International Banking Federation

Pinners Hall
105-108 Old Broad Street
London EC2N 1EX

tel: + 44 (0)20 7216 8947
fax: + 44 (2)20 7216 8928
web: www.ibfed.org

W1283BEW

Mr Stefan WALTER
Secretary General
Basel Committee on Banking Supervision
baselcommittee@bis.org

20th September 2010

Dear Secretary General,

RE: IBFed response to BCBS consultation paper on countercyclical capital buffer proposal

The International Banking Federation (IBFed) is the representative body for national and international banking federations from leading financial nations around the world. Its membership includes the American Bankers Association, the Australian Bankers' Association, the Canadian Bankers Association, the China Banking Association, the European Banking Federation, the Indian Banks' Association, the Japanese Bankers' Association, the Korean Federation of Banks, and the Bankers' Association of South Africa. This worldwide reach enables the Federation to function as the key international forum for addressing legislative, regulatory and other issues of interest to the global banking industry.

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In principle we believe that there is merit in introducing measures to achieve the macro-prudential goal of protecting the banking sector from periods of excessive aggregate credit growth and the associated build up of system wide risk. However while we support the Basel Committee's goal we have some concerns with the proposal, as described in this response.

Whilst we believe in the need for all banks to hold sufficient capital to guard against unexpected loss and see them through periods of severe financial stress we encourage the BCBS to recognise that the amount of required extra capital over and above the minimum

Pillar 1 requirement will vary according to the nature scale and complexity of the bank in question. Proportionality should be a key consideration as regulators consider the role the countercyclical capital should play, as should the possibility that in many cases complementary alternative measures to a rules-based countercyclical metric may have a greater role in protecting society from the disruption that the failure of a bank brings. In particular we believe that improved internal risk management practices and governance procedures, supported by rigorous supervisory challenge in the Pillar 2 Supervisory Review and Evaluation Process (SREP) are the cornerstones on which the case by case establishment of a bank's regulatory capital requirements should be based.

The role of countercyclical measures alongside other potential enhancements to the architecture of banking supervision.

Sound credit underwriting standards and assessment coupled with good business judgement are the foundation on which resilient, through the economic cycle banking is built. The possible use of countercyclical buffers should be viewed as on of a range of tools, both existing and those that are potential new regulatory measures, that could be deployed to help mitigate the potentially damaging impact of economic cycles on the wider financial system, of which the banking industry is just one part.. Among those that we view as potentially focussed on reducing the impacts of cyclicality are:

> **Forward looking provisioning**, which we very much support as being one of the most important contributors to reducing procyclicality, is the move from an impairment methodology based on incurred losses to one grounded in a forward looking expected loss approach. We support the work the BCBS is doing in conjunction with the International Accounting Standards Board on changing the impairment methodology and look forward to its speedy conclusion.
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> **Stress testing** is a tool that is explicitly designed to examine the possible impact of a period of either idiosyncratic or market-wide severe financial stress on the bank's ability to survive supported by exploratory reverse stress testing and informed regulatory dialogue we believe stress testing has the potential to become a potent tool to counter cyclical effects in the economy.

The industry sees countercyclical capital buffers as just one the macro prudential tools in the range of potential measures that can alleviate the effects of the economic cycle and in ensuring that banks individually and collectively build up sufficient capital buffers in the good times that can be used in times of stress. They are however techniques that rely on the exercise of supervisory judgement, through the Pillar 2 process to a greater extent than mechanistically calculated capital. We believe that more focus should be applied, perhaps by the Standard Implementation Group, to ensuring the proper application of the SREP in a harmonised way around the world, than developing what to us seems as a blunt instrument.

One buffer, not a multiplicity of buffers

Our members are concerned that there is a potential for buffers on buffers to build up. The result would be that bank capital is trapped, preventing its effective use in the economy more broadly. This concern arises partly at least from an unclear understanding of the ways in

which the different buffers that have been proposed – the capital conservation buffer, countercyclical; capital buffers and any idiosyncratic buffer - interact.

The industry's vision is for a single, variable capital buffer set bilaterally between the bank and its home state regulator. We should note that whilst the capital conservation buffer is labelled as a buffer we do not believe it will be regarded as a buffer in practice. Bank boards will not wish their ability to manage the way in which returns from their businesses are shared with various stakeholders, such as owners and employees, to be impeded because capital levels are trending lower, for what may be good reasons. Therefore the capital conservation buffer should be recognised by regulators for what they have made it - a more permanent add-on to the minimum regulatory capital requirement, which we do not believe is risk sensitive.

Thus the industry's vision is for a single variable buffer. It would be made up of components that would be set holistically and managed on the basis of a particular bank's exposure to the risks that a downturn would bring, taking into account the particular stage in the economic cycle, the structure of the banking system, the availability of safety nets and business models of each country or bank. This would avoid the risk of building up multiple layers of buffer.

Countercyclical buffers – a critique

The industry sees a number of flaws in the concept of countercyclical buffers. These are:

- Establishing formulaically a bank's capital buffer mixes up macroeconomic and politically determined factors such as monetary and fiscal policy with banking regulation. It is not clear that this is a sustainable position in the long term – since in all practicality fiscal policy will trump sound and prudent bank supervision every time, hence the danger of any program that tries to mix the two.
- Economic cycles, market conditions and other factors differ between countries depending on the framework within that country's economic system operates, parameters such as the structure of the banking system, the availability of safety nets and business model diversity.
- All banks would be required to build up and draw down a countercyclical capital buffer if it was distinctly separate requirement. This risks penalising more prudent bank managements.
- The countercyclical capital buffer requirement is only designed to apply to banks. As experience from the recent financial crisis shows, non-bank financial firms have in recent years posed real threats to financial stability. Therefore unless mechanisms such as countercyclical capital buffers are applied to the entire financial system they may not be truly efficient in achieving their goals of preventing the build up of excessive levels of credit. This asymmetric scoping of the countercyclical capital buffers application should be recognised and corrected.

Buffer determination

A single variable capital buffer should be determined on a firm by firm basis, at the consolidated level, based on rigorous examination of that firm's capital planning process

undertaken in a dialogue with its home state regulator as part of the SREP. Again, we reiterate that robust application of Pillar 2 tools on a harmonised basis by regulators around the world can achieve the objectives that we believe the countercyclical buffer is designed to meet.

The level of buffer should be set based on scenarios designed by the bank with its supervisor to capture threats arising from macroeconomic and system-wide stresses and recognise the strength of a firm's risk governance practices and its risk systems and controls. We would expect that a positive assessment of these qualitative factors would result in a lower quantitative single variable capital buffer. Once the buffer is set, it should be expressed as a percentage of risk-weighted assets (RWAs) and required to be held in Tier 1, (i.e. going concern capital).

The methodology for setting the single and variable capital buffer should be set by the Standards Implementation Group and use internationally consistent tools, frameworks and processes, building on or improving the implementation of Pillar 2. Colleges of regulators will have a key role in facilitating this process at a level of an internationally active banking, or other financial services, group.

The buffer must be set on a consolidated basis

The single variable capital buffer should be set at the level of the consolidated group and determined by the home state regulator, in dialogue with core host state regulators, based on their local authority's assessment of the state of credit growth within their economy.

Having been set at the level of the consolidated group it should also be held at the level of the consolidated group to ensure that capital is deployed most efficiently. Capital buffers should not be set or held at the level of individual legal entities, at sub consolidated level, or at national level.

The bank's single variable capital buffer must be confidential

Whilst we see merit in disclosing jurisdictional credit to GDP guides, on the condition that they are set according to a coherent and uniformly applied methodology that is globally accepted and applied we are more concerned about the proposal that individual bank capital buffers be disclosed.

Were this to happen we fear that market commentators and analysts would instinctively add-on a further amount of capital making it more difficult for banks to draw down on buffers as economic conditions deteriorate. Furthermore, the drawing down a publicly disclosed capital buffer could be perceived as a signal of weakness, by the market, creating or making a deteriorating situation worse.
Therefore we recommend that the bank specific single variable buffer should not be publicly disclosed but subject to confidential discussion and agreement between the bank and its supervisor at the conclusion of the Pillar 2 process.

Conclusions

We recognise the importance of building capital buffers that can be drawn down in times of economic stress but believe that such countercyclical capital buffers are just one element of a range of measures that can alleviate the risks that excessive credit growth brings. Indeed we believe that other measures, such as a forward looking provisioning methodology, and more rigorous stress testing within a better applied Pillar 2 could be more effective.

We are concerned that the current proposals could result in multiple layers of capital buffer being held. For this reason we suggest that a single variable capital buffer be established which is held in the form of Tier 1 capital at the consolidated level.

The single variable capital buffer should be bilaterally agreed between the bank and its regulator and not subject to public disclosure; although we recognise that there are merits in making individual jurisdiction's assessments public in a form that is readily understood by the market.

I would be delighted to discuss our response to your helpful consultation in more detail if this would be beneficial.

Yours sincerely

Sally J Scutt

Sally Scutt
Managing Director
International Banking Federation