August 4, 2010

Nout Wellink
Chair, Basle Committee on Banking Supervision,
Bank for International Settlements,
Centralbahnplatz 2
Basel
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CH-4002 Basel

Dear Nout,

I am writing to you, in my personal capacity, to comment on the recent BCBS counter-cyclical proposals (Countercyclical Buffer Proposal, July 2010). As you know, I have benefitted from both experience on the regulatory and supervisory side, and, more-recently seeing things from banks' perspective. The proposal, as currently specified, while well intentioned, would be extremely hard to implement effectively, goes against the long tradition of how home-host issues in the Basle framework are handled, and risks detracting from financial stability.

In essence, I believe that analysts, investors, rating agencies and regulators are unlikely to allow the buffer to come down in a timely way. Nor are banks going to risk having dividends restricted. We also have not proven we can forecast turning points in the credit cycle with a reasonable degree of accuracy. So implementing the buffer will likely act as a permanently higher minimum, and would detract from, not support financial stability.

The goal of counter-cyclical capital proposals is understandable. OSFI's successful efforts in the mid-1990's to push up capital and provisioning levels, in anticipation of a possible downturn, would have been improved if there had been a well-understood counter-cyclical framework in place, and if there had been explicit support from all financial stability authorities in Canada at the time, not just OSFI.

The stated goal of the BCBS proposal is to protect the banking sector from risks from excessive economy-wide credit growth. A secondary goal is to lean against the boom phase of economic cycles. By protecting the banking sector as a whole from "excess economy-wide credit growth associated with a build-up of system-wide risk", the hope in the paper is that the

banking sector will maintain the flow of credit in the economy, without its solvency being questioned, when significant stresses materialize as a result of that growth.

I have several specific concerns: that in practice the buffer will not act as a temporary, infrequent one (the paper refers to once every 10-20 years) but as a permanent, higher minimum; that the timing and announcement effects may actually reduce financial stability; that the proposal does not recognize banks capital planning; and, that behavior of markets and rating agencies need to be addressed if the concept is to have a chance of working as planned.

Lack of Symmetry—So the Buffer Will Likely be Permanent

Correctly, the original architects of this idea insisted that buffers had to go down as well as up—counter-cyclical buffers had to be symmetrical. If the buffer does not go down in a timely way, and/or if banks cannot easily dip into the buffer when losses emerge, it will not achieve its aims. Then the proposal will merely have raised the regulatory minimum and left banks with less margin of actual capital over the minimum to absorb losses—a contrary result. Unfortunately, the Basel paper does not include such symmetry in its proposed international standards, and is much more tentative about how buffers are removed than about how they are imposed.

Unless the behavior of market participants, analysts, investors, and rating agencies was altered, it would be very difficult or impossible for regulators (or banks) to allow the buffer to go down during a stress period or its immediate aftermath, without it appearing like a sign of weakness and threatening a downgrade. None of these issues are even recognized by the Basel paper. I have made proposals elsewhere (in a C.D. Howe Institute Research Paper) about how changes in behavior could be encouraged through the use of Pillar 2, changes in bank capital-target-setting and disclosure, and supervisor-encouraged changes in rating agency methodologies.

Timing Problems

Timing is everything, or worse than nothing in these sorts of proposals. The Basel proposal rightly emphasizes the role for judgment in operating a counter-cyclical policy, but gives insufficient help for determining when ‘excess’ credit growth is judged to be ‘systemically risky’. More work by the Committee on elaborating a few internationally-accepted, qualitative criteria to be specified in any final rule would be extremely useful. It would be even better if

there could be agreement among supervisors in the Standards Implementation Group on broad principles of how implementation would work in practice.

Without that, there is bound to be extreme uncertainty in banks and markets. This will contribute to the proposal being taken by banks as a permanent buffer that they want to hold capital in excess of.

The Basel proposal itself undercuts its message of the importance of judgment by detailing at length how temporary capital buffers could be mechanistically linked to measures of growth in credit in the economy. This is unduly complex. When the buffer was triggered, banks would have a year to get their capital up. To illustrate the timing problems of the BCBS proposal, consider the example for Canada in the annex to the Basel paper. It suggests a big credit growth gap in 2008/2009, so that we would have been implementing a material buffer in 2009 and the maximum buffer in 2010. That is too late to have influenced the credit build-up that did start a few years ago, and might have made it harder for banks to support economic recovery. To cushion losses emerging after the global crisis, provisions and capital should have been built up (and were by Canadian banks) at least a year earlier than 2009. In addition, semi-automatic measures to raise capital buffers in 2008-2010 would likely have signaled that the authorities thought banks were undercapitalized. That would not have been helpful for financial stability. Market expectations of such measures according to some formula would have been problematic, and raised communication issues for the authorities.

Some may say that is just an example—we would use judgment. But the proposal is silent on how that judgment would operate. Moreover, many countries will have to put this proposal in regulations, and that may stifle the role of judgment and common sense unless the criteria for exercise of judgment are explicit and internationally agreed so they can be included in implementing legislation.

Again, the paper suggests that triggering the counter-cyclical buffer should be infrequent (which I agree). But the illustrative table in the annex shows the proposed formula would suggest a buffer in some 40% of the years since 1980 for the 19 BCBS countries for which there are reasonably-long time series. The communication challenges for supervisors and central banks of operating this system would be significant. And a proposal that purports to apply so frequently will reinforce banks' taking it as a permanent additional buffer.

Fundamentally, we have not proven we can forecast turning points in the credit cycle with a reasonable degree of accuracy and we need to be able to do this for these proposals to be useful.

Inadequate Recognition of Banks' Capital Planning

The paper gives no deference to banks own capital planning process and may undercut the progress that has been made in Pillar 2. If a bank responsibly builds up its capital well beforehand to cover possible future losses (as many have), that is given no credit. Prudent banks manage their capital to cushion losses and avoid having to raise capital when it is expensive to do so. Regulators should be further harnessing those incentives, not supplanting them.

The proposal, unfortunately, is very clear that "this is not a Pillar 2 approach as it does not relate to a supervisor review of individual banks….capital used to meet Pillar 2 requirements should not be used to satisfy the counter-cyclical capital buffer requirement...Pillar 2 will need to adapt to accommodate this buffer, the capital conservation buffer and other proposed changes to the Basel capital adequacy framework." Yet Pillar 2 already contains material requirements re stress testing, economic downturns, and forward-looking capital planning relative to risks. Are these to be dropped? Banks might be ahead of the authorities in recognizing a possible downturn--shouldn't banks not be discouraged from early build-up of a buffer on their own?

As you know, thinking through how counter-cyclical buffers would work relative to bank capital planning, supervisory stress test requirements and Pillar 2 is tough to do. But that needs to be done if a counter-cyclical capital proposal is to work as intended. The Basel paper does not address these issues.

As an example of the confusion created by the proposal, if supervisors insist on pushing the same stress tests as now in Pillar 2 (which I think they should do) then there is 'doubling up' of capital for economic downturns.

I believe a better fundamental approach would be to work with the elements of the Accord by further beefing up Pillar 2, rather than grafting on a new element. The BCBS could give Pillar 2 more of a counter-cyclical element, including more explicit need for banks to take account of the credit cycle in capital planning, and authorities occasionally specifying stress test scenarios based on macro-economic conditions, that they wanted banks' capital to cover. That could also include more explicit expectations by supervisors about how banks actual capital would move over a cycle. There is nothing that restricts Pillar 2 to only being used on a bank-by-bank basis. Using Pillar 2 would allow experience of operating these sorts of counter-cyclical proposals to be worked out in practice. The supervisory monitoring committee you are suggesting would help in that regard, especially if it included supervisors as well as central bankers.

Misunderstanding of Consequences for Breaching Buffers

The Basel paper continues the misguided belief that buffers set by regulators will be treated by banks as guideposts they can fall somewhat below. The Basel paper suggests that restrictions of dividends for small shortfalls below the buffer would be 'minimal'. Every bank that I know regards any restriction on its ability to pay dividends (however small or remote) as something to be avoided, if at all possible. This is important, as it makes the added buffer more of a new minimum and lessens the ability of the buffer to absorb losses.

In addition, a main reason a bank might slip below the buffer is unanticipated credit losses in a quarter. Then the bank is likely to have low or negative current-period income, and dividends are determined quarterly, relative to that period's income. I assume the concept in the paper is to restrict a bank's distributions in relation to current-period income. So even though the proposed restriction for those banks that fall slightly below the buffer is distributions of no more than 60% of income (40% minimum capital conservation) that likely would bind a lot for such a bank. Once you move away from measuring dividend restrictions in relation to current-period income, in order to deal with this problem, determining how a restriction would work is a non-trivial task. A further reason for banks to just say they want to avoid all this by treating it as a new permanent minimum.

So I believe that, taken together, there is a high likelihood that banks will likely treat these supposed temporary buffers as a permanently-higher requirement. That ought to be factored in to the BCBS consideration of calibration of the overall revised Basel capital system.

Home-Host Issues

I am also concerned that the home-host application of the proposal is moving the BCBS away from the basic Concordat approach. The home-host proposal results in a bank in a country having and reporting different capital requirements on a consolidated basis depending on their mix of domestic and foreign business. Effectively, the home-country consolidated capital requirements become a mix of home and host country requirements. This is a new approach to home-host regulation and I wonder if that would set a precedent for other areas of the Accord. In other areas of the capital Accord, where host countries want to impose added requirements particular to the local market, they do so on the local subsidiary. That has an impact. It is very unclear why that approach should to be jettisoned for one that has obvious drawbacks.

In summary, I believe that ideally the counter-cyclical goals of the FSB and the BCBS should be implemented through a beefed up Pillar 2, as outlined above. If the BCBS is

committed to a more formal buffer, I suggest that the Committee delay finalization and implementation of a proposal until the issues above can be dealt with. To that end, I believe that it is essential that the Standards Implementation Group of the BCBS explicitly be asked to further examine how this proposal could be adjusted, and how it would be implemented by supervisors, and how Pillar 2 could be beefed up instead to meet the BCBS goals. That would promote cooperation between central bankers and supervisors which would be an important success factor in implementation of any proposal.

I would welcome you sharing this letter with the Committee. I appreciate very much the work you and your colleagues are doing in other areas.

Regards,

Nick Le Pan

.cc Stefan Walter
Jose Maria Roldan
M. Carney
J. Dickson
S. Andresen