I am responding to the consultative document “Countercyclical capital buffer proposal, July 2010” as a private citizen, not on behalf of my current employer.

There can be little doubt that capital and liquidity rules and practices across the globe were found wanting during the so-called global financial crisis. There are many complex and inter-related causes of this financial crisis. The Basel capital adequacy framework was just one of many contributors to the underpricing of risk in the lead up to the crisis.

Since the crisis, many organisations have put forward proposals to enhance the regulatory system(s) in place. They include your proposals for the introduction of the “countercyclical capital buffer” and the “capital conservation buffer”.

In my view, the main benefits of these approaches are to –

- Boost bank capital levels in times (normally during strong credit growth) when they would be under downward pressure
- The focus on earnings, not just solvency
- Level playing field internationally
- By restricting dividend payouts, be specific capital-augmenting measures
- Publication of data that may be interpreted as measuring the build-up of a financial “bubble”. (This is obviously also of use to monetary authorities).
- Signalling to the broader market that bank capital ratios need to be raised
- By the above and higher overall cost of funding, hopefully curtailing some of the excess credit demand in the first place

One objection I have to the proposals is that they focus on dividend payouts as a form of boosting capital ratios. From a capital management perspective, this is just one of many tools to raise capital and perhaps it would be better to leave it to the banks themselves as to how they do this. However, I acknowledge there may be some additional “signalling” benefits.

Instead of the above proposals, my preference would be to develop capital rules whose parameters are more constant over the various credit and market-risk cycles.

The obvious danger for risk models is that the key parameters tend to fall in comparatively benign times. This can be for credit (e.g. PDF, LDG) or with regard to market risk (e.g. rate volatility). The lower perceived risk parameters magnify the pro-cyclicality by reducing the capital required and hence the overall cost of borrowing. This in turn encourages the build up of debt within the economy.

Of course, when the system finally reaches some “tipping point”, this cycle goes into reverse. Most credit metrics rise, capital becomes more expensive and credit dries up. This “boom and bust” cycle may be seen as the inevitable result of a human society caught between the conflicting emotions of fear and greed and by our “follow the pack” nature. Seen in this light, any set of financial regulations can at best try to act as a counterweight to the mood of the markets.

As the consultative papers state, even if the regulators correctly believe the markets are currently underpricing risk, are they able to quantify this understatement? No one knows for sure exactly where we are in the current cycle and how large the impending “bust” will be. There is also the general unknown about how the financial system may interact with the “real economy” and how certain losses can snow-ball beyond almost everyone’s worst expectations.

I believe that the key parameters underpinning the capital rules should be aimed at some conservative “cyclical average”. There are some fairly obvious steps that can be taken, including –

- Increasing the confidence level chosen – the costs of financial institutions failing have very big consequences for the broader economy than other companies and need to be capitalised accordingly
- Including a multiplier to take into account “fat tails” that may invalidate the assumption of normality
- Using a run of data that includes at least one major credit / market risk crisis
- Using pooled / industry data, especially when trying to capture relatively rare events. (This may be particularly important for some operational risks)
- Regulators to require banks to justify lower risk parameters during relatively benign times, to try to counter the impact of favourable credit migration and aim for these key parameters to be some form of cyclical average

Regulators, rating agencies and banks themselves are now able to access a wealth of data which should assist with better through-the-cycle parameters for key risk metrics.

Securitisation and other financially-engineered products can also greatly alter the risk profile, as well as risk transference. Much has also been written about “agency costs” and executive remuneration, which can distort risk incentives and downplay the underlying risks for investors. So-called “animal spirits” and the follow-the-pack mentality of most markets can make it very frustrating for regulators and others who perceive that risk is being under-priced or misunderstood. As well as trying to ensure that capital (and liquidity) levels are adequate, regulators and monetary authorities can try to give the markets a “wake up call” through speeches and media releases. This can be a powerful counter-cyclical tool.

Where “new” products emerge in the financial system which do not neatly fit the existing credit rules, regulators need to be quicker to react to ensure that the underlying risks are identified and sufficient capital (and liquidity) allocated. Often such financial engineering involves attempts to arbitrage the regulatory standards. This assessment may need to be done at a national level prior to the international standards being set and harmonised.

One final point, if I may. At least in the Australian banking context, most banks are “forced” (or choose) to hold actual capital ratios significantly higher than the formal Basel 1 and Basel II ruler. This effectively recognises that the formal capital ratios do not cover the full array of risks. Unless these risks can be assessed through some other form of risk modelling, perhaps the new rules can add a certain percentage (say 2% of RWA) or multiple of existing risk capital for “other risks not specifically identified”. This approach also ties in with the separate proposal to have a single, simple minimum capital ratio (not dependent on risk weighting assets). One of the benefits is that it does not vary with perceptions of risk. It is not pro-cycical.

Kind regards

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