Febelfin

Mr Nout Wellink
Chairman of the Basel Committee
Secretariat of the Basel Committee on Banking Supervision
c/o Bank for International Settlements
Centralbahnplatz 2
CH – 4002 Basel (Switzerland)

By email: baselcommittee@bis.org

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Brussels, 15/09/2010

Countercyclical capital buffer proposal, Febelfin comment

Dear Sir,

Febelfin, i.e. the Federation which regroups four trade associations from the Belgian financial industry[1], welcomes the opportunity to express its views on the consultation document mentioned above.

We welcome the clarifications which are brought by the Consultative document regarding the creation of a countercyclical capital buffer. While we agree that the procyclical amplification of financial shocks like we witnessed during the last financial crisis needs to be addressed, we wish to share with the Committee several major concerns we have regarding the proposal.

First, we are of the opinion that **the primary responsibility for controlling excessive credit growth should rest with the economic and monetary policy makers to take steps and avoid the building up of bubbles in the first place**. We do not think it neither sound nor effective to mix up monetary and prudential supervision in order to avoid a over-heating of the economy. We think it advisable to recommend regulators to control credit growth first and foremost by macroeconomic variables: interest rates, minimum reserve requirements of central banks, etc...

Second, given the important overall impact of the new capital requirements, **we advocate that double counting of regulatory measures is to be avoided**. In this regard, we would welcome insights in the results of the data collection done by the Committee in order to measure the cyclicality of the capital requirement. Especially, we would welcome more clarification in how far the use of through the cycle PD (probability of default) estimates and downturn LGD (loss given default) estimates fall short of reducing the cyclicality of the capital requirement in a sufficient way. Should such data be subject to confidentiality concerns, we would appreciate that such a comparison could at least be used in the calibration of the countercyclical capital buffer.

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[1] The following trade associations are constituents of Febelfin: the Belgian Bankers' and Stockbroking Firms' Association (ABB/BVB); the Professional Union of Credit Providers (UPC/BVK); the Belgian Asset Managers Association (BEAMA), the Belgian Leasing Association (BLA). In addition, the following federations have joined Febelfin as associate members : the Belgian Private Banking Association, the Belgian Private Equity and Joint Venture Association. Equally, other financial market infrastructure providers, such as Euroclear, SWIFT and Euronext have taken the status of associate members.

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Third, it is of the utmost importance that **an international level playing field in the application of the countercyclical capital buffer** is applied. We fear that European banks will be submitted to the new requirements in a disproportionate way compared to banks in other major economic areas of the world such as the US, China and India.

Fourth, we wonder how this buffer will differentiate between institutions using the SA (standardized) approach and the IRB (internal ratings based) approach **(proportionality).** Banks using the SA (standardized) approach may need higher capital requirements than those using the IRB (internal ratings based) approach. We welcome more clarification about the cyclicality of the capital requirements under the SA (standardized) and IRB (internal ratings based) approaches respectively, in order to determine whether a differentiation in the application of the countercyclical capital buffer is necessary.

Fifth, **we warmly welcome** the proposal **that the judgment is to be anchored by a clear set of principles in order to promote sound decision-making** in the setting of the countercyclical capital buffer. It is of the utmost importance that **all subjectivity is taken out of this process** in order to avoid unlevel playing fields.

Sixth, we would welcome **a more precise definition of the credits to be taken into account**. At the moment it is unclear to us which forms of credit (trade finance?) are to be taken into account as well as their status (granted loans vs outstanding loans).

Finally, we also fear that conservative business models will be penalized for the behavior of more aggressive competitors. While non-regulated credit channels would remain unaffected by the measure. Also the proposed measures will constrain dividend driven investment in the banking sector at a time where banks have to raise significant amounts of capital.

Our more detailed comments can be found in the annex of this letter. We hope these remarks will be taken into account. Please do not hesitate to contact our services and our working group, should you want any further information.

Yours sincerely,

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Michel Vermaerke
Chief Executive Officer

Daniel Mareels
General Manager

Enclosure

Cc. JP Servais, Chairman, Banking, Finance and Insurance Commission (CBFA)

Countercyclical capital buffer proposal, Febelfin comment, annex

General remarks:

We welcome the clarifications which are brought by the Consultative document regarding the creation of a countercyclical capital buffer. While we agree that the procyclical amplification of financial shocks like we witnessed during the last financial crisis needs to be addressed, we wish to share with the Committee several major concerns we have regarding the proposal.

First, we are of the opinion that the primary responsibility for controlling excessive credit growth should rest with the economic and monetary policy makers to take steps and avoid the building up of bubbles in the first place. We do not think it neither sound nor effective to mix up monetary and prudential supervision in order to avoid a over-heating of the economy. We think it advisable to recommend regulators to control credit growth first and foremost by macro-economic variables: interest rates, minimum reserve requirements of central banks, etc... While we recognize that at this moment in time the room for manoeuvre for national banks, without endangering the flow of credit to the real economy, is limited, we do believe that a fair balance is to be found between additional capital burden for the banking sector and hard (and thus politically unpopular) macro-economic policy decisions to be taken in order to keep the economy healthy.

If the countercyclical buffer were to become a new monetary policy tool to better control the extension of credit to the economy, the measure as currently proposed would be ineffective as the measure would apply to regulated institutions only. For the measure to be effective it should seek to curb all new lending, including the portion extended by non regulated entities.

Moreover, there would be the danger that authorities may be tempted to try to use the buffer for macroeconomic, as opposed to macro-prudential, purposes if, for example it is politically difficult to tighten monetary policy, or central banks that do not have control of interest rates will seize the buffer as an expedient (although far from optimal) tool for policy ends. If that happened, the risk-based and objective premises of the entire international capital accord would be undermined.

Second, we would like to bring forward that Basel II has already introduced through the cycle PD (probability of default) estimates as well as the use of downturn LGD (loss given default) estimates in order to achieve a more stable capital requirement over the economic cycle. Also the use of a downturn PD (probability of default) is already foreseen. As the now proposed countercyclical capital buffer is meant as an addition to these measures (which have not been able fully to prove their usefulness given the financial crisis occurred shortly after the introduction of Basel II), we wonder whether the proposal does not (partly) overlap with them. In this regard, we also mention the use of stress testing exercises in order to measure the appropriateness of the current capital requirement.

Given the important overall impact of the new capital requirements, **we advocate that double counting of regulatory measures is to be avoided.** In this regard, we would welcome insights in the results of the data collection done by the Committee in order to measure the cyclicality of the capital requirement. Especially, we would welcome more clarification in how far the use of ttc PD (probability of default) estimates and downturn LGD (loss given default) estimates fall short of reducing the cyclicality of the capital requirement in a sufficient way. Should such data be subject to confidentiality concerns, we would appreciate that such a comparison could at least be used in the calibration of the countercyclical capital buffer.

In the same context, the different regulatory initiatives (European Commission, CEBS and now the Basel Committee) which are taken regarding procyclicality create confusion within banks. What's

more, the differences in approach between each of these initiatives make it difficult for banks to prepare themselves in an appropriate and timely way. We advocate therefore the development of one harmonized approach between regulators ensuring a level playing field treatment amongst banks.

The Basel Accord includes cyclical conditions in the scope of Pillar 2; therefore, the interaction of the new countercyclical buffer with Pillar 2 needs to be sorted out, both to avoid double-counting and to preserve a significant dimension for firm-specific risk analysis, especially as firms are unlikely to be affected equally by macroeconomic developments.

Banks should already be taking environmental and cyclical issues into account in making Pillar 2 assessments. Thus, they would need to back those determinations out of future Pillar 2 discussions, at least insofar as macro-cyclical issues are concerned. Failing that, a bank that has prudently included macro issues in its ICAAP process would be hit with an additional "countercyclical" buffer requirement for risks already covered by its ICAAP. In effect, the most conservative and prudent banks are likely to be penalized by the new buffer. We also wonder how the proposed countercyclical buffer interrelates with the expected loss approach to be defined by the IASB and whether the calibration should not take into account this expected change in accounting practices? We are of the opinion that a sound forward looking provisioning system should be the most 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 (as it was experienced in the Spanish banking system during the crisis), additional rules-based systems could only overlap the provisioning system.

Finally we note that the capital conservation buffer and the countercyclical buffers form two additional layers on top of the minimum capital requirement. As it can be expected that markets will interprete the capital conservation buffer as an integral part of the new minimum capital requirement, we are of the opinion that this higher requirement will reduce the possibility that the capital requirement is seen as insufficient over the cycle, thereby minimizing the need for an additional layer in the form of a countercyclical capital buffer. Restrictions on dividends and share buy-backs are likely to be more disruptive of firms' ability to manage their capital and maintain relationships with investors than is recognized. This would induce treatment of the combination of both buffers as a new minimum, and hence undermine the intended countercyclical flexibility, creating a strong incentive for banks to be more restrictive of credit overall than intended by the Basel scheme.

From the point of view of the industry the overall result of the proposed building-block approach is likely to be highly conservative. There is serious concern that the capital requirements will in fact double or triple up through the layered capital requirements in ways that would be beyond the intent of the model, and hence defeat its purposes.

Third, it is of the utmost importance that **an international level playing field in the application of the countercyclical capital buffer** is applied. We fear that European banks will be submitted to the new requirements in a disproportionate way compared to banks in other major economic areas of the world. In this regard we would like to make the following comments:

- It will give an advantage to banks operating in countries where financing is largely "disintermediated".
- For example, there may be instances where an internationally diversified bank with a low market share in a particular country may choose to resort to aggressive lending to win local market share, thereby fueling excessive credit growth in that particular country. The counter-cyclical buffer would then result on all local banks being unduly penalized regardless of the soundness of their credit policy. In this example, local banks with high

market shares will also find it more difficult to adapt before the countercyclical buffer comes into force compared to the bank(s) responsible for fueling credit growth.

- The issue of "location" of risks is more complex than the discussion assume. For example, a revolving credit facility, a standby facility, a trade-finance facility, or a working-capital facility for a multinational corporation may allow the borrower to allocate funds where needed in its network, or to on-lend funds to subsidiaries. A company from country X may use funds in country X or abroad. It is clear for risk-management purposes that the credit risk is the country X company, but the purpose of the buffer is to curb excess credit. In this example, there may be no credit overheating in country X, but it could be an issue in an emerging market where the country X company uses a portion of the proceeds. Conversely, it could be that the country X authorities have become concerned about excessive credit expansion and have imposed a buffer, but that could be irrelevant to the emerging market, where there is a *need* for credit and no current danger of overheating. In that case, applying the buffer would "dampen" credit in a country where ample credit is needed. This might be even more complex if the country X company borrows through an offshore finance subsidiary.
- It seems that the new countercyclical buffer might be applied to a bank that has no exposures in the overheating sector(s). To take a real-life example, bank A had no mortgage exposures whatsoever in 2007, but bank B was aggressively involved in subprime lending. As discussed later herein, bank A's Pillar 2 analysis might already have taken into account environmental issues. Bank B's pillar 2 discussions with its regulators should have taken into account its intensive participation in the subprime mortgage market. If additional capital charges were necessary to dampen the overheating sectors of the market, they should presumably apply primarily to bank B, and ideally would already have been imposed. Even from a macro-prudential point of view it is not evident why bank A, which, in addition to having no exposure to the critical sector, has taken cyclical issues into account in its risk management processes, should also be taxed with this additional capital burden on its businesses, which are unrelated to the overheating. While the Committee has certainly thought about this issue in aiming to design a systemic buffer raising capital across the system, the disparate impact of the new buffer across institutions is nonetheless troubling. Imposition of the new buffers – and the need to anticipate them in capital planning – could paradoxically create incentives against prudence, or penalize more conservative business models.
- We are looking forward to the application of the Basel 3 requirements, including the countercyclical capital buffer, within the US and this for all banks. The non or partly application of these requirements in the US would in contrast mean an important unlevel playing field for European banks.
- We wonder how the credit volume be dealt with which is owned by Government-sponsored enterprises in the US such as Freddy Mac and Fannie May. As one of the major elements in the past financial crisis, disregarding this credit volume because they have been taken on the balance of the Federal Reserve would again mean an important unlevel playing field in the treatment of European banks.
- The methodology presents particular issues in its application to emerging economies, which is important because large emerging economies are likely to account for a substantial portion of global credit growth in the coming credit cycle.

  First, it might be problematic for a number of emerging markets to construct a credit: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.

  Second, a number of emerging markets are likely to experience a strong secular increase in credit in coming years as part of the process of returning to financial health. Countries with

a history of high and volatile inflation (e.g. Brazil and Mexico) experienced a secular decline in Credit: GDP in the 1970s through the 1990s associated with poor macro performance. As macro-stability is restored, a process of re-monetization is to be expected (and is indeed now underway). Credit: GDP ratios may thus be changing over time reflecting strong but sound growth. While the proposal gives such countries the freedom to use judgment in distinguishing such sound trends from impending bubbles, there is no guidance as to how to analyze the different dynamics of emerging-market countries, especially the stronger ones, or more generally of how to discern sound upward trends. This is an issue that will need to be studied carefully before the proposal can be implemented with confidence on a global basis. Also it should be avoided that future growth in mature economies (eg through new innovative industrial breakthroughs) is hampered by focusing too much on the slope of the economical growth as known in the past.

- It is known that emerging economies often lack sufficient historical data for the use of credit activities. While this could be corrected through judgment of the local supervisor, this may lead to a large degree of subjectivity in the estimation of the local trend.

Fourth, we wonder how this buffer will differentiate between institutions using the SA (standardized) approach and the IRB (internal ratings based) approach **(proportionality).** Banks using the SA (standardized) approach may need higher capital requirements than those using the IRB (internal ratings based) approach. We welcome more clarification about the cyclicality of the capital requirements under the SA (standardized) and IRB (internal ratings based) approaches respectively, in order to determine whether a differentiation in the application of the countercyclical capital buffer is necessary.

Fifth, we warmly welcome the proposal that the **judgment is to be anchored by a clear set of principles in order to promote sound decision-making** in the setting of the countercyclical capital buffer. It is of the utmost importance that **all subjectivity is taken out of this process** in order to avoid unlevel playing fields.

Sixth, we would welcome **a more precise definition of the credits to be taken into account**. At the moment it is unclear to us which forms of credit (trade finance?) are to be taken into account as well as their status (granted loans vs outstanding loans, letters of credit, uncommitted lines, bonds, derivative exposure...), Also should be taken into account the differences between banking-book exposures and trading book exposures and in the criteria for the identification of the **location** of exposures (e.g. standby facilities to multinational companies).

We also wonder whether a segmentation by industry sectors and by mortgages, of the credits to be taken into account would not be more appropriate in calculating the credit-to-GDP gap. As lending to some segments is more stable than to others, this difference could be taken into account to calibrate the buffer.

Other comments

- *Efficiency and fairness.*
  - The buffer would be applied to the banking sector in aggregate, in a given market that shows signs of overheating. An additional buffer could thus be imposed on banks that are not or not aggressively involved in the activities that cause the overheating (e.g. subprime lending). Banks that are running a **conservative business model would then be penalized** for the behavior of more aggressive competitors. While **non-regulated credit channels would remain unaffected** by the measure. This raises questions both of efficiency and fairness of the proposal.
- *Market sensitivity.*
  - It is impossible to predict how markets will react to the unpredictability of additional buffer requirements. Markets might well anticipate potential buffer requirements and treat

additional buffers **as if they were immediately applicable.** Thus creating additional difficulties for banks' capital planning.

- On the other hand, "buffer uncertainty" might induce **clients to rapidly draw down** credits on uncommitted facilities to avoid potential higher costs or reduced credit availability. This might increase procyclicality instead of dampening it.

- *Capital conservation mechanism*
  - The countercyclical capital buffer would be enforced by restricting dividend payments and other capital distributions. Such enforcement mechanism is highly undesirable as it risks to further **constrain dividend-driven investment** in the banking sector at a time where banks have to raise significant amounts of additional capital.
  - Taking into account the adverse market signals of any restriction to capital distribution, banks will most likely want to avoid any risk of falling below an assumed countercyclical buffer. This would further add to credit conservatism and would effectively turn the buffers into **de facto higher permanent capital requirements.**
- *Interaction of home and host supervisors*
  - The interaction between home and host supervisors needs more clarity and is clearly a matter for further thought. Notably to avoid **doubling up** of buffer requirements at solo (host) level and consolidated (home) level. Or to address **conflicting views** between home and host supervisors or in respect of the same market.
  - **Independent and coordinated decision making, preferably at supranational level,** will be required to prevent anomalies and distortions of competition.
- *12-month time horizon*
  - The possibility of a buffer being imposed on 12 month's notice will create particular complexities in respect of **capital planning,** notably taking into account the possibility of separate buffer announcements in multiple jurisdictions where an internationally active banks has exposure. But also to manage the pipeline of **approved credits and commitments** that cannot simply be turned back in response to a buffer announcement.

Detailed comments

p. 4: '*The home authorities will always be able to require that the banks they supervise maintain higher buffers if they judge the host authorities' buffer to be insufficient. However, the home authorities should not implement a lower buffer add-on in respect of their bank's credit exposures to the host jurisdiction.*' We disagree with this proposal as this is illogical.

p.8: '*In addition, the calculated long-term trend of the credit/GDP ratio is a purely statistical measure that does not capture turning points well. Therefore, authorities should form their own judgments about the sustainable level of credit in the economy.*'

We advocate that the utmost care is taken by authorities in defining buffers, as the interpretation of the economical activity and possible excessive growth may be extremely difficult. Care is to be taken for not slowing down the economical growth in an unduly way.

p.9, footnote 6: We ask more clarification why exposures to financial entities are included at the individual bank level for calculating the countercyclical buffer.