ABI Associazione Bancaria Italiana

ABI Comments on consultative document issued by Basel Committee on Banking "Supervision Countercyclical capital buffer proposal"

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POSITION PAPER

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Introduction and summary

ABI believes that the proposal of the Committee on countercyclical capital buffer must be examined in the overall context of the corrective measures proposed within "Basil 3", so that the supervisory authorities and the banking system may ascertain the overall impacts on capital ratios and carry out consequently a correct calibration of the interventions.

We are reluctant to introduce new capital requirements and constraints on dividend policy, in that they are instruments poorly effective for reducing the cyclicality with regard to the burden and to the regulatory restrictions to the charge of the banks. As observed during the previous meeting, Pillar 2 already contains measures that reduce cyclicality. We request to implement and assess the effects of the measures already contemplated instead of introducing new measures; moreover, the current measures based on stress tests take the bank-specific risk profiles into consideration.

The proposed rules are not coordinated with the rules in force concerning Pillar 2, which lays down processes, methods and instruments for assessing capital adequacy with methods other than those provided by Pillar 1. As shown when issuing the Basel II regulation, the provisions of Pillar 2 offer incentives to banks - especially those with a more sophisticated approach - in order to implement instruments for determining the suitability of the capital able to grasp a wider range of risks and financial sources/requirements not identifiable by means of the standard rules of Pillar 1.

The results of the Stress Test show that the whole Pillar 2 architecture represents an efficient instrument for assessing capital adequacy.

The current regulatory trend contemplates, in addition to specific capital requirements that encourage the use of internal models, an autonomous assessment by the intermediary of its own capital adequacy.

However, according to the proposal, the coexistence of two pillars both used for determining the sound balance sheet structure of the bank is no longer needed. The overall assessment deriving from Pillar 2 either strengthens what was already indicated by Pillar 1 or points out any critical element, to which the management decisions aimed at restoring capital adequacy are related.

The corrective measures that the banks should adopt if this buffer is considered inadequate must be coordinated with the regulations of Pillar 2.

In fact, we believe that the non-distribution of profits must not represent the preferential and compelling instrument for restoring the "depleted" buffers, but must be the last action to be carried out after checking the feasibility of other solutions, as set out currently in Pillar 2.

It is preferred that the supervisory authorities indicate the capital level to be reached/maintained over a set period of time, letting the intermediary choose the interventions to be activated within the "capital planning process". In this way, an important role is also assigned to the disclosure on the capitalisation and consistency levels with the required buffers and on the actions to be implemented (composition/optimisation of the credit portfolio, transfers, capital increases, etc…) to respect the time limits of the authority.

Otherwise, to avoid restrictions on the distribution policy of dividends (which would directly affect the stock market price), the intermediaries will be forced to resort to sudden interventions on loans/RWA, underlining procyclical trends.

Targeted policies of distribution of dividends, also in the presence of non-optimal capitalisations, represent useful prerequisites for the success of future capital increase operations.

Therefore, in our opinion, the proposal on the restriction on profit distribution, at least at the beginning of the implementation of the new regulation, must be provided only within Pillar 2, by changing the current rules

Moreover, buffer proposals should take due account of the specific nature of the models, as the one of Italian Cooperative credit banks (Banche di Credito Cooperativo (BCC)), which already incorporate a capital buffer system represented by the obligation to allocate 70% of the profits to reserve and which present structural and legal limits to the capacity of carrying out capital increase operations.

Operational arrangements on a combined or free-standing basis of the different buffers must be defined better in order to assess the impact on banks.

The methods of application of buffers must assume a very close cooperation among supervisory authorities; whereas, the proposed methods do not guarantee equity among different jurisdictions. The correlation between lending volumes and the depth of the crises derives from macroeconomic analyses that allow the national supervisory authorities to choose the variables determining the threshold for starting the buffer add-on.

Other discretion margins of national supervisory authorities increase the uncertainty of stakeholders on return on investment, which cannot be inferred from the information that can be obtained from the industrial plans.

The application of a single buffer level within the same jurisdiction creates inequality caused by the lack of homogeneity in the risk parameters used within Pillar 1.

For IRB banks there are different approaches (through the cycle vs. point in time) - more or less sensitive to the economic cycle - that imply a different level of probability of default among different intermediaries. Also within the same approach, some model choices or the depth of the time series used imply a higher or lower responsiveness to the cycle.

Finally, banks operating at a local level as Cooperative credit banks could be obliged to build other capital buffers both in the absence of growth in loans and when the situation of the circumscribed geographic context is different than the countrywide average.

Further details on key elements of the proposal

In order to calculate the buffer, the weighted average of the add-ons applied in jurisdictions to which the banks have exposures is proposed.

This method gives rise to potential arbitrages.

For example: assume that for Italy the $((CREDIT_t/GDP_t)X100\%)-(TREND_t)=2\%$, for Spain $((CREDIT_t/GDP_t)X\ 100\%)-(TREND_t)=4\%$ and that the buffer for both countries is 5%.
Considering a Bank with only a two-loan portfolio, one of € 100 to businesses in Italy, standard RWA 100, and the other one of € 100 to businesses in Spain, standard RWA 100. The overall GAP $(Gap=(CREDIT_t/GDP_t)X100\%-TREND_t)$ should be ((100/200)*2%+(100/200)*4%)=3%, with a consequent add-on of ((3%-2%)/(10%-2%))*5%=0.63%.
Supposing a new loan to an Italian government entity of € 100 euro, the situation becomes ((200/300)*2%+(100/300)*4%)= 2.67%, with a consequent add-on of ((2.67%-2%)/(10%-2%))*5%=0.42%. Whereas, supposing a new loan to a Spanish government entity of € 100 euro, the situation becomes ((100/300)*2%+(200/300)*4%)= 3.33%, with a consequent add-on of ((3.33%-2%)/(10%-2%))*5%=0.83%. Therefore, the buffer is different even if, in the two cases, the Bank decided to finance government entities of different States with the same risk level in terms of risk weighted assets (RWA).

The proposal of anchoring the buffer to the credit flows of each country, without distinction with regard to the actual growth of banks, does not affect the greater or lower business aggressiveness adopted by each intermediary.

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

The proposal does not integrate the capital conservation buffer with the countercyclical capital buffer, nor does it assess both instruments in the light of their interaction with the bank-specific correction, aimed at contrasting the cyclicality of the minimum capital requirement.

The bank-specific correction dampens the cyclicality of the capital, in that during the periods of expansion, the probabilities of default decrease (except in the case of rating perfectly through the cycle) and determine, through the reduction of RWAs, a lower capital requirement to meet the minimum requirement; the effect is symmetrical in case of periods of recession.

The stabilisation of the probabilities of default to the downturn value or to the average value lessens this effect the more considerably the more the rating system tends to the Point in Time. Since a single scaling factor applies to all the rating classes, migrations among classes imply a capital ratio that increases in the case of a positive scenario and decreases in case of a negative scenario (by making the overrunning of the target ratio more likely during recession).

The proposed countercyclical capital buffer, which would come into action during periods of positive economic scenario and therefore low probabilities of default on average, raises the target ratio and increases the capital accumulation of banks during the period of expansion.

Therefore, it is crucial to calibrate the proposal in order to prevent the sum of the two measures (bank-specific correction and countercyclical capital buffer) to give rise to excessively prudential countercyclical effects. Moreover, the effect on the capital ratio of the bank-specific correction is different for each operator, also in virtue of each rating system, whereas the countercyclical capital buffer can be applied without discrimination to all the banks belonging to the same jurisdiction.

For this reason, the corrective measures of the indicators defined at jurisdiction level must be calibrated according to the operational characteristics of each bank (for example, size, credit context, internal rating cyclicality, etc.), thereby enabling a different application of the buffer on the system.

Annex 2: The credit-to-GDP guide

The proposal creates problems also to banks during periods of recession and in the consequent initial periods exiting the negative cycle.

In fact, according to the example of buffer calculation for England, in which the guide buffer add-on is calculated by using the English credit to GDP

ratio, it emerges that there is a large positive gap during the recession quarters of 2009.

This implies the 100% add-on of the proposed buffer, during the worst moment of recession, in which profits become losses for the banks and the capital is further put under stress with the proposed add-on. Likewise, distortions are created at the end of a period of recession, when generally high credit growth occurs, with subsequent increases in gap (credit to GDP) and capital increase. Therefore, the RWAs are penalised just when the probabilities of default, receiving the previous negative signs, are at the highest level in connection with favourable forecasts in terms of prospective default rates.

This means that the so-called "defusing" of the buffer is crucial.

On this point, we share the doubts on the prediction characteristics of the credit-to-GDP measure concerning the methods for defusing the buffer. As a result, it is advisable for the indicator to be accompanied by other variables. The buffer must be released during the moments of crisis of the banking system, regardless of the indication provided by the gap measure ($Gap=(CREDIT_t/GDP_t)X100\%-TREND_t$), by using other alert measures, if necessary.

Notwithstanding the need to identify other macro variables to accompany the GAP indicator, we do not agree on the proposal of using measures such as the asset price or CDS spread in that, besides implying data retrieval issues, they may be misleading and involve a large measure of discretion for the national supervisory authorities.

Therefore, for the purposes of the so-called buffer "defusing" without indicators explaining the economic cycle, the analyses of the relevant Gap measures compared to the long-term trend can, in our opinion, be combined with an approach that considers also the positive changes of the GDP macro variable (not of the gap) in the short term. Specifically, the first case could analyse the GDP percentage changes (i.e. GDP(t)/GDP(t-1)). In this way, the last two quarters considered in the example would present a negative change of the return on GDP and would imply the discontinuance of the buffer. In the example, the two quarters have a positive high GAP compared to the long-term trend.

Then, by using different periods for calculating the trend, there is the risk of obtaining completely different results, as shown in the enclosed document.

In the BIS document (estimate over 1980-2010), for example, the Italian banking system should always accumulate the buffer, except from 1980 to 1985 and in 1997-98. During the 2008-09 crisis, it should continue to accumulate the buffer. The same in the currency crisis of 1992.

Whereas, according to our estimate, by using the same BIS method but starting from 1995, the year in which the regulatory provision became stable, the accumulation phase of the buffer should be limited to 1995-96 and to 2008-10. The non-accumulation phase should therefore range from 1997 to 2007. However, also in this case, during the 2008-09 crisis period, the mechanism would send a wrong sign.

Moreover, the BIS proposal gives space to different lambda parameters (used for estimating the trend) for each country. According to the annexe, it emerges that the effect is substantial in case of Italy.

Using the credit-to-GDP ratio as a guide guaranteeing consistency in international decisions could imply that the credit-to-GDP ratio becomes the only guideline of the markets, source of possible misleading indications if considered in itself, and that banks are exceedingly oriented to prudential behaviours with a view to strengthening their capital methods. The risk is unidirectional, since the banks cannot autonomously take decisions on the release of the capital buffer, but they can always anticipate the build-up with a view to prevention.

Enclosure: CREDIT-TO-GDP RATIO

ABI COMMENTS ON CONSULTATIVE DOCUMENT ISSUED BY BASEL COMMITTEE ON BANKING "SUPERVISION COUNTERCYCLICAL CAPITAL BUFFER PROPOSAL"

ENCLOSURE - CREDIT-TO-GDP RATIO

Credit-to-GDP Ratio

The use of the Credit-to-GDP Ratio, which the BIS considers preferable to other indicators, actually presents a series of critical states.

Diagram based on the distance of the Credit-to-GDP Ratio from the trend

The method of requesting more capital when the Credit-to-GDP Ratio is above the trend implies considering in the same way countries with a strong trend (and therefore potentially risky) and countries with moderate trends (less risky).

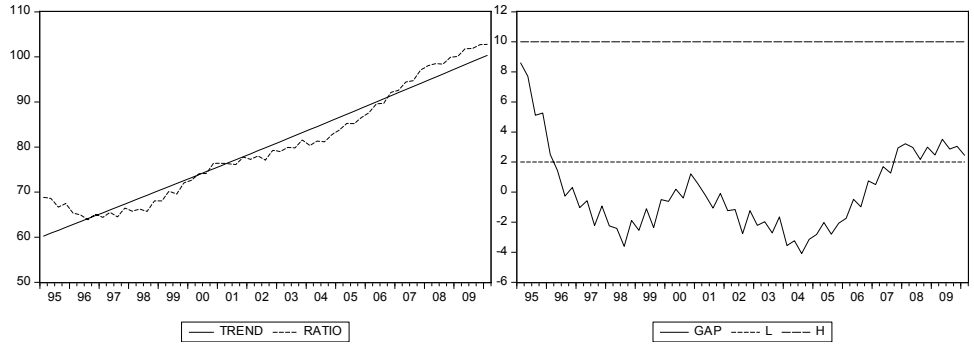
Trend being equal, it is not the same thing if the levels of the Credit-to-GDP Ratio are low (for example, the developing countries) or high (with credit products sold to more and more unreliable brackets of population, such as sub-prime loans).

Difficulty in finding the trend

The "mechanical" identification of the trend, by using common international methods, could be inadequate, given the specificity of credit in each country. For example, in Italy, estimates start from 1980 without considering that from 1980 to 1994 the legal regime in force was completely different from the one after 1995, in which law regulations became stable.

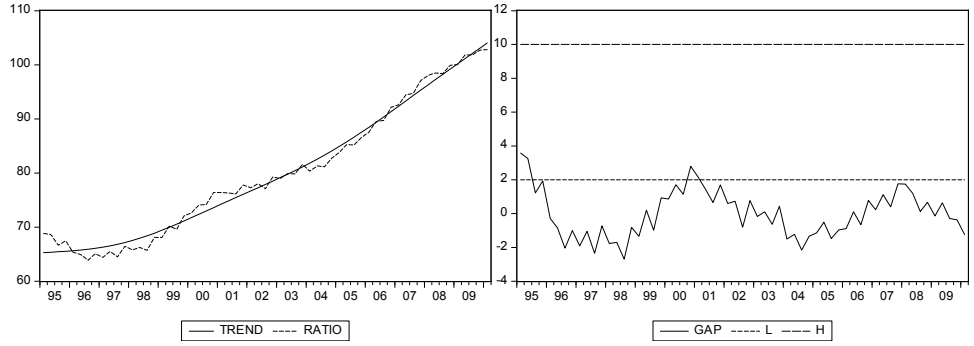
By using different periods for calculating the trend, the results are completely different. The results of the proposed mechanism are heavily affected by the period of estimate of the trend.

Analysis according to the BIS method (HP Filter with lambda 400,000):
Italy - 1995.Q1 – 2010.Q1 period



Alternative analysis (HP Filter with lambda 1,600):
Italy - 1995.Q1 – 2010.Q1 period

ENCLOSURE - CREDIT-TO-GDP RATIO



Further differences could occur if a lambda parameter (which is used for estimating the trend) is used specifically for each country. A similar approach would seem more appropriate, instead of having a common parameter for all the countries as in the consultative document.

The BIS proposal gives space to different parameters for each country. We verified that in the case of Italy the effect seems substantial. By using a lambda equal to 1600 as standard in literature (instead of the proposed 400,000), the 2008-09 period would no longer require a (wrong) buffer accumulation. Moreover, in general, resorting to the buffer would only be episodic (in 1995).

In substance, even if we understand the reasons for a proposal of a common and objective guiding principle to guide the decisions of activating/releasing the countercyclical capital buffer, the Italian case is typical for the fact that specific adjustments by country should be taken in due account, not only with regard to the set of indicators to be considered in the assessment, but also in the guiding principle of the Credit-to-GDP Ratio.

Aims of the method

The method proposed in the paper that is at the basis of the BIS consultative document (Drehmann, Borio, Gambacorta, Jimenez, Trucharte (2010), "Countercyclical capital buffers: exploring options", BIS Working Paper 317) is not always clear whether it aims to identify the best leads of the credit cycle or the bank crises. The initial and general part of the paper analyse the first objective, but the second objective is treated afterwards (in the more detailed part).

A similar ambiguity remains in the BIS consultative document.

However, by analysing only the Credit-to-GDP Ratio, not necessarily a country with wide fluctuations compared to the trend creates the conditions for financial crises or for such strong reflexive phases of the credit cycle to determine, through business crises, a spinning of the financial system.