Comments of Magyar Nemzeti Bank, the central bank of Hungary on "Countercyclical Capital Buffer Proposal" (BIS Consultative Document)

Calibration

The implementation of the proposed countercyclical capital buffer is based on a numerical procedure explained in the document and explored in the background material of Drehmann et al. (2010). The successful operation of the proposed macroprudential tool depends on the parameterization of the above procedure. The document and the background material give detailed guidelines how to determine some of the parameters but remain silent regarding some others.

The first step of the procedure is to calculate the percentage deviation of the credit/GDP from its long run trend (credit/GDP gap). The proposed method for calculating the trend is the HP filter and the document clearly specifies the proposed numerical value of the *lambda* parameter of the filter. The second step is to determine a lower threshold of the credit/GDP gap when the procedure should start building up capital buffers and an upper threshold at which the maximum buffer should be reached. The document and the background material find and suggest some particular numerical values of the thresholds which provide very robust results regarding the trade-off between *type 1* and *type 2* errors. The next step is to map the values of the credit/GDP gap between the thresholds into levels of the countercyclical capital buffer add-on. By definition, the add-on is 0% at the lower threshold, *X*% at the upper one and varies linearly between them. The final step determines how to calculate the capital conservation ratio of a given bank. To implement the last step one has to specify numerical intervals of the level of capital above the minimum capital requirement and of the conservation ratios.

While the document and the background paper provide exact numerical suggestions regarding the first two steps, they do not provide guidance regarding the last two steps, e.g., the published numbers of the intervals on page 15 are purely illustrative. However, as mentioned, the chosen level of *X* (the maximum level of the add-on) and the numerical values of the discussed intervals play key roles in the practical implementation and the success of the proposed countercyclical capital buffer.[1]

Although we agree that calibration of the above parameters by the national authorities should not be uniform and should take into account particular characteristics of the economy in each jurisdiction, national calibration procedures would need *more guidelines* than explored in the document and the background paper and require more international coordination. Without coordination the whole

[1] In contrast with the document, in international press some particular values of the add-on are circulating. E.g., on 6 Sept. Die Zeit newspaper reported on a required additional "anti-cyclical capital buffer" of 3 percent.

calibration process would result in *incompatible* national implementations of the countercyclical capital buffer and put at risk the success of the proposal.

To ensure the consistency of national calibration procedures, at least two measures would be necessary. First, the proposal should specify more clearly the intended size of the capital buffer in a financial distress. According to the document the capital buffer should protect banks against future potential losses and maintain the flow of credit in the economy in a crisis period. However, while determining the size of a capital buffer to cover expected losses is at least conceptually straightforward, it is much *less clear* and *obvious* even theoretically what *size of capital buffer* would maintain the credit flow in a financial crisis. Of course it is possible that in different economies different levels of capital buffer can guarantee the provision of credit in stress time. Consequently, the document should not provide exact numbers regarding this issue, but *clear principles* are needed. Without these principles, there is a risk that national authorities might form totally diverse and incompatible views on this issue which may yield incompatible calibrations results.

Second, after finding a consensus view on the desired level of the buffer, each national authority should present *simulations* to *confirm* that their proposed calibrations regarding the maximum level of the add-on and the capital-conservation-ratio intervals would approximately *provide* the specified level of capital buffer. Of course, such a simulation is data intensive, but necessary information might be available for national authorities.

Rules vs. discretion

The proposal suggests that instead of following a hard rule based approach national authorities should apply judgements in the setting of the buffer after using the best information available. In this particular case there is a clear trade-off between rules and discretion. In the one hand, there are firm arguments supporting discretionary policy: lack of comprehensive knowledge on the behaviour of credit cycles and their statistical indicators makes strict policy rules unreliable. On the other hand, complete discretion may result in serious problems in practical applications, especially if national authorities cannot resist political or lobbying pressures. As Brunnermeier et al. (2009, section 4.8) discuss, the idea of macroprudential regulation is never popular when it is really needed. While the benefit of an increased capital buffer can be realized only in the uncertain future, its immediate, possibly negative, impact on economic growth may hurt short run political and business interests and can be quite unpopular in an overly optimistic environment.

It is impossible to determine the right trade-off, however, it might be between the two extremities, full discretion and hard rules. Nevertheless, it is possible to interpret the recent version of the document in such way that completely depreciates the importance of rules and gives full discretion to

national authorities: for example, according to *Principle 2* "The credit/GDP guide … *does not* need to play a *dominant role* in the information used by authorities to take and explain buffer decisions. "

Hence, future versions of the document should emphasize that deviations from the implications of the credit/GDP gap signal is rather an *exception* than a regular way of decision making and any deviations has to be c*onfirmed* by strong supporting arguments. It should be clear that due to limits of our knowledge, the implementation of a hard rule is impossible but the practice of *full discretion* would *endanger* the operation of the proposed countercyclical capital buffer.

The issue of 'leaning against the wind'

The proposal declares that the main primary objective of the countercyclical capital buffer measure is to ensure that the banking sector has the capital on hand to protect it against losses and to help to maintain the flow of credit in a period of stress after excess credit growth. As a positive side benefit, the measure may also help to lean against the build-up phase of the financial cycle, however, it is not the primary aim of the proposed tool.

Due to our limited knowledge, it is understandable that this new macroprudential tool has a limited role and is not designed for 'leaning against the wind'. However, several authors and institutions argue for using macroprudential tools instead of monetary policy to react to asset price bubbles and excess credit growth. See, e.g., Blanchard et al. (2010) and the speech given by José Manuel González-Paramo, Member of the Executive Board of the ECB, on 3 September 2010.[2] Moreover, some authors call explicitly for countercyclical capital adequacy ratios to manage credit cycles. E.g., Brunnermeier et al. (2009, chapter 4) claim that "We favour a 'lean against the wind' risk-management approach. We argue that such a leaning should be primarily done by counter-cyclical regulatory measures, such as we propose here, not solely via interest rates", and "To achieve this, CARs are needed that are based on better risk spillover measures that take leverage, maturity mismatch and financing into account."

In our opinion, future version of the proposal should react to this issue in a more extended way. It should *clarify* whether the current *limited scope* of the tool is a long run strategy or it is possible that after gaining *sufficient experience* on the operation of the countercyclical capital buffer it *might be used* for 'leaning against the wind' as the above references suggested.

[2] http://www.ecb.int/press/key/date/2010/html/sp100903.en.html

Cross-border issues

According to the proposal, internationally active banks would calculate their countercyclical capital buffer add-on as a weighted average of the add-ons that are applied in jurisdictions to which they have exposure. Since this principle is a key element of the current proposal it is very useful that its practical implementation is illustrated by a clear numerical example on page 10. From an expositional point of view, using such numerical explanations for clarifying important issues is a definite positive feature of the document.

On the other hand, the algorithm for determining the location of the countercyclical capital buffer, a related important element of the proposal, is explained only in a very compact way on page 11. Since successful implementation requires avoidance of any ambiguity and misunderstandings we suggest that the above issue should also be illustrated by some clarifying examples in future versions of the document. Probably the numerical example of page 10 could be enhanced by explaining how the institutional forms of foreign lending (that is, direct cross-border lending, lending through branches and subsidiaries) influence international allocation of the countercyclical capital buffer.

Financial contagions

Although the document discusses issues related to international linkages and contagions, in our opinion the proposed measures might not be able to treat sufficiently the harmful effects of financial contagions.

As discussed, the countercyclical capital buffer add-on of internationally active banks would depend on their foreign exposure. This element of the proposal partly treats the problem of international contagions. If a bank is active in a region where excess credit growth with a high system-wide risk can be observed then the bank has to take into account the higher capital buffer requirement of that region in calculating its own capital buffer. One can argue that in this way it is ensured that those banks which operate in risky regions are protected more by their higher capital buffers proportional to their exposure to the risky regions. This argument would only be correct if the harmful effects of a financial contagion were proportional to direct credit exposures.

However, the recent financial crisis proved clearly that channels of global contagion are far *more complex* than simple *credit exposures* which are not the only and not the most important factors in contagions: for example, decreasing asset prices and the general loss of confidence were also

important channels in propagating the crisis. Nevertheless, it is very hard to identify ex ante the relevant channels of contagion.[3]

If in a certain region excessive credit growth with high systemic risk can be observed then even those banks should be guarded against the risk of a contagion which are not active in that region. On the other hand, the accumulation of global systemic risk may affect a national banking system even if the national supervisor reacts the domestic credit cycle. As a consequence, an insurance against *global systemic risk* should be incorporated in the proposed countercyclical capital buffer.

To the extent that global credit growth is a good indicator of the building-up of global systemic risk[4] the current proposal could be enhanced with a capital add-on depending on the *global credit gap*. This modification would still ensure that banks operating in high-risk regions have higher capital buffer in order to provide them extra protection, however, it also takes into account that in a financial collapse even banks seemingly unrelated to risky regions can be influenced heavily by various propagation channels, hence they also need enhanced protection.

[3] For example, the subprime bust in the US resulted in an interbank funding crisis in Europe which eventually triggered the FX liquidity crisis in Hungary.

[4] E.g., Alessi and Detken (2009) demonstrate that global credit indicators are efficient early warning indicators of high-cost collapses of asset price booms.

References

Alessi, L. and C. Detken, 2009,'Real time' early warning indicators for costly asset price boom/bust cycles -- A role for global liquidity, *ECB Working Paper* No. 1039.

Blanchard, O., G. Dell'Ariccia and P. Mauro, 2010, Rethinking macroeconomic policy, *IMF Staff Position Note* 10/03.

Brunnermeier, M., A. Crocket, C. Goodhart, A.D. Persaud and H. Shin, 2009, The fundamental principles of financial regulation, *Geneva Reports on the World Economy* 11, CEPR.

Drehmann, M., C. Borio, L. Gambacorta, G. Jiménez and C. Trucharte, 2010, Countercyclical capital buffers: exploring options, *BIS Working Paper* No. 317.