Basel Committee Countercyclical Capital Buffer Proposal (16 July 2010). Key points of attention for KBC Group.

- The Countercyclical capital buffer is one of the 4 proposals in the Basel III package aimed at addressing **procyclicality issues**:
  1. Use of downturn or long term average PDs to calculate minimum capital requirements.
  2. Forward looking provisioning.
  3. "Capital conservation buffers", defined above the minim capital requirement, within which capital distribution is constrained.
  4. "Countercyclical capital buffers".
- The **Countercyclical capital buffer** would be added on top of the capital conservation buffer, effectively extending the range of this buffer:
  - supervisors would set buffer requirements on the basis of macro-economic variables, incl. credit-to-GDP ratios;
  - host supervisors would take the lead. Home supervisors correct the calibration at consolidated level taking into account the geographic spread of exposures;
  - buffer requirement would enter into effect 12 months after announcement.

1. As regards objective and general principle of the proposal

- *Monetary policy offers a better defense against credit bubbles.*
  - It is highly questionable whether adding another layer to the capital that banks are required to hold, would offer the best defense against future credit bubbles. It will in any case require further testing and research before a convincing case in favour of the buffer as a macro-prudential tool can be built. As far as the banking sector is concerned, it is reasonable to **question the need and effectiveness** of such buffer. The regulatory and supervisory framework that is being designed as a reaction to the financial crisis and the overall change in banks' conduct of business (improved internal risk-management, stricter underwriting standards,…) already create an effective defense against credit bubbles and make an additional buffer less needed.
  - If additional measures would be needed, notably to manage the effect of lending by non-regulated entities, then **traditional monetary policy** would offer the best defense against credit bubbles .
- *Risk of double counting*
  - The countercyclical buffer would add another layer of required capital above the regulatory minimum and the capital conservation buffer. It is unclear how double counting can be avoided, notably taking into account the proposed **use of downturn PDs** for the calculation of minimum required capital and the already existing requirement to **take into account environmental and cyclical issues** under Pillar 2 assessments.
- *Efficiency and fairness.*
  - The buffer would be applied to the banking sector in aggregate, in a given market that shows signs of overheating. An additional buffer could thus be imposed on banks that are not or not aggressively involved in the activities that cause the overheating (e.g. subprime lending). Banks that are running a **conservative business model would then be penalized** for the behavior of more aggressive competitors. While **non-regulated credit channels would remain unaffected** by the measure. This raises questions both of efficiency and fairness of the proposal.
- *Complexity.*
  - Complexities in **defining, calculating and geographically allocating "exposures"** of internationally active banks and the **home-host interaction** will make the proposal unduly difficult to implement and to manage.
- *Market sensitivity.*
  - It is impossible to predict how markets will react to the unpredictability of additional buffer requirements. Markets might well anticipate potential buffer requirements and treat additional buffers **as if they were immediately applicable**. Thus creating additional difficulties for banks' capital planning.

- On the other hand, "buffer uncertainty" might induce **clients to rapidly draw down** credits on uncommitted facilities to avoid potential higher costs or reduced credit availability. This might increase procyclicality instead of dampening it.

2. As regards methodology

- *Capital conservation mechanism*
  - The countercyclical capital buffer would be enforced by restricting dividend payments and other capital distributions. Such enforcement mechanism is highly undesirable as it risks to further **constrain dividend-driven investment** in the banking sector at a time where banks have to raise significant amounts of additional capital.
  - Taking into account the adverse market signals of any restriction to capital distribution, banks will most likely want to avoid any risk of falling below an assumed countercyclical buffer. This would further add to credit conservatism and would effectively turn the buffers into **de facto higher permanent capital requirements**.
- *Interaction of home and host supervisors*
  - The interaction between home and host supervisors needs more clarity and is clearly a matter for further thought. Notably to avoid **doubling up** of buffer requirements at solo (host) level and consolidated (home) level. Or to address **conflicting views** between home and host supervisors or in respect of the same market. If the Belgian supervisor would be more conservative than the host in e.g. Hungary, then KBC would be at a competitive disadvantage in that market.
  - **Independent and coordinated decision making, preferably at supranational level**, will be required to prevent anomalies and distortions of competition.
- *12-month time horizon*
  - The possibility of a buffer being imposed on 12 month's notice will create particular complexities in respect of **capital planning**, notably taking into account the possibility of separate buffer announcements in multiple jurisdictions where an internationally active banks has exposure. But also to manage the pipeline of **approved credits and commitments** that cannot simply be turned back in response to a buffer announcement.
- *Calculation of the buffer*
  - Much more clarity will be needed notably in defining what constitutes an "**exposure**" (loans, letters of credit, uncommitted lines, bonds, derivative exposure…), in the **calculation** of these exposures thereby taking into account the differences between banking-book exposures and trading book exposures and in the criteria for the identification of the **location** of exposures (e.g. standby facilities to multinational companies).
  - Activity in **emerging market economies** is likely to cause specific problems. On the one hand, the data to calculate credit/GDP ratios might not be as readily available as in more mature economies. On the other hand, it is not clear how the proposal would ensure that different dynamics in emerging markets and mature markets would be take into account when setting buffer requirements at consolidated level.
- *Release of the buffer*
  - Too much unclarity persists regarding the conditions for release of the buffer and the **possibility for banks to use the buffer to absorb credit losses in times of stress**. Banks would need certainty about the possibility to draw down on the buffer in case of stress periods or to release the buffer in case of changes in the economic environment.

3. Conclusion

- Taking into account the numerous methodological and practical elements of the proposal that clearly need further development it would appear advisable to **carry out a sufficiently extended observation phase** during which a buffer scheme can be tested both from a risk management as from a macro-economic and market perspective.