatory capital model. Applying the countercyclical capital buffer on top of any Pillar 2 requirements would not be meaningful, as the intraday exposures that Euroclear considers in its economic capital calculations do not contribute to funding economic activity. More generally, if capital used to cover Pillar 2 requirements cannot be used for the buffer, it might create an incentive for institutions to reduce the stringency with which they determine their Pillar 2 requirements.

In addition, it should be noted that banks may already have defined in their pillar 2 approach a buffer with similar aims to those of the countercyclical capital buffer. This is the case, for example, of Euroclear's capital stability buffer, which comes on top of the economic capital that Euroclear believes it should hold to cover the various risks that it runs. We believe that regulatory authorities should allow the use of (part of) such a capital stability buffer in lieu of the regulatory countercyclical buffer.

Finally, how the buffer fits within the Basel II philosophy is unclear: it seems not to belong to any of the existing pillars. There is an intrinsic inconsistency in positioning the buffer as a compulsory capital requirement, while at the same time precluding banks from using capital set aside to cover their risks under Pillar 2 for the purpose of that buffer.

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