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The Director General delegate

Paris, September 10th 2010

French Banking Federation's Response on the Consultative document on countercyclical capital buffer (BCBS 172)

Dear Sir,

The French Banking Federation (FBF) is the professional body representing over 430 commercial, cooperative and mutual banks operating in France. It includes both French and foreign-based organizations.

The FBF is pleased to take this opportunity to comment on the proposal devised by the Basel Committee on Banking Supervision in its consultation paper on countercyclical capital buffers. We understand the objectives pursued by the BCBS to address the issue of procyclicality with the goal of protecting the banking sector from periods of excess credit growth

However, we do not support the Basel Committee proposal to introduce countercyclical buffers. We believe that a more effective and consistent application of Pillar 2 across the different jurisdictions should eliminate the need for near-automatic countercyclical buffers. In our opinion forward-looking provisioning and other measures already included in the Pillar 2 approach should remain the priority to tackle the cyclicality issue.

If there is a perceived need to improve such consistency, we urge the Committee to achieve this aim by working towards a more structured and consistent approach of Pillar 2.

We regret the constrained time frame of this consultation that lasted less than two months during the summer. We hope that the Committee will be in a position to study the different responses before taking any decision on this matter.

Mr Stefan WALTER
Secretary General of the Basel Committee
on Banking Supervision
Bank for International Settlements
CH-4002 Basel
Switzerland

You will find in the attached annex our detailed comments on the proposal.

The French Banking Federation wants to see the instigation of healthy competitive conditions and believes the only way to do is to establish appropriate regulations. The FBF remains at your disposal for any further discussion on these matters.

Yours sincerely,

Pierre de Lauzun

FBF response to the BCBS consultation document on the Countercyclical Capital buffer proposal (BCBS 172)

The French Banking Federation is pleased to respond to the BCBS 172 consultation on Countercyclical Capital buffers. The proposal set out in this consultation paper is closely related to the previous BCBS proposal on regulatory buffers described in the Basel Committee consultation paper of December 2009. Therefore, we think it's important in this response not only to provide our specific comments on the countercyclical buffer but also to reiterate some of the concerns that we previously expressed in relation to the broad concept of capital buffers.

A. FUNDAMENTAL CONCERNS WITH THE PROPOSAL

1. The proposed countercyclical buffer mechanism involves the issue of mixing up economic or monetary policy objectives with prudential supervision.

By placing some constraints on the supply of credit through additional capital requirements, the proposed buffer mechanism seeks to correct the effect of an overheating of the economy. But the primary responsibility for taking steps to avoid the building up of bubbles in the first place should rest with the economic and monetary policy makers. We do not consider it sound or effective to mix up monetary and prudential supervision.

We question whether the countercyclical buffer, as it is devised, is the most effective way to address the excessive credit supply from a macroeconomic standpoint: indeed it will apply exclusively to regulated institutions and it will affect both existing and new loans instead of focusing on the increase in new lending from regulated and more importantly non-regulated sectors which would in our view appear more effective.

Due to the amount of time needed to detect and measure the excessive credit growth, before taking the decision to impose a buffer in coordination with the various supervisors and give banks an incompressible time period to adjust, one might also question whether the implementation can be swift enough to be effective from a macro-economic standpoint compared to other economic and monetary policies steps that can be taken.

2. We are concerned by the lack of clarity regarding the interaction of the countercyclical capital buffer mechanism with Pillar 2.

We understand from the BSBC consultation paper that the countercyclical capital buffer mechanism is neither a Pillar 2 nor a Pillar 1 measure; this is perplexing and testifies to the difficulty to resolve the issue of the interaction between the proposed buffer and the existing regulatory framework. The paper states that the Pillar 2 approach will need to adapt to accommodate this new instrument; it however provides little guidance as to how to resolve this key matter. Furthermore, we are particularly concerned by the statement that the capital used to meet Pillar 2 requirements should not be used to satisfy the countercyclical capital buffer requirement. In our opinion, this raises serious issues regarding the double counting of capital requirements with Pillar 2.

For instance stress-testing already reflects credit cycle effects and may translate into additional layers of capital in Pillar 2 to withstand the macroeconomic environment. We can not be comfortable with a proposal that fails to address how this double counting can be sorted out.

As developed below, we are of the view that the credit cycle effects can already be addressed through a more consistent and effective application of the Pillar 2 approach.

3. The proposed buffer has level playing field implications and will create a counterproductive incentive towards disintermediation and a "shadow banking system".

The importance of a level playing field amongst institutions that supply credit cannot be overstressed. The recent crisis has clearly demonstrated that the unregulated sector may play an important role in fuelling excessive credit growth. The proposed buffer may aggravate level playing issues in that respect given the difference of constraints that will apply to the regulated and non-regulated sectors when the countercyclical buffer comes into force. We believe there is a significant risk that the countercyclical buffers will simply create strong incentives to shift borrowing from the regulated banking sector to non regulated entities. Such unintended consequence is particularly of concern, as it would take place at the very times when the risk of credit bubbles would require more discipline to control the excessive supply of credit in the entire financial system.

We also deplore that the buffer should apply equally to every bank in a jurisdiction, thus failing to differentiate between business models, lending policies or degrees of vulnerability to an overheating of the economy.

For example, excessive credit growth could be fuelled primarily by banks with a specific business model or overly active in a particular industry sector. Yet the proposed mechanism would make all banks subject to the countercyclical buffer even though they are unlikely to be equally affected by the macroeconomic environment.

We believe that the prudential approach would be more effective if the additional capital add-ons were specifically targeted to the banks directly responsible for excessive credit growth, or to the ones which would most likely be affected by it.

4. As stated in our previous response to the December 2009 consultation, we continue to have strong reservations about the concept of capital buffers in general, especially because they will inevitably translate into a permanent increase of the minimum capital requirement.

We continue to seriously 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, the capital buffers will inevitably translate into a new minimum capital requirement to be respected at all times. This could defeat the initial purpose of the Basel Committee proposal in terms of cyclical flexibility and even undermine the objective of an optimal financing of the economy.

Operating under capital ratios that could imply constraints on earnings distribution would be sending too negative a signal to the market, thereby weighing on the bank's market capitalisation and ability to raise capital.

That is why banks will integrate the capital buffer add-ons in the permanent minimum ratios targeted in their capital planning. Furthermore, we remain highly sceptical of the fact that banks would be allowed, by the market, the rating agencies or even their supervisors, to actually use their buffer when the economic situation deteriorates. It is precisely at this time that banks would be expected to hold *more* capital to withstand the economic or financial crisis. This in turn increases the risk that buffers form part of the actual new minimum capital requirement.

As stated in our previous response to the December 2009 consultation, we also believe that the proposed mechanism unduly interferes with shareholder's rights. In our opinion, overly restricting Management's and Shareholders' rights in respect of earnings distribution is an excessive intrusion of the supervisory bodies in the banks' management.

5. More generally, the interplay between the various proposals to reduce procyclicality requires more consideration as it may translate into overlapping and multiple applications of buffers.

The consultation document released in December 2009 identified four measures to dampen the financial system procyclicality, countercyclical capital buffers being only one of them. We are concerned by the risk of overlapping of proposals with neither a clear understanding of the potential interplay between the various measures nor a full assessment of their cumulative and incremental implications.

There is a serious concern that the building-block approach to capital requirement currently underway may not achieve the required level of efficiency anticipated in the absence of a proper consideration and assessment of the risk of double or triple counting through various layers of capital requirement. There is also insufficient clarity about the interaction with the existing or future macro-prudential tools.

We also note that the various layers of capital requirements greatly add up to the complexity of the regulatory framework and tend to reduce clarity and predictability. In terms of bank management, the complex capital buffers mechanism will for instance make it very difficult to adequately reflect actual and projected capital requirements in the pricing of credit.

B. PRACTICAL DIFFICULTIES

We can foresee a number of practical difficulties that could make the implementation of the countercyclical buffers more complex and challenging than expected:

- We believe that the modus operandi of the countercyclical buffers may raise complex **home/host supervisor issues**. The mechanism leaves the door open to differences of opinion between supervisors on the calibration and timing of the buffer decisions. As a result , national discretions may prevail and create undesirable competitive imbalances. There is no comfort to be found in the system envisaged to solve such issues in a satisfactory way. The host authorities will have the possibility to demand that the countercyclical buffer be held at the level of entities located in their jurisdiction; however what remains unclear is how this can work where the credit exposure to this jurisdiction is booked in another country.

- **The criteria retained to determine the country location of an exposure may lead to inconsistencies or arbitrage**, particularly if it is based on the borrower's nationality. In the case of multinational companies, lending can be redirected to a borrowing entity located in a country where there is a null to low countercyclical buffer, irrespective of the actual location where the proceeds will actually be used. In case of disagreement between the home and host supervisors, banks may be tempted to shift exposure from one country to the other.

- The Committee acknowledges that the calibration of the additional countercyclical buffer (in terms of sizing the buffer required based on macro economic variables) will remain a **difficult exercise requiring a lot of judgment on the part of the regulators**. We deplore that the BSBC paper provides no real guidance in respect of **criteria to be used for releasing the countercyclical buffer** whilst this will be an equally critical decision to take.

- The **one-year advance notice period for the countercyclical buffer** may not be manageable from a capital planning or market perspective: the market or rating agencies may actually reduce this theoretical lead time by requiring for capital raising to be achieved as soon as possible. Markets could become congested if countercyclical buffers were to lead banks to simultaneously reinforce their capital structure in a large number of countries for potentially significant amounts.

- **The markets' reaction** to public announcements made as a result of a decision to impose or release buffers is not fully predictable. There may be unintended consequences: negative sell signals on bank shares, market congestion weighing on the ability to raise capital, increase of credit demand before the buffer is imposed, etc...

C. CONCLUDING REMARKS

We do not support the Basel Committee proposal to introduce countercyclical buffers. Whilst we support the goal of reducing excess procyclicality and making sure the banking system is adequately capitalised to withstand the impact of exuberant credit growth, we believe this could be better addressed through the implementation of an effective forward-looking provisioning framework and a consistent application of Pillar 2 rather than through additional layers of regulatory capital buffers.

As the Committee acknowledges, countercyclical buffers are not intended to be used frequently (maybe once every ten or twenty years). Obviously, such buffers are also unlikely to be required in the near future, given the current pace of economic growth in most countries. This should be kept in mind especially when considering a proposal that appears innovative, raises challenging questions both conceptually and in terms of implementation and above all fails to be supported by convincing evidence regarding its effectiveness. Furthermore, even though this may be outside the immediate scope of intervention of the Basel Committee, we deplore that the proposal should be envisaged without giving more serious consideration to ways and instruments required in parallel to better control the excessive supply of credit from the non regulated "shadow banking system".

Put in perspective, this sustains the view that incorporating countercyclical buffers in the revised prudential framework should not be a priority at this stage. This is all the more necessary as we are not certain that the full implications of the interaction between the proposal and the numerous changes underway in the regulatory framework can be evaluated in a satisfactory way. As a matter of priority, we urge the Basel Committee to focus instead on more robust and critical aspects of the new regulation framework.

1. Capital buffers can already be accommodated within the Pillar 2 approach.

We believe that the current definition of Pillar 2 already covers the issue that the countercyclical buffers seek to address.

According to paragraph 724 of the 2004 Accord, banks and supervisors must already take account of "*factors external to the bank (e.g. business cycle effects)*" in their Pillar 2 application. This suggests that Pillar 2 should already be able to connect micro prudential supervision with broader macro prudential concerns, as capital requirements under Pillar 2 should factor in not only individual risk profiles but also macroeconomic and cyclical considerations. In our view, additional capital requirements tailored individually for each bank under Pillar 2 is not only fairer but more effective than a fixed countercyclical buffer applied without differentiation to all banks. Effective supervision requires that capital ratios take into consideration business models and lending policies and be raised primarily for the banks that are directly impacted by, or responsible for, the excessive credit growth.

The ability of a number of banks to weather the recent financial crisis was related to the degree of prudence of their supervisors when setting discretionary buffers under Pillar 2 over the minimum capital requirements. We believe that a more effective and consistent application of Pillar 2 across the jurisdiction should eliminate the need for fixed countercyclical buffers. If there is a perceived need to improve such consistency, we urge the Committee to achieve this aim by working towards a more structured and normalized approach of Pillar 2 through the Standard Implementation Group (for example by providing supervisors with more guidance on how to integrate macroeconomic signals in their Pillar 2 approach) rather than pursuing the current proposal on countercyclical buffers.

2. The proposal of the Committee in respect of forward-looking provisioning, if correctly implemented, should significantly reduce the need for countercyclical capital buffers.

Finally, we take this opportunity to reiterate our support to the principle of forward-looking provisioning advocated by the Committee. In our view, the implementation of an effective framework of forward-looking provisioning would greatly reduce the need to resort to countercyclical buffers. As explained in our response to the December 2009 consultation, this is provided that forward-looking provisioning is correctly implemented, i.e. inter alia the accounting and prudential standards are aligned and the framework fully reflects a "through the cycle" approach (as stated previously, we remain opposed to the current 2009/12 exposure draft from the IASB which is not based on a "through the cycle" approach and would fail to reduce cyclicality).

By directly and immediately affecting the P&L, a well-designed forward-looking provisioning scheme would significantly impact the banks' behaviour in case of excessive credit growth and relaxing of credit standards and would help build reserves to weather down cycles. The "reserve cushion" built through forward looking provisioning should in turn be taken in consideration when assessing capital requirements in Pillar 2 and ability of the bank to withstand credit bubbles.