FINANSTILSYNET
THE FINANCIAL SUPERVISORY
AUTHORITY OF NORWAY

NB NORGES BANK

Secretariat of the
Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002 Basel
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Response to the Basel Committee's consultative document on countercyclical capital buffer

Introduction
Norges Bank and Finanstilsynet support establishing mechanisms to ensure that banks build up countercyclical capital buffers. Norges Bank and Finanstilsynet also support the establishment of a more formalised and harmonised consideration of systemic risk when evaluating and requiring the building of buffers within the capital adequacy framework.

Objective
The stated objective of "protecting the banking sector from periods of excess aggregate credit growth that have often been associated with the build up of system-wide risk" has the backing of Norges Bank and Finanstilsynet. We appreciate that this will mainly be obtained by building capital buffers to meet future losses. But as noted by the Committee, the proposal may have some positive side benefit by reducing potential losses through a dampening effect on excess credit growth.

Home-host
A necessary condition for the proposal is that all banks operating in one jurisdiction, including branches of foreign banks, will be subject to the same buffer requirement. Otherwise, the proposal would distort competition between domestic and foreign banks. Host authorities will set the buffer requirements in their countries, but home authorities will be responsible for imposing those buffers for their banks' branches in host countries. Finanstilsynet and Norges Bank endorse the home-host balance in the proposal, which is a significant contribution to

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improving the existing capital regulation framework.

Pillar 2

Finanstilsynet currently requires banks to explicitly consider the need for a countercyclical buffer as part of capital planning and decisions on capital standards, and the banks generally have set target capital ratios in Pillar 2 that are significantly above the Pillar 1 minimum.

As a part of the process of calibrating the buffers, banks are required to run stress tests on their portfolios based on the assumption of a severe economic downturn that lasts over several years. Finanstilsynet will compare assumptions and outcomes with historical experiences and in particular with the Norwegian banking crisis which came after a period of excess credit growth.

If the total buffer is deemed not to be sufficient, supervisory authorities are provided with the legal basis for imposing corrective measures not only to reduce dividend payments, but also to instruct a bank to raise new capital.

The buffer requirements will be based on system-wide indicators, and can be considered a floor for what banks will need to withstand a systemic crisis. The introduction of the countercyclical buffer will cover some of the considerations that have previously been used by Finanstilsynet for defining Pillar 2 requirements. Our understanding is thus that the Pillar 2 process will need to change. But it will still be the case that some banks will need additional countercyclical Pillar 2 capital due to their risk profiles. During milder business cycle booms when the countercyclical buffer is not turned on, all such buffer needs must be met under Pillar 2, with the limitations set in the current framework as to the host country's ability to impose buffers on branches.

Given the interactions between the countercyclical buffer and Pillar 2, it seems that Pillar 2 evaluations may become even more complicated than they are today. We would therefore suggest that the Committee provides clarifications and guidelines on Pillar 2 practices:

- How are the Pillar 2 requirements and the buffer restrictions supposed to work together?
- How should one calculate the Pillar 2 need for buffers above the countercyclical buffer?
- To what extent should Pillar 2 include some consideration of systemic risk?
- The possible impact on the need for public disclosure of Pillar 2 requirements?

The credit-to-GDP guide

Norges Bank and Finanstilsynet generally support the credit-to-GDP guide in the proposal. We share the view that a more mechanical rule is not viable. Norges Bank is conducting a related empirical exercise and preliminary results indicate that the credit-to-GDP is the best indicator choice also on Norwegian data. The exercise on Norwegian data shows that the credit-to-GDP guide has a relatively high probability of type II error, i.e. building a countercyclical buffer when no systemic financial crisis occurs. We believe the cost of type II errors to be low, however. The accumulation of buffer capital, with a possible reduction in credit growth, comes in periods of very high credit supply.

The proposal states clearly that an increase in the buffer requirement comes into effect after 12 months, but it is somewhat unclear whether there are proposed additional lags before a bank with insufficient buffer capital meets constraints on distribution of earnings (page 4 and 16 in the proposal). We believe 12 month preannouncement is a relatively long period of warning if a risk of excessive credit growth exists, provided that the relevant authorities

regularly communicate their view on the need for countercyclical buffers.

Constraints on discretionary earnings – shares versus hybrids
When a bank's capital level is inside the buffer range, there are constraints on discretionary payments. In the current proposal these include dividends, share buy-backs and discretionary bonus payments. According to the December 2009 proposal, discretionary payments on other Tier 1 capital instruments should also be included. If contractual coupon payments to hybrids are not considered discretionary and thus not subject to constraints, the conservation and countercyclical buffers can foster hybrids in Tier 1.

Norges Bank and Finanstilsynet urge that the earnings constraints are implemented in a way that treats payments to shares and hybrids in a way that does not undermine the ongoing efforts to improve the quality of capital.

Release of buffer capital
We interpret both the December 2009 proposal on conservation buffer and the July proposal on countercyclical buffer to mean that the countercyclical buffer (add-on) can be released while the conservation buffer requirement is always active. We believe never releasing the conservation buffer is sensible, as earnings always should be conserved in the bank when the bank is close to the minimum regulatory capital requirement.

Our analysis on Norwegian data confirms that a viable mechanical rule for when the buffer capital should be released is even harder to find than for the build-up of buffers. We believe this is no severe shortcoming in the proposal, as judgment is likely to work better for the release decision than for the build-up decision: It is easier to know when a crisis has hit and there is urgent need for buffer capital. Moreover, when contemplating the release decision, the authority will not meet the same opposition from market participants and others as when the build-up decision is needed amid market exuberance.

A positive aspect of the proposal might be that markets will have a higher degree of acceptance when institutions choose to grind off some of the buffer capital, without their solvency being questioned, when the economy has turned.

Yours sincerely,

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