September 10, 2010

IIF Views on the Basel Committee Consultative Document
Countercyclical Capital Buffer Proposal

The Institute of International Finance, through its Steering Committee on Regulatory Capital, its technical working groups on capital and liquidity issues, and its Macroeconomic Effects Working Group, is pleased to contribute this comment to the Basel Committee's consultation document on countercyclical capital.[1]

The Institute has, in a number of publications beginning in 2008, embraced the premise that taking measures to reduce procyclicality is sound in principle and, appropriately implemented, could make a real contribution as one element of the wider reform program to improve the long-term resilience of the international financial system.[2]

This note will discuss both the risk-management and practical implementation questions arising from the proposal and elements of the macroeconomic methodology that is the basis of the proposal. With respect to both sets of issues, the Institute and the relevant groups of experts from member institutions stand ready to consult or provide further reflection.

Introduction and Executive Summary

It cannot be over-stressed that the industry supports the goals of reducing procyclicality and lessening the vulnerability of the banking system in periods of heightened systemic risk. There is also general agreement that banking-sector capital regulation needs to take into account the overall market and macrofinancial environment. The Institute appreciates the Basel Committee's ground-breaking work, and especially the goal of achieving an internationally consistent solution; nonetheless, given the numerous theoretical, risk-management, market, and practical issues, the current view is that more analysis, assessment of market impacts, and dialogue with stakeholders is necessary before any operative proposal is defined.

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[1] Of course, a complete evaluation of the countercyclical buffer proposal would require understanding the full scope of measures intended to reduce procyclicality, some of which have not yet been made public. Furthermore, given the short time available over a summer period, it is possible that the Institute would need to supplement these comments at a later date, as firms complete their analyses of the proposal and of the "main design elements" announced by the Committee on July 26. Nonetheless, the Committee and related technical working groups have examined the proposal closely and offer these comments in hopes of contributing to achievement of the Basel Committee's goals for the proposal.

[2] Previous IIF discussions on methods to mitigate procyclicality can be found in the July 2009 *Restoring Confidence, Creating Resilience* Report (http://www.iif.com/press/press+76.php) and the December 2009 *Reform in the Financial Services Industry* Report (http://www.iif.com/press/press+125.php), as well as the April 16 IIF Response to BCBS Consultative Documents 164 and 165 (http://www.iif.com/press/press+147.php).

Beyond the specific, pragmatic points made below, there is a basic question of adaptation of a countercyclical buffer in the new regime that will be applied once the "final package" of Basel reforms is implemented. While the proposal would make sense if applied to the 2003-2007 period, many changes now being made may make the buffer less likely to be needed. These include all the microprudential capital and liquidity requirements, but also other regulatory changes outside of the Basel Accord, such as more rigorous underwriting standards, new requirements for mortgage origination, consumer credit, and securitization, accounting changes including more forward-looking impairment and provisioning standards, and the other dimensions of current regulatory change. From the point of view of the industry, the overall result of the comprehensive set of reforms is likely to be highly conservative, even disregarding the countercyclical buffer. As discussed further below, there is a substantial risk that the buffer will be treated as a de-facto permanent feature of the "minimum" capital requirements, whatever the intent of its only being applied rarely. Thus, the proposed countercyclical buffer should be reconsidered in light of the issues raised herein, and on the basis of rigorous QIS and economic-impact analysis. More consideration needs to be given to the effects of the new overall framework, including the other features of the capital regime and prudential and conduct of business changes, in designing any macroprudential measure designed to reduce procyclicality.

Given the highly innovative nature of the macroprudential instrument that is proposed, the following observations are offered in the spirit of contributing to development of an approach that will be fully effective to achieve the intended goals on an internationally consistent basis. Major concerns can be summarized as follows:

- *Macroprudential goal.* The proposal aims at using capital to achieve the specific macroprudential goal of "protecting the banking sector from periods of excess aggregate credit growth", not to manage the credit cycle. This is a laudable aim but an ambitious one. More study and debate are required to understand how this *macroprudential* goal will interact with *macroeconomic* policy and issues.
- *Macroeconomic methodology*. The methodology proposed is stimulating but challenging from a theoretical perspective; it needs more development and testing. Independently of the need for more theoretical and empirical development, there are a number of issues with the credit:GDP guide from a practical, implementation point of view.
- *Complexity.* The proposal is complex theoretically and, even more, will be challenging to implement. Attention needs to be given to the reduction or management of these complexities, at the firm level, at the jurisdictional level, and across the home-host plane.
- *Role of judgment in triggering buffer*. The underlying economics work illuminates the strengths and limitations of the analysis to date. While judgment will likely always be needed in any countercyclical exercise, the scope of judgment in the proposal at this stage is very wide, as is the latitude to set aside the methodology; thus, in refining the proposal, the Committee should aim to provide a more fully developed and precise framework for the exercise of local judgment in triggering the buffer in order to assure a more internationally consistent approach.
- *Blunt instrument.* Using capital to protect the banking system from excessive credit expansion would be a blunt instrument, to which regulators should resort only if fiscal

- *Relevance to emerging economies*. 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, if recent developments are any guide.
- *Building-block approach.* The building-block approach to capital requirements is conceptually elegant, but the industry has reservations as to whether it can operate with the efficiency assumed. There is serious concern that 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. The industry needs to understand more completely the relationship of the countercyclical buffer to the "fixed" buffer and the overall calibration of capital requirements.
- *Disruptive effects; Need for both buffers actually to be usable.* The industry continues to have reservations about the "capital conservation" mechanism to enforce both the countercyclical and "fixed" buffers. Restrictions on dividends and share buy-backs intrude into the management of the firm and are more likely to disrupt firms' ability to manage their capital and maintain relationships with investors than is recognized. The result would probably be that firms and investors treat 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. "Buffers" make sense only if they can actually be run down.
- *Release of the buffer*. It is concerning that the terms and conditions of release of the buffer are among the least-developed and most subjective aspects of the proposal. This is likely to contribute to making the buffer difficult to draw down as a practical matter.
- *Interaction with Other Measures.* The place of the buffer in the overall scheme needs to be clarified and rationalized, especially:
    - TTC calculations and conservatism already hard-wired in Pillar 1 and other aspects of the Accord;
    - adjustment to take into account forward-looking provisioning once a global standard is agreed; and
    - most importantly, as the current Accord includes cyclical conditions in Pillar 2, its interaction with the new buffer needs to be sorted out, 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.
- *Market sensitivity.* There is concern that the proposal requires further market research and that market reactions may preclude the smooth operation of the instrument as described.
- *Other sources of credit; disintermediation.* The proposal focuses exclusively on credit exposures of banks and protection of the "banking sector" in each country, despite the obvious fact that there are many sources of credit in most countries and the proposed buffer may simply create incentives to disintermediate the banks in cases where credit demand is strong.
- *Home-host complexity.* The proposal breaks new ground on the interaction of decisions taken by home and host regulators. The industry cannot be comfortable with

- *Efficiency, fairness, and incentives of the proposal*. The analysis and design of the new instrument raises *issues not only of effectiveness, but of efficiency, fairness and incentives*. As designed, the new countercyclical buffer would be applied to a bank that has *no* exposures in overheating sector(s). It is of course to be expected that overheating will often be most acute in specific sectors of a given economy.
    - 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 the risks of its intensive participation in the overheating 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 should already have been imposed.
    - Even from a macroprudential 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. This is an issue that will have to be addressed no matter what the final boundaries between the new buffer and Pillar 2 are determined to be.
    - 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.[3]
    - Conservatively run banks are concerned that they would be particularly affected by the new requirements, in ways that might undermine their capital strategies and their relations with the market.
- *Need for time to observe and test.* The buffer is aimed at periods of excess credit growth; it is intended to be used only once in 10 or 20 years. Given that most of the world is currently far from suffering from excess credit growth, there is time for a period of observation and testing (both from risk-management and macroeconomic perspectives) before the countercyclical buffer proposal is finalized and made mandatory. As such a macroprudential instrument is completely innovative, a period of testing and evaluation, similar to that decided by the Committee for the leverage ratio and the net stable funding ratio, is in order.[4] After further development, a pilot program could be useful.

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[3] See the further discussion of Pillar 2 issues, including the risk of double-counting requirements, below. See paragraph 724 of the 2004 Accord regarding inclusion of business-cycle effects in Pillar 2 analysis.
[4] Of course, the proposal recognizes at several points the need for further study and experience to improve understanding of the transmission mechanism between the banking sector and the wider economy. Such study and experience is essential to facilitate development of the common legal authorities and tools necessary for consistent

- *Implementation schedule.* The implementation schedule of the proposal is unclear, though one might conclude that it would be subject to the 2012 target for the overall Basel revisions. It follows from the foregoing that setting a firm implementation target at such an early date would perhaps be harmful to banks' recapitalization efforts, as well as unnecessary.
- *Open consultative process.* The industry appreciates the Committee's soliciting industry views both on the paper and on the underlying research, and that the Committee recognizes that a significant departure from the way prudential regulation has hitherto been conducted "increases the importance of a dialogue with the industry and other stakeholders, to ensure that the aim and mechanics of the proposal are fully understood." The need for a consultative development process will thus continue beyond September 10, and the Institute and its members stand ready to participate in the work that will be required.

Finally, as discussed further below, consideration needs to be given to the effects of the countercyclical buffer -- and, perhaps more importantly, borrowers' and investors' expectations – on the management of the regulatory perimeter. Creating incentives to move borrowing outside of the highly regulated bank sector, or from country to country, may not be the best way to achieve the Committee's goals.

All these issues converge on the conclusion that more analysis and testing are in order. The proposal as set out could well have unintended consequences of restructuring the provision of credit in the global system via its effect on firms' costs and via the likely disintermediation effects. If that is the intent, the goals should be set clearly and pursued more directly; if that is not the intent, a good deal of caution is in order before launching the proposed new instrument.

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application across jurisdictions and, for example, the communications strategies that, as the paper acknowledges, are not fully developed in all jurisdictions.

Detailed Comments

Section 1
The following comments correspond to the outline of Section 1 of the consultative document.

Objective and operation of the proposal
The idea of a single objective implemented through jurisdictional decisions based on agreed principles and with jurisdictional reciprocity is attractive, but raises a number of conceptual and practical issues discussed throughout this comment letter.

The single, macroprudential goal of protecting the banking sector in "periods of excess aggregate credit growth" is understood, but a number of questions arise, discussed with respect to Principle 1 below.

National buffer decisions and jurisdictional reciprocity
Twelve-month horizon. Buffer decisions would be announced in each jurisdiction 12 months in advance to give banks the chance to take steps to meet the requirements before they take effect. [5]

The 12-month horizon is the minimum feasible, and, even so, will be problematic in several ways. Major banks' capital-planning horizons are typically longer than 12 months and the possibility of a buffer's being imposed on 12 months' notice will certainly complicate the process. Many firms will of course want to accumulate capital in advance of need, anticipating the one-in-20 events implied. The complexity of anticipating buffer announcements in multiple jurisdictions could be somewhat alleviated, though not mitigated completely, by clear, regular, and well-understood communications strategies by the authorities, as discussed further below.

This is not just a matter of managing complexity or inconvenience to banks' capital planning. Clarity or lack thereof will have to affect banks' definition of their risk appetite and strategies. This is the type of issue on which there should, if at all possible, never be surprises: markets will be most comfortable if clarity and predictability are maximized. Unexpected developments, or a sense that bank investors are hostage to unpredictable decisions and forces, would certainly have negative consequences for the raising of bank capital and funding under the new regime, and probably create unintended consequences that are difficult to predict at this stage.

The countercyclical buffer proposal creates potential for a novel and complex form of "announcement risk".[6] Even if markets do not simply add the expected gross amount onto their capital expectations of banks when a final, global announcement about the buffer is made (a very real possibility), markets may react negatively to a specific-jurisdiction buffer announcement,

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[5] A point of interpretation: At page 4, the document says that if a bank's capital level falls into the extended buffer range it would be given 12 months to get capital above the top of the range before restrictions on distributions of earnings come into effect. This is somewhat unclear. If it means that a bank would have 24 months (12 months' preannouncement plus 12 months to raise capital to the required range), then the capital planning issue would be considerably, though not completely, alleviated, but the economic forecasting challenges would be compounded. This should be clarified.

[6] "Announcement risk" is the risk that the market may in effect impose announced regulatory requirements upon a firm announcement of calibrated requirements, regardless of whatever phase-in the authorities may envision. See the Institute's letter to the Basel Committee of September 7, 2010.

especially in a firm's home market, regardless of the lead time, and treat the additional requirement as if it were immediately applicable, further complicating banks' capital planning, and affecting the orderliness of the market.

There could well be a rush to market by borrowers in anticipation of a decision to apply the buffer or shortly after its imposition, causing market congestion.

Moreover, certain practical issues would affect banks' credit-availability and pricing policies and therefore need to be taken into account. Banks may already have in the pipeline approved credits and commitments that cannot easily be turned off in response to the imposition of the buffer (or to the market's capital expectations triggered by the buffer announcement). Alternatively, anticipation of the buffer could induce clients to draw down credits on uncommitted facilities in expectation of higher costs or reduced availability, thereby stoking expansion and augmenting, rather than reducing, procyclicality. All this suggests that the task of bank credit committees and borrowers' finance committees, which already attempt to forecast credit trends, will be compounded by the need to forecast buffer decisions as well. Again, part of the solution is clear and consistent disclosure by the official sector in all relevant markets.

Home-host questions. The Committee anticipates the need for international coordination and jurisdictional reciprocity; however, further guidance for jurisdictions and clarity as to how this would work are in order. It is a good thing that, as stated, the Committee continues to keep the home/host aspects of the proposal under consideration, but it is hard to see how a proposal could be promulgated for actual implementation before those issues are settled.

While principles of implementation by jurisdictions are foreseen, they need more fleshing out to be convincing. What if a jurisdiction decides for political, competitiveness or other purposes not to impose a buffer when it otherwise should? Part of avoiding that problem must be the independence of the decision-making process and of the agency making the decisions (see the discussion of "selecting the authority to operate the buffer" below).

Even if such independence of macroprudential decision-making is assured, there is no guarantee that the authorities in question would not make a "this time it's different" decision and fail to implement. These risks are unavoidable, but will complicate the overall macroprudential effort if too many jurisdictions make such errors: in fact, any sense that countries are invoking "special reasons" not to apply the buffer is likely to increase reluctance by other countries to do so.

More guidance from the Committee or perhaps the FSB regarding jurisdictions' exercise of judgment – and inclusion of such judgments in peer reviews – would help. And a good program of disclosure by jurisdictions of their thinking will be necessary. Strong leadership by the Basel Committee and FSB will be essential if the purposes of the countercyclical buffer are to be achieved.

Other conflicts of interest or of perception between home and host regulators, or from different stability/growth tradeoffs also need to be examined. If a host regulator decides to impose the buffer, but the home regulator concludes that doing so would unduly burden a bank when its own analysis is that additional capital impositions would be unadvisable, how is the problem to be

mediated, or would the home be expected (as the proposal suggests) simply to follow the host decision, regardless of its own views?

Conversely, if a home regulator decides there is excessive credit growth in a foreign country in which its banks have extensive interests and imposes a buffer on them, but the relevant host does not make the same judgment, the anomaly would create a competitive advantage for the host's domestic banks.

Different jurisdictional decisions would create incentives to borrowers to move borrowing from country to country (as discussed under "Calculating bank-specific buffers" below, attributing the usage of credit to a specific jurisdiction is often difficult). This could have an amplifying effect: The introduction of a 0.5% countercyclical buffer add-on in country A may lead to a price advantage to shift borrowing from country A to country B (without add-on). This price advantage would not only affect the "excessive" borrowing, but also non-excessive borrowing in less-affected sectors in both countries. After some time, country B might, partly as a result, observe credit growth deemed excessive, and introduce a countercyclical buffer add-on, while country A might conclude that its buffer add-on had worked and release it. To some extent this issue could be alleviated by regulatory coordination, but given the current country-specific credit:GDP guide, a solution driven by wider market developments would not be the primary consideration.

A further home/host question arises from the question whether solo or consolidated positions are addressed. Whereas the principle is clear that exposures are to be treated in accordance with the appropriate host buffer decision where exposures can be "located", care may need to be taken that home regulators avoid doubling up at the consolidated level any buffer impositions on local entities. (See the discussion of the "location of the buffer", below.)

The foregoing types of problems illustrate that reconciliation of views between countries that have significant home and host relationships will be essential to the success of any buffer along the lines proposed.

Presumably the analysis will also need to be supported by good discussion of buffer-related issues in relevant colleges, so that good microprudential understanding on both sides of the home/host divide can be bubbled up to the macroprudential decision.

Finally, it would be helpful to know the country coverage that is intended in the proposal (G20? Basel Committee members? All countries?).

Emerging markets – distinguishing sound growth trends. There are particular problems in the application of the proposal to emerging-market economies. 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 (this is also discussed below in the comments to Annex 2).

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.

Common reference guide and principles to promote sound decision making
See the discussion of specific principles in Section 2 below.

Communicating buffer decisions
As discussed further below, communication issues will be critical to the success of any countercyclical scheme.

As the Committee recognizes in announcing creation of a new subgroup to look at buffer decisions and make recommendations to update the guidelines, excellent international coordination will be indispensable to success of any version of the proposal on an international basis.

It is worth pointing out that the proposed buffer only works as a global matter if the capital regime to which it is added is consistent across markets. The Institute has always argued for uniform implementation schedules of all material parts of the Basel frameworks to banks headquartered in all Basel Committee countries, and this should include any countercyclical buffer regime or other technique intended to achieve the same goals.

Section 2
The following comments correspond to the outline of Section 2 of the consultative document.

Principles underpinning the role of judgment
Given the challenges of developing a new instrument on the basis of new methodologies, the Institute agrees with the Committee that considerable judgment would be required in applying the buffer but, equally, that good, ongoing communication of the grounds for judgment exercised and principles to channel international consistency would be essential. Most importantly, the Committee should strive to lessen the variability of approach when jurisdictions have recourse to judgment in applying the instrument by further work on its economic underpinnings and further refinement of principles that can truly shape and guide the local exercise of macroprudential judgment, and, ideally, add a greater degree of predictability to the overall scheme.[7]

The conclusion to this comment argues for a pilot program or testing program for the proposed buffer, a new instrument that is based on new methodologies and the exercise of macro- and microprudential judgment in novel ways. The Credit:GDP guideline raises numerous issues that

[7] Of course, as a completely separate matter, traditional supervisory judgment will continue to be required at the individual-bank level in making Pillar 2 evaluations.

would be difficult to back-test, even on a theoretical basis. Thus, a further work program will be important for taking the concept from the stage of economic analysis to the stage of implementation as a risk-management tool to be applied by supervisors and banks.

Even more difficult from a formal point of view is how to assess the effectiveness and analytical correctness of the judgment required. The methodology is not unlikely to yield false signals, which the proposal recognizes judgment must correct for, yet this exercise of judgment must be approached with caution. Use of judgment is appropriate and inevitable if something like the proposal is adopted; but it will be essential to proceed carefully in order to create confidence in the process.

While the proposed principles are a good step in the right direction, given the complexities of an unproven global proposal, an iterative approach to refining and developing the principles is in order.

Principle 1. It is well understood that the buffer is not *intended* to be used to manage economic cycles or asset prices.

However, a number of points arise, on which further debate is needed.

There is concern that the "potential side benefit" of moderating the cycle itself could easily take over the process, eclipsing the primary aim. The Basel Committee and the FSB will need to commit resources to maintain international focus on this primary aim.

Should that focus slip, the proposed instrument could rapidly become ineffective at achieving its main aim of protecting the banking sector from the cycle, and, in the worst case, become distorted by the other goals and political implications of monetary policy.[8] There will be the danger that authorities may be tempted to try to use the buffer for macroeconomic, as opposed to macroprudential, 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.

The best defense against bubbles is in general sound credit-underwriting standards and good business judgment. While these certainly cannot always be assured, especially if there is competitive pressure from outside the regulated sector, much new regulation at the international and national levels aims to create the conditions where better standards will be observed, as does much of the internal progress already made by firms on risk appetite and risk governance.

For purposes of attempting to *mitigate* bubbles, therefore, other means including internal risk-management, regulatory, and supervisory measures should be applied before the blunt instrument of an additional capital buffer becomes necessary, even for the limited, defensive purpose of protecting the banking system from the *consequences* of bubbles.

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[8] For a very general discussion, see box 2.d at page 18 of HM Treasury's paper "A New Approach to Financial Regulation", July, 2010 (HMT 2010).

The purpose of this comment is not to discuss arguments for more effective ways to head off bubbles in detail, but to raise the concern that use of any *macroprudential* countercyclical buffer along the lines proposed ought to be kept strictly separate from any such *macroeconomic* efforts.

A good deal of history and analysis is available on the use of reserve requirements, minimum loan-to-value requirements, loan servicing requirements, margin requirements, and possibly variable risk weights, to mitigate overheating.[9]

If traditional monetary policy, plus any such additional measures, fail to manage the cycle appropriately, then it may be necessary to consider protective measures. In such cases, it ought to be clear to all that such protective measures as the proposed buffer are defensive only, not cycle-management tools. However, it will inevitably be the case that triggering the additional buffer would interact with monetary policy at least to the extent of signaling.

This in turn relates to the point that the proposed buffer would affect only the banking sector, non-bank or "shadow banking" credit would continue to be provided absent other, parallel measures. Consideration of such parallel measures is clearly necessary to avoid unduly favoring non-bank credit channels, and thereby penalizing banks and their underlying investors. While non-bank channels are beyond the remit of the Basel Committee, the issue is serious and should be taken up by the FSB, certainly before any finalization of a countercyclical buffer proposal.

Principle 2. The idea that the credit:GDP "common reference point … need not play a dominant role" but "should [not] be totally ignored" is at least perplexing and amply sustains the Institute's conclusion that a period of study and observation is in order.

Given the importance of international consistency, the "credit:GDP guide" should be more than a throw-away point of reference, although it cannot be the only measure. This is especially so because, as discussed above, however difficult analysis and back-testing of the "guide" may be, corrective "judgment" will necessarily be highly subjective and, at least initially, without a lot of experience as a basis and good international guidance from the Committee as to its application.

While the Committee's "comply or explain" approach to use of the credit:GDP guide is entirely appropriate, given the novelty of the instrument and the difficulty of the analysis, the presumption for use of the proposed guide should be made much stronger and more confident before the buffer proposal is rolled out for actual implementation.

Regardless of the strength of mandate for use of the "guide", the Committee's points that "there is a need to disclose the guide on a regular basis" and that the authorities should explain clearly and carefully the information used in taking buffer decisions are entirely correct and will be essential to the successful implementation of any international buffer scheme. This is discussed further below.

Principle 3. Again, the Institute considers it essential, as the Committee says, to explain what information is used, how it is synthesized, and the thinking behind buffer decisions. This is

[9] See, e.g., Lyons, Gerard (2010 July 27). "West has much to learn from east's policy toolkit". *Financial Times*. Retrieved from http://www.ft.com.

important not just for the credibility of decisions to banks and to other national authorities, but also and even more so for credibility of the decisions in the markets. This will in large part determine how successful banks will be in managing the buffer as intended.

Principle 4. Prompt release of the buffer in times of stress is critical, but release of the buffer is in many ways the least-developed portion of the scheme.

It is certainly correct that "releasing the buffer may be required to reduce the risk of the supply of credit being constrained by regulatory capital constraints." And that in many cases the flow of credit to the economy may be "jeopardized by uncertainty about when the buffer will be released." But surely more analysis and guidance will be required to make release of the buffer both effective and internationally consistent. Section 4 of Annex 2 is a good beginning, but in effect only sketches out a research program, without providing much tangible guidance. The industry is interested in participating in this work, to try to develop more clarity around the release, as well as the imposition, of the buffer.

As the discussion of Principle 4 implies, the market effects of the timing and pacing of release need to be considered carefully. Authorities confronting a decision whether to release a buffer once imposed will need to think about the signaling effects of the decision to the market as a whole. This is not just a matter of effects on banks or bank stocks, but whether investors might take the announcement as a general "sell" advisory for the market as a whole. On the one hand, a well-timed announcement could contribute to confidence in a soft landing; on the other (and perhaps more plausibly), an announcement if not perfectly timed could accelerate the weakening of the relevant economy and undermine confidence in its banks and possibly even in other, connected markets. An easy solution to this dilemma does not seem to be available, but creation of this dilemma is one knock-on effect of the proposal, and not a minor one. Potential market effects could well paralyze a decision to release the buffer; it would be better if the difficulties of eventually releasing the buffer create caution about imposing it in the first place.

Regardless of the announcement problems, releasing the buffer should not be just a matter of reducing the buffer in coordination with "banking system financial results"; rather all relevant credit, market and macroeconomic information should be considered on a dynamic basis, and it seems unlikely that the need will coincide neatly with publication schedules.

Certainly, it is important to allow for prompt release of the buffer under circumstances of rapid change in the economy.

In any case of release of the buffer, it would, as proposed, be appropriate for the authorities to indicate how long they expect the release to last, *if* they have a view; otherwise, the release announcement should refer to the stated assumptions behind the buffer, including that it is expected to be used only every 10-20 years.[10] It will be important (as the document recognizes) to reduce market uncertainty about future capital requirements, not only to give banks assurances about the use of the capital released, but also, and perhaps more importantly, to give the markets clear signals on which investment decisions can be made and demands and expectations made by

[10] As discussed below, there is some doubt whether the proposal would actually work this way.

investors and analysts on banks can be defined. Borrowers will also need to be able to anticipate future credit supply and cost, and adjust their own funding plans accordingly.

Principle 5. As discussed above with respect to Principle 1, it is important to keep defensive, *macroprudential* goals distinct from *macroeconomic* policy decisions. The discussion of Principle 5 is correct in considering that the buffer should be only one of several tools for purposes of defending the banking system from the consequences of credit bubbles. It is also correct that other less-drastic and better-targeted tools, such as loan-to-value ratios, should be used as mitigants when overheating threatens in a particular sector, such as real estate.

The important point that is missing in discussion of Principle 5 is that the blunt instrument of the countercyclical capital buffer as proposed should normally be used only when macroeconomic policy has failed to prevent a bubble or overheating has spread from particular sectors to constitute a system-wide risk.

One final note is that countermeasures against overheating economy including loan-to-value ratios, especially if they are used coupled with countercyclical buffer, on top of the fixed buffer and capital-conservation requirements, may rapidly reduce banks' ability to supply credit and thus weaken economy. While this is to some extent the intent, the danger of overshooting should not be discounted.

The notion of "sectoral capital buffers" is mentioned but not explained. This raises the issue of the relationship between the proposed countercyclical buffer and Pillar 2, as discussed further below.

Calculating bank-specific buffers

Calculation methodology

Assuming implementation of a buffer along the lines proposed, a methodology of determining an aggregate buffer reflecting the geographic composition of the bank's portfolio of exposures across markets is appealing, especially insofar as it recognizes the benefits of diversification across markets.

However, a number of questions remain unanswered in the proposal.

It is not clear what is meant by *"exposures"*. For analytical purposes, use of BIS statistics was reasonable; however, this reliance breaks down from a risk-management and compliance perspective as the focus shifts to actual implementation at the firm level.

While it may be possible to use existing definitions from other bodies of regulation, it would be preferable, to assure international consistency, to have guidance as to what constitutes an "exposure" for these purposes. A loan of course raises no questions. But what of a letter of credit? A trade-finance commitment? An undrawn but committed line or revolving credit facility? An uncommitted line? A bond? A securitization? A derivatives exposure? While the rules for other purposes are clear, it is not evident that macroprudential considerations should be

based on exactly the same analyses. In addition, the discussion talks at times about "loans" and at others about "exposures", which can be somewhat confusing.

Additionally, of course, there is the issue that a foreign bank in a host country will often have a specific mix of business, which might not be much affected by overheating in a given sector in the host country, such as real estate. A foreign bank largely focused on trade finance, lending to its home-country corporate customers, and perhaps foreign-exchange activities would not be contributing much to real-estate overheating but might in fact be supporting in a substantial way the non-bubble sectors of the host economy.

A further, and very important, question arises with respect to trading-book exposures. Most trading-book exposures are managed with trading goals and market dynamics in mind. From a "locational" point of view (see below), their focus is on the relevant market, which will often be an international market, rather than on the use of proceeds by the underlying obligor (which, in the case of a tradable bond, for example, may well have used the proceeds in multiple locations at a point in time well in advance of when a trading desk acquires the exposure). The counterparty to which a firm has an exposure may itself be seeking to hedge its own risks relating, among other things, to the dangers of overheating.

Furthermore, trading-book exposures are calculated differently from banking-book exposures. How should trading-book exposures be measured for purposes of application of the buffer? The proposal seems to assume that all exposures "located in" a given jurisdiction would have the same RWAs, but this assumption raises any number of questions on the trading-book side. It is not at all evident, upon full reflection, that trading exposures are directly related to the problem intended to be solved or that they should be taken into account in the calculation of this additional buffer, but the proposal is silent on this point.

A further point is that the tenor of the consultative document suggests that the percentage buffer should be calculated on the basis of credit-risk RWAs, as credit-to-GDP overheating is the risk targeted by the buffer. However, this point is not made explicitly, and, indeed, Annex 1 implies targeting a percentage of total RWAs. This creates some thorny practical difficulties: it would be difficult, for example, for banks to identify the operational-risk capital related to a particular credit exposure in a given country; trading-book related issues are discussed elsewhere herein.

Data availability
The issue of *"location"* of exposures is more complex than the discussion assumes. While banks consider country risk carefully as a matter of normal, prudent risk management, systems and procedures have been designed for other purposes than application of a jurisdiction-by-jurisdiction macroprudential measure.

Many exposures are not difficult to locate. Real-estate and project-finance exposures are the obvious cases. At the other end of the spectrum, identification of a "location" may be less obvious. 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.

Would a trade-finance facility "count" for buffer purposes with regard to the nationality from which goods are purchased or to that of the purchaser of goods? The complexities and trade implications either way need some consideration, but are ignored in the present proposal.

In any case, money is fungible. If, for example, there is no buffer imposed in country Y but there is one in country X and the country X company meets part of its finance needs through its country Y subsidiary or branch, even if the proceeds are used in some sense exclusively in country Y, the borrowing made in country Y would displace to some extent a borrowing need that might, under other circumstances, have been made at the country X home office. [11]

These issues are all the more acute with respect to the trading book and investment securities. If a bank has a bond in its trading book, where should the exposure be attributed for these purposes? . If the bank has a bond in its investment portfolio, it will know the identity and country of incorporation of the issuer, but, again, will not have any way (nor any business incentive) to try to ascertain the "location" of the issuer's use of the funds represented by the bond, which may have occurred years before the exposure is acquired. In any case, the issuer itself will in most cases be using the funding for general corporate purposes without regard to jurisdiction.

It would clearly be inappropriate to burden banks with elaborate requirements to trace uses of funds solely for this purpose.[12] A likely response would be to include covenants in loan documentation imposing uneconomic duties to use the proceeds only in specific geographic locations. This would impose management burdens on the company, but not really affect its use of credit in any particular place, especially if it has access to credit from public markets or from hedge funds or other lenders not subject to the Basel capital requirements. This of course would affect borrowers' incentives and create lending opportunities for less-regulated lenders.

Note that the problem just discussed is different from the issue of "definition of credit" discussed in Annex 2. It is quite right to use a broad definition of credit for purposes of the "buffer guide"; however, having done so, the consultative paper otherwise seems to focus almost exclusively on

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[11] Footnote 8 of the consultative document suggests that this problem arises only if borrowing is through an offshore subsidiary, but this is of course not the case. The proposed remedy of a "global credit gap metric" for multinationals needs further explanation.

[12] Depending on how framed, such requirements could include substantial IT investments to get to a close level of granularity that would not, in fact, add much to achieving the results, as the buffer would be a blunt instrument and exact measurement not would add a lot. The wisdom of requiring such investments focused on locating exposures could be questioned, especially when banks already have large IT investments and demanding programs for purposes more obviously related to risk appetite and risk management.

bank exposures and effects of the buffer on banks in applying the buffer. Whereas Annex 2 discusses "incentives for banks to divert the supply of credit to other parts of the financial system …" as if that were the only issue, the paper is without much recognition that other actors than banks (borrowers especially but also hedge funds, underwriters, exchanges, institutional investors that may lend directly, etc.) will be given incentives to act in different ways by the imposition of the proposed buffer on banks alone, and hence added cost of bank lending.

So long as the BIS aggregate statistics are judged sufficient for the macroprudential determinations that need to be made by authorities, and such determinations are made reasonably consistently across jurisdictions, buffer decisions should have sufficient integrity for the contemplated purposes.

Similarly, at the bank level, requiring new systems or new covenants that would not have substantial business or risk-management uses should not be necessary.

If a bank has many exposures to multinational borrowers that create ambiguities for purposes of the countercyclical buffer, a simple attribution solution developed through the ICAAP process should be sufficient to resolve the issue by approximation, without requiring elaborate IT developments or disrupting customary business arrangements. This point again illustrates the interaction of the proposed buffer with Pillar 2, something on which clarity is essential.

While simple solutions can be envisioned at the bank level, a critical need before proceeding further is to have clear, internationally consistent rules as to what is expected for "location" of exposures.

Location of the buffer
The complexities of "locating" the buffer need more development. What is missing from the discussion is the importance of avoiding double counting.

If, as suggested, a buffer is imposed by a host country, the norm should be for the home country to count it against consolidated capital requirements at its level, carefully avoiding duplication. This would not preclude a Pillar 2 adjustment by the home country, of course if there were some compounding or mitigating risk characteristics of a given bank's exposures in the host, but at least the principle of non-duplication of additional impositions driven by a given jurisdiction's buffer decisions should be clearly established.

Frequency of calculation. Aligning calculation of the buffer to the date of calculation of minimum capital requirements is appropriate.

Interaction with Pillar 1 and 2
Pillar 2 issues. While the proposal puts forth a conceptual distinction between the new buffer and Pillar 2, there is a great deal of concern whether this will work as intended in practice.

It is said that "Pillar 2 will need to adapt", but more explanation is needed as to how one of the main elements – one of the three pillars – of the Basel accord is to work in the future. This is especially important as the current definition of Pillar 2 covers some of the same issues as the

new countercyclical buffer. Under paragraph 724 of the 2004 Accord, "factors external to the bank (e.g. business cycle effects)" are one of the "three main areas" for treatment under Pillar 2.[13]

If the concept is understood correctly, the proposed countercyclical buffer should be applied objectively depending on a bank's exposures across jurisdictions. The credit:GDP guide should be extraneous to a bank's idiosyncratic risk issues. This is probably the reason why the proposal says "capital used to meet Pillar 2 requirements should not be used to satisfy the countercyclical capital buffer requirement." But will the distinction be so clear in practice?

Certainly, given the definition quoted above from Paragraph 724, regulators and 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 macrocyclical issues are concerned. Failing that, a bank that has prudently included macro issues in its ICAAP process (or a supervisor that has imposed to a greater degree such factors) would be hit with an additional "countercyclical" buffer requirement for risks already covered by its ICAAP.

Banks' stress tests and economic capital processes also take macro and cyclical issues into account, again raising the possibility of double- or triple- counting cyclical risks.

In effect, the most conservative and prudent banks are likely to be penalized by the new buffer, unless something is done to rebalance Pillar 2 and the new buffer. This will not be easy, another reason why a period for analysis, experimentation, debate, and perhaps parallel run is indicated.

An alternative favored by some members would be to dispense with the countercyclical buffer altogether and rely on Pillar 2 to cover cyclical issues. Other members are skeptical of this proposition at this stage because they believe it is better to keep any attempt at a countercyclical buffer separate from the calibration of other parts of the accord and that it would compromise the bank-specific nature of Pillar 2 to import macroprudential considerations into it. In either case, it is evident at a number of points in these comments that the proposed buffer and Pillar 2 do have significant potential overlaps, and clarity as to how these parts of the structure are expected to perform is essential. If managing the effects of cyclicality were to be kept in Pillar 2, it would help resolve the disparate-impact problem summarized in the introduction to this paper, *viz.* that a prudently managed firm with little material net exposure to an overheating sector would be hit with the same additional capital as an aggressively managed one with substantial exposure to that sector. It would also probably lessen the danger of the new buffer's being hijacked for other policy purposes than its stated intent. On the other hand, use of a Pillar 2 mechanism would put a premium on communications amongst regulators of their assessment of the Credit:GDP issues in

[13] This is an issue not only with respect to the countercyclical proposal, but to the success of the overall revisions to the Accord first proposed in December 2009, subject to the decisions announced on July 26, 2010. The Institute's comments on the December proposals underscored at several points the need for a clear and well-understood role of Pillar 2. While the overall discussion of "Basel III" has sometimes eclipsed Pillar 2 issues, and while there have been some ill-informed press comments that take Pillar 2 to be a kind of national opt-out, the Institute considers that getting Pillar 2 right – taking the capital issues of each bank properly into account in the overall context of the Accord – is essential.

their jurisdictions; it would also require a new kind of management of Pillar 2 analysis to keep the countercyclical dimension within the "once in 10-20 years" limitation foreseen here.

Thus, Pillar 2 needs to be redefined and its role and that of the new buffer clarified. It will continue to be an important Pillar of the Accord, all the more so in the complex new regime. Expectations need to be made clear, and it will certainly be a priority task of the Standards Implementation Group to find ways to provide guidance to channel application of Pillar 2, if the buffer is kept separate, or to manage cyclicality issues, if in the end it appears preferable to keep them in Pillar 2.

Pillar 1 issues. A similar issue arises under Pillar 1 in that double counting could arise from the fact that some banks use (and have been encouraged by supervisors to use) "through the cycle" (TTC) rating systems. The resulting risk parameters (PDs in particular) will already incorporate a component reflecting the economic cycle. This will need attention to avoid double counting or penalizing the banks with the most sophisticated (or conservative) risk systems.

More basically it is important to consider the effects of yet another compounding layer of conservatism in regulatory capital requirements, further multiplying additions of conservatism to the risk-based accord (the two buffers, downturn LGDs, the 6% AIRB scaling factor, the new calibration) to an extent that the level of capital requirements overshoots the intended level of conservatism and ends up grossly disproportionate to the underlying risks. If it is decided to add a countercyclical buffer more or less as proposed, then these earlier additions of conservatism, with the complexity they necessarily bring to the process, should be reevaluated to determine whether they remain necessary to the overall new scheme.

Furthermore, it is entirely unclear how the countercyclical buffer relates to the trading book, as already discussed.

To some extent, the foregoing issues reflect the fact that the relationship of the buffer requirement to the capital adequacy structure is not clear. It does not appear directly to affect the core tier 1, tier 1, or total capital Pillar 1 measures, or the Pillar 2 assessment of total capital vs. total required capital. It is important to articulate expectations about this interaction for the building-block approach to be workable. How will the ratio be calculated and monitored after applying the buffer? This relates to how the buffer would be disclosed, as discussed below.

Forward-looking provisioning. A related issue is how this buffer would be affected by the forward-looking provisioning for loan losses that the industry and the Basel Committee have both been advocating to the accounting standard setters. While loan-loss provisions would be conceptually separate from the buffer as proposed, it is also true that extensive use of more effective, forward-looking, expected-loss-based provisioning would tend to reduce any need for countercyclical buffers. In certain countries, the existence of a forward-looking provisioning standard is believed to have contributed to mitigating cyclicality, so the effects of an effective, globally consistent forward-looking provisioning approach in general terms similar to what the Basel Committee has advocated should not be discounted too readily.

All of this provides another sound reason for the reinforcement of the role of colleges of supervisors in buffer and Pillar 2 discussions. As the Institute has argued in previous representations to the Committee, there is a need for colleges to take an active role in the regulatory process, not just information-gathering and coordinating for supervisors, important though that is, but also providing consistent and reliable supervisory outputs that firms can work with and build upon.

The considerations raised in this section, especially the risk of double- or triple-counting of risks for capital purposes suggests that the final version of any countercyclical proposal should be subjected to a rigorous QIS and included in comprehensive net cumulative impact studies.

(The issues of relating the countercyclical buffer to the capital conservation buffer are covered below.)

Publishing the jurisdictional buffers and the bank-specific buffers

The Committee is right to raise *publishing information about the authorities' regular review* of information necessary for countercyclical-buffer decisions. It is helpful that it plans to centralize such information on a website. The Institute also hopes that the Committee's Standards Implementation Group would be active in managing this process. However, the Committee has been much too non-committal in setting out minimum information expectations.

More market research is required before definitive publication norms can be established, but, given the impact of the prospect of buffers' being imposed on markets for bank capital and funding, and on banks' own capital planning, very regular updating of buffer-related thinking on the part of the authorities will certainly be required. Although the Committee explicitly rejects the idea of mandatory quarterly statements, some in the industry consider that quarterly updates would be the minimum to allow for orderly capital planning and to manage market expectations.

Certainly, any "significant changes to the authorities' outlook for the prospect of changes to buffer settings" need to be disclosed promptly, as stated, but this is the sort of issue where surprises to the market must be avoided if at all possible, and thus regular, reliable reporting of official-sector thinking is essential.

The Committee has in effect deferred the issue of communication strategies, perhaps understandably given the relatively short period in which the proposal has been developed. But the proposal would risk becoming destabilizing rather than conducive to grater stability if implemented before a full analysis of information needs and a fully developed communications strategy.

The proposed disclosure by banks under Pillar 3 raises another set of issues. Caution will be needed in designing bank-level disclosure requirements. Insofar as the buffer overlaps with Pillar 2 considerations (and indeed some would argue it ought to be incorporated in Pillar 2), the well-understood limitations on disclosure of Pillar 2 information should apply. It is not evident what purpose bank-specific disclosures would accomplish, especially if the jurisdiction-level buffer decisions are publicized as planned.

In addition, bank-level disclosures would add yet another factor making it difficult actually to draw down the buffers. If specific, bank-level disclosures were nonetheless to be required, a clear solution to the problem of determining the "location" of exposures, as discussed above would be necessary, but the extensive caveating that would be required might make such disclosures more burdensome than useful to the market. Thus, a more complete disclosure proposal is needed before industry comment can be given usefully.

Treatment of surplus when buffer returns to zero

The industry agrees that there should be no a-priori restrictions on distributions when the buffer is turned off. There is no need for special provisions, as any restrictions that might be appropriate at a specific bank should already be part of the Pillar 2 dialogue with its supervisors.

Selecting the authority to operate the buffer

The Committee's observations on the need for the relevant authorities to assess both supervisory and macroeconomic information and to keep in mind impacts on monetary, fiscal, and prudential policies are appropriate. The admonition to be sure that the actions of all parties, in addition to being well informed, are consistent with each other, though appropriate as a goal, may be difficult in actual situations, as discussed further above (see also the discussion by HM Treasury cited at footnote 8). There may be times when there are tensions, if not conflicts, between these policy goals.

To manage such tensions, and to assure that the focus is indeed on the *macroprudential* goals set out by the Committee, it would be useful to specify that the ultimate decision making ought to be by an independent authority focused primarily on such goals, acting independently of, but with good information by, the other relevant authorities.

The role of monitoring the individual banks and ensuring they comply with the decision about the buffer should naturally fall on the microprudential supervisory authority. It would be important to establish a close link between the micro- and macroprudential authorities, and good communications with the macroeconomic policy committee of the central bank.

A further significant question is how the process of implementing and communicating the countercyclical buffer would be connected to the developing procedures for macroprudential oversight and systemic-risk regulation. The US, the UK, the EU, and other countries are putting in place systemic-risk authorities, and the FSB has important systemic and macroprudential responsibilities, which should be enhanced over time to assure international coordination. Yet there is almost nothing about this in the proposal to explain how these processes will be integrated and coordinated with the buffer mechanisms.

The tools for communication of macroprudential thinking with respect to the possible future application or removal of the buffer will be crucial. One might be some transformation of the Financial Stability Reports currently published by several central banks, or parallel publications edited by the macroprudential policy makers. Such reports could be somewhat similar to the Inflation Reports published by many inflation-targeting central banks, describing the economic and financial environment providing the background to decision-makers' current thinking, as well as discussing the more technical issues under consideration from time to time. Together

with publication of the minutes of the meetings leading to the buffer decision, this would contribute to the transparency and accountability of the process.

International comparisons and exchanges of views.
The Institute certainly endorses the need for regular, senior-level review by the Basel Committee and ongoing involvement of the Standards Implementation Group. However, peer review could be made more demanding than is implied, if a jurisdiction seriously strays from the international principles set by the Committee.

Annex 1: integrating the countercyclical capital buffer and the capital conservation buffer

The Institute has commented extensively on the capital conservation buffer and, as that buffer does not seem to have been changed by the present proposal, reference is made to those comments.[14]

As discussed above with respect to Pillars 1 and 2, there is a very real concern about double- or triple-counting of capital requirements. That unnecessary multiplication of capital burdens would be damaging is obvious from the close link between GDP and credit that is the basis of the current proposal.

Effects of capital-conservation enforcement. The two buffers would be enforced by restrictions on payment of dividends and other distributions. Although the present consultative paper downplays this and says that restrictions of dividends for less-material buffer shortfalls would be "minimal", there is no doubt that bank managements and boards would treat any restriction of the ability to set and pay dividends as highly undesirable, not only because of the abridgment of Board discretion over capital strategy and market relations, but more importantly because of the resulting market signals. This would tend to cause the buffers to be treated as a minimum and reduce their actual ability to act as countercyclical loss absorbers.

Most banks would manage the business conservatively to avoid unanticipated credit losses that would lead them to fall below the buffer requirements. Any uncertainty about the buffer's application or release would be built into this process, and add further conservatism.

This in turn relates back to the problem that banks will be affected differently by macroprudential problems such as cyclicality. A conservative bank with a strong reputation to maintain and immaterial or well-managed exposures in sectors prone to over-heating could well be doubly disadvantaged, first by the application of credit:GDP factors not actually related to its relevant exposures, and second because it would be less willing than an aggressively run bank or a bank with weaker capital resources to take the risk of falling into *any* dividend and payout restrictions, and hence would need to add conservatism to mitigate the perception risk.

Will buffers actually be usable? A related and even more basic concern is whether the market and rating agencies will allow buffers to be drawn down in times of need, regardless of

[14] Please see pages 24-6 of the IIF Comments on Basel Committee Consultative Document *Strengthening the Resilience of the Banking Sector*, excerpt attached.

regulatory decisions, quite apart from the question, already evoked, of whether national regulators will in fact be willing to release them. With respect to the countercyclical buffer, this is in part a function of whether resort to the buffer would be as infrequent as stated.[15] The more frequently it is applied, the more likely it would be seen as permanent.

There is thus the danger that the two buffers will yield a permanent, higher minimum, which will be substantially less efficient for the overall economy than the optimum regulatory requirement the Committee aims to define. If the buffer is not in fact allowed to be reduced when the economy turns down or tapped when losses emerge, then it will not achieve its goals. Rather, a higher-than-intended de facto minimum will leave banks with less of a usable margin to absorb losses, and thus they will be induced to reduce lending sooner in a downturn, which is the opposite of the intent.

The Committee recognizes this problem, but also seems to assume it away. More study and closer examination of likely market, investor, and rating-agency behavior is necessary: the goal should be to make the buffers actually usable. As discussed elsewhere in these comments, part of the solution must be very clear and consistent communication with the market on a no-surprises basis; however, the acute discomfort remains that the buffer, once imposed, will become a de-facto necessity, and this still needs to be addressed more confidently.

Annex 2: The credit:GDP guide.

The methodology proposed is theoretically appealing, but until the data and the completeness, specificity, and interaction of the variables are well understood, it cannot be concluded with confidence that it would be a sound basis of macroprudential policy.

Combining judgment with a rule is inevitable for any policy decision making, but raises the issues of creating confidence already discussed. Nevertheless, for prudential policies involving many jurisdictions it would be particularly important to have a well-developed and widely accepted rule providing a common ground for judgmental assessments. In addition, as discussed at length in this comment, there are important implementation issues for the proposed credit:GDP gap based rule. If not addressed correctly, they may defeat the intent of the rule.

One of the appealing aspects of the proposed rule is its simplicity: the buffer add-on increases linearly with the gap as soon as the gap increases above a lower threshold and until the gap

[15] Looking at the data in the annex for which reasonably long time series are provided, it seems plausible that the buffer would be triggered more often, or, having been triggered, would remain in place for more substantial periods than would be expected given the intent of the proposal. Using table 2C.2 of the consultation document as a reference point as to when the buffer would be on (in practice authorities would presumably look at a wider range of variables), even if the buffer might only be turned on every ten or twenty years, the buffer could stay on substantially longer, if a correct understanding of the calculation is that whenever the number is higher than 2, then the buffer is turned on. The buffer is on at a maximum weight when the number is higher than 10. If that is correct, then a look at Australia, for example, shows that the buffer would have been on for the past fourteen years (including in 2009 when there were credit losses and rising unemployment). In Italy the buffer would have been only off for four of the past 25 years.

reaches its maximum level. However, the linearity assumption might not be necessarily optimal: in the report, excessive credit build-up is associated with an increase in risk - an increase in the gap just above the lower threshold would be considered less risky than one in the region close to the upper bound. By result, it might be better to have the buffer add-on building up more quickly at the upper end than at the lower and of the credit:GDP gap range.

Within the proposed credit:GDP gap metric there are issues with:

1. the credit variable (definition and measurement)
2. the vintage of data to be used for both credit and GDP
3. the information content of the gap

With respect to point 1, the proposal stresses the importance of using a broad measure of credit, which incorporates all types of lending to the private sector, by both banks and non-banks. Using a narrower measure, based only on bank credit, could indeed shift lending to vehicles outside the banking sector. Constructing this measure is not an easy task. Central bank statistics tend to focus on banks only. Therefore, broad credit measures are not often readily available but need to be constructed from different sources. For some countries, data might simply not be available, making the 'broad' credit measures not comparable across countries. The proposal appears (wrongly) to downplay the importance or difficulty of constructing the right measure of credit. The table of data sources provided in Appendix 2 clearly shows a significant heterogeneity in the definition adopted across country.

With respect to point 2, it is important to observe that, in real-time policy making, the credit:GDP gap series constructed at any point in time will be subject to revisions, as GDP data (and possibly credit data?) are subject to sometimes large revisions, often after a number of years.[16] This may have at least three implications. First, the analysis summarized in the paper, which shows that the credit:GDP gap measure outperforms other metrics in the build-up phase of a credit boom leading to a financial crisis, may be inconclusive as it has been performed on mostly mature data. The analysis should be redone using real-time data – which could change the results substantially.

Secondly, if a prudential authority were to use the credit:GDP gap metric, it would probably need to 'adjust' the data to account for future revisions. This is not an impossible task (GDP data are regularly 'adjusted' for monetary policy making purposes) but would add a degree of discretion to the non-judgmental part of the methodology. Finally, the process of data revision is highly country-specific; data quality is not subject to the same type of scrutiny in each country, which might make the credit:GDP gap measure less than ideal for cross-country comparisons.

With respect to point 3, for several countries, particularly emerging markets, data might not be available to construct sufficiently long time series of credit:GDP data. With short series, the HP filter of the historical data would, despite the discussion in the consultative paper, not necessarily represent a trend ('equilibrium') value. For these countries, therefore, the gap may misrepresent the build-up of imbalances. A related point is that an HP filter may not be necessarily the best

[16] In recognition of this issue, the Bank of England has started to publish fan charts of past GDP data – the width of the fan chart is usually not negligible.

approach for estimating the 'equilibrium' credit:GDP. Other approaches should also be considered, including more theoretical ones such as the ratio of nominal credit to potential real growth reflated by either the current GDP deflator or some estimate of an inflation target. Finally, a well known problem of the HP filter is that it suffers of an 'end-point bias'. This problem is usually corrected by extending the series to be detrended with forecasts, which however makes the goodness of the trend estimation a function of the goodness of the forecast.[17]

In summary, although the proposal (and the background paper) illustrates the impressive work the BIS has done in terms of identifying the best type of indicator, the analysis is not conclusive, but needs more investigation to address the issues raised above. Furthermore, the disconnect between the quantitative approach prescribed in the build-up phase of the buffer and the much more judgmental one to be followed in the release phase is quite remarkable and it is not obvious that this asymmetry is justifiable. The inability to find an indicator which 'works' in the release phase is not a sufficiently strong argument. The proposal should be reformulated to provide, insofar as possible, a more reliable approach in the build-up phase and a more structured one in the release phase. Provision should be made for the development of guidance over time by the Basel Committee and the BIS to the use of the "guide" and the exercise of judgment to create conditions for increasing credibility and reliability of both over time.

Conclusions

The Committee has made an impressive start on one of the most challenging dimensions of the macroprudential project of the G20.

The questions raised by the industry reflect real, practical concerns, *not* dissent from the overall stability goals.

Given the untried nature of the underlying elements of the proposal, the numerous implementation issues discussed, and the buffer's relationship to the other Basel capital requirements and their calibration, it would make sense, after further research and debate, to envision a pilot program, perhaps in the form of a parallel run. While a parallel run would create burdens on the industry and on supervisors, it would certainly be preferable to have a period of reporting without binding application of the buffer scheme. This would give all parties the opportunity to assess how all the elements of the idea work, how the credit:GDP "guide" performs, what challenges judgment would phase, and what IT refinements are required. It would also give supervisors the time to reflect upon and develop the necessary reporting on their side. While it seems unlikely that the system as a whole would face credit overheating in the next few years, it is reasonably possible that specific countries might face the kind of situation that the buffer is intended to confront, which would create realistic test conditions.

By suggesting further analysis and development, and a test period, are in order, the Institute does not mean to detract from the significant intellectual step forward that the consultative document represents. It does, however consider that, because of the methodological issues, the practical

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[17] Other approaches have been developed in the econometric literature, involving modifying the penalty function which the HP filter minimizes, which allows to reduce the end-point problem. In either case, a simple and straight application of the HP filter should not be advocated.

questions of implementation, and the very substantial problem that the proposal focuses only on banks, not on other sources of credit, rapid implementation, certainly on the original 2012 timeframe, would be most ill advised.

Attachment

Excerpt from IIF Basel Response, April 16, 2010 to "Strengthening the resilience of the financial sector"

Fixed Buffers – pages 24-6

Fixed Capital Buffers (*paragraphs 247-59*): As already stated, the Institute supports the work of the BCBS in regard to adequate management of the capital implications of procyclicality. In its 2009 *Reform in the Financial Services Industry* Report the IIF recognized that '*firms should have available a set of potential measures for adjusting their actual capital structures in line with cyclical developments in capital requirements"* and that the choice of tools *"should enable banks to balance the need to conserve capital with wider business and strategic objectives"*[18].

Drawbacks of the Fixed Buffer Approach: However, the proposal for "fixed" capital buffers through capital conservation, as sketched out in the Consultative Document, has a number of drawbacks that will likely affect its effectiveness.

a. While capital conservation measures are supported by the industry, such measures would be more effective under a flexible Pillar 2 approach, allowing for a firm-focused discussion with the respective supervisor. Indeed, the approach at *paragraphs 247ff* is broadly consistent with what at least some regulators already do, requiring banks that are in weaker condition to restrict payouts. As to the buffer's eventual implementation, the Institute also notes that in some jurisdictions, the prescribed operation of the proposed buffer mechanism would overlap or even overrule existing Pillar 2 supervisory dialog addressing precisely the same procyclicality challenges.

b. However, the proposals fail to specify the methodology under which the target capital (or buffer range) would be set, other than to specify that the buffer should be *"large enough to enable banks to remain above the minimum requirement in the face of losses (…) during a severe downturn"*. The industry would appreciate additional details on the methodology under which this would be done, including the time horizon of the type of losses the buffer is expected to cover, the difference between the proposed buffers and the regular capital requirements. Transparency on the process is necessary so that the firm may engage in a meaningful discussion with its supervisor as to the appropriateness of the proposed buffer as well as to provide sufficient information to market participants in regard to the buffer, its size and determining factors.

c. There is also a basic, philosophical issue here. Although supervisors have long had the power to restrict dividends and stock buy-backs when a bank is in precarious state (or below prompt-corrective action thresholds), restriction of the ability of

[18] See New Recommendation D in Appendix V of the IIF Report *Reform in the Financial Services Industry* (Dec 2009)

boards to pay dividends or conduct share buy-backs to the extent apparently envisioned would seriously narrow the business judgment of management and boards, hobble firms' ability to manage their capital and their relations with the market, and quite likely make redressing a firm's situation more rather than less difficult. While the reasons for the proposed reduction of discretion are clearly stated at *paragraphs 253-255, they* overlook the fundamental role of management and boards in the strategic management of their relationship with the capital markets. Although capital conservation restrictions do make sense when the firm enters the prompt-corrective-action or similar zone, a calibration of the proposed fixed buffers much above that would quickly put the supervisors, rather than the board, in charge of some of the most basic corporate functions (among other things changing in unforeseeable ways the incentives for the basic management of the firm that, at least in principle, would remain with the board per *paragraph 256.*

d. Fundamentally, the industry is highly skeptical as to the potential effectiveness of the capital buffer concept with a stated buffer range and minimum capital conservation ratios as proposed. Most importantly, it is unclear whether firms would be able in practice to draw from the capital buffer during times of stress, and this is a source of great concern to the member firms of the Institute. Recent experience during the crisis has demonstrated that during times of economic stress market participants expect banks to hold *additional* capital as opposed to *less* capital. The current assessment is that markets, investors and rating agencies would prevent banks from using the buffers. The BCBS is aware of this problem, but there is no indication as to how the Committee could make buffers actually usable in hard times. Buffers that cannot be used would become another incremental capital requirement, in addition to all the liquidity, leverage, capital and risk-management requirements, all of which will contribute to a bottom-line constraint on credit in the global economy. This effect would be pro-, not anti-, cyclical: to the extent buffers cannot be used in harder times, the burden of carrying them will force banks to reduce assets and new lending, contributing to the downward spiral.[19]

e. Similarly, initial discussions with rating agencies indicate that some market participants could find it difficult to accept that banks draw down their capital buffers during time of economic stress. Currently, rating agencies assign a low investment grade to banks that operate close to the regulatory minimum and only assign high ratings to banks with sufficient and permanent capital buffers. A reduction from the buffer would under many circumstances be penalizing from the rating point of view, which would result in the practical impossibility of using the buffer as proposed by the BCBS. Whether this likely effect could be mitigated by transparency or supervisory guidance remains highly debatable.

[19] As noted in Capital Appendix A during the discussion of *paragraph 92* on contingent capital, the role of contingent capital needs to be worked out, and may play an important part in the effectiveness of any proposed buffer".

f. Any potential measures to be developed in this area should clearly operate at the consolidated group level. Application at the subsidiary level would not only be impractical but also extremely difficult to apply, particularly in regard to subsidiaries in which the holding company does not exert majority of control. Finally, if the expanded capital-conservation measures are applied at the subsidiary level, firms would lose the diversification benefit of having subsidiaries in multiple countries; any application of capital-conservation at the subsidiary level should be debated through the group's college of supervisors

Need for Additional Guidance: In conclusion, the Institute believes that unless the very serious doubts as to the practical effectiveness of the proposed buffers are addressed, the BCBS should consider providing additional guidance, if necessary, on the use of currently available Pillar 2 tools for the purposes of capital conservation at individual banks. Similarly, for cross-border groups, the SIG should develop guidance so that colleges of supervisors introduce into their methodologies, the determination of capital buffers and specific criteria for the use of a wide range of supervisory tools to address any deficiencies in regard to building up sufficient capital resources.