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10 September 2010 (By email: baselcommittee@bis.org & post)

Secretariat of the Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002 Basel
Switzerland

Dear Sirs,

Consultative Document - Countercyclical Capital Buffer proposal

We refer to the Consultative document, "Countercyclical capital buffer proposal" published by the Basel Committee on Banking Supervision ("BCBS") in July 2010. On behalf of our members, we set out our views on various proposals in the Consultation Documents:

General comment

We welcome the consultation process on BCBS's proposal to achieve the broader macro prudential goal of protecting the banking sector from periods of excess credit growth. We recognize the need to ensure the banking sector has a buffer of capital to protect it against future potential losses when excess aggregate credit growth is judged to be associated with a build-up of system-wide risk.

While we recognize that excessive credit growth may give rise to a build-up of systemic risk, we have concerns about the viability of the proposal in the consultative document to introduce a countercyclical capital buffer as a means of addressing procyclicality. The potential impact is difficult to evaluate at this stage as the various proposals suggested by the consultative document ***"Strengthening the resilience of the banking sector"*** are not yet finalized. We are keen to ensure that the cumulative impacts of all proposals are assessed and calibrated accordingly to ensure that there is no double counting of capital requirements. We therefore would like to recommend that BCBS allows the banking industry sufficient opportunity to assess and discuss with regulators the cumulative impacts of all proposals before finalization of the proposals.

It is also important that the measures eventually introduced are implemented on an internationally consistent basis to maintain a level playing field and avoid regulatory arbitrage, and for this to be achieved, there needs to be a balance between

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introducing more regulation and increasing the complexity of regulation. We advocate a measured and straightforward approach that addresses the key issues identified by the financial crisis.

Our comments on the proposals are listed below.

1. Countercyclical buffer converges to Pillar 2 ICAAP requirement

Under the existing Pillar 2 regime, banks are required to apply the Internal Capital Adequacy Assessment Process ("ICAAP") to assess its capital demand on a current, planned and stressed basis. The assessment covers the major risks faced by banks in addition to credit, market and operational risks that are covered under the minimum capital requirements in Pillar 1.

While we agree to the need to address the issue of procyclicality on the capital requirements of banks, the existence of the many layers of 'capital buffers' (namely Pillar 1 minimum capital, the proposed capital conservation buffer and the countercyclical capital buffer) makes the quantification and assessment of the overall impact on capital difficult and may result in double counting of capital requirements. This, without a detailed and informed overall impact study may also lead to unintended consequences to both the banking sector and the economy.

Therefore, we would like to recommend BCBS to consider converging the countercyclical buffer requirements into the existing ICAAP regime so that the issue could be addressed by modifying or enhancing the existing framework without introducing additional rules and complications to the current regulation.

If the countercyclical capital buffer is not included within ICAAP, we question whether there is still a need to maintain the existing ICAAP process.

2. Banking regulators' role in macroeconomic policies

As set out in the consultative document, the primary objective of the countercyclical buffer is to achieve the broad macro prudential goal of protecting the banking sector from periods of excessive credit growth. The capital buffer will cause the cost of credit to rise and therefore dampen the credit supply thus producing a moderating effect on the build-up phase of the credit cycle.

We are concerned on the impact of these proposals on the general economy at large because there are different monetary tools being employed by different jurisdictions as part of their fiscal and monetary policies. Adding a capital buffer as another macroeconomic tool will increase the unpredictability of the outcome on the economy. In an economic boom, the higher capital buffer required may even drive banks to extend more credit under the pressure of shareholders' ROE expectation. Conversely, in a recession, the intended effect of releasing capital constraint on credit supply may not crystallize. Under these circumstances, the proposed measure of

additional capital buffer may not always match the intended objectives. Moreover, we think it is imperative that the possible combined effects of the proposed capital buffer and other monetary tools being used be understood and evaluated.

We also query if it is the role of bank regulators to make decisions on macroeconomic policies.

In view of this, we would like to recommend BCBS to consult other policy makers and bodies before finalizing this proposal.

3. Trial or observation period

Under this proposal, buffer add-on decisions would be preannounced by 12 months to give banks time to meet the additional capital requirements before they take effect.

While we recognize that banks need time to build up their capital, we would like to point out that the signalling effect of buffer decisions will likely affect bank behaviour at the time buffer decisions are announced or even earlier, not at the time when the buffer decisions take effect. On the other hand, at the time when the new buffer requirement becomes effective, the economic environment may have changed completely and the buffer add-ons may no longer be suitable.

Therefore, we recommend BCBS to carefully evaluate the effectiveness of the 12 months' preannouncement timeline.

In addition, we strongly recommend the BCBS to allow a 3 year observation period for the proposals so that the effectiveness of the proposal and its various impacts can be fully evaluated. During the 3 year observation period, we recommend that banks should meet the additional capital requirements within the agreed timelines but should not be restricted in terms of distributions.

4. Consistency and International transparency

The consultative document has proposed a methodology (***credit / GDP guide***) to calculate an internationally consistent buffer guide that can serve as a common starting reference point for taking buffer decisions. Authorities in each jurisdiction will be responsible for setting the buffer add-on applicable to credit exposures to counterparties / borrowers in its jurisdiction. For internationally active banks, their buffer add-ons will be equal to a weighted average of the add-ons applied in jurisdictions to which they have exposures.

The proposal assumes that there is ***jurisdictional reciprocity*** but allows the home authorities the discretion to require that the banks they supervise maintain higher (but not lower) buffers if they judge the host authorities' buffer requirements to be insufficient. Also, under the proposal, where banks have exposures to jurisdictions

that do not operate and publish buffer add-ons, the home authorities will be free to set their own buffer add-ons. In addition, authorities are expected to apply judgment in the setting of the buffer after using the best information available to gauge the build-up of system-wide risk.

We are of the view that by allowing home authorities to make judgments on capital buffers for other jurisdictions, this will create inconsistencies in capital requirements between various countries and consequently there is no level playing field between domestic and internationally active banks. We also think that it may be extremely difficult for regulators across the globe to reach a common consensus in calibrating their buffer add-ons.

Therefore, we recommend a high level of transparency in disclosures on buffer decisions and a simple set of rules or guidelines which should apply across the globe, irrespective of the size of the banks and their jurisdictions.

Finally it is also imperative that the implementation timeline be the same across all countries adopting the Basel capital regime in order to prevent any regulatory arbitrage.

5. <u>Other macro prudential tools</u>

We are of the view that the imposition of capital buffers on the banking industry based on credit growth is a very high level and indirect macroeconomic tool. The proposal does not focus on specific sectors in the economy which may be subject to excessive credit growth and may result in curbing credit in sectors where growth is actually desired.

There are a range of potential macro prudential tools that could be utilized to control the build-up of systemic risk through excessive credit growth, e.g. the imposition of higher collateral requirements for certain industry sectors such as loan-to-value limits for property lending.

We recommend that BCBS should consider using macro prudential tools that directly target areas of excessive credit growth and which are more focused on specific sectors of the economy.

6. <u>Principles underpinning the role of judgment</u>

Section 2 only provides the high level principles, most of the judgment and assessments of information contained in the credit/GDP guide and other guides rest on the minimum standards by jurisdictional authorities.

We expect BCBS to further elaborate the implementation of those principles. This will ensure the internationally consistent application and facilitate local authorities to develop concrete minimum standards.

Conclusion

The countercyclical capital buffer would not be an effective macro-prudential tool for controlling the build-up of excessive credit in the economy and implementing such a tool would be fraught with practical implementation challenges. A much more appropriate approach would be to enhance the existing Pillar 2 framework and ensure that it is properly implemented on an internationally consistent basis. The effectiveness of other potential macro-prudential tools, including tools already being used effectively in a number of jurisdictions such as loan-to-value limits, need to be evaluated further.

We will continue to engage in what we trust is seen as constructive dialogue to improve the resilience and sustainability of the banking industry and to enable it to continue supporting the economic recovery and growth.

If you have any questions or require any clarification, please do not hesitate to contact us.

Yours faithfully

Rita Liu
Secretary

c.c. Ms. Karen Kemp, Executive Director (Banking Policy), Hong Kong Monetary Authority