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Basel Committee on Banking Supervision
Bank for International Settlements
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10th September, 2010

Re: **"Countercyclical capital buffer proposal" (BCBS 172)**

Dear Sirs and Madams,

Thank you for the opportunity to respond to your consultative document issued July 2010.

First we would like to express our appreciation for the committee's work to establish a strong and resilient financial system. An objective we all share. We also appreciate the transparent consultative process you have adopted which provides for effective industry engagement.

In respect of the Countercyclical capital buffer proposal we completely support the principles and objectives set out in the consultation document. There are however many practical difficulties which will need to be addressed if implementation is to be effective.

1. The putative buffer addresses the symptoms, not the causes, of procyclicality. Procyclicality will persist unless changes are made to both accounting and regulatory capital regimes. Regulatory capital estimates based on historic volatility will perforce be procyclical as long as asset values and volatility remain negatively correlated. Equally mark-to-market accounting regimes, or those which permit only specific and not general reserving, will also generate procyclicality. As well as focussing on a capital buffer regime which alleviates the symptoms, it may be worthwhile to draw attention to changes at source. Most obviously the adoption of general reserve accounting policy for bank assets would create an automatic stabiliser which would alleviate if not remove procyclicality.

2. As the consultative paper points out there are significant jurisdictional challenges which will prove very difficult to overcome in the absence of truly international regulation. Most obviously this will arise in jurisdictions which book a high percentage of non-domestic assets. Will the local credit environment determine buffers applied to international banks operating in that jurisdiction? Differing local credit conditions will inevitably lead to 'regulatory tourism' on the part of international banks with multiple booking centres.

Additionally, without clearer global standardization, localised decisions may favour a domestic majority over silent minorities. Taxpayer support for too-big-to-fail firms - still in place now - creates dramatically skews incentives and capital markets. No such effect is intended through the proposal but is conceivable without closely coordinated action.

3. The calculation methodology rightly creates incentives to diversify risk. This will have two effects. It further increases economies of scale and increases barriers to entry. For smaller banks seeking to increase diversification, portfolio credit swaps may be a solution. But this gives rise to agency problems, increasing counterparty risk and excessive complexity. All of which were features of the last crisis.

4. Whilst we support the thoughtful research to support this proposal, we see potential unintended effects which cannot be tested a priori. The complex interplay of disclosure, transparent modelling and market perception could have much more dramatic firm-specific consequences than expected. In extremis, weaker or smaller firms may be dangerously squeezed both in margins and in cost of capital. As we have seen from the recent crisis, regulation can lead to fewer participants and higher barriers to entry.

5. The greater the complexity of the regulatory capital regime the greater the potential for 'regulatory arbitrage'. This may be of benign intent, as a result of banks following regulatory signals that are sub-optimal economically (again there were many examples from the last crisis). Or it could be of malign intent (banks deliberately exploiting regulatory regime loopholes). So we would be concerned that there may be perverse unintended consequences arising as a result of excessive regulatory complexity.

6. The proposed remedy for inadequate capital buffer (controls over earnings distribution) is very one dimensional. Firms need to be able to express their earnings distribution policy with reasonable confidence beyond any current period. Given the wide variation of corporate structures and cross-border regulatory relationships, it is quite feasible for localised regulatory interpretation to impact firms beyond their 'home' market and/or local source of capital. Alternative solutions should be considered to reflect the various (and often competing) interests of different stakeholder groups.

Thank you once again for the opportunity to provide feedback and commentary on the Committee's proposals. We appreciate the excellent work done in the pursuit of a more resilient regulatory framework.

Sincerely yours.

David Benson
Senior Managing Director and
Chief Risk Officer